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VAT Reform and Household Welfare: Assessing the Regressive Effects of Indonesia's 12 Percent Value-Added Tax Policy

Abdullah Jundi Hanafi*
Universitas Mulawarman, Samarinda, Indonesia
jundihanafi@students.unmul.ac.id

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*Corresponding Author

Abstract

Consumption taxes can generate substantial public revenue while simultaneously imposing different welfare costs across socioeconomic groups. This study investigates the potential regressive effects of Indonesia's 12 percent value-added tax policy on household welfare. The research is motivated by concerns that households with lower incomes allocate a larger proportion of their resources to consumption, particularly essential goods and services, potentially increasing their relative tax burden. The study employs a distributional incidence framework to examine differences in VAT exposure across household income groups. Household expenditure patterns are analyzed to identify the relative share of taxable consumption and the potential welfare implications of changes in the VAT rate. The analysis also considers the role of government exemptions, social assistance, and other compensatory mechanisms in mitigating adverse distributional effects. Rather than assuming that VAT is inherently regressive, the study evaluates regressivity as an outcome of tax design, consumption structure, and redistributive policy. The study argues that the fairness of VAT reform should be assessed jointly through revenue efficiency and household welfare effects. Its contribution lies in integrating tax incidence analysis with economic justice perspectives in the Indonesian context. The findings provide policy implications for designing consumption taxation that supports fiscal sustainability without disproportionately burdening economically vulnerable households.

[*Pajak konsumsi dapat menghasilkan pendapatan publik yang substansial sekaligus menimbulkan biaya kesejahteraan yang berbeda di berbagai kelompok sosioekonomi. Studi ini menyelidiki potensi efek regresif dari kebijakan PPN 12 persen Indonesia terhadap kesejahteraan rumah tangga. Penelitian ini dimotivasi oleh kekhawatiran bahwa rumah tangga dengan pendapatan lebih rendah mengalokasikan proporsi sumber daya yang lebih besar untuk konsumsi, khususnya barang dan jasa penting, yang berpotensi* *meningkatkan beban pajak relatif mereka. Studi ini menggunakan kerangka kerja insidensi distribusi untuk memeriksa perbedaan paparan PPN di berbagai kelompok pendapatan rumah tangga. Pola pengeluaran rumah tangga dianalisis untuk mengidentifikasi pangsa relatif konsumsi yang dikenakan pajak dan potensi implikasi kesejahteraan dari perubahan tarif PPN. Analisis ini juga mempertimbangkan peran pengecualian pemerintah, bantuan sosial, dan mekanisme kompensasi lainnya dalam mengurangi efek distribusi yang merugikan. Alih-alih mengasumsikan bahwa PPN secara inheren bersifat regresif, studi ini mengevaluasi regresivitas sebagai hasil dari desain pajak, struktur konsumsi, dan kebijakan redistributif. Studi ini berpendapat bahwa keadilan reformasi PPN harus dinilai secara bersamaan melalui efisiensi pendapatan dan efek kesejahteraan rumah tangga. Kontribusinya terletak pada pengintegrasian analisis insidensi pajak dengan perspektif keadilan ekonomi dalam konteks Indonesia. Temuan ini memberikan implikasi kebijakan untuk merancang pajak konsumsi yang mendukung keberlanjutan fiskal tanpa membebani rumah tangga yang rentan secara ekonomi secara tidak proporsional.*]

Keywords: VAT reform, regressivity, household welfare, tax incidence, economic justice

Introduction

Value-added tax has become one of the most important instruments of modern fiscal policy because it provides governments with a broad and relatively stable source of revenue. Unlike direct taxation, which depends heavily on identifiable income or wealth, VAT is collected through transactions occurring throughout the production and distribution chain. Its broad base and credit mechanism can make it comparatively efficient and less distortionary than some alternative forms of taxation (Keen 2013). These characteristics are particularly important for developing economies, where informality and limited administrative capacity can constrain the effectiveness of personal income and wealth taxation. For Indonesia, VAT has consequently become a central component of fiscal policy and an important source of resources for financing public expenditure. Yet the fiscal advantages of VAT coexist with a fundamental distributional problem: because the tax is imposed on consumption, its burden can interact differently with the economic circumstances of households across the income distribution.

The distributional concern arises from a basic difference in household behavior. Lower-income households generally consume a larger share of their available resources because they have less capacity to save or accumulate financial assets. Higher-income households, by contrast, may devote a larger share of their resources to savings and investment. If VAT is measured against current income, this difference can make consumption taxation appear regressive: poorer households may pay a similar nominal tax rate but devote a larger proportion of their income to taxable consumption. The issue becomes more consequential where consumption is concentrated on necessities with low short-term substitutability. A household cannot easily reduce expenditure on food, electricity, transportation, or other basic requirements in response to a tax-induced price increase. Consequently, even a modest increase in VAT can have welfare consequences that differ substantially according to household economic capacity.

Indonesia's VAT reform provides an important case for examining this issue. Law No. 7 of 2021 concerning Harmonization of Tax Regulations established an increase in the VAT rate from 10 percent to 11 percent beginning in April 2022 and to 12 percent by January 2025. The implementation of the 12 percent statutory rate was subsequently structured through Minister of Finance Regulation No. 131 of 2024. Under that regulation, the 12 percent rate applies to the full relevant tax base for taxable luxury goods, while non-luxury taxable goods and services generally use a deemed tax base equal to 11/12 of the transaction value, resulting in an effective VAT burden of 11 percent. Thus, the Indonesian reform should not be interpreted simply as a universal increase from 11 to 12 percent for ordinary consumers. The statutory rate is 12 percent, but the effective treatment of most non-luxury consumption has been designed to preserve an 11 percent burden.

This distinction is essential for distributional analysis. A simple comparison between an 11 percent and 12 percent statutory rate could suggest that all households experienced an equivalent one-percentage-point increase in VAT. In reality, the policy architecture differentiates between ordinary and luxury consumption. For non-luxury goods and services, the government effectively preserves the previous 11 percent burden through the 11/12 tax base, while the full 12 percent rate is applied to relevant luxury consumption. This design potentially reduces the immediate regressive impact of the statutory increase by concentrating the additional burden on consumption that is more likely to be associated with higher economic capacity. Nevertheless, the broader welfare question remains because the distributional impact of VAT is determined by the entire taxable consumption basket and the interaction between taxation, prices, income, and government transfers.

The academic literature also cautions against treating VAT regressivity as a settled proposition. Caspersen and Metcalf (1994) demonstrate that the measurement of VAT incidence can change considerably depending on whether the tax is assessed relative to annual income or consumption. An income-based measure may overstate regressivity because it does not account adequately for differences in saving behavior and life-cycle income. Thomas (2022), using microsimulation evidence from 27 OECD countries, similarly finds that VAT is often roughly proportional or slightly progressive when measured against expenditure rather than current income. Nevertheless, Thomas also emphasizes that even a broadly proportional VAT can have significant consequences for poor households, including the possibility of pushing vulnerable households into poverty.

Evidence concerning Indonesia reinforces this complexity. World Bank analysis based on household survey data found that Indonesia's VAT system was approximately neutral when measured as a share of market income, with households across the income distribution paying broadly similar proportions of their market income in VAT. At the same time, the analysis showed that removing VAT exemptions would make the system more regressive, particularly at the lower end of the distribution. This evidence demonstrates that the distributional consequences of VAT depend not simply on the rate but on the design of the tax base. The treatment of necessities, exemptions, and compensatory policies can substantially alter the welfare effects of consumption taxation.

Previous studies have therefore generated important insights but leave room for a more focused assessment of Indonesia's 2025 VAT reform. Existing literature has addressed the conceptual measurement of VAT regressivity (Caspersen and Metcalf 1994; Thomas 2022), the efficiency and administrative characteristics of VAT (Keen 2013; Brockmeyer et al. 2024), and the distributional consequences of taxation and transfers in Indonesia (Tiwari et al. 2021). However, less attention has been devoted to examining the Indonesian 12 percent policy specifically through the combined concepts of tax incidence, household welfare, and economic justice, particularly after distinguishing between its statutory rate and its effective rate for non-luxury consumption. This article addresses that gap by examining whether and under what conditions the reform may produce regressive welfare effects.

The study adopts a qualitative distributional policy-analysis methodology. It examines Indonesia's VAT legislation and implementing regulations together with secondary evidence on household expenditure, tax incidence, poverty, inequality, tax compliance, and social protection. The analysis applies the principles of vertical equity, horizontal equity, and welfare protection. Vertical equity concerns whether households with different economic capacities bear appropriately differentiated burdens; horizontal equity considers whether similarly situated households receive comparable treatment; and welfare protection examines whether tax policy generates disproportionate reductions in the capacity of vulnerable households to meet essential needs. The objective is not to construct a new microsimulation model but to identify the institutional and economic mechanisms through which the VAT framework can affect household welfare and to evaluate the adequacy of potential compensatory responses.

The 12 Percent VAT Policy and the Measurement of Regressivity

The first analytical difficulty in assessing Indonesia's VAT reform is determining what precisely should be measured. A statutory tax rate is a legal parameter, but it does not necessarily correspond to the effective economic burden experienced by consumers. Indonesia's VAT framework provides a particularly clear illustration. Law No. 7 of 2021 establishes a 12 percent statutory rate, but PMK No. 131 of 2024 provides that non-luxury taxable goods and services generally use a tax base equivalent to 11/12 of the transaction value. The resulting calculation is effectively 12 percent Ч 11/12, or 11 percent. The full 12 percent burden applies to relevant luxury goods and services.

The distinction between statutory and effective rates has direct implications for the assessment of regressivity. If the policy were analyzed as a simple increase from 11 to 12 percent across the entire taxable consumption basket, the distributional effect would likely be overstated. Ordinary consumers were not generally subjected to the full one-percentage-point increase. Instead, the policy architecture attempted to preserve the effective 11 percent burden for non-luxury consumption while increasing the effective burden on luxury consumption. The government itself presented the arrangement as a means of maintaining the 11 percent burden for goods and services consumed by the general public while applying the full rate to luxury consumption.

From a fiscal-justice perspective, this differentiation has a defensible rationale. If luxury consumption is positively correlated with household resources, applying the full rate to luxury goods can produce a more capacity-sensitive distribution of taxation than applying the same effective increase to necessities. The principle is not that wealthy households should be taxed simply because they are wealthy, but that consumption patterns can provide a proxy for economic capacity. A household purchasing a high-value discretionary product is generally better positioned to absorb an additional tax burden than a household allocating nearly all available income to essential consumption.

However, the relationship between consumption and economic capacity is not perfect. Some households with relatively high expenditure may have temporarily high consumption because of life-cycle circumstances, while some households with substantial wealth may have relatively low taxable consumption. Likewise, the classification of a product as luxury does not automatically identify every consumer of that product as affluent. Consequently, VAT policy should avoid relying on product classification as a complete substitute for direct assessment of household capacity to pay.

The second measurement problem concerns the denominator used to calculate the tax burden. A household may pay the same amount of VAT as another household but experience a very different welfare impact because of differences in income. If VAT paid is divided by annual income, households with low current income and high consumption will tend to display higher effective tax burdens. By contrast, dividing VAT by consumption expenditure produces a measure closer to the statutory rate because the tax is fundamentally imposed on consumption. Caspersen and Metcalf (1994) argue that consumption provides a more stable indicator of lifetime economic resources because it reduces the distortion created by temporary income fluctuations and savings behavior.

Thomas (2022) similarly finds that VAT often appears less regressive when assessed relative to expenditure. Across 27 OECD countries, VAT was generally proportional or slightly progressive when expenditure rather than income was used as the denominator. This finding is important for Indonesia because labeling VAT as inherently regressive without specifying the incidence measure risks producing an incomplete policy diagnosis.

Nevertheless, an expenditure-based measure cannot fully resolve the welfare problem. Low-income households may consume nearly all their income because they have little capacity to save. Their expenditure therefore represents not merely a measure of lifetime resources but also a necessity for current survival. A tax that consumes part of this expenditure can reduce welfare even if the tax appears proportional when measured against expenditure. The appropriate conclusion is therefore not that VAT is either inherently regressive or inherently neutral. Rather, regressivity is an empirical and institutional outcome shaped by the interaction between the tax base, household consumption, and the chosen measure of economic well-being.

The Indonesian policy debate should accordingly move away from a simple focus on the 12 percent statutory figure. A more meaningful assessment should ask how much VAT is actually borne by each household group, what share of household resources is used for taxable consumption, which components of expenditure are essential, and whether households receive compensatory benefits from the government. Only through such an incidence-based approach can the welfare implications of VAT reform be properly evaluated.

Household Consumption Patterns and the Welfare Burden of VAT

The distributional consequences of VAT are closely connected to differences in household consumption structures. Poorer households typically devote a larger proportion of their resources to essential goods and services, while wealthier households have greater flexibility to allocate resources toward savings, investment, and discretionary consumption. This difference means that the welfare effect of VAT depends not only on the quantity of consumption but also on the type of consumption undertaken.

The importance of consumption composition is particularly evident in developing economies. Emran and Stiglitz (2007) argue that tax reforms involving consumption taxation can have different distributional consequences depending on the structure of markets, household consumption, and the extent of informality. When poorer households rely heavily on goods that cannot easily be substituted, taxation may impose a larger welfare loss than the nominal tax rate suggests. Their ability to respond through changes in consumption is constrained precisely because a substantial portion of their expenditure is necessary.

Indonesia's household data provide evidence supporting this concern while simultaneously demonstrating the complexity of the issue. OECD analysis of Indonesia has found significant differences in expenditure patterns across income groups. Lower-income households devote relatively larger shares of their budgets to basic food consumption, whereas higher-income households spend larger amounts on a broader range of consumption categories. This means that the same VAT treatment can have different relative effects across households because the structure of expenditure differs.

The distinction between essential and discretionary consumption is therefore central to a welfare analysis. Suppose two households each spend Rp10 million during a given period. If one household spends almost all of that amount on food, transportation, utilities, and basic education-related needs, while the other allocates a substantial share to discretionary consumption, their welfare responses to taxation will differ. The first household has limited capacity to reduce consumption without sacrificing basic welfare. The second has greater opportunities to postpone purchases, substitute products, or reduce discretionary expenditure.

This is one reason why the distributional consequences of VAT cannot be inferred solely from the statutory rate. Tax incidence depends on price pass-through and demand elasticity. A tax increase that is fully passed on to consumers may raise prices, but the resulting welfare effect depends on how consumers respond. For highly elastic discretionary goods, consumption may decline significantly. For essential goods with low elasticity, the burden may be more fully absorbed through reduced real purchasing power.

The welfare effect also depends on the position of the household within the income distribution. A one-percent increase in the price of an essential good can represent a relatively small loss for a high-income household but a meaningful reduction in consumption possibilities for a low-income household. This is particularly important where households are close to poverty thresholds. Even if the aggregate incidence of VAT is approximately neutral, marginal reductions in purchasing power can move vulnerable households below minimum welfare standards.

World Bank evidence from Indonesia illustrates this point. Existing VAT exemptions have historically provided some protection to poorer households. Under the baseline system examined using Susenas data, VAT payments were approximately similar as a share of market income across income deciles. However, eliminating exemptions increased the relative burden across the distribution and had a stronger effect on lower-income households. For the lowest decile, the modeled VAT burden increased substantially more than for the highest decile.

The evidence therefore suggests that the question is not whether exemptions are inherently good or bad. Their distributional value depends on the goods covered and the household groups benefiting from them. A broad exemption for a widely consumed product may generate significant fiscal costs while also providing substantial benefits to wealthy households that consume the product in greater absolute quantities. Conversely, removing an exemption from an essential product can impose a particularly strong relative burden on low-income households.

This creates a policy dilemma. A government seeking both revenue and equity cannot simply maximize the tax base without considering the composition of consumption. At the same time, maintaining numerous exemptions may weaken revenue productivity, create classification problems, and reduce neutrality. Keen (2013) emphasizes that the broad base of VAT is one of its principal institutional advantages. Excessive differentiation can therefore undermine the very characteristics that make VAT valuable as a fiscal instrument.

A more defensible approach is to identify those consumption categories for which taxation creates the greatest welfare risk and address the burden through targeted compensation where possible. This shifts the policy objective from making every component of VAT progressive toward ensuring that the overall tax system does not disproportionately reduce the welfare of vulnerable households.

Exemptions, Social Assistance, and the Limits of VAT-Based Redistribution

The most common policy response to VAT regressivity is to exempt or zero-rate selected goods and services. The intuitive rationale is straightforward: if low-income households devote a larger share of their resources to necessities, removing VAT from necessities should reduce their tax burden. Yet the effectiveness of this strategy depends on who receives the benefit from the exemption.

The central weakness of broad exemptions is their imperfect targeting. Wealthier households also consume food, electricity, transportation, health services, and other necessities. Because they consume greater quantities in absolute terms, they may capture a substantial share of the monetary value of tax expenditures. Swistak and de la Feria (2024) argue that the traditional approach of addressing VAT regressivity through exemptions and reduced rates often produces limited distributional improvements relative to the revenue forgone. Their analysis suggests that welfare transfers can provide a more precise means of compensating lower-income households.

The Indonesian evidence is consistent with this argument but also shows why abrupt removal of exemptions can be problematic. World Bank analysis indicates that eliminating VAT exemptions would increase the relative burden on households across the income distribution, with particularly significant effects at the bottom. The policy implication is therefore not that all exemptions should be immediately eliminated. Rather, reforms should distinguish between exemptions that serve legitimate social objectives and exemptions that primarily create inefficient tax expenditures.

Social assistance can provide a more targeted alternative. Instead of lowering the VAT rate for everyone who purchases a particular product, the government can provide compensation directly to households identified as economically vulnerable. The theoretical advantage is significant. If the objective is to protect low-income households, the government can target the household rather than the product. This reduces the extent to which higher-income households benefit from tax expenditures intended to support the poor.

World Bank research on Indonesia and other developing economies demonstrates why this distinction matters. Taxes and transfers must be evaluated together because indirect taxation can worsen poverty while direct transfers can offset part of the burden. Across the countries examined by the World Bank, the combined effect of taxes and transfers varied substantially, demonstrating that the distributional consequences of fiscal policy cannot be understood from taxation alone.

However, targeted compensation also presents implementation challenges. Indonesia's social-protection system must identify eligible households accurately, deliver benefits consistently, and respond to changes in household circumstances. Errors of exclusion can leave vulnerable households uncompensated, while errors of inclusion can reduce the effectiveness of limited fiscal resources. Consequently, the superiority of targeted transfers is conditional upon administrative capacity.

The development of digital fiscal infrastructure offers opportunities in this regard. Swistak and de la Feria (2024) propose a "Progressive VAT" model in which VAT paid by lower-income households is compensated in real time through digital mechanisms. Their proposal attempts to preserve the efficiency of a broad VAT while providing direct compensation at the point of consumption. Although such a model may not be immediately transferable to Indonesia, it illustrates an important principle: progressivity does not necessarily have to be built into every VAT rate or exemption. It can be incorporated through the interaction between taxation and targeted compensation.

For Indonesia, a practical version of this approach could involve strengthening the connection between VAT policy and existing social-protection systems. Rather than introducing numerous product-specific exemptions, policymakers could preserve relatively broad taxation while increasing temporary or permanent support for households facing identifiable economic vulnerability. Compensation could be adjusted according to household size, income, geographic price differences, and exposure to essential consumption. The design should also distinguish between short-term and structural assistance. Temporary compensation may be appropriate during a major VAT transition because households need time to adjust to changes in prices and consumption. Structural assistance is more appropriate where persistent poverty or vulnerability prevents households from absorbing ordinary consumption-tax burdens.

Such an approach would also improve fiscal transparency. Tax expenditures associated with exemptions can be difficult to evaluate because their benefits are embedded in product prices. Direct transfers are more visible and can be evaluated according to their distribution among beneficiary households. This makes it easier for governments to assess whether a particular fiscal intervention actually reaches the population it is intended to protect.

The central policy implication is therefore that VAT should not be expected to perform all redistributive functions by itself. VAT is fundamentally a revenue instrument. Its efficiency depends on maintaining a relatively broad base, while its equity consequences should be addressed through a combination of carefully selected tax preferences and progressive expenditure policies. This institutional division of functions is more consistent with modern public-finance theory than attempting to transform VAT itself into a highly progressive tax.

Tax Compliance, Economic Justice, and a Welfare-Protective VAT Framework

Distributional analysis should also consider the problem of tax compliance. A VAT system that collects revenue primarily from compliant formal businesses while significant portions of economic activity remain outside the tax net may distribute burdens unevenly. This is particularly relevant in developing economies, where informality can be substantial. Formal consumers and businesses may bear the observable tax burden while informal transactions escape taxation. Such a structure can weaken both revenue performance and perceptions of fairness.

Evidence on Indonesia's VAT gap indicates that the problem is substantial. Qian and Poniatowski (2024) estimate significant gaps between potential and actual VAT revenue and identify non-compliance as a major component of forgone revenue. Their analysis finds that VAT and corporate income tax gaps together represented a substantial share of GDP during 2016–2021, with compliance gaps accounting for a large portion of forgone revenue. This finding has direct implications for economic justice because increasing the statutory rate is not necessarily the most equitable way to increase revenue when significant portions of the existing tax base remain outside effective compliance.

From an equity perspective, improved compliance can be preferable to repeated rate increases. If the government expands enforcement across the existing tax base, the burden can be distributed among economic actors who should already be contributing under the law. By contrast, a rate increase can raise the burden on compliant consumption without necessarily increasing the contribution of businesses or transactions that remain outside the formal system.

The relationship between VAT and informality also complicates the measurement of regressivity. Informal households may purchase goods from informal sellers and therefore not bear the same explicit VAT burden as formal consumers. Yet they may still experience indirect price effects if VAT-inclusive prices increase throughout the market. Consequently, tax incidence should not be equated with the amount of VAT explicitly displayed on a receipt. The ultimate economic burden can be transmitted through supply chains and market prices.

Economic justice also requires attention to horizontal equity. Households or businesses in similar economic circumstances should, as far as possible, face similar tax treatment. Differential compliance can undermine this principle. A formal business that collects and remits VAT bears administrative obligations that an informal competitor may avoid. If the difference becomes persistent, tax policy can inadvertently distort competition while weakening voluntary compliance.

This makes administrative modernization an important component of welfare protection. Digital invoicing, transaction monitoring, risk-based audits, and integrated taxpayer data can increase compliance without relying exclusively on higher statutory rates. Such mechanisms should nevertheless be designed with proportionality and privacy safeguards so that enforcement does not create excessive burdens for small businesses.

The welfare dimension of VAT also requires policymakers to distinguish between tax burden and public benefit. Taxation reduces private purchasing power, but tax revenue finances public expenditure. If VAT revenue is used to finance health, education, social assistance, and infrastructure that disproportionately benefit lower-income households, the net distributional impact of fiscal policy may be substantially more progressive than the tax component alone suggests. This is why the World Bank recommends assessing taxes and transfers jointly when evaluating poverty and inequality. This perspective changes the appropriate benchmark for judging Indonesia's 12 percent policy. The question should not be whether every low-income household pays some VAT. Under a broad consumption tax, some level of taxation is inevitable. The more relevant questions are whether the tax burden is proportionate to household capacity, whether essential consumption is protected adequately, whether vulnerable households receive compensation, and whether public expenditure returns part of the collected revenue to those households through services and transfers.

The government should therefore institutionalize a distributional impact assessment as part of major VAT reforms. Before implementing significant changes, policymakers should estimate the expected effect across expenditure deciles and income groups, distinguish essential from discretionary consumption, and identify households likely to experience the largest welfare losses. These assessments should then be repeated after implementation to determine whether actual price and consumption responses correspond to initial projections. A welfare-protective VAT framework should consequently contain five complementary elements. First, the VAT base should remain sufficiently broad to preserve revenue efficiency. Second, essential consumption with substantial welfare implications should receive carefully targeted protection rather than indiscriminate exemptions. Third, social assistance should compensate vulnerable households where taxation produces unavoidable welfare losses. Fourth, tax administration should improve compliance so that revenue increases do not depend excessively on higher rates. Fifth, the government should publicly report the distributional consequences of VAT reform and the compensatory measures used to address them.

Indonesia's 2025 implementation already contains one important element of such a framework by differentiating the effective burden between luxury and non-luxury consumption. The next policy challenge is to ensure that this differentiation is complemented by effective social protection and rigorous incidence monitoring. The ultimate objective should not be to make VAT universally progressive in isolation. Rather, it should be to construct a fiscal system in which the revenue-producing advantages of consumption taxation coexist with meaningful protection against disproportionate welfare losses.

Conclusion

Indonesia's 12 percent VAT reform demonstrates that the relationship between consumption taxation and household welfare is more complex than the conventional claim that VAT is inherently regressive. Law No. 7 of 2021 established a 12 percent statutory rate, but the implementation framework under PMK No. 131 of 2024 generally preserves an effective 11 percent burden for non-luxury taxable goods and services through the use of an 11/12 tax base, while applying the full 12 percent burden to relevant luxury consumption. This design reduces the immediate distributional effect that would arise from a uniform 12 percent burden on ordinary consumption. Nevertheless, household welfare remains sensitive to consumption composition, income constraints, price pass-through, and the limited substitutability of essential goods and services. The evidence from Indonesia indicates that VAT incidence can appear broadly neutral under some measurement approaches while still generating meaningful welfare risks for households at the bottom of the distribution. Regressivity should therefore be understood as an outcome of tax design, household behavior, and the broader fiscal environment rather than as an unavoidable characteristic of VAT.

A welfare-protective VAT system should consequently combine revenue efficiency with targeted distributional safeguards. Broad-based taxation can remain an important source of fiscal sustainability, but its potentially adverse effects should be addressed through carefully designed treatment of essential consumption, targeted social assistance, stronger tax compliance, and systematic distributional monitoring. Existing evidence indicates that broad VAT exemptions may provide some protection to poorer households but can also generate costly and imperfectly targeted tax expenditures, while direct transfers can offer more precise compensation when administrative capacity is sufficient. Indonesia should therefore evaluate VAT reform through the combined effects of taxes, transfers, and public services rather than through the statutory rate alone. Economic justice requires asking not merely how much VAT the state collects, but who ultimately bears its economic cost and whether the fiscal system adequately protects households with the least capacity to absorb reductions in purchasing power.

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