



OPTIMIZING VAT THRESHOLD: THE KEY TO IMPROVING VAT PERFORMANCE

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Abstract

The low tax ratio in Indonesia is an issue often associated with suboptimal tax revenue performance. This study examines the role of the threshold for Value Added Tax (VAT), which is suspected to significantly influence the optimization of VAT revenue, while also exploring the effect of VAT rate and Gross Domestic Product (GDP) per capita. The study analyzes data from member countries of the Organization for Economic Co-operation and Development (OECD) in 2022 using multiple linear regression methods. The results show that increases in the VAT threshold and VAT rate positively impact VAT revenue performance, while an increase in per capita GDP has a negative effect. A higher VAT threshold allows the country to focus on larger taxpayers, while the Micro, Small, and Medium Enterprises (MSMEs) benefit from reduced administrative burdens. These findings can serve as a basis for government evaluation in determining the appropriate threshold and VAT rates to enhance tax revenue performance optimally.

Keywords: GDP per capita, OECD, VAT rate, VAT revenue, VAT threshold.

INTRODUCTION

Discussing tax performance as a pillar of state revenue cannot be separated from the topic of tax ratio. The tax ratio is the comparison between tax revenue and a country's Gross Domestic Product (GDP) (Panjaitan, 2023). According to the report titled "Public Expenditure Review: Spending for Better Results" published by the World Bank in 2020, Indonesia's tax ratio is at the average level of low-income countries. Indonesia's tax ratio is even at the lowest position compared to several other developing countries in Southeast Asia, such as Cambodia, Thailand, the Philippines, and Malaysia (Ministry of Finance, 2023). One solution to address this issue is by boosting tax revenue, including Value-Added Tax (VAT). According to data from the Central Bureau of Statistics (2024), VAT is the second-largest contributor to domestic tax revenue after income tax. If managed effectively by the state administrative authority, VAT can become one of the most impactful and cost-efficient types of taxes in generating state revenue (Mgammal et al., 2023).

In response to the issue of Indonesia's low tax ratio, the World Bank has provided several recommendations to increase tax revenue. First, the government is advised to lower the minimum turnover threshold required for the registration of taxable enterprises, known as the VAT threshold, and to maximize registration upon voluntary application for taxpayers who have not yet met this threshold. As stipulated in Minister of Finance Regulation Number 197/PMK.03/2013, Indonesia's current VAT threshold is set at 4.8 billion rupiah, an increase from the 2010 threshold of 600 million rupiah. Second, the government should also reduce the maximum turnover limit for Micro, Small, and Medium Enterprises (MSMEs) to align with the lowered VAT threshold.

The concept of a lower VAT threshold proposed by the World Bank has been a topic raised by several researchers. Taqiyuddiin & Wijaya (2021) even mention that one way to increase revenue from the VAT sector is by eliminating the application of the taxable enterprise threshold or VAT threshold. This is supported by various findings that show the VAT threshold as one of the triggers for bunching cases. However, if eliminating the threshold is not feasible, the reverse charge mechanism for corporate taxpayers could be a viable alternative solution to consider (Sagala & Wijaya, 2022).

However, several studies disagree with the concept of lowering or eliminating the VAT threshold. Zu (2018) argues that setting a low threshold would be regressive for small



businesses due to the relatively higher VAT compliance burden compared to their income. On the other hand, imposing a high threshold could create competitive distortions between businesses that are required to register as taxable enterprises and those that are not. In response to this dilemma, Satterthwaite (2018) presents two conclusions in his work. First, a higher threshold would minimize the number of companies affected by the unfairness caused by the threshold. Second, a policy allowing small businesses to voluntarily apply for registration would be a fairer alternative. Therefore, according to Satterthwaite, setting a high threshold can be a middle ground, promoting fairness and efficiency simultaneously.

Setting a relatively high threshold creates at least two conditions: fear of potential loss and a sense of unfairness that might be felt by larger businesses that are required to register as taxable enterprises. However, it is difficult to see a causal relationship between changes in the VAT threshold and the resulting revenue due to influencing macroeconomic variables, especially price volatility (Satterthwaite, 2018). Although it is hard to observe revenue changes due to threshold adjustments, the Fiscal Policy Agency (BKF)'s annual Tax Expenditure Report shows the significant potential loss caused by the increase in the VAT threshold from 600 million rupiah to 4.8 billion rupiah, amounting to 42 trillion rupiah in 2019 (Sulfan, 2021). This potential loss figure represents the government's tax expenditure in the form of untaxed VAT. The expenditure value is calculated under the assumption that businesses with a turnover of 600 million rupiah (the average taxable enterprises threshold/GDP per capita in ASEAN) up to 4.8 billion rupiah would be designated as taxable enterprise and thus required to collect, remit, and report VAT. Based on the report, it can be concluded that raising the threshold could increase potential loss, which otherwise could contribute to additional VAT revenue.

Not only the VAT threshold, but other factors that can influence VAT revenue performance include policies related to tax rates and the tax base (Ebrill in Sulfan, 2021). Generally, the impact of VAT rates on VAT revenue, represented as the ratio of VAT revenue to GDP, varies significantly. Europe has a relatively high average VAT rate, corresponding with its relatively high average tax revenue. Meanwhile, countries in the Asia-Pacific region have lower average VAT rates, in line with their lower VAT revenue. However, there is an anomaly in Africa, where VAT rates are relatively higher than those in the Americas, but the average VAT revenue is lower. This may be due to the diverse economic characteristics of each region (Qibthiyyah, 2018). Meanwhile, Lin and Jia (2019) also studied the relationship between tax rates and revenue using the Laffer Curve theory. Their research found that the peak of the Laffer Curve for generating the most optimal tax revenue in China is at a 40 percent rate. However, after conducting a sensitivity analysis, the peak tax rate in China is consistently 5 to 10 percent below the Laffer Curve's peak, indicating that the government should set tax rates below the peak shown on the Laffer Curve.

The increase in VAT revenue is also influenced by the purchasing power of the people, one of which can be measured using the GDP per capita indicator. The higher a country's GDP per capita, the greater the economic capacity of its citizens to consume goods and services. However, conversely, the VAT revenue of Asia-Pacific Economic Cooperation (APEC) member countries tends to decrease as their GDP per capita rises (Fadhilah & Wijaya, 2023). This occurs because some of these countries impose low VAT rates, or even 0%, to stimulate trade and investment in their regions. A study focused on BRICS countries (Brazil, Russia, India, China, and South Africa) conducted by Kusuma dan Wijaya (2023) yielded similar results, showing that an increase in GDP per capita tends to reduce VAT revenue. This is because the majority of the population has low incomes, so most of them can only afford to purchase relatively low-priced consumer goods, which are generally VAT-exempt.

The optimization of VAT and luxury goods tax (PPnBM) performance will have a significant impact, given their high contribution to total tax revenue in 2022, reaching 40.1%



or equivalent to 687.6 trillion rupiahs (Ministry of Finance, 2023). Globally, VAT revenue has been shown to have a positive effect on economic growth, represented in the form of GDP. For example, a 1 percent growth in VAT revenue was found to increase Nigeria's real GDP by 16.78 percent (Onyema & Anyamaobi, 2018). Additionally, the increase in VAT revenue in Kenya also had a positive, though not significant, impact on GDP growth, amounting to 0.0356 percent (Owino, 2019). Therefore, the comparison of VAT revenue to total GDP can serve as a proxy to illustrate the performance of VAT revenue collection. This comparison, or ratio, is also one of the indicators forming the VAT efficiency ratio calculation method. The VAT efficiency ratio is found by dividing the ratio of VAT revenue to GDP by the tax rate percentage (OECD, 2022). The higher the VAT efficiency ratio, the more efficient VAT collection is.

Although several studies have analyzed the impact of VAT threshold policies, research that specifically measures the direct effect of VAT thresholds on VAT revenue performance using a quantitative approach remains limited. Therefore, this study aims to fill this gap by exploring the impact of the VAT threshold on VAT revenue performance, tested simultaneously with two other independent variables, namely VAT rates and GDP per capita. By using OECD member countries in 2022 as the object of study, the results of the study are expected to provide a meaningful contribution to fiscal policy decisions, specifically in determining the ideal VAT threshold to increase tax revenue without hindering economic growth.

LITERATURE REVIEW

VAT Threshold

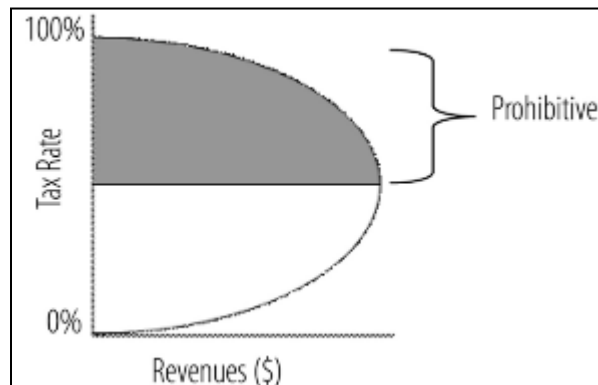
The imposition of VAT is often considered burdensome for small and medium-sized enterprises, leading many countries to implement certain relief measures, one of which is the establishment of a minimum turnover threshold for businesses required to be registered as VAT-registered enterprises, also known as the registration threshold. The OECD (2022) defines the registration threshold as the limit that exempts businesses from the obligation to register and collect VAT. This threshold is generally calculated based on the total business turnover in one year. With this threshold, businesses with a turnover below the specified limit are not required to register as taxable enterprises (PKP) or fulfill the related tax obligations. The setting of a threshold is a middle ground between two important considerations: minimizing compliance and administrative costs for small businesses, and protecting the tax revenue base while avoiding competitive distortions (OECD, 2022).

Tax Rate

One instrument that can explain the relationship between tax rates and tax revenue is the Laffer curve. Laffer (2004), as cited in Liapis et al. (2020), explains the relationship between tax rates and tax revenue represented in two opposing effects: the arithmetic effect and the economic effect. In the arithmetic effect, a reduction in tax rates will result in a decrease in tax revenue, while the economic effect explains that tax cuts, conversely, can create incentives to increase output, employment, and production. This relationship is illustrated in the form of the inverted U-shaped Laffer curve as follows.



Figure 1. The Laffer Curve



Source: The Laffer Center (2012)

In the curve, it is shown that when the tax rate is 0 percent, tax revenue is zero. Tax revenue will increase as the tax rate rises until it reaches a maximum point, and then it will decrease back to zero when the tax rate reaches 100 percent. However, this curve is widely debated because it is not always relevant in all conditions. In their empirical study, Liapis et al. (2020) found that a parabolic laffer curve occurs when there is a high indication of tax avoidance. However, when tax avoidance opportunities are reduced or can be mitigated, the mathematical relationship between the two changes to an asymptotic hyperbola. This indicates the influence of socioeconomic variables that can affect the relationship between tax rates and revenue.

GDP per Capita

In The World Bank's metadata, Gross Domestic Product (GDP) per capita represents the gross value added by all producers in an economic region, plus any taxes and minus subsidies that are not included in the product's value, and then divided by the total population in that economic area. GDP per capita is a core indicator of economic performance, often used to measure the standard of living or the well-being of a country's population. However, this indicator is not without its shortcomings, such as its inability to depict the distribution of GDP among the citizens. The GDP per capita figure may appear to increase, even though more people may be experiencing a decline in well-being due to a significant rise in income inequality (OECD, 2013).

VAT Revenue Performance

One indicator that can be used to assess VAT revenue performance is the ratio of VAT revenue to total GDP. This ratio forms one of the indicators used in calculating VAT performance, known as the VAT efficiency ratio. The VAT efficiency ratio is determined by dividing the ratio of VAT revenue to GDP by the tax rate percentage (OECD, 2022). The higher the VAT efficiency ratio, the more efficient the VAT collection.

METHODS

This study uses a quantitative approach with secondary data from 2022 in the form of cross-sectional data. To examine the impact of the VAT threshold and other independent factors on VAT revenue performance, this study uses a population of OECD member countries. The population includes 37 out of 38 countries listed as OECD members in 2022. The United States is excluded from the study population because it does not have a VAT system, but rather a sales tax, with different threshold rules in each state. OECD member countries were selected as the research subjects due to the accuracy and completeness of the available data. The data tested in this study include the VAT threshold, VAT rate, GDP per capita, and the ratio of VAT revenue to GDP. The VAT threshold, VAT rate, and VAT-to-GDP ratio data were obtained from the



official OECD website, while GDP per capita data was obtained from the official World Bank website.

In experimental research, commonly used variables are independent, dependent, and control variables, with the control variables being regulated to avoid contaminating the results (Soesilo, 2019). As stated by Soesilo in his book, this study also employs three similar groups of variables: the ratio of VAT revenue to GDP as the dependent variable, the VAT threshold as the independent variable, and GDP per capita and VAT rate as control variables.

To determine the influence of the independent and control variables on the dependent variable, the author uses multiple linear regression analysis, as more than one independent and/or control variable is involved. In this study, two variables will be presented as percentages: the VAT threshold and GDP per capita. Therefore, the author employs a log-linear regression model to determine the relationship between the variables in percentage growth terms. Rosalia et al. (2011), as cited in Anggraini et al. (2023), explain that the log-linear model is used to develop a statistical model that shows the relationship between variables with ordinal or nominal scale data.

Based on the hypotheses and variables determined, this study will use the following research model equation.

$$VAT = \beta_0 + \log \beta_1(THR) + \beta_2(TRT) + \beta_3 \log(GDP) + \varepsilon$$

dengan,

VAT : VAT revenue to GDP ratio;

THR : VAT threshold;

TRT : VAT rate; and

GDP : GDP per capita.

The procedure used to analyze the variables in this study begins with conducting classical assumption tests, including normality tests, heteroscedasticity tests, multicollinearity tests, and autocorrelation tests. The coefficient tests are then carried out through F-statistics, t-statistics, and R^2 (adjusted R^2) tests. All of these testing procedures are performed using the STATA 18 application.

RESULTS AND DISCUSSIONS

Descriptive Statistical Test

The following table summarizes the average, minimum, and maximum values of the data from the 37 tested countries.

Table 1. Descriptive Statistics

Variable	Mean	Min	Max
VAT threshold (USD)	51.925	0	155.039
VAT rate (%)	19	5	27
GDP per capita (USD)	39.079,74	6.842,5	109.714,9
VAT revenue to GDP ratio (%)	10,63	4,75	17,32

Source: data processed (2024)

The descriptive analysis in Table 1 shows the diverse economic policies of OECD members. The average VAT threshold for these countries is USD 51,925, or approximately 850 million rupiah. The Czech Republic stands out with the highest threshold policy of USD 155,039, while six countries, including Colombia and Costa Rica, do not implement a VAT threshold for business registration. VAT rates among the countries vary significantly, with an average rate of 19%. The lowest rate is 5%, found in Canada, while the highest rate is 27%, in Hungary. In terms of macroeconomics, the average GDP per capita for the tested countries is USD 39,079.74. There is a significant gap between the country with the lowest GDP per capita,



Colombia (USD 6,842.5), and the highest, Luxembourg (USD 109,714.9). Lastly, the average VAT-to-GDP ratio among OECD members is 10.63%, with Australia having the lowest ratio at 4.75% and Greece the highest at 17.32%.

Classical Assumption Test

Based on the classical assumption tests conducted, all variables meet the conditions for testing, with the following details.

Table 2. Classical Assumption Test Results

Test	Prob.	Test Result
Normality	0,6721	No normality symptoms
Multicollinearity	1,29	No multicollinearity symptoms
Heteroscedasticity	0,8525	Homogeneous data
Autocorrelation	0,4451	No autocorrelation symptoms

Source: processed by the author using STATA (2024)

Regression Analysis

Table 3. Regression Analysis Results

Variable	Coefficient	t-stat	Prob.
Cons	19,18534	3,32	0,002
Log_THR	0,290768	3,19	0,003
TRT	0,3535076	5,78	0,000
Log_GDP	-1,731548	-3,06	0,004
R-squared		0,6206	
Adj. R-squared		0,5861	
Prob > F		0,0000	

Source: processed by the author using STATA (2024)

The regression results in Table 3 show that all independent and control variables, both partially and simultaneously, have a significant impact on the dependent variable. A significant simultaneous effect is indicated by the Prob>F value of less than 0.05, at 0.0000. Each independent and control variable also has a probability value of less than 0.05, allowing us to conclude that the VAT threshold, VAT rate, and GDP per capita each have a significant partial effect on VAT performance. Table 3 also reveals that all independent and control variables explain 62.06 percent of the dependent variable, while the remaining 37.94 percent must be explained by other variables not included in this study.

Testing all variables results in the following regression equation.

$$\text{VAT} = 19,18534 + 0,290768 \text{ THR} + 0,3535076 \text{ TRT} - 1,731548 \text{ GDP} + \varepsilon$$

Based on the equation above, it is found that increases in the VAT threshold and VAT rates have a positive effect on the VAT-to-GDP ratio, while increases in GDP per capita have a negative effect.

The Impact of VAT Threshold on VAT Revenue Performance

Regression testing on 37 OECD members shows that a 1 percent increase in the VAT threshold will increase VAT revenue performance by 0.29 percent. This conclusion contradicts the World Bank's recommendation, which suggests that Indonesia should increase VAT revenue by lowering the VAT threshold. However, the results of this regression test align with Parisa et al. (2020), who examined factors influencing the VAT-to-GDP ratio in 48 countries between 2008 and 2017. The study found that the VAT registration threshold positively affects VAT revenue. A higher threshold allows tax authorities to focus on larger taxpayers, who are likely to generate higher VAT revenues. Additionally, administrative and compliance costs can be reduced as resources are allocated to monitoring larger taxpayers. Setting a higher threshold indirectly encourages the growth of small businesses by not burdening them with excessive tax obligations. This is expected to expand the tax base in the long term as small and medium



enterprises (SMEs) grow and eventually exceed the threshold. In Indonesia, paying more attention to the sustainability of SMEs is crucial, given that the country has 65.5 million SMEs supporting 61 percent of national GDP, or 9,580 trillion rupiah (Coordinating Ministry for Economic Affairs of the Republic of Indonesia, 2023).

In 2019, the Fiscal Policy Agency (BKF) simulated the impact of lowering the VAT threshold from 4.8 billion rupiah to 300 million rupiah on the 2018 economy. The simulation was conducted using a Computable General Equilibrium (CGE) economic model. The simulation revealed that lowering the threshold to 300 million rupiah increased inflation by 0.592 percent. This rise in inflation led to a 0.227 percent decline in household consumption. Additionally, investment was projected to decrease by 1.013 percent due to an increase in production wage costs by 0.727 percent, which compressed the rate of return in the business sector. Imports were also affected, resulting in a 0.296 percent decrease. These simultaneous declines in macroeconomic indicators reduced GDP by 0.015 percent, despite the fact that the simulation showed an additional VAT revenue of 50.529 billion rupiah.

The sectors most affected by the reduction of the VAT threshold to 300 million rupiah are those related to investment, such as infrastructure and machinery manufacturing, due to the decline in the rate of return as previously explained. Furthermore, the manufacturing industry, particularly food and beverage processing, would also be impacted because many businesses operate with a turnover in the range of 300 million to 4.8 billion rupiah. Therefore, lowering the VAT threshold should be done carefully to continue encouraging business growth, especially in the SME sector.

The Impact of VAT Rates on VAT Revenue Performance

The VAT rate has a significant impact on its revenue performance. Testing shows that a 1 percent increase in the VAT rate can increase the VAT-to-GDP ratio by 35.35 percent. For example, a 1 percent VAT rate increase in South Africa resulted in a 4.2 percent increase in VAT revenue in 2019 and 5.8 percent in 2020 (Koloane & Makananisa, 2020). These findings are in line with Qibthiyah (2018) research, which states that there is a positive and significant relationship between the VAT rate and the VAT-to-GDP ratio. However, this relationship reverses when the VAT rate reaches an optimal point, in accordance with the Laffer Curve theory.

According to Qibthiyah (2018), the maximum VAT rate should not be viewed solely by its ability to achieve optimal VAT revenue but should also consider the ideal goal of minimizing welfare losses (inefficiency). Therefore, VAT rate increases should be done gradually while monitoring the various effects that occur. Referring to VAT rate increases implemented in other countries, these increases are generally gradual, ranging from 1 to a maximum of 5 percent. For example, Chile increased its VAT rate by 1 percent, from 18 percent to 19 percent in 2005. In 2006, the Philippines raised its VAT rate from 10 percent to 12 percent, while Ghana increased its VAT rate from 12.5 percent to 17.5 percent in 2014. This gradual increase is a strategy also being implemented in Indonesia. Since April 2022, the government officially raised the VAT rate from 10 percent to 11 percent, following the mandate of the Tax Harmonization Law, with the rate expected to increase gradually to 12 percent by 2025. This policy was taken with careful consideration, given that the current rate is still relatively low compared to other countries, where it reaches up to 15 percent. This increase is expected to balance the reduction in corporate income tax (CIT), which dropped from 25 percent to 22 percent and was set to 20 percent in 2022 (Aziz, 2024).

The Impact of GDP per Capita on VAT Revenue Performance

GDP per capita is the only independent variable that has a significant negative relationship with the dependent variable, the VAT-to-GDP ratio. A 1 percent increase in GDP per capita reduces VAT revenue performance by 1.73 percent. In line with Fadhilah and



Wijaya's (2023) research, an increase in GDP per capita among APEC member countries resulted in lower VAT revenues. According to the authors, this is due to many APEC countries applying low, even 0 percent, VAT rates on certain taxable goods to boost trade and investment in the region.

A 1 percent increase in GDP per capita in BRICS countries (Brazil, Russia, India, China, South Africa) also reduced VAT revenues by 4.01 percent. This is because the large populations of China and India cause their GDP per capita to be below the BRICS average. As a result, most of the BRICS population falls into the low-income category, with access primarily to essential goods that are often taxed at a 0 percent VAT rate, leading to minimal growth in VAT revenue.

Similar to APEC and BRICS countries, OECD members in this study have also lowered or eliminated VAT rates on crucial taxable goods. Luxembourg reduced the VAT rate on essential goods like food and medicine from 16 percent to 3 percent. Germany lowered the VAT rate to 7 percent on items like books and public transport tickets. Meanwhile, the UK reduced the VAT rate to 5 percent on fuel and electricity, while some food items and children's clothing are exempt from VAT (OECD, 2022). Several OECD countries have proposed lowering VAT rates to promote equity by reducing the tax burden on the majority of household spending by low-income earners. Lower VAT rates are expected to stimulate the consumption of merit goods like books, promote labor-intensive activities such as tourism, and address environmental externalities (Enache, 2023).

CONCLUSIONS

Conclusions

Based on the series of tests and analyses conducted, it was found that an increase in the VAT threshold positively contributes to VAT revenue performance. With a relatively high threshold, countries can focus on large taxpayers who can make significant contributions to tax revenues, while also encouraging the growth of the SME sector by reducing the administrative and tax obligations imposed on them. In addition, higher VAT rates have also been proven to significantly improve VAT performance. Although this may increase the tax burden on consumers, careful VAT rate adjustments can be an effective fiscal policy instrument to boost state revenues. However, an increase in GDP per capita has a negative impact on VAT performance. The application of a 0 percent VAT rate and even exemptions on essential taxable goods means that economic growth does not always translate into proportional increases in VAT revenues. Thus, these findings are expected to serve as a guide for policymakers in formulating more effective and sustainable fiscal strategies.

Recommendations

Although the subjects of this study are OECD member countries, which are mostly developed nations, the results can be used as relevant recommendations for the government in responding to the World Bank's suggestion to lower the VAT registration threshold and raise the turnover threshold for small businesses benefiting from SME facilities. Given the vital role of SMEs in Indonesia's economy, the decision to lower the threshold must be carefully considered. The government must ensure that this policy does not hinder the development and growth of SMEs, while allowing them to scale up and contribute more significantly to the economy.

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