OPTIMAL COMMODITY TAXATION IN THE SECOND BEST SITUATION

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The standard theory on optimal commodity taxation is incomplete in the sense that it ignores the fact that taxation -as a system- is attributed with administrative and other costs. The costs could be very large even for the theoretically optimum one. In addition, its application requires estimations of preference and elasticities that can be unobtainable for developing countries. The common practice of applying a uniform rate across sectors does not always produce better results. Therefore, in the second best situation it might be useful to focus on minimising the taxation costs.

A CGE model representative to the Indonesian economy is developed to examine this issue by first assessing the marginal excess burden and welfare costs of the existing commodity taxation. The latter is then used as a basis for designing an optimal allocation of commodity taxation. The results suggest that most sectors have already been over taxed and the existing tax system is not an efficient way for collecting revenue. The proposed commodity tax rates will give much better results for the economy, welfare and even for the government revenue.