Value-Added Tax (VAT) has been imposed in Indonesia since 1984 after Taxation Reform Volume II, which was built upon Law No. 8/1933 about Value-Added Tax on Goods and Services and also previously based on Tax Sales on Red Onions which have been revised with Law No. 42/2009 (VAT Law). The implementation of VAT in Indonesia has adopted the prevalent international VAT collection principles, which include:

- **Indirect Tax** (Pajak Tidak Langsung), this VAT is indirectly imposed on taxpayer (Belasting Desnataris) via Employer Tax (Pengusaha Kena Pajak) collection;
- **Multi Stage Levy**, this VAT is imposed on every production process and distribution of goods and services gradually;
- **Indirect Subtraction/Credit/Invoice Method**, this VAT must be paid and calculated with subtracting VAT on the last product consumed with VAT on raw materials used in the production processes with the documentation of Tax Invoice;
- **Tax on Domestic Consumption (Destination Principle)**, this VAT imposed on the consumption of goods and services in custom areas;
- **Consumption Type**, this VAT imposed on goods and services that are applicable for taxation;
- **Single Rate**, this VAT has the same rate in every production process and distribution of goods and services;
- **Non-Cumulative**, this VAT is imposed on every production process and distribution of goods and services gradually with the credit mechanism approach, thus it does not cause cumulative tax effect;
- **Objective Tax**, this VAT is an Objective Taxation with tax points mechanism (tatbestand) imposed on goods and services in domestic industry, while taxation subject is not that relevant.
According to Article 4 Section (1) VAT Law outlines that VAT objects consist of:

- Transfer of goods applicable with VAT in Customs Areas completed by Employers;
- Import of Taxable Goods;
- Transfer of Taxable Services in Customs Areas;
- Utilization of Intangible Taxable Goods from outside Customs Areas inside Customs Areas;
- Utilization of Taxable Services coming from outside of Customs Areas into Customs Areas;
- Export of Tangible Taxable Goods by Taxable Employers;
- Export of Intangible Taxable Goods by Taxable Employers; and
- Export of Taxable Services by Taxable Employers.

Additionally, according to Article 7 of VAT LAW, the regulated rate is 10%, except for export of tangible Taxable Goods, export of Intangible Taxable Goods, and export of services, which are imposed a 0% rate.

Article 4 Section (2) VAT Law regulates that the limit of activity and the kind of taxable services export with VAT is further regulated through Ministerial Decree. Due to this Article, the Ministry of Finance RI eventually put in place Ministerial Decree of Ministry of Finance No. 70/PMK.03/2010 about the Limits of Activity and the Kinds of Taxable Services Export with a specific VAT, in which this was then revised with an updated Ministerial Decree of the Ministry of Finance No. 30/PMK.03/2011, which regulates that there are three services exports that are qualified for 0% VAT rate and these services are:

- Contract Manufacturing services (Jasa Maklon) in which its activity limitations consist of the following terms and conditions:
  ◦ The customer or the supplier of Taxable Services outside Customs Areas and Taxable Overseas (Wajib Pajak Luar Negeri) and as well as those who do not have a Permanent Business Establishment (Bentuk Usaha Tetap) as mentioned in Law No. 7/1983 about Income Taxation and its changes;
  ◦ Specifications and materials provided by the buyers or receiver of taxable services;
  ◦ The goods, which consist of raw materials, half-finished goods, and/or adjuvant goods, that will be processed are considered as taxable goods;
  ◦ The ownership of goods is in the hands of the buyers or receivers of taxable services; and
  ◦ Employers of Contract Manufacturing Services send the results of their work according to the buys or receiver of taxable services outside Customs Areas.
- Repair services (Jasa Perbaikan dan Perawatan) that are attached to on goods or services that are utilized outside of Custom Areas; and
- Construction services outside Custom Areas, which consists of consultation services for construction planning, services in project construction, and consultation services for supervision/evaluation of construction projects.

For services export that are not included in the three criteria above, the General Directorate of Taxation RI gives further explanation through the General Directorate’s Circular Letter No. 49/PJ/2011 about the delivery the Ministry of Finance’s Ministerial Decree No. 30/PMK.03/2011 about the Amendment on Ministry of Finance’s Ministerial Decree No. 70/PMK.03/2010 about the Scope of Activity and the kind of Taxable Services in which its Services Exports are subjected to Value-Added Tax due to these following reasons:

1. If the transfer of Taxable Services carried out inside Customs Areas, the services is still subjected to a 10% VAT rate in Customs Areas with terms of the VAT regulated through VAT Law Article 4 section (1) letter (c); and
2. If the Taxable Services carried out outside of Customs Areas, the services is not subjected to Value-Added Tax because it is not in the scope of VAT Law.

For other services exports aside from the three services export subjected with 0% VAT, the determined place of delivery because the main point of VAT imposition. This is stated in Article 6 of Government Regulation No. 1/2012 about the Implementation of Law No. 8/1983 about VAT on Goods and Services Subjected to Red Onions as it has been amended for a few times with the latest amendment with Law No. 42/2009 about the Third
Amendment of Law No. 8/1983 about VAT on Goods and Services and Taxation on Red Onions Sales, which regulates that VAT imposition on Taxable Services inside Custom Areas carried out by Employers for the use inside or outside Custom Areas, which makes VAT imposition does not require whether the services to be used/consumed inside Custom Areas or not.

Table 1: VAT Treatment of Services Delivery

<table>
<thead>
<tr>
<th>No</th>
<th>Delivery</th>
<th>Usage</th>
<th>VAT</th>
<th>Legal Basis</th>
<th>Notes</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Inside Areas</td>
<td>Inside Areas</td>
<td>Yes</td>
<td>Article 4 (1) c VAT Law</td>
<td>--</td>
</tr>
<tr>
<td>2</td>
<td>Inside Areas</td>
<td>Outside Areas</td>
<td>Yes</td>
<td>Article 4 (1) c VAT Law</td>
<td>Services Delivery</td>
</tr>
<tr>
<td>3</td>
<td>Outside Areas</td>
<td>Inside Areas</td>
<td>Yes</td>
<td>Article 4 (1) c VAT Law</td>
<td>Services Import</td>
</tr>
<tr>
<td>4</td>
<td>Inside Areas</td>
<td>Outside Areas</td>
<td>Yes</td>
<td>Article 4 (1) h VAT Law and Ministerial Decree of Finance No. 70/2010 and 30/2011</td>
<td>Services Exports limited to Manufacturing Services, Repair and Maintenance Services, and Construction Services.</td>
</tr>
<tr>
<td>5</td>
<td>Outside Areas</td>
<td>Outside Areas</td>
<td>No</td>
<td>Article 44 (1) VAT Law</td>
<td>Services Export</td>
</tr>
</tbody>
</table>

Practically, VAT disputes on services exports often caused by different interpretation on the place of services delivery between Taxpayer and General Directorate of Taxation. Some of the disputes are as follows:

1. **Cellular Interconnection Services**
   Telecommunication companies in Indonesia provides Interconnection Services to other telecommunication companies abroad by connecting cellular calls between customers abroad to customers in Indonesia. ON the one hand, Taxpayer argues that the delivery of Interconnection Services is carried out in the “point of interconnection” outside Indonesia’s Custom Areas and makes it not subjected to VAT. On the other hand, the General Directorate of Taxation argues that the delivery of Interconnection Services carried out inside Indonesia’s Custom Areas because the process of connecting cellular calls from customers abroad to customers in Indonesia means that Taxpayer must use communication network from Indonesia, which is subject to VAT.

2. **Debt Securities Guarantor Services**
   Indonesia’s companies that need extra liquidity from abroad generally establish Financing-Special Purpose Vehicle (SPV) in other countries with “financial centre” to issue international obligation. In the process of the obligation issuance, an Indonesian Company will act as a Guarantor by giving Guarantee Services to SPV Financing abroad. Taxpayer argues that the delivery of Guarantee Services is carried out outside Customs Areas during obligation omission and therefore not subject to VAT. Meanwhile, the General Directorate of Taxation RI argues that Guarantee Services is carried out inside Customs Areas because in providing Guarantee Services, Taxpayer must guarantee assets inside Customs Areas and therefore subject to VAT.
**Policy Recommendation**

The imposition of VAT on services exports is a "trade barrier" and counterproductive to services sector’s growth in Indonesia. This taxation is lowering competitiveness of national services sector and, in the long run, would hold back the capitalization of human resources quality and technological growth in national development.

Ideally, the policy to increase government’s revenue should be carried out effectively with policies that could boost economic growth that is suitable with the function of taxation as instruments of budgeter and reguleren. The elimination VAT rate on services exports is not only boosting services growth and employment absorption, but also increasing government’s revenue from Income Tax and other revenue sources resulting from the increase of services activity.

Policy reforms in VAT on services export should be carried out for the following purposes:

1. Maintaining *Tax on Domestic Consumption (Destination Principle)* in policies and administration of Indonesian VAT aligned with international standard;
2. Increasing domestic services competitiveness in international trade to boost Indonesia’s participation in the Global Value Chain and as well as increasing investment in services sector;
3. Providing incentives to leading services sector that are export-oriented.;
4. Increasing services sector’s contribution to national revenue.

Policy reforms of VAT on services exports could be implemented gradually in stages via a short-term program, and mid to long term program that is aligned with the development of the national services sector and the need of government’s revenue. The reform stages are outlined below:

1. **Short-Term Program**
   Revising an amendment on the Ministry of Finance Decree No. 70/PMK.03/2010 about the Scope of Activity and Taxable Services Export which has been revised with the Ministry of Finance Decree No. 30/PMK.03/2011 with an addition of a group of services sector which exports are qualified for the 0% rate are those services with export-oriented, such as telecommunication services, design services, business and consultation services, and financial services.

2. **Mid-Term Program**
   Revising an amendment on Article 6 of Government Regulations No. 1 Year 2-2- about the Implementation of Law No. 8 Year 1983 about Value-Added Tax on Goods and Services and Taxation on Luxury Goods as been amended multiple time with the latest amendment with Law No. 42 Year 2009 about Third Amendment on Law No. 8 Year 1983 about Value-Added Tax on Goods/Services and Tax on Luxury Goods, defining and explaining that “Delivery of Services) that uses the main criteria of the location used for services and the party that uses services based on the *Destination Principle* in VAT taxation.

3. **Long-Term Program**
   Revising Law No. 42 Year 2009 about the Third Revision of Law No. 8 Year 1983 about Value Added Taxes on Goods and Services and Tax on Luxury Goods with the definition and explanation in details about the delivery of services that uses the main criteria of the location used for services and the party that uses services based on the *Destination Principle* in VAT taxation.
With a simple regression under double logarithm (services exports as dependent variables and VAT as an independent variable), the elasticity of services exports to the VAT. Table 2 above shows the elasticity between services export and the revenue from the VAT. Although this is a rough estimate (because the revenue from VAT is through the proportion of services export to the total exports, the elasticity analysis could be used to see which services sectors would have an increased export as a result of lowering the VAT rate. With negative elasticity value on manufacturing services, construction services, financial services, and telecommunication and computer services; it shows that if the VAT revenue decreases (due to a lower VAT rate), it would increase export volumes in the respective sectors. For example, by lowering the VAT rate by 1% would result in an increase of the financial services exports by 0.24%, and an increase in telecommunication & IT exports by 0.23%. Hence, if the VAT rate is zeroed (at 0% rate), it would increase the exports of financial services and telecommunication & IT services by 2.3% and 2.4%, respectively. Hence, eliminating the VAT on services exports would increase the total services exports by 5.1%.
Overview

As of December 2016, total assets combined of life insurance companies were at IDR411,709 billion, while general insurance and reinsurance companies at IDR141,512 billion. The top ten life insurers hold 74% of total market (the majority of whom are foreign joint venture life insurers), and the top ten general insurers hold 51% of the total market share (all of whom are local Indonesian companies). Joint venture companies in life insurance hold a 74% market share and general companies hold a market share of 28%. Currently, there are 52 entities of general insurance companies, 76 life insurance companies, and 40 entities of companies operating with the Sharia principle. Graph 1 below shows an overview of the Indonesian insurance market.

Graph 1: Quick Facts of the Indonesian Insurance Market

Source: PwC Indonesia 2017
The general insurance industry is currently experiencing negative growths on premiums, a pressure on tariffs and high cost expense schemes and as well as a mix of poor underwriting and financial performance indicators. In life insurance, investment instruments are currently limited. For Sharia Insurance, the market share is only at 5% of the total insurance market in Indonesia. This figure is similar to the share of Sharia banking, which is at 6% of the banking industry. The regulation environment for Sharia insurance is currently the same as conventional insurance even though the Sharia insurance market is still relatively very small. Indonesia’s Sharia insurance industry is not yet at the same standard of the other Muslim majority countries such as Malaysia, the UAE, etc. despite Indonesia having the largest Muslim population in the world. And lastly, insurtech, which is a future trend, is rising but is still relatively slow in Indonesia. Insurtech has the potential to help fill the gap in the insurance market in Indonesia. This could also mean that foreign insurance companies could enter the Indonesian market without physical presence, although it is still not very clear what the claim mechanism would look like if the policy holder is in Indonesia while the Insurtech company is based outside Indonesia. Perhaps, global regulations be feasible to handle this claim mechanism issue.

Issues and Recommendation

Below is the list of factors affecting the growth of the insurance sector in Indonesia.

- **Regulations**
  There are currently multiple and simultaneous regulations for compliance. Compliance itself is faced with stringent tax regulations. Foreign ownership is still relatively limited, which holds back greater foreign direct investment into the insurance sector. There is also a need for the alignment of insurance accounting standards and current regulations, which currently have various interpretations due to unclear implementation guidance. Tax withholding requirements are relatively extensive and there is a growing attention to transfer pricing issues. Domestically, the government has increased its efforts to prepare a framework for Indonesian insurance industry development. As a whole, clarity and compliance with regulations are necessary, particularly on new regulations and the time-frame period for the industry to comply with such regulations.

- **Foreign Ownership and Legal Framework**
  There is a domestic market protection approach with the existing of various protectionist regulations, i.e. local reinsurance portion regulation, commission and tariffs. There is also an emerging development of limiting single shareholder’s ownership, which is similar to the banking industry. Minimum capital requirement have also been set for the insurance industry. As a whole, the government needs to strengthen the regulations enforcement, particularly the bankruptcy law. Additionally, there is a need to continuously improve agency regulations and relations.

- **Trends towards Auto Insurance and unit-link products**
  Auto insurance cover and unit-link products have become more and more popular recently and preferred by Indonesian consumers. Unit-linked products are the main driver of the life insurance business at the moment. Companies that are not offering auto insurance through multi finance/bancassurance and unit-link products seem to grow at a slower pace.

- **Competitiveness**
  In terms of competitive landscape, the Indonesian insurance market is relatively attractive and has a large potential for growth in the future due to low market penetration, large numbers of people who are underinsured/uninsured and the emergence of middle class. Currently, the insurance industry in Indonesia is fragmented considering the large number of players.

- **Distribution Network and Talent**
  There is a substantial competition and relatively high costs in the distribution channels. Alternative distribution channels such as bancassurance have become more common and popular recently. Bancassurance has increasingly been used as the distribution channel due to lower cost for the distribution. The emerging of insurtech further increases distribution channels’ competition. In terms of talent, there is still a scarcity in insurance expertise and an increase on turnover. Among other challenges, human talent could be considered
as the major barrier in the Indonesian insurance industry. Overall, the insurance industry needs to implement effective distribution channel strategy with reasonable costs and continue to build alternative channels.

- **Financial**
  Indonesia’s interest rates are relatively volatile, which is quite a hold back to financial performances. There is a limited availability of investment portfolios and dynamic macroeconomy and capital market conditions. This is in part caused by limited investment instruments and compliance with investment regulations. Strategies to boost investment in the insurance industry are essential seeing that a large number of Indonesians are underinsured and low market penetration. And managing insurance risks needs to strengthen underwriting process, assessment of macroeconomic impact, portfolio diversification, and maintain a favorable loss ratio level.

- **Infrastructure**
  There are some infrastructure concerns in information technology to support business and strategy, talent management and risk management systems. Increasing the insurance market penetration could be built through existing and new distribution channels.

- **Insurtech/Disruptive Technologies**
  Insurance Technology, or insurtech plays both as a disruptive innovation and a new collaboration for growth. In other sectors, the emerging of startups and digital economy in general have become aggregators to traditional business. For example, unused residential space can now be used by AirBnB as hotel operators, which is causing some stress upon the hotel industry. Similarly, unused cars while sitting idle in car parks can now be used by Uber as online taxis, which also creates potential costs and threats to the taxi industry. Insurtech has an enormous potential to fill Indonesia’s insurance’s untapped and low penetrated market, which may jump straight into the digital market. If this is the case, insurtech therefore would not be that disruptive to the conventional insurance industry.

  There is a need for a synergized collaboration between insurtech and insurance companies, especially for: as alternative distribution channels for insurers, to enhance market penetration strategy, and increase efficiency in underwriting, claims and other related insurance activities. Since insurtech is relatively new in Indonesia, there will be issues surrounding regulations for legal basis or framework, digitization of insurance documents, data security and its risk, market education/awareness, and potential improper use of policyholders’ data. As whole disruption is not a very meaningful term in a sector that is still young and largely un-tapped market, but disruptive innovations could radically change the market. Businesses that have traditionally dominated the market would need to adapt, but many new businesses would have the opportunity to develop, grow and prosper as a consequence of the disruptive innovation. Identifying these opportunities and implementing them is key.

**Recent Issues**

1. **Commission to Bancassurance**
   There is a growing concern surrounding the regulation on the commission to Bancassurance as an agent, a distributor, or a hybrid institution, particularly with OJK’s Circular Letter No. 32 /SEOJK.05/2016 on allowing commission to bancassurance as a third party, which in this case it is usually agents/brokers. This regulation seems to not quite aligned with the Insurance Law UU No. 40/2014 about Insurance where it states that the third party that’s eligible to receive commission are the intermediaries, which are only registered and authorized agents and brokers. Moreover, a bank’s position to sell bancassurance products is relatively not that ideal to receive commission when other financial institutions have the role of beneficiaries and therefore should not receive commission.

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