

School of Media, Creative Arts, and Social Inquiry

**Assessing the Institutional Capacity of the Indonesian State:
Taxation Reform since 2002**

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Doctor of Philosophy
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Declaration

To the best of my knowledge and belief this thesis contains no material previously published by any other person except where due acknowledgement has been made. This thesis contains no material which has been accepted for the award of any other degree or diploma in any university.

The research presented and reported in this thesis was conducted in accordance with the National Health and Medical Research Council National Statement on Ethical Conduct in Human Research. The proposed research study received human research ethics approval from the Curtin University Human Research Ethics Committee (EC00262), Approval Number HR 147/2011



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Abstract

Much of the literature has perceived the Indonesian government as a patrimonial state, which is characterised by cronyism, domination of the economy by patronage, particularistic policies, and a tendency to blur the boundaries between the public and the private realms. This research focussed on the changing nature of the institutional capacity of the Indonesian state making its path to move away from patrimonial legacies. The Indonesian government in the post-Soeharto era has carried out a number of reforms, which includes taxation reform. By using both qualitative and quantitative research methods, the effectiveness of taxation reform was examined to assess whether the implementation of the reform has improved the capacity of public sector institutions to provide public goods and services. Accordingly, this research suggested strategies for developing stronger institutional capacity by studying the connection between patrimonialism, taxation reform and its impact on the institutional capacity of the Indonesian state.

A starting point for data analysis used the last major taxation reform begun in 2002, as in this reform, the Indonesian tax authority, known as the Directorate General of Taxes (DGT) was the pilot project for far-reaching institutional reform in Indonesia. The research measured the effectiveness and the efficiency of the taxation reform by analysing tax revenue, tax ratio, tax compliance ratio and cost of collection ratio as well as its outcomes, achievements and critics, and then related them to the implementation of the reform in other public sector institutions. Interactions between the state and citizen created the arrangement in which taxpayers complied with tax requirements in exchange for the benefits of taxes. Generally, it led to more acceptable taxes, more efficient tax administration and greater professional examination of how to spend public money. The taxation reform produced significant achievements in terms of the volume and substance of the reforms but effective implementation of the policies has been slowed by poor coordination between relevant government agencies, and uncertainty about the legal framework remained high

This research also looked at the reform of the Indonesian bureaucracy to find out the extent of the improved capacity resulted in the process of building a stronger state. It explores the reform of the Indonesian bureaucracy, with regard to the “Grand Design *Reformasi Birokrasi 2010-2025*” which aims to provide directions to the national policy on bureaucratic reforms during 2010-2025 and contains several key performance indicators addressing bureaucratic reform target. This research discussed the indicators and their efficacy but has been restricted to the time frame of the research.

Findings showed that reform has improved the state capacity in a way that supported main government revenues, so that the increasing government expenditure in providing public goods and services could be safeguarded. Notwithstanding its limitations and constraints, the process of tax reform has indeed influenced reform in other areas of government towards a rational legal administration system of bureaucracy and leaving the patrimonial system behind.

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Abbreviations

AR	Account Representatives
BEEPS	Business Environment and Enterprise Survey
BKF	Badan Kebijakan Fiskal
BLU	Badan Layanan Umum
BPK	<i>Badan Pemeriksa Keuangan</i> (Supreme Audit Agency)
CIDA	Canadian International Development Agency
CPI	Corruption Perception Index
CPIAs	Country Policy and Institutional Assessments
DGT	Directorate General of Taxes
ECLAC	Economic Commission for Latin America and the Caribbean
GAC	Government and AntiCorruption
GBHN	<i>Garis-garis Besar Haluan Negara</i> (Broad Outlines of State Policy)
GCB	Global Corruption Barometer
GDP	Gross Domestic Product
GOI	Government of Indonesia
HPAEs	High Performing Asian Economies
ICW	Indonesia Corruption Watch
IMF	International Monetary Fund
INFID	International NGO Forum on Indonesia Development
KKN	<i>Korupsi Kolusi Nepotisme</i> (Corruption, Cronyism and Nepotism)
KPK	<i>Komisi Pemberantasan Korupsi</i> (Corruption Eradication Commission)
LTO	Large Taxpayer Office
LeIP	<i>Lembaga Kajian dan Advokasi untuk Independensi Peradilan</i> (Indonesian Institute for an Independent Judiciary)
LARI	<i>Lembaga Advokasi Reformasi Indonesia</i> (the Indonesian Reform Advocacy Institute)
MDGs	Millenium Development Goals
MENPAN	<i>Kementrian Pendayagunaan Aparatur Negara dan Reformasi Birokrasi</i> (Ministry of Empowerment of State Apparatus and Bureaucratic Refom)
MTI	<i>Masyarakat Transparansi Indonesia</i> (Transparency Indonesia)
MTO	Medium Taxpayer Office
NG	New Governance
NPM	New Public Management
OCIF	Organisation Capacity Improvement Framework
OECD	Organisation for Economic Co-operation and Development
PINTAR	Project for Indonesian Tax Administration Reform
PWI	<i>Persatuan Wartawan Indonesia</i> (Indonesian Journalists Association)
SOGC	Society of Obstetrician and Gynaecologists of Canada
STO	Small Taxpayer Office
TSCCO	Tax Service, Counselling and Consultation office
UN	United Nation
UNDP	United Nations Development Programme
USAID	United States Agency for International Development
VAT	Value Added Tax

CHAPTER 1. INTRODUCTION

“It matters that governments tax their citizen rather than live from oil revenues and foreign aid, and it matters how they tax them. Taxation stimulates demands for representation, and an effective revenue authority is the central pillar of state capacity.” (Brautigam, Fjeldstad, & Moore, 2008)

Issues of taxation, as the main state revenue source of most countries in the whole world, have always drawn close public¹ attention. It is unavoidable because taxation is among the core functions in central government. As Eccleston (2004) emphasises, by its nature taxation demands government weigh up economic, ethical and political considerations when determining distribution of the tax burden across society. The ability to raise revenue largely determines the resources that enable government to pursue its economic, social and political objectives. There is therefore, a need to raise revenue more efficiently and to do so, a comprehensive review of the taxation system become an important matter.

In Indonesia equally, taxes have a great potential to be the major source of government funding. Due to declining oil and gas revenues and less reliance on foreign debt, the Indonesian government had to face this challenge to ensure its economic and fiscal sustainability. Efforts were made particularly to mobilise funding and increase the efficiency of expenditure. On the revenue side, the government has had no choice but to effectively mobilise revenue from taxes. A comprehensive taxation reform seems to be one of best strategies to ensure the longer term fiscal sustainability of the state. Taxes as the main source of government revenue have shown a significant increase, going from 60 per cent of national revenue in the 1990s to reached almost 80 per cent in 2012.

This research provides a description of the major Indonesian taxation reforms between 1984 and the present, with a more detailed account of the comprehensive tax administration reform which began in 2002. It aims to examine whether the nature of the Indonesian state has changed through these reforms, by examining a case study of

¹ Public in this sentence and in the context of this thesis means the people as a whole including government, general societies, academics, taxpayers and journalists without any limitation whether a person is a respondent for this thesis or not.

the Indonesian tax authority, known as “*Direktorat Jenderal Pajak*” (DGT – the Directorate General of Taxes).

Tax is very closely related to money, and the money may become a big problem if the tax officials plays with illicit money. Tax administration is often ranked as one of the poorest performing public sectors in terms of corruption as it is also very important to state’s development and economic health. Carrying the heavy duty of collecting 80per cent of the state's income, the DGT needed to work hard to build perceptions as an institution that was free from corruption. In Indonesia, the taxation sector was considered as one of the softest areas to commit acts of corruption. In addition, tax administration was identified as one of the top barriers to investment, so that performing taxation reform has been an important part of economic reform.

Since the 1980s Indonesian governments have carried out a number of taxation reforms in the interest of generating revenue. The first major tax reform was implemented in 1983. This reform was crucial as the Indonesian tax administration moved from an official assessment to a self-assessment system for tax collection. An official assessment system is where the tax authority decides on how much taxes should be paid by a taxpayer. Meanwhile in a self-assessment system, a taxpayer is responsible for determining and calculating his/her tax base and the amount of tax to be paid. As a developing country with the political will to undertake a major overhaul of its tax system, this first reform was successful in reaping significant economic benefits (Khalilzadeh-Shirazi & Shah, 1991). However, there were obstacles to increasing tax revenue. Tax non-compliance and corruption still hindered the effectiveness and efficiency of tax collection. Most Indonesians did not comply with their tax obligation, while tax corruption was pervasive and hindered development.

The second taxation reform was implemented in 1994 and then the third one in 2000. Even though tax compliance has always been a core issue, the main need for the reform shifted to generating more tax revenue rather than changing the tax system and administration – a response to the prevailing economic conditions. The 1980s tax reform eliminated specific tax incentives, but in 1994 incentives were reintroduced to make the investment a high priority in the economic sector. The 2000 tax reform was later performed in response to the Asian economic crisis in 1997-1998 with an emphasis on policy and legal amendments.

In terms of generating revenue, the reforms of the Indonesian taxation system had many positive results. However, the overall tax ratio is relatively low compared to

other countries in the region – tax revenue to Gross Domestic Product (GDP)² was about 12 per cent in 2001³, compared to an average of 14 per cent among non-OECD (Organisation for Economic Co-operation and Development) countries⁴ and an average of 30 per cent among OECD countries⁵ (Ikhsan, Trialdi, & Syahrial, 2005). In addition, those reforms did not display elements of good governance (Rizal, 2011). The recognition of the capacity building process that emphasises good governance practices and focuses upon compliance was disregarded for the sake of generating more tax revenue. The success in policy and legal reform had not yet eliminated corruption within the DGT, nor had it changed the public's trust in it. There was a growing pressure in mass media from society, as the external shareholders of the DGT, to perform another tax reform in 2002, notwithstanding that some new tax laws were amended a year before. The coming reform was hoped to be the one that implemented good governance practices and improve public trust in the DGT.

Taxation provides an attractive focus for research, as the real world challenges associated with tax collection are intimately linked with many of the central analytic concerns of political scientists, including questions about state building (Lieberman, 2002). The development of state power or the state's authority over society is usefully examined by highlighting its ability to get citizens to do something that they would rather not do: to pay taxes. A central objective of tax administration is to collect all taxes due in a cost effective manner and according to a high standard of integrity. In pursuing this objective, a tax authority applies a mixture of measures to lead taxpayers to comply with the requirements of the tax laws and to enforce compliance when taxpayers fail to do so voluntarily. Both sets of measures have played a role in Indonesia's tax administration reform strategy (Brondolo, Silvani, Borgne, & Bosch, 2008).

² The total market value of all final goods and services produced in a country in a given year.

³ Judging tax revenue to GDP or tax ratio of a country and comparing to others may mislead the conclusion because every country has its own characteristics such as political and economic structure, tax structure, income per capita and public service capacity in general.

⁴ Tax ratio for other non-OECD countries are for example 15.9 per cent for China, 14.3 per cent for Malaysia, 13.1 per cent for Philippines, 16.3 per cent for Singapore and 14.1 per cent for Thailand.

⁵ Tax ratios for OECD countries are 30.6 per cent for Australia, 27.1 per cent for Japan, 26.4 per cent for Korea and 36.2 per cent for New Zealand.

1. Aims and objectives of the research

This research aims to examine whether the nature of the Indonesian state has changed through taxation reforms. The reform was very important as the Indonesian tax authority, the DGT, was the pilot project for far-reaching institutional reform in Indonesia. The central question of this research is: “To what extent has the institutional capacity of the Indonesian state increased since 2002?”

Institutional capacity continues to be regarded as an important issue in the development studies. The process of capacity development is intended to enable the institution to move from an existing state to a higher state of capacity (UNDP, 2010). Much academic literature has perceived the Indonesian government as a patrimonial state, which has features such as cronyism, domination of the economy by patronage, particularistic policies, and a tendency to blur the boundaries between the public and the private realms (Bowie & Unger, 1997; Budd, 2004; Crouch, 1979; Hadiz & Robison, 2005; Liddle, 1999; Resosudarmo & Kuncoro, 2006; Schwarz, 1999; Webber, 2006). According to Max Weber (1968) a patrimonial state is one in which practically everything depends explicitly upon the personal judgment of the ruler, the attitude towards applicants and their concrete requests, and upon personal connections, favours, promises and privileges. In fact, Weber’s ideal-typical patrimonial state was found in the traditional Javanese kingdom that existed before the Netherlands colonised Indonesia (Anderson, 1990). Later, patrimonialism re-emerged during the first presidency of Soekarno and progressed to a higher level under the second president, Soeharto’s rule. Over three decades under the leadership of Soeharto, social, economic and political development was based on a discretionary, corrupt and patrimonial system. Corruption, collusion and nepotism symbolise the social cost, inequities and abuses of the Soeharto regime (Hamilton-Hart, 2001) and have also penetrated the DGT (Rizal, 2011).

Bowie and Unger (1997) acknowledge that the Indonesian state represents an interesting mix of strength and weakness. On the one hand, the bureaucratic apparatus is relatively strong; on the other hand, the state is quite weak and vulnerable to numerous pressures from elite business linkages which use patronage networks that permeate the corridors of power, facilitating the activities of individuals who use clientelism to influence policy. Soeharto, as the Indonesian leader and president, preserved his ability to use clientelism. As long as the economy was growing, as it had for decades, the Soeharto government could consolidate its power by cultivating

clientele links with different groups in society in the form of privileged contracts and protected monopolies. Family members and business acquaintances were also well rewarded.

As an example, during the boom years of high global oil prices, the treasury was flush with oil revenues, and the government was able to freely dispense aid to its favourite clients. A complex network of patron-client ties bound the top officials to members of the economic elite. These economic elites plundered the state to serve particularistic, not national, interests.

For Budd (2004) Indonesia is ranked as a highly patrimonial state, but up until the Asian financial crisis of 1997, Indonesia experienced rapid economic growth. This is contrary to Budd's hypothesis: patrimonialism represents a barrier to economic growth. There should be, therefore, a negative correlation between a nation's level of patrimonialism and its degree of development. The presence of a strong bureaucracy in Indonesia was constructed by the Dutch during its colonial domination. The Dutch 'ethical policy' sought to promote economic development in Indonesia and to do so greatly enhanced the size of its bureaucratic apparatus. Instead of countering his proposition, Budd (2004, p. 44) tried to qualify it by stating that, "...in time of crisis, patrimonial states like Indonesia, which possess a strong bureaucracy, can develop a coherent developmental plan, assuming the leaders have the political will to provide the bureaucrats with a degree of insulation from powerful societal groups". The Soeharto's use of patronage to maintain the loyalty of his immediate subordinates was extended to the dependent status of all civil servants by giving low official salaries and allowances. The civil servants became dependent on the involvement and approval of their supervisors to give them benefits as additional rewards for their loyalty and obedience. It is likely that this policy was applied in order to exercise control over the bureaucrats.

The reason most often given for corruption in Third World countries⁶ is the carry-over into the present day political behaviour of cultural values inherited from a patrimonial past (Clapham, 1985). Webber (2006) concludes that the practice of patrimonialism, regardless of the purpose of its practitioners, is what is now viewed commonly as corruption by another name. Webber's opinion is acceptable considering

⁶ The phrase 'the third world' is taken to include the Americas south of the United States; the whole Africa; Asia apart from the Soviet Union, China and Japan; and the oceanic islands apart from Australia and New Zealand (Clapham, 1985).

that corruption is most likely to be an outcome of patrimonial practices. Kwik Kian Gie, the Indonesian economist, states that an entrenched corruption mentality was brought about during 32 years of Soeharto's rule⁷. King (2008) argues that a system of corruption has been inherited from Soeharto. Some are concerned about the return of New Order-era powerful figures, and about continuing corruption and other practices that are associated strongly with Soeharto's New Order regime (Heryanto & Hadiz, 2005).

Robertson-Snape (1999) explains Liddle's description of the Soeharto government, well known as "the New Order Regime", by stating that corruption in Indonesia might be described as a steeply ascending pyramid, with Soeharto on top. The New Order is a term created by the student activist of 1966⁸ and later adopted by Soeharto to contrast his rule with that of his predecessor, Soekarno, which dubbed the "Old Order". Soeharto secured his dominant position by authoritarianism as well as co-optation, with patronage as the key mechanism. He had the ability to buy loyalty through dispensing of favours, which made it possible for him to hold the reins of power for 32 years. He guaranteed that the benefits of corruption were scattered widely through the pyramid, and therefore, bureaucrats at all levels had a stake in the system.

Harberger (1989) considers that the outstanding feature of the 1983 Indonesian tax reform was the degree of care that went into its preparation. He mentions that from the political side, the government efforts were epitomised by two features. Firstly, the whole operation was steered by a committee of senior government officials drawn from all parts of the Ministry of Finance. The committee took part in all decisions that dealt with key policy matters. In the Indonesian context, high level bureaucracy is probably the most important focus of political forces and pressure. Members of this bureaucracy attended the entire reform operation, and thus guaranteed that the initiatives taken would be in line with political reality and that the final product would stand a reasonable chance of approval and implementation. The involvement of foreign consultants made this achievement was recognised as such at the time. Secondly, as mentioned above, the legislation drafters engaged in an all-out effort to transform the

⁷ As cited in Hamilton-Hart (2001)

⁸ The student activist of 1966 or 'Generation of 66' epitomised talk of a new group of young leaders and new intellectual thought. Following Indonesia's communal and politic conflicts, and its economic collapse between the late 1950s through the mid-1960s, this group was committed to achieving and maintaining political order and economic development.

committee technical papers and proposals into draft laws. Fuad Bawazier⁹ (2011), a former Minister of Finance, conveys his disappointment at the involvement of foreign consultants in the first major tax reform by stating that domestic experts actually had the capability to handle it if they were given a chance and trust from the Indonesian government. This therefore indicates that the government political will was not strong enough to prevent influences from vested interests. Tax changes invariably confront strong vested interests that stand to lose from any proposed reform programs. These vested interests are often economic and political elites who are especially able to block the reforms.

Taxation is at the centre of good governance and state building. The quality of a country's governance is critical to its ability to promote growth and development. Much attention should therefore be given to the relationship between the state and its citizens in the way public revenues are raised. Increasing the level of taxation is thus increasing the capacity of the state to extract resources from its citizens. As building compliance is a central incentive for the state to engage with society, the tax system is also central to state building.

Paying taxes gives citizens a powerful incentive to engage with government and the political process. Persuading taxpayers to be more willing to pay tax and spend less on evasion is a political process. Technical solutions in tax reform, such as simplification of programmes and broadening the tax base, require political will to build the tax morale of economic and political elites, tackle vested interests, and address complex causes of widespread informality. For example, the private sector is willing to pay taxes for state building that will benefit it either directly (a particular public good), or generally (by removing market barriers and reducing costs and political risks).

The three key inter-related concepts used to frame this research project – patrimonialism, taxation reform and institutional capacity – are each related to various literatures. The discussion of these key concepts in the literature reviews reveals further public policy implications.

⁹ Fuad Bawazier was also the former Director General of Taxes (1993-1998) who was then appointed as the Minister of Finance for a very short time (16 March 1998-21 Mei 1998) because of cases of corruption involving him during his service in the Soeharto era.

This research addresses three specific research objectives. It asks:

1. How effective has the implementation of the taxation reform been since it was begun in 2002?
2. Has the implementation of the taxation reform improved the capacity of public sector institutions to provide public goods and services?
3. To what extent has the improved capacity of public sector institutions resulted in the movement away from patrimonial legacies?

The research is significant in a number of ways. Firstly, it provides a better understanding of the effectiveness of taxation reform. Although there have been surveys on taxpayers' satisfaction, there has not been any comprehensive study on the impact of the reform itself. Secondly, this research is crucial for evaluating the reform process for public sector institutions, as the DGT has been the pilot project for institutional reform. Thirdly, this research could also assist the DGT in dealing with factors that may undermine its effectiveness in the reform process. Finally, the research suggests other ways of developing stronger institutional capacity for Indonesia as a whole.

Many developing countries have set up a structure of administrative governance which continues to rest on a foundation of patrimonial rule. Even in cases where governments are sincerely interested in pursuing reform, when they are beholden to clients for support and have little or no ability to reconcile or resist their supporters' demands, then moving ahead with change becomes difficult or even impossible. In addition, this also influences the capacity to provide routine public goods and services. According to Brinkerhoff and Goldsmith (2002), to cope with the effects of patrimonialism a government needs to promote institutional change. Therefore, this research aims to assess whether taxation reform has improved the capacity of public sector institutions in Indonesia to provide public goods and services, which then has resulted in movement away from patrimonial legacies.

In performing governance reform, the Indonesian government has prioritised bureaucratic reform with the creation of the “Grand Design *Reformasi Birokrasi* 2010-2025”¹⁰ (here-after referred to the ‘Grand Design’). This 15 year longitudinal design emphasises that, in 2025, the Indonesian government aims to achieve world class

¹⁰ The term used in Presidential Regulation Number 81 of 2010 drafted by “*Kementrian Pendayagunaan Aparatur Negara dan Reformasi Birokrasi*” (MENPAN – the Ministry of Empowerment of State Apparatus and Bureaucratic Reforms) on designing reform of the bureaucracy.

professional governance of high integrity. However, this plan is not the first bureaucratic reform in Indonesia since Soeharto's resignation. The Ministry of Finance, as one of the key government organisations in the central government, pioneered the bureaucratic reform in the Indonesian government in 2002 by choosing one of its departments, the DGT, as a pilot project. This appointment shows the significant role of the DGT in the Indonesian government's economic reform. There is an expectation that other government institutions will eventually implement what has been done by the Ministry of Finance.

2. The Indonesian tax system

As mentioned earlier, the DGT has been the pilot project for far-reaching institutional reform in Indonesia. Since this research used the DGT as the organisation for the case study, it is necessary to briefly describe the organisational structure at this point. The organisation has a vision statement to be a government institution which implements a modern tax administration system that is effective, efficient and trusted by the public with high integrity and professionalism. Its mission statement is to collect tax revenue based on tax law that enables the state to have an independent of debt state budget. In order to achieve this goal, in recent years the government has been trying to reduce its dependence on debt-development financing and to develop greater fiscal stability from tax revenue.

The DGT has been through the process of institutional structural changes intended to ensure that the organisation is broad based, equitable and transparent. The government put more emphasis on the effectiveness of tax administration at an organisational level. Brondolo et al. (2008) argue that the DGT organisational structure had some weaknesses that might hinder tax administrative performance. Its headquarters was not organised in a manner that would effectively support its ongoing operations to develop new tax administration programs. Meanwhile, the operational offices had separate units for administering different types of taxes and a parallel network of audit offices and property tax offices, all of which operated largely in isolation from each other. This organisational structure led to a disintegration of tax administration programs, both at headquarters and the operational offices, resulting in a lack of accountability to achieve the goals. In addition, human resources management and development needed to be improved to create a customer oriented public service and eradicating corrupt behaviour. These factors respectively became considerations

for performing taxation reform. The creation of the Large Taxpayer Office (LTO)¹¹ in 2002 symbolised the beginning of the last major reform in the DGT. Therefore, the year of 2002 is the starting point for this case study research.

The DGT is structured under the Ministry of Finance. The DGT has a responsibility to collect tax revenue based on tax laws that enable the state to perform its duty. The DGT is the largest Directorate General within the Ministry of Finance. In terms of human resources, there are about 32,000¹² tax officials all over Indonesia. Of the human resources in the Ministry of Finance, more than half of its employees are in the DGT. Those resources are deployed in order to secure tax revenue which is increasing year on year.

The government measures the performance of the DGT in several ways. Short term performance is measured by the realisation of tax revenue in accordance with an annual target of tax revenue determined in the state budget. Meanwhile, long term performance is measured by several indicators such as tax ratio, tax compliance ratio, tax coverage ratio and cost collection ratio. A tax ratio is the ratio of tax revenue over Gross Domestic Product. A tax compliance ratio is the ratio of the number of filed tax returns over the number of taxpayers. A tax coverage ratio is the ratio of tax revenue realization over achieved tax revenue over potential tax revenue. A cost collection ratio is the ratio of total costs of the DGT over achieved tax revenue.

Taxes are compulsory levies on citizens. All taxation involves the actual exercise of state power starts when taxpayers are obliged to give away money, with no firm guarantee of reciprocity, in situations where they are perceived to have little or no choice. By identifying incentives and occasions for state agents to extract money from unwilling payers, Moore (2008) raises a question: does the tax relationship not continually nurture authoritarian or bureaucratic rule? He argues that the dependence of government on tax revenue encourages bargaining with taxpayers and exchange of voluntary compliance over tax payments for institutionalised influence over public policy.

Thirty-two years of authoritarian government under Soeharto indeed provoked the same question as Moore's. In the early 1980s, government depended heavily on revenue from oil and gas but it continually declined to only between 10-20 per cent in the 2000s. The growing dependence of government on tax revenue meant

¹¹ The concept of LTO is discussed in Chapter 3

¹² As of 31 December 2012 (DGT, 2013)

comprehensive action had to be taken. Article 1 of the Indonesian tax law on general provisions and tax procedures (GOI, 2007) defines tax as “mandatory contribution to the state owed by an individual or entity that is enforceable under the Act without getting rewarded directly and used for state purposes for the greatest prosperity of the people.” By looking at the definition, it is obvious that it is not an easy task to get taxpayers to fulfil their obligation voluntarily. Paying taxes is a basic obligation of citizenship and by not paying taxes means violating the obligation as a citizen. Therefore, when the state punishes a citizen for failing to pay taxes, it is acting as coercive as punishing a citizen for other misconducts.

It is important for any tax authority to be aware of how much is spent for every taxes collected. Generally the DGT’s collection cost was perceived to be low, which may be interpreted that the Indonesian government had not yet funded its tax authority adequately. With the fact that the number of taxpayers increased each year, the level of tax compliance ratio remained steady, which means that taxpayers did not fully fulfil their tax obligations. Although it has never been easy to persuade a taxpayer to comply voluntarily, taxpayers questioned the access to basic information about collected taxes as there is no clear understanding of the link to tax revenue with observable changes in public spending. In 2003, “*Yayasan Lembaga Konsumen Indonesia*” (YLKI – the Indonesian Consumer Foundation) questioned more than 2,000 consumers on why they do not want to pay taxes. 41 per cent of the participants answered that they did not believe that taxes that they paid would benefit them.

In the meantime, enhancing democratic governance became a major agenda for the government. This agenda promotes the willingness to implement the good governance practices in the public sector, including the DGT. The role of the DGT, in a democratic Indonesia, has therefore become more important; a modern democratic public administration including tax administration is needed to satisfy the public’s changing demands upon government. It must be effective and efficient in collecting tax and providing tax services and law enforcement, and it must also satisfy democratic requirements such as fairness, justice, transparency and accountability. Therefore, this research suggests that overall taxation reforms can generate solutions to such challenges in state building.

3. The starting point of examining the nature of the Indonesian State

It is reasonable to say that the East Asian economic and financial crisis in 1997-1998 is the starting point for the examination of the contemporary Indonesia economy journey. The crisis was triggered by the collapse of the Indonesian exchange rate which drove stock prices down and severely devalued the currency. In this period, most aspects of the economy were crushed, and economic growth stalled. Furthermore, after the crisis the national economy featured drastic changes, mainly due to economic reform policies.

The variations in economic performance such as economic growth rate, gross domestic product, rate of saving, poverty rate and employment rate have become significant features of developing countries. Notwithstanding the fact that Indonesia was one of the eight¹³ high performing Asian economies (HPAEs), often called the “East Asian miracle”, and showed a remarkable record of sustained economic growth during the 1970-1990 period, official policy preferences were routinely subverted by a patrimonial based allocation of rent-taking opportunities within the state elite (Weiss, 1999). After the crisis, some experts shifted their focus from industrial policies to the effects of corruption, rent seeking and crony capitalism. For example, Jomo (2001) emphasizes that in Southeast Asian countries, especially Malaysia and Indonesia, state intervention seems to have been more influenced by individual and influential business interest.

According to Yustika (2012) Indonesia economic reform policies after the crisis practiced reversed economic reform, in which government embarked on macroeconomic level then preceded in the micro level. Firstly, the government drastically changed the ownership of public/non-private economic resources into private, including economic resources that should be owned and controlled by the state. Secondly, price controls were removed one by one, particularly with respect to agricultural commodities, while the institutions of production and distribution have not fully reached by government. As a result, food commodity prices soared, but the profit was taken by the economic players in the downstream sector (instead of farmers). Thirdly, most economic sectors were extensively liberalised, particularly the finance and banking sector, therefore, the financial sector disturbed the economy more easily when external instability happened. Fourthly, the privatisation strategy was

¹³ The eight HPAEs are Thailand, Korea, Malaysia, Indonesia, the Philippines, Hong Kong, Taiwan and Singapore.

preferred by government to build a corporate culture and state enterprises efficiency. The government believed the private sector (domestic or foreign) had better ability to improve the performance of dying state enterprises. In conclusion, a variety of factors may affect reforms being performed, but in terms of timing, fiscal crises are the most important triggers. Reform proposals may be enacted under the duress of fiscal crisis, but their longer term implementation depends heavily on economic and political factors (Heredia & Schneider, 1998).

The Asian crisis also hit the investment climate, which was considered as poor in Indonesia as compared to other countries in the same region¹⁴. In 1999 and 2000 the World Bank (2000) conducted a survey to determine the quality of the investment climate and business environment. Eighty-nine out of 100 Indonesian firms included in the survey responded to a question related to taxes, and more than two-thirds of them acknowledged that high taxes had been a major obstacle to their performance. Another study by the Asian Development Bank and World Bank (2003) revealed that companies in Indonesia perceived the most crucial investment obstacles were macroeconomic instability, economic uncertainty, corruption, infrastructure, taxation and labour issues. Almost half of surveyed companies viewed tax administration as a moderate to very severe business obstacle. To improve the general climate for business and investment would require a broader program that included the amendment of investment and tax laws (Boediono, 2005). Since tax administration was identified as one of the top barriers to investment, performing taxation reform has been an important part of economic reform.

In March 2000, the Partnership for Governance Reform in Indonesia¹⁵ was established and employed good governance as a concept. Reforms in several sectors became its priority, including economic reforms, reforms in the judiciary system, public administration, and decentralisation (regional autonomy). The economic reforms agenda received the widest attention from international financing institutions particularly in relation to the elimination of corruption and the establishment of institutions that support a free market economy (Meijer & Oey, 2002). All programs

¹⁴ Based on International Country Risk Guide 2000 and 2002, Indonesia ranked the last among regional countries such as China, India, Malaysia, Philippine, Singapore, South Korea, Thailand and Vietnam. Out of 140 countries being ranked Indonesia's rank was 118 in 2000 and 122 in 2002.

¹⁵ The Partnership for Governance Reforms in Indonesia is a cooperative initiative of the World Bank, United Nations Development Program and the Asian Development Bank, in which the Dutch government contributed substantially.

were directed towards the establishment of good governance. However, there is no reform strategy that is fail-safe, given it is difficult to predict the amount of time needed for any governance reform to be successfully accomplished.

4. Research Method and Investigation Techniques

A case study is the preferred strategy when the researcher has little control over events or when the focus is on a contemporary phenomenon within a real life context (Burns, 2000; Yin, 1992). A case study can serve evaluation purposes directly by being able to assess outcomes and to test hypotheses. These formulations then become the main vehicle for developing generalizations from the case study findings. Due to the wide scope of this research, the collection of data includes both qualitative and quantitative types in order to ensure reliability and validity. The information was obtained through interviews, focus group discussions and analysis of archival collections including, but not limited to, online resources, printed media, and related research reports. The research also used a wide range of quantitative data from various government sources and international institutions, such as ministries, the “*Badan Pemeriksa Keuangan*” (BPK – the Supreme Audit Agency), the World Bank, the Asian Development Bank (ADB) and the International Monetary Fund (IMF). These quantitative data were available online on the institutions’ website.

Although the Indonesian people have experienced a relatively democratic environment and freedom of expression since the Soeharto era, public servants in general are still reluctant to talk openly about their organisations. Therefore, an in-depth interview is considered suitable for this part of the research because it gives an opportunity to the researcher to explore deeply and to identify additional indicators in order to encourage the informants to express their own experiences, opinions and attitudes. In-depth interviews may also minimise misunderstanding and give more opportunities to check inconsistencies, which in turn help the researcher to obtain as much accurate information relevant to the research problem as possible. In addition, the focus group discussions are considered appropriate in this study because they give an opportunity to the researcher to gain as much information as possible in a relatively short period of time.

Setting standardised indicators to assess performance of public sector institutions is not always easy because the process involves a complex mix of political, financial, social and technical considerations. Therefore, the performance of public

sector institutions sometimes is not assessed in absolute measures but by comparison (Carter, Klein, & Day, 1992). The most common strategy used is a time-series comparison is measuring the performance of the same organisation over time.

The development of the LTO in 2002 was used as a starting point, and the effectiveness of the reform was measured in the period since 2002. This research attempts to answer questions such as: Has the DGT achieved its revenue targets? Has the tax ratio increased? Has the number of taxpayers increased? Has the level of tax compliance increased? Has the number of complaints gone down? Have the audit findings of the BPK revealed a better performance of the DGT? If so, this would indicate that the taxation reform has achieved its goals and that the reform itself has been effective. There is a possibility that only some of these various goals were achieved. In this case, it is wise to look further into the reasons for failure and analyse them appropriately. Quantitative data for these guiding questions was obtained from documents and reports of the DGT, the Ministry of Finance, and the BPK.

In addition, semi-structured interviews were carried out with relevant government officials, especially those who are involved heavily in tax reform, including the Board of Directors of the DGT and experts from donor countries/organisations who have assisted the process of tax reform in Indonesia. This method of interview was selected because it uses various sets of relevant questions, but in a flexible way to enable deeper exploration of the interviewees' area of proficiency. Interviewees were selected purposefully to allow study into, and in-depth understanding of, the whole process of tax reform and its achievements.

For interviewees and members of focus group discussions who are the officials of the DGT, the criteria used to select the sample of participants were based on job position, location, kinds of office and significance of participant experience in the research topic. They were Echelon Two, Echelon Three, and Echelon Four officials, Account Representatives, reform trainers and public relations officers. The Echelon Two officer is a senior officer who holds a position as the member of the Board of Directors or the Head of the Regional Office. The Echelon Three officer is a senior officer who holds a position as deputy director, head of the division in the regional office, or a head of the tax office. The Echelon Four officer has the responsibility as head of section in the head office, the regional office, or the tax office. An account representative is an officer who is responsible for monitoring taxpayer's compliance. A reform trainer is an officer who is appointed to perform special training on reform

issues to the tax officers. A public relations or communication officer is an officer who communicates with the external stakeholders of the Directorate General of Taxes. All participants work in offices in Jakarta and East Java based on the justification that Jakarta and East Java area covers almost 80 per cent of tax revenue (see Appendix 1) thus representing the most crucial areas for the DGT. This choice itself indicates regional variations in reform success rates.

Interviewees from Echelon Two have been working for the DGT more than twenty years and have involved in the 2002 reform from the very beginning. They had experience in holding a position as Board of Directors of the DGT headquarters and the head of regional offices. I believe that the interviewees have the capability to provide narratives that are highly significant to the topic. Interviewees from Echelon Three have also been working for the DGT more than twenty years.

Ten interviewees from Echelon Four have been working for the DGT between ten and twenty years. They were the head of the controlling and consultation section in the Jakarta tax office. Their duties are to monitor taxpayer's compliance, perform consultation and provide advice on tax regulation, and issue tax assessment notices. Eight interviewees from account representatives have the experience of working with the DGT for more than seven years. They are under the supervision of the head of controlling and consultation section. Their duties are to help their supervisor with regards to taxpayers being assigned to them. However, they make more contact with taxpayers than their supervisor. Lastly, there are four interviewees who are reform trainers as well as communications officers. Their working experience varied from five to ten years. These interviewees represent a broad range of experience, skills and seniority.

Other participants were from outside the DGT. All of these participants have particular knowledge or understandings about the taxation reform. They included interviewees from representatives of donor countries/international organisation who have assisted the reform process, academics, journalist and senior representatives of corporate organisations incorporated in Indonesia that obtain public goods and services delivered by public sector institutions. An interviewee from academia was chosen from the university that had a tax centre in the campus, a special unit which keeps regular communication with the DGT for the purpose of tax education and research. The existence of the tax centre provided assurance that the interviewee has a regular contact with the DGT and kept himself/herself informed with the reform

process. In order to get a different point of view, another academia interviewee was invited from a university that does not have a tax centre yet. The journalist was one of the managing editors of the national newspaper who understood the process of taxation reform. Senior representatives of corporates – as in commercial corporations which were also taxpayers, were tax managers who were aware of changes in the DGT and had personal experiences in dealing with tax offices.

Some participants were recruited through the researcher's personal network that was built upon previous connections with the Taxation Reform Team in the Head Office of the DGT. Informal discussions with several members of the team were performed before the fieldwork and showed that they were committed to discussing the evaluation of the reform process. Others were identified on the basis of purposive selection from publicly available information according to their appropriateness to the study.

All participants gave their informed consent before formal interviews or focus group discussions commenced. The consent was expressed in writing and supplemented by a Participant Information Sheet (see appendix 2, 3 and 4). Even when such consent was given, there is a possibility that the participants may be disadvantaged as a result of the information divulged in the interview and focus group discussion processes. The research may lead the participants to social harms. They might divulge information about their employer and co-workers activities which could damage their social networks or relationships with each other. They might also reveal information that exposes them to criticism by their clients or the authorities. Therefore, the confidentiality of participants was maintained by identifying all interviewees and members of focus group discussions by a number only, and all distinguishing features of participants (such as place of work, current position or any other potential characteristics) were not mentioned. The list of interviewees is available in appendix 5. This research project has been approved by the Curtin University Human Research Ethics Committee with approval number HR 147/2011 (see appendix 6)

5. The structure of the thesis

The thesis consists of seven chapters. This introductory chapter provides the background of the research, explains the aims and objectives of the research as well as the methods. This chapter also introduces the Indonesian tax authority as the institution used for the case study.

Chapter 2 explains the theoretical framework and literature reviews on patrimonialism and its development in Indonesia. It describes literature review different approaches used in assessing institutional capacity for public sectors. This research uses the combination of several approaches with some adjustments to suit the real conditions of the research object. It also establishes the base for taxation as an important aspect of state building.

Chapter 3 explains the importance of state building for developing countries. At the same time, it describes the major Indonesian taxation reforms between 1984 and the present, with a more detailed account on the comprehensive tax administration reform which began in 2002. Chapter 3 also explains what has been happening in the DGT during the reform process in term of organisation, business process and human resources management.

Chapter 4 examines data gathered from different sources including the interviews and focus group discussions performed during the field work. It clarifies the first research question on how effective the implementation of the taxation reform begun in 2002 has been by discussing outcomes, achievement and critics on taxation reform in terms of service quality of the tax office, the image of the DGT and human resources management.

In Chapter 5, the performance of the DGT is examined by using tax ratio, compliance ratio, cost of collection ratio and some other indicators. In order to find out results on the second research question, this chapter discusses whether the reform has been an accountable reform agenda and how it affected other public institutions.

Chapter 6 explores the reform of the Indonesian bureaucracy, with regard to the 'Grand Design' for reform of the bureaucracy. It also discusses key performance indicators of the 'Grand Design' and some challenges for the reform itself. Finally, Chapter 7 concludes a summary of research findings, an analysis of their implication for the institutional capacity of the Indonesian state, and recommendations for further research.

CHAPTER 2. COMBATING PATRIMONIALISM AND DEVELOPING INSTITUTIONAL CAPACITY – THE INDONESIAN CONTEXT

“Institutions are the rules of the game in a society or, more formally, are the humanly devised constraints that shape human interaction. In consequence they structure incentives in human exchange, whether political, social or economic. Institutional change shapes the way societies evolve through time and hence is the key to understanding historical change” (North, 1990).

This chapter defines some central concepts of patrimonialism and explains how it has shaped the Indonesian state for decades. In the introductory part of the chapter some features of patrimonialism are explored in more detail to describe historical changes within patrimonial legacies. Then it examines how the Indonesian state has been moving to leave patrimonial practices behind as they seem to go against Article 33 of the 1945 Constitution of the Republic Indonesia, which contains the basic arrangements for organising the Indonesian economy by emphasising the social responsibility of the state. This Article 33 stipulates that productive activities which govern the livelihood of the masses should be controlled by the state. The state as the corporate entity is the highest ideal in which the constituent parts work towards the common good. The state’s purpose is to protect that common good from elements within society which seek to undermine it, such as vested and particular interests. The following part of this chapter includes discussions about institutions, institutional change, institutional capacity and approaches to measure an institutional capacity.

1. Concept of Patrimonialism

As mentioned in chapter 1, the Indonesian government has long been perceived as a patrimonial state. Some of the essential features of a patrimonial state are as follows: the exchange of resources from political officials to their associates – mostly cronies; policies tend to be particularistic rather than universalistic; the rule of law is secondary to the law of the ruler; and political officials tend to blur the boundaries between the public and the private realms¹⁶.

¹⁶ As citing by Budd (2004) from Thomas M. Callaghy (1984) and S. N. Eisenstadt (1973).

According to Budd (2004), in industrial development, patrimonial officials tend to be more interested in promoting their own interest, or those of their associates rather than national development. This is the case because their ability to maintain power is reliant upon their ability to provide the goods and serve as the super patron. Thus, patrimonial states tend to promote industries that enjoy close ties to political officials. Connections rather than considerations of efficiency or productivity, determine which industries are promoted. Patrimonial government lacks, above all else, the bureaucratic separation of private and official spheres. Patrimonial rulers may exploit state authority as if it was their personal right, and these rulers rarely serve impersonal purposes.

In a patrimonial system, particularistic considerations end up distorting the economic decision-making process – rather than rationally allocating resources in order to further the national interest, capital is allocated according to the interests of officials and their cronies. Moreover, due to the blurring of the boundaries between the public and private realms, officials treat national funds as their private domain, to be plundered at will. It is not surprising that there is little capital left over to foster industrialisation. Patrimonialism promotes speculative rather than productive activities (Budd, 2004). It does not only discourage productive activities among the favoured elites, but also among the non-favoured, potential entrepreneurs. This is because these individuals come to feel as if the only way to make money is through connections.

According to Brinkerhoff and Goldsmith (2002) there are five economic and social phenomena associated with patrimonialism and clientelism in practice: rent-seeking activity, public corruption, interrupted reform and weak implementation capacity, ethnic politics, and the perpetuation of poverty and social exclusion. They state that there is no bright line separates patrimonialism and clientelism. The two complement each other where clientelism as a mean for setting policy about who set what in the government, patrimonialism provides ways for carrying out policy.

Brinkerhoff and Goldsmith (2002) refer to the term clientelism, also known as the patron-client model of politics, as a complex chain of personal bonds between political patrons and their individual clients or followers. This political system is based on conditional loyalties and involves mutual material advantages, in which individuals of unequal power are linked together through the exchange of favours. There are

several famous contemporary examples of clientelism include Senegal's *marabouts*¹⁷ (Fatton, 1986) Mexico's *caciques*¹⁸ (Fox, 1994) and The Philippine's *bossism*¹⁹ (Sidel, 1999). Meanwhile Kaufman (1974, p. 285) defines clientelism as "a special type of dyadic exchange", distinguishable by the following characteristics:

1. The relationship occurs between actors of unequal power and status;
2. It is based on the principle of reciprocity; that is, it is a self-regulating form of interpersonal exchange, the maintenance of which depends on the returns that each actor expects to obtain by rendering goods and services to the other and which ceases once the expected rewards fail to materialise;
3. The relationship is particularistic and private, anchored only loosely in public law or community norms.

Patrimonialism and clientelism lead to rent-seeking activity which performed by individuals or groups in order to alter public policy and procedure on ways that will generate more income for themselves. It also included a misallocation of resources and other inefficiencies that impose sacrifices on other groups. Patrimonialism and clientelism are also widely associated with corruption, which is usually described as behavior involving misuse or abuse of public²⁰ office, powers or resources for private gain (Andvig & Moene, 1990; Robertson-Snape, 1999; Rose-Ackerman, 1975; Shah, 2000; USAID, 1999). Corrupt activities involve taking advantage of the power inherent in a government office to advance personal interests. Abuses include bribery and extortion, nepotism and favoritism, and embezzlement or theft of state fund (Brinkerhoff & Goldsmith, 2002). Corruption from a government officer's perspective includes using the workplace as a venture from which to gain extra income. Corrupt officers may take bribes as part of the execution of government policy, such as for granting of licenses, state bank loans or government contracts. They also may misdirect public funds for their own or an acquaintance's benefit. Corruption arises in government because officers have the means, motivation, opportunity and occasion to put their interests ahead of duty to their principals, in this case the community. Instead

¹⁷ *Marabouts* were local holy men and teachers who delivered the votes of their followers whom they repay with farm implements and other gifts.

¹⁸ *Caciques* were local power brokers who provided plots of land and loans, acted as intermediaries for peasants, and run shops and businesses. They were critical components in the party and often used strong-arm tactics to reinforce their power. The peasants voted for the dominant party in order to gain services and security.

¹⁹ Bosses enjoyed discretionary power over local funds and the appointment of officials in the local administration, and they could influence the awarding of concessions, contracts and franchises.

²⁰ Corruption takes place within private organisations is beyond the scope of this research.

of working as civil servants delivering public services directly to the citizens, they more look after themselves by acting in a manner that disadvantages the public.

In practice, the complexity occurs in defining what ‘public’ and ‘private’ interest means due to cultural variations, and this makes corruption sometimes culturally defined (Brinkerhoff & Goldsmith, 2002; Johnston, 1996). In other words, some culture is more tolerant of conflicts between public and private interest than the laws ruling the people of that culture. However, the degree of tolerance differs from society to society, and in patrimonial societies, people expect friends in high places to bend the rules for them.

Furthermore, not only are patrimonial systems not based upon the rule of law but patrimonial officials are above the law as well. The rulers of patrimonial states are simultaneously the source of the law and beyond its jurisdiction. Patrimonialism represents the law of the ruler. Patrimonialism bypasses democratic institutions such as the judiciary, the legislature, political parties and so forth. All of these institutions lack autonomy, and instead are either the creations or the personal vehicles of the patrimonial leaders. As defined by Benedict Anderson (1990), a patrimonial state is a state in which “real power is seen to flow out from the concentrated center”.

Budd (2004) examines the proposition that patrimonial states are unable to adopt and implement coherent development plans. He states that the depersonalisation of economic and political activity is required in order that decision-making can be based upon rational and profit-seeking considerations. Such a depersonalisation of the political and economic realms represents the antithesis of the patrimonial state, in which particularistic interests dominate. Therefore, the requirements for having successful development planning are vision (a plan for future challenges and response to changes in the domestic and international political economies); autonomy (adoption and implementation of its developmental plan without intervention from powerful individuals in society in ensuring the promotion of national interest rather than particularistic interest); and an effective bureaucracy (one with the capacity to implement its program). The next section discusses this proposition in the Indonesia context along with the constitutional background which could help combat the emergence of coherence and an end to patrimonialism within state power system.

2. Patrimonialism in Indonesia – “Soeharto Era”

As a newly independent state, in 1945 Indonesia confronted innumerable challenges. The departing Dutch colonialists left the country unprepared, and the promotion of economic growth became the first priority. However, in the following twenty years, there was not much space to put into practice any sort of economic development policy until Soeharto became the second president of Indonesia in 1966 (Resosudarmo & Kuncoro, 2006). As the first president of Indonesia, Soekarno put his attention more into developing the bureaucratic system adapted from the Dutch. Soekarno’s power relied on political parties which he classified into three groups; nationalist, religious and communist. Welcoming communist in his cabinet later on resulted in constitutional crisis and public service disturbance. The next president, Soeharto then realised that the key to public support was to fix the economy. Soon after he was elected as president, Soeharto stipulated the national priority for policy making to be economic stabilisation.

Despite Soeharto’s economic achievement, there were student demonstrations against policies which they believed advantaged a small elite and members of the president’s families – relatives, children, wives, nephews, close friends and cliques (Bahauddin, 1974)²¹. Many student groups did target Soeharto and his family in their demonstrations and publications, especially at a time when his family’s depredations were becoming increasingly obvious (Aspinall, 2005). There was a time when business was as much about whom you knew as what you did, and the best people to know were the Soehartos. His family members and their associates had highly sought-after business connections and were then essential to successful business in Indonesia. They had, therefore, often been given equity interests in corporations which needed their connections in order to be granted permits and approvals. In fact, the phrase “*Korupsi, Kolusi dan Nepotisme*” (KKN – corruption, cronyism and nepotism) has come to symbolise the abuses of the Soeharto regime, and the Soeharto family name is now forever associated with such practices. Budd (2004, p. 4) cites an Indonesian economist’s statement that “The presence of vested interests discourages entrepreneurs from taking the risks they ought to be taking. They convince many Indonesian businessmen that the only way to get ahead is to cultivate friendships with government officials”.

²¹ In edited book by Ian Chalmers and Vedi Hadiz (1997) *The Politics of Economic Development in Indonesia*. London: Routledge

In the 1980s, the emergence of big conglomerate corporations controlled by cronyism with good connections to Soeharto's personal leadership made the patrimonialist aspects in the Soeharto era become more obvious. The conglomerates were all very closely connected to Soeharto and his family. In addition, Mackie (2010) states that in the Soeharto era the patrimonial system extended down through its lower levels with governors, district/municipality heads, sub-district heads and even village heads implementing the same sort of powers of control and patronage in their subordinate offices. Although the president's office held a domineering force, governmental structure under Soeharto allowed the involvement of other important players in decision-making process, namely the technocrats, the technicians and the patrimonialists (Resosudarmo & Kuncoro, 2006). The technocrats were a group of western-trained economists who embraced the neoclassical view and helped Soeharto in designing the economic stabilisation. The technicians were mostly engineers with inclination towards a more protectionist industrial policy. In the patrimonial group were military personnel, privileged bureaucrats and the ruling members of *Golongan Karya*, the political party which supported Soeharto. Later on, the President's children became major beneficiaries of the government protectionist policies and became members of the patrimonial group. This group was in charge of distributing rewards to those within the political elite and possibly to some outside this small ring. This patron-client relationship in the Indonesian civilian bureaucracy was presumed to be the root cause of corruption (Resosudarmo & Kuncoro, 2006; Vial & Hanoteau, 2009).

As mentioned earlier, Budd (2004) states that the requirements for having successful development planning are vision, autonomy and effective bureaucracy. Policy makers under Soeharto's governance were able to formulate a vision for the nation's development incorporating development plans. Long term planning was incorporated into "*Garis-garis Besar Haluan Negara*" (GBHN – the broad outline of state policy). Based upon the GBHN the government drew up a series of five year plans. Soon after he was elected as the president, Soeharto stipulated the national priorities for guiding the policy making process, as follows: economic stabilisation, restoration of the requisite condition for sustainable growth and the consolidation of national control. The design of economic stabilisation policy included the announcement of a balanced budgetary policy, the abolition of multiple exchange rates, the devaluation of the currency to its market value and the liberalisation of foreign trade. In addition, the new investment law was decreed containing generous tax

concessions in order to make Indonesia more attractive to foreign investors, and close ties with the international donor community, the International Monetary Fund (IMF) in this case, were re-established to enable Indonesia to borrow concessionary loans for the purpose of rehabilitating its previously neglected physical infrastructure (Resosudarmo & Kuncoro, 2006). Vision was not lacking in the Indonesian context, but it was vision without a degree of autonomy in decision making which could be readily overwhelmed by powerful vested interests.

Considering the patrimonial practices mentioned in the above paragraphs, the development process that occurred during the Soeharto era failed to establish the distribution of equity for the welfare of the community, especially among the people with lower economic and social circumstance, as stipulated in the Article 33 of the 1945 Indonesia Constitution. Economic growth actually exacerbated the gap between rich and poor communities. The upper class people or the rich, who were also large employers, did not focus on developing sectors that provided job opportunities for the poor.

Hveem and Nordhaug (2002) describe the year of 1997 as a hard year for Indonesia. Plantation companies had started forest fires to clear new land, and as the fires had got out of control, they had developed into environmental disasters which destroyed enormous forested land areas and polluted large tracts of Indonesia and Southeast Asia. At the same time, Indonesia was badly affected by the currency and financial crisis that hit several of her neighbouring countries. The exchange rate fell and the country's foreign debt escalated, while agriculture was also affected by a major drought. Trumping these problems, a political succession crisis broke out as the ailing President Soeharto declined to nominate a successor.

The Soeharto regime was clearly not able to address these political, environmental and economic problems. Its inability to handle the financial crisis escalated into the political crisis of 1998. The government was hesitant when it came to implementing the kind of reforms demanded by the International Monetary Fund (IMF) in return for supplies of new credit. The reform demanded by the IMF included removal of subsidies on food and fuel, banking reforms and anti-monopoly reforms, which went against the economic interests of Soeharto's family and close associates. The opposition capitalised on this by exposing the cronyism and nepotism of the regime at a time of national hardship, while the government's brief attempts to heed the IMF's call for removal of subsidies triggered political turmoil and growing

opposition against the regime. The anti-Soeharto demonstrations and riots increased in intensity and on 21 May 1998, Soeharto was forced to resign from his presidency as it became apparent that he was unable to summon a reform cabinet to win time (Hveem & Nordhaug, 2002).

3. Patrimonialism in Indonesia – “Post-Soeharto Era”

Webber (2006) expresses several phenomena that are symptomatic of the post-Soeharto government’s incapacity to govern effectively as follows: First, government had a very limited revenue base. Less than one percent of Indonesians filed personal tax returns; the tax ratio was less than 14 percent of GDP, which was one of the lowest in Southeast Asia. Second, the proportion of government expenditure that reached the intended recipients was low. For example, about 75 percent of the low-income assistance fund from the reduction in the fuel subsidy in 2001 missed the target, mostly due to corruption. Third, the level of educational qualifications and work ethics of civil servants was inadequate. In 2003, the minister in charge of the civil service stated that fewer than half of Indonesia civil servants know what they are doing and do their jobs properly. The majority, in his view, were ‘under-educated, unmotivated, unsupervised and rarely held accountable’²². Above all, the most critical symptom was the level and pervasiveness of corruption in all branches of the state: executive, legislative and not least judicial.

After Soeharto resigned in May 1998, Indonesia embarked on an extensive political and institutional reform program. For example, economic reform aimed to increase the transparency of government operations. Multilateral and bilateral donors are now heavily involved in the reform process. The main multilateral donors to Indonesia are the World Bank and the Asian Development Bank, and the major bilateral donors are Japan, Australia and the United States²³. New budget standards and financial management procedures are being put in place. The off-budget sources of funding and hidden financial accounts operated by many departments and agencies in the Soeharto era were examined and then being disclosed. Key government organisations are subject to a new audit, monitoring and disclosure requirements.

²² As quoted by Webber (2006, p. 408) from ‘Minister wages war on slack bureaucrats’ in *Strait Times*, 13 June 2003.

²³ For more information see Indonesia Country Strategy (CIDA, 2009), Profiles of Indonesia Foreign Debts (INFID, 2007) and Donor proliferation and donor coordination in Indonesia: the case of governance reform (Edi & Setyaningtias, 2007).

There is no doubt that enthusiasm for an end to the corruption that pervaded Indonesian society at many levels decrease, if an essential starting point for reforms, that is transparent governance, remains lacking, (Robison & Hadiz, 2004).

Even in cases where governments are sincerely interested in pursuing reform, where they are beholden to clients for support and have little or no ability to reconcile or resist their supporters' demands, then moving ahead with change becomes difficult or even impossible (Brinkerhoff & Goldsmith, 2002). This also shapes the capacity to provide routine public goods and services. In neopatrimonial²⁴ states, the distribution of services is determined by what Migdal (1988) calls "triangles of accommodation" among bureaucrats, politicians and strongmen²⁵. Where survival depends on satisfying patrons and sustaining power over clients, bureaucrats tend to do just enough to deliver services according to formal regulations and procedures while informally exchanging public resources for power, influence and cooperation.

Corruption is particularly serious among public utility agencies, the police, political parties and the courts. Although the standard of living for Indonesian bureaucrats has improved from time to time, the wide spread corruption is still generally explained by the low wage rates of Indonesia's civil servants (Hamilton-Hart, 2001; Hill, 1996; McLeod, 2000, 2005; Robertson-Snape, 1999; Schwarz, 1999; Tjiptoherijanto, 2007). Corruption however, was not only because of low official wages but also the president's need to secure his position by enabling key figures in the bureaucracy and the military to take advantage economically (Crouch, 1979; Robertson-Snape, 1999; Vial & Hanoteau, 2009). Civil service reform plays a part in most efforts to restrain patrimonial rule (Brinkerhoff & Goldsmith, 2002).

Furthermore, corruption is also sustained by political and economic conditions. Indonesian politics under Soeharto was marked by a lack of accountability, of transparency, of democratic institutions and a free press. Restraint on civil associations and the press were largely removed by Soeharto's successor, President Habibie, and these new freedoms were maintained by President Abdurrahman Wahid. During his presidency, the next president, Susilo Bambang Yudhoyono (well known as SBY) took

²⁴ Neopatrimonial is a modern form of Max Weber's traditional Patrimonial form of rule. It is a mixed system where elements of patrimonial and rational-bureaucratic rule co-exist and are sometimes interwoven

²⁵ Strongmen in this context are what Migdal (1988, p. 256) describes as local people who "have succeeded in having themselves or their family members places in critical state posts to ensure allocation of resources according to their own rules, rather than the rules propounded in the official rhetoric, policy statements, and legislation generated in the capital city or those put forth by a strong implementor".

care of and protected the freedom of the press. In fact, on 9 February 2014, he received an award as a ‘friend of the press’ from “*Persatuan Wartawan Indonesia*” (PWI – the Indonesian Journalists Association) for his contributions and role in extending press freedom (“SBY named “Friend of Press”,” 2014, 9 February). The rise of a broad range of civil associations was marked by multiple organisations expressly focused on corruption, legal reform and government probity, such as the Indonesia Corruption Watch (ICW), the Government Watch, “*Lembaga Kajian dan Advokasi untuk Independensi Peradilan*” (LeIP – the Indonesian Institute for an Independent Judiciary) and “*Lembaga Advokasi Reformasi Indonesia*” (LARI – the Indonesian Reform Advocacy Institute). In addition, a new anti-corruption law passed in 1999 provides stiff penalties for corruption including death penalty and an instruction to establish a national commission for anti-corruption. The new commission was then established in 2002 called “*Komisi Pemberantasan Korupsi*” (KPK – the Corruption Eradication Commission). It is an independent state agency which has a goal to combat corruption professionally, intensively and sustainably. It was not established to take over the task of eradicating corruption of institutions that existed previously, but becomes a trigger mechanism to push combating corruption efforts to be more effective and efficient. During the 2000s, more anti-corruption institutions were created, for example “*Komisi Ombudsman Nasional*” (the National Ombudsman Commission) and “*Satuan Tugas Pemberantasan Korupsi*” (the Corruption Eradication Task Force) (Hamilton-Hart, 2001; ICW, 2005; MTI, 2006; Sherlock, 2002).

An interesting development after the fall of Soeharto was the initiative towards regional decentralisation. During the Soeharto era, the governmental system was very centralised: almost all decisions at the local level were decided or strongly influenced by the central government; most revenues from economic activities in the regions were collected by central government, although they were then distributed back to regional governments, natural resource-rich regions felt that they should get much more than they got based on their contribution of the extracted resources. The new environment of freedom created euphoria in some parts of local government, who demanded greater autonomy. The immediate impact of the implementation of the decentralisation policy was increased conflict between the central government and the regions, especially where the central government wanted to keep key responsibilities and related laws and regulations were not well defined. Another impact was that the decentralisation policy

created a strong temptation for local government to raise their own local revenue through various forms of nuisance taxes. A nuisance tax is a tax based on the cost of the item purchased and collected directly from the buyer. Lack of coordination between the central government and regional governments resulted in several goods and services being taxed twice (double taxation). Last but not least, the immediate impact concerned the nature of corruption which became a more fragmented bribe collection system where central government and local government officials as well as others, such as military/police, legislative members and judicial members were demanding bribes (Hadiz & Robison, 2005; Heryanto & Hadiz, 2005; Resosudarmo & Kuncoro, 2006; Robertson-Snape, 1999).

In the paper titled “One Size Fits All? Decentralization, Corruption and the Monitoring of Bureaucrats”, Lessmann and Markwardt (2009) quoted the argument of Prud’homme and Tanzi on corruption at the local level as follows. Prud’homme argues that there are more opportunities for corruption at the local level because local bureaucrats and politicians are likely to be more subject to the pressing demands of local interest groups, and that local decision-makers have usually more discretionary power than do national officials. Moreover, Tanzi states that corruption may be more common at the local level, particularly in developing countries, because local officials live closer to the citizens, and this contiguity allows local interest groups to have a greater impact and facilitates a higher level of corruption. This perspective is relevant to the Indonesian case because notwithstanding the greater transparency facilitated by political liberalisation and the adoption of numerous laws and measures aimed at combating the phenomenon within local government, levels of corruption were generally perceived to have risen in the post-Soeharto era. The pattern of corruption, according to Webber (2006) became anarchical or chaotic, and much of the daily life of post-Soeharto Indonesia remained very patrimonial.

Crouch (1979) describes patrimonialism in the Indonesian state as the distribution of patronage to win and retain the loyalty of key divisions of the political elite. One of the most obvious impacts of such patronage is corruption (Clapham, 1985; Crouch, 1979; Resosudarmo & Kuncoro, 2006; Robertson-Snape, 1999; Robison, 1988; Vial & Hanoteau, 2009). Corruption is not the only practice that relates to patrimonialism; there are other patrimonial practices such as those mentioned in the earlier paragraphs; rent-seeking activity, public corruption, interrupted reform and weak implementation capacity, ethnic politics, and the perpetuation of poverty and

social exclusion. However, this study highlights corruption as perhaps the most important effect of patrimonialism in Indonesia. We can thus consider the level of corruption as one of the measures to gauge whether Indonesia is leaving patrimonialism behind. A couple of corruption surveys conducted by the Transparency International, namely the Corruption Perception Index (CPI) and the Global Corruption Barometer (GCB) have been utilised as the means to assess the significance of corruption. Both surveys rank the level of corruption in different countries by gauging the perception of business people and country analysts (CPI), and by studying how and where the ordinary people feel the impact of corruption (GCB). The results of these surveys for the period of 2002 to 2012 will be discussed in Chapter 4.

4. Moving away from patrimonial legacies?

Patrimonialism is one of Weber's (1947) types of traditional authority. The other types are gerontocracy and patriarchalism; these two are the most primitive types of traditional authority where a personal administrative staff of the chief is absent. Gerontocracy refers to "a situation where so far as imperative control is exercised in the group at all it is in the hands of elders who are the most familiar with the sacred traditions of a group", and patriarchalism is the "situation where, within a group, authority is exercised by a particular individual who is designated by a definite rule of inheritance" (Weber, 1947, p. 346). He concludes that with the development of a purely personal administrative staff, especially in the form of military force under the control of the chief, traditional authority tends to develop into patrimonialism.

Weber contrasted patrimonialism with legal authority, in which legitimacy is based on rational grounds – "resting on a belief in the legality of patterns of normative rules and the right of those elevated to authority under such rules to issue commands" (Weber, 1947, p. 328). The rational-legal authority is characterised by a graded hierarchy, written documentation, full-time staff and political neutrality. Adherence to official rules is highly valued in this bureaucratic system. People working under them are not supposed to charge for services, except in the case of user fees, which go to the government, not into the civil servants' pockets. Weber's rational-legal authority is an ideal type of the hierarchical organisation that exists to carry through specific ends, and where the office holders are there not because of their personalities or their family or status line but because they are matched to that office in terms of their ability to

carry out its tasks. The aim is maximum performance through speciality and the chain of command. There are subordinates and superordinates in a pyramidal system.

Brinkerhoff and Goldsmith (2002, pp. 7-8) sum up the idealised distinctions between patrimonial and rational legal bureaucratic systems in the following table.

Table 1
Continuum of Administrative System

Patrimonial	←————→	Rational-legal Bureaucratic
<ul style="list-style-type: none"> • Administrators are recruited and promoted as reward for personal connections with political leaders 		<ul style="list-style-type: none"> • Administrators are recruited and promoted in competitive processes that judge their merit and expertise
<ul style="list-style-type: none"> • Administrators can be dismissed for no reason 		<ul style="list-style-type: none"> • Administrators can only be dismissed with cause
<ul style="list-style-type: none"> • There is an unspoken hierarchy, with little specialisation or specification of output and uncertain reporting channels 		<ul style="list-style-type: none"> • There is an authorised hierarchy with clear division of labour, specific standards for output and well-defined reporting channels
<ul style="list-style-type: none"> • Important orders may be given orally 		<ul style="list-style-type: none"> • Important orders are put in writing
<ul style="list-style-type: none"> • The public and private realms are blurred 		<ul style="list-style-type: none"> • The public and private realms are kept separate
<ul style="list-style-type: none"> • Administrators supplement their salary with bribes and kickbacks 		<ul style="list-style-type: none"> • Administrators are prohibited from supplementing their salary
<ul style="list-style-type: none"> • System is decentralised allowing wide discretion on the job 		<ul style="list-style-type: none"> • System is centralised with little room for discretion on the job
<ul style="list-style-type: none"> • Administrators' actions are arbitrary, based on subjective reasoning and follow ad hoc procedures 		<ul style="list-style-type: none"> • Administrators' actions are predictable, based on objective method and follow uniform procedures
<ul style="list-style-type: none"> • Rules are applied with partiality and some citizens get preferential treatment 		<ul style="list-style-type: none"> • Rules are applied with neutrality and all citizens receive equal treatment
<ul style="list-style-type: none"> • Verbal agreements are used in government procurement and sales 		<ul style="list-style-type: none"> • Binding legal contracts are used in government procurement and sales
<ul style="list-style-type: none"> • Internal controls are lax 		<ul style="list-style-type: none"> • Internal controls are strict
<ul style="list-style-type: none"> • Documentation is spotty with sensitive matters left off the books 		<ul style="list-style-type: none"> • Thorough records are maintained and regularly audited
<ul style="list-style-type: none"> • Subjects have little recourse for poor service 		<ul style="list-style-type: none"> • Citizens have appeal channels if given poor service

Source: Brinkerhoff and Goldsmith (2002, pp. 7-8)

Goulder (1954) did not believe that bureaucratic authority is either accepted or is inevitably the most efficient. This finding comes about from seeing how enforcing bureaucracy leads to opposition. An example of opposition happened in a gypsum mine in the United States where after a lenient enforcement of bureaucratic authority, a new mine manager enforced the rules of the system effectively in an aim for better

efficiency. The outcome, however, was a big fall in morale, increased labour-management conflict and ‘a wildcat strike’. The intention was to produce an efficient organisation working in conformity to rationally designed impersonal rules and procedures. Impersonal rules are not all bad, it is just that there are unintended as well as intended consequences, and these unintended consequences nevertheless come about and make Weber's bureaucracy not the efficient machine he presents.

Another problem with Weberian bureaucracy identified by Gouldner is the built-in contradiction between the authority of experts and the authority of hierarchy and discipline. One comes from superior knowledge and another from the office held. Professionals may have more technical knowledge than hierarchical superordinates. Furthermore these professionals, called cosmopolitans, may be committed to their skills, and how they address the general job title, but not as such to the organisation itself. The hierarchical people, called locals, show loyalty to the organisation. Loyalty to the organisation therefore comes at a price of speciality and efficiency, or efficiency comes at a price of maximising loyalty to the organisation (Gouldner, 1957).

Rational legal bureaucratic systems are ideal types rather than descriptions of real institutions. However, adjudication and administration of laws are calculable in leading to governance that creates a better investment climate and encourage economic development. Rational legal bureaucracy also has the advantage of being less discriminatory than systems founded on personalised exchange relationships (Brinkerhoff & Goldsmith, 2002).

Many developing countries set up a structure of rational legal administration but continued to rest on a foundation of patrimonial rule. The term applied to this kind of administrative system is what Bratton and van de Walle (1997, p. 62) call neopatrimonialism “in which the customs and patterns of patrimonialism co-exist with, and suffuse, rational-legal institutions”. By the 1970s, the concept of neopatrimonialism gained ‘quasi-hegemonic’ status very fast in the study of sub-Saharan Africa²⁶ (Laruelle, 2012). In his study, Christopher Clapham (1985, p. 48) defines neopatrimonialism as “ a form of organisation in which relationships of a

²⁶ Some recent studies on neopatrimonialism in sub-Saharan Africa are ‘How does neopatrimonialism affect the African state's revenues? The case of tax collection in Zambia’ (Soest, 2007), ‘Rethinking Patrimonialism and Neopatrimonialism in Africa’ (Pitcher, Moran, & Johnston, 2009), ‘Patrimonialism and neopatrimonialism: comparative trajectories and readings’ (Bach, 2011), and ‘How Neopatrimonialism Affects Tax Administration: a comparative study of three world regions’ (Von Soest, Bechle, & Korte, 2011)

broadly patrimonial type pervade a political and administrative system which is formally constructed on rational-legal lines”. More recently, Erdmann and Engel (2007, p. 105) reconsider neopatrimonialism by defining it as “a mixture of two co-existing, partly interwoven, types of domination: namely, patrimonial and legal-rational bureaucratic domination”. Neopatrimonial rule takes place within the framework of legal-rational bureaucracy but the distinction between the private and the public exists and is accepted. Officers who hold authority in bureaucratic institutions have powers which are formally defined, but exercise those powers as a form of private property. In other words, formal structures and rules do exist although practically the separation of the private and public sphere is not always observed.

As mentioned in Chapter 1, Brinkerhoff and Goldsmith (2002) state that to cope with patrimonialism a government has to promote institutional changes, and this research aims to assess the extent to which the Indonesian state has been moving away from patrimonial legacies and heading to rational legal authority, or being trapped in neopatrimonialism. This objective will be discussed in more details in Chapter 4, 5 and 6. Prior to discussing the process of institutional change, it is necessary to specify the terms “institutions” and “institutional capacity” and the remaining part of this chapter explains those concepts.

5. Developing Institutional Capacity

Using the words of Chang and Evans (2000, p. 1) in defining institutions, they are “systematic patterns of shared expectations, taken-for-granted assumptions, accepted norms and routines of interaction that have robust effects on shaping the motivation and behaviour of sets of interconnected social actors”. Institutions are usually embodied in authoritatively coordinated organisations with formal rules and capacity to impose coercive sanctions, such as government.

Chang and Evan (2000) feature three views on conceptualising institutions. First, institutions are seen as ‘constraints’. They point out North’s definition of institutions as follow:

“institutions consist of a set of constraints on behaviour in the form of rules and regulations; a set of procedures to detect deviations forms the rules and regulations; and, finally, a set of moral, ethical behavioural norms which define the contours that constrain the way in which the rules and regulations are specified and enforcement is carried out” (North, 1984, p. 8).

According to North (1984), constraints make possible human organisation by limiting certain types of behaviour and make possible civilisation. It is implied that when human beings come together and form an organisation, they jointly maximise their understanding of the form of organisation. However, it is extremely costly to specify and enforce the contractual arrangements that underlie institutions.

Instead of viewing institution as constraints, Chang and Evan (2000) suggest employing a different rhetoric by seeing institutions as enabling devices rather than constraints. They suggest as an example that firms can engage in innovation more aggressively because there are intellectual property rights which may prevent other agents from copying the ideas and seizing the gains that should accrue to the firms. In this case, shifting rhetoric from the constraining dimension to the enabling dimension of institutions is an important shift of perspective because there is a negating view that unconstrained institution is a nature order.

The third view of institutions from Chang and Evan (2000) sees institutions not just as enabling or constraining, but also as constitutive because they have a symbolic dimension and therefore inculcate certain values into the people inside them. In other words, as people continue to behave under a certain set of institutions, they begin to internalise the values embodied in those institutions, and as a result they begin to change by themselves. This research uses the institution defined by Chang and Evan (2000) in which constraints are seen as part of the institution but may be used for empowering itself.

Institutions serve multiple functions, for example, budgetary institutions serve to enhance macroeconomic stability, social protection for the welfare of the state and investment in productive assets such as physical infrastructure (Chang, 2007b). There are also many institutions that serve the same functions, although they would all serve other functions as well, which may or may not overlap. It is also possible that the same function could be served by different institutions in different societies or in the same society but at different times. Chang (2007b) concludes that it is therefore impossible to come up with a single list of functions and form of institutions that are desirable and essential for the development process. In addition, institutions do not function in a vacuum but interact with other institutions. Changing institutions by means of importing new forms may not be effective if they are incompatible with local institutions. However, this does not mean that there is nothing that a country can do to improve the quality of institutions in the development process.

In the early 1980s development theorists argued that the success and failure of development in any country was affected by a number of interrelated factors: the skills, values, attitudes, and beliefs of the people in the country; the socio-political structure within which people perform their roles; the availability of resources; and the institutional machinery through which development planning and implementation takes place (Cheema, 1980; Korten, 1980; Rondinelli & Ingle, 1980).

In the 1990s the role of institutions in development came to be seen as even more significant. For example, Goldsmith (1993) portrays institutions as imperative for socioeconomic development, whereas Adamolekun in McGill (1996) suggest that institutional weaknesses constitutes a roadblock to development in many African developing countries. Thus, it is unlikely that any country will be able to sustain and maintain growth and prosperity if the institutions are dysfunctional (Salmen, 1992).

In the 2000s international agencies such as the World Bank, the IMF and the Organisation for Economic Co-operation and Development (OECD) continued to stress the increasing influence of institutional economics within development thinking. These organisations started to impose many governance related requirements on borrowing country, to adopt better institutions on improving governance. Many rich country governments also started to attach government conditionality to their bilateral aid (Chang, 2011). Various bilateral, regional and multilateral trade and investment agreements such as the World Trade Organisation and the North American Free Trade Agreement also began to put pressure on developing countries for adoption of better institutions, often called the Global Standards Institutions²⁷ (Chang, 2011).

The issue of institutional capacity in the canon of development literature has also experienced significant changes over time²⁸. At the beginning of the 1950s, international agencies introduced an ‘institutional building’ approach to build basic institutional infrastructures in target countries. During the 1960s and 1970s an ‘institutional strengthening’ approach emerged, implying that the objective of development was to strengthen newly established institutions. An ‘institutional development’ approach replaced this in the early 1980s, which emphasised working with the already established organisations in a broader environment to include not only

²⁷ Global Standards Institutions (GSIs) are institutions that are typically found in Anglo-American countries, which are seen as maximising market freedom and protecting private property rights most strongly.

²⁸ For more comprehensive discussion on the approaches see Shileld 1989; Morgan and Qualman 1996; Morgan 1999.

public institutions but also private and non-governmental institutions. This approach emphasised not only developing the capacity of government agencies, but also the ability of these agencies to sustain their capacity. In the 1990s, a ‘capacity building’ or a ‘capacity development’ approach came forward, recognising the importance of the systemic environment within which institutions operate. Since then, the capacity building approach continues to be an effective approach for nurturing capacity in developing countries. The Paris Declaration²⁹ of the OECD mentions capacity building in many paragraphs as it is considered vital in achieving development results: it encompasses governing capacity, institutional capacity to formulate effective development policies, and implementation in a way that will produce results (OECD, 2008a). These changes in development thinking show that institutional capacity continues to be regarded as an important issue, one which plays a pivotal role in the development process.

It is important to define capacity and capacity building even though they are common terms in almost all development literature. The concepts are often expressed merely in terms of training and enhancing the technical skills of individuals. Capacity entails much more than a group of individual skills, indeed capacity building incorporates individual skills enhancement in a holistic system of structural and procedural improvements and feedback (Bateson, Lalonde, Perron, & Senikas, 2008).

The United Nation Development Program (UNDP) defines capacity as “the ability of individuals, institutions and societies to perform functions, solve problem and set and achieve objectives in a sustainable manner”. Capacity development is the ‘how’ of making development work better and is about making institutions better able to deliver and promote human development (UNDP, 2010). The World Bank (2005) describes capacity building as “long term process requiring a systematic approach, demand for improved public sector performance, and supply of well-structured organisations and skilled personnel”. Another definition by the European Centre for Development Policy Management (2007) mentions capacity as “that emergent combination of attributes, assets, capabilities, and relationships that enables a human system to perform, survive and self-renew”. The Canadian International Development

²⁹ The Paris Declaration, endorsed on 2 March 2005, is an international agreement to which over one hundred Ministers, Heads of Agencies and other Senior Officials adhered and committed their countries and organisations to continue to increase efforts in harmonisation, alignment and managing aid for results with a set of easy to monitor actions and indicators.

Agencies (CIDA) (2008) defines capacity as the ability of an entity (a person, an organisation, or a system) to perform planned functions effectively, efficiently and sustainably to achieve their planned objectives in support of their organisational mission. For international organisations, an agenda for capacity building must go beyond reforming technical cooperation but also address the institutional and policy environment which affects its effectiveness. There is not a shared definition of what constitute capacity building support; however, new ways of building the capacity to realise a more effective state would have to come from experimentation and learning.

In fact, the UNDP has been developing a framework for capacity building since 1990s, in order to better manage capacity assessments and development initiatives. According to Hopkins, a consultant to the UNDP, a capacity building agenda should be constructed on the following (Hopskin, 1994, p. 6):

1. Empowerment of people and ownership by the people primarily concerned should be a key goal for a capacity building strategy;
2. Good governance should be promoted through measures such as support to the judiciary, mass media, democratic institutions etc.;
3. Capacity development should not be equated with training, education and technology transfer. Attention should be shifted to the environment in which people apply their skills. The focus should be on strengthening management systems for improved capacity utilisation.
4. Capacity development for sustainable human development includes not only public sector management but strengthening of civil institutions and investments in social capital.

Based on evolving thinking and practice in capacity building areas performed since mid-1990s, the World Bank (2005, pp. 7-8) suggests key features of successful capacity building as follows:

1. Enhanced capacity should be treated as a goal in its own right, not merely as a means for achieving other development objectives.
2. Support for public sector capacity building needs to address three dimensions of public sector capacity – human capacity, organisational capacity and institutional capacity.
3. Demand as well as supply factors shape capacity constraints and capacity building opportunities and outcomes.

As discussed earlier, the role of institutions in the development process has been gaining traction over time. The capacity of institutions is significant because governments in any country must work through institutions to perform their functions. The important role played by public institutions in development has been recognised by international aid agencies. For example, the United Nations (UN) suggests that the government in developing countries believe that institutions are effective instrument for social change and development, and therefore accept institution building as a major effort for promoting consistent accelerated economic, social and political progress (2002). The UNDP even emphasises that the strength of institutions is central to the achievement of national development goals (UNDP, 2010). A study by the World Bank before the Asian economic crisis found that over the 30 years to 1994, countries with sound policies and capable and effective government institutions grew at three per cent per capita each year, while those with sound policies but weak institutions grew only 1.4 per cent per year (1998). In 2000, the World Bank remained convinced that unsatisfactorily functioning public sector institutions and weak governance are major constraints to growth and equitable development in many developing countries (2000). In the early 2000s Indonesia needed supports for governance reform in the certain areas such as core executive public sector capacity building, civil society strengthening and anti-corruption initiatives. These conditions show that a developing country has not yet have a well functioned public sector and strong governance.

The many functions of the government can broadly be grouped into three categories; policy making, service delivery oversight and accountability. Most of these functions are performed by various public sector institutions and in order to successfully perform these tasks, public sector institutions must have a high level of capacity. In term of their functioning, four main improvements have consistently been pushed that the public sector should aim for; reduced cost or increased efficiency, improvements in service delivery or effectiveness, reducing opportunistic behaviour or dishonesty, and giving users a greater say in what the public sector does (Jooste, 2008).

Therefore, there is always the call for change in both what the public sectors do and how they do it. In other words, their role and functions are subject to reform. The initiatives of public sector reforms aim to modernise and render more effective public sectors. The rise of ‘new public management’ (NPM) was one of the most striking international trends in public administration (Hood, 1991). It was popular

during the 1980s as it controlled the public sector reform agenda in the United Kingdom, Australia, New Zealand and many other OECD countries. In this period, public sectors in those countries exposed Hood's (1991, pp. 2-3) seven overlapping doctrinal components of NPM i.e. hands-on professional management, explicit standards and measures of performance, greater emphasis on output controls, a shift to disaggregation of component units, a shift to greater competition, stress on private-sector styles of management practice and stress on greater discipline and parsimony in resource use. The NPM was presented as a framework of universality, in so far as the set of doctrines was presented as the means to solve management ills in many diverse and politically neutral contexts.

Later, the NPM was found to be not applicable as public problems became too complex for public sectors to handle on their own. There was a lack of consensus on the proper ends of public actions, and because the government lacked the authority to enforce its will on the new network of actors (Salamon, 2001). Salamon (2001) introduced a new approach of public administration called 'new governance' (NG). NG introduces five key concepts³⁰ that form the core of public administration: the use of distinctive tools or instruments through which public purposes are pursued, organisational networks, a new perspective to the relationship between government and the other sectors (from 'public vs. private' to 'public and private'), from 'command and control' to 'negotiation and persuasion', and from 'management skills' to 'enablement skills'³¹. The key of NG is a shift in the basic paradigm guiding action on public problems. The focus of attention is not on public agencies or public programs but the distinctive tools used to address public problems. Similar approaches had actually been established before but used different terms such as 'intergovernmental management' (Rhodes, 1996), 'governance' (Stoker, 1998), and more recently 'new public governance' (Osborne, 2006).

Several different classifications of tools are available in the literature. For example, Hood (1986) sorts tools in terms of two major dimensions: the role of government for which they are used and the governmental resource they enlist. McDonnel and Elmore (1987) produce a four-fold division of tools: mandates,

³⁰ For more detail explanation on these concept see Salamon (2001)

³¹ Enablement skills are the skills required to engage partners arrayed horizontally in networks, to bring multiple stakeholders together for a common end in a situation of interdependence, namely activation skills (to activate the networks), orchestration skills (to sustain the networks) and modulation skills (to control rewards and penalties) (Salamon, 2001, pp. 1637-1639).

inducements, capacity building and system changing. Another classification focuses on the behaviours that programs seek to modify i.e. authority tools, incentive tools, capacity tools, symbolic or hortatory tools and learning tools (Schneider & Ingram, 1990). Vedung (1998) in turn identifies three classes of tools based on the extent of force that each involves: carrots, sticks, and sermons. Finally, Salamon (2001) identifies three criteria in terms of which public interventions are typically assessed: effectiveness, efficiency and equity, in addition to two other criteria suggested in political science literature: manageability and political legitimacy. It is clear that tools have multiple dimensions in terms of how they can be compared and contrasted, and particular tools may be alike along some dimensions and different along others. Because various tool dimensions have significant consequences for how programs operate and what results they produce, the most appropriate dimensions to use depend on which outcomes are of particular interest to the programs and on which tool dimensions the programs suggest might affect them (Salamon, 2001).

In conclusion, the discussion by now should not be focussed on the need for capacity building or the need for new approaches and model of capacity building. Instead, the new approaches should include capacity assessment frameworks. In the next part of this chapter, several frameworks that have been developed will be discussed.

6. Measuring the Institutional Capacity of the Public Sector

There are many approaches developed by many organisations. Each approach has its own specialties and characteristics. However, only some of them will be discussed in this study. This section describes approaches to capacity assessment developed by two international organisations, the UNDP and the World Bank, because their approaches are the most utilised by countries around the world especially in the Sub-Saharan Africa, Latin America, Asia and Arab States. The IMF follows the UNDP's framework in performing capacity building assessment in donor recipient countries. In addition, other frameworks by the European Centre for Development Policy Management and the Canadian International Development Agency are also briefly discussed to compare the scope covered by each approach.

The UNDP framework

The UNDP framework identifies three level of capacity building: the individual level, the organisation or entity level, and the broader system or environment level (1998). These three levels of capacity building are interlinked, so that a comprehensive strategy for building capacity should ensure that capacity is developed at all three levels. The IMF uses the UNDP's framework for capacity building in supporting capacity building in all three levels in order to contribute to the efforts of countries to meeting the Millennium Development Goals³² (Hakura & Nsouli, 2003).

The measurement of capacity is critical for understanding the success of capacity development process. The fact that capacity development is a long-term process and is one of many factors contributing to the achievement of development goals cannot be an excuse for lack of measurement; indeed these conditions should inform the importance of formulating a framework for the measurement. The process of capacity development is intended to enable the institution to move from an existing state to a higher state of capacity (UNDP, 2010). For this reason, the UNDP offers a framework measuring the change between the existing state and a higher state.

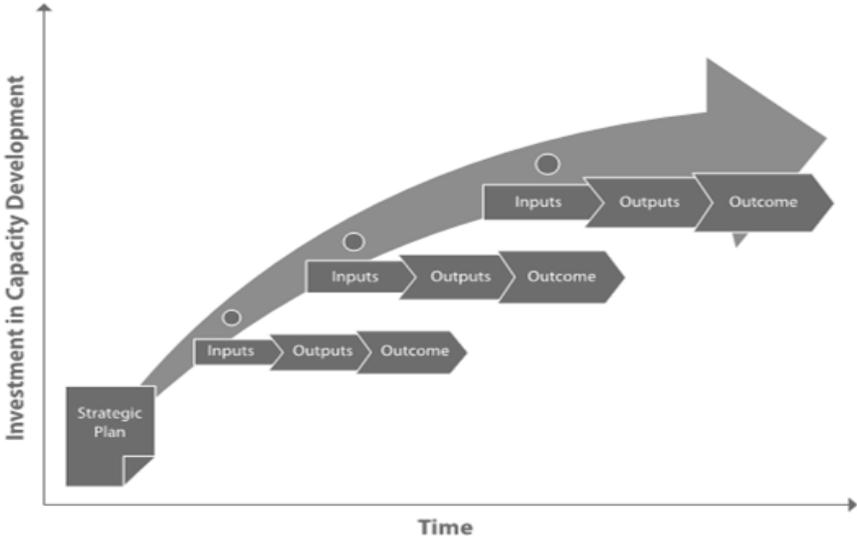
In order to achieve their goals, all institutions use their existing resources and competencies to transform inputs to outputs, which then contribute to achievement of outcomes, which then again contribute to impact or achievement of goals. The UNDP entitles this chain of events, inputs – activities – outputs – outcomes – impact, as the results chain. It is “a simple, systematic cause-effect approach to managing and measuring development results in as tangible a manner as possible” (UNDP, 2010, p. 3). Managing development results and its previous approach, results based management, are applied by many government and international agencies to simplify planning and ensure focus remains on achievement of impact and outcome. This approach includes four key components to planning, monitoring and evaluating for development results within the context of capacity development. The four components are strategic planning, impact, outcome and output.

For an institution, defining goals, outcomes and output without a clear understanding of the institution's strategic direction can lead to misleading focus and

³² The Millennium Development Goals (MDGs) represent a global commitment to improve economic and social conditions in low income countries. It was adopted by the United Nations member states on 8 September 2000 in order to declare their commitment for improving economic and social conditions in developing countries. The declaration put in place eight millennium development goals to be achieved by 2015.

resources being distracted from real needs. The UNDP defines strategic planning as a process that involves consultation with stakeholders to identify specific changes that are important for the achievement of goals. This process may include identification of key problems, grouping root causes, scenario planning and cost/benefit analysis of various options. The second component, impact, is an actual or proposed change in human development. It is measured by people’s well-being, captures change in people’s lives and represents underlying goals. An outcome is an actual or intended change in development conditions. It relates to changes in ability of an institution to work better and fulfil its obligations. An output, as the last component, is defined as a short term development result produced by any activities. It is a product or service that makes achievement of outcomes possible. The chart below illustrates how increased focus on capacity development over time can lead to greater development results.

Figure 1
Results-Based Approach to Capacity Measurement



Source: The UNDP: Capacity Development: Measuring Capacity (2010, p. 5),

Using a results-based approach for measuring capacity, UNDP views three levels of measurement; impact, outcome and output. Each level is strongly linked to the next.

The UNDP also supported a number of studies on capacity building. Among results of those studies is an approach for measuring the institutional capacity of public sector institutions proposed by Hilderbrand and Grindle (1997) which will be discussed in the following section.

Hilderbrand and Grindle framework

For their study, Hilderbrand and Grindle (1995, p. 445) define capacity as “the ability to perform appropriate tasks effectively, efficiently and sustainably”. In turn, capacity building refers to improvements in the ability of public sector organisations to perform appropriate tasks. Hilderbrand and Grindle’s approach contains a framework with five dimensions of institutional capacity³³. These five dimensions include: the action environment, the institutional context of the public sector, the task network, organizations, and human resources (Figure 2). Hilderbrand and Grindle’s framework has been used by a number of researchers to investigate and understand factors that affect the capacity of different government institutions in Romania, Bolivia, the Central African Republic, Ghana, Morocco, Sri Lanka, and Tanzania (Merilee S. Grindle, 1997; Mirilee S. Grindle & Hilderbrand, 1995; Hilderbrand & Grindle, 1997; Nientied & Racoviceanu, 2000). This five-dimensional framework proposed by Hilderbrand and Grindle is used for determining factors affecting the institutional capacity of public sector institutions.

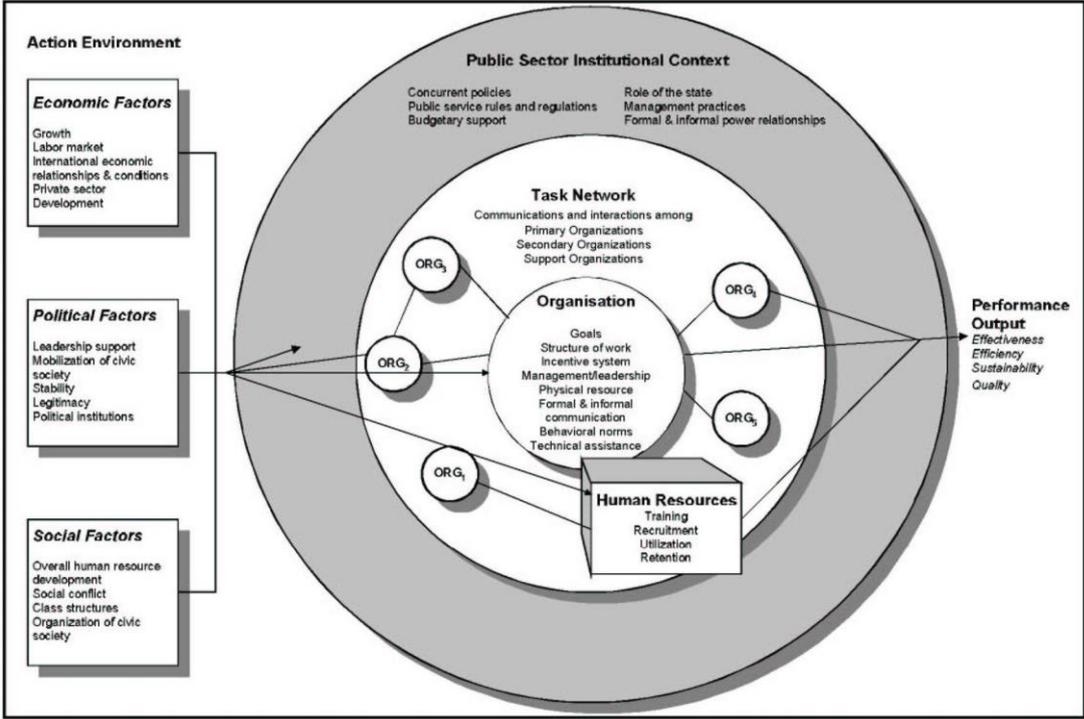
Hilderbrand and Grindle’s first dimension, the action environment, refers to the social, political, and economic condition of a country. Conditions in the action environment such as the rate and structure of economic growth, the degree of political stability and legitimacy of government, and the human resources profile of a country can affect the performance of government institutions. The action environment can either facilitate or hinder the capacity of government institutions. Hilderbrand and Grindle’s case studies indicate that the action environment is much more important as a constraint in some countries than others. For example, it is impossible to improve the capacity of public sector institutions in some countries before securing basic economic, political and social condition, whereas in other countries the capacity of public institutions can be improved despite uncondusive social, political, and economic circumstances (Hilderbrand & Grindle, 1997).

The second dimension, the public sector institutional context, refers to overall rules and procedures that direct the government organizations and employees across a

³³ For detail explanation on the framework see (Merilee S. Grindle, 1997; Mirilee S. Grindle & Hilderbrand, 1995; Hilderbrand & Grindle, 1997)

country, the financial resources government has to carry out its activities, and structures of formal and informal influence that affect how public institutions function.

Figure 2
Hilderbrand and Grindle Framework



Source: Hilderbrand and Grindle (1997, p. 35)

The task network, which refers to the ability of an organisation to coordinate and communicate with other organisations to perform particular tasks, is another dimension that can affect the capacity of public institutions. Hilderbrand and Grindle (1997) argue that weaknesses in the task network that constrain performance come from the absence of organisations to fulfil needed roles for any given task and the lack of effective interactions among organisations in the network.

Hilderbrand and Grindle’s fourth and fifth dimensions are organisation and human resources. The organisation dimension refers to the structures, processes and resources of the organisation and management styles adopted by members of the organisation, whereas the human resources dimension refers to the ability of an organisation to recruit, utilize, train and retain employees.

The World Bank approach

The World Bank has done much research to provide data that can be used to assess governance performance across countries and time (Wilhelm & Kushnarova, 2004, pp. 2-3). First, country policy and institutional assessments (CPIAs) are used to assess the quality of a country's present policy and institutional framework in terms of how conducive it is to fostering poverty reduction, sustainable growth, and the effective use of development assistance. The CPIAs constitute four clusters: economic management, structural policies, social inclusion policies and equity, and public sector management and institutions. Each cluster is then rated, and the ratings are used in comparison with others.

Second, cross-country governance indicators are used to measure and monitor the quality of governance and institutions. These indicators provide a relative measure of governance across countries based on survey data. Third, multi-country survey instruments, such as the Business Environment and Enterprise Survey (BEEPS) in 1999 and 2002, and Doing Business Indicators, provide more specific governance issues at the country level. These instruments permit the analysis of recent developments in institutional quality, performance, and constraints in the public and private sectors from a firm-level perspective.

Other survey instruments collect feedback from citizen (service delivery users), enterprises, and public officials, and ask detailed questions about types, manifestations, extent, costs of misgovernment and corruption. An integral approach called "governance and anticorruption (GAC) diagnostics" combines these instruments and helps assess the scope for political change and reform. The results of all surveys are made publicly available³⁴, so that any country may utilise them without any effort of doing so.

The CIDA approach

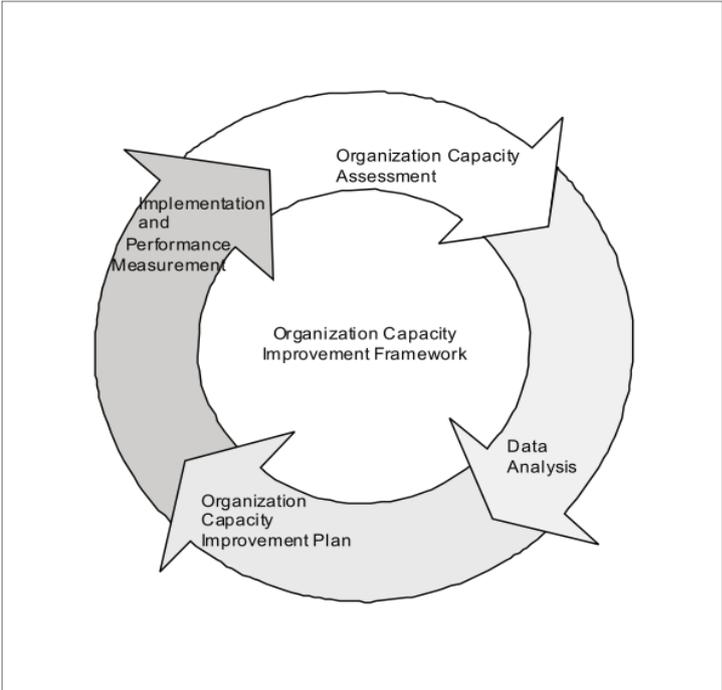
Since 1998 the Canadian International Development Agency (CIDA), through the Canadian Partnership Program, has funded the Society of Obstetrician and

³⁴ Access <http://siteresources.worldbank.org/IDA/Resources/Quintiles2003CPIA.pdf> for the 2003 CPIA ratings, <http://worldbank.org/wbi/governance/pubs/agindicators.html> for cross-country governance indicators, <http://info.worldbank.org/governance/beeps> for BEEPS 1999-2000 and <http://info.worldbank.org/governance/beeps2002> for BEEPS 2002, and <http://rru.worldbank.org/DoingBusiness/default.aspx> for Doing Business Indicators.

Gynaecologists of Canada (SOGC) Partnership Program to undertake capacity development efforts in three countries; Uganda, Guatemala and Haiti. The SOGC’s experience shows that capacity development requires an ‘ongoing cycle of action’ and ‘learning from experience’ that feeds into improved policies and renewed action at the organisational level (Bateson et al., 2008, p. 888). In addition, capacity development also requires time and the commitment of various position holders in organisational governance to understand the institution’s capacity needs, and to be willing to effect positive change.

The SOGC developed a comprehensive framework for assessment and improvement known as the Organisation Capacity Improvement Framework (OCIF), a versatile model that can be applied to any organisation concerned with developing capacity (Figure 3). The OCIF prioritises four core elements: organisation capacity assessment, data analysis, organisation capacity improvement plan, and implementation and performance measurement (Bateson et al., 2008).

Figure 3
 Organisation Capacity Improvement Framework



SOGC has the right to utilize all figures associated with the organization capacity improvement cycle in any publications it authors or approves.

Source: Bateson et al. (2008, p. 890)

The first element, organisation capacity assessment, considers the organisation from four major perspectives supporting capacity sustainability and addressing the core areas of competence generally accepted in the development environment. The

four major perspectives are organisational cultural factors (vision and mission, values and reward), operational capacity factors (leadership and strategy, governance and management structure, financial management, human resources, systems and procedures, communication, and infrastructure), organisation performance factors (effectiveness, efficiency, organisational relevance and financial health), and external and perception factors (rules and norms, legal and political framework, linkages and networks, and ownership and participation). This element is generally in accord with other tools that have been developed for the assessment of capacity building in the public sector and non-profit associations.

In the data analysis process, results of the assessment are assigned with a score based on the rating scale and then calculated to get an overall capacity rating scale. The scale is then analysed from any of three perspectives: theoretical ideal, benchmark, or inter-organisation comparison. Following the assessment and analysis, the framework focuses on planning and developing an overall strategy of priority improvement actions to address areas of weakness and to support the organisation's strategic plan and objectives within its operational environment. In developing the capacity improvement plan and performance measures, this framework takes into account other strategic objectives of the organisation by facilitating prioritised actions that link the capacity improvement plan to supporting overall organisation objectives.

This research uses the combination of both, the UNDP approach and Hilderbrand and Grindle's dimension, to achieve its objectives. Related components from other approaches were taken into consideration in implementing the chosen approaches into the case study. The utilisation of the approaches is discussed in chapter 5. The World Bank's approaches were also used in discussing key performance indicators of the 'Grand Design' in chapter 6.

Institutional capacity continues to be regarded as an important issue that plays a pivotal role in the development process. However, discussing institutional capacity cannot be separated from state capacity. Huntington (1968, p. 1) states that "the most important political distinction among countries concerns not their form of government but their degree of government". In this research, state capacity was perceived in terms of Huntington's second element, that was the degree to which governments control and regulate society. State capacity must not be associated with the strength of a particular government. Zaire and Indonesia were two examples of weak states at the time of Mobutu and Soeharto, who both stayed in power for more than 30 years.

Migdal (1988, p. 4) sees state capacity as the ability “to penetrate society, regulate social relationships, extract resources, and appropriate or use resources in determined ways”. This research applies state capacity in the sense of the degree to which the agents (governments) and institutions of the state are able to penetrate, control and extract resources from society. This definition includes the extent to which the state provides public goods and services.

Definitions of the term ‘state’ in this research is referred to Weber’s (1964) definition, the accepted definition in the social sciences, as a human community claims the monopoly of the legitimate use of physical force within a given territory. A weak state is undeniably the source of many of the world’s most serious problems, such as poverty, drugs, AIDS and terrorism. State weakness created major human rights disasters during the 1990s in Somalia, Haiti, Cambodia, Bosnia Herzegovina, Kosovo and East Timor, and the AIDS epidemic in Africa³⁵. By looking into Weber’s definition of state, Fukuyama (2004) argues that the essence of stateness is its enforcement. That is, the ultimate ability to send someone with a uniform and a gun to force people to comply with the state laws. The context in which the present agenda for state building has developed is the post-Cold War world. The end of the Cold War left a band of failed and weak states extending from the Balkans through the Caucasus, the Middle East, Central Asia and South Asia (Fukuyama, 2004). The following paragraph describes this condition in the Indonesian context.

Crouch (1979), in his paradigmatic description of the Indonesian patrimonial state, portrays the state in which government has the ability to rule in the interest of the privileged without much concern for the general population who are poor, considered socially backward, politically passive and kept in check by the regime’s military forces. The main instrument to win and retain the loyalty of key divisions of the political elite is the distribution of patronage. In this respect, one can assume that military forces of the Indonesian state were quite strong. During the Soeharto era, Indonesia had enforcement agencies at central and local levels to enforce all rules and laws. Defence spending in the national budget was only about 2 per cent of GDP but was supplemented by revenue from many military businesses and foundations. The country was at a relative peace with its neighbours, and the military viewed its prime mission as ensuring internal security. Nevertheless, Soeharto’s authoritarian

³⁵ For more detailed stories see Fukuyama (2004)

government evolved into a steeply hierarchical affair characterised by tightly centralised control and long term personalised rule (Alexander, 2004). Soeharto was at the apex of the hierarchy and made important policy decisions, whilst below him was a bureaucratic state in which the military played the central role. In addition, Soeharto also used the economy for political ends. Oil revenues were vital for the Soeharto regime but they also bared a bureaucratic capitalism system:

a system based on patrimonial bureaucratic authority in which powerful public figures, especially in the military, gained control of potentially lucrative offices and used them as personal fiefs or appanages, not only to build private economic empires but also to consolidate and enhance their political power (Alexander, 2004, p. 92).

During the 1970s until the 1990s, pervasive corruption became a political issue that the regime could not entirely stifle. These practices weakened the Indonesian state in that it did not have the capacity “to penetrate society, regulate social relationships, extract resources and appropriate or use resources in determined ways” (Migdal, 1988, p. 4). Robinson (2007) also argues that weak states which are authoritarian, can slip quickly from managed to unmanaged elite conflict when a leader is replaced since they often do not have fully institutionalised and legitimate succession processes.

With regard to state weakness, globalisation allowed parts of the globe by undermining the weak sovereignty even further and made it less likely that such a state could be reconstructed. According to Robinson (2007) this puts state building on the agenda of international politics because it made it a global problem. During Soeharto’s rule international financing institutions and donors tended to avoid discussion on the issue of governance (Meijer & Oey, 2002). The World Bank and the Asian Development Bank explained this by stating that it is the mandate of its institution to respect the sovereignty of the country and not to interfere in its political affairs. Soon after Soeharto’s resignation in 1998, donor countries and international financial institutions started to express concern for governance. In the beginning, it was limited to the recovery of the financial sector and avoided direct interventions in political affairs. At this time the term ‘institutional development’ and ‘sectoral restructuring’ emerged in Indonesia, which in reality, including political matters such as campaigning for the elimination of corruption and changes in the political system (Meijer & Oey, 2002).

Institutional development is one of many approaches used by international agencies for developing the institutional capacity of the state. The institutional

development approach emphasises working with already established organisations in a broader environment to include not only public institutions but also private and non-governmental institutions, to develop the capacity of government agencies as well as the ability to sustain at capacity.

Mann (1984) pioneered a study on state capacity by making a useful distinction between the state's "despotic" power, the ability of decision-makers to act in isolation from or even against the wishes of non-state actors, and "infrastructural" power, the ability of the state to penetrate society and see that its decisions are carried out. By using Mann's distinction between despotic and infrastructural powers, Weiss and Hobson (1995) argue that the state must work *with* rather than *against* non-state actors. Another study by Painter and Pierre (2004) defines state capacity as a measure of the state's ability to mobilize social and economic support and consent for the achievement of public – regarding goals. These studies show that state capacity focused on the relation between the state and society, or on how the state interacted with society. In other words, they implied the degree to which the government and the institutions of the state are able to penetrate, control and extract resources from society. A strong state will thus provide more public goods than a weak state implying the problems of weak states have increased the need for state building.

Some studies have used taxation as a way of measuring the size and scope of the state around the world. For instance, Guyer (1992, p. 57), who studied taxation without representation in Nigeria, says "the public revenue system is a powerful moral, political and economic theory of state and society". In his study of Brazil, Weyland (1996) measures the rise and decline of Brazil's 'Developmental State' with taxation revenues. Chaudhry's analysis of the development of the Saudi and Yemeni states depicts tax collection as an important aspect of state building (Chaudhry, 1997). Similarly, Cheibub (1998) uses taxation as a way of measuring the ability of government to impose unpopular policies, "the extractive capacity of government".

In more recent studies, John (2006), who examined issues of tax reform in post-war economies, states that tax is the most closely related to question of state formation and capability. It also provides one of the principal lenses in measuring state capacity, power and political settlement in a society. Moreover, the OECD (OECD, 2008b) proposes that one of the most fundamental drivers in governance and state-building is the way state revenues are raised, thus "taxation system can contribute significantly to shaping accountability relationships and strengthening state capacities". State-society

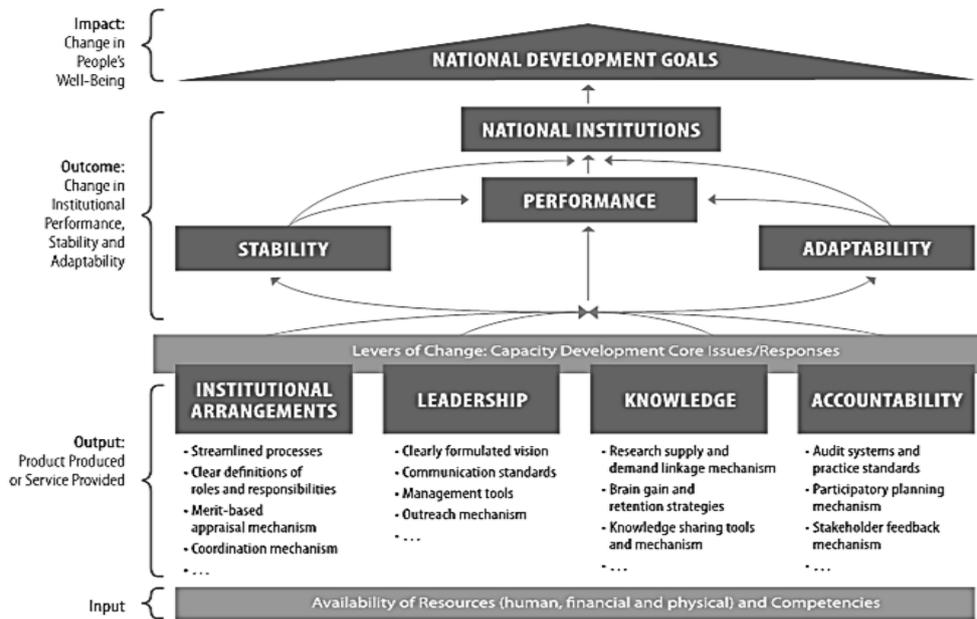
relationship in the area of tax makes a unique contribution to building more effective, accountable states and public institutions.

7. Conclusion

Having noted how a patrimonial state with unfavourable features would challenge any government to move away from patrimonial legacies, the discussion suggests that to cope with the effects of patrimonialism a government needs to promote institutional development. There is no simple formula for institutional development that a country can apply neatly. The process has been a long one with diversity across countries. Institutional development may be achieved through deliberate imitation and adaptation of foreign institutions, and improvised local innovations, as proposed by Chang (2007a). However, it is important to note that in cases where governments are sincerely interested in pursuing institutional changes, they should not be beholden to patrons for support. Instead they have to have the ability to reconcile or resist their supporters' demands, moving ahead with changes would become easier. This research supports Budd's (2004) requirements that successful development planning requires a government to develop vision, autonomy and effective bureaucracy.

The UNDP framework on three levels of capacity building, the individual, the organisation and the environment, is suitable for the case study method in this research. The framework suggests starting by building the capacity of existing resources and competencies in order to transform inputs to outputs, then contribute to the achievement of organisational outcomes, before ultimately impacting on achievement of national development goals. Based on a foundation of existing competencies and resources in an institution, the following framework portrays these three levels, and the connection between them.

Figure 4
UNDP Framework for Measuring Capacity



Source: The UNDP: Capacity Development: Measuring Capacity (2010, p. 7)

In summary, in order to determine factors affecting the institutional capacity of the organisation used in this research, Hilderbrand and Grindle's framework (1995), with its five dimensions, was taken into consideration. The human resources dimension was utilised in discussing the individual level. The organisation and task network dimensions were taken into account in examining the entity level. The other two dimensions, public sector institutional context and action environment, were applied in determining factors affecting national development goals.

International organisations share their experiences in performing institutional development in their respective donor recipient countries and provide approaches to measure the institutional capacity. Developing countries have the benefit of being able to imitate institutions that exist in the more developed countries, considering the right institution that is accurate for their circumstances. In that way, they cut down the cost associated with developing new institutions.

CHAPTER 3. THE IMPLICATIONS FOR STATE BUILDING OF TAXATION REFORMS

“The history of state revenue production is the history of the evolution of the state” (Margaret Levy, 1988, p.1)

It is certain that taxation is fundamental to sustainable development because it supports the basic functions of an effective state and sets the context for economic growth. Levels of tax collection are of intrinsic interest simply because they are the key source of revenue for welfare, defence and other government programs around the world, and because of their influence on markets. Governments use tax systems as policy instruments to achieve many objectives, such as income redistribution, economic stabilisation, providing public goods and services, and fostering economic growth.

This chapter discusses the importance of taxation in the process of state building. Recent research on the role of taxation changed its focus from maximising revenue and compliance to a central strategy for state building. Research on taxation and development also found that raising taxes can strengthen state-society relationships (Moore, 2007; John, 2009; Prichard, 2010). This chapter thus offers an explanation of the process of taxation reform in Indonesia from early 1980s to 2012, in the Soeharto and the post-Soeharto era respectively, with the emphasis on the last major tax reform which was began in 2002. The last reform embraced a multi-year program of development, involving restructuring of the organisation along functional lines, transforming business process, improving human resources management and effective utilisation of information and communication technology.

The implications for state building of taxation reforms will be undertaken by examining the following four issues; taxes as the main source of state revenue, the political economy of tax reform, the relationship between taxation and developing state capacity and taxation reform for state building. These issues shall be examined chronologically ending with a discussion of the Indonesian state building through taxation reforms. In the end, this chapter will be closed by the conclusion which analyses the implications of these developments of a more robust taxation scheme for Indonesia.

1. Taxes as the main source of state revenue

Historically, states have depended mainly on two main kinds of material resources extracted from the societies over which they rule – conscript manpower for military purposes, and financial resources (M. Moore, 2007)³⁶. At present, few militaries depend significantly on conscripts as it is very costly to train personnel and provide them with modern weapon systems. Thus, contemporary states require financial resources as the dominant material resource begging the question ‘from where do states obtain their money?’ Taxation, surplus from natural resources and development aid are the dominant income source for contemporary developing states. Therefore, the following questions need to be addressed: from where do governments obtain their revenues, how much of their income do citizens pay in taxes, who and what is taxed, and how are taxes assessed and collected? According to Moore (2007, p. 16), those questions show the relative complexity of the taxation-governance connection. This will be discussed later in this chapter.

Based on the Indonesian national budget, a full breakdown of revenue sources are separated into two main sources: domestic state revenues and grants. The table below shows revenue resources posture of the national budget in 2002-2012.

Table 2
The Indonesian State Budget Revenue

In trillion rupiah

Year	Domestic Revenue		Grants	Total Revenue	Percentage of Tax to Total Revenue
	Tax Revenue	Non Tax Revenue			
2002	210.09	88.44	0.30	298.83	70.30
2003	242.05	98.88	0.40	341.33	70.91
2004	280.56	122.55	0.30	403.40	69.55
2005	347.03	146.89	1.30	495.22	70.08
2006	409.20	226.95	1.83	637.99	64.14
2007	490.99	215.12	1.69	707.81	69.38
2008	658.70	320.60	2.30	981.61	67.14
2009	619.92	227.17	1.67	848.76	73.04
2010	723.31	268.94	3.02	995.27	72.68
2011	873.87	331.46	5.25	1,210.58	72.19
2012	1,032.60	278.00	5.79	1,292.88	79.87

Sources: Budget Statistics 2006-2012 (MoF), State Budget 2012 (BKF), Buku Saku Pajak Dalam Angka 2001-2009 (DGT) and LKPP 2012 (BPK)

³⁶ As quoted from Levi, M (1997) *Consent, Dissent and patriotism*, Cambridge and New York, Cambridge University Press.

The domestic state revenues include tax revenues and non-tax state revenues. The tax revenue components are income taxes, value added tax and sales tax on luxury goods, land and building tax³⁷, excises, import duties and export duties. These taxes are administered by the central government; in this case, the Directorate General of Taxes (DGT) and Directorate General of Custom and Excise within the Ministry of Finance. The contribution of tax in state revenue shows the increasing amount of revenue every year. In ten years, total domestic state revenue increased fourfold, including tax revenue which increased even higher, to a fivefold amount.

The non-tax state revenues components are surplus from natural resources extraction (including oil and gas), state-owned enterprise profits and other non-taxable revenues such as surplus of the central bank and *Badan Layanan Umum* (BLU – public service agency)³⁸. As the main source of non-tax revenue is profit from natural resources, the government policy efforts were focused on the provision of facilities for operations of the oil and gas mining, strengthening the collection and controlling of oil and gas revenue, increasing the production of coal and mineral commodities, and exploring the potential revenue in the forestry sector (BPK, 2013b). In order to secure revenue from state-owned enterprise profits, policy measures include internal restructuring to improve their performances either through management restructures or state capital involvements. As for other non-tax revenue such as BLU, the improvement efforts were performed through intensification and extension activities, quality services and clearer regulations.

The grants data also showed an increasing amount from 2002 to 2012. This demonstrates an increase in donor countries' commitment to assist the Indonesian government. In 2012, expectation for the grant revenue was for 0.82 trillion rupiah because based on their contracts some donor countries had reached the end of their grant period in 2011. However, the grants received amounted to 5.79 trillion rupiah, which was equal to 701.35 per cent of the target. Besides the donor countries'

³⁷ Starting in 2011, the land and building tax for rural and urban areas was gradually transferred to the local governments.

³⁸ According to the Government Regulation number 23 of 2005, a public service agency is a government environmental agency established to provide services to the community by supplying goods and/or services sold without profit and based on the principles of efficiency and productivity. Its budget surplus can be used in the next financial year except by order of the Ministry of Finance or governors (depending on the organisational structure of the public service agency, either in the central or local government), and the surplus has to be remitted, partially or completely, to the treasury general with regard to its liquidity condition. The most common public service agencies are state universities and regional hospitals.

commitment, factors affecting the huge amount of grant included the Indonesian government’s policy in promoting aid by creating easier grant mechanism and grant accounting system (BPK, 2013b). This also showed the grant donor countries have increased their trust to the Indonesian state.

Notwithstanding the insignificant contribution of non-tax revenues and grants to state revenue sources, the table 2 above shows the pivotal importance of tax revenue as a major source of state revenues in Indonesia and this figure emphasises the need to continue to pursue taxation reform policies. Further discussion on tax revenue is included in chapter 4 which explores the growth rate of tax revenue in accordance with reform initiatives.

Moore (M. Moore, 2007) built up a model of the political implications step by step for the consequences of a governance for being dependent on taxes in the table below.

Table 3
The effects on governance of a state relied on tax revenue

Immediate effects	Intermediate effects	Direct governance outcomes
on the state The state focuses on obtaining revenue by taxing citizen	(i) The state is motivated to promote citizen’s prosperity (ii) The state is motivated to develop bureaucratic apparatuses and information sources to collect tax effectively	More responsiveness More bureaucratic capability
on citizens The experience of being taxed engages citizens politically	(i) (Some) taxpayers mobilise to resist tax demands and/or monitor the mode of taxation and the way the state uses tax revenue	More accountability
on state-society interaction State and citizen begin to bargain over revenues. Taxpayers comply with tax demands in exchange for some institutionalized influence over the level and form of taxation and the uses of revenue (i.e. public policy)	(i) Taxes are more acceptable and predictable, and the taxation process more efficient (ii) Better public policy results from debate and negotiation (iii) Wider and more professional scrutiny of how public money is spent (iv) The legislature (assuming one exists) is strengthened relative to the executive	More responsiveness, political and bureaucratic capability More responsiveness and political capability More accountability More accountability

Source: Adapted from Moore (2007, p. 17)

The table shows that a government in a state which depends on taxes as the main state revenue has a direct share in the prosperity of its citizens as it influences scenarios of the government's future income. The capability of the state to determine and respond to citizens' needs and wants complemented the political capability to define needs and to encourage bargaining and compromise among competing interests, and the bureaucratic capacity to settle on functional policies, to deliver public services and to enforce the authority of the state. In the Indonesian tax law, it is clearly stated that tax is mandatory contribution to the state and used for the greatest prosperity of the people. Therefore, the Indonesian government has incentives to promote that prosperity. Further, dependence on taxes also promotes bureaucratic capacity, this requires the state to develop a reliable tax administrator with professional and un-corrupt tax officials who trusted by citizens being taxed. The Indonesian tax reform programs aimed for this kind of administrator. The citizens may resist taxation or closely monitor utilisation of their tax money, either way the accountability of government tends to increase. The interaction between state and society over taxation issues creates productive bargaining around taxation. Agreements on taxation between the state and taxpayers benefit to a more predictable tax demands, increase taxpayers' compliance and reduce cost of tax collection. These also lead to encouraging policies that are beneficial to both governments and citizens, more specifically the tax administrator and taxpayers.

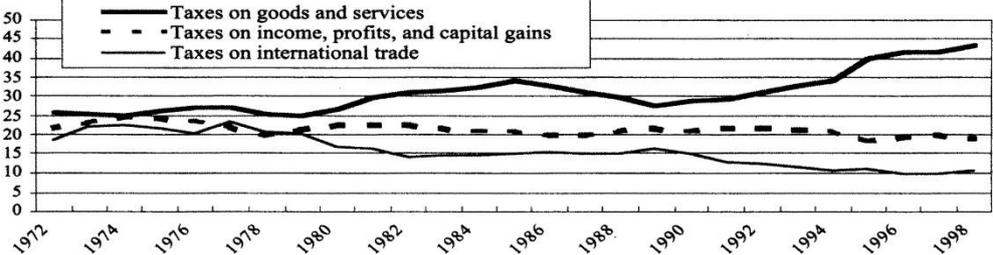
Moore (2007) emphasis that the question of how heavily a government tax its citizens is distinct and conceptually less complex and that taxpayers might take political actions when the level of revenue demand is beyond their expectations. The political implications may not directly emerge but the more taxes to be paid the more citizens are likely to be politically engaged.

2. The political economy of tax reform

The political economy of tax reform remains an under-explored question in many respects (OECD, 2010). Many countries have transformed their formal tax structures and tax administrations, but levels of tax collection have tended to be stable over time. For example, figure 5 shows a portrait of Latin America tax reform by looking at the evolution of three kinds of revenue, average over fifteen countries during 1972 -1998 (Mahon, 2004). The figure shows that revenue from income, profits, and capital taxes declined slightly over the period and nearly symmetrical pattern of falling inflows from

on international trade taxes but there was rising revenues from taxes on goods and services. Issues common to most public sector reform programs explain the difficulty in elevating levels of collection. The OED concludes that, among other elements, is the need for the government’s political will, local ownership, appropriate design, effective sequencing in implementation, strong vested interest confrontation and public support mobilisation.

Figure 5
 Tax revenue by type, fifteen countries, 1972-1998
 (Percentage of total revenue)



Source: WB World Development Indicators

The study of tax reform has been dominated by economists, thus the literature has usually not considered any political, historical or institutional underpinning (Sanchez, 2011). Before the 1990s, economists³⁹ focused on normative issues of tax policy which rested on the assumption that economic and technical factors alone were responsible for inducing tax policy change. Ahmed and Sheikh (2011), who examined tax reforms in Pakistan, stated that political organisations has very critical role in promoting tax culture in a country. Developing countries that have political-economy problems tend to make worse policy choices, and this could also be influenced by colonial legacies. For economists, the political arena tended to be an obstacle to overcome, rather than an arena “in which interests are articulated and the reformer may be able to enhance the long-term viability of the policy innovation through negotiation and the accommodation of various interests” (Sanchez, 2011, pp. 5-6). Sanchez, who examined tax reforms in Chile and Argentina for the period of 1989-2001, states that “...fiscal systems constitute a basic pact between state and society, major tax reform is therefore an important political watershed...”

³⁹ See for example Ascher (1989), Bates (1989) and Gillis (1990)

In the Latin American and Caribbean region, the broadest political interpretation for explaining tax reform is focussed on the concept of the ‘fiscal covenant’, that is, a basic socio-political agreement that legitimises the role of the state and establishes the area and scope of government responsibility in the economic and social spheres. The term ‘fiscal covenant’ suggests that

The objectives of macroeconomic stability, social equity, transparency and efficiency in the public sector will be better achieved if there is an agreement among the various sectors of society on the role of the state in economic and social development, the amount of resources it should manage, the sources of its revenues and the rules governing the allocation of public funds. (ECLAC, 1998, p. 1).

Pakistan, which was suffering from tax aversion, smuggling and corruption, could not make significant progress after two decades of tax administrative reform. Tax evasion showed the inability of the state to extract revenue resources from elite class and big land lord. This country needed a strong political and administrative will to improve its tax culture and tax structure. A sustainable economic development could be achieved if the role of fiscal reforms took a central place in achieving macroeconomic stability.

A study by Steinmo (1993) on taxation and democracy in Sweden, Britain and the United States showed that among established capitalist democracies, tax systems differ significantly in objectives, structure and effectiveness because of differences in the design of their political institutions. Thus the design of institutions decisively shapes tax outcomes because they shape the type of relationship the state establishes with civil society.

In terms of political factors that affect the outcome of tax reform, Ito and Krueger (1992) conclude that domestic political considerations are such important elements that international issues hardly surface in the four countries⁴⁰ being researched. In this sense, the countries performing tax reforms should not have worried too much about other countries’ interventions on their reform implementations. In Japan, introduction of value-added tax failed several times due to changes of government, and it took ten years of struggle to introduce this tax. Homma (1992) analyses the political considerations that lay behind the Japanese tax reforms that took three different governments to achieve. The first attempt by Prime Minister Ohira in 1979 was abandoned when his party lost the general election because of the tax reform

⁴⁰ Japan (Homma, 1992), United States (Charles E. McLure, 1992), Korea (Kwack & Lee, 1992) and Taiwan (Lin, 1992)

issue. Prime Minister Nakasone then reintroduced a value-added tax as a sales tax in 1986 but also failed, with serious political consequences. He was accused of dishonesty as he had pledged not to introduce the tax proposal reform during the campaign and simply waited until his party won the election. The third effort by the Takeshita government won approval in 1988 by introducing a consumption tax, which is a special variant of a value-added tax using no invoice but heavily dependent on bookkeeping.

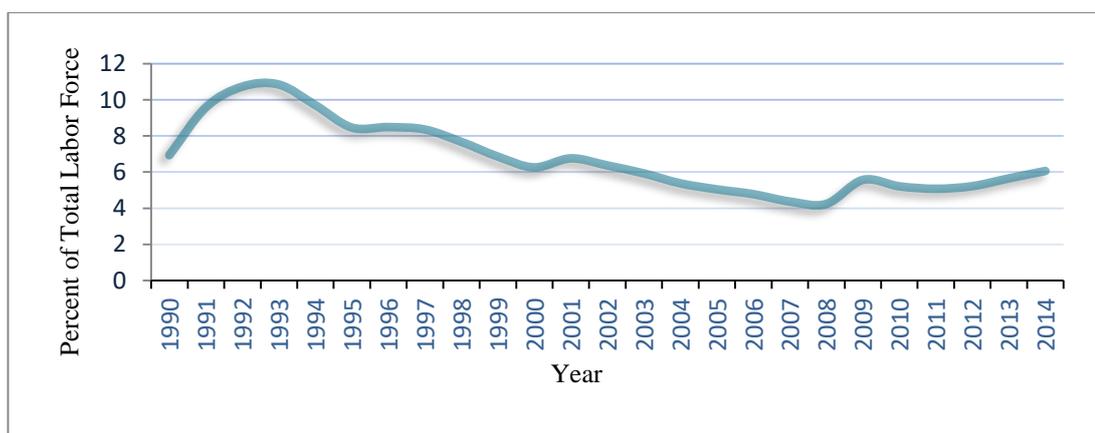
In the United States, a large number of very inefficient exceptions, complications and special treatments introduced into the American tax code over a sustain period of time, were believed to be politically impossible to remove. According to McLure (1992), 'luck' played a large role in the passage of the US Tax Reform Act of 1986. Ronald Reagan was a strong and popular Republican president who detested high tax rates and was supported by his key staff – the Secretary of the Treasury and the White House Chief of Staff. These political figures led a group of technocrats which developed a simplified tax structure without public scrutiny, and turned the tax reform from political suicide to political necessity.

Japan and the US experience above showed that the leader's political will to perform a reform in their government was an important aspect. Another study by Bahl (1989) reveals that the personal and close involvement of the prime minister set the tone for the 1986 Jamaican tax reform, and the active participant of the chairman of the Inland Revenue Department made a great contribution to successful implementation of the reform. Similarly in Venezuela President Perez played a prominent role throughout the process of tax reform began in late 1975 (Abente, 1990). Although the public policy context of taxation reform in Latin America was typically described as authoritarian-clientelist-corporatist: one in which the groups involved in the decision-making process were limited, non-competitive, recognised by the state and enjoyed a deliberate representational monopoly, the Venezuelan policy making process for tax reform differed significantly from those in authoritarian setting. In the reform which culminated with the Taxation Reform Bill of 1978, congress and parties played a significant role, labour and business interest groups were active and influential in enhancing their negotiating position and the executive was powerful but not as powerful as its counterpart in the authoritarian systems. The role of media is thus extremely important in shaping public opinion not only toward the reform issues but also the more general question of the role of the state (Abente, 1990). The

substantial differences between the Venezuelan public policy with those of Latin America demonstrated that regime type was a relevant explanatory variable reflecting shifting in socioeconomic and political consideration.

In 2004, the Australian Election Study revealed the result of a survey that has been doing for so many years with little change in responses. That year, however, it showed a different result for the first time ever. The survey had asked its respondents "If the Government had a choice between reducing taxes or spending more on social services, which do you think it should do?" In the 1980s most Australians (four to one) had clearly supported the tax-cutters, but from the mid-1990s onward that share had steadily declined. By 2004, more respondents favoured social spending (37per cent) than supported tax cuts (36per cent). Considering these results and the analysis of the Federal government budget measures on the 2005 and 2006 tax cuts, Leigh (2007) suggests that the Australian policy makers should generate a greater boost to social welfare than the reductions in top marginal tax rates that had preoccupied them over years⁴¹. Since periods of high unemployment in Australia was no longer the issue in 2004 (see figure 6 below), the importance of health has replaced unemployment as the national issue of greatest public concern. Grant (2004) observes that the strong public reaction on the perceived decline in the standard of health services and the shift in public attention from the cost of private health insurance to the funding of public hospital had influenced the respondents' point of view.

Figure 6
The Unemployment Rate in Australia



⁴¹ See Richard Grant (Grant, 2004). More spending on social services were for health services, old pensions and family benefits, unemployment benefits, single parent payments and assistance for minority groups. Most Australian opinion polls show public acceptance for higher taxes to pay for the popular broad-based items of health services and old age pensions.

Public sector reform programs in Indonesia experienced the same common issues as those countries discussed in the above paragraphs. The governments' political will and strong vested interest confrontation explained the difficulty in elevating levels of collection. In the 1980s Indonesian tax reform process, the drafting of taxation legislation was completed in an extremely secretive way to avoid adverse reaction (Asher, 1997). According to Gillis (1984) this was undertaken after consideration of the experience of the 1968 Musgrave Commission in Colombia⁴². An international team of domestic and expatriate lawyers was given the responsibility of converting tax policy decisions into tightly crafted draft legislation. Unlike the tax reform processes in Japan and the USA, in Indonesia the government hired foreign consultants⁴³ to assist in drafting tax laws due to the government's less confident in implementing the reform. The members of foreign expert team had experience in helping the process of taxation reform in countries such as Chile, Columbia, Ghana, Bolivia, Liberia and Japan. In the process of drafting, inconsistencies in policy decisions were detected and sent back to decision-makers, such as the Minister of Finance and other members of the Economic Cabinet, for resolution before final drafting. However, at the beginning drafting process, there was no significant support from senior tax officials because they had little reason to adopt changes since they already enjoyed financial prosperity compared to other civil servants (Malcom Gillis, 1990).

In the political economy of taxation, it is important to understand the role played by political organisations as they can mediate in conflicts between interest groups, classes and coalitions. Political parties operate in a zone that links state and civil societies. The policy makers are urged to move beyond the technical features of tax reform and develop a more contextualised and political economic view of taxation and tax reform, and their relationship to state development and consolidation. It is very difficult to mobilise public support for tax reform and any reform tends to be perceived as threatening even by those who stand to benefit, owing largely to limited trust in

⁴² The 1968 Musgrave Colombia Commission was distinctive for several reasons, not least of which was that six years later most of the Musgrave Commission proposals were adopted in a comprehensive tax reform. This was also the first reform package to make integral use of an international team of expatriate and local lawyers to draft actual tax reform legislation. For more study see Musgrave and Gillis (1971) Fiscal reform for Columbia, Cambridge.

⁴³ The foreign consultants were 28 members of technical expatriates consisted of economists, lawyers, tax administrators, accountants and computer scientist from six nation; US, Canada, Holland, Chile, Germany and Columbia

government and poor understanding of tax mechanism. The following section discusses in more detail the relationship of taxation and tax reform to state formation.

3. Taxation and developing state capacity

Tax revenues allow states to provide security and fund essential public goods and services. Editors of the book titled *Taxation and State Building in Developing Countries* (Brautigam et al., 2008) quote Margaret Levy's declaration that "The history of state revenue production is the history of the evolution of the state (1988:1)". The World Bank also emphasises that tax systems are instrumental to building effective states because taxation is a core manifestation of the social contract between citizens and the state (John, 2009). The question of how taxes are raised and spent shapes government legitimacy by promoting accountability of governments to taxpayers and by stimulating effective state administration and good public financial management. Therefore, taxation should be accorded a central role in the analysis of state building.

The nature of societies such as societal characteristics and social organisation and the way these aspects shape collective action and the state building project demonstrates features of state-society relations. Brautigam (2008, p. 25) emphasises that "societies shape state-building, and taxation is a strategic nexus between the state and society". The relationship is affected by macro social factors like power, class and race, and makes the aspects of society central to the way taxation affects state building and governance.

The standard economic approach to framing the relationship between taxation and state building is to explain the level of taxation and, implicitly, the government's capacity through a combination of the level of economic development and economic structure (Brautigam et al., 2008). Taxes whether direct or indirect are linked with the economy of the country and that is generally represented with the term Gross Domestic Product (GDP). Tax revenue to GDP ratio or simply 'tax ratio' is the ratio of total government tax revenue by the country's GDP. Countries with higher incomes have higher tax ratios, which accompany the rise of other factors in developments such as literacy, industrialisation, and debt. This shows an augmentation at relationship between taxation and state capacity. Detailed discussion on the Indonesian's tax ratio is presented in Chapter 5.

As noted earlier, improvement in tax administration may lead to broader improvement in state capacity through four channels. According to Prichard (2010, pp. 13-14) reform of tax administration may:

1. Prompt administrative innovations, such as increased meritocracy or improved internal monitoring, which subsequently spread throughout the civil service;
2. Generate pressure for improvements in related agencies essential to tax collection, such as business registration, foreign investment promotion and land registration;
3. Require an enhanced government presence in remote areas, thus also expanding the reach of government services; and
4. Provide data and information that is essential to other government activities, such as economic planning, business promotion or service targeting.

In addition, the World Bank (John, 2009, p. 3) concludes that sound and fair domestic taxation systems promote good governance because:

1. Raising taxes efficiently requires political effort to secure taxpayer consent;
2. Raising taxes effectively requires the development of a competent bureaucracy; and
3. Raising taxes equitably requires political concern for the fair and equal treatment of citizens by the state.

As a summary, taxation is at the centre of good governance, civil society and state building. The perceived fairness of the tax system is very important for building an effective state based on citizens' consent. Willingness to pay taxes is a good indicator of the perceived legitimacy of the state. The tax system is also central to state building as building compliance is a central incentive for the state to engage with society. The state building approach to taxation thus requires a well-structured tax policy and its administration.

According to Brautigam, Fjeldstad and Moore (2008, p. 1), there are two principal areas that show the role of taxation in state building: "the rise of a social contract based on bargaining around tax and the institution-building stimulus provided by the revenue imperative". Progress in the first area may foster representative democracy and in the latter it strengthens state capacity. Both areas have the potential to bolster the legitimacy of the state and improve accountability between the state and its citizens.

The OECD (2008d) identified how a social contract can be established around taxation. The study found that when a government depends on a large number of

taxpayers for state revenue it has incentives to promote broad prosperity and to develop bureaucracies capable of collecting and administering taxes effectively. This makes the government more responsive to its citizens and helps build state capacity. Comprehensive programs of tax reform also have the potential to improve governance. By implementing more transparent tax administration systems a government can encourage taxpayer mobilisation and by widening the tax net it then leads to improved relations with taxpayers and thus increase voluntary compliance. Moreover, it can encourage taxpayers to engage in constructive bargaining with government, such as by monitoring how tax is collected and used. As tax compliance increases, an OECD report (2008d) found that state capacity improves and the taxation process becomes more efficient.

Tax reform is meant to create an improved tax administration. But can a tax administration, as an authorised revenue collector for the state, be a catalyst for broader administrative gains? It is a central to many studies that there is a prediction that the positioning of tax administration in mobilising revenue for the state is more likely to create positive effects. However, limited existing research and evidence on tax reform has yet to provide a detailed illustration of these positive impacts, suggesting four other scenarios instead (OECD, 2010).

First, improvements in tax administration may build state capacity through strengthening linkages between tax administration and other areas of government. Through strong linkages, improvements and innovations in tax administration are either transmitted relatively explicitly to other areas of government, or create pressure for reform in those related agencies. Building linkages across government is also useful for improving information sharing such as with business registration, the land registry, vehicle licensing, and investment promotion agencies, which have important information for tax collection purposes.

Second, data collection, sharing and transparency are given priority as these are essential to aid broader economic management. The ability of tax administration to collect data and share it with other institutions has the potential to produce system-wide benefits. Tax data can also be valuable in helping tax administrators with law enforcement efforts. The simplest example is that tax returns can quickly identify unexplained income or suspicious assets that cannot be explained by declared income.

Third, administrative innovations are potentially replicable if the elements of tax reform are relevant to other areas of public administration. For example, reforms

that emphasise meritocracy in hiring, performance management and evaluation or citizen outreach may be very relevant to other areas of government and it is important to emphasise reform strategies and innovations that may have broader relevance for building state capacity.

Fourth, tax administration reform is extended to local tax administration. Improvement in local tax administration combined by cooperation between national and local tax officials could allow tax administrative reform to be used as a vehicle for improving broader government capacity.

Besides those four considerations above, improvements in tax administration may also build state capacity by example. The experience of the introduction of a unique Taxpayer Identification Number (TIN) in Latin America is one example (Prichard, 2010). TIN was initially introduced for tax administration alone, but then additional government institutions immediately began utilising the same number in order to improve information sharing, which lead to broad improvement in performance and data management. In Chile, the TIN is used by various agencies that interact directly with the tax administration, including municipal government, the civil and company registries and private bank.

Prichard's (2009) study in Ghana reveals that the plan to modernise taxation became a part of a larger "E-Ghana" information technology (IT) modernisation programme supported by the World Bank. The 2006 program was intended to create an IT system that would explicitly link the Internal Revenue Service to agencies responsible for business registration, vehicle licencing, land registration and customs. This would have vastly improved IRS performance. Unfortunately, the program remains in the planning stage due to the high cost and bureaucratic and political resistance. Throughout Latin America, the tax authorities were frequently leaders in the introduction of e-government functions, particularly through e-filing of tax returns and the electronic management of customs clearance. In Ghana, the company that runs the IT system for customs administration is responsible for a broader civil service IT reform program.

The lack of coordination between national and local tax officials may create a high degree of arbitrariness and abuse in a local tax system, while little attention is paid to economic efficiency. In Ghana, the absence of effective taxation outside of major centres made local tax officials sometimes urge citizen to pay local taxes instead of national taxes. Meanwhile, local officials complain that the national government

has monopolised virtually all available tax bases and offers little if any administrative support (Prichard, 2009). This happened in Indonesia in early 2000s but with the enactment of regional government law in 2004, the regional administrations were provided with the broadest possible authority as the local taxes and levies is one source of income important area. Local policies were then implemented using democratic principles adjusted to the tax potential areas: equity and justice, community participation and accountability.

4. Taxation reform for state building

Before describing the importance of taxation on state building, it is necessary to clarify state building's definition. State building is "the process of increasing the administrative, fiscal and institutional capacity of governments to interact constructively with their societies and to pursue public goals more effectively" (Brautigam et al., 2008, p. 2). It is a social process that unfolds over long periods of time. It lends itself well to methods emphasising the consequence of history and those that improve a role of power bearers and state-society alignments⁴⁴. State building also has been defined as "an endogenous process to enhance capacity, institutions and legitimacy of the state driven by state-society relations"(OECD, 2008c). In simpler terms, Fukuyama (2004, p. ix) defines state building as "the creation of new government institutions and the strengthening of existing ones." He points to an analytical framework for understanding the multiple dimensions of 'stateness' – namely, the functions, capabilities and grounds for legitimacy of governments. This framework explains why states are not too strong but rather too weak, in most developing countries.

According to John (2009), taxation and tax reform is central to state building, viewed as the process through which the state enhances its ability to function, for several reasons:

1. Governments must be able to ensure sustainable funding for social programs and for public investment to promote economic growth and development;
2. Taxation is the main nexus that binds state officials with interest groups and citizens;

⁴⁴ For more detailed discussions, see for example Barrington Moore (1966), Sven Steinmo (1993) and Atul Kohli (2004).

3. Taxation, particularly in the form of land and property taxes, customs and border collection, can help increase the territorial reach of the state;
4. Fiscal capacities are needed to build a legitimate state;
5. Taxation is central to the construction of survival functions which refer to a set of core processes essential to the survival and strength of the institutional framework of the state;
6. Taxation contributes to the achievement of an expected level of functionality which is an important part of the state building process.

The state building approach to taxation requires the construction of a tax policy and its administration. This, according to John (2009), can strengthen the legitimacy of the state in the eyes of its citizens through five core characteristics: political inclusion, accountability and transparency, perceived fairness, effectiveness, and political commitment to shared prosperity. By paying taxes citizens are encouraged to engage with government and the political process. Taxpayers demand explanation for the utilisation of tax revenue and perceive that the state treats them equally and impartially. The tax system component of the state building must promote economic growth with better public goods, more capable government and increased political stability.

Based on the strengthening of state legitimacy and the ability to mobilise revenue for the state, Everest-Phillips (2010, pp. 81-90) identifies the same characteristic for a state building tax system as John's and recognises two more principles, legitimisation of social norms and economic interest, and effective revenue-raising.

The usage of tax revenues is justified to taxpayers, who demand to know if tax revenues are properly used. Explaining transparency on how taxes are spent and maintaining accountability for a relationship of trust with taxpayers are crucial in maintaining public confidence in the tax system. The right of taxpayers or taxpayer charters upheld by tax appeals boards and tax tribunals are important institutions for securing taxpayers' rights and establishing fair and transparent procedures to address disputes.

Principles of fairness and effectiveness are both important for a state building tax system. Tax administrative attitudes, incentives and discretion are potentially problematic and can result in unequal treatment. Within a strong tax system, taxpayers perceive that they are treated equally and justly by the state. Perceptions of unfairness,

such as failure to address widespread tax exemptions or the informal economy, limit both revenue and willingness to pay. Taxation always acts as a key incentive for states to create competent administrations with the administrative capability that translates increased public revenues into better public goods, encourage more capable government and increases political stability. Effective taxation system however, must be able to collect enormous amount of information efficiently.

Successful state-building demands political leadership with a vision of tax as delivering a national purpose supported by actual and potential taxpayers. Political commitment that can deliver a political vision of national purpose built on political stability is important to an effective tax system. The tax system component of the state building effort must explicitly link to a national strategy for promoting economic growth.

Effective tax reform requires proposing valuable incentives that encourage taxpayers to develop tax compliance. The state through the fiscal system can convey official national recognition of social and economic institutions, in which they feel that their significant payment for taxes receiving benefits in return. This in turn can be highly significant in motivating citizens to support the legitimacy of that state. Lastly, effective revenue-raising means effective in terms of the other six principle of state building. An effective state needs adequate resources for providing the physical security, property rights and effective contract enforcement needed to deliver economic growth with appropriate welfare systems that secure political stability.

According to Fjeldstad and Moore (2007) tax reform might contribute to state building through four channels: providing revenue, shifting toward more appropriate revenue sources, creating more effective tax administrations and encouraging constructive state-society engagement around taxes. In most cases, tax reform agendas promise the delivery of increased revenue. In doing so, governments have to have the organisational capacity to make a successful transition to more demanding revenue sources. Tax reform also represents a shift of the tax burden toward more diversified revenue sources, for example, a shift toward other type of consumption tax such as value added tax, taxing the informal sector, or tax exemption for aid funds.

Fjeldstad and More (2007, p. 9) state that “the notion of improving tax administration is so open and ill-defined that it may be difficult to imagine how it could have become one of the pillars of the global tax reform agenda”. The simultaneous spread of digital information and communication technologies have made possible a

range of new ways of organising and working the tax administrations. In order to encourage constructive state-society engagement around taxes, tax reformers would want to arrest the attention and political energy of a substantial fraction of their citizens in taxation issues by raising taxes from them. They felt the experience of paying taxes should be shared sufficiently to ensure that taxation issues become prominent on the public political agenda. In addition, tax reformers would want to levy taxes as consensually and as transparently as possible. It is true that taxation experiences should be noticeable by the public to show them that changes in the reform agenda aimed for an improved tax administration that supports increasing tax compliance. Citizens need to be assured that their tax obligations are being closely monitored and their tax money is spent wisely for their prosperity.

5. Indonesian state building through tax reforms

Lledo, Schneider and Moore (2004) set out a useful categorisation of some of the many approaches to tax reform found in the literature. The four approaches are as follows:

1. The public economic approach; the focus of this approach is on setting up a tax system that maximises social welfare, balancing efficiency and equity in accordance with society's objectives.
2. The macroeconomics approach; this approach focuses less on the internal structure of the tax system and more on the impact of taxes on real aggregates, such as the growth rate and the level and distribution of income and wealth.
3. The administrative approach; this approach emphasises the interplay between what can be done and what should be done. It stresses simplicity.
4. The political approach; this approach recognises both that there is no such thing as the benevolent dictator implicitly assumed in the public economics approach, and that taxation always reflects the clash and interplay of interest within an evolving institutional context.

Based on the above approaches, the Indonesia tax reforms are blend of the public economic approach and the administrative approach. The reforms were regarded as a public economic approach in the sense that the goal was to increase state revenue so that state expenditure could be funded, and society would have a better welfare. It utilised the administrative approach as the effort of the reform itself was actually towards a more efficient and effective tax administration. Bird (2004) suggests a simpler approach for those charged with instituting and implementing sustainable

tax reform, that is by dividing the process of tax reform into three distinct stages. First, policies are formulated, then they are authorised legally, and finally they are implemented. In this straightforward approach, defining the tax reform process as encompassing both the formulation and implementation of proposals would both improve the quality of the reforms process and increase the likelihood of their adoption and successful implementation.

However, designing an appropriate and workable tax reform is not an easy task in any country. There is no simple answer to the many complexities facing those who undertake this task. Each country performing a tax reform must take its own particular path. As Bird (2004) emphasises, any major tax reform is unique in the sense that it takes place in the unique circumstances of that place at that time. Khalilzadeh-Shirazi and Anwar (1991) state furthermore that tax reform is often a sensitive and difficult process, since the gains from comprehensive reform often become visible only in the medium to long term.

Countries often succeed in implementing fundamental tax reforms which go beyond small changes in tax rates and provisions. They can be confined to one tax or involve a more complex package of tax increases and reductions. They can be designed to be revenue neutral or to increase or decrease tax revenue. Brys (2011) adds that fundamental tax reform can be systemic, involving fundamental changes in tax rules and structures, or a limited parametric change in existing rates. However, from the outset, tax reform proposals set the framework for reforms. There is a possibility that the implementing tax reform is revised to such an extent during the process and then results in different tax reform objectives. This can happen when policy makers wrongly anticipate the obstacles that should be overcome and thus policy makers must be aware of the major challenges they are likely to face during the reform process.

In Indonesia, fundamental tax reforms have been complex packages of tax rate increases and reductions, but always designed for increasing tax revenue and involving fundamental changes in tax rules and structures. Formulating an approach to tax reform is never an easy task, as policy makers confront a hard choice between attempting to adopt a comprehensive tax reform more or less at once, and pursuing a more incremental strategy. In general, comprehensive tax reform is preferable when the institutional and political context is favourable, the reform's objectives are clear, and the obstacles may be predicted (Brys, 2011).

Indonesia's reform efforts were also carried out in various countries in recent decades. Their efforts have been tremendously similar across countries and circumstances, as a result of pressure from international institutions and the growth of a global tax experts' community (Fjeldstad & Moore, 2008; Prichard, 2010). The existing global tax reform agenda usually includes tax structure and tax administration. Indonesia is one of many countries which implemented this kind of reform agenda.

As discussed briefly in the introductory chapter, several fundamental tax reforms have been performed by the Indonesian government during different eras. Even though the starting point of Indonesian state building for the contemporary economic journey is the East Asian economic and financial crisis in 1997-98, it is worthwhile to understand what happened before that time given that reform is a never-ending process. Previous reforms were definitely useful experiences and valuable bases for the following reforms and the sections below explain key tax reforms performed since the 1980s (the Soeharto era), with a detailed account of modernisation of the tax administration system begun in 2002 (the post-Soeharto era).

1983 Tax Reform: Initial movement towards a more simplified tax administration

In 1983, the Indonesian government implemented the first major tax reform. As mentioned in the introductory chapter, this reform was fundamental as taxpayers started to be given the authority for determining and calculating their own tax base and the amount of tax to be paid, as well as paying that amount directly at a bank or post office; it is known as the self-assessment system. The reform introduced much simplified regulation reflected in the structure of five tax laws with 156 articles and include only nine tariffs, compared to the previous structure which consisted of 13 tax laws with 587 articles and included 270 tariffs (Tjakradiwirja, 1993). The new laws, as Gillis (1984) states, replaced out-dated, complicated and unproductive taxes which had been enacted several decades earlier by the former Dutch colonial administration. The corporation tax dated from 1925 and the individual income tax from 1944. The sales tax, enacted in 1951, was a form of turnover tax that by the 1980s had been discarded by every country in the world. The property tax, dating back to the 1600s and applicable to both urban and rural areas, was collected mainly from the latter and had degenerated to insignificance with ever-growing exemptions (Tanzi & Shome, 1992).

Before 1983, the tax system was extremely complex and collection was small⁴⁵. Direct taxes were a combination of royalties, property and income taxes, though they were all treated under the income tax nomenclature for foreign tax credit purposes. They included exemptions and exclusions that were not implemented efficiently. Progressive scales applied to both the personal income tax and the corporate income tax. The term ‘progressive’ refers to the way the tax rate progresses from low to high. In other words, a progressive tax is a tax where the tax rate increases as the taxable base amount increases. Consumption taxes comprised a turnover tax, selected excises and custom duties. The turnover tax operated in cascading tax that was applied at every stage in the supply chain without any deduction for the tax paid at earlier stages. It was subject to eight rates differentiations resulting in distortions and evasion. Tanzi and Shome (1992, p. 49) conclude that “there was a widespread belief that tax administration was very poor while evasion widespread”. The complexity of the tax system stimulated evasion and corruption, and thus only a fundamental reform could improve the situation.

Moreover, procedures for tax collection were ill-suited for any tax system. Tax evasion was a relatively simple affair for most corporations with or without bribing tax officers. In some cases, statutory penalties for non-compliance were rarely applied, and in others so light as to constitute no deterrent. Frequent contact between tax officials and taxpayers in official-assessment system resulted in increasing the scope for corruption in tax compliance and collection. Without regretably a fear of consequence laws are only good for those who will adhere to them without penalty. Withholding tax mechanism was then heavily applied with intention to enhance simplification and enforcement.

There was also an unsatisfactory taxpayer identification number system, and automatic data processing of tax information was completely absent. The original drive for the reform was not fiscal crisis, but was more focused on supplanting a projected decline in oil revenue, in addition to achieving more effective income redistribution, simplification of taxation, a new tax information system and streamlining of tax administration.

⁴⁵ Compared to other Asian countries (Singapore, Korea, Malaysia, Thailand and Philippines), the Indonesian tax ratio was below the average rate and steadily declined during 1978-1986 (Tanzi & Shome, 1992).

The key features of the 1983 reformed system included a new income tax law applied to both, corporates and individuals, lower tax rates, a simplified fringe benefit treatment, a new withholding mechanism, and a new value-added tax (VAT) law. The new income tax law replaced a complex maze of four separate taxes on businesses, individuals, interest, dividends and royalties, and withholding tax. The lower tax rates became a strong argument for abolishing tax incentives which were found to be weak tools for attracting foreign investment. The new VAT law was a consumption-type VAT to simplify tax administration.

According to Amir et al. (2013), it is typical in developing countries that tax systems are not efficient due to lack of modern tax administration and a limited number of taxpayers. In Indonesia, prior to the 21st century, this situation was worsened by the high level of tax avoidance and corruption. If a government expects to continue developing the economy, taxes are the only avenue for raising the needed revenues and it will have to deal seriously with those twin problems. If not, the reform will end up being no more than an example of government's inability to overcome the inefficiency that has tainted so many tax collection efforts for decades (Prawiro, 1998).

In many developing countries, tax experts were strongly opposed to the use of tax incentives which were seen to breed corruption and rent-seeking activities and to negatively affect the quality of the tax system, and were often seen to be ineffective. The effectiveness of tax incentives may depend on the characteristics of the public bureaucracy (Tanzi & Shome, 1992). In countries where the public bureaucracy was made up of well-paid, well-trained, powerful and respected elite, and where the population was highly homogenous and deeply committed to achieving particular social goals, the use of tax incentives did not lead to these harmful influences. For example, in Korea, Singapore and Taiwan, civil servants used the incentives to push economic decisions that facilitated the growth process (Tanzi & Shome, 1992). In Indonesia, the government tried through tax incentives to encourage export as well as investment in industries, by applying five year income tax exemptions (tax holidays) for priority industries and tax incentives to hold domestic equities and to invest in particular regions, whilst at the same time, attempting to discourage investment in unproductive expenditure through high income tax rates. However, the incentives were not equally applied and had not been effective tools to attract investment. For example, tax holidays usually involved hidden cost beyond the real cost of taxes foregone during the tax holiday period (Malcolm Gillis, 1984).

Based on their research on several studies⁴⁶ of the Indonesian tax reform, Tanzi and Shome (1992) conclude that the reform has been successful in certain respects at least. Firstly, it has reduced external distortions caused by the previous tax structure which was influenced by current world thinking. Secondly, it increased tax revenues, especially from VAT which doubled in three years. Lastly, administrative reform was a major objective in which initial gains seem to have been made. Another study by Ikhsan et al. (2005) concludes that the tax reforms were successful in increasing government revenue, but were not at the optimal level.

In the 1983 tax reform, the government played a major role in the provision and the maintenance of a stable economic framework and the promotion of growth. The structure of tax administration was directly related to macroeconomic stability, in the sense that raising tax revenue necessarily helped reducing fiscal deficit as a result of decreasing revenue from oil and gas. The abolition of tax incentives, which were seen as trigger of corruption and rent-seeking activities, positively affected the quality of tax system. In addition, a long time preparation in organising tax reform allowed the government to incorporate a large expansion in training program for officials as well as important non-structural issues such as tax procedures reform and establishment of a computerised tax information system. The implementation of self-assessment system indeed created engagement between taxpayers and tax officials, or in general terms, between citizens and the state. This supported the increasing state capacity and made a stronger base for state building. After ten years of implementation, it was deemed necessary to revisit the 1983 tax reform. Unfortunately, evaluation of the results indicated that many taxpayers exploited the implementation of self-assessment system by avoiding paying the right amount of tax or performing tax evasion. Therefore, the government decided to have another fundamental reform in 1994.

1994 Tax Reform: Providing legal provisions to prevent tax avoidance and evasion

After ten years of enforcement, it was deemed necessary to revisit the 1983 tax reform. Evaluation of the reform results indicated that many taxpayers exploited the implementation of self-assessment system by avoiding paying the right amount of tax or performing tax evasion. Unlike in developed countries where implementation of

⁴⁶ See also Booth and McCawley (1981), Asher (1989) and Gillis (1990) among others.

self-assessment system has encouraged taxpayers to make tax planning, taxpayers in developing countries including Indonesia manipulated the system legally or illegally in order to lower tax payments. While tax officials' attitude in developed countries were in general more disciplined, in Indonesia tax officials were actively looking for chances to earn money for individual advantages by abusing their authority (Bawazier, 2011).

The reform program was continued in 1994, in order to protect the implementation of self-assessment system effectively by reducing contacts between tax officials and taxpayers. It also aimed to implement final income tax rates, combat corruptions and collusion, and of course increase tax revenues. A final income tax is a simple way of imposing tax because tax payers can calculate the amount of tax due only by multiplying their specific income with a single flat rate without considering any tax deductions or allowances. In a final tax, loss is not recognised, any taxpayer pays the same amount of tax, whether they gain profit or suffer from loss in their entities. The specific incomes imposed by a final income tax rate include income from rent, prizes or lottery, deposit and saving interests. Another goal of the reform was to put investment as high priority in the economic sector by reintroducing specific tax incentives that have been eliminated in the 1983 reform. These objectives were indicated in the amendment of four tax laws, namely, general rule and tax procedures, income tax, value added tax and property tax. In 1994, these tax laws were amended to in order to comply with the reform objectives. Changes in tax laws also aimed to provide more fairness, improve services to taxpayers, increase certainty and law enforcement, as well as anticipate advances in information technology. Systems, mechanisms and procedures for the implementation of the rights and obligations of a simple tax characterised and patterned the changes which still adhered to the self-assessment system.

The key features of the 1994 reform were the introduction of final income tax, a more progressive income tax rates, and a clearer definition and scope of tax subject and object. Income tax is a final tax on certain income where a taxing mechanism has been deemed completed at the time of withholding, collecting or depositing itself by the taxpayer concerned. A final income tax rate is usually imposed on withholding taxes. Final withholding taxes are taxes in which the payee cannot claim any tax credit when calculating the income tax payable for a year of income. The consideration underlying this special treatment is given for the sake of simplicity in taxation, justice

and equity in taxation treatment so as not to add to the administrative burden for taxpayers and the tax authority, and with regard to economic and monetary development. Taxpayers appreciate the implementation of final income tax because the mechanism was simple and easy, and provided more legal certainty and fairness to taxpayers with the same type of income. For tax offices, the implementation of final income tax was easier to administer and required lower collection cost. The amendment of value added tax law mainly covered improvement of the scope of taxable goods and services, and tax refund issues. Meanwhile, the amendment of property tax included the introduction of non-taxable objects and a new mechanism for property tax appeals.

In 1997, the government enacted four new laws on tax court, tax collection with coerce warrant, non-tax state revenues and acquisition duty of right on land and property, and amended the law on local taxes and levies. However, this 1997 tax reform was actually part of the 1994 tax reform. It took three years to finalise the legal drafting and obtain parliamentary approval for those four new laws and one amendment and it is important to note that tax reforms in 1994 and 1997 were handled by domestic officials without any help from expatriate consultants (Bawazier, 2011).

As discussed above, the 1983 tax reform eliminated specific tax incentives, as they revealed corruption and rent-seeking activities, and were often seen to be ineffective. In the 1994 tax reform, incentives were reintroduced to make investment a high priority in the economic sector. According to Tanzi and Shome (1992, pp. 58-59), government bureaucrats believe that with proper tax incentive policies, costs of collection may be reduced by increasing the scarce factors of productions. For instance, the incentive policy that favours technologically advanced activities signals to investors that the government seeks to generate a desirable habitat in those activities. This incentive stimulates investors to search for and acquire the relevant technology. Later on, it signals to individuals that education in technical fields is well compensated. The study of tax reform in Korea, Singapore and Taiwan shows that the tax incentives may have an announcement effect that in time improved the comparative advantage of the country (Tanzi & Shome, 1992). The reintroduction of tax incentives in the Indonesian 1994 tax reform was intended to make the announcement effect worked and accordingly increased investment.

2000 Tax Reform: stronger legal bases for tax intensification and extensification

Very similar to the 1994 tax reform, the reform in 2000 was presented with emphasis on policy and legal amendments. The changes in laws and their implementing regulations were reinforced in response to economic crisis and five laws were again amended. Those laws were general rules and tax procedures law, income tax law, VAT law, tax collection with coerce warrant law, and acquisition duty of right on land and property.

There were few substantial changes in the 2000 law amendments, the changes consisting mainly of elucidating tax subjects and objects in more details, so that tax intensification and extensification programs could be performed with fewer loopholes in the regulations. In tax intensification programs, additional tax revenue is explored from existing taxpayers by utilising external and internal data, based on the data taxpayers are convinced to recalculate their tax due and submit revised tax returns. In tax extensification programs, efforts to obtain tax revenue are performed to those who have not registered as a taxpayer and by broadening tax base in which the government imposes taxes to other kinds of assets or certain amount of revenue that have not been taxed before. For example, the DGT received data on buyers of luxury cars which can be matched with taxpayers' list of assets or reported revenue. If taxpayers list of assets does not include a luxury car or their reported revenue does not show a sufficient amount to buy a luxury car then the DGT performs the intensification program by commanding these taxpayers to fix their tax returns. In case the buyers have not registered as taxpayers then the DGT performs the extensification program by telling the buyers to get their tax identification number and then educates them on their tax obligations

The aim of the amendments was not only to support tax intensification and extensification programmes but also to provide a fairer tax burden and to eliminate incentives that did not have strong legal bases and harmed the national economy. The income tax law amendments included transfer pricing issues and restriction on 'final income tax'. In addition to the five amended laws, the law on tax court was also revised in order to provide more fairness and legal certainty for taxpayers. Again, the discussion in parliament took longer than expected as it was enacted two years later.

As mentioned in the introductory chapter, in generating revenue, these three major reforms had many positive results but have not yet encompassed good governance elements. Good governance exists where the DGT is perceived to have

acquired legitimate human resource capability showed by having professional tax officer with integrity that enhances productivity, tax compliance and improving the image of the DGT in the eyes of the public. In addition, an appropriate voice is accorded to those whose interests are affected by decisions (Rizal, 2011). Good governance should result in performance that is responsive to the interest of taxpayers and other stakeholders. There should also be genuinely accountable participation between the DGT as the agent and the government as the principal. Accountability cannot be effective unless there is openness and transparency in the conduct of organisation's work. Lastly, governance should be fair, which implies compliance to the rule of law and principles of equity. In this context, the next major tax reform encompassed good governance.

On the other hand, these three reforms made the state-society relationship growing stronger. The implementation of the self-assessment system in tax administration in the 1984 reform began to develop the state-society relationship as the government gave taxpayers the authority to calculate and report their tax due. Law amendments in the 1994 and 2000 reforms enhanced the relationship as both reforms upheld the principle of fairness by creating equality in the laws. A rule imposing sanctions was not only set to taxpayers who broke the rules but also to tax officials who did not perform their duties properly. Thus, the taxpayers felt more justice and put more trust in the government. The next tax reform was discussed in more details as it played a significant role in the Indonesian state building.

6. Modernisation of Tax Administration since 2002

The year of 2001 would become pivotal for tax administration reform in Indonesia. In that year, the national budget targeted a substantial reduction in the deficit which would require, among other things, increasing tax revenue. About one-half of the revenue increase was to be generated through tax administration improvements. To achieve the targeted increase, the government called upon the tax authority, the DGT, to identify specific administrative measures for increasing tax collections. Linking the tax administration reforms to higher order economic objectives would prove crucial to locking in the political commitment needed to implement DGT's reform agenda. Problems in tax administration were perceived as being among the top obstacles to doing business in Indonesia, so the taxation reform strategy was eventually broadened to include measures aimed at simplifying the compliance requirements of the tax

system, promoting integrity among tax officers, and a number of other investment-enhancing initiatives.

The tax administration reform prepared in 2001 is called as the “Modernisation of Tax Administration”. Later it was called the Tax Administration Reform Phase 1 (2001-2008), with the process of modernising all the DGT units completed by the end of 2008. The reform continues with the launching of the Tax Administration Reform Phase 2 (2009-2014), the so called “Project for Indonesian Tax Administration Reform (PINTAR)”. The PINTAR was the Indonesian government project supported by the World Bank which focused more on developing information technology, business processes, human resources management information system, and corporate culture and practices (World Bank, 2008). It aimed to lead the DGT to a clean bureaucracy showing an absence of official corruption and more transparency as an institution. Furthermore, it would change tax officials’ behaviour, provide a better service to taxpayers and increase state revenue.

PINTAR is a major transformation of organisation and corporate culture and practices, which requires strong change management leadership. Its objectives are to (i) increase taxpayer voluntary compliance by lowering the compliance costs and increasing the efficiency and the effectiveness of the DGT, and (ii) improve integrity, efficiency and governance in tax administration by strengthening transparency, professionalism, accountability and control mechanism (World Bank, 2008). The core tax system improvements include taxpayer registration, returns processing, taxpayer accounts, document management, and integrated systems architecture. A full description of the PINTAR core tax project can be found in the appendix 7. These improvements, supported by systemised audit, collections, objections and appeals, are designed to improve taxpayers’ compliance. In addition to developing human resources information systems, there are also efforts for enhancing policies and procedures, capacity building and internal control system.

In general, the modernisation of tax administration focuses on organisation, business process and human resources management. In order to catch up with the development of the business sector and to adapt with changing environment, the DGT has to innovate and perform continuous improvements in its organisation. The transformation of business process is one of the key strategies in modernising the operation of the DGT. This makes the tax system easier for taxpayers to comply with and for tax officers to administer. The utilisation of adequate and appropriate

Information Technology (IT) is also an important key factor. Without IT improvement, the DGT will struggle to catch up with innovation in the business sector. The utilisation of IT may enhance transparency and minimise misconduct through automatic monitoring system. And reform in human resource is critical to achieving sustainable performance improvements. The capacity of tax officers to carry out their duties should be continuously improved to perform higher productivity leading to higher public trust in the DGT.

Prior to discussing each focus of the modernisation efforts it is important to recall that the DGT has a primary duty to formulate and implement technical policies and standardisation in the area of taxation. In executing its main task, the DGT performs the functions of:

1. Preparing the taxation policy of the Ministry of Finance;
2. Implementing tax policies;
3. Preparing standards, guidelines, manuals, criteria and procedures in the taxation area;
4. Providing technical guidance and evaluation in the taxation area; and
5. Performing tax administration.

Tax policy-making entails the creation of the core properties of tax legislation from the tax acts themselves to the lowest level of rules in the following order:

1. Government decrees: rules regarding the application of tax acts;
2. Finance minister decrees: rules regarding the application of government decrees; and
3. Director General decrees: rules regarding the application of finance minister decrees.

In the making of tax policy the following elements are determined:

1. Tax subjects: those who are regarded as taxpayers,
2. Tax objects: income or revenue in any kind on which tax is imposed,
3. Tax tariffs: concern with how tax liability is calculated, and
4. Tax procedures: concern with the system and process of tax collection.

As a tax administrator, the DGT covers the process of registration of tax subjects, tax return administration, tax assessment, tax arrears handling, tax audit, tax objections handlings (tax appeal is separately handled by the tax court) and delivery of tax facilities (tax exemption and reduction). In the modernisation reform all

processes were rechecked and improved in terms of organisation, business process and human resources management.

The following three sections discuss each focus of the modernisation efforts in more detail. The researcher's personal experiences as a tax official involved in the modernisation reform process enriched the knowledge of the process of DGT reform.

A new and improved organisation structure

In term of organisation, the DGT structure is hierarchical, meaning that higher level offices supervise lower level offices. There are three levels of office in the hierarchy and each level carries out different tasks. At the apex is the head office, responsible for tax policy-making, tax administration and supervision of regional offices in the application of tax policy and tax administration policy. This consists of the Secretariat of the Directorate General, twelve directorates and four senior advisor positions.

Regional offices are the second level of the hierarchy and responsible for supervision and coordination of tax administration at operational offices which are located in each regional office area. The location of regional offices is mainly in the capital city of each province. Several regional offices usually serve the provinces with a high population density, whereas those provinces with a low population density are served by a single regional office. At this level, there is also a Data Processing Centre, responsible for receiving, scanning, recording and storing tax documents using information technology.

At the base of the hierarchy, tax offices are responsible for running tax administration in day-to-day contact with taxpayers. Based on taxpayer demographics, tax offices are differentiated into:

1. *Kantor Pelayanan Pajak Wajib Pajak Besar* – Large Taxpayer Office (LTO)

LTOs administer national large corporate taxpayers, state-owned enterprises and high wealth individuals. The head office has the authority to decide which taxpayers are managed by the LTO.

2. *Kantor Pelayanan Pajak Madya* – Medium Taxpayer Office (MTO)

MTOs administer regional large corporate taxpayers, foreign investment companies, permanent establishments and expatriates, and public listed

companies. The head office has the authority to decide which taxpayers are managed by the MTO.

3. *Kantor Pelayanan Pajak Pratama* – Small Taxpayer Office (STO)

STOs serve local individual and corporate taxpayers which are not administered by the LTO or the MTO. STOs have the authority to perform tax extensification programs. Because of their large territory, some STOs are supported by Tax Service, Counselling and Consultation office (TSCCO) to serve the local community in remote regions.

At the beginning of 2012, the DGT had a total of more than 500 operational offices, consisting of thirty one regional tax offices, four LTOs, twenty eight MTOs, 299 STOs and 207 TSCCOs (DGT, 2013). In this reform, the DGT shifted its office structure from a tax-based organisational structure into a functionally-based organisational structure. This is characterised by grouping together the staff based on essential administrative functions, such as taxpayer services, monitoring and consulting, audit, and arrears collection (Brondolo et al., 2008). Prior to this, each tax office was mixed, organised by type of taxes (corporate tax, individual tax, withholding tax and value added tax) and by function (an arrears collection function and objection function). In addition, there were two other tax offices, one specifically handling land and building tax whilst another dealt with audit functions. A taxpayer thus needed to make contact with three different offices depending on the enquiry. In this initiative, the tax service offices, tax audit offices and land and building tax offices were liquidated and then all services handled by LTO, MTO and STO. The organisational structure of a tax office before and after the 2002 tax reform can be found in the appendix 8.

Tax administration in any country can be organised broadly by type of tax with a second tier division by geographic zone, by function or by segment of taxpayers stratified by size of assets or turnover (McCarten, 2004). The organisational design based on type of tax may result in efficiency lost through duplication of function and needs excessive direct contact between taxpayers and tax officers which exposes the tax administration to an unnecessary risk of corruption. Under a functional approach, there is a strategic element of cross checking among staff in which work performed by one function acts as a control on other functions. This approach reduces the compliance burden on taxpayers because they only have to deal with a single contact point. McCarten (2004) emphasis that the functional approach is increasingly being

combined with the taxpayers segmentation design. This combination is also implemented in the Indonesian tax administration. The taxpayer segment approach ensures that each size group of taxpayers has different characteristics and tax compliance behaviour, and it requires the delivery of a set of strategies that is appropriate to maximising voluntary compliance for each taxpayer segment.

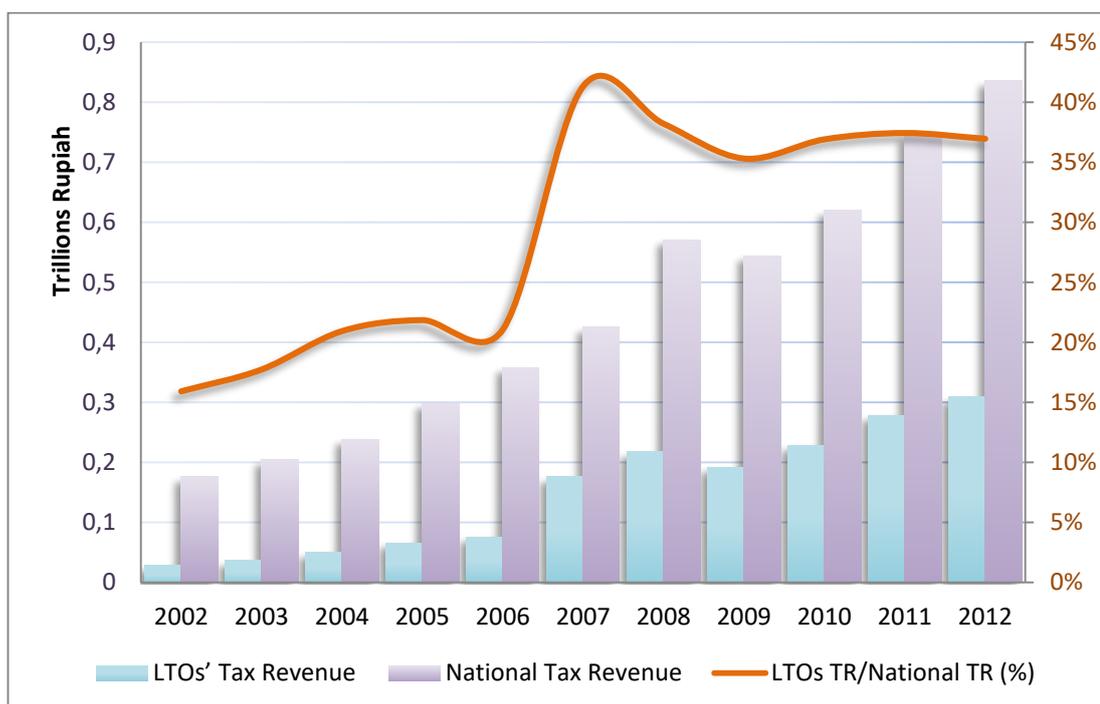
The creation of the LTO in 2002 symbolised to the public the beginning of modernisation processes in the DGT. It promised to increase tax revenue by achieving tight control over a large portion of the tax base and improve the investment climate by providing large taxpayers, who are also large investors, with high quality services, while introducing a number of measures to restrain misconduct by tax officers.

Service to large businesses has been improved through Account Representatives (AR) who were trained in the tax law issues that often arise when dealing with large taxpayers. The key feature of a taxpayer services function is the assignment of an AR to each large taxpayer. The AR serves as the first point of contact into the LTO for answering questions on taxation laws, straightening out problems involving a taxpayer's account and following up on such issues as delays in issuing refunds. The AR also closely monitors the taxpayer's filing and payment obligation, and is authorised to undertake some initial enforcement actions such as contacting taxpayers who file a late return or failed to pay on time.

At the LTO, enforcement is strengthened through the quick identification and treatment of taxpayers who filed their tax returns late, paid their taxes late, or committed other forms of noncompliance. Staff at the LTO are carefully trained, given substantially higher wages, attached to a widely publicised code of conduct, and facilitated by improved IT, and office facilities. This optimal working environment is crucial in promoting productivity and non-corrupt behaviour among LTO staff.

The LTO reforms were well implemented and seem to have produced excellent results. In 2006, a comprehensive assessment of taxpayer satisfaction with the LTO was undertaken by AC Nielsen. Based on Nielsen's method for measuring customer satisfaction, the LTO scored an overall performance rating of 81 per cent, indicating an exceptionally high level of taxpayer satisfaction. Among the survey's respondents, about 85 per cent reported that the LTO reforms dramatically simplified their tax obligation and nearly 80 per cent reported positive changes in tax officials' behaviour (Brondolo et al., 2008). The effects of the LTO on tax collections also showed positive impacts (see Figure 7).

Figure 7
The effects of the LTO on tax collection



Source: DGT Annual Report and LTRO presentation

The tax administration features that were introduced at the LTO later became the standard for the DGT and were gradually rolled out to additional field offices. The roll-out of reforms commenced in 2004 at the Jakarta Special Regional Office, which administered significant numbers of large taxpayers and large investors in the form of state owned enterprises, foreign investment corporations, public listed companies, and expatriates. Having established arrangement for large taxpayers, the DGT moved on to developing new approaches for administering medium size taxpayers in the MTOs and small size taxpayers in the STOs. The foundation of the segmentation of taxpayers is based on the premise that different groups of taxpayers have different needs of services and pose different risks of noncompliance. This stage of the reform was performed first in Central Jakarta and then replicated throughout the country. The last offices were successfully modernised by the end of 2008 (DGT, 2009).

The concept of LTO (or Large Taxpayer Unit/LTU) itself is widely known as an endorsed program of the International Monetary Fund (IMF), initially began in Latin America in the 1970s (Argentina, Peru and Ecuador) spread to Africa (Kenya, Tanzania), Eastern Europe (Hungary, Latvia, Poland, Bulgaria, Russia) in the 1990s and also in South Asia (Sri Lanka, Pakistan). These countries piloted administrative

reforms in auditing, self-assessment, the functional organisation of work and taxpayer services (Artjan, 2011). In the 1990s, some developed countries such as Netherlands, Australia, New Zealand and USA also began to implement tax administration which supported different size segments of taxpayers. The LTO has been described as “a potential Trojan horse for administrative reforms in tax administrations which have become seriously dysfunctional or, worse, completely overrun by a malfeasant administrative culture” (McCarten, 2004, p. 22).

Some countries have succeeded in implementing the LTOs for examples Kenya’s tax modernisation program, started in early 1990, achieved a successful outcome in tax revenue performance when revenue yields reached 27 per cent of gross domestic product (GDP) in 1993/1994 compared to a floating range of 22 per cent of GDP (Jerkin, Conrad, Glenday, & Kelly, 1997). Pakistan started the implementation of large taxpayers units in 2002 and succeeded in reaching a 14 per cent increase in tax revenue during 2004 (McCarten, 2004). In Argentina, large taxpayer software was finally applicable to all taxpayers, although Baer, Benon and Toro’s review⁴⁷ reported that the strategy failed to meet small taxpayers’ need because the administration was too complicated.

As mentioned in the introductory chapter, the DGT initiated the institutional reform in the Ministry of Finance in 2002, other units in the Ministry of Finance started their reform programs in 2007. The decision to carry out comprehensive reforms in the Ministry of Finance was an important decision that was immediately taken by the finance minister at that time held by Sri Mulyani. After being appointed as the finance minister in 2005, corruption prevention and eradication efforts in the ministry of finance became her priority.

In July 2007, another revenue arm of the Ministry of Finance, the Directorate General of Customs and Excise, launched the pilot of its “Major Customs Office” in Tanjung Priok port in Jakarta, which processed around 70per cent of Indonesia exports and imports. This office was similar in concept to the LTO. It had a new organisational structure and officials employed at this office received significantly higher salaries albeit subject to higher standards of discipline. The Director General was committed to increasing customs revenue whilst reducing unofficial/informal payments. In

⁴⁷ As cited by McCarten (2004) from Bear, Katherine; Benon, Oliver P.; Toro R. Juan, 29 April 2002, IMF Occasional Paper No. 215 “Improving Large Taxpayers’ Compliance: A Review of Country Experience.

addition he promised a more transparent and faster import/export handling process. Another unit, the Directorate General of Treasury, also agreed to implement the modernisation concept in its State Treasury Offices in September 2007. The 18 modernised State Treasury Offices became the pilot projects with a commitment to perform better and faster services to the government treasury and project partners, and prohibit any kinds of bribes involved in the process. One of Sri Mulyani's first policies as the finance minister was to fire corrupt officers in the Ministry of Finance. She gained a reputation as a minister with integrity. In 2006, only one year after serving as minister, the *Euromoney* magazine chooses her as the *Euromoney* Finance Minister of the Year and in 2007 and 2008, *Emerging Markets* magazine also selected Sri Mulyani as the Asia's Finance Minister of the Year.

Another reform effort at the Ministry of Finance aimed to increase internal control mechanism, this was performed through reforming the internal control unit called the Inspectorate General. It is a common unit in the Indonesian ministry that has the main function of controlling all tasks and functions within the ministry. The performance of the Inspectorate General was improved by establishing a new division – the Investigation Unit. Its remit was to create a new, respectable and credible internal control unit whilst at the same time, eliminating the problem of auditing other units' performance known to be a tool in gaining personal income through selling audit findings (Artjan, 2011). The new unit was built through highly selective recruitment from existing officials by examining their background, audit skill, motivation and the most importantly integrity, by using a lie detector during interviews. The selected officials also received a new allowance to ensure they performed their tasks with that integrity.

Changes in the organisation structure would not mean anything if its business process was not clear enough to be performed. For the DGT, business process is defined as “a series of repeated activities to create customer value through a process which transform an input into valuable output” (DGT, 2012, p. 122). The transformation of business process is a key pillar of the strategy in modernising the operation of the DGT. This makes the tax system easier for the taxpayers to comply with and for the tax officers to administer. The next section discussed transformations of the DGT's business process.

A transformed business process for effective and efficient tax administration

A reform is a never ending process. Having finished restructuring all offices did not mean that the reform process was ended. The DGT continuously refines its business processes to adopt dynamic changes in line with the organisation's goals. The business processes can be performed more effectively and efficiently with the support and optimal use of information technology. For the DGT, the year of 2009 was declared as the starting point for stage two of the reform process. During 2010, proposals for the establishment of new offices were submitted, including establishment of the Technical Implementation Unit for Data Processing Centre (DGT, 2011a). This is to support the utilisation of information technology in the DGT operation. This unit plays a role as the back office – the part of the organisation that operate without personalised contacts with taxpayers (McCarten, 2004). It also handles automated data processing such as the processing of returns and notification of non-filing returns.

The transformation of business process is closely related to the utilisation of adequate and appropriate information technology. Information technology combined with specific communications technologies such as the internet enables citizen to self-register, download forms and regulations, and perform electronic filings. As a result of this initiative, tax offices are brought closer to public, so that the public could see clearly the daily operations of the DGT. For organisational strengthening, particularly in the decision support system, information technology is an important key factor. Moreover, the utilisation of adequate information technology enhances transparency and minimises misconducts and abuse, as organisational design results in a structure with clearly defined division of labour and varying intensities of contact with taxpayers across units. Non face-to-face contacts with taxpayers through telephone and electronic communication channels have been implemented to reduce contacts with taxpayers as well as reduce opportunities to make unlawful arrangements regarding tax obligations.

The DGT also developed business process mapping which depicts the entire business process performed in the organisation (DGT, 2012). The map was used to understand the existing business processes and a guideline for improving and developing new business processes and it can be used to analyse the efficiency and effectiveness of a business process. The information technology system and infrastructure was continuously developed to improved services and monitoring quality to taxpayers.

In the area of improving services to taxpayers, development of business process included encouraging taxpayers to switch their reporting system from a manual reporting to using digital media. The DGT improved its business process and application of e-Filing service facilities. Starting 2014, the Head Office even set the target for each tax office on the number of taxpayers that should report their tax return using e-Filing application. This target setting resulted in increased numbers of e-filing utilisation from 21,799 taxpayers in 2012 to 26,187 taxpayers in 2013 and then more than 700,000 taxpayers in 2014. The development of e-Filing became very important considering that the process of loading manual tax returns to the administrative system is costly, time consuming and drained most of the human resources. As part of the adjustment to the development of business process, the DGT often make changes to the form, content and procedures for filing and submission of tax forms.

Another business process that improved service to taxpayers was the implementation of Value Added Tax (VAT) refund on goods purchased by tourists for consumption outside Indonesia. As part of international best practice, the DGT developed the application of information technology system for the VAT refund scheme for tourist. Its business process was changed from a manual base to a web-based application which provided convenience for the DGT in monitoring data transaction in real time as well as convenience for taxpayers in getting easier refund.

In addition, the developments included improving the DGT information system by enhancing the audit and collection modules. The enforcement program has been strengthened by increasing audit effectiveness through reforming the audit program. Audit performance has been achieving better results by implementing improvement audit regulations, capacity building of tax auditors, audit quality control and audit supporting system. Tax investigation as another form of enforcement program has also been strengthened by undertaking several cooperation and coordination activities with certain institution such as the Indonesian National Police, the Attorney's Office and the Indonesian Financial Transaction Report and Analysis Centre.

In order to broaden the scope of reforms, some of the most fundamental constraints on the DGT's performance were also addressed. One of them was simplifying the tax laws by conducting their comprehensive review, which was then followed by a revision of the rules and procedures governing tax administration. Some features of the tax laws were however considered unnecessarily complex (Brondolo et al., 2008). The tax laws included a number of provisions, relating to both income and

consumption taxes, which presented difficulties for taxpayers to comply with and for the DGT to enforce. A review of tax laws was subsequently required in order to provide significant advantages for taxpayers and the tax authority alike.

At the beginning of 2001 three amended taxation laws were implemented: the General Rules and Tax Procedures Law, Income Tax Law and Value Added Tax Law. Regarded as complex laws, these were amended again and implemented later on in three different years: 2007, 2008 and 2009. Simplification of rules and procedures is an important way to increase the effectiveness and efficiency of the tax administration business process.

The transformation of organisation structure and business processes required more attention in human resources management. The large number of human resources was carefully managed to perform fairness amongst all tax officials with high quality and excellent performance.

The formation of human resources with more qualified performance

The initiative to develop human resources aimed at increasing the capacity of individuals to carry out their duties resulting in higher productivity, higher tax compliance and higher public trust in the DGT. Improved human resources is critical to achieving sustainable performance improvements. To strengthen the capacity of officers inherently requires fundamental changes in their behaviour. This includes officers' sense of vision, mission and goal setting to work effectively and efficiently, as well as a commitment to integrity and best taxpayer services.

The present demands and expectations concerning the performance of the DGT staff are high and will be much higher in the future. In this regard, there is a high need for a competent and skilled workforce with multifunctional talents. It is also very important to develop disciplined and efficient officers with good human relations. In this regard, taxpayers will be easier to be approached by the DGT if it projects the right attitude combined with the best practise.

A modernised organisation requires clear duties and roles for each unit and personnel in order to attain its objectives. The DGT has consistently applied performance management based on a Balanced Scorecard since 2007. The Balanced Scorecard is "a tool to measure performance in order to help an organisation interpret its visions, missions, and strategies into actions, by utilising financial and non-

financial indicators, which are interconnected in a cause-and-effect relation” (DGT, 2012, p. 26). Within this performance management, the DGT’s performance is not only viewed from the stakeholders’ perspective but also from three other perspectives; customers, internal process and learning and growth. From those four perspectives, strategic goals necessary for each perspective are established. Furthermore, several Key Performance Indicators are set out to measure the achievement of each strategic goal.

In carrying out optimal tax revenue collection duties, the DGT has to continually improve itself so it can adapt to occurring changes. One of the many things that have been taken into action was improving institutional work values and culture. The internalisation program of the DGT organisational values serves as a stimulus to motivate and to strengthen employees’ integrity by using those values as a behavioural guidance.

Other aspects in the reforms included implementing a performance measurement system, providing greater flexibilities over human resource management policies and creating an internal investigation unit. To create good governance practices, the DGT has also been continuously developing internal compliance system policies and activities. For example, the DGT develops a whistleblowing system by creating internal complaint channel and public complaint facilities. This system was to support the internal investigation unit established to improve the effectiveness of preventive and any corrective measures taken on misconduct. As the DGT is the first government office to implement rules on whistleblowing, this demonstrates its commitment to developing a clean institution.

Whistleblowing is an important mechanism in the prevention and detection of improper conduct, harassment or corruption. A whistle blower (a person who tells the public or someone in authority about illegal activities) may make his/her allegation internally (to other people within the accused organisation) or externally (to regulators, law enforcement agencies, to media or to groups concerned with the issues). The Ministry of Finance is the first ministry in the Indonesian Government to implement the whistleblowing system as stipulated in the Finance Minister’s Decree on the ‘Procedures of Managing and Following up Whistleblowing’ of 10 May 2011. The DGT was the first unit in the Ministry of Finance to implement further regulation by creating rules regarding its application in the form of Director General Decree in the 19th August 2011.

The process of modernisation of tax administration continues until present. The DGT carries on monitoring and evaluation process to changes in the organisation structure, its business processes and human resources management in order to keep the progress and make sure that they proceed to achieve effective and efficient tax administration as well as excellent human resources performance.

7. Conclusion

As the main state revenue resource, taxes should be administered in a way that encourages taxpayers to engage in constructive bargaining with government. Many countries have reformed their formal tax structures and tax administrations, but levels of tax collection have tended remain stable over time. It is therefore, important to develop an agenda for accountability in implementing tax reforms. This requires the political will to persuade taxpayers to be more willing to pay tax and reduce evasion. Taxpayers need to understand how taxes are spent as this is very important in building their trust in the tax system. Within a strong taxation system, taxpayers perceive that they are treated equally and justly by the state.

The Indonesian government has performed several major tax reforms with many outcomes. As the contribution of taxes to state revenue has increased every year, the central objective of the reform is to increase state revenue so that state expenditure can be funded for the greatest prosperity of the society. The discussions above describe the reform process that has taken place in the Indonesian tax authority from the 1980s up to 2012. The research covered the tax reform period of 2002-2012, but the earlier period of tax reform was considered as important steps towards the latest reform. The first three major reforms strengthened the state-society relationship started with the implementation of the self-assessment system in the 1984 reform as the government gave taxpayers the authority to calculate and report their tax due. Later, law amendments in the 1994 and 2000 reforms enhanced the relationship as both reforms upheld the principle of fairness by creating equality in the laws both for taxpayers and tax officials. The modernisation of tax administration started in 2002 implemented reforms in all areas of tax administration including organisation structure, its business processes and human resources management, and encompassed good governance principles. The fiscal aspect of a state is one of the most important. The construction of a state and its operation cannot be understood without looking at its revenue resources or the tax system, both historically and today.

The Indonesian taxation reforms responded to changes in society and created the opportunity to learn by doing for the central government in the process of state building for a better shape of the state. Patterns of taxation shaped the contours of the state in its societies. The process of reforms from 1984 gave greater importance for the Ministry of Finance, specifically the DGT, to perform key roles in state building. Through the reforms process, Indonesia has formed the framework of the state through reformation in all areas of the organisation. Taxation reforms should be promoted continuously by learning from experiences and get all stakeholders participated in the process. This process of the nation state building required changes in attitudes and awareness of those participating in the process. To investigate whether the Indonesian tax reforms have an accountable reform agenda requires further analysis and this will be discussed in the next two chapters.

CHAPTER 4. AN ATTEMPT TO INCREASE STATE CAPACITY – OUTCOMES, ACHIEVEMENTS AND CRITICISM ON THE INDONESIAN TAXATION REFORM

More than ten years have passed since the DGT launched the reform with new paradigm of modernisation of tax administration involving good governance elements. A reform needs time to proceed and its results always depend on the criteria underlying the evaluation. In September 2012 the term “tax boycott” suddenly surfaced and became a hot issue in mass media, triggered by the results of a National Congress of Nadhlatul Ulama (NU)⁴⁸. The NU demanded that the government had to improve tax management because there were massive irregularities in collection, management and use of tax revenue. The NU’s leaders called on members to join the civil disobedience campaign by not paying taxes as part of a movement to curb the misuse of taxpayers’ money and also suggested that all citizens should stop paying their taxes (Murtaufiq, 2012)⁴⁹. This issue was considered as the NU’s criticism to government for eradicating corruption in the country. Is this a sign of failure of taxation reform? This could be a success in a point of view that taxation reform has uncovered abuse of powers by tax officials but this could also be a failure in a way that taxation reform has not yet prevented tax officials from conducting wrongdoings in their tasks. And if the taxation reform failed or succeeded how it would affect state capacity?

⁴⁸ The NU is the largest independent Islamic organisation in Indonesia and one of the largest in the world. It was led by Abdurahman Wahid (well known as Gus Dur) who served as the President of Indonesia from 1999 to 2001. Some estimates of its membership range as high as 40 million, although it is hard to account for this number. NU also is a charitable body as it funds schools and hospitals as well as organises communities to help alleviate poverty. NU also helps to complete many of the shortcomings of the Indonesian government. In 2006 NU described its vision as being the establishment of social justice and democratic order, based on the Islamic doctrine, and its mission as being to influence the legal system and promote policies that ensure social justice and democratic order, as well as community empowerment (Bush, 2009), helping to complete many of the shortcomings of the Indonesian government; it funds schools and hospitals, and organises communities into more coherent groups in order to help combat poverty. The NU as a social and religious organisation is inseparable from political activity, but focuses on high level politics.

⁴⁹ More information on this issue are on electronic and printed media issued between 14-19 September 2012, for example the Jakarta Post (“Death penalty for graft,” 2012; “NU calls on members to stop paying taxes,” 2012, 17 September), Tempo.co (Agustiar, 2012, 14 September) and inilah.com (Purwantono, 2012, 19 September)

Chapter 3 explored the relationship between taxation and state capacity development, and how a taxation reform would build this relationship. Efficacious state-society relations are the essence of improving state capacity. Through taxation reform, the state has opportunities to engage with society. Chapter 3 also examined the process of the Indonesian taxation reform from early 1980s to 2012, with more details on the latest reform of 2002-2012.

Chapter 4 evaluates the taxation reform begun in 2002 by examining data gathered from different sources, including the interviews and focus group discussions undertaken during the fieldwork as well as the specific issues on the effectiveness of taxation reform. By using in-depth interviews and focus group discussions this research gained expressions of interviewees' experiences, opinions and attitudes regarding the taxation reform and then put them together with quantitative data to conclude research findings. This chapter thus aims to answer the first research objective – how effective has the taxation reform been since its inception in 2002? It covers a discussion of outcomes, achievements and criticism on taxation reform.

As described in the introductory chapter, during the fieldwork, discussions and interviews took place with tax officers as well as taxpayers. These respondents made statements on what they viewed to be the three most important that happened during the taxation reform. Comments from interviewees who were tax officers included better remuneration, increased integrity and appropriate reward and punishment mechanism. Meanwhile for the interviewees who were tax managers of corporate taxpayers, the important things included better service quality, more open communication and improved quality of human resources. In general, all points of view could be grouped into three topics; service quality, image and human resource management. The following sections explain these three topics with regard to its outcomes, achievements and its criticism.

1. Improved quality of services delivered by tax offices

From the interviews and discussions performed for this study, it could be summarised that generally the service quality of the office after the reform was perceived as much better; service was more satisfactory, the officers were friendlier, helpful and professional, and the offices had better supporting facilities. There were three services most frequently mentioned by interviewees representing taxpayers in conceiving a better quality of service delivery. First, the presence of an information

and complaint service the “*Kring Pajak 500200*” helped the public to obtain tax information quickly and easily, as well as provided channels for public to submit their complaints related to the services provided. Second, the “Drop Box” program provided special boxes at places where most individual taxpayers usually do their daily activities that enabled them to file their Annual Tax Return by dropping it in the box instead of going to tax offices and facing a long queue. Third, the interviewees felt that the job was accomplished in a shorter time and there was a time limit in completing it, especially for the services included in the “Quick Wins” program. The Quick Wins service is one of the DGT’s commitments to deliver excellent services by determining tight time limit for completing certain services. These three services will be discussed in more detail later in this section

Given the breadth of taxpayers’ base, the general complexity of the laws to be administered and the self-assessment system adopted for many taxes, the delivery of quality services to taxpayers and their representatives should be a key goal of all revenue authorities. The OECD guideline (2008c) describes that in a service context, quality has many dimensions, such as timeliness, accuracy of advice, and scope of services provided. Furthermore, specific aspects of service delivery include processing of refunds, substantive responses to written enquiries, providing in person inquiry services at walk-in offices, answering taxpayers’ telephone enquiries, and resolving taxpayers’ complaints and registering a new business. Although not all things can be accomplished in accordance with this guideline, all efforts made since the tax reform in 2002 has led to what is stated in the guideline.

In 2008, these efforts providing better services were recognised when the Director General of Taxes accepted an award as a pioneer of excellent services innovation by the Ministry of State Apparatus Empowerment and Bureaucratic Reform (DGT, 2009). The Indonesia Public Service Monitoring survey by MarkPlus Insight performed in August-September 2009 showed an appreciation by the public of the DGT as the most innovative public service provider compared with other institutions in respect of service quality improvement (DGT, 2010a). Another stakeholders’ acknowledgement given by *Warta Ekonomi*⁵⁰ inaugurated a Special Achievement Award in public service to the DGT, as well as an e-Government Award for the runner up for the best government institution implementing information

⁵⁰ *Warta Ekonomi* is one of the leading economic magazine published in Jakarta and circulated nationally

technology (DGT, 2010a). These achievements show that taxation reforms have gained a wide public attention.

First of all, the presence of “*Kring Pajak 500200*” has become very popular since the first time it was launched in 2008. It received so many incoming calls that the officers could not cope with the volume. This became a significant issue as it was disappointing to taxpayers with high hopes. In 2008, less than 40per cent of all incoming calls, for both information and complaint services, were handled (DGT, 2009). The performance of “*Kring Pajak 500200*” was steadily improved to meet the public demand and figures show that in 2009, the number of answered incoming calls for information services⁵¹ increased to 66.45per cent (DGT, 2010a). In 2010 the services achieved 76per cent for information and 81.78per cent for complaints respectively (DGT, 2011a). In 2011, the number of answered calls for information services⁵² also increased to 80per cent (DGT, 2012) and increasing again in 2012 to 86.98per cent. Unfortunately, the number of answered calls for complaints only reached 78.64per cent in 2012 (DGT, 2013).

This “*Kring Pajak 500200*” received an excellence award as the Best Contact Centre Indonesia 2010 and 2011 organised by Indonesia Contact Centre Association which was also given to its agent, supervisor and back office. At an international level, the centre won first place for Direct Response Campaign at Asia Pacific regional level in Gold Coast, Australia, and world championship level in Las Vegas, USA held by the Contact Centre World in 2011(DGT, 2012). The growing number of calls showed that there was an increased demand from public for information and complaint channel. This situation has resulted in a decision to upgrade the centre position into a special office instead of being part of another unit. On the 16 November 2012, the Minister of Finance signed a decree on the establishment of “*Kantor Layanan Informasi dan Pengaduan*” or Office of Information and Complaint Service (DGT, 2013).

In addition to the “*Kring Pajak 500200*”, in term of communication, most interviewees felt that there have been more tax dissemination and education activities

⁵¹ There is no data for the number of complaint services incoming calls received in 2009, but out of 368 received complaints 331 were handled in the same year, and the rest was still in process and carried on to the following year.

⁵² There is no data for the number of complaint services incoming calls received in 2011, but the statistic shows that the number of complaint received decreased from 1,341 in 2010 to 1,036 in 2011. This decreasing number might be interpreted as an increase of taxpayers’ satisfactory.

since the 2002 reform. These activities were very useful for improving their understanding and confidence in meeting their tax rights and obligations. The assignment of an account representative (AR) to each taxpayer also made a huge contribution for increasing service quality. As the first point of contact, AR provided an in person inquiry service both by direct communication face to face and indirectly using telephone or email. AR was also responsible for answering questions on the tax law, following up on enforcement issues and monitoring the taxpayer's filing and payment obligations. Besides direct communication with the AR, the use of media, such as radio, television, newspaper, magazine, billboard, etc. were also very useful and, in some cases, preferred as some taxpayers remained hesitant to make contacts with tax officials.

One of important aspects in the rational-legal bureaucratic framework was providing citizens with appeal channels if given poor service (Brinkerhoff & Goldsmith, 2002). The "*Kring Pajak 500200*" certainly opposed the patrimonial legacies where public had little recourse for poor service. This meant that the "*Kring Pajak 500200*" has led the Indonesian tax authority towards rational-legal administrative system

Secondly, all interviewees appreciated the service in providing special boxes to receive Annual Tax Return called "Drop Box" which was placed at shopping centres, business centres, government offices and other strategic locations. Starting from 2009 corporate and individual taxpayers could submit their annual tax return directly to drop box at any point where they found such boxes. From the interviewees' point of views, this program gave broader discretion to taxpayers in filing the return since they were no longer necessary to visit the tax office in which they were initially registered. This program may also make taxpayers more convenient in enabling them to exercise their tax obligations because there was no time-consuming queue as in previous years, especially approaching the deadline of return submission. This program has increased the number of filed tax returns significantly (see Table 9 page 134).

Thirdly, when it was firstly introduced in 2007, Quick Wins comprised just eight services. As one of the DGT's commitments to deliver excellent services, this was increased gradually and became 16 in 2012. Quick Wins initiatives aim to create more effective, reliable and advanced tax administration system. The implementation of this program is expected to sustain the entire DGT business process and is developed

in conjunction with the implementation of information technology development. Among other things, the success of Quick Wins depended heavily on the readiness of information technology. The DGT could not achieve the 100 per cent target of Quick Wins completion in 2012 because there were technical problems in information technology resulting in 98.71 per cent requests was completed. However, the performance was better than 2011 when the completed requests reached 95.29 per cent. Nevertheless, there were inputs from the interviewees that some procedures should be simplified so that the job could be finished faster, for example in the refund procedure. The DGT has not yet formulated an easier tax refund procedure. Every refund application must have been gone through an audit process except for taxpayers with certain requirements. In addition to causing uneasiness for taxpayers, refund audit process also makes tax auditors occupied by performing audit for resolving refund instead of gaining more tax potential. For those taxpayers which do not need refund audit are actually given a preliminary refund which may be subject to post audit. The preliminary refund should be based on risk analysis that considers taxpayer's compliance. These taxpayers are:

1. Individual taxpayers who do not run business or have one source of income;
2. Individual taxpayers conducting business or independent activities who claim for income tax refund at most of 10 million rupiah;
3. Corporate taxpayers who claim for income tax refund at most of 100 million rupiah; and
4. Taxable entrepreneurs who claim for Value Added Tax refund at most of 100 million rupiah.

Results of customer satisfaction surveys performed in 2007 and 2010 by independent survey institutions – *Institute Pertanian Bogor* (IPB – Bogor Agricultural University) and the Nielsen Company show that the level of satisfaction decreased in some areas, namely general work performance and customer service, but there was a significant increase in the level of tax return delivery service. Meantime in term of professionalism level, taxpayers considered that tax officers' performance in handling tax audit and billing process was much better than before (DGT, 2008, 2011a). These figures illustrated that when taxpayers reached a certain level of satisfaction in the past their expectation on the service quality for the future was getting higher. For example, in 2007 the satisfaction level of customer service was scored at 55, taxpayers certainly expected a better customer service in the following years. However, even though the

DGT had improved its service quality above the 55 score, index expectation could not be fulfilled in 2010 because the target was the score of 70. The 2010 survey resulted in taxpayers' satisfaction index of 66. The surveys suggested that the DGT must try to maintain as well as improve its customer satisfaction level all the time. However, another survey performed by IPB in 2012 resulted in a satisfactory score of 78 for the level of taxpayers' satisfaction or 3.90 of stakeholders' satisfaction index (with a scale of 1 for the lowest to 5 for the highest).

Considering that Indonesia is a large country with high population, there were still many taxpayers that have not been reached by tax education programs. One of the interviewees stated that the programs should be improved with more down to earth programs using appropriate communication techniques, especially for regions with dense populations (I29). This input showed that there was a demand from the public for the DGT to undertake tax education, which also meant that public awareness on tax issues was higher.

Although the quality of service was generally improved, in some cases, problems still occurred. Realistically it is near impossible to prevent some type of problem occurring. The most frequent problem occurred was in interpreting rules and regulations. There were still many rules and regulations contained unclear rulings and caused multiple interpretations. This problem might take a long time to solve especially when a tax office looked for a clarity of a different interpretation between taxpayers and tax officials by asking for a ruling from the Head Office of the DGT, or when it was brought up to an objection or appeal process. Other examples were complaints on the quality of services provided by tax offices in remote regions, mostly due to inept officers or IT failures (I06, I08, I11).

2. The image of the DGT: from most corrupt institution to most trusted public institution

The DGT has been notorious as one of the most corrupt institutions in Indonesia. Therefore, the reform program also aimed to restore trust in tax process and administration. In general, this research found that public has seen improvements and with the improved quality of the office in terms of its public service, all respondents stated that taxpayers had more confidence and felt more comfortable attending tax offices or dealing with tax officers. The 2010 survey performed by the Nielsen

Company mentioned in the previous page also shows that tax offices were perceived to have a good image. Sixty-three per cent of survey's respondents supported this result.

The entrance of each tax office was redesigned with a new look of "*Tempat Pelayanan Terpadu*" (TPT – one stop tax services) which shows a welcoming environment for taxpayers. The interior was intended to make visitors easy to find what they need. The TPT is standardised with service standards including to provide a help desk for anything with unclear direction. Inside of the office was also redesigned to have more open communication between tax officials and taxpayers. Human resources play a vital role in creating a better perception on the image of tax offices. The human resources contexts will be explored in the next section.

At a time when the image of the DGT was improving in the eyes of public, a case of alleged abuse of power by some officials early 2010 was very unwelcome. This case, well known as the 'Gayus Tambunan' case, eroded public trust in the DGT. This case was exaggerated by the media but, unfortunately, the top managers of the DGT did not effectively respond to press criticism. As a result, the public did not get the full picture of what was happening. It was the biggest scandal of tax corruption in Indonesia history and seriously damaged the public image of the DGT and its staff. It is worth examining more closely because it revealed how the 31 years old Gayus conspired with tax evading companies to defraud the tax office by as much as ten millions US dollars in less than three years within the DGT's current reform era⁵³.

This case absorbed huge public attention becoming a cause celebrate that also forced President Yudhoyono to take action by issuing his first instruction in 2011 – the Presidential Directive number 1 dated 17 January 2011 on accelerating completion of legal cases and tax fraud. Under the coordination of Vice President Boediono, the Indonesian State Police, Attorney General's Office, the Ministry of Justice and Human Rights, and the Ministry of Finance continued to implement the president's instruction. They were also supported by "*Pusat Pelaporan dan Analisis Transaksi Keuangan*" (PPATK – the Centre for Financial Transaction Report and Analysis), "*Satuan Tugas Pemberantasan Mafia Hukum*" (Judicial Mafia Eradication Task Force), as well as

⁵³ Gayus Tambunan was deployed in the Head Office which had its new modernised structure in 2007 and the case happened in early 2010.

“Komisi Pemberantasan Korupsi” (KPK – the Corruption Eradication Commission).

The instructions from the president included instructions to:

1. Take the necessary measures according to each task and authority to speed up the settlement of legal cases and tax fraud including but not limited to Gayus Tambunan case;
2. Conduct performance and financial audit to the institutions associated with the process of law enforcement;
3. Implement a fair and un-discriminatory law enforcement to all parties involved in the case;
4. Freeze all assets and funds came from criminal offences and tax irregularities as the efforts to return the country’s wealth;
5. Perform administrative and disciplinary actions to all officials obviously did aberrations and offenses, and immediately replaced or dismissed those officials.

Gayus was a tax official who made an illegal fortune assisting tax evaders. As he worked on taxpayers’ objection division, he assessed their cases, which eventually went to the Tax Court. As a tax objection officer, he had the capability to utilise the information for providing consultation to taxpayers during the litigation, which he was forbidden to do. After he was apprehended, his case was processed in the court, and during his judicial process, he absconded to Bali and beyond. In January 2011, he was sentenced by the South Jakarta District Court to seven years in prison for corruption. The case was earlier on trial at Tangerang District Court which set him free. He went in and out of jail at least 68 times over four months. Later, his testimony in court disclosed the involvement of law enforcers such as police, attorney, lawyer and judges. These groups of people (later on recognised as “tax mafia”) cooperated and supported each other in performing tax crime. At the beginning of 2012, there were more than 20 people convicted or found guilty by the court of first instance. These included three police officers, two lawyers, three cases brokers, one district court judge, one prosecutor, three tax officials, one tax consultant and nine officers from detention centre (UKP-PPP, 2011). In addition, there were more than 50 officials handed down administrative and disciplinary actions including heavy penalties in the form of exemption from duty. These were 20 soldiers and police officers, 12 employees of the prosecutor, 35 immigration officials, as well as dozens of tax officials including Gayus’s director, supervisors and colleagues (UKP-PPP, 2011).

This situation led to perceptions that there were still practices of corruption, tax scandal cases and unresolved tax cases in the DGT. Law enforcement agencies had important tasks on handling the tax mafia. A joint team consisting of State Police, civil servant investigators and the Inspector General kept continued their investigations in tracing the alleged tax mafia. In connection with Gayus's case, the priority search was focussed on taxpayers handled by him. The Ministry of Finance carried out several actions regarding this case (UKP-PPP, 2011), such as:

1. Performing audit investigation into the process of tax objections and appeals within the DGT and Tax Court Secretariat, with the supervision from KPK;
2. Extending the obligation to submit *Laporan Harta Kekayaan Penyelenggara Negara* (LHKPN – report on wealth of civil servant) not only for echelon staff but also for certain employees non-echelon;
3. Developing internal examination system and quality assurance for tax audit;
4. Providing infrastructure implementation for whistleblowing system; and
5. Improving tax court by pushing for transparency judicial process, new judges' recruitment as well as implementing a more optimal control.

In conclusion, the case shows that it was important that all relevant agencies understood that to fulfil the President's instruction required further cooperation, coordination and synergy. It was also important for the agencies to communicate to the public clearly, regularly, comprehensively and effectively on what has been happening.

A few months after Gayus was caught, another case of a corrupt tax officer was discovered. This case involved a senior tax officer who abused his position in the DGT to gain profit for his own interest. Proven to have the extraordinary amount of money in his bank accounts, as well as his family's account, in addition to luxury houses and hectares of land, the officer insisted that he did not get his assets out of taxpayer's pocket but from profits and interests of his business activities. Nevertheless, in the eyes of public, he was a corrupt tax official and was sentenced to jail. At the beginning of 2012, another case involving a huge amount of assets owned by a tax officer was revealed. This case also gained public notoriety (Marta, 2012).

These cases certainly damaged the image of the DGT. They provoked the idea of a tax boycott mentioned earlier in the opening paragraph. The Nadlatul Ulama (NU) raised the term tax boycott as the NU's challenge to the Indonesian government to release an instruction prohibiting Muslims from paying taxes if the tax continues to be

corrupted. One NU leader argued that paying taxes is actually not mandatory in Islam but become mandatory because Muslims obey the government provided that the government utilises taxes for the benefit of the people. He also said that the tax boycott would be the beginning of a citizen dissent against the government (Purwantono, 2012, 19 September). Adhie M. Massardi (spokesman of the former president Abdurrahman Wahid) stated that, behind the boycott, there was a hidden spirit of civil disobedience such as Mahatma Gandhi had done in India, but, unfortunately, this rebellion emerged in the middle layer of the NU not at the top (Hatta, 2012, 16 September). Further, Massardi said that the resistance even seems paradoxical because the NU General Assembly invited the President Yudhoyono to attend the closing ceremony. Thus it was likely that after the completion of the assembly, the resistance that was originally envisioned would blaze, quickly dimmed leaving little but ash (Hatta, 2012, 16 September). Even though a tax boycott remained an issue, the corruption cases by some tax officials were clear evidence that the DGT had not done enough to promote good governance in the taxation reform process. From a different point of view, the cases could also be seen as success indicators of tax reform. If there was no reform process, corrupt attitudes might become a habit and even become enmeshed in the culture.

However, the DGT has been performing mass anti-corruption programs through socialisation, education, surveys, official website, posters, banners, flyers and other media as well as other normative and cognitive efforts. Such effort was assessed by the KPK in 2010 through the Anti-Corruption Initiative Evaluation program. This program assessed corruption eradication initiatives and service quality improvement taken by government institutions. The KPK assessed 80 units from the central government and 8 units from the local government. Out of 88 assessed units only 13 units scored above 6 (in scale of 0 to 10) and 8 of those were units from Ministry of Finance. The DGT was ranked 4 with the score of 8.18 and the highest score of 8.99 reached by the Directorate General of Treasury, Ministry of Finance (DGT, 2011a).

In 2011, the DGT call centre conducted a survey on public trust to find out taxpayers' expression on the DGT's integrity. The results showed that the public trust level was at 82 per cent, which was 12 per cent higher than the expected level of 70 per cent as well as 16 per cent higher than the 2010 level. In 2012, the same survey was performed by an independent survey institution – PT Surveyor Indonesia. The result reported that the public trust level increased to 84 per cent, which was also higher

than the expected level of 80 per cent. These surveys strengthened tax officials' belief that taxpayers generally appreciated their efforts in improving services and demonstrating integrity.

The DGT received the Bronze Indonesia Brand Champion Award 2013 in recognition of these improvements, and was cited as the Most Trusted Public Institution⁵⁴ on 24 September 2013. The award was presented by MarkPlus Insight and Marketeers magazine, which conducted a survey on awareness, image, likeability and usefulness, involving 700 respondents from six main cities including Jakarta, Surabaya, Bandung, Semarang, Medan and Makassar. The hope was that this achievement would encourage tax officials to perform even better, and this award also demonstrated that society had more confidence in service quality delivered by the DGT.

Those achievements would not be attained without input and some criticism from external shareholders. For example, the research by the Partnership for Governance Reform shows that many taxpayers had little confidence in the fairness of tax administration because taxpayers saw themselves as vulnerable to arbitrary actions of tax officers (2001).

Even though the DGT has been educating people directly and advertising through media, many still did not really understand the purpose of taxes. The interviewee 01 addressed this issue by mentioning two suggestions. First, the DGT must demand cooperation from other government and public sector institutions to publicise the usefulness of taxes to the public. Second, the benefits of taxes should be stated clearly in the national budget. These suggestions are worth considering as they may increase people's awareness on the importance of taxes whilst showing that the public is becoming increasingly engaged in tax reform issues. A clear statement and transparency are two key strategies in which citizens can ascertain where their tax contributions go or where the distribution of tax is clearly demarcated.

As part of education program, the dissemination of tax benefits has been performed for a long time, but because the DGT personnel were still perceived as corrupt officials, it was not easy to explain tax issues to the public. There were still people with the mindset that the tax money would go directly into tax officials'

⁵⁴ Further details on the news <http://news.detik.com/read/2013/09/25/174300/2369423/727>, <http://birokrasi.kompasiana.com/2013/09/25>, <http://www.pajak.go.id/node/8373?lang=en> and *Media Keuangan* (2013) Volume VIII Issue 74 Sekretariat General of Ministry of Finance

pockets. Cooperating with other institutions should demonstrate that these institutions have utilised the tax money for their operation appropriately and that tax money has been used correctly.

The making of the Indonesian national budget has to go through a long process. Based on the Law on preparation and adoption of the budget Number 17 of 2003, the budget is a form of financial management set each year by law. Having specific fiscal policy and macroeconomic framework, the central government discuss the general policy and budget priorities as a reference for any institutions in the preparation of budget proposal with the House of Representatives. The budget proposal must be submitted to the House of Representatives and subject to another discussion. The results of the discussion become materials for preparing a draft version of the state budget. Considering that the approved law will contain budget for revenues and expenditures, most institutions have a closer look and pay more attention to this state budget law. Ideally, all institutions have to understand where the money spent for their expenditure came from. By including the importance or the benefits of taxes in the law, all institutions, members of the House of Representatives and other related agencies should become more aware of the benefits of taxes.

The persistence of corruption in Indonesia is shown in many international surveys, which generally indicate that corruption does not stop shadowing governance reform. The Indonesian level of corruption in international comparison as shown on the corruption perceptions index of Transparency International was low (in a scale of 1=highly corrupt and 10=very clean).

Table 4 contains scores of 1995-1998 to show the condition during the authoritarian period. The first CPI scores released by Transparency International in 1995, announced Indonesia as the most corrupt countries among 41 countries being surveyed. Even though the score increased in the next two years, Indonesia was still in the lowest group. The highest score in this period was 2.7, reached in 1997. To the extent that Indonesia had problem with its ranking due to the perceptions that the international business had of the state of affairs in Indonesia. The fact that the score increased 0.8 point in two years was remarkable and stemmed from the government's efforts to make the country had a better perception. Unfortunately, the score dropped by 0.7 point in the following year. The increasing scores did not continue as Indonesia faced political problems when the Soeharto regime was defeated.

Table 4
Indonesia's Corruption Perception Index Scores 1995-2013

Year	CPI Scores	Ranking	No. of Countries Surveyed
1995	1.9	41	41
1996	2.6	45	54
1997	2.7	46	52
1998	2.0	80	85
1999	1.7	96	99
2000	1.7	85	90
2001	1.9	88	91
2002	1.9	96	102
2003	1.9	122	133
2004	2.0	133	146
2005	2.2	137	159
2006	2.4	130	163
2007	2.3	143	179
2008	2.6	126	180
2009	2.8	111	180
2010	2.8	110	178
2011	3.0	100	183
2012	3.2	118	176
2013	3.2	114	177

Source: Annual corruption perception surveys of Transparency International (www.transparency.org)

The table also shows that since 1999 Indonesia has been moving toward a lower level of corruption. Even though there was a slight decrease of the score in 2007, it was eclipsed by the increased score in the years that followed. With the fluctuation of scores ranging between 1.7 at the lowest in 1999 and 2.6 at the highest in 2008, Indonesia's records show no significant improvement over a decade post Soeharto era. However, there are many factors that can influence the score of corruption perception index. From 2009 onward, the score increased gradually. According to Transparency International Indonesia, in the Corruption Perception Index Survey 2009, Indonesia's corruption index demonstrated a significant improvement from previous years. This was due, among other things, to the bold reforms within the Ministry of Finance. It is worthwhile noting too that public and business community perceived the impact of the Ministry of Finance reform directly, especially in tax and customs (TII, 2009).

The World Bank illustrates the corruption problem of countries worldwide as one of dimensions of governance in the Worldwide Governance Indicators (WGI)⁵⁵ project. The World Bank’s corruption control indicator has been showing improvement since 2002 as illustrated in the table below. However, this improvement did not upgrade Indonesia’s corruption position which still remained in about the lowest 30 percentile in the world (in a range of 0=highly corrupt and 100=very clean). This World Bank’s corruption rank supported the results of the corruption perception index, where both showed that Indonesia was still one of the most corrupt countries in the world. Even though the score was increasing, its rank did not put Indonesia in a better position internationally.

Table 5
Control of Corruption’s Percentile Rank

Year	1996	1998	2000	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Percentile	31	10	19	8	15	17	20	21	33	34	22	26	28	29

Source: www.worldbank.org

Another issue arose in this research regarding the corruption perception concerned one specific article of the Law on General Rules and Procedures for Taxation. Some interviewees mentioned their concern about the implementation of the new article 35A. This law was first enacted in 1984 then revised several times and the last revision was on 2007. Article 35A, which was enacted in the 2007 amendment, is an expansion of the existing article 35 in the former amendment. Article 35 stipulates that for the purpose of law enforcement, the DGT has the authority to demand information or evidence from banks, public accountants, notaries, tax consultants, administrative offices or other third parties with a relationship to a taxpayer. Furthermore, article 35A obligates every government institutions, taxpayers associations and other related parties to send any data and information related to taxes to the DGT in a way that is governed by a government decree.

It was an unfavourable situation for the DGT as the government decree was difficult to be formulated because those agencies were actually reluctant to comply with the law. The law stipulates penalties for those who did not comply but it was

⁵⁵ The WGI project reports aggregate and individual governance indicators for 215 economies over the period 1996-2012, for six dimensions of governance: voice and accountability, political stability and absence of violence, government effectiveness, regulatory quality, rule of law and control of corruption.

weak in implementation. Given the importance of data for context of potential taxation, in the submission of audited financial report of the central government to the president on 1 June 2011, BPK (the Supreme Audit Agency) emphasised the importance of the implementing regulation of article 35A (KPK, 2013). After 5 years, the government regulation was finally created and signed on the 27 February 2012. Although the government regulation had been effective from the 27 February 2012, it was technically referred to the Minister of Finance's regulation governing the details of the type of data, procedure for submission and its time frame. As a follow-up to the mandate of the government regulation, the Minister of Finance issued the required regulation on 4 January 2013 and another one on 11 April 2013 which stipulated that there are 19 institutions obliged to provide data to the DGT. By the end of 2014 the number of institutions increased to 31.

Unfortunately, the implementation of these regulations was not smooth. There was no mechanism for the DGT to acquire data on taxpayers' transactions automatically. This weakness led to disadvantages in imposing taxes and monitoring taxpayers' compliance. The absence of a data delivery mechanism from third parties certainly hampered the availability of data. Limitations of data may result in poor self-assessment mechanisms and law enforcement. Later, tax compliance may decrease and eventually tax revenue might be difficult to increase. Thus, it is very important to safeguard the implementing regulations. In the current condition, the availability of data drawn from third parties has been collected within a framework of cooperation in the form of an agreement; it has been executed by DGT's request to an agency or the third party that has the desired data. Since each agency or third party has various data needed by the DGT, many agreements have to be executed while follow up agreements have to be performed by regional offices with each regional agency or third party. These complex techniques have to be done, considering that most Indonesian institutions have not had the information technologies that connect to each other. One of the interviewees stated that what has been stipulated in article 35A is the DGT's right. Therefore, the DGT must take the initiative actively to pushing all authorised agencies to prepare and issue the implementing regulations (I 30).

Corruption is not explicitly mentioned in the law but if this article was well implemented, it is likely that the level of corruption would be reduced. And this has implication for the nature of the Indonesian state. As discussed in Chapter 3, data collection, data sharing and transparency have the potential to produce system-wide

benefit. Strong linkages between a reformed tax authority and other agencies may build state capacity by transforming reform strategies and innovations, as well as creating pressure for reform to related agencies.

Corruption is an interesting issue to discuss especially when an institution is recognised as having a reform. If no one was looking for corruption it would not have been revealed and though damaging it was also improving the DGT to be more serious in monitoring the tax officials' attitude. There is no direct correlation between corruption and the DGT performances but indirectly it could be assumed that the increasing rating in corruption was proportional with the increasing ratio of tax compliance. Recognition from the Transparency International Indonesia that the increased score in 2009 was among other things due to the DGT's reform programs has also proved that an overall improvement as governance structures become more transparent and effective.

3. Human resources management: new established internal compliance department and whistle blowing system

With around 32,000 personnel consists of 75 per cent male and 25 per cent female, the DGT often faces the difficulty to find and select the best employees within the organisation. In 2011, the DGT defined human resources management blueprint that described plans in designing, formulating, implementing and evaluating comprehensive and sustainable human resources management. The blueprint consists of four phases (DGT, 2012):

- Phase I (2011-2012): building performance culture and developing excellent leadership;
- Phase II (2013-2014): developing employees' competency and building a reliable human resources management information system;
- Phase III (2015-2016): developing human resources planning and implementation of employees' career management;
- Phase IV (2017-2018): building reward culture as the base for the development of talent management.

As the blueprint is put in place, the DGT is expected to be able to produce employees with the best competency and performance supported by sufficient reward culture. Accordingly, complaints about incompetent officers especially in the remote

regions will decrease. The following paragraphs discuss Phase I of the blue print and its preparation. Phase II to IV was not covered in this research, however, human resources management activities included preparation process of those phases.

To build a better performance culture, during 2011-2012, the DGT conducted an employee performance award program for certain positions, such as account representatives, objection's reviewer, auditors, tax bailiffs and taxpayer services officers. Dissemination of performance culture was done through the DGT internal media and continuous internal meetings. In this period, all tax officers, starting from the Director General to the lowest layer officers, had to sign a performance contract. This contract was evaluated through an electronic individual performance measurement application (e-performance) provided by the Ministry of Finance.

For officials holding key positions, especially those of Echelon Three, the DGT provided a leadership development program through coaching and managing conflict training and transformational leadership training. The program focussed on improvement of performance and enhancement of leader as a role model. There was also a seven habits programme for managers training provided for echelon four. This training emphasised on performance improvement in managing resources and building good coordination with supervisors, colleagues and subordinates (DGT, 2013). As part of human resources management blueprint, developing excellent leadership turned out to be coaching and training for leaders. This does not considered as a strong development program for eliminating corruption within the DGT. It is important for the DGT to prove that the leaders are exemplary that should be transparently incorruptible themselves and inspiring of discipline, pride and *esprit de corps*.

No matter how much training and personal development programs have been given, inefficient, incompetent and corrupt tax apparatus have remained strong disincentives for potential taxpayers. Therefore, adopting good governance elements may minimise collusion and corruption. However, the main risk in implementing this initiative is whether the DGT officials will take the governance framework seriously and adjust their behaviour, or simply ignore it and continue their bad practices. It needs to be injected into the business processes so it became something that cannot be ignored. The challenge is thus to construct a transparent and accountable system that has two primary objectives: first, to prevent fraud from taking place and second, to inspire taxpayers' trust in a fair and decent system in which there is a realistic chance for detecting fraud, evasion and corruption (Rizal, 2011). In addition, the internal

investigation division need to be siloed and allowed autonomy which will also assist in creating active counter corruption outcomes. The establishment of the Directorate of Internal Compliance and Apparatus Transformation showed that the DGT is taking this HDR issues seriously.

Being part of reform program, all officials had to sign a statement letter showing that they are going to comply with the tax official code of conduct. This letter could help when confronting tax officials with corrupt conduct. The DGT is the first government institution that has its own code of conduct in addition to the civil service code of conduct. The dissemination of the code of conduct was performed continuously as a starting point for corruption eradication. This dissemination was supported by the availability of implementation mechanism, institutionalisation, and enforcement of the code of conduct. This specific code of conduct convincingly increased tax officials' integrity in performing their duties. However, the code of conduct alone would not prevent tax officials from misconduct behaviour, there should be the information technology system used to monitor officials' work performances and support the implementation of transparency and professionalism of apparatus.

As complimentary to the code of conduct, the amended articles 36 of the 2009 law on general rules and procedures of taxation renewed the code of conduct and significantly strengthened sanctions for violations. The provisions included establishing a committee to supervise its administration and review all violations, placing taxpayer abuse for personal gain under the criminal code and bribery under the anti-corruption law and extending the ministry's internal investigators' responsibility to investigate tax officers who intentionally act beyond their authority.

It is not an easy task to measure an officer's integrity. It is something that becomes apparent once a person commits a crime or infringement. There should be guidelines for officials to adhere to and supervisors who have a special role in modelling behaviour and encouraging good work attitude. As a researcher, I do not have the expertise to judge someone's personal integrity, but one of interviewees expressed feelings so sincerely as to make others look up to this officer.

Work is like worship, and in my work I would focus on how to encourage my fellow friends to perform well in making the office improve its performance in a condition where all staff feel safe and comfortable, and increase their work ethics. The key ways to achieve these goals are togetherness, gratitude, patience and sincerity. There is no way that I would to ask to be promoted. A higher position that is not obtained by the Almighty's wish will end up in distress that may influence other people around us as a result of incompetent and unfair leader (I 03)

Another issue that affected human resources management after the taxation reform was the remuneration system. Indonesian civil service has a very low salary rate, so when the DGT launched the pilot project for reform program in 2002 by creating the Large Taxpayers Office (LTO), it was announced that tax officers who have been selected to work in that office will receive a higher salary. Since then, every tax officer was hoping that he/she would be placed in the LTO. Indeed, better remuneration motivated most tax officials to perform better. Being at the LTO also means that a tax official has performed well in the previous works and there are more chances of being promoted. This system is in line with rational-legal bureaucratic system where officers are recruited and promoted in competitive processes with regards to their merit and expertise.

However, although many LTO's officials were promoted, there was still doubt from those who worked at the LTO on the absence of a formal promotional pathway. Officials who got a promotion are usually relocated to another office which is so far away from their previous office. This issue had been hindering officials from performing at their best. For example, they would rather stay as an account representative at the LTO, which is in Jakarta, than promoted as the head of section at the office in the eastern part of Indonesia.

Moreover, mandatory rotation of skilled and specialised officials to comply with the general civil service policy diluted the job specific expertise accumulated by officials. For instance, auditors at the LTO are required to have advanced auditing skills mostly in specialised sectors. Their skills may take several years to develop. The rotation to unrelated positions results in loss of expertise that will take newer staff a substantial period of time to develop.

At the beginning of 2012, the Director General of Taxes signed a new regulation on patterns of redeployment for tax officials' career position. The regulation stipulates four administrative requirements for vertical redeployment or promotion as follows:

1. Having educational level and qualification which correspond with the new position that will be occupied;
2. Holding a required rank or one level below the required rank with regard to priority for senior civil servants;
3. Not currently undergoing disciplinary punishment; and

4. Each element in “*Daftar Penilaian Pelaksanaan Pekerjaan*” (DP3 – the Employment Performance Appraisal) for the last two years achieved good results.

Moreover, there are also two technical requirements: work performance and competency. The technical requirements match rational-legal bureaucratic system in which officers are promoted based on merit and expertise, but the second administrative requirement that is, giving priority to senior civil servants, do not align with rational-legal bureaucratic system. This means that patrimonial legacies are still embraced in some parts of the DGT bureaucracy. Even though in practice, this priority has been paid less attention than work performance and competency, the fact that it is stated in the regulation do not eliminate patrimonial legacies.

The new regulation on patterns of redeployment also set technical requirements for horizontal task rotation. The requirements specifies the duration of service in a particular position and/or working area, work performance, competence and ranking position. Out of four requirements, one of them remains patrimonial – the duration of service in a particular position and/or working area. However, time could be disregarded if the official’s competency is needed in the other places more. In Indonesia, with high levels of corruption, it is reasonable to consider period in position and or working as justification for horizontal task rotation. Staying in the same position over a long period might develop an entrenched and opportunistic relationship between an officer and his/her clients or taxpayers which then might influence the decision that has to be made.

On the contrary for some officials, working in the reformed offices meant that they were closely monitored by their supervisors which was not easy for them. By the end of 2008, all units in the DGT had been restructured, those who had been reluctant to join the reform process tried to avoid being placed in the LTO by underperforming. This implied that these officials would rather work in the STOs in the remote areas where the pressure of works was not as high as at the LTO but kept the same salary.

Most respondents realised that they had more take home pay compared to other Indonesian civil servant but it was disappointing that the amount has remained static for the last ten years. Considering macroeconomic conditions and growing pressure on efforts to achieve tax revenue target, they hoped that there will be adjustments on their salaries. There is a growing issue that there should be a different level of salary based on the type of the tax office. This means that officials who work at the LTO should

earn more salary than those who work at the MTO or STO. In addition, evidence on government salaries indicates that civil servants receive a lower salary compared to private sector officers, both at the highest grade and lowest grade levels. The growth of the private sectors has led salaries in the private sectors to rise rapidly. This has resulted in an increased temptation to resign from public office and join the private sector. DGT's statistics in the annual reports (2011a, 2012; Khairi, 2013, 30 August) show that the number of tax officials in 2010 was 32,741. This number decreased in 2011 to 31,736 officials, which means the DGT lost almost a thousand of its staff. In 2012, the number continued to decline and left the DGT with 31,316 on its payroll. No data is available either about the exodus of civil servants from the DGT but based on the statistics above and the author's personal relationship with tax officials, the number has increased over the last four years. Recently one of the DGT officials posted on his/her *Facebook* account: "If in 2007-2008, 100 officials resigned was considered miserable, what would you think if in a year the exodus of more than 2,000 officials happened in an institution". Another post also from one of the DGT officials stated: "never mind the disparate fortune, be grateful for the fortune we've got - chill to see other people earn so much money, no wonder many officials resigned #save the DGT#".

The importance of adequate remuneration in ensuring honest civil servants is widely recognised in the policy debate (Van Rijckeghem & Weder, 2001). Van Rijckeghem and Weder cite the study of Besley and McLaren in 1993 and Faltter and McLeod in 1995 which suggest that ensuring this level of honesty may be prohibitively expensive. Meanwhile, Haque and Sahay (1996) argue that raising wages could be cost-effective by ensuring better human capital in tax administration. Another study concludes that bribes may be less efficient than bonus payments in encouraging effort among tax enforcers (Mookherjee & Png, 1995). Research by Van Rijckeghem and Weder (2001, p. 307) found evidence of "a statistically and economically significant relationship between relative civil service pay and corruption ... The relationship implies that a rather large increase in wages is required to eradicate corruption solely by raising wages". Their research also indicated that 100per cent increase in relative pay is associated with an improvement in the corruption index around 0.5 points. Without taking into account indirect effects, quasi-eradication of corruption is associated with a relative wage of two to eight times the manufacturing wage (Van Rijckeghem & Weder, 2001).

As mentioned in Chapter 2, the standard of living for Indonesian bureaucrats has improved from time to time but the widespread corruption is still generally explained by the low wage rates of Indonesia's civil servants. Since the Soeharto era, the amount of civil servant salary has been gradually increased but only by around 10 to 15 per cent. The civil service system is captured in Law Number 8 Year 1974 and its amendment of Law Number 43 Year 1999. Article 7 of the law stipulates that the payroll system for civil servants is based on merit, in accordance with workloads and degree of responsibility. However, this system has not been implemented yet and to date the amount of salary is only based on rank and class.

According to Haque and Sahay (1996), paying salaries that ensure public administrative efficiency is important for several reasons. Firstly, as the pervasive nature of government activity in developing countries creates unchecked opportunities for bureaucratic discretion, without the right incentives set for civil servant, public resources are likely to be misappropriated. Secondly, as the government employees are expected to play a crucial role in transforming underdeveloped economic structures and rudimentary institutions into advanced market-based ones, government must attract skilled staff by compensating them adequately. Thirdly, as wages in the private sector are likely to rise rapidly, government pay scales must rise concurrently with the trends in the private sector, to preclude mass exodus of skilled government employees. As quoted by Haque and Sahay (1996, p. 754) "The commitment to reform cannot long survive, unless government provides adequate pay, recognition for jobs well done, accessible training and decent working conditions" – The Volcker Commission (1990). The remuneration system must therefore be one of top priorities in reforming an institution.

Punishment and reward system in human resources management also became one of the topics raised by the interviewees. The DGT performs disciplinary enforcement to personnel through internal audit and investigation on ethical and/or disciplinary misconduct. Table 6 shows statistics of disciplinary actions to tax officials.

Table 6
Disciplinary Actions of the DGT's Officials

Year	Warning	Light Sanction	Medium Sanction	Heavy Sanction	Demotion	Suspension	Total
2003	402	33	17	34	n/a	n/a	486
2004	120	31	13	44	n/a	n/a	208
2005	167	13	5	66	n/a	n/a	251
2006	70	32	37	71	n/a	n/a	210
2007	105	36	37	76	n/a	n/a	254
2008	155	98	61	88	0	4	406
2009	382	42	28	56	0	8	516
2010	506	61	33	30	11	16	657
2011	89	86	43	32	9	4	263
2012	0	94	47	76	3	6	226

Source: the DGT Annual Reports

In 2003, the DGT issued warnings indicating that they were serious about undertaking reform in human resources management. However, the total number of 402 did not represent the number of tax officials who received disciplinary sanctions as a tax official may receive more than one warning. A warning is the softest disciplinary action in reprimanding an official, for example, for being late, leaving early or absent without notice. This could be given to an official a maximum of three times for each case. In most cases, warnings were issued as results of being late or leaving early. This happened as the DGT was deploying the use of fingerprint reader machine for recording the start and the end of working hours, replacing the manual signature systems.

The number of enforcements declined for several years before beginning to increase in 2007 to reach a peak in 2010. The year of 2007 and 2008 were the last periods of the modernisation phase I. There were 188 offices being modernised in 2007 and 314 offices in 2008. Out of the total 568 tax offices around the country, 502 offices were modernised during 2007-2008. As so many offices being redeveloped, this happened in 2003 re-occurred in 2009 and again 2010, where the number of issued warnings was enormous as (being late to come at the office or leaving the office early) shown in these fingerprint reader machines.

Statistics of disciplinary actions enforced to the tax officer were published in the mass media. Some interviewees thought that by announcing punishment statistics to the public meant that the DGT admitted the existence of misconduct in its operation. In my perspective, the reason for this announcement was actually to show that the

DGT had undertaken serious enforcement measures. Some other interviewees however, thought that the DGT was more reactive in implementing discipline than rewarding those who reached great achievements in their work.

Moreover, the development of a whistle-blower system was not seen as an opportunity to be rewarded. On the contrary, it doubts the whistle-blower, notwithstanding how great the rewards were. The regulation on whistle-blower system stipulates that any tax official taking action as a whistle-blower would be rewarded by a certificate of appreciation and (a) promotion up to echelon IV or recommendation to be promoted up to echelon II, (b) rotation to a desired place, (c) special or extraordinary preferment, (d) training or short course, and/or (e) special reward performance amounted ten times of whistle blower's allowance (DGT, 2011b).

This system was still in the very early stage of implementation, those officials placed in the handling unit still need more training and experiences in order to perform their tasks properly. In many cases of whistle blowing, there were "reverse attacks" where people reporting corrupt activities were charged with defamation. Thus, instead of being protected and rewarded, the whistle-blower faces intimidation, threats and even physical attacks because of their actions (Maulia, 2008, 26 December).

One of the interviewees had experience in which he/she reported a tax official's misconduct to the internal compliance unit at the Head Office, but it happened before the whistle-blower system was implemented. This interviewee regretted what he/she has done as he/she became the one that being investigated rather than being protected (I20). There were internal auditors who checked on his/her assets such as houses and cars. He/she felt that they came to check on how the house appearance, where it is located and how many cars were parked outside. In order to make the whistle-blower system works well, the DGT and its vertical unit (Ministry of Finance) have to be well prepared. Otherwise, this will remain as toothless action devoid of positive results.

In addition, the establishment of internal compliance team within the Head Office and regional offices for improving effectiveness of preventive and corrective measures taken on misconduct had been twisted to the contrary. This taskforce was supposed to investigate public complains reported directly to the DGT and suggested proper sanction if they were proven. Some interviewees felt that instead of investigating public complaints, this taskforce was more on searching for officials' misconducts and entrapped them in an uneasy situation.

Nevertheless, in 2012 the DGT developed several mechanisms for supporting a whistle-blower system. Other components including building complaint helpdesk, completing an internal complaint menu through human resource information system, creating a review team for issuing a certificate of appreciation for whistle-blower, and making a report on the implementation of whistleblowing system were added. The public is now also able to access the WiSe – the application provided by the Ministry of Finance for those who have information and would like to report a violation of the indicated act that occurs in the Ministry of Finance. The DGT has been implementing these efforts to show its seriousness in introducing a whistle-blower system for a greater transparency.

Other characteristics of a patrimonial administrative system are those where officials supplement their salary with bribes and kickbacks can be dismissed for no reason and where internal controls are lax (Brinkerhoff & Goldsmith, 2002). The implementation of the tax official code of conduct showed an effort to move away from patrimonial legacies, where officials were prohibited from supplementing their salary and that they could only be dismissed with cause. The establishment of the internal control unit and the implementation of the whistle-blower system showed that internal controls were strict. In addition, stronger enforcement of reward and punishment systems indicated that the DGT was heading towards a rational-legal bureaucratic system.

4. Conclusion

Chapter 3 discussed the impact of tax reform to state capacity development in theoretical term. In this chapter the discussions outlined what has been done and events taking place at the DGT, as well as the achievements and the impact of taxation reform for the internal staff of the DGT and the taxpayers. In order to answer the first research objective – how effective has the taxation reform been since its inception in 2002? – based on discussion of outcomes, achievements and criticism on taxation reform, it is likely to state that service quality, image and human resource management were much better than before. Thus, the taxation reform programs for these three areas have been performed effectively.

As it is known that the needs and expectations of the taxpayer against taxation service performance given by the DGT is dynamic, diverse and varied. The DGT is always required to be able to fulfil in the best way, high quality and low cost. In other

words, taxpayers demanded a minimum sacrifices to obtain the most satisfactory services. One way of doing monitoring and evaluation for service performance is to do a survey. Surveys performed in 2007, 2010 and 2012 resulted in the scores of taxpayers' satisfaction level of 55, 66 and 78 out of 100 per cent. The increasing scores showed that taxpayers satisfied with the DGT's service quality. Even though taxpayers' expectation got higher each year, the DGT has been maintaining and improving its quality correspondingly. Prior to 2012 the survey to find out the level of taxpayers' satisfaction or stakeholders' satisfaction index has not been performed in a regular basis but since the result obtained from the 2012 survey was very useful in creating policies to increase tax services, the survey then performed every year. Based on results of the 2012 survey, the DGT increased its service performance in the following areas; supporting facilities, services system operating procedures, human resources, service applications and information access. All figures in service performances above proved that taxation reform programs in the field of increasing the quality of services performed to taxpayers has been effective.

Known as the most corrupt institution but achieved an award as the most trusted public institution was a great achievement for the DGT. It would not have happened without hard efforts and strong willingness of the DGT officials. This success showed that tax reform programs to create a better image of the DGT in the eyes of public has been performed effectively. The survey on public trust level supported the effectiveness of reform programs by showing the increasing level of public trust from 2010 to 2012, starting from 66, 82 and then 84 (in scale of 0-100).

The persistence of corruption in Indonesia shown in the Transparency International's Corruption Perception Index indicated that corruption activities still hinder governance reform. However, Indonesia's CPI scores increased from 1.9 in 2002 to 3.2 in 2012, and the country's rank levelled up from rank 96 out of 102 countries in 2002 (included as one of 10 most corrupt countries in the survey) to rank 118 out of 176 countries in 2012. These figures showed that the government has been eradicating corruption seriously. Among other things, the taxation reforms within the Ministry of Finance influenced the public perception on corruption in Indonesia.

In term of human resources, taxation reform programs put emphasis on comprehensive and sustainable human resources management. In order to build a better performance culture, the DGT conducted an employee award program and a leadership development program. These two programs were given as part of a reward

system. Reward was not necessarily manifested in the form of financial support but could be given as a compliment or expression of appreciation and recognition for achievement. This reward system successfully increased tangible outcomes such as individual and group performance as well as the quantity and quality of the performance. It guided actions and behavior in team work, cooperation and creativity. It also motivated tax officials and foster their spirit for performance improvement. With a new regulation on pattern of redeployment for career position implemented at the beginning of 2012, there was a clearer path for tax officials' future job rotation. In conclusion, effective management of human resource has led to a healthier organisation in which reward and punishment system was properly applied as suggested in the rational-legal bureaucratic system.

Prior to discussing the impact of reform to other stakeholders, it is necessary to examine whether this tax reform has enhanced accountability of the DGT by exploring the efficiency and effectiveness of tax administration reform. This topic will be explored in the next chapter.

CHAPTER 5. AN ATTEMPT TO INCREASE STATE CAPACITY – EFFICIENCY AND EFFECTIVENESS OF TAX ADMINISTRATION REFORM

*“Taxes are what we pay for a civilized society” Oliver Wendell Holmes - US
Supreme Court of Justice (1904)*

The administration reform in DGT is often viewed as a successful effort of the Ministry of Finance. Several surveys by independent institutions showed good results, both in the performance of tax officials and services delivered to taxpayers. Reports from donor countries as well as donor organisations also indicated positive responses. Chapter 4 discussed these results of surveys and achievement obtained during the reform process. However, there is no universal agreement as to how to measure the success of the reform. Success is a subjective concept and not easily measured. Efficiency and effectiveness can be seen as the quantitative aspects of a reform while others such as transparency and accountability are qualitative ones.

This chapter still aims to answer the first research objective – how effective has the taxation reform been since its inception in 2002? It examines several measures of effectiveness and efficiency namely revenue target, tax ratio, tax compliance ratio and cost of collection ratio. In order to find out how the implementation of the taxation reform has improved the capacity of public sector institutions to provide public good and services – the second research objective – this chapter then examines whether the reform has been implemented with accountable agenda and has shown the extent of how it has affected other public sector institutions. The researcher suggests that the reform has indeed improved the capacity of the Indonesian state in a way that supports main government revenues so that increasing government expenditure in providing public goods and services is covered and has influenced other institutions to reform themselves. This situation leads to more civilised society as observed by Holmes (1927) in which a good share of legitimately allocated revenue from taxes are being imposed.

The World Bank Institute suggests five stages of reform in assessing and enhancing the capacity to build efficient and accountable institutions, known as ‘Public Sector Governance Reform Cycle’. The cycle moves from (a) recognising strengths

and weaknesses in governance and building awareness to, (b) assessing the scope for political change to, (c) technical diagnostics and the design of reforms to, (d) managing the politics of reforms and, (e) evaluating results (Wilhelm & Kushnarova, 2004, p. 2). However, to limit the scope of the research, only the last stage is used in this discussion.

This last stage of the cycle involves evaluating results in order to yield information that can be used in future policy adjustments and diagnostics. There are three tools for evaluating results of reform; surveys, scorecards and capacity enhancement need assessment (CENA). These three tools have been used in monitoring taxation reform in Indonesia with some adjustments to the country's situation and condition. Independent agencies have performed several surveys on service quality. Community scorecards have also been used to get direct citizen feedback on the performance of public services. In the CENA approach, several international institutions assisted the DGT in developing capacity building for human resources.

Most institutions continuously strive to strengthen their capacities to fulfil their directives. One of the institutional measures proposed by the UNDP was to describe efforts by institutions to boost their capacities such that the institution performs more effectively and efficiently in delivering on its mandate. Performance is a combination of the effectiveness and the efficiency with which an institution fulfils its intended purpose (UNDP, 2010). Effectiveness is the degree to which the institution's objective has been achieved, and efficiency is a comparison between what has been produced (or achieved) and resources used. Taking into account the DGT's goal to collect tax revenue for the state, the following analysis explains the effectiveness and efficiency of tax administration reform. With regard to suggestions from the World Bank Institute and the UNDP mentioned above, the analysis will cover tax revenue achievements, tax ratios, tax compliance ratios and cost of collection ratios.

1. Increasing Tax Revenue

Since the 1980s tax reform, realisation of tax revenue targets through improvement in tax administration has always been an important objective. In addition to internal factors such as service, counselling and audit, tax revenue realisation also depends on external factors over which the DGT has no control. The income tax, value added tax and import duties depend on general economic trends. Moreover, taxpayer's

behaviour or tax culture is affected by the quality of public services and infrastructure provided by other government agencies. Macroeconomic indicators such as economic growth, inflation rates, exchange rates and oil prices, should not be disregarded, as they influence the amount of revenue predicted during state budget preparation. It is therefore good that during the economic recovery, 2002 up to 2011, the DGT achieved the tax revenue targets several times. Although there were times when the targeted revenue could not be met due to circumstances mentioned above, for the most part the accomplishment was reached by analysing the growth rates. This suggests that the operation of the DGT has become more effective and efficient. Data on tax revenue target and the rate of increase in targets collected (tax growth) is shown in the table below.

Table 7
Realisation of Tax Revenue Target and its Growth Rate

In trillion rupiah

Year	Tax Revenue		Realisation (per cent)	Growth (per cent)
	Target	Actual		
2001	156.57	158.58	101.28	
2002	180.10	176.32	97.90	11.19
2003	210.79	204.66	97.09	16.07
2004	238.59	238.64	100.02	16.60
2005	302.16	298.54	98.80	25.10
2006	371.70	358.20	96.37	19.98
2007	432.52	425.37	98.35	18.75
2008	534.53	571.11	106.84	34.26
2009	577.39	544.53	94.31	-4.65
2010	661.50	620.20	93.76	13.90
2011	763.67	742.74	97.26	19.76
2012	885.03	835.83	94.44	12.53

Source: DGT Annual Reports and *Pajak dalam Angka 2001-2009* (DGT, 2010b)

In the period of 2002-2012, in only two instances did the DGT succeed in achieving revenue target, namely in 2004 and 2008. Failures in achieving targeted revenues were mainly due to lower economic growth. For example, in 2012 the state budget law predicted the rate for economic growth as 6.5 per cent, but by the end of the year the real economic growth was only 6.3 per cent. Lower economic growth means that global and domestic economic conditions are worse than expected. This lower growth may lead to decreasing profit of corporate and lower consumption or spending of individuals. In the same year, tax revenue from mining and excavating sources also suffered negative growth of 15.05 per cent. Considering that these sources

contributed almost 10 per cent of total tax revenue, negative growth was not a good stimulus as it reduced the predicted amount of tax collection (DGT, 2013). In the end both, lower economic growth and negative growth, affected the amount of tax revenue.

Up to 2008, the DGT's administration reform was a success in terms of meeting tax revenue growth rate. From Table 7 it can be counted that the annual average of the tax revenue growth rate from 2002 to 2008 was 20.28 per cent. In addition to the national economic condition, the highest tax revenue performance in 2008 was attributed to the high global oil price⁵⁶ and the taxpayers' positive response to "Sunset Policy". The sunset policy program is the softest tax amnesty granted by the government to noncompliant taxpayers. This policy provided for individuals with the opportunity to register voluntarily to get Tax Identification Number and also submit their tax returns in 2008. There was also a chance for registered taxpayers to revise voluntarily their filed tax return during this period without penalty.

However, the good figures in 2008 discontinued in 2009. The tax revenue failed to grow and showed a negative growth of 4.65 per cent. It was unprecedented in the history of taxation that the total tax revenue was nominally lower than the previous year. The rate of economic growth that had been predicted at 6.0 per cent at the beginning of the year worsened to 4.4 per cent⁵⁷ (DGT, 2010a). Although there was two months extension of sunset policy period up to the end of February 2009, the additional revenue gained from this program unfortunately, did not help reduce the negative growth.

The sunset policy period was extended to meet the demand of taxpayers who required a longer time to revise their tax returns. Many taxpayers decided to take advantage the facility of the elimination of penalties, which supposed to be enforced in the amount of 2 per cent of the underpaid tax per month, approaching the end of sunset policy period. Beside the elimination of penalties, the sunset policy program gave two benefits to taxpayers (i) all filed tax returns would not be audited unless the DGT found data which showed that tax returns were incorrect, and (ii) data and information contained in the filed tax returns were not used as a basis for issuing assessments on other taxes. The total tax returns filed up to the end of 2008 were 556

⁵⁶ In that year, the oil price reached US \$ 97.10 per barrel, which showed an increase of US \$ 26.40 from the previous year, or 37.88 per cent respectively (DGT, 2010b)

⁵⁷ This was mainly caused by the oil price that went down to US \$ 61.60 per barrel from US \$ 97.10 in 2008 and US \$ 70.70 in 2007. The decreased price affected overall tax revenue.

thousand with tax revenue up by 5.56 trillion rupiah and 3.5 million new taxpayers were registered. Within the two months extension, 248 thousand more tax returns increased the amount of tax revenue in excess of 7.46 trillion rupiah. In addition, there were as many as 2.09 million additional taxpayers. The goal of sunset policy program was to boost the amount of tax revenue collected and to increase tax returns filing compliance. The result showed that the policy indeed help in increasing tax revenue in 2008 and 2009 but not in a significant amount. The result also showed that the filing compliance ratio⁵⁸ increased significantly.

Although there are many factors that may influence the tax revenue realisation, one of the interviewees insisted that the DGT performance should be measured from the realisation of tax revenue targets not from tax growth rates. The revenue target is mandated by law on the national state budget, so if the target is achieved the DGT has performed well. This interviewee also made a comment on the calculation of tax revenue's growth. This person disagreed with the way growth rate has been calculated. Where revenue targets were not achieved, the growth rate should be calculated from the target not from the actual revenue. For example, in 2012 the revenue target was not achieved but there was the revenue growth of 12.53 per cent⁵⁹. According to this interviewee, the real growth was actually only 9.45 per cent⁶⁰. I disagree with this interviewee because his/her calculation did not describe the real achievement. Whether the target was achieved or not the growth rate should be calculated from the actual revenue.

The determination of tax revenue target in the national state budget has never happened in such a manner had risen significantly from the calculation of the previous year target. By the end of the year, when the DGT officials stated that the tax revenue realisation had reached for example the rate of 25 per cent increase in taxes collected, the actual increase might only 15 per cent because the base for the growth calculation was the previous realisation of tax revenue which is only 90 per cent of the revenue target. The growth rate could be used as an indicator of performance, but I think it is more important to show how well you received the tax revenue target and managed to achieve 100 per cent of realisation. (I 30)

Apart from achieving revenue target, two main tasks of tax administration reform are achieving higher effectiveness – capacity to achieve a high level of tax compliance, and efficiency – capacity to make administrative costs per unit of tax revenue as small as possible (Ott, 1998). Tax administration is considered effective if

⁵⁸ See Table 9 page 134

⁵⁹ $(835.83-742.74)/742.74=0.1253$

⁶⁰ $(835.83-763.67)/763.67=0.0945$

there is a high tax compliance ratio, and it is efficient when administrative cost ratio is low. The following sections explain these ratios in more detail.

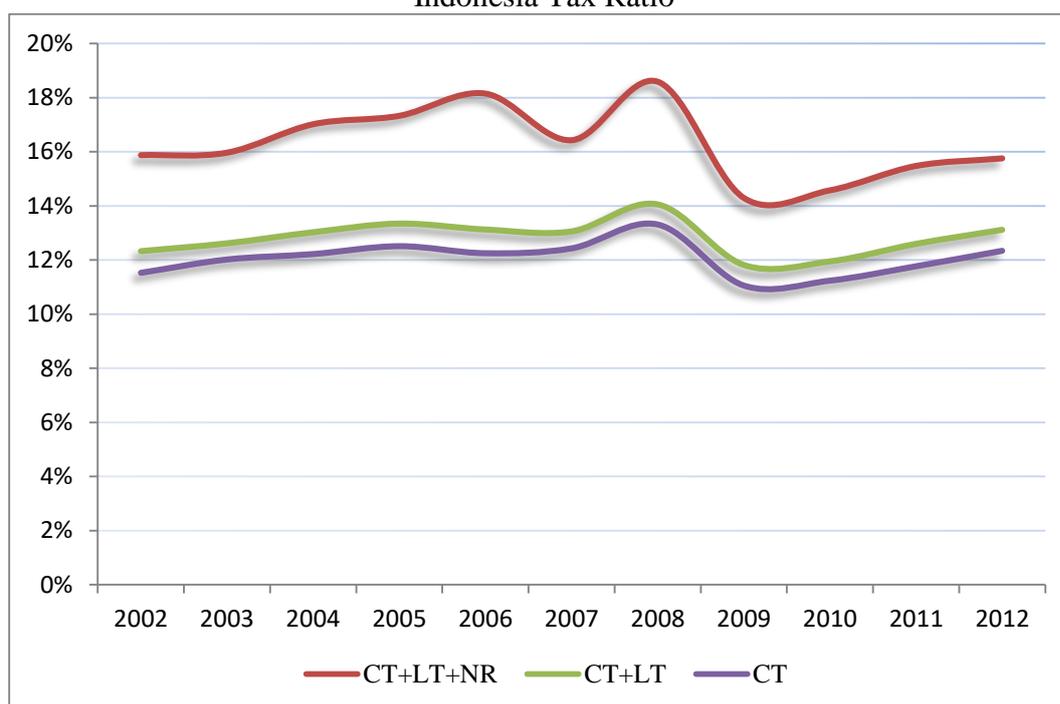
2. Stable Tax Ratio

As mentioned in the previous chapter, the Indonesian overall tax burden or tax ratio was relatively low compared to other countries in the region. Taxes whether direct or indirect are linked with the economy of the country and that is generally represented with the term Gross Domestic Product (GDP). Tax revenue to GDP ratio or simply 'tax ratio' is the ratio of total government tax revenue by the country's GDP. Judging tax ratio of a country and comparing to others may be misleading since every country has its own characteristics such as political and economic structure, tax structure, income per capita and public service capacity in general. As the OECD (2008c) reminds its members, care needs to be taken when comparing the tax burden of the countries under consideration given the possibility of differences in the way the underlying aggregate data may have been compiled. Thus, it is important to know how the data on total tax revenue is gathered. However, a country with a low tax ratio indicates that its tax administration is ineffective and inefficient.

For the purposes of their research, international organisations, such as IMF and OECD, include five components of total tax revenue (i) taxes on income, profits and capital gains; (ii) taxes on payroll and workforce; (iii) taxes on property; (iv) taxes on goods and services; and (v) taxes on international trade and transaction (IMF, 2011). In addition, the OECD reports social security contributions as a sub-component of total tax.

In Indonesia, there are three methods in defining tax revenue used for calculating tax ratio. The first one is purely the total of tax revenue collected by the central government (CT), or component (i), (ii), part of (iii), (iv) and (v) respectively. The second includes the amount of tax revenue collected by both central and local governments (CT+LT). In the last method, revenue from natural resources is accumulated (CT+LT+NR). However, the first method has been commonly used for international purposes. Figure 8 shows the Indonesian tax ratio using the three methods of calculation.

Figure 8
Indonesia Tax Ratio



Source: the DGT Annual Reports

Using the tax revenue collected by the central government as a base, the Indonesian tax ratio has remained stable for the last ten years – between 11 per cent and 13 per cent or 12 per cent in average. This ratio was very low compared to other countries in the region. According to the IMF’s fixed country grouping (2011), Indonesia was a lower middle-income country, and the average tax ratio for countries⁶¹ in this group was 17.7 per cent. The Indonesian 12 per cent tax ratio was even worse compared to the average tax ratios of low-income countries⁶², which was 13 per cent. This indicated that there was a problem in tax collection capacity or, more positively, there was still tax potential that has not yet been extracted and tax effort should be increased.

⁶¹ Countries in lower middle-income group are Angola, Armenia, Belize, Bhutan, Bolivia, Cameroon, Cape Verde, China, Republic of Congo, Cote d’Ivoire, Djibouti, Ecuador, Egypt, El Salvador, Georgia, Guatemala, Guyana, Honduras, India, Indonesia, Jordan, Kiribati, Lesotho, Maldives, Moldova, Mongolia, Morocco, Nicaragua, Nigeria, Pakistan, Papua New Guinea, Paraguay, Philippines, Samoa, Senegal, Sri Lanka, Sudan, Swaziland, Syrian Arab Republic, Sao Tome & Principe, Thailand, Tonga, Tunisia, Ukraine, Uzbekistan, Vanuatu, Vietnam, and republic of Yemen.

⁶² Bangladesh, Benin, Burkina Faso, Burundi, Cambodia, Central African Republic, Chad, Comoros, Congo Dem. Republic, Eritrea, Ethiopia, Gambia, Ghana, Guinea, Guinea-Bissau, Haiti, Kenya, Kyrgyz Republic, Lao Republic, Liberia, Madagascar, Malawi, Mali, Mauritania, Mozambique, Myanmar, Nepal, Niger, Rwanda, Sierra Leone, Solomon Islands, Tajikistan, Tanzania, Togo, Uganda, Zambia and Zimbabwe.

A half century ago, Nicholas Kaldor (1963), argued that in order to be “developed”, a country must be able to collect taxes between 25 to 35 per cent of its GDP. Less ambitious advice came from the UN Millennium Project (United Nation, 2005) which stated that developing countries need to mobilise an additional four percent of GDP in tax revenue beyond their current average level of about 18 per cent. Meanwhile, Bahl and Bird (2008, p. 280) summarise the average level of the tax ratio for three groups of countries in the following table.

Table 8
Tax Level: Tax Revenues as Percent of GDP in Decade Average

Country Groups	1970s	1980s	1990s	2000s
Industrialised	30.1	33.7	35.5	33.4
Developing	16.2	17.3	17.0	17.0
Transition ⁶³	n.a.	47.7	29.6	29.1

Source: Calculated from data IMF 2003 by Bahl and Bird (2008) with limited data available for 2000s

The table above shows that in developing countries the tax ratio increased only slightly. Kaldor’s suggestion was essentially for underdeveloped countries in the 1960s, thus it might not suitable enough to become a standard for today’s situation. However, it is indeed a motivated advice for developing countries. The recommendation from the UN and Bahl and Bird is more realistic for the present condition. The fact that Indonesia’s tax ratio was still far behind the recommended ones, should motivate the Indonesian government to perform better in increasing tax revenues.

Very low tax ratio is a common characteristic of most developing countries as they typically suffer from an insufficient supply of internal resources (A. Haque, 2012). Very broadly, the tax ratio is used to identify the country’s overall tax efforts. However, this very broad measure may not provide a realistic picture of the overall tax efforts of the country. A more desirable measure of tax efforts is the ratio of the actual tax revenue to the predicted tax revenue or potential tax. According to Haque (2012), tax effort is a measure which gives a general indication on how a country is raising tax

⁶³ The transition country group refers to the former Soviet-bloc countries as well as China and Vietnam, which are seen as being in transition from centrally planned to more market dominated systems. The tax ratio in the transition countries actually declined in the last decade reflecting the continuing realignment of public-private expenditure responsibilities in those countries (R. W. Bahl & Bird, 2008, p. 280).

revenue relative to its given economic and structural potential. Tax effort index is constructed by dividing the actual tax revenue by estimated or fitted tax revenue (commonly known as tax capacity).

The question about tax effort often arises if there is a scope at macro level for increased tax revenue for financing a development program or other purposes. According to Lotz and Morss (1967), a relevant consideration in answering the question is how the tax effort of the country compares with that of other countries in similar circumstances. They were the first to use the difference between actual and predicted tax ratios for the purpose of making inter-country tax effort comparisons. Their research included 72 countries and used per capita income and openness of the economy as independent variables. Using the same country set as Lotz and Morss, Shin (1969) extended the research by adding three more variables; the ratio of agricultural income to total income, the rate of growth of population, and the rate of growth of prices.

After conducting an extensive survey of earlier researches, Bahl (1971) produced solid theoretical grounding for tax effort approach of cross country comparative analysis. According to Bahl “tax effort may be defined as the extent to which a country makes use of its taxable capacity”, i.e. tax effort is the ratio of actual tax collections to taxable capacity. Bahl broadened Lotz and Morss’ research by developing a model using three general determinants of taxable capacity; the size of the foreign trade sector, stage of development and some measure of sectoral composition of value added.

More recently, Pessino and Fenochietto (2010) performed their research on 96 countries’ tax capacities by firstly determining countries’ tax effort. Pessino and Fenochietto (2010) state that this tax capacity represents the maximum tax revenue that could be collected in the country given its economic, social, institutional, and demographic characteristics. The dependent variable in their research was the general tax revenue collected by central and subnational governments as percentage of GDP. The independent variables were the level of development, the degree of openness of the economy, the ease of tax collection, level of education, income distribution, inflation, and inefficiencies in collection. The results reveal that countries with a higher level of GDP per capita and public expenditure on education are near their tax capacities, thus have a higher tax effort. Their analysis also shows that most European countries with a high level of development have a higher tax effort taking into account

its per capita GDP, GINI coefficient⁶⁴, trade, agricultural sector, education, inflation and corruption. Among different inefficiencies, such as corruption, weak tax administrations, government ineffectiveness and low enforcement, the researchers chose only one variable to represent inefficiencies in collection. That is the Transparency International's corruption perception index, as it can represent the mentioned inefficiencies in collection as well as the quality of the institution.

The study by Pessino and Fenochietto (2010) also reveals that, in 2004, with a tax ratio of 12.3 per cent, Indonesia's tax effort point was 62.0 and its tax capacity point was 20.6. This shows that there were still much room for expanding the tax base and that the authority has not yet a full capacity in fulfilling its duties. A fair tax capacity could increase the tax revenue by reducing the inefficiencies, particularly the level of corruption as discussed in more detail earlier in this chapter.

According to Brautigam et al. (2008), a standard economic approach to framing the relationship between taxation and state building is to explain the level of taxation and, implicitly, the government's capacity through a combination of the level of economic development and economic structure. Countries with higher incomes have higher tax ratios, which accompany the rise of other factors in the development such as literacy, industrialisation, and debt. This shows an increment in the relationship between taxation and state capacity. Looking at the Indonesian tax ratios itself, which remained stable from 2002 to 2012, the state capacity did not get much support from taxation. Even if the calculation of the tax ratio included local taxes or, local taxes and natural resources, the trend remained the same. However, the tax ratio alone did not represent the country's state capacity as there were other elements that should be taken into account.

3. Increasing Tax Compliance Ratio

Tax return-filing compliance ratio or simply 'compliance ratio' is the ratio of income tax returns filed by taxpayers to total registered taxpayers. In the Indonesian tax legislation, not all registered taxpayers have an obligation to file an annual income

⁶⁴ GINI coefficient is the World Bank's index which measures the extent to which the distribution of income or consumption expenditure among individuals or households within an economy deviates from a perfectly equal distribution. It is used as an independent variable in the research because a better income distribution should facilitate collection as well as voluntary taxpayer compliance.

tax return. Those registered taxpayers who earn income below the amount of tax threshold are exempt from this obligation.

The reform has resulted in an improvement in the number of registered taxpayers which increased significantly from 2.59 million in 2002 to 22.36 million in 2012. Of this last figure, 19.91 million were individual taxpayers and 2.45 million were corporates. This means that the number of individual taxpayers increased tenfold in ten years. This is due to a crash program on 10 million of Tax Identification Number (TIN) launched in 2005 and the Sunset Policy program in 2008.

In 2005, instead of waiting for people to register voluntarily as taxpayers, the DGT more aggressively mapped potential taxpayers who remained outside the tax net through their property and car ownership, credit cards and other financial transactions. Based on this data, millions of new taxpayer identification numbers were officially issued and mailed to taxpayers. This program did not automatically increase the number of individual taxpayers as some problems arose in the aftermath. Examples include a car owner uses someone else's identity card when he/she registered the car, a credit card holder did not give a valid address on his/her application, someone could have more than one identity cards and used them unlawfully. Sometime, it had to go through a long process until finally each taxpayer could be identified correctly. Nevertheless, the program indeed increased people's awareness to register as a taxpayer.

As mentioned earlier in this chapter, the sunset policy program, launched in 2008, was considered very successful because the DGT received two awards from the Indonesian World Record Museum (Museum Rekor Dunia Indonesia-MURDI) for getting the highest number of new Tax Identification Numbers in a year – 3,545,076 new numbers – and for getting the highest number of new Tax Identification Numbers in a day, which was 163,255 new numbers on the 31 December 2008 (DGT, 2009). These globally recognised awards symbolised the DGT's successful efforts in making their society more aware of taxes.

Unfortunately, the increased number of taxpayers did not automatically increase the tax return filing compliance. During the period 2002-2008, the level of compliance ratio remained steady around 30 per cent. The ratio for 2008 was 33.08 per cent; this means that about 67 per cent of taxpayers, intentionally or unintentionally, did not fulfil their tax obligations. This level of noncompliance was considered very high and it was a serious problem. However, it has never been easy to

persuade a taxpayer to comply voluntarily. The DGT may need to perform harder in law enforcement but the main causes for this condition were burdens for taxpayers in term of uncertainties in the laws and countless regulations, complex tax returns, excessive information reporting requirements and poor service.

As Indonesia adopts self-assessment system, the primary responsibility for the assessment process lies with the taxpayer rather than the DGT. Taxpayers are expected to understand and comply with their tax obligations. The most basic factor in choosing to comply or not to comply is the tax law. Logically, the more complex the tax laws are, the more chances a taxpayer will opt not to comply. The number of those who chose not to comply also grows when tax law enforcement is perceived as ineffective, impartial or unprofessional.

During the reform process, the DGT formulated and implemented strategies on programs and activities which could keenly increase taxpayers' attentiveness and voluntary compliance including performing effective law enforcement. The DGT also conducted tax awareness campaign with more comprehensive communication policies. In addition, the sunset policy massive campaign exerted a great influence on the compliance ratio. The campaign's features included self-assessment principles, openness, sunset policy benefits and information about new regulations concerning individual income tax rates that take effect immediately – someone who does not have a TIN is subjected to higher income tax rate on his/her earnings (DGT, 2009). As a result, the level of compliance ratio started to increase in 2009. Table 9 shows that the compliance ratio reached the level of 54.15 per cent in 2009 and 58.16 per cent in 2010 but then slightly decreased to 52.74 per cent in 2011. In 2012, it was anticipated that the compliance rate would reach 62.50 per cent but reached only 53.70 per cent. This due to several factors as follows:

1. Evaluation results of taxpayers' master file⁶⁵ showed that there were many individual taxpayers had a double identity;
2. Some new taxpayers were pensioners who did not understand their tax obligations;
3. There were taxpayers who were not registered in taxpayers' master file;
4. There were taxpayers with invalid addresses (DGT, 2013).

⁶⁵ Taxpayers' Master file is a computer database file providing general information on each taxpayer.

Table 9
Compliance Ratio

Year	Registered Taxpayers		Total Registered Taxpayers	Taxpayers obliged to file Annual Tax Return	Filed Annual Tax Returns	Compliance Ratio (in per cent)
	Corporates	Individuals				
2002	920,873	1,670,383	2,591,256	2,359,058	788,992	33.45
2003	1,024,104	2,007,861	3,031,965	2,763,152	967,613	35.02
2004	1,133,566	2,311,525	3,445,091	3,131,064	1,070,192	34.18
2005	1,233,552	2,629,833	3,863,385	3,481,787	1,182,437	33.96
2006	1,420,276	2,937,738	4,358,014	3,871,823	1,240,571	32.04
2007	1,553,537	3,251,753	4,805,290	4,231,117	1,278,290	30.21
2008	1,656,611	4,988,449	6,645,060	6,341,828	2,097,849	33.08
2009	1,823,251	8,388,816	10,212,067	9,996,620	5,413,114	54.15
2010	2,014,642	13,949,750	15,964,392	14,101,933	8,202,309	58.16
2011	2,205,443	17,327,184	19,532,627	17,694,317	9,332,626	52.74
2012	2,450,655	19,913,904	22,364,559	17,659,278	9,482,480	53.70

Source: DGT Annual Reports (2010, 2011, 2012) and *Buku Saku Pajak dalam Angka* 2001-2009

The number of registered taxpayers should be found easily in the taxpayers' master file. Within the DGT, the Head Office keeps national master file and each tax office has its own master file in accordance with its region. Data in the master file is updated periodically to record any data changes and maintain validity and quality of data. In addition, the updated data is also important to improve services to taxpayers, particularly to deliver information and guidance on an ongoing basis. Taxpayers with invalid addresses might not receive reminders for filing tax returns. Taxpayers who are not in the master file might not be included in the number of complied taxpayers. Whilst individual taxpayers with a double identity will certainly increase the number of taxpayers but since they only file one tax return, this will decrease the compliance rate.

In order to increase the compliance rate, taxpayers are also encouraged to file their tax return electronically. In 2005, the DGT started to introduce an Electronic Tax Return (e-SPT) to facilitate taxpayers in preparing their tax liabilities and e-Filing procedures to submit their reports. The number of taxpayers using this facility increased but not significantly. The use of internet for taxation reports has not yet accustomed for Indonesian taxpayers. Rolling out new information and communication technologies, and then educating taxpayers and tax officials in their use is not easy tasks for any government, particularly for Indonesia, where citizens

face limited broadband access, power shortages, slow network speeds and system failures. The implementation could be slow and face greater challenges. In 2009, the DGT obligated the submission of e-SPT for taxpayers registered in LTOs and MTOs, but there was no obligation for reporting through e-Filing. The 2011 statistics show that there were 120,790 taxpayers using e-SPT and out of that number only 9,850 taxpayers reported their e-SPTs using e-Filing facility. Although the figure indicated a very low level of taxpayers using electronic facilities, less than 1 per cent of taxpayers, this was double the previous year of 4,941 tax returns (DGT, 2012). In 2012, the number increased more than 100 per cent, where 21,799 tax returns were submitted through the e-filing system (DGT, 2013).

Although the number was still low, in recognition of implementation of the e-Filing Annual Tax Return Project, the DGT was awarded as the Public Sector Organisation of the Year – in the South East Asia region at the seventh annual FutureGov Awards in the 25 October 2013 at Phuket, Thailand. FutureGov Awards are the international benchmark by which public sector innovation is judged – uniquely celebrating agency and project success, as well as the most successful city modernisation programs in the region. In 2013, the award winner E-Filing Annual Tax Return Project application has so far been made available to two categories of taxpayers - ‘simple’ and ‘very simple’ - covering 70 per cent of all the taxpayers. The 2013 DGT annual report has not yet been published but if the project went well, it was expected that millions of taxpayers will have utilised the e-Filing. In 2014, the project will be opened to self-employed and corporate taxpayers.

Harry Gumelar, Director of Transformation, Technology, Communication and Information at the DGT, shared with FutureGov how his agency leveraged IT to enable more efficient resource utilisation in this key revenue-earning authority.

“Indonesia has a high internet penetration at 42 per cent, and Indonesians are now very familiar with online applications and mobile devices. For 2014, we are targeting to receive 1 million tax returns through the e-filing system. We are also planning to make the e-filing application available on mobile devices. This project will start in 2014 and we hope to implement it in 2015. The app will be developed in-house in consultation with technology experts. The agency has received positive responses from users of e-filing as they can now conveniently file their tax returns. Moreover, employees can now be focused on core activities rather than clerical work. It has also promoted transparency and good governance” Gumelar says (Basu, 2013).

The electronic system for filing, if implemented well and used by most taxpayers, benefits both tax authorities and taxpayers. For tax authorities, e-filing

lightens workloads and reduces operational costs such as for processing, handling and storing tax returns. At the same time, e-filing increases compliance with tax obligations and save time, both for tax authority and taxpayers.

Compliance with tax laws is important to keep the tax system working for all, and eventually the tax revenue increase to support the development programs. One way to encourage compliance is to keep the rules as clear and simple as possible. Over complicated tax systems are associated with high evasion. Furthermore, high tax compliance costs are associated with larger informal sectors, more corruption and less investment. An economy with a simple and well-designed tax system is able to support the growth of business and certainly the growth of investment. Low tax compliance cost and efficient procedures can make a big difference for businesses.

The *Paying Taxes* study, as part of the World Bank Group *Doing Business*⁶⁶ project, uses a case study scenario to measure the taxes and contributions paid by a standardised business and the complexity of an economy's tax compliance system. The *Paying Taxes 2014* provides data on tax compliance of 189 tax systems around the world. The tax compliance burden are measured using three sub indicators: the total tax rate, the time needed to comply with major taxes and the number of tax payments (PWC, 2013, p. 8). The total tax rate measures the amount of taxes borne by a standard company (as a percentage of the commercial profit or the profit before all of those taxes). The time needed to comply with the measured taxes captures the number of hours it takes to prepare, file and pay the taxes. And the number of payments measures the frequency with which the taxpayer has to file and pay different types of taxes, adjusted for the manner in which those filings and payment are made.

Since 2009, *Doing Business* reports have recorded 57 tax reforms around the world introduced or enhanced online filing systems (PWC, 2013). These efforts combined with other improvements to simplify tax compliance reduced the time to comply with the three main taxes measured (profit, labour and consumption) by 20 hours on average, and the number of payment by 4 on average. Europe and Central Asia had the biggest improvement, reducing the time by 80 hours and the number of payment by 20 on average. Globally the *Paying Taxes 2014*'s case study average company made 26.7 payments, took 268 hours and had a tax cost of 43.1 per cent of its commercial profit. The range for each indicator was very wide, starting from 3 to

⁶⁶ *Doing Business* is an annual report prepared by the International Finance Corporation, the World Bank, by measuring and tracking changes in countries' economies.

71 for the number of payments, 12 to 2,600 hours to deal with taxes, and 8.2 per cent to 283.2 per cent points of total tax rate. The highest total tax rate was found in the Gambia and closely followed by Comoros, the two countries being the last remaining economies where a cascading sales tax still existed⁶⁷.

Since the beginning of the study in 2004, of the three indicators, the number of payments has fallen by the biggest percentage which demonstrates the successful implementation of electronic filing and payment systems around the world (PWC, 2013, p. 28). However, challenges clearly have remained in terms of introducing such systems, making sure that they are used by the majority of taxpayers and that they are user friendly.

Tax compliance analyses for the Asia Pacific region shows that all indicators were below the global average. With total tax rate of 36.4 per cent, this region had the second lowest total tax rate compared to other regions around the world. The region experienced a slight decline in a number of payment over the period of the study (from 27.1 to 25.4 payments) mainly as a result of the Maldives's introduction of profit, labour and other taxes in 2011, which contributed the increase of 27 payments. The reduced time to comply from 286 hours in 2004 to 232 hours in 2012 was resulted from significant and broad reforms in China, Lao PDR, Timor Leste and Indonesia. The PWC analyses recognised Indonesia's simplified tax filing and increased use of electronic systems. The Indonesia's tax compliance analyses show the total tax rate of 32.2 per cent, with 259 hours to comply and 52 payments. Even though the Indonesia reform programs have contributed significantly to the region analyses, the results themselves show that the time to comply and the number of payment are still above the region's average. This condition should be a challenge for the Indonesian government, particularly the DGT, to improve its performance.

The technologies in taxation have made it possible to offer extraterritorial services to taxpayers. A Russian cosmonaut, Pavel Vinogradov, an International Space Station crew member was able, whilst in orbit, to do his taxes using these technologies. He became the first person ever to pay taxes from space and Russia became the only country that managed to take a tax from a man who was in space (Kalmykova, 2013, 16 May). Revenue authorities around the world are continuously making great efforts to streamline administrative processes and modernise payment systems

⁶⁷ Cascading tax is a turnover tax that is applied at every stage in the supply chain, without any deduction for the tax paid at earlier stages.

In addition, in 2011 the DGT also carried out “*Sensus Pajak Nasional*” (SPN – the National Census of Tax). This program aimed to explore tax potency through tax object data collection in order to broaden the tax base. With the economy growing rapidly throughout Indonesia, the total number of registered taxpayer remained relatively low, and this was one of the most basic of challenges for the DGT. Based on the Statistic Indonesia data, as of 31 December 2011, the number of active workforce in Indonesia was 110 million. Compared to 19.9 million of individual taxpayers, this means that the ratio of individual taxpayers to active workforce was only 18per cent. The census was continued in 2012 and implemented simultaneously all over the country. Considering the geographical spread of the country, priority in choosing the location was given to economic/business centres, high rise buildings, high wealth housing areas and other potential areas. The 2012 census result reported that most respondents responded well to the census. It contributed to an increased number of filed tax returns and updated data within the taxpayers’ master file. The census demonstrated tax potency in line with the Indonesian tax philosophy where all taxpayers are registered, all taxable objects are taxed and all taxes are fulfilled timely and correctly. Increased compliance ratio implicitly showed that there was a good relationship between tax authority and taxpayers, or in more general terms, between state and the society. As state capacity is all about the state-society relationship, the increased compliance would contribute to the increased state capacity.

4. Low Cost of Tax Collection Ratio

A cost of tax collection ratio or simply cost ratio is the ratio of expenses for collecting tax revenue (administrative costs) to total tax revenue achieved each year. Administrative costs apparently include the cost of running and maintaining revenue authorities, including salaries, accommodation and office expenses, the costs of legislative enactment relating to the tax system and also the judicial costs of administration of the dispute system. A common practice is to restrict administrative costs to those costs that relate to the running of the revenue authorities, but aside from simplicity of measurement and availability of the relevant statistic, there is no other reason for this. The decision as to what to include or exclude from administrative costs is heavily dependent on the availability of data.

It has been a common practice for revenue authorities to calculate and publish, for example in their annual reports, the cost of collection ratio as a surrogate measure

of the efficiency and or effectiveness of their administration (OECD, 2013). Most authorities tend to publish the ratio for a number of years, and changes in the ratio over time should reflect movements in relative efficiency and or effectiveness. This trend arises from the fact that the ratio is derived from a comparison of inputs (administrative costs) to outputs (tax revenue collections). The OECD (2013) emphasises that a descending trend in this ratio can constitute evidence of a reduction in administrative cost (improved efficiency) and or improved tax compliance (improved effectiveness). However, there are many factors that can influence the ratio which are not related to changes in a revenue authority's efficiency and or effectiveness such as changes in tax rates, macroeconomic changes, abnormal expenditure of the revenue authority, and changes in the scope of taxes collected.

It is important for any tax authority to be aware of how much is spent for every dollar (rupiah, in case of Indonesia) collected. Monitoring this ratio over time provides necessary information on the tax performance. This information could then be used to formulate strategy to enable the authority to finance more schemes that benefit the citizens (GOLD, 2001).

In order to count the ratio, the DGT defines the administrative costs as the annual costs of administration incurred over the course of the fiscal year. During the reforms, the DGT's collection cost was perceived to be low. For example, only 0.33 per cent was needed for each rupiah collected in 2001, 0.58 per cent in 2002, 0.56 in 2008 and 0.68 per cent in 2010. Collection cost was low in comparison with the 2 per cent figure of other countries in the region⁶⁸. Before the reform these figures may have been distorted, since some operations were financed by either individual money or off budget funds (Rizal, 2011). In the past, the utilisation of tactical budget helped the DGT in lowering the cost of collection but this was against good government practices. Table 10 shows the cost of collection ratio for the DGT and comparison with other countries.

⁶⁸ In 2000, when Indonesia's cost of tax collection ratio was 0.34 per cent, Japan was 2.40 per cent, Taiwan was 1.57 per cent, Hong Kong was 1.31 per cent and Singapore was 0.95 per cent (DGT, 2006)

Table 10
Cost of Collection Ratio

Year	Indonesia			Other Countries		
	Adm. Costs	Revenue	Ratio	Australia	Japan	Singapore
2001	0.52	158.58	0.33	1.06	1.54	0.87
2002	1.03	176.32	0.58	1.07	1.66	0.90
2003	0.93	204.66	0.45	1.05	1.67	0.99
2004	1.06	238.64	0.45	1.05	1.58	1.01
2005	1.31	298.54	0.44	1.04	1.65	1.02
2006	1.43	358.20	0.40	0.99	1.52	0.93
2007	2.41	425.37	0.57	0.93	1.50	0.83
2008	3.21	571.11	0.56	0.95	1.49	0.77
2009	4.31	544.53	0.79	1.00	1.71	0.80
2010	4.32	620.20	0.69	1.05	1.93	0.89
2011	5.40	742.74	0.73	0.99	1.75	0.87
2012	5.22	835.83	0.62	0.98	1.84	0.78

Source: Annual Report 2009, 2010, and 2011; Pajak dalam Angka 2001-2009 (DGT, 2010b) Tax Administration 2013 (OECD, 2013)

The dynamics of tax administration reform increased the demands on the operational fund. It was not only used for human resources training and incentives but also infrastructure development and maintenance, IT development and reorganisation. There was almost double leap of the cost in 2002, in comparison with 2001, due to the need to develop LTO offices. This enormous increase should not be judged as a lowering in efficiency because at that time there was an abnormal expenditure for the procurement in preparing the LTOs. In the four years that followed, the ratio slightly lowered and reached 0.40 per cent in 2006. As a result of modernisation, collection cost decreased with a simplified tax law and more effective administration. In 2009, there was a considerable increase of 0.23 per cent compared to 2008. This happened as the reform project continued with a procurement process for IT improvement.

Compared to Australia, Japan and Singapore, the Indonesian ratios were below these countries' ratios. This did not automatically indicate that the DGT was more efficient and or more effective than the other three countries, on the contrary this may be interpreted as a sign that the Indonesian government had not yet provided its tax authority with adequate funding to perform its duties. The ratios of Australia and Singapore tended to decrease slightly over the period. In general, these suggested that both revenue authorities have improved their efficiency and effectiveness. Meanwhile, Japan revenue authority's ratio fluctuated and needed further investigation to conclude

whether its efficiency and effectiveness improved or not. As mentioned above, other factors should be considered with regard to the revenue authority's efficiency and or effectiveness.

Given the many similarities in the taxes administered by tax authorities from country to country, there has been a natural tendency to make cross country comparison of cost ratio and draw conclusions on the authority's efficiency and effectiveness. However, it is recognised by most researcher that doing international comparison on collection ratio is dangerous. Sanford (1995) identifies a number of reasons why such comparisons are more likely to mislead than enlighten. In another study, Sanford (2007, p. 306) offers the advice that "comparison of ... operating costs should be used sparingly, with the greatest care and with a comprehensive statement of their limitations". Moreover, the OECD indicates variables that have to be taken into account in doing international comparison. These variables include (OECD, 2008c, pp. 80-81):

1. Differences in tax rates and the overall legislated tax burden;
2. Variations in the range and nature of taxes collected;
3. Differences in the underlying cost structures of the revenue authorities resulting from unusual institutional arrangements, and/or the conduct of non-tax functions (e.g. custom);
4. Lack of commonly accepted measurement methodology.

Evan (2003) provides an overview of studies into the operating cost of taxation that has taken place in the last 20 years. The studies show that collection ratio was rarely exceeds 1per cent of revenue yield and more usually came in well below 1per cent. Even though those studies used a variety of methodologies the following examples showed that Canada's collection cost on personal income taxes and payroll taxes for the period of 1986-1987 was 1 per cent, UK's collection cost in value added tax for the period of 1986-1987 was 1.03 per cent, Sweden's collection cost on personal income taxes and business tax for the period of 1983-1993 was 2 per cent, and India's collection cost on personal income taxes for 2001 was 2.49 per cent (Evan, 2003). The Philippines authority presented another example in evaluating performance indicator of property tax administered by Local Government Units (LGU). If the ratio is more than one, the LGU is spending more than what it is getting as revenue from the real property tax (GOLD, 2001).

In this research, data on cross country ratio and time comparison was undertaken cautiously and intended to seek broad trends rather than to score national points or political agendas. Although cost ratio does not have a direct impact on state capacity, it is an important factor in assessing the efficiency and the effectiveness of a tax authority. An efficient and effective one has a reasonable cost ratio. However, the meaning of ‘reasonable’ depends on many considerations, as mentioned above. But it is no exaggeration to say that with a reasonable cost ratio, the state budget will remain stable and may be utilised for other purposes.

5. An accountability-enhancing tax reform program

According to Prichard (2010, p. 23) an accountability-enhancing tax reform agenda is likely to create public awareness, spur public engagement, generate taxpayer unity and offer citizens leverage in bargaining with government. It includes four priorities:

1. Improving equity in tax enforcement and administration;
2. Improving public awareness, transparency and taxpayer services;
3. Broadening and improving direct taxation; and
4. Strengthening civil society engagement with tax issues.

The following paragraphs explore each priority in more detail in terms of the implementation of the Indonesian taxation reform.

Improving equity in tax enforcement and administration

In terms of taxation, citizens have a simple logic ‘I will pay taxes as long as everybody else pays their fair share’. Thus, it is important that all taxpayers are subject equally to existing tax laws. Where taxpayers are not treated equally under the law, do not trust one another and do not trust the government, it is unlikely to reach a constructive tax bargaining. It is common sense in most developing countries that citizens are likely to trust government only to the extent that they believe that the government will act in their interests, that its procedures are reasonable and fair and that their trust of the state and others is reciprocated (Fjeldstad, 2004).

In Indonesia, the tax authority is often perceived as performing “*berburu di kebun binatang*” – ‘hunting in the zoo’ which is certainly much easier than ‘hunting in the jungle’. What this means is that increasing tax revenue from existing taxpayers through intensification activities is much easier than raising tax revenue from newly

registered taxpayers. In other words, the DGT gets the easy pickings from those taxpayers who are easy to catch such as large and medium taxpayers. A large taxpayer organisation is easy to find as it will have a verifiable address, a big office and proper bookkeeping. Law enforcement activities acting on this large taxpayer usually cover the fulfilment of tax obligations resulting in additional tax revenues. This is unlike a newly registered taxpayer who might have just opened a new business and has not earned profits yet. Sofyan Wanandi⁶⁹ states that because the DGT is burdened with increased revenue target each year, it struggles with intensifying revenue from the same taxpayers instead of new ones, hence the phrase ‘hunting in the zoo’ (Khairi, 2013, 30 August). He also suggests that business in Indonesia faces a number of challenges, such as an employers’ ability to adapt to unclear tax laws, which may be complex, weak and give rise to diverse interpretations. The term hunting in the zoo is still relevant today as the tax ratio is still below 12 per cent (Investor Daily Indonesia, 2012, 13 December). When the government issued a new regulation on income tax for small and medium enterprises, the current Minister of Finance emphasised that it was not intended to broaden the area for hunting in the zoo as perceived by the society (Jefriando, 2013, 11 November). Nevertheless, it is an extensification program to support tax revenues that have been studied with consideration.

Besides improving tax administration through providing better services, laws are also enforced to increase revenues and taxpayers’ voluntary compliance. Law enforcement activities in a tax authority are carried out by audit, investigation and collection. These three activities basically aim to give deterrent effects to taxpayers. To optimise law enforcement activities and to avoid the possibility of disputes between taxpayers and tax authorities, the activities must be implemented measurably, objectively, consistently, professionally and systematically according to the prevailing laws and regulations (DGT, 2012).

To avoid the ‘hunting in the zoo’ and to treat taxpayers equally, the DGT sets regulations for audit criteria. The objective of the audit is basically to test taxpayer’s compliance in the fulfilment of tax obligation. There are two types of audits for this objective, routine and special audit. However, an audit is also performed for other reasons; to provide taxpayers with certain services, such as the elimination of Tax

⁶⁹ Sofyan Wanandi is the chairman of “*Asosiasi Pengusaha Indonesia*” (APINDO – the Indonesian Employers Association, an organisational body which represents Indonesian employers from both private and state owned companies throughout the country.

Identification Number, confirmation and annulment of taxable entrepreneurs for value-added tax purposes, and fulfilment of information request from tax treaty partner countries. A routine audit is undertaken for example in the case of refund. Meanwhile, a special audit is performed based on the result of risk analysis on taxpayers' profile or information, data, report and denunciation analysis. All criteria for audit are available in Minister of Finance Decree which can be easily accessed. This shows that the DGT tries to make taxpayers understand the reason for the audit. The decree also contains audit procedures and timeline.

Another activity of law enforcement is tax collection – an action taken to induce the tax bearer to pay any outstanding tax debt. For the effectiveness of collection, the DGT sets the priorities in determining which tax bearers taken for enforcement, based on the amount of tax debt and characteristics of tax bearers. According to the Indonesian tax laws, tax criminal investigation is the ultimate law enforcement mechanism (*ultimum remedium*) by the DGT (2012). The performance of collection and investigation is improving year by year due to IT supports, increased capability of tax collectors and tax investigators through training, and coordination with other casual institutions. However, these mechanisms may not show equity in collection and investigation because there are many other issues that have to be considered, for example taxpayer's liquidity and taxpayer's existence. Even if the most extreme efforts of collection procedures have been implemented, it will not make the tax bearer pays the debt if there are no funds available and nor asset to be seized. Sometime, the tax bearer no longer existed, because it has been liquidated or dissolved, in case of individual he/she has died.

Equitable treatment is shown by the unambiguous criteria and procedures in the regulation. Even though sets of criteria and procedures are available, there are still different factors that affect taxpayers' attitudes towards tax compliance: opportunities to evade that may impact on the cost of compliance, their perceptions of the enforcement system, and interactions with other taxpayers (Ulph, 2005). Taxpayers are more likely to be compliant when they feel the tax authority treats them in a fair and respectful manner. One way or another, taxpayers may assume that enforcement is carried out at random and an enforcement secured now does not mean not getting another one in the future. The authority's reputation in implementing the enforcement is likely to influence taxpayers' compliance. Deterrence varies across enforcement

and monitoring instruments, from inspections, intermediate enforcement actions, administrative fines to eventual criminal prosecution (Shimshack, 2007)

Improving public awareness, transparency and taxpayer services

In order to encourage a reciprocal exchange of tax compliance, taxpayers must communicate their expectations of government and their willingness to support those goals through fiscal contribution. In turn, government must draw a clear connection between taxation, public spending and the achievement of the goals to obtain the support from taxpayers. Awareness and transparency are the basic requirements for building public engagement and essential trust and without some degree of both, taxation is likely to remain characterised by conflict (Prichard, 2010).

As improvement in transparency could improve tax compliance, it is important for the public to access basic information about collected taxes. Unfortunately, the DGT does not demonstrate connections between revenue and spending although it provides taxpayers with information on current tax revenue, disaggregated by tax type and industry sector. The information is made available by press releases, annual report and through the DGT website. The DGT's duty is to collect the revenue together with the DG Custom and Excises, and it is the duty of Directorate General of Budget⁷⁰ to decide on how it is spent. It is possible that the public gleans information on revenue and spending through the state budget, but there is no clear understanding of the link to tax revenue with observable changes in public spending.

Fjeldstad (2004, p. 541) states that taxpayers' compliance is shape to a greater degree by (i) whether or not they believe that other taxpayers are paying, (ii) how effectively they believe that the revenue is being used, and (iii) whether or not they believe that the tax administration is honest and fair. As mentioned previously in this chapter, the DGT has made considerable efforts to improve the public awareness on tax benefits. However, the public still feels that the campaigns are more for reminding them about their obligation to pay tax. During interviews and focus group discussions, the researcher raised the topic about public awareness on tax benefits. Most of the respondents constantly said that the public in general has failed to grasp the benefits.

Generally, society understands that taxes are the main sources of government spending, and tax revenues target is increasing each year, but the way taxes are spent

⁸ Directorate General of Budget is of another organisation in the Ministry of Finance.

is still not understood. For example, in campaigns on the importance of education, the government announced that it had set aside 20 per cent of state budget spending for an education fund. This increased budget would not benefit the public directly, as it is mostly used for routine expenditures such as increasing teachers' wages, providing schools' supplies, and schools' maintenance cost. The public's expectation is for direct capital expenditures, such as the building of more public education institutions, improving schools' facilities e.g. library and laboratories, and removing schools' tuition fees (Bonasir, 2011; Minglie, 2013, 25 May). Therefore, only those who are involved in education institutions feel the improvement of education spending.

Broadening and improving direct taxation

Developing countries usually have a low share of revenue from direct taxes. According to Prichard (2010), this situation reflects the difficulty of improving direct tax collection due to the basic administrative challenges in effective direct tax collection and the existence of political barriers to taxing local elites. The greatest barrier to equity in the application of tax laws is the failure to impose personal income tax to many elite groups effectively. Direct taxes require the tax administration to effectively monitor the economic activities and assets of taxpayers so that their tax liabilities can be estimated. Information and data sharing across agencies, for example, data on vehicle and property ownership is very useful to detect tax evasion and could yield large gains. As long as there is a strong political will to tax a relatively narrow economic elite, direct taxes collection will be improved.

As discussed earlier in this chapter, the DGT still faces the problems of obtaining data automatically from other agencies. With this limitation, the DGT has been trying to utilise the existing data as much as possible, especially data on individual properties, but the amount of personal income tax revenue has not yet shown a significant contribution. The table in the following page shows details of tax revenue by type of tax for the three years period (2010-2012).

Table 11
Comparison of direct and indirect taxes 2010-2012

In trillion Rupiah

Type of Tax	2010		2011		2012	
	Rp	per cent	Rp	per cent	Rp	per cent
Total Tax Revenue	620.20	100.00	742.74	100.00	835.83	100.00
Direct Tax	298.17	48.08	358.01	48.20	381.65	45.66
Corporate Income Tax	131.00	21.12	154.60	20.81	152.13	18.20
Personal Income Tax	3.60	0.58	3.28	0.44	3.76	0.45
Salary Withholding Tax	55.30	8.92	66.74	8.99	79.59	9.52
Other direct tax	108.27	17.46	133.39	17.96	146.17	17.49
Indirect Tax	230.60	37.18	277.79	37.40	337.58	40.39
Other taxes *	91.42	14.74	106.92	14.40	116.63	13.95

Source: Annual Report 2012

* consist of land and building tax, acquisition duty of right on land and building, and oil and gas tax

During this period, personal income tax contribution contributed less than one per cent of total tax revenue, 0.58 per cent in 2010, 0.44 per cent in 2011 and 0.45 per cent in 2012 respectively. Compared to corporate income tax revenue, these numbers are only about one fortieth, and compared to salary withholding tax revenue are about one twentieth. Among other things, the reason for this is that individual entrepreneurs may not be registered as a business but misreporting the status as an employee of that company. The profit gained from business investment remains within a business considering that tax planning is easier to do at the corporate level. In this situation, it is possible for an individual to avoid reporting all actual income and be taxed from their salary instead. As a result, the amount of salary withholding tax is much more than personal income tax.

In its research report on the DGT, the Transparency International Indonesia (TII) expressed that it is unfair if an entrepreneur is not included as a high net worth individual (TII, 2011). Article 4 of income tax law clearly stipulates that additional net wealth derived from income that has not been taxed is a tax object, furthermore article 39 of general tax procedures threaten taxpayers, who intentionally fail to file a tax return or file a tax return that is false and harmful to the state's finances, with criminal acts and fines. As a benchmark, TII presented data stating that in 2010, the wealth of the top 40 richest individuals was about US\$ 71.3 million; equivalent to 10.3 per cent of the Indonesian GDP. This figure was also equivalent to the wealth of 15 million of the poorest families, around 60 million people.

The unfair tax revenue structure can be identified using comparisons of income tax and value added tax. Income tax is a direct tax in which the burden is borne by the taxpayers, meanwhile value added tax is an indirect tax in which burden is borne by the consumer. A good revenue structure is when income tax revenue collected exceeds value added tax. In Indonesia, there is not much difference between the value of direct tax and indirect tax. The table above shows that in 2010 and 2011, the difference was about 10 per cent and decreased to 5 per cent in 2012.

As mentioned earlier, the political regime has significantly influenced the tax mix. The current structure of tax revenue is far from ideal and there is still much to be done in terms of broadening and improving direct taxation. Resolving the process of acquiring data automatically from other agencies should be amongst the top priorities.

Strengthening civil society engagement with taxation reforms.

In order to strengthen civil society engagement with taxation reforms Prichard (2010) suggests the tax authority needs to support the formation of inclusive business associations and taxpayers' associations. In Indonesia, taxpayers' associations are almost completely unheard of. Most taxpayers join or form a business association instead of a taxpayers' association. Generally, business associations should be amongst the most important stakeholders arguing for an effective tax bargain. The DGT has sought to embrace the business associations since the start of tax reform process. Business associations' members were given an explanation of things that would be done in the reform process and consulted on such matters. They were also given the opportunity to provide input in terms of policy changes adopted during the reform period.

Because business associations are fragmented, some of the more powerful business interests pursued narrow benefits, such as tax exemptions or special privileges, rather than broader improvements in tax administration. Business associations may also be a mouthpiece providing wrong information to its member to provoke to the DGT when the DGT's image was in question, for example, when a tax official being caught by the police or KPK for illegal action. However, the DGT realises that it is important to show interest in working more closely with business associations. It is not easy to reach and inform all taxpayers when a new regulation is issued, business associations would certainly help in disseminating such changes to its

members. The tax education office has the responsibility to endorse this cooperation with business associations. In the end, cooperation with business associations may support increasing taxpayers' compliance.

The DGT also takes the opportunity to partner with civil society organisations to improve education, awareness and trust. For example, the DGT collaborates with a university institute to build a tax centre that serves as a centre of study, research, training and dissemination of taxation. A tax centre is an important conduit for improving awareness and education because of their existing links to taxpayers and the fact that taxpayers may trust a tax centre more than the tax office itself. Effective partnership between tax authority and civil society organisations may actually lead to better compliance among their members. In addition, the DGT is also active in the corporate social responsibility program but to remain focused on the task and its main function, the DGT is committed to support corporate social responsibility programs by providing direct benefits to the community with regard to conditions in each region.

6. Conclusion

In the Indonesian tax reforms, the achievement of tax revenue target has always been a primary objective. Although the targeted revenue could not be met in most of the time during 2002-2012, for the most part the tax revenue's growth rate increased gradually. The average Indonesian tax ratio of 12 per cent for the period of 2002-2012 was considered low compared to other countries in the region. This may indicate that there was still potential for maximising tax revenue through improvements in tax administration.

In addition to achieving revenue target, other main tasks of tax administration reform are achieving a high level of tax compliance and making administrative costs per unit of tax revenue efficiently. During the period 2002-2008, the level of compliance ratio remained steady around 30 per cent. In 2009 the level of compliance ratio started to increase as a result of new strategies on programs and activities which could keenly increase taxpayers' attentiveness and voluntary compliance. The dynamics of tax administration reform demanded the increasing operational fund and thus fluctuated the cost of collection ratio. However, increased growth rate and compliance ratio implicitly showed that there was a good relationship between tax authority and taxpayers. The trust between tax authority and taxpayers supported the

relationship between state and the society and at the end would contribute to the increased state capacity.

As mentioned in the introductory chapter, Prichard (2010) states four considerations that may generate positive outcomes of tax reform in state capacity development:

1. Are there links developed within government?
2. Has the process of data gathering and data sharing with other agencies been working well?
3. Is the process replicable to other areas of governments?
4. How the process has been affecting local tax administration?

Improvement and innovation in tax administration may establish links within government by transmitting reform efforts to other areas of government or creating pressure for reform to related agencies. And the process of tax reform is indeed influencing reform in other areas of government. Even though the remuneration system became the trigger for reform, other institutions certainly have to review various processes themselves. Starting in 2002 at the DGT then at other agencies in the Ministry of Finance in 2007, by the end of 2013 63 ministries and central government agencies have been reformed. These figures show that the process of tax reform is replicable to other areas of governments with necessary adjustments.

The 2009 law of local tax and levies requires land and building tax, which used to be administered by the DGT, be transferred to local government by 1 January 2014 at the latest. In order to make the process of transfer runs smoothly, the DGT monitored and evaluated the preparation process in each local government. The staffs at the local tax administrations were trained and given technical skills to manage land and building information system that has been developed by the DGT. In the process of transfer knowledge, the staffs at local tax administration also gained other things about modernised tax administration. The reform of bureaucracy at local government level was established in mid-2013 by appointing 33 provinces as pilot projects. By the end of 2013, 16 of them had started to develop their road map for reform (Humas MENPAN, 2014, 17 January).

In 2003, the DGT tried to initiate the development of Single Identification Number (SIN). In Indonesia, each institution has its own information identity management system which is set up by different procurement, standard and specification. As a result, the same object may have more than one identity. For

example, to find the identity of some land each institution needs to know its identity: the tax object number listed by the DGT, the certificate number of land ownership listed by the national land agency, and the certificate number of measurement made by the local government. These three different numbers complicated the integrated utilisation process. SIN development aimed to improve efficiency of government administration. The basic principle of SIN is to synchronise existed identity systems and create a common identity. This common identity would then be enriched by other information such as personal identity and vehicles ownership. By coordinating with other institutions who keep other data, eventually the common identity would be data rich. Unfortunately, this model failed to be developed as the DGT has limited authority to acquire data from other institutions but the process of developing information systems is still going on.

Tax reform program could be considered as enhancing the accountability of a tax administration as it improved equity in tax enforcement, public awareness, transparency and taxpayer services, and strengthened civil society participation in taxation issues. In the DGT, the existing conditions were not supportive enough to perform major changes in direct taxation, especially for the purpose of increasing personal income tax revenue but this has been included as one item in the long term plan.

Positive outcomes of tax reform on state capacity development include replicating the reform in other areas of governments. As mentioned above, the DGT reform, or in general the Ministry of Finance's reform, motivated other institutions to reform themselves. Each institution has its own goal and objectives in performing reform. However, this research focus on the reform of the bureaucracy as it has been part of the national agenda for so many years. The next chapter will discuss the reform process of the Indonesian bureaucracy with emphasise on customised bureaucratic reform prepared by the Ministry of Empowerment of State Apparatus and Bureaucratic Reform (MENPAN).

CHAPTER 6. REFORMING THE INDONESIAN BUREAUCRACY

As mentioned in the previous chapters, increasing accountability, incentives and capacity of civil service is equally critical. A strengthened public financial management system that has been in place since 2002 will not by itself resolve the weaknesses in the implementation program. The civil servant plays an equally important role in driving institutional performance. There is an increasing recognition that the lack of administrative capacity and distorted incentive structures within the government bureaucracy have hampered the effectiveness of spending and the quality of service delivery. Moreover, fundamental features of the existing civil service continue to provide compliance-based human resources management and distorted incentives, resulting in poor performance in large parts of the Indonesian state administration (World Bank, 2009). The hopes placed on decentralisation reforms to improve public services have yet to materialise, and decisive reforms are necessary to improve service delivery. Among other things, priority reform options should include clarifying the objectives and refocusing the bureaucracy on accountability for results (World Bank, 2014).

The necessity for civil service reform has grown strongly since the fall of Soeharto regime and particularly over the last decade as a result of the strong reform commitment of President Yudhoyono's government. The creation of the "Grand Design *Reformasi Birokrasi 2010-2025*"⁷¹ or the 'Grand Design' (2010) has shown society, both nationally and internationally, that the Indonesian government wants to achieve a world class professional government of high integrity. In fact for Indonesian public administration researchers, this design is epitomised as "a speck of dew after a long dry season" (Dwiyanto, 2011). In other words, long after witnessing the failure of the government to take care of and fix the bureaucracy, the 'Grand Design' brings new hope for the existence of a clear direction for reform of the bureaucracy and the serious intent by government to make bureaucracy capable of aspiring to those hopes. The World Bank's (World Bank, 2009) development policy review on Indonesia

⁷¹ Referred to footnote 10 in Chapter 1 "The term used in Presidential Regulation Number 81 of 2010 drafted by Kementrian Pendayagunaan Aparatur Negara dan Reformasi Birokrasi (MENPAN – Ministry of State Apparatus Empowerment and Bureaucratic Reforms) on designing reform of the bureaucracy".

however, showed that civil service reform was not simply a matter of reforming human resources management practices or increasing salaries. The researcher's experiences during the field work also reached the same conclusion. To gain the desired impact, the civil service reform must not simply reform human resources management practices or increase earning power but it must also review the way public institutions are structured, operate and are financed.

This chapter explores the reform of the Indonesian bureaucracy, with regard to the 'Grand Design' for reform of the bureaucracy. It aims to provide directions to the national policy on bureaucratic reforms during 2010-2025, so the bureaucracy within government institutions runs effectively, efficiently, proportionally, consistently, and is integrated, institutionalised and sustainable. Major reforms of tax that have been discussed in the previous chapters were considered as significant achievements in terms of the volume and substance of the reforms. But "effective implementation of the policies has been slowed by poor coordination between relevant government agencies, and uncertainty about the legal framework remains high" (World Bank, 2009). Many agencies with overlapping authority shared responsibility for management and oversight of various aspects of the civil service. As a result no single agency was proactively managing the structure and shape of the civil service and no agency had the recognised authority to undertake comprehensive civil service reform. It is hoped that the 'Grand Design' will resolve this problem. To find out whether the 'Grand Design' has succeeded in achieving its goal, it contains key indicators addressing bureaucratic reform target. This chapter also discusses the indicators and their efficacy but restricted to the time frame of this research.

In terms of general outline, it is worthwhile describing the history of the Indonesian bureaucracy that had affected and shaped the conditions of Indonesian bureaucracy. The reform of the bureaucracy in Indonesia is a historical inevitability because the government inherited the colonial bureaucracy that was designed for a different purpose than that of an independent state (Dwiyanto, 2011). The legacy of the past had strong roots causing slow progress in building a future bureaucracy. This chapter will show that regardless of a large number of reforms programs each with their significant accomplishments, the widespread implementation has been less successful, due mainly to a lack of coordination within the government and indecision in legal intervention.

1. History of the Indonesian bureaucracy

The discussion on the history of the Indonesian bureaucracy is grouped into two separate periods: Pre-Soeharto era and Soeharto Era.

The Indonesian Bureaucracy in the Pre-Soeharto Era

In the discussion of the reform of the Indonesian bureaucracy, Masyarakat Transparansi Indonesia (2010) considers three major kingdoms in Indonesian history that influenced the shape of the Indonesian bureaucracy. Originally, each kingdom had its own terms in defining its identity, but this research had used the term kingdom generically. The three largest kingdoms were *Kerajaan Sriwijaya*, which existed from the 7th century (650-1377), *Kerajaan Majapahit*, which existed between 1293 and 1527, and *Kerajaan Mataram*, which existed between 1588 and 1681. In these kingdoms, the King held the pre-eminent position of power in the central government, surrounded by his family members as subordinates. The king controlled local governments' bureaucracies which had certain obligations to the government of the central kingdom. Integration with local governments tied it to the myth like king who had the authority over government and military. These kingdoms developed division of duties as well as their requirements and behavioural guidelines.

The above paragraph summarises how the authoritarian bureaucratic system was started in Indonesia. With the highest leader in central government, there was no autonomy in the local governments. However, the relationship between central and local governments had been developed through hierarchy with top-down structures, and separation of government functions had been implemented.

From the early 17th century, the Dutch gradually took control of the entire area. When it finally colonised Indonesia, the Dutch started to create a system based on the principles of modern bureaucracy. For example, the division of governmental duties was held by specific expertise, the hierarchy of authority was firmly held, rules and regulations were neatly arranged, and impersonality was emphasised to its officials. This form of bureaucratisation was certainly apt for the purpose of colonisation. However, the Dutch embraced these fiefdoms which became part of the bureaucracy whose framework featured a hierarchy with top-down structures.

The Dutch setup the government by means of a rational law based on *Grondwet*⁷² Netherlands of 1814. This law was amended eight times up to 1938. Based on *Grondwet*, the Dutch government stipulated several things that should be regulated by law: budget, rates, central bank, treasury and mining. According to the legislation in force, the Dutch government bureaucracy was composed of a governor general, directors and *volksraad* (people's council). The Governor-General's authorities were for example the authority in the executive and legislative, entered into treaties with the kings and indigenous people, and recruited civil servants. Meanwhile the director led a department. *Volksraad* was formed in 1917 and held its first session in 1918 to select its members, consisting of Indonesian and Dutch (MTI, 2010). *Volksraad* was intended to be autonomous but its function was not fully performed. Instead it was virtually a toothless people's council with just an advisory status to the Governor General in planning the budget revenue and expenditure

Claiming to initiate the principles of modern bureaucracy in Indonesia, the Dutch set a strong baseline for the Indonesian government, especially for example, in arranging rules and regulations. These Dutch laws were still enacted even when colonisation was over. Among other things, the Governor-General concept was adapted into the president, directors into ministries, and *Volksraad* into "*Dewan Perwakilan Rakyat*" (DPR – the House of Representatives).

After independence, the bureaucratic system in the 'Old Order'⁷³ Era initially adhered to the 1945 Constitution which put "*Majelis Permusyawaratan Rakyat*" (MPR – the People's Consultative Assembly) as the highest state institution with the authority to establish the constitution, "*Garis Besar Haluan Negara*" (GBHN – the broad outlines of state policy), and the election of a president and vice president. The president held the highest executive authority and was assisted by ministers. In performing his duties the president was accompanied by "*Dewan Pertimbangan Agung*" (DPA – the Supreme Advisory Council) as an advisory board. There was also "*Badan Pemeriksa Keuangan*" (BPK – the Supreme Audit Agency) which monitored the implementation of the state's finances and then reported the results to the parliament for overseeing the president's duties. The legislative authority was held by

⁷² *Grondwet* is a Dutch compound words, formed from *grond* means ground or base, and *wet* means law.

⁷³ The 'Old Order' was a term created by the student activists of 1966 – and later adopted by Major General Soeharto – to refer to the period when President Soekarno, the first Indonesian president, was President (1945-1966).

the president with the approval from DPR. Meanwhile the judicial power was held by “*Mahkamah Agung*” (MA – the Supreme Court).

Soekarno planned his bureaucracy which was able to oversee most of Indonesia. In building his power, Soekarno relied on political parties and the military (MTI, 2010). The cornerstone of his thinking was to play off fears among political parties, consisted of nationalists, religion and communists groups, by uniting these three groups in his government, characterised by *Nasakom* (“*nasionalis, agama dan komunis*” – nationalist, religious and communist). This addressed concerns that he would split the nation if the three groups were left conflicting. As Soekarno welcomed communists in his cabinet, “*Partai Komunis Indonesia*” (PKI – the Communist Party of Indonesia) later on dominated his government. The military also held sway and thus together with PKI became the foundation of Soekarno’s government. Many leaders of political parties became ministers in Soekarno’s government and they had the responsibility of public service recruitment in their own departments. Thus, the theme of the department depended on the political party in power. Public service became disrupted because the party’s interest took precedence. This approach confused and shocked many Indonesians, and resulted in a constitutional crisis that could only be resolved by a presidential decree (Maga, 1990). However, after the 1945 Constitution was reinstated through the Presidential Decree on the 5 July 1959, Soekarno’s government made efforts to improve governance. Amongst other things was the enactment of a new law which stipulated that a civil servant was banned from active in a political party (GOI, 1961).

At the end of the Old Order era, Soekarno developed a bureaucratic division into a number of units, each of which has specific roles, with the formation of “*Kabinet 100 Menteri*” (a cabinet of 100 ministers). Since there were in fact more than 100 ministers, the structure of bureaucracy became a complex structure. The formation was not based on Soekarno’s desire to develop high specialisation but rather to accommodate as many people in the cabinet in order to enlarge his political support base (Dwiyanto, 2011). The government bureaucracy under Soekarno ceased as Soeharto was elected as a president. Moreover, ineffective government resulted in stagnation and negative growth during the last several years of his rule, contributing to political instability, a violent change of regime, and an effective takeover of government by the army (McLeod, 2003).

The Indonesian Bureaucracy in the 'New Order' – Soeharto Era

As the president, Soeharto initially sought only to consolidate his political position, using the 1945 Constitution. In 1971, he made a more systematic arrangement for civil service's position by building "*Korps Pegawai Republik Indonesia*" (KORPRI – Indonesian Civil Service Corps) which became the only institution to gather and educate civil servants. In the New Order era, KORPRI became a political machine. The ban for civil service to perform actively in a political party, developed by Soekarno, was cancelled and then a new law was enacted stating that the civil service was allowed to be a member in political parties as long as it did not interfere with their duties (GOI, 1975). In performing its function KORPRI always sided with Soeharto's main political party called "*Golongan Karya*" (the Functional Group)⁷⁴. Thus, a civil servant as a member of KORPRI was automatically also a member of "*Golongan Karya*". As the bureaucracy fully supported "*Golongan Karya*", this party became the biggest during the Soeharto era. During his rule, there was no policy governing restrictions on political parties tied to the bureaucracy. In a case of a civil servant who actively joined in a political party other than "*Golongan Karya*", he would be excluded from the ranks of bureaucracy (MTI, 2010). As a result, politicisation of bureaucracy occurred and contributed to the process of political decay and weakened its performance. Besides having "*Golongan Karya*" as his main political machinery, Soeharto positioned the army as guardian of the state ("Indonesia, a Nation in Transition," 2001, 25 May). Since the state was personalised around Soeharto alone, the army also served to protect him.

After the regime became established in 1974, Soeharto's government fixed the central government bureaucracy by regulating position, duties and functions of the ministry as well as its organisational structure (GOI, 1974). The organisational structure of a ministry thus consisted of a minister, a secretariat general, an inspectorate general, several directorates general with each own determined field of work, a research and development board, an education and training board, and vertical institutions. A vertical institution was a regional office of the ministry or the directorate general performing duties and functions in the provinces which supervises lower grade institutions in districts or municipals and coordinates with local governments. Each element had each own organisational structure. This arrangement formed a hierarchy

⁷⁴ *Golongan Karya* is a political party that fully supported Soeharto in the elections. It legally operated not as a political party but a functional group, although in fact it was a party.

of authority. As a local government had its own regional authorities to formulate regulation with regards to the region’s need, this created ambivalence in the bureaucracy between central and local governments.

Bureaucracy in the New Order also experienced what was referred to as ‘Parkinsonization’ or growth in number of government personnel. It is Parkinson’s approach in postulating two basic properties of any bureaucratic organisation namely: (1) every civil servant strives to increase the number of his inferiors, and (2) all civil servants produce (unnecessary) work for each other (Evers, 1987). Bureaucracies have thus a tendency to grow in term of personnel irrespective of the task they have to perform. Evers (Evers, 1987) shows that in 1970 the number of civil servants was 515,000 and this number increased to 2,047,000 in 1980. From 1986 to 1992, the number grew by 25 per cent, with a significant lower growth rate in the latter years of this period (Tjiptoherijanto, 2012). The number of civil servant reached its peak in 1993 with slightly more than 4 million employees. This number remained the stable until 2012 with only slightly increase to became 4.6 million. The number of civil servants over the years is shown in the table below.

Table 12
Growth of the civil servants

Year	Number of Civil Servants	Growth rate
1950	303,500	
1960	393,000	22.74
1970	515,000	23.69
1980	2,047,000	74.84
1993	4,009,000	48,94
2012	4,646,357	15.90

Source: Tjiptoherijanto (2011, p. 4)

The increase in numbers of civil servants did not automatically indicate an increase in over-all government control over the lives of citizen, nor did it necessarily indicate a development of a formal rationale for administrative procedures. On the contrary, it was to fulfil the needs to reward loyal followers of revolutionary movements and to redistribute income through civil servant salaries, even when government revenue resources were restricted and budgets were difficult to balance. Another aspect of bureaucratisation(Evers, 1987), ‘Orwellization’ or the growth of over-all bureaucratic control, also happened in the new order era. The pattern of

bureaucracy was intended as a control on economic, political and social activities by using regulations and, if necessary, obligations. Both models made the growing bureaucracy a convoluted and inefficient bureaucracy with bloated bureaucracies. In addition, a bureaucrat positioned himself/herself as a ruler rather than a public servant, serving the interests of government rather than the public.

Until the end of the New Order's era, conditions in the Indonesian bureaucracy tended to experience inefficiency, abuse of authority, corruption, collusion and nepotism. New Order bureaucracy was used structurally to support the elected government's political party. Although bureaucrats were required to perform neutral and fair public services, they sometimes became obstacles or problems in the justice and democracy development, which lead to discrimination and abuse of facilities, programs and state funding.

McLeod (2003) argues that with Soeharto's demise, Indonesia gained democracy but lost effective government. He interpreted effective government in a purely economic sense to mean doing what is needed to achieve rapid growth, which depends on a complementary relationship in which the public sector provides thing desired by the public but which the private sector is not able to produce. Soeharto created incentives for effective government in a 'franchise' system – a system that included the legislative (MPR, DPR and political parties); the judiciary and the legal bureaucracy; the military/police; the bureaucracy; and the state-owned enterprises. With Soeharto as franchise owner, each of them existed at national, provincial and district/municipal level. The franchise system gave Soeharto too much control over franchisees and their branches, and at the same time he dealt with potential threats from within by buying off the individuals in question with appointments to senior positions within the bureaucracy or by granting privileged access to concessions, and practicing overt levels of corruption and nepotism. Each public sector institution was intended to serve the interests of general public, but in cases where there was any conflict, the interest of the franchisee generally took precedence (McLeod, 2003).

2. The Reform of the Bureaucracy in the Post-Soeharto Era

In the transition period from Soeharto's government to reform government (1998-1999), civil servants started to move toward political neutrality by dissolving KORPRI within the ministry, stating that it was not affiliated to any political party, removing the KORPRI branding, and proposing KORPRI leave *Golongan Karya* altogether.

There was an urgent pressure for a government regulation stating civil servants must be neutral and should not use state facilities for specific groups' interest (MTI, 2010). BJ Habibie, who was then the president, issued this regulation which emphasised that civil servants should be neutral and if they insisted in becoming members of political parties they should not be active in their posts. The next presidents, Abdurrahman Wahid and Megawati Soekarno Puteri, continued the spirit of bureaucratic reform though they had not yet implemented the bureaucracy in accordance with good governance.

Despite reform efforts begun in 1998, the reform of bureaucracy is never an easy task. Governments that emerged after the reform could not guarantee that the continuity of reform would achieve stated goals. In the Global Competitiveness Report 2011-2012, Indonesia ranks at 46 out of 142 countries being examined (WEF, 2011). This annual survey measures the level of competitiveness of a country among other countries in the market competition mechanism. Indonesia's ranking decreased compared to the previous year, which was ranked at 44. Macroeconomic stability had not yet been enough to raise the country's bargaining position in international environment. Indonesia was deemed to be 'problematic' in the bribery issue and corruption (WEF, 2011). In addition to that, another crucial factor causing the decline in competitiveness is that bureaucracy was rarely efficient with the survey's data showing that bureaucracy is a crucial issue in the development process. It is still regarded as inhibiting the investment and a 'dead card' in the practice of public service (Rohman, 2011). In other words, bureaucracy was considered unproductive and awaiting reform.

Under the leadership of President Yudhoyono, MENPAN implements programs to reform the bureaucracy with a focus on improving public services. As mentioned in the introductory chapter, the creation of the "Grand Design *Reformasi Birokrasi* 2010-2025" emphasised that the Indonesian government aim was to achieve a world class professional government with the highest integrity by 2025. The 'Grand Design' was created with the president's decree number 81 on the 21st December 2010. As the master plan, it provides policy direction for national reform of bureaucracy and is complemented by a reform road map which includes three of five years operational plans with details steps for every stage and clear goals per year. The following sections discuss the 'Grand Design' in more detail.

Background for the creation of the ‘Grand Design’ can be traced back to the economic crisis in 1997, which then grew into a multi-dimensional crisis, followed by strong demands for immediate implementation of reforms in politics, law, economics and bureaucracy. In term of bureaucratic purposes, MPR set out certain decrees: on principles of development reform, on enforcement of clean and free KKN (corruption, collusion and nepotism) state, on eradication and prevention of KKN, and on enforcement of rule of law and bureaucratic reform with emphasis on transparent, accountable, clean and responsible culture as well as serving the public and the state. These decrees are in line with the basic values expressed in the 1945 Constitution in realising democratic government and to improving welfare. However, the government realised that in the reform period of 1998-2003, the reform of bureaucracy did not have enough attention compared to other reforms (GOI, 2010). Therefore, in 2004, the government reiterated the importance of applying the principles of clean government and good governance which are universally held to be the principles in providing services excellence to the community. This commemorated the first wave of bureaucratic reform (2004-2009). Development of a clean bureaucracy concerns all aspects, not just civil services or bureaucrats alone, but includes construction of structures, systems, business process and moral ethics. The ‘Grand Design’ was created for a comprehensive development of the bureaucracy that concerns all of those aspects. As the ‘Grand Design’ was enforced in 2010 and its programs divided into five years plans, the second wave of the reform is for the period of 2010-2014. The differences between the two phases of reform are shown in table 13.

The nature of reform in the first phase was considered as an institutional reform as it was designed in a way that did not challenge current central policies. Instead it worked around existing policies and regulations (World Bank, 2009). For example, the reformed institutions did not try to adjust the national basic pay scheme but instead improved remuneration by adding new allowances.

Table 13

Comparison of bureaucracy reform phase I and II

Bureaucracy Reform Phase I (2004-2009)	Bureaucracy Reform Phase II (20010-2014)
Nature: Institutional	Nature: National and Institutional
Target: To create good governance	Target: 1. To create a clean and free of KKN governance 2. To improve the quality of public services 3. To increase the capacity and accountability of bureaucratic work
Area changes: <ul style="list-style-type: none"> • Institutional (organisation) • Organisational culture • Management • Regulation – Deregulation • Human resources 	Area changes: <ul style="list-style-type: none"> • Organisation • Management • Legislation • Human resources • Monitoring • Accountability • Public services • Bureaucrats' mind set and culture set

Source: Presidential Regulation No. 81 of 2010 (GOI, 2010)

3. Understanding objectives and principles of the 'Grand Design'

The 'Grand Design' states some problems of bureaucracy which became the judgement for designing the policy, as follows:

1. Government organisations have not properly functioned and have not been the right size;
2. Some of the legislation on state apparatus are still overlapping, inconsistent, and vague and open to multiple interpretations. Some of them conflict with each other and have not been amended according to the dynamics in governance and the demands of society;
3. The allocation of state apparatus in terms of quantity, quality and territorial distribution is not balanced and the level of productivity is low. In addition, the civil service payroll system has not yet reflected the workloads and responsibilities;

4. There are still irregularities and abuse of authority in the governance process and government institutions' performance accountability is not yet solid;
5. Public services have not been able to accommodate the interests of all society and have not met the basic rights of citizens;
6. Bureaucrats' mind-set and culture-set have not accommodated a bureaucracy which is efficient, effective, productive and professional (GOI, 2010).

The scope of the 'Grand Design' is focussed on the reform of the government bureaucracy. It aims to provide directions to the national policy on bureaucratic reforms during 2010-2025, so that bureaucracy at the government institutions runs effectively, efficiently, scalable, consistently, integrated, institutionalised and sustainable. With a vision "to achieve the world class government", the bureaucracy is hoped to be able to face 21st century challenges by 2025.

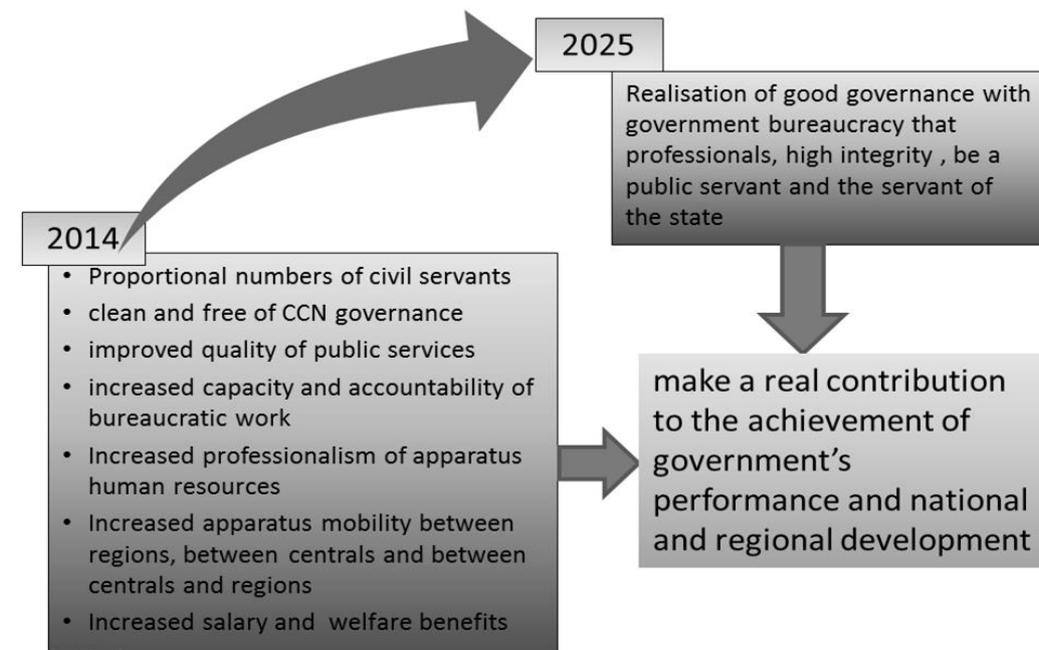
Reform of the bureaucracy has several missions, namely:

1. Create or amend legislation in order to achieve good governance;
2. Perform structuring and strengthening in terms of organisation, procedures, management state apparatus, accountability, public service quality, mind-set and culture-sets;
3. Develop an effective control mechanism;
4. Manage administrative disputes effectively and efficiently (GOI, 2010).

The 'Grand Design' also set the objective of the reform to create a professional government bureaucracy with some areas of changes that cover all aspects of government as mentioned in the opening paragraph of this section (GOI, 2010). Firstly, government organisations should be properly functional and of the right size. Government's systems, processes and procedures are clear, effective and efficient, and measured in accordance with the principles of good governance. Secondly, regulations should be in order, not overlapping. Thirdly, human resource apparatus should be neutral, competent, capable and professional, as well as well supervised to achieve a clean and free from KKN government. Fourthly, bureaucrats' performance should be improved in terms of capacity and accountability. Fifthly, service excellence should be provided as required by the community. Lastly, the changes in mind-set and culture set of the apparatus would create a bureaucracy with high integrity and performance.

In 2025, it is expected that governance will achieve the conditions as expressed in the following figure.

Figure 9
Desired Bureaucracy Conditions



Source: President Regulation Number 81 of 2010 (GOI, 2010)

The 'Grand Design' thus applies the following principles: outcomes oriented, measurable, efficient, effective, realistic, consistent, synergetic, innovative, compliant and accountable (GOI, 2010). It must be outcomes oriented as all programs and activities undertaken in connection with the reform should be able to achieve the results (outcomes). The implementation of the reform should be measurable and has clear targets and time frame. It should also pay attention to the utilisation of existing resources efficiently and professionally. The reform of bureaucracy should be carried out effectively in accordance with its targets. The outputs and outcomes of the implemented programs and activities should be specified realistically and can be achieved optimally. The reform must be implemented consistently all the time and involve all levels of government, including individual employees. Moreover, programs and activities should be carried out in synergy to avoid any overlap between government institutions. The reform should also provide a broad space for an institution to be innovative in government processes, and exchange knowledge and

best practices. Finally, the reform should be carried out in accordance with the laws and institutionally monitored to ensure that all stages are reached, targets are achieved in accordance with the plan, and any deviation can be seen immediately and be repaired (GOI, 2010).

Among other things, salary and welfare benefits of the Indonesian civil servants become an important aspect within the bureaucracy. General opinion that civil servants receive low wages is still widespread. This contributes to low performance and productivity of civil servants. As mentioned in the previous chapter, the low salary level of civil servant is the root of many problems in civil servants management that leads to irregularities and abuse of authority. Prior to discussing the achievement of the ‘Grand Design’, it is necessary to outline the civil service system.

4. The Indonesia Civil Service System

The civil service system is captured in the Law Number 8 of 1974 and its revision of Law Number 43 of 1999. After 15 year in force, this law was recently amended in accordance with the implementation of state apparatus management based on required competence and qualifications in the process of recruitment, appointment, placement and promotion in line with good governance. The new Law Number 5 of 2014 aims to recognise state apparatus as part of the reform of the bureaucracy. Therefore, it is necessary to define a civil service as a profession which has an obligation to self-manage and self-develop as well as takes account of its performance and apply the merit principle in the implementation of state apparatus management (GOI, 2014).

The civil service is managed by “*Badan Kepegawaian Negara*” (BKN – the Civil Service Agency), which keeps all records and has to give approval to all appointments above a certain rank. The Indonesian civil service has a dual system of ranking. Every civil servant has a rank (*Golongan*) and a position. There are four rank of civil servant, started from I to IV. The position can be ‘structural’, ranging from Echelon I to IV, or ‘functional’. A structural position is a line management position in the administration although it includes some high-level advisors. A functional position is a career position which requires a specialised skill, for example teacher/lecturer, auditor, computer operators and lawyer. There is no formal job classification in the civil service. Entry ranks are determined by education level, and increases in rank are driven by seniority. There is a direct relation of rank and grade with the echelon level

for those civil service position that are classified as structural positions, i.e. the higher the echelon position, the higher rank and grade of the civil servant.

In the payroll system, civil servants are paid according to rank, seniority and position. The pay scales are defined according to rank and include several elements, namely a basic salary, a family allowance, children's allowance, a food allowance and some other incidental allowance. Since the 1997 crisis and for other reasons such as comparison to decentralisation and institutional reform, pay increases have been given in the form of an allowance, not in the form of an increased basic salary. In addition to the basic salary and allowances, many positions either have a structural allowance or a functional allowance. These allowances, for some positions, can be significantly larger than the basic salary.

The payroll system is classified in a combination scale system since it combines the single scale system and the double scale system (Tjiptoherijanto, 2012). Under a single scale system, civil servants at the same rank receive the same basic salary regardless of the position. Under a double scale system, salaries are determined based on civil servants' position. Under the combination scale system some civil servants might have significantly higher salary than their colleagues at the same rank. In addition there are retired civil servants who receive pensions started from the following month the civil servant is declared retired until the pension recipient has passed away. As this pension period may take years or even decades to finish, the government spend about a quarter of government spending on pensions of the civil service. This situation worries the government which has considered revising the pension system that has been implemented since 1969.

The civil service system includes functions related to planning, recruitment, trainings and payment of salary and pension systems. There are several central government institutions that have this responsibility concerning civil servant matters, namely the office of the President, Ministry of Finance, MENPAN, BKN and "*Lembaga Administrasi Negara*" (LAN – the National Institute for Administration). The division of responsibility in relation to human resources among ministries and public sector entities is as shown in table below. Tjiptoherijanto (2012) states that the 1999 law on civil service has stipulated that the government should establish a civil service commission – a special institution responsible for human resources management, but the government did not show an intention to build one. However, the new law of 2014 still requires the establishment of the commission and this time the

government has taken this matter seriously as the process of selection for members of the commission finished in September 2014. This type of commission has been established in many countries such as Korea, Thailand, New Zealand and other Commonwealth nations, and shown positive results.

Table 14
Institutional Responsibilities for Human Resources Management

Agency	Function
Office of the President (State Secretariat)	Overall government policy
Ministry of Finance	Salaries, allowances and pensions
MENPAN	Supervision, coordination, monitoring and evaluation of all civil service matters
BKN	Appointment, promotions and transfer
LAN	Education, training and organisational design

Source: Tjiptoherijanto (2012)

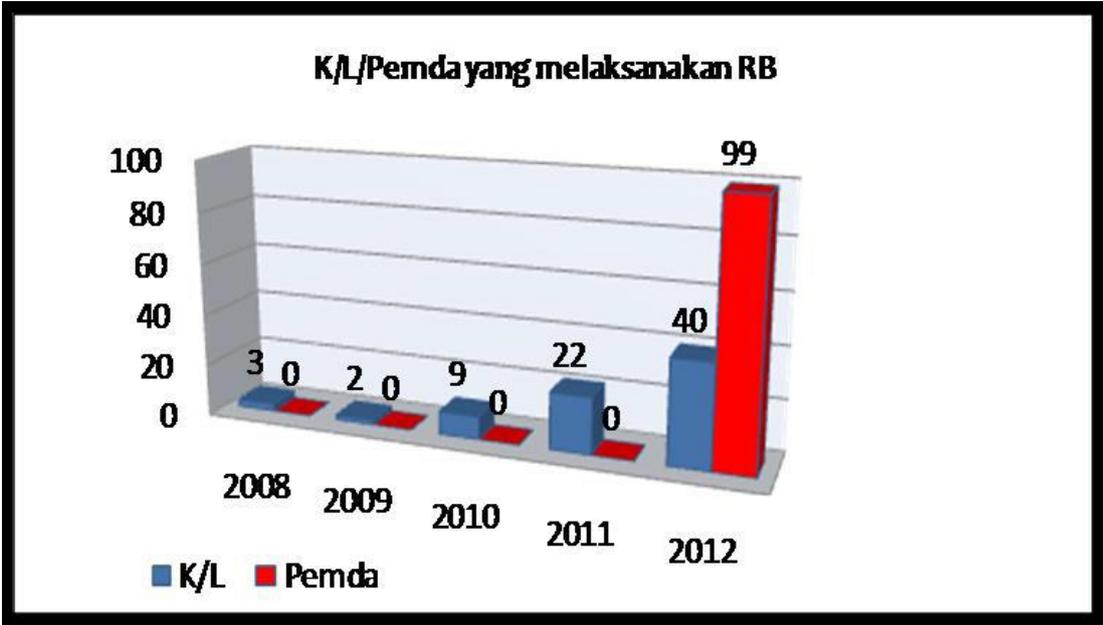
Considering a rather complex civil service administration, which involves five government institutions mentioned in Table 17, it is not easy to recruit civil servants when they are urgently needed. Coordination, at least between the institution which needs more officials, MENPAN and BKN, has to be made in advance. At the same time it is also difficult to fire civil servants when they do not perform well. Even for a corrupt official like Gayus Tambunan, the DGT alone could not fire him from civil service. Rather it has to go through administrative process handled by the Ministry of Finance and BKN. As mentioned earlier, salaries are determined based on civil servants' position. This may motivate civil servants to perform well to get a higher position or on the contrary, may provoke them to get a higher position in a shameless manner, for example, by bribing the human resources manager or other senior staff to give them a higher position. At certain levels, the process of bribery may happen in all involved institutions. This kind of practices occurred quite regularly before the reform of the bureaucracy, but has been decreasing over the years.

5. Current reform of the bureaucracy

Chapter 3 and 4 discussed the administrative reform in the DGT in detail and in the Ministry of Finance in general. In 2004, the government actually determined three institutions to be the pilot project for the reform of the bureaucracy in the central government, namely the Ministry of Finance, MA (the Supreme Court) and BPK (the

Supreme Audit Agency). By the end of 2008, the performance of these three institutions were assessed as successful in performing the reform (Humas MENPAN, 2008, 3 December). Having good results from the pilot project, the government had the confidence to roll over the reform of the bureaucracy to other institutions. In the following year, the state secretariat and the cabinet secretariat started the reform process in their own institutions. In 2010, other nine institutions also started their reform process. By the end of 2012 the number has reached 76 institutions out of 81 institutions in total. The reform of local government bureaucracy was launched in the middle of 2012 by pilot projecting 16 provincial governments, 59 districts and 24 cities. These local governments have drawn up a road map of bureaucratic reform and still in the process of implementing their reform plan. These figures show that the government has been taking this reform seriously.

Figure 10
Central and Local Government Agencies performing the Reform of Bureaucracy



Source: National Development Planning Agency

To support the Grand Design’s objective to achieve a clean and free of KKN government, in 2012, the government launched a guidance on development of “zona integritas” (ZI – integrity zone) as “wilayah bebas korupsi” (WBK – regions free of corruption). ZI is a title given to an institution (in both central and local governments)

whose leaders and their staff demonstrate a commitment to achieving a clean bureaucracy and to serve the public (MENPAN, 2012). To be declared as WBK, a ZI has to fulfil absolute indicators and obtain the assessment point of operational indicators above 75 and obtain unqualified opinion from BPK on its financial reports.

In 2013, the government carried out an evaluation of 55 ZIs committed to WBK. Out of 55, only five units achieved the WBK title. These five unit are the Kediri Office of Surveillance, Customs and Excise, Malang State Treasury Office, the Jakarta State Property and Auction Office, the Jakarta Electronic Procurement Service, and Jakarta *Tiga* Large Taxpayer Office (Humas MENPAN, 2014, 17 January). Four out of five WBK are structured under the Ministry of Finance. This shows that the Ministry of Finance as the pilot project for the reform of bureaucracy has put a lot of effort for its commitment in achieving a clean bureaucracy. Since 2013 the Ministry of Finance has always received the WBK title at most compared to other ministries. Sri Mulyani, who was appointed as the Minister of Finance for the second time, determined that all units in the Ministry of Finance must achieve this title.

The last part of the ‘Grand Design’ mentions that the key to success in implementing the reform of the bureaucracy lies in the following factors:

a. National commitment

There are three regulations that show national commitment for the reform of the bureaucracy, namely the Law No. 17 of 2007 on long term planning of national development 2005-2025, the Presidential Regulation No. 5 of 2010 on short term planning of national development, which emphasises the reform of the bureaucracy as the main priority, and the Presidential Decree No. 14 of 2010 on the establishment of the steering committee of national reform of the bureaucracy and the team of national reform of the bureaucracy.

b. Bureaucratic reform activator

The steering committee of national reform of the bureaucracy chaired by the vice president and the team of national reform of the bureaucracy chaired by the Minister of State Apparatus and Bureaucratic Reform lead the process of reform nationally. In addition every leader in central government institutions and local governments should be an activator in implementing the reform of bureaucracy in their own organisation.

c. The guidance of the reform

Guidance of the reform is formulated in the ‘Grand Design’ and its road maps. In the implementation it is important to set priorities on central government institutions and local governments based on strategic important for the country and benefits to community.

d. The process of the reform

The process should be decentralised in which each central government institution and local government performs all steps of reform with reference to the ‘Grand Design’ and road maps and with regard to characteristic of each organisation. It should be performed simultaneously and gradually as well as with coordination with all level of institution. Furthermore, it has to be monitored and evaluated periodically, sustained and institutionalised (GOI, 2010).

As has been mentioned several times previously, the reform is not an easy task, it is a lengthy process and it is not easy to measure. However, in order to find out if the reform is performed well or not, one of the ways is by determining key performance indicators (KPI). The ‘Grand Design’ contains several key performance indicators which put the year of 2009 as a base line and 2014 as its five years target. The following section discusses the achievement of the Grand Design’s KPIs in 2012. The discussion is limited to 2012 as this research time frame is ended in 2012. By looking at the three years results (2010, 2011 and 2012) and other things that influenced the results, it is possible to see how the reform has been going.

6. The unsatisfactory achievements of the Grand Design’s KPIs

The Grand Design’s time frame is between 2010 and 2025, as a result the achievement in 2009 is determined as the base line. Every five years the government sets the target to be achieved. In the first five years the reform’s objective is on strengthening the government bureaucracy in order to realise a clean and free KKN governance, an improved quality of public service to the community, and an increased capacity and accountability of the bureaucracy. The following table shows the 2009 base line and the 2014 KPIs as determined in the ‘Grand Design’ and the achievement of KPIs in 2012 obtained from different sources.

Table 15
The Grand Design's Key Performance Indicators

Objective	Indicator		Base line (2009)	Target (2014)	Achievement (2012)
Realisation of clean and free CCN government	Corruption Perception Index		2.8	5.0	3.2
	Unqualified Opinion from The Supreme Audit Agency	Central Govt	42.17%	100%	73.40%
		Regional Govt	2.73%	60%	27.23%
Realisation of improved quality of public services	Public Service Integrity	Central Govt	6.64	8.0	6.86
		Regional Govt	6.46	8.0	6.32
	Doing Business Rank		122	75	128
Improved capacity and performance accountability of bureaucracy	Government effectiveness		-0.29	0.5	-0.29
	Accountable government institutions		24%	80%	25%

Source: Presidential Regulation No. 81 of 2010 – except for 2012 achievement as discussed below.

By comparing the 2014 target and the 2012 achievement as shown in the table above, it is unfortunate that despite three years into the five year plan, the reform has not yet reached half of the target. It is even more sobering to report that some of the results were lower than the base line. In two year time afterwards unlikely though that the target may appear. There are eight KPIs for the Grand Design's objective in the first five years. Each KPI will be discussed in more detail in the following paragraphs.

The first indicator is Corruption Perception Index (CPI). This subject has been discussed in the previous chapter, but in regard to the 'Grand Design' it is important to revisit. In 2012, Indonesia CPI's score was 3.2. This score remained the same in 2013, even though the rank increased from 118 to 114. In other words, in this period Indonesia made some progress in comparison to other countries. To achieve the score of 5.0 Indonesia has to be in the 50th rank, which means it has to make better progress than about 60 countries currently placed higher than Indonesia. Compared to ASEAN countries, in 2012, Indonesian's position was also included in the lowest group (see table 18). However, "Indonesia is one of the few countries in the CPI that has shown a steady and marked improvement coinciding with the start of the Yudhoyono administration in 2004" ("Corruption in Indonesia: the Corruption Perceptions Index of 2013," 2013, 4 December).

Table 16

Comparison of 2012 CPI Score for ASEAN Countries

	Singapore	Brunei	Malaysia	Thailand	Philippines	Indonesia	Vietnam	Myanmar
CPI Score	8.7	5.5	4.9	3.7	3.4	3.2	3.1	1.5
Rank	5	46	54	88	108	118	123	172

Source: Transparency International at www.transparency.org

The “Grand Design” determined the 2014 CPI target to be 5.0 from 2.8 in 2009. The increased score of 2.2 in five years is something that has never happened in the history of Corruption Perception Index survey in the Asia Pacific Region. But there are only three countries in the world that had experienced the increased score of more than 2.0 in five year period, namely Rwanda, Liberia and Georgia. These three countries are perceived to have made more progress than most other low and lower middle income countries on tackling corruption (Chene, 2011). Even though they had different conditions, Chene (2011) states that Rwanda, Liberia and Georgia benefited from common conditions that may have contributed to their anti-corruption program, namely, a radical regime change or post conflict context which created a momentum for reform, a strong political will to eradicate corruption, a wide public support and demand for anti-corruption reforms. The following table shows their CPI score’s progress.

Table 17

CPI Score for Rwanda, Liberia and Georgia 2005-2012*

Country	2012	2011	2010	2009	2008	2007	2006	2005
Rwanda	5.3	5.0	4.0	3.3	3.0	2.8	2.5	3.1
Liberia	4.1	3.2	3.3	3.1	2.4	2.1	na	2.2
Georgia	5.2	4.1	3.8	4.1	3.9	3.4	2.8	2.3

Source: Transparency International at www.transparency.org

*) Rwanda and Liberia started to be included in the survey in 2005

Amongst other things, simplification of tax administration was one of the key accomplishments in fighting corruption in Georgia and Rwanda. As a sector where citizens interact with the state most frequently, the tax authority became one of institutions that has crucial importance in fighting corruption (Kupatadze, 2012). Another anti-corruption lesson learned from the three countries experiences is the reform of the bureaucracy. In Georgia, the bureaucracy was cut dramatically, with the number of public sector employees was reduced by 50per cent, while the salaries of

the remaining civil servants increased roughly 15-fold. Meanwhile in Rwanda, its far reaching public sector reform included a rapid downsizing with the dismissal of 6000 under qualified employees and the removal of 6,500 ghost workers, and an increased salaries (Chene, 2012). The Indonesian government has learnt these lessons, even if the results have not yet been as successful as those three countries. With regard to downsizing the number of civil servants, the civil service law stipulates that a civil servant can be made redundant if the institution is streamlined or there are government policies that result in early retirement, but practically, this action has never been done in Indonesia.

The second indicator is the financial statements audit result from “*Badan Pemeriksa Keuangan*” (BPK – the Supreme Audit Agency) to the central government. This indicator was the only indicator that gained a good result in achieving the target. The target is to gather an unqualified opinion on all of central government institutions. An unqualified opinion for a financial statement is given when the auditor concludes that the financial statements give a true and fair view in accordance with the financial reporting framework used for the preparation and presentation of the financial statement. By aiming to achieve an unqualified opinion, the ‘Grand Design’ wanted to show that the central government should have financial statements which comply with relevant statutory requirements and regulation. Instead of an unqualified opinion, auditors may express a qualified opinion if after obtaining sufficient appropriate audit evidence they conclude that misstatements are material but not pervasive to the financial management. A qualified opinion may also be given if auditors are unable to obtain sufficient appropriate audit evidence but conclude that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive. From 2009, the central government’s financial report, finally, obtained a qualified opinion, after five years of a disclaimer opinion. Auditors must disclaim an opinion when they are unable to obtain sufficient appropriate audit evidence and they conclude that the possible effects on the financial statements of undetected misstatement, if any, could be both material and pervasive.

The central government of Indonesia consists of MPR, DPR, BPK, MA, DPA, the State Secretariat, the ministries, and other bodies or agencies that gain financial resources from the state budget. The financial reports of all entities in the central government are audited by the BPK. Because the BPK is part of the central government, its financial report is audited by an independent public accountant. Each

year, the BPK gives an opinion on the overall central government's financial statements. This opinion represents all opinions given to each entity. For example in 2012, the central government's financial report obtained a qualified opinion. However, out of the 94 central government entities being audited only 69 entities, or 73.40 per cent, obtained the unqualified opinion. The rest obtained qualified and disclaimer opinions. The improvement of audit result from 2008 to 2012 is shown in the following table.

Table 18
Audit results of the central government entities

	2008	2009	2010	2011	2012	2012 (%)
Unqualified	35	45	53	67	69	73.40
Qualified	30	26	29	18	22	23.40
Disclaimer	18	8	2	2	2	2.13
Total Audited Entities	83	79	84	87	93*	98.94
Overall Opinion	Disclaimer	Qualified	Qualified	Qualified	Qualified	Qualified

*) Total audited entities is 94 entities, one of them was not finished audited yet.

Source: BPK's Executive Summary of Audit Result of the Central Government (<http://www.bpk.go.id>)

With regard to a qualified opinion of the central government entities for the audited year 2012, the BPK (BPK, 2013b) mentioned four things that need to be improved:

1. Profit or loss from all transaction using foreign currency has not been done in accordance with governmental accounting standard, which then affected the calculation of the real revenue and or expenditure;
2. The process of budgeting and budget utilisation illustrated weaknesses in procurement for consumer goods, capital goods and social assistance expenditure;
3. There were assets of "*Badan Penyehatan Perbankan Nasional*" (BPPN – the Indonesian Bank Restructuring Agency, IBRA)⁷⁵ that have not been traced and

⁷⁵ IBRA or BPPN (*Badan Penyehatan Perbankan Nasional*) is part of a series of strategic policies taken by the Indonesian government in response to banking and economic crises. It was established in 1998 and was planned to have lifespan of five years for undertaking its tasks, but then prolonged until finally liquidated in 2004. Its tasks were to administer the government's guarantee program and to supervise, manage and restructure distress banks, as well as to manage the government's assets held by distress banks.

property assets managed by “*Perusahaan Pengelola Aset*” (PPA – the Asset Management Company, AMC)⁷⁶ has not been assessed;

4. The amount of budget surplus was different compared to its physical presence.

It is important to note that main audit findings of the BPK did not mention anything related to tax administration. In fact, this has been happened since 2011. For decades up to 2011, problems in tax administration had always been the main issue of audit findings. For example in 2010, the BPK expressed a qualified opinion because there were problems in collecting and recording tax revenues, as well as problems in controlling over recording tax receivable (BPK, 2011). Furthermore, in the 2009 audit report (BPK, 2010), the BPK summarised that during 2004 to 2007 there was a restriction on tax revenue auditing and that tax revenue could not be deemed reasonable. This restriction was eliminated in 2008 but there was still a problem in the tax revenue’s recording.

In addition to the central government, the BPK also performs audit to regional governments. The audit result from the BPK to regional governments is the third indicator of the ‘Grand Design’. The regional governments being audited include provincials, districts and municipals. In 2012, Indonesia consists of 34 provincials, 402 districts and 93 municipal, or 529 regional governments in total. Among them are one new provincial and four new districts which did not have an obligation to make a 2012 financial report (BPK, 2013a). Out of 524 regional governments which have obligation to submit their 2012 financial report to the BPK, 523 reports have been audited. And from these, only 120 reports or 22.95 per cent obtained unqualified opinion. The total of regional governments which obtained unqualified opinion increased quite significantly in 2011 and 2012, by 33 entities and 53 entities respectively (BPK, 2014). These numbers are shown in the table below. Only if this improvement continues in the following years, the target of 60 per cent or 314 entities with unqualified opinion by the end of 2014 would be achievable.

⁷⁶ AMC or PT PPA (*PT Perusahaan Pengelola Aset*) was established in 2004 and was planned to have lifespan of five years but then changed to a going concern. Its duties include managing ex-IBRA assets, restructuring and/or revitalisation of state owned enterprises, and managing state owned enterprises’ assets.

Table 19
Audit Results of Local Governments

	2008	2009	2010	2011	2012	2012 (%)
Unqualified	13	15	34	67	120	22.95
Qualified	323	330	341	349	319	60.99
Disclaimer	118	111	121	100	78	14.91
Adverse	31	48	26	8	6	1.15
Total Audited Entities	485	504	522	524	523	100

Source: BPK's Overview of Audit Results Semester I and II Year 2013 (<http://www.bpk.go.id>)

An increase in the percentage of unqualified opinion and a decrease in the percentage of qualified, disclaimer and adverse opinion in both, the central government and regional government reports, generally illustrates the improvement achieved by the government entities in presenting reasonable financial reports in accordance with the applicable principles. Furthermore, presentation of the fair financial report figure is resulted from better financial management. As the financial statements are responsibility of the entity, any opinions given to them is a reflection of the quality of management and financial statement presentation (BPK, 2013a).

The next Grand Design's indicator is the improvement of public service quality which is measured by using the result of Public Service Integrity Survey performed by the KPK. The survey measures the quality of public service of government institutions, both at central and regional levels. Public sector is one of the sectors wherein corrupt acts, mainly in form of bribery, extortion and gratuity, still frequently occur (KPK, 2010). As public sectors obtain funds to perform their function from the state budget, their accountability of utilisation of such funds is by providing the best services to the public without the burden of various collections. The survey is conducted every year and its results is actively disseminated to the mass media, the public and service provider institutions in order to drive the public sector to voluntarily carry out efforts to eradicate corruption in its service units (KPK, 2010). This survey adopts the assessment of public organisation integrity by the Korea Independent Commission against Corruption (KICAK).

The public service integrity level of the central government is fourth KPI of the 'Grand Design'. The 'Grand Design' determined the target of integrity value in

2014 to be 8.00⁷⁷, an increase of 1.36 from the 2009 base line. The result of 2012 public service integrity survey shows that the average value of public sector integrity at the central government was 6.86. This value was acquired from a compilation of variables of experienced integrity and potential integrity, both of which were obtained from indicators and sub-indicators in public service units. The experienced integrity or perceived integrity measures the level of corruption experienced or perceived by citizens using public services or dealing with public organisations. It reflects personal experience and perception of corruption (OECD, 2005). Meanwhile the potential integrity reviews the prevalence of potential factors causing corruption as perceived by citizens. It indicates the presence of factors that are likely to correlate with actual incidences of corruption in the future(OECD, 2005). The 2012 average value of 6.86 was not far from the minimum integrity value of 6.0 determined by the KPK. With the average value at 6.86, the potential integrity value at 5.97 is much lower when compared to the experience integrity value at 7.31(KPK, 2013). The potential integrity variable has four indicators, namely working environment, administration system, personal attitude and prevention on corruption. Among these four indicators prevention on corruption obtained the lowest value, which was at 3.79. This means that level of efforts towards anti-corruption and public complaint mechanisms, as sub-indicators of prevention on corruption, were still unsatisfactory for the survey's respondents (KPK, 2013).

The Grand Design's target to achieve the average value of public sector integrity at the central government at 8.00 in 2014 looked possible considering that in 2013 it reached 7.37 (Humas KPK, 2013,16 December). In 2013, the potential integrity value increased to 6.91 from 5.97 in 2012. This indicates the seriousness of efforts within public sector institutions to tackle corruption. The increase was mainly caused by higher value of prevention on corruption indicator, which showed the value of 5.94 or an increase of 2.15 from the previous year respectively. The deputy chairman of KPK, Busyro Muqoddas expects that the improved potential integrity value of 2013 became a motivational assessment in making improvements and increasing the quality of public services on other indicators that remain weak (Humas KPK, 2013,16 December).

⁷⁷ The value is measured on a scale of 1 to 10, with 10 being the highest level of overall integrity.

The fifth KPI of the ‘Grand Design’ is the public service integrity level of the regional governments. Unlike the average value of public sector integrity at the central government, the regional governments’ value in 2012 was lower than the 2009 base line (KPK, 2010, 2013). The 2009 value was at 6.46 and the 2012 value was 6.32. There was an increase in the experienced integrity value from 6.68 in 2009 to 6.82 in 2012. In contrast, the potential integrity decreased from 5.82 in 2009 to 5.30 in 2012. In order to achieve the 2014 target value at 8.00, the regional governments would have to put in a sustained effort in addressing every variable within its indicator measure.

It is not however really objective to compare the achievement of one year with another. This survey methodology used a random sample strategy in determining survey locations, number and criteria of institutions or units to be surveyed, and number and criteria of respondents. For example, 196 public service units were surveyed across 49 local governments in 2009 and 180 public service units across 60 local governments in 2012. The public services surveyed in 2009 were birth certificates, aid for building/renovation/physical repairs of school, basic health services at public health centres and procurement of good and services in regency/municipality environment (KPK, 2010). Meanwhile, in 2012 the public services included in the survey were “*Kartu Tanda Penduduk*” (KTP – citizen identity card), “*Surat Ijin Usaha Perusahaan*” (SIUP – company business licenses), and “*Ijin Mendirikan Bangunan*” (IMB – building permits)(KPK, 2013). It is thus important to note that the survey involves different institutions which may have different stages of institutional reforms, or different respondents who may have different perceptions and experiences regarding acts of corruption. However, any increase in the integrity value has to be recognised as real effort to improve the quality of public service. This is in line with the purposes of the survey (KPK, 2010) as follows:

1. Mapping of the public sector integrity level through routine survey activities every year;
2. To provide information concerning the performance of the public sector in Indonesia;
3. To provide information on the level of implementation of integrity elements in the public sector in Indonesia;
4. To provide input towards improvement in public sector integrity in Indonesia.

In Korea, the KICAC also publicly announces the survey result through mass-media to encourage an institution’s efforts in anti-corruption. In addition, it submits

official recommendations for systemic improvement. The anti-corruption act stipulates that the institution should provide a report on its actions implementing the KICAC recommendations within a limited period of time (OECD, 2005). Since the KICAC launched the integrity survey in 2002, public sector institutions have been paid keen attention to the results. To get a higher level of integrity, the KICAC redoubled efforts to strengthen their internal assessment, conducted various educational programs and improved its systems and procedures (KICAC, 2006). Moreover, public sector institutions and their subsidiaries worked together to improve the overall picture of integrity every year. For example, the institution responded most actively to the survey's results was the Korea Electric Power Corporation (KEPCO). After the KEPCO found out that it ranked at the bottom of the list of surveyed institutions, it organised a workshop for the employees and operated a computer-based hotline. As a result, the KEPCO produced an outstanding 2.92 increased point in the following survey (OECD, 2005). This outstanding improvement in previously underperforming institutions resulted in the increase of the overall integrity value as shown in the table below.

Table 20
Changes of public perceptions in Korea 2002-2005

	2002	2003	2004	2005
Overall Integrity Value	6.43	7.71	8.38	8.68
Perceived Integrity	6.52	7.79	8.63	9.05
Potential Integrity	6.33	7.64	8.13	8.31

Source: Integrity of Public Sector in Korea (KICAC, 2006)

The success of integrity assessment in Korea has been attributed largely to public sector institutions which performed active participation in tackling corruption problems and to the government's commitment to combating corruption (KICAC, 2006). If funds allowed the Indonesian government could have done the same things.

The sixth KPI in the "Grand Design" is the Indonesian rank in ease of doing business. From 2009 to 2012, the rank in ease of doing business decreased from 122 in 2009 to 128 in 2012. The rank is influenced by several aspects as shown in table 21.

Table 21

The Indonesian Ease of Doing Business Rank and its influencing factors

Focuses/Rank each year	2009	2010	2011	2012
Ease of Doing Business	122	121	129	128
Starting a business	161	155	155	166
Dealing with construction permits	61	60	71	75
Employing workers	149	n/a	n/a	n/a
Getting electricity	n/a	n/a	161	147
Registering property	95	98	99	98
Getting credit	113	116	126	129
Protecting investors	41	44	46	49
Paying taxes	126	130	131	131
Trading across borders	45	47	39	37
Enforcing contracts	146	154	156	144
Closing a business	142	142	n/a	n/a
Resolving insolvency	n/a	n/a	146	148

Source: www.worldbank.org

In 2010, the rank for ease of doing business increased to 121. This was due to more straight forward business start-ups by reducing the cost for company name clearance and reservation and the time required to reserve the name and approve the deed incorporation (World Bank, 2010). The easier business ranking also resulted from the change in paying taxes where corporate income tax rate was reduced. However, the rank of paying taxes decreased from 126 to 130. This was because many economies around the world performed tax reforms and accomplished better results than Indonesia. In 2011, starting a business was made even easier by introducing a simplified application process which allowed an applicant to simultaneously obtain both a general trading licence and a business registration certificate. However, the rank remained the same at 155 (World Bank, 2010).

It was more difficult for a business to get electricity as the connection fee was increased in 2012 (World Bank, 2011). By considering this factor during 2012, the utility PT Perusahaan Listrik Negara (PLN – the State Power Company) then set up a call centre enabling customer to request a new electricity connection by phone. It simplified the application process by eliminating the requirement to bring in a copy of a neighbour's bill to help determine the exact address of the new customer's business (World Bank, 2012).

Table 22 shows the relative position of Indonesia compared to other member of ASEAN countries. Indonesia was still far behind its neighbouring countries such as

Thailand and Malaysia. In 2013, Indonesia rose in rank 120 but this result did not support any indication that the 2014 target of rank 75 in ease of doing business would be achieved. It needs tough efforts to surpass 45 countries in two years for which there is no precedent.

Table 22

The Rank of Doing Business for ASEAN Countries, 2008-2012

Country	Rank of Doing Business					
	2008	2009	2010	2011	2012	2013
	181	181	183	183	183	189
1	Singapura	1	1	1	1	1
2	Thailand	19	12	16	16	17
3	Malaysia	25	21	23	23	18
4	Vietnam	87	91	88	90	98
5	Brunei	83	94	117	86	83
6	Indonesia	127	129	115	126	129
7	Philipina	136	141	146	134	136
8	Kamboja	150	139	145	138	138
9	Myanmar	-	-	-	-	-
10	Laos	162	165	169	163	165

Source: National Development Planning Agency

In order to achieve the target of improved capacity and performance accountability of bureaucracy, the grand design put governance effectiveness as the seventh indicator. Governance effectiveness is one of six worldwide governance indicators by the World Bank. Governance effectiveness⁷⁸ captures perceptions of the quality of public services, the quality of the civil service and the degree of its independence from political pressures, the quality of policy formulation and implementation, and the credibility of the government's commitment to such policies. The range for government effectiveness indicator is -2.5 for the weakest and 2.5 for the strongest. Comparing Indonesian's government effectiveness from 2009 to 2012 did not show an improvement, it was -0.29 in both years. Looking at the World Bank's data of government effectiveness for Indonesia in 2009 was actually -0.28. If the World Bank's data is used, the Indonesian's government effectiveness in 2009 and 2012 indicated a decline. The table below shows government effectiveness in the period 2008-2012.

⁷⁸ Definition from www.worldbank.org

Table 23

The Indonesian government effectiveness score and rank

	2008	2009	2010	2011	2012
Score	-0.24	-0.28	-0.20	-0.25	-0.29
Rank	47	47	48	46	44

Source: www.worldbank.org

The table shows that in 2009 the government effectiveness was worse than 2008, even though the rank remained the same. After 2009 the condition improved with a score of -0.20, but then declined to -0.25 in 2011 and to -0.29 in 2012. In term of rank, it shows an improvement starting 2010.

The last KPI of the ‘Grand Design’ is the percentage of accountable government institutions as another indicator of improved capacity and performance accountability of bureaucracy. The percentage of accountable government institutions is taken from “*Sistem Akuntabilitas Kinerja Instansi Pemerintah*” (SAKIP – the System of Performance Accountability of Government Institutions). This system is an implementation of performance management in the public sector in line and consistent with the application of bureaucratic reform, which is oriented to the achievement of outcomes and attempts to get better results (Humas MENPAN, 2012). It integrates planning systems, budgeting systems and performance reporting systems. Each institution is required to record and report any use of state budget and its compliance with applicable regulations. The end product of SAKIP is “*Laporan Akuntabilitas Kinerja Instansi Pemerintah*” (LAKIP – the Report of Performance Accountability of Government Institutions), which illustrate the performance achieved by a government institution for the implementation of programs and activities funded by the state budget (Humas MENPAN, 2012). The report includes five components: performance planning, performance measurement, reporting performance, performance evaluation and achievement of performance. The highest value of report evaluation is AA (excellent) with a score of 86-100, A (very good) with a score of 76-85, B (good) with a score of 66-75, CC (satisfactory) with a score of 51-65, C (quite good) with a score of 31-50, and D (bad) with a score of 0-30. There are three groups of report evaluation: central government institution, provincials and districts/municipals. The reports on each group are provided in appendix 9. Between 2010 – 2012, there was no government institution achieved an excellent score, the number of institutions with a very good score increased slightly, but the number of institutions with a good score

increased quite significant. Problems with performance accountability of the government institutions, among other things were accountability concepts too complicated to applied, accountability system was not supported by reward and punishment mechanism, and only a few institutions used accurate data in reporting the realisation score. This result shows acceleration programs of the reform of the bureaucracy was still low.

7. Conclusion

Bureaucracy is one element of the state administration that runs government functions such as regulator, licensing, providing public services and supervising the utilisation of existing resources. Its role, functions and authorities has made the bureaucracy as a strategic organisation. In regard to governance, bureaucrats have the authority that can control many broad and strategic aspects. The bureaucracy controls accesses to natural resources, budgets, employments, development projects as well as access to knowledge and information. With that authority, the bureaucracy has to make the right policy to gain supports from the society.

Now that Indonesia has developed a strategy to reform the bureaucracy, there are many opportunities for people to engage in governmental process. While governance reform can produce positive outcomes, the debate on how it has been performing still is arising. Despite the fact that reform has been for quite a while, declared and put into the national agenda, the agenda has yet to demonstrate any substantial influence in improvement of government, services and development qualities.

The slow acceleration of the reform program somehow resulted in high cost but low performance. There are still reform programs that focused on increased remuneration. The reform of the bureaucracy which was interpreted as increased remuneration caused financial problems especially in local governments with weak budget planning. The reform of the bureaucracy has not yet progressed in significant changes of mindset and work ethos. The organisational culture has not yet fully oriented towards best performances.

The creation of the 'Grand Design' with its KPI set the target to be achieved so that the results of the reform could be easier to be monitored and evaluated. By using 2009 as the base line year and set 2014 as the target year, the 2012 results revealed unsatisfactory indicators. The results could be interpreted as low seriousness level of

the government institution or high level of government expectancy. However, the failures in achieving the KPIs target during 2009-2012 became lessons learned for pursuing the 2014 target.

The reform process in the Directorate General of Taxes (DGT) and the Ministry of Finance has been the major program to reform bureaucratic structure and improve organisational capacity. The reform process is supposed to bring more transparent structure, customer service orientation, effective in terms of functions and efficient in terms of number officials employed and cost attributed to the process. The reform becomes a main instrument for the ministry to give strong signal to the public about fundamental reform and later on considered as a pioneer for overall public sector (bureaucratic) reform in Indonesia (Artjan, 2011). Tax administration reform in the DGT has included three important aspects of the reform of the bureaucracy. It created a new and improved organisation structure, transformed its business processes to be more effective and efficient as well as formatted its human resources management.

CHAPTER 7. CONCLUSION: MOVING AWAY FROM PATRIMONIAL LEGACIES

This research began with a question about the extent of increased institutional capacity within the Indonesian state since 2002. Its aims were to examine whether the nature of the Indonesian state has changed through taxation reforms. The last major taxation reform began in 2002 was used as a starting point for data analysis, as in this reform, the Indonesian tax authority, known as the Directorate General of Taxes (DGT) was the pilot project for far-reaching institutional reform in Indonesia. This research measured the effectiveness and the efficiency of the taxation reform by analysing tax revenue, tax ratio, tax compliance ratio and cost of collection ratio and then related them to the implementation of the reform in other public sector institutions. It also looked at the reform of the Indonesian bureaucracy to find out if the extent of improved capacity resulted in a shift away from patrimonial legacies. The findings of this research show that the reform has improved the state capacity in a way that supported main government revenues so that the increasing government expenditure in providing public good and services could be safeguarded. Notwithstanding limitations and constraints, the process of tax reform has indeed influenced reform in other areas of government towards a rational legal administration system of bureaucracy whilst leaving the patrimonial system behind. Below is a discussion of how the nature of the Indonesian state has changed through taxation reforms.

1. Efficiency and effectiveness of tax administration reform, and its implementation on other public sector institutions

As discussed in Chapter 2, the Indonesian government has long been perceived as a patrimonial state, which has features such as cronyism, domination of economy by patronage, particularistic policies and a tendency to blur the boundaries between the public and the private realms. These practices were in conflict with Article 33 of the 1945 Constitution of the Republic Indonesia which contains the basic arrangements for organising the Indonesian economy by emphasising the social responsibility of the state. According to Anderson, in Indonesia, this patrimonial state was found in the traditional Javanese kingdom that existed before the Netherlands colonised Indonesia.

During Soekarno's government, patrimonialism recurred and later progressed to a higher level under Soeharto's authoritarian rule.

In order to leave patrimonialism a government needs to promote institutional changes. Institutional development is one of many approaches used by international agencies for developing the institutional capacity of a state. The process of institutional development is not simple and may take a long time to achieve its aims. For Indonesia, the fall of Soeharto in 1998 was commemorated as the beginning of the reform era. Reforms within several sectors have become the government's priority in developing the state capacity, including economic reform which received the widest attention from international and domestic institutions. Among other things, the appointment of the DGT as the pilot project for institutional reform shows the pivotal role of the DGT in the Indonesian government's economic reform, and generally in the process of the Indonesian state building.

The 2002 tax reform focussed on improving the organisational structure, transforming business process and managing human resources. In this reform, the DGT shifted its office structure from a type of tax-based organisational structure into a functional-based organisation structure. Under this approach, there has been developed a strategic element of cross checking among staff in which work performed by one function acts as a control on other functions. This approach reduces the compliance burden on taxpayers because they only have to deal with a single point of contact. This functional approach was combined with taxpayers' segmentation to ensure that each group of taxpayers had its own strategies appropriate for maximising their voluntary compliance. The transformation of business process was a key pillar of the strategy in improving the operation of the DGT and made the tax system easier for the taxpayers to comply with and for the tax officers to administer. In order to achieve sustainable performance improvements, the development of human resources management was aimed at increasing the capacity of individuals to carry out their duties resulting in higher productivity, higher tax compliance and higher public trust in the DGT.

In the Indonesian tax reforms, the accomplishment of tax revenue targets through improvement on tax administration has always been an important objective as the contribution of taxes in state revenue demands the increasing amount of revenue every year. The ratio of total government tax revenue by the country's Gross Domestic Product (GDP) or tax ratio may show the effectiveness and efficiency of tax

administration. The average Indonesian tax ratio of 12 per cent for the period of 2002-2012 was considered low compared to other countries in the region. This may indicate that tax collection capacity was not fully implemented yet or expressed more positively, there was still potential for maximising tax revenue as long as effort for raising tax was strengthened. Countries with high tax ratios are linked with the rise of other factors in their development such as literacy and industrialisation. This shows an increment in the relationship between taxation and state capacity. Looking at the Indonesian tax ratios which remained stable from 2002 to 2012, this shows that the state capacity did not get much support from taxation. However, the tax ratio alone did not represent the country's state capacity as there were other elements that should be taken into account. Judging tax ratio of a country must consider its own characteristics such as political and economic structure, tax structure, income per capita and public service capacity in general.

As shown in Table 3 the state reliance on taxation may affect the state immediately in its focus on obtaining revenue by taxing citizens. This motivates the government to be more responsive in order to promote citizen prosperity and to increase bureaucrats' capacity to collect tax effectively. Citizens may also be affected by this condition, as experiences of being taxed mobilise (some) taxpayers to resist tax demands and/or monitor the mode of taxation and the way the state utilises tax revenues (John, 2009). For Indonesia, which is now a country that relies on taxes as the main source of government revenue, the above mechanism of effects of taxation to the state and citizens enhanced the development of effective governance. Interactions between the state and citizen created the arrangement in which taxpayers comply with tax requirements in exchange for benefits of taxes. Generally, this leads to more acceptable taxes and more efficient tax administration with more professional scrutiny in how public money is spent. One simple example to show this enhancement is by examining the increased compliance ratio during 2002-2012.

Compliance ratio is the ratio of tax returns filed by the taxpayers to total registered taxpayers. During 2002-2008 the ratio had remained the same in about 30 per cent, but 2009 the number increased to more than 50 per cent. In addition to the soft amnesty program called 'Sunset Policy', the innovative program of 'Drop Box' was greatly utilised by taxpayers and contributed to an improved ratio. The implementation of electronic Tax Return and electronic filing moreover, provided taxpayers with simpler but more advanced procedures in fulfilling their obligation,

whilst the DGT gained benefit of lighter workloads and less operational cost in handling tax returns. Notwithstanding that it was still far from the ideal 100per cent compliance, the increased ratio implicitly showed that there was a better understanding between tax authority and taxpayers, or in more general term, between state and the society. As state capacity is all about the state-society relationship, the increased compliance would contribute to the increased state capacity. As Max-Everest (2010) states, the long-term goal of state-building taxation is a broad 'quasi-voluntary compliance' – that is, taxpayers have an intrinsic willingness to pay taxes to a state that they perceive to be legitimate and to a tax authority that they regard as a competent agent of legitimate state, and that state uses public revenues well in improving public welfare for the common good. He supports Levi's⁷⁹ argument that the tax collection requires both substantial coercive power and a state, to be legitimate because most taxes are collected when the level of voluntary compliance is high.

To be regarded as a competent agent, the DGT has to be able to build its image in the eyes of taxpayers to restore trust in tax process and administration which had been viewed as one of the most corrupt institutions. This research found out that public has seen improvements in the DGT – with the improved quality of service and the improved capability of human resources, taxpayers had more confidence and felt more comfortable attending tax offices or dealing with tax officials. The improvement in the DGT as a result of the reform could not avoid increasing demands on the operational fund. The fund was used not only for human resources training and incentives but also infrastructure development and maintenance, IT development and reorganisation. If the DGT's operational fund to the total of tax revenue (collection ratio) is compared to other countries', it can be seen that that the collection ratio was low. Although cost ratio does not have a direct impact to the state capacity, it is in fact an important aspect in assessing the efficiency and the effectiveness of the tax authority. An efficient and effective tax authority has a relatively reasonable cost ratio. However, the meaning of reasonable may vary depended on many aspects as mentioned above. But it is not an exaggeration to say that with a reasonable collection ratio, the state budget may be left untouched and may be utilised for other agencies.

The agenda of tax reform could be considered as an accountability-enhancing agenda as it flourished improving equity in tax enforcement and administration, public

⁷⁹ As cited by John (2009)

awareness, transparency and taxpayer services, and strengthened civil society engagement in tax issues. The reform implemented equal treatment to taxpayers by creating clear criteria and procedures of tax enforcement and administration in the regulation. The DGT has also made considerable efforts to improve the public awareness on taxation using all possible media. To strengthen civil society engagement, cooperation with business associations and civil society organisation were activated, as these may support increasing taxpayers' compliance. This research illustrated that both taxpayer and tax officials have benefited from the process of tax reform each with their own perspectives. The tax reform led to conditions in which, generally, taxpayers felt that they received better services and experienced more open communication, and tax officials felt more secure and confident. This was followed by taxpayers' elevated awareness and increased compliance, and the fact that the DGT received various awards showed that these achievements have been recognised.

Positive outcomes of tax reform on state capacity development include building linkage within government, data sharing with other agencies, replicating the reform in other areas of governments and affecting local tax administration. Although the outcomes were not yet as expected, the process of reform has been heading in the right direction. According to John (2009) tax collection reflects basic core capacities of state to collect vast amounts of data which is essential for the formulation of informed policy decision. After the completion of the first phase of modernisation in 2008, the DGT's second phase was commenced in 2009 by evaluating tax administration business processes. One of the results of this evaluation recommended that data processing operation should be restructured by expanding the operation of data processing centres and establishing a data and document processing offices. These actions were taken in 2010 and 2011 with limited availability of data, but the process data gathering is continuous. The tax authority's efforts in collecting and monitoring the data needed for developing a tax base was considered as one of the most challenging functions a state can undertake. Therefore, taxation has functioned as a key incentive for the state to create competent bureaucracies.

2. The reform of the Indonesian bureaucracy

History has revealed that conditions of the Indonesian bureaucracy until the end of Soeharto era led to inefficiency, abuse of authority, corruption, collusion and nepotism. Bureaucracy was misused for gaining supports from political parties which

then led to discrimination and abuse of facilities, programs and state funding. The 1997 crisis weakened the situation and triggered strong demands for the immediate implementation of total reforms, including the reform of the bureaucracy. In 1998-2003, the reform of the bureaucracy was not paid enough attention as the government concentrated more on prevailing economic conditions. In 2004, the first wave of bureaucratic reform was begun by reiterating the importance of applying the principles of clean government and good governance. The nature of reform in the first wave (2004-2009) was institutional because the reform was designed to work around existing policies and procedures without challenging the existing central policies.

The creation of the “Grand Design *Reformasi Birokrasi 2010-2025*” in 2010 provided policy direction for national reform of bureaucracy. As mentioned in Chapter 6, the ‘Grand Design’ emphasised that the Indonesian government aims to achieve a world class professional government with the highest measure of integrity by 2025. The objective of the ‘Grand Design’ includes making government institutions properly functional and of the right size, making regulations appropriately, and providing excellence in service delivery. It also takes account of creating a neutral, competent, capable and professional apparatus which would improve their capacity and accountability, and with the correct mind-set and culture leading to a bureaucracy with high integrity and performance.

The ‘Grand Design’ contains several key performance indicators which put the year of 2009 as a base line and 2014 as its five years target. This research looked at the results in 2012 to see how the reform of bureaucracy has been going in the first three years. In this chapter the 2014 realisation is also discussed for examining the progress of reform and its influences to the nature of the state.

The Corruption Perception Index, as the first indicator, failed to achieve the target of 5.0 in 2014. The 2012 score was 3.2 which only increased 0.3 point from the base line, suggesting either the government had not yet performed well in anti-corruption program. With the fact that in 2013 the score was still in the same level as 2012 at 3.2 and then increased slightly to 3.4 in 2014, this showed that corruption eradication efforts were unsuccessful to meet its target. In term of country rank, Indonesia levelled up its rank from 118 in 2012 to 107 in 2014. Transparency International said that the improved score was due to cooperation in eradicating corruption between the government, civil society and business community. The government has been constantly put its best efforts to curb corruption, and in the same

time civil society and business community have been actively participated in educating all citizen on corruption prevention and eradication. However, political corruption is a major problem in Indonesia, so that the country was advised to “adopt radical anti-corruption measures” (Transparency International, Press Release 3 December 2014). The 2014 election was a moment for politicians and citizens in Indonesia to involve in the largest democracy party. Public perception survey conducted by the KPK (2013) to find out the integrity level of election revealed that 71 per cent of respondents understood that the practice of money politics in election was common in Indonesia, and 92 per cent of respondents stated that leaders and politicians who are involved in corruption cases are common. Notwithstanding that there was larger opportunity for political corruption, in 2014, the CPI score increased by 2 point. This showed that the government through the KPK held extensive powers to combat political corruption by investigating and prosecuting that were engaged in graft and corrupt practices.

The next two indicators are audit results of both the central government and local governments from the BPK (*Badan Pemeriksa Keuangan* – the Audit Supreme Agency). It was expected that in 2014 the target of 100 per cent unqualified opinion would be obtained by the central government agencies and 60 per cent by local governments. The audit results show that in 2012, 73.40 per cent of the central government agencies and 27.23 per cent of local government achieved the targeted unqualified opinion. These two numbers showed significant increases from the base line of 42.17 per cent and 2.73 per cent respectively in 2009. Unfortunately, the improvement did not continue as it was expected. It turned out that in 2014 the number of central government agencies which got unqualified opinion from BPK remained the same at 73.40 per cent, but for the local government agencies the number increased to 48.90 per cent. Both indicators were still far behind the target. To overcome this failure the government promised to refine rules, systems and procedures related to budgeting, implementation of the state budget and government financial reporting, as well as to monitor the maximum absorption of budget by referring to effective performance of services to the community.

The next indicators are the scores of public service integrity survey performed by the KPK both to the central government and regional governments. The 2014 target for both government agencies was 8.00. The central government’s scores reached 6.86 in 2012 and 7.37 in 2013. These scores looked promising for the 2014 target achievement and indicated the seriousness of efforts of public sector institutions in the

fight against corruption if they were compared to the 2009 base line's score of 6.64. But the fact was the score decreased in 2014 to 7.22. Therefore, service units still need to improve and provide optimal services to all users. In order to create transparent services the government needs to perform a better anti-corruption education, manage public complaints, utilise existed media facilities for communication and improve the use of information technology. Unlike the average value of public sector integrity at the central government, the regional governments' value in 2012 was lower than the 2009 base line. Started with the base line score of 6.46 in 2009, in three years the score dropped to 6.32 but then increased to 6.82 in the following year. In 2014 the survey did not include the regional government agencies because it focussed on the service units associated with the national interest and concerning the lives of many people.

The sixth KPI in the 'Grand Design' is the Indonesian rank in ease of doing business. From 2009 to 2012, the rank in ease of doing business decreased from 122 in 2009 to 128 in 2012. In 2013, Indonesia succeed in increasing its rank to 120 but this result did not show a supportive indication that the 2014 target of rank 75 for ease of doing business would be achieved. In fact, in 2014 the rank remained in the same level of 120.

Government effectiveness of the World Bank as the next Grand Design's indicator also did not show a good result. With a target of 0.5 to achieve in 2014, the score of -0.29 in 2012 was very disappointing considering that the score remained the same as the 2009 base line at -0.29. Although Indonesia reached the maximum point of -0.01 during 1996-2014 in 2014, this achievement still far behind the target index of 0.5.

The percentage of accountable government institutions is the last KPI of the Grand Design. To be regarded as an accountable institution, the institution has to achieve at least a satisfactory level in its report evaluation. With the target set for 2014 to reach 80 per cent, the result of 2012 at 53.43 per cent made it difficult to achieve. The KPIs have shown unsatisfactory results overall. The table below showed all performance of realisation.

Table 24
The Grand Design's Key Performance Indicators
(Comparing Target and Realisation of 2014)

Objective	Indicator		Base line (2009)	Target (2014)	Realisation (2012)	Realisation (2014)
Realisation of clean and free CCN government	Corruption Perception Index		2.8	5.0	3.2	3.4
	Unqualified Opinion from The Supreme Audit Agency	Central Govt	42.17%	100%	73.40%	73.40%
		Regional Govt	2.73%	60%	27.23%	48.90%
Realisation of improved quality of public services	Public Service Integrity	Central Govt	6.64	8.0	6.86	7.22
		Regional Govt	6.46	8.0	6.32	6.82
	Doing Business Rank		122	75	128	120
Improved capacity and performance accountability of bureaucracy	Government effectiveness		-0.29	0.5	-0.29	-0.01
	Accountable government institutions		24%	80%	53,43%	59,04%

Although all targeted KPIs could not be achieved, the creation of the 'Grand Design' with its vision and missions has however opened a clearer trajectory for the reform of the Indonesian bureaucracy. All aspects that identified as problems, should be prioritised in order to make the reform process runs smoothly. The Minister of Bureaucratic Reform stated that inefficient and ineffective reform of the bureaucracy in Indonesia due to improper institutional functions, improper size of government institutions and their unresponsive actions to problems that existed in the society. Therefore, in order to make sure that the road map for 2015-2019 reform of the bureaucracy implemented with sustainable strategies, the government established *Tim Independen Reformasi Birokrasi Nasional* (TIRBN - the Independent National Bureaucracy Team) and *Tim Penjamin Kualitas Reformasi Birokrasi Nasional* (TPKRBN – the Quality Assurance Team for the National Bureaucratic Reform). The TIRBN provides independent advice and input to the government concerning the reform of bureaucracy as well as proposed national quick wins in the implementation of the reform. The TPKRBN ensures that the implementation of the reform in accordance with the 'Grand Design' and provides recommendations related to issues of unqualified implementation, as well as proposes risk mitigation for identifiable failure. The Minister emphasised the bureaucracy is the main tool of the state

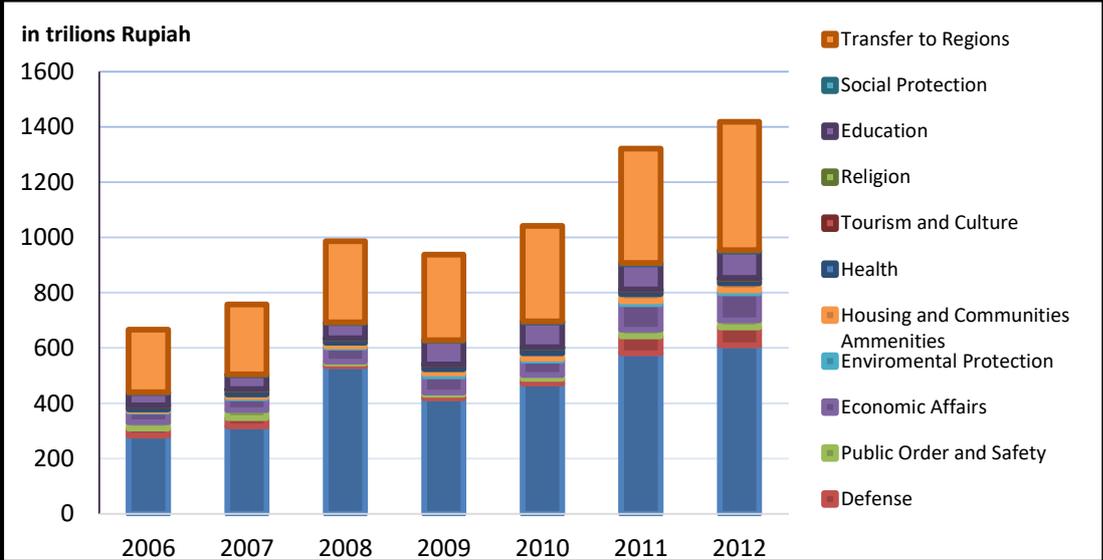
administration, it does not only serve to translate the political decisions into public policies but also must ensure that the implementation of the policies are operational especially in providing public services. Failures in achieving the KPIs target during 2009-2014 became the basis for proposing targets for the next period, 2015-2019. The new KPIs figure are more realistic but still in optimistic manner.

3. Proposal for further research

Everest-Phillips (2010) suggests that a tax system should aspire to the virtuous circle of state building in which political governance, economic growth and taxation create mutually reinforcing processes of state-building. Institutional and political factors shape tax systems, while tax collections influence the effectiveness of state institutions as well as the dynamics of the investment climate and economic growth. The resulting higher tax revenues in turn pay for better functioning public administration and improved public goods and services.

As mentioned at the beginning of this chapter, this research found that the reform has supported main government revenues so that the increasing government expenditure in providing public good and services could be safeguarded. The table below shows the increasing amount of expenditure funded by taxes.

Figure 11
Government Expenditure 2006-2012



This thesis has provided an empirical study on the importance of taxation in the process of state building in general. It does not, however, provide a discussion on the influence of taxation reforms on specific government agencies or other public

sector institutions. As discussed in chapter 5, society's awareness on tax benefits is still ambivalent. Other research is thus needed to evaluate whether taxation reforms can provide a positive contribution to other sectors, such as education, health and infrastructure. For example, research may be undertaken to investigate whether taxation reform can also influence the reform in education area by motivating teachers' capacity building and providing access to quality education services evenly. Increased state revenues are distributed to public sector institutions to be spent according to their proposed budget specifically for the welfare of the society, and since 2009, the education sector has been allocated with a special 20 per cent of government spending.

Every citizen has the right to access education services, but access to quality education is currently controlled by the upper class population in Indonesia. However, Indonesia has made great improvements in providing access to basic education, including to its poorest citizens. The World Bank (2010) suggests that to make a successful transition to a competitive middle-income country, Indonesia's citizens must have the educational skills to accelerate economic growth, reduce poverty and strengthen its role in the global economy. Taking into account efforts of increasing public awareness and capability of human resources in taxation reform agenda, education institutions may implement them in improving the delivery of quality education service and capability of graduating a skilled workforce, including lecturers and teachers.

Most countries in the world have tax systems that are responsible for generating the major state revenue required to fund public goods and services. A revenue body requires adequate powers and autonomy to perform in an efficient and effective manner considering that it has been given the range and focus of the laws to be administered, the enacted self-assessment system and the large numbers of clients (OECD, 2013). In addition, it must operate in a fair and neutral manner, and be subject to a variety of checks and balances to ensure its transparency and accountability.

Taxation reforms have created considerable changes in the structure of organisation and a key part of the performed reforms has positioned organisational autonomy in the middle. This thesis has not evaluated the possibility of establishing a separate unified body for tax administration removed from the internal structure of the Ministry of Finance. The discussions in chapter 4, chapter 5 and chapter 6 have revealed that there were problems of authority in the DGT operation. For example in the area of human resources management, the process of recruitment, redeployment

and dismissal of tax officials should be coordinated with not just the Ministry of Finance but also other agencies. Moreover, the fact that the DGT has been perceived as a super body which made policies in taxation and then applied them in its operation has triggered the idea of establishing an autonomous tax authority. This thesis could be the starting point for more research focussing on the autonomy of a tax authority using the “executive agency” model or in a revenue administration context known as “revenue authority” model. This model describes a practice of creating a separate unified body for tax administration covering all taxes, removed from the structure of the Ministry of Finance and with a broad range of autonomous powers (OECD, 2013). The practice has been the subject of a fair amount of external scrutiny on behalf of various national and international organisations but not within Indonesia.

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Appendix 1

Jakarta and East Java Tax Revenue compared to National Tax Revenue

Region	in trillion Rupiah									
	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Central Jakarta	5,379	8,497	11,271	13,183	16,259	20,611	23,861	26,850	33,613	40,077
West Jakarta	2,634	4,298	5,397	5,911	6,492	9,025	10,684	14,007	16,870	20,507
South Jakarta	5,598	7,772	10,282	12,178	14,242	19,707	22,312	28,323	36,245	40,431
East Jakarta	2,566	3,863	5,000	5,337	6,204	7,583	6,904	8,849	11,131	12,131
North Jakarta	2,860	3,947	5,513	5,745	6,082	7,844	8,573	11,113	13,650	17,241
Jakarta Special	17,382	24,761	40,826	45,579	53,600	72,486	72,087	84,934	108,369	113,858
Large Taxpayer	51,069	86,494	120,585	148,436	155,640	196,823	186,154	229,312	285,079	345,103
	87,487	139,631	198,873	236,369	258,520	334,080	330,576	403,389	504,957	589,348
East Java I	2,504	4,915	5,838	6,576	6,768	7,811	8,681	10,475	12,242	14,825
East Java II	1,720	2,742	2,688	3,294	3,771	4,794	5,526	7,702	9,153	10,505
East Java III	1,420	2,441	3,305	3,776	3,734	4,071	4,626	6,361	7,641	8,512
	5,644	10,098	11,831	13,646	14,273	16,676	18,832	24,539	29,037	33,842
Jakarta & East Java	93,132	149,730	210,704	250,016	272,793	350,756	349,408	427,928	533,993	623,190
National	120,359	191,876	256,889	304,611	344,538	438,952	445,484	570,220	698,439	817,081
	0.77	0.78	0.82	0.82	0.79	0.80	0.78	0.75	0.76	0.76

Appendix 2

Letter of Introduction

Dear Sir/Madam

This letter is to introduce Inge Diana Rismawanti who is a PhD student at Curtin University, Perth Western Australia.

She is undertaking research on the subject of “Assessing the Institutional Capacity of the Indonesian State: Case study of Taxation Reform since 2002”. She would be most grateful if you would assist in this project by granting an interview on this topic or later as a participant in a focus group discussion. She will be in Indonesia between 19 December 2011 to 10 February 2012.

Your participation is completely voluntary and you can decide at any time to withdraw from the participation without any consequence. Confidentiality of all information will be preserved and you will remain completely anonymous. You will be given the chance to overview the transcript of the interview in order to give you an opportunity to suggest amendments to the information that you have provided.

Any enquiries you may have concerning this project should be directed to me by email, letter or telephone, the details of which are given below.

This research project has been approved by the Curtin University Human Research Ethics Committee (Approval number HR 147/2011). If needed, verification of approval can be obtained either by writing to the Curtin University Human Research Ethics Committee, c/- Office of Research and Development, Curtin University, GPO Box U1987, Perth 6845 or by telephoning at +61 8 9266 2784 or by emailing hrec@curtin.edu.au.

Thank you for your attention and assistance.

Yours sincerely,

Dr Ian Chalmers

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Email | I.Chalmers@curtin.edu.au
Web | <http://curtin.edu.au>

Appendix 3

Participant Information Sheet “Assessing the Institutional Capacity of the Indonesian State: Taxation Reform since 2002”

By

Inge Diana Rismawanti

PhD Student in Curtin University, Perth Western Australia

Research Aims: This research examines how the Indonesian state has changed since taxation reform began in 2002. It asks the following questions: How effective has been the implementation of the taxation reform? Has its implementation improved the capacity of public sector institutions to provide public goods and services? Accordingly, this research will suggest ways to improve the institutional capacity of the Indonesian state.

My study involves the collection of documentary materials and information from interviews and focus group discussions. I will interview people affected by the taxation reform from a range of government and public sector institutions. I have asked to meet you because I believe that you may be able to assist in this project. I hope you will grant me an interview or participate in a focus group discussion dealing with certain aspects of the topic.

Participation: Be assured that any information provided will be treated in the strictest confidence. None of the participants will be individually identifiable in the resulting thesis. Your participation is completely voluntary and you are entirely free to discontinue at any time, or to decline to answer particular questions – and without any consequence. You will be given the chance to overview the transcript to give you the opportunity to suggest amendments to the information that you have provided. No more than one hour will be required for an interview, and normally between one and two hours for a focus group discussion. If I need more time than that, I will ask for a further meeting. I will only audio-record and make written notes of interviews and discussions with your consent.

I will be seeking responses to questions about the result of the taxation reform and its implementation in changing the nature of the Indonesian state, such as:

1. What do you think about the quality of the tax office in terms of its public service (on time, helpful, satisfactory)?
2. What do you think about the image of the tax office? How can its operations be improved?
3. What are the three most important things that have happened during the taxation reform?
4. What has been the impact of the taxation reform on other public sector institutions?
5. What do you think have been the costs and the benefits of the reforms of the Indonesian Bureaucracy since 2002?
6. Are there any other related matters that you believe are important in this discussion?

Researcher's Details: You are welcome to contact me at any time with any questions, comments, or concerns regarding this research, by email zero_inge@yahoo.com or ingediana.rismawanti@postgrad.curtin.edu.au, by phone +62 811 951649 (Indonesia) or +61 430 161541 (Australia), or mail to Jl. Lima Benua No. 32 RT 002 RW 05 Ciputat, Tangerang Selatan Banten Indonesia 15411 or 61 Armagh Street Victoria Park, Western Australia 6100.

I am conducting the research under supervision of Dr. Ian Chalmers and Dr. Christopher Hubbard, from the Department of Social Sciences, Faculty of Humanities, Curtin University, Perth Western Australia. They can be contacted at email address: I.Chalmers@curtin.edu.au and C.Hubbard@curtin.edu.au.

Ethics Clearance: This research project has been approved by the Curtin University Human Research Ethics Committee (Approval number HR 147/2011). If you have concerns with the way the research was conducted, please contact the Curtin University Human Research Ethics Committee (Secretary) either by phone at +61 8 9266 2784, or email hrec@curtin.edu.au, or in writing to Office of Research and Development, Curtin University, GPO Box U1987, Perth Western Australia 6845.

Appendix 4

Consent Form

Dear Mr/Mrs/Ms.

First of all, I would like to introduce myself. My name is Inge Diana Rismawanti, a PhD student at Curtin University, Perth Western Australia.

I am undertaking research on the subject of “Assessing the Institutional Capacity of the Indonesian State: Case study of Taxation Reform since 2002”. I kindly request you to assist me by granting an interview on this topic or later as a participant in a focus group discussion.

Your participation is completely voluntary and you can decide at any time to withdraw from the participation without any consequence. Confidentiality of all information will be preserved and you will remain completely anonymous. You will be given the chance to overview the transcript of the interview in order to give you an opportunity to suggest amendments to the information that you have provided. Your data will be encrypted and stored on a laptop computer owned by the researcher, and backed up on an external hard drive that is stored securely in an appropriate facility at Curtin University for five years. After that it will be destroyed. Only the researcher and the supervisors will have access to the data. I attach a “Participant Information Sheet” with a few examples of questions.

If you agree to participate, please sign on the participant line below. By doing this, you indicate that you fully understand the above information, and you freely and voluntarily agree to participate in this research.

I look forward to gaining your consent, and thank you for your kind attention and assistance. Your contribution to this research is greatly appreciated.

Kind regards,

Inge Diana Rismawanti

Participant Signature	_____
Date	_____

Appendix 5

List of Participant

Code	Description
I 1	Echelon Two
I 2	Echelon Two
I 3	Echelon Three
I 4	Echelon Three
I 5	FGD Echelon Four
I 6	FGD Echelon Four
I 7	FGD Echelon Four
I 8	FGD Echelon Four
I 9	FGD Echelon Four
I 10	FGD Echelon Four
I 11	FGD Echelon Four
I 12	FGD Echelon Four
I 13	FGD Echelon Four
I 14	FGD Echelon Four
I 15	FGD Account Representative
I 16	FGD Account Representative
I 17	FGD Account Representative
I 18	FGD Account Representative
I 19	FGD Account Representative
I 20	FGD Account Representative
I 21	FGD Account Representative
I 22	FGD Account Representative
I 23	FGD Reform Trainers/Communication Officers from Echelon Four
I 24	FGD Reform Trainers/Communication Officers from Echelon Four
I 25	FGD Reform Trainers/Communication Officers from Echelon Four
I 26	FGD Reform Trainers/Communication Officers from Echelon Four
I 27	Tax Manager of Corporate Taxpayer
I 28	Tax Manager of Corporate Taxpayer
I 29	Representative of Donor Country Officer
I 30	Journalist
I 31	Academic
I 32	Academic

Appendix 6

Ethics Approval

This form is to be completed and returned via email to hrec@curtin.edu.au or posted to the *Secretary, Human Research Ethics Committee, c/- Office of Research and Development*. If this report is for a low-risk approval, please submit your completed report to your Ethics Support Officer. **Please note forms sent by email using your curtin.edu.au address is a valid electronic signature and you do not need to physically sign the form.**

Approval Number:	
Project Title:	

Was this project:	<input checked="" type="checkbox"/> Completed → Date (dd/mm/yyyy): 30 /07 /2014
	<input type="checkbox"/> Discontinued → Date (dd/mm/yyyy): ___ / ___ / _____

Question	Yes	No	Comments
Did the project proceeding exactly as specified in the protocol? <i>If no state how in the comments section.</i>	<input type="checkbox"/>	<input checked="" type="checkbox"/>	
Have any ethics related issues emerged? <i>If yes please describe in the comments box. E.g. Breach of confidentiality, harm caused, inadequate consent, adverse events etc.</i>	<input type="checkbox"/>	<input checked="" type="checkbox"/>	
Have any ethics related issues been brought to your attention by others? <i>If yes please describe in the comments box. E.g. study respondents, organisations, colleagues, the general community etc.</i>	<input type="checkbox"/>	<input checked="" type="checkbox"/>	

Please outline the results of the study

E.g. number of participants recruited, data collected/analysed, papers published.

Thirty two participants were recruited for in-depth interviews and focussed group dicussions.

Interviews and discussions were held in Jakarta and East Java, Indonesia.

Quantitative data (documents and reports) was collected from the DGT, the Ministry of Finance, and *Badan Pemeriksa Keuangan* (BPK – the Supreme Audit Agency).

Data Storage

Length of storage	Research - 7 years after date of publication or completion of projec, whichever is later	
If your data involved children <18 years of age what was the year of birth of your youngest participant?	_____	
Where are data stored? <i>Do not store data on your personal computer, laptop or C://. Data must be stored on the Curtin J:// or R://. Hard copy data must be stored in a locked office or locked filing cabinet on a Curtin campus.</i>		

Investigator Signature

NOTE: forms sent by email using your *curtin.edu.au* address is a valid electronic signature and you do not need to physically sign the form

Name:		Position:	Choose an item.
Signature:		Date:	

Office Use

Approved by:		Date:	
Action:			
Archive until:			

Appendix 7

PROJECT FOR INDONESIAN TAX ADMINISTRATION REFORM (PINTAR)

The World Bank's Board of executive Directors approved the US\$ 110 million loan for Indonesia on the 15 January 2009 to be used for financing Project for Indonesian Tax Administration Reform (PINTAR). The project was started on the 9 February 2009 and should be completed by the end of 2015. The objectives of the Project are to: a) increase taxpayer compliance by increasing the efficiency and effectiveness of the Directorate General of Tax (DGT); and b) improve good governance in tax administration by strengthening transparency and accountability mechanisms.

There are four components to the project. The first component of the project is increasing the efficiency of taxpayer data collection and management. This component aims at:

- a. improving taxpayer registration by strengthening of the Taxpayer Identification Number (TIN) system including simplification of registration procedures and improvement of registration validation;
- b. improving tax returns processing by linking of input in document processing centres with accounts processing and audit, improving automated front-end error checking of tax returns, improving stop-filer detection and follow –up, and supporting the preparation of accurate and timely statistics for managing the efficiency of tax returns processing;
- c. strengthening centralised taxpayer accounts management by improving data integrity and quality of the existing master file and taxpayer accounts, developing an application software to support account management, providing tools for data matching, developing a comprehensive management information database and analytical tools for risk assessment, improving a system security and introducing an online access to taxpayer accounts;
- d. improving taxpayer document management by creating a system-generated notices, introducing an automated case file construction and creating an automated arrears notices;

- e. improving the tax system computing architecture by integrating of all automated systems in a workflow scheme, increasing security and enhancing a backup facilities.

The second component of the project is human resource management and development. This component will support and strengthen ongoing reforms in DGT by:

- a. reviewing human resource policies in terms of job classification and remuneration, recruitment policies, staff rotation program and outplacement policies and practices;
- b. enhancing training capacity by developing and implementing a train-the-trainers program and enhancement of an e-learning system, developing technical training programs targeted at functional specialist and developing induction and managerial training programs;
- c. strengthening accountability and integrity by strengthening the DGT's risk assessment capacity, internal control functions, auditing and sanctions regimes, reviewing and disseminating code of conduct, and developing anti-corruption training modules.

The third component of the project is strengthening compliance management operations. This component will increase the efficiency of selected core operational functions of tax administration. It will concentrate on:

- a. tax audit by introducing risk-based audit selection, reforming business processes for desk and field audit, computerising processes supporting the tax audit function, and improving the audit planning and monitoring process;
- b. tax arrears collection by enhancing the arrears monitoring system, reforming business processes for arrears collection, and enhancing the collection enforcement ICT system.

The fourth component of the project is project and change management. This component will support the management of the project, through technical assistance, in particular a change management program including improving internal and external communications and feedback surveys, familiarisation and specific transition training.

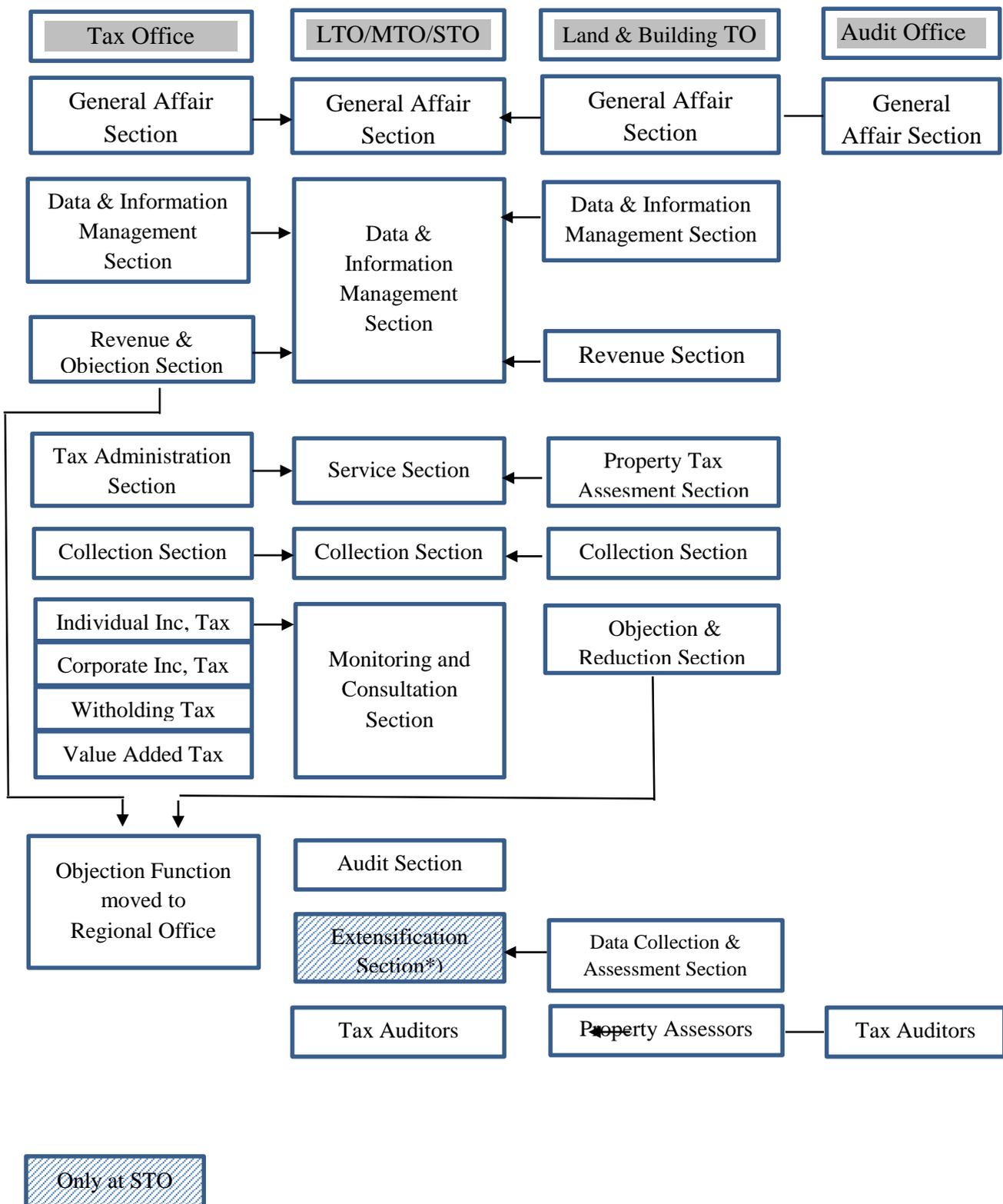
The following table shows the performance indicators of the project complemented by the starting point of indicators as the base line, the end target and achievement by the end of 2012.

Project Development Objective Indicators			
Indicator Name	Baseline 2009	2012	End Target 31 Dec 2015
Number of registered active taxpayers	16,465,819		25,000,000
Tax Compliance Ratio	33.08	53.70	85.00
Percentage of additional taxes assessed through audit compared to taxes actually collected	1.47	2.27	6.00
User Perception of Quality of Public Services	66.00	77.30	85.00
Tax Ratio	11.22	12.34	15.00
Intermediate Results Indicators			
Indicator Name	Baseline 2009	2012	End Target 31 Dec 2015
Reduction in the percentage of inactive taxpayers in the tax registry	Na	na	Na
Numbers of training	0	729	5,000
Percentage of tax arrears older than 12 months compared to total arrears	39.82	47.32	20.00
GAAP has been implemented	No	No	Yes
Average Processing Time for Public Services (in hours) – Doing Business survey	266	266	150
Total number of transactions for the main public service targeted by the project	8,202,309	8,202,309	21,250,000
Electronic Transaction of Public Services (e-SPT and e-Filing)	0.01	0.01	50.00
Total number of transactions of the main public service targeted by bthe Project	8,202,309	8,202,309	21,250,000
Cost of Collection Ratio	0.76	0.69	1.50

Source: www.worldbank.org

Appendix 8

Organisation Structure Tax Office



Appendix 9

Report Evaluation on Government Institutions

Report evaluation on central government institutions

	2009	2010	2011	2012
Total Institution	72	79	82	81
Evaluated Institutions	72	79	82	81
Evaluation Result				
AA	0	0	0	0
A	2	2	2	3
B	7	11	17	26
CC	29	39	49	48
C	33	27	14	4
D	3	1	0	0

Source: www.menpan.go.id

Report evaluation on provincial governments

	2009	2010	2011	2012
Total Institution	33	33	33	33
Evaluated Institutions	27	29	30	33
Evaluation Result				
AA	0	0	0	0
A	0	0	0	0
B	0	0	2	6
CC	1	9	17	19
C	20	18	11	8
D	0	2	0	0

Source: www.menpan.go.id

Report evaluation on district/municipal governments

	2009	2010	2011	2012
Total Institution				491
Evaluated Institutions	55	59	39	438
Evaluation Result				
AA	0	0	0	0
A	0	0	0	0
B	1	0	1	2
CC	4	3	8	104
C	44	29	23	255
D	6	27	7	77

Source: www.menpan.go.id