SUBNATIONAL OWN SOURCE REVENUES AND SHARED TAXES IN INDONESIA: TAKING STOCK AND LOOKING FORWARD

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I. Introduction

Indonesian subnational governments have faced considerable challenges with local revenue generation over the years. Well before the introduction of decentralization through Laws 23 and 25 (1999), local revenue powers were recognized to be limited and performance was typically considered weak.[1] Various initiatives to improve subnational revenues emerged over the years, but serious policy reform efforts did not begin until the 1990s. With the arrival of the "big bang" decentralization just over a decade ago, additional policies and laws were developed to promote further reform. Despite the efforts to date and the genuine progress realized, major challenges persist.

The experience of Indonesia is far from atypical. Public finance specialists have elaborated well-defined normative principles for designing subnational revenues in the context of larger fiscal systems. It is clear from the empirical literature, however, that even where these have been followed, local revenue generation continues to suffer from frustrating underperformance.[2] Productive reforms have occurred in many countries, but more commonly for individual revenue sources rather than for the broader systemic reforms needed for more substantial impacts.

Recent steps taken by the Government of Indonesia demonstrate a continued commitment to improving the subnational revenue system. Developing specific options for furthering reform, however, is challenging. Technical revenue reforms can proceed independently, but their adoptions and performance ultimately depend on the underlying incentives of the actors involved and how the elements of the intergovernmental system work together.

This paper focuses on the challenge of improving subnational own source revenues and shared taxes. (Other components of the revenue system—shared non-tax revenues and intergovernmental transfers—are covered in separate papers.) It is divided into four additional sections. The next section presents a brief overview of the evolution of own-source revenues and shared taxes in Indonesia, with a focus on the current situation. An assessment of the system (to the extent data allows) is provided in section III, and issues

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[1] See, for example, Devas (1989), Bastin and Smoke (1993), and Shah and Quereshi (1994).
[2] See, for example Bahl and Linn (1992); Shah (1994); Ter-Minassian (1997); Bird and Vaillancourt (1998); Litvack, Ahmad and Bird (1998); Smoke (2001); Ahmad and Tanzi (2002); Shah (2004); Ebel and Taliercio (2005); World Bank (2005); Bardhan and Mookherjee (2006); Connerley, Eaton and Smoke (2010), Martinez-Vazquez and Vaillancourt (2011).

that need to be taken into account in considering further reforms are discussed in section IV. Finally, section V proposes some ideas for moving forward.

II. Overview of Own Source Revenues and Shared Taxes: The Evolution of the Current System

Subnational Taxes

Prior to the adoption of Law No. 18 (1997) provinces were entitled to only a few taxes (vehicle tax, vehicle transfer tax, household tax and some minor sources), but there were more than 30 local taxes and more than 180 provincial and local retributions (fees, permits and licenses). The law expanded the provincial tax base by adding the motor vehicle fuel tax and the surface and ground water tax. It also eliminated many local taxes and charges judged to be unproductive or problematic, reduced the base of certain local taxes, and adjusted (mostly lowered) tariffs and fees. This law limited local government revenues to nine specified taxes and authorized approximately 30 types of retribution.[3]

Although Law No. 18 (1997) substantially simplified the subnational revenue system and took major steps towards eliminating unproductive local taxes, critics charged that it suffered from implementation problems (some resulting from the Asian economic crisis in the late 1990s) and that it was not consistent with the autonomous status conferred on subnational governments by the 1999 decentralization laws. In part to address the latter problem, Law No. 34 (2000) replaced Law No. 18 (1997). The new law assigned a few additional taxes to local governments and also allowed them to impose other local taxes and charges not specifically assigned to them, but subject to certain restrictions.

The criteria for adopting new local revenue sources included requirements to focus on bases with low mobility, to limit competition for central or provincial bases, and to conform to conventional tax principles of revenue potential, efficiency and equity, among others. To ensure compliance, local governments were required to submit proposals for new sources to the Ministry of Home Affairs (MoH) for review and to formalize them in local by-laws. If MoH determined (in consultation with the Ministry of Finance—MoF) that a revenue source violated Law 34 (2000), it had to be rescinded.

As it turned out, local governments created many new taxes and charges that were inconsistent with official criteria. Many were low yielding nuisance taxes or created undesirable economic effects (e.g. by taxing major commodities or production inputs). Quite a few new local taxes and charges were not submitted for formal approval, and certain subnational governments were more aggressive than others in creating new revenue instruments, although not necessarily those with weaker fiscal capacity.[4]

[3] The provisions and effects of Law No. 18 (1997) are analyzed in detail in Mahi (2002) and Simanjuntak and Mahi (2004).
[4] See the discussion in Lewis (2003b), Taliercio (2005), Lewis (2006) and Lewis and Suharnoko (2009).

In 2004, Laws 32 and 33 were adopted to update the provisions of Laws 22 and 25 (1999). Law 33 specifically constrained subnational governments from establishing a revenue source that would lead to a "high-cost economy" (interpreted as duplicating a central or provincial revenue source) or that would hinder the free movement of people, goods and services internally or internationally (Article 7).

Further codification of local revenues occurred in Law 28 (2009), which authorized a list of five provincial taxes and eleven local taxes. (Table 1 lists the current sources of revenue and how they evolved since Law 18 (1997)). This legislation replaced Law 34 (2000) and took away the ability of subnational governments to create additional taxes, restricting them to using the revenue instruments included on the so called "positive" list detailed in the new law. The main changes to the list included assigning the cigarette tax to the provincial governments (as of 2014) and devolving the urban and rural land and building tax (PBB—as of 2014), the tax on transfer of land and buildings (BPHTB—as of 2012), and the tax on ground water (formerly a provincial tax) to the local governments.

Table 1: Comparison of Provincial and Local Own Source Tax Structure Over Time

	Law No. 18 (1997)	Law No. 34 (2000)	Law No. 28 (2009)	Comments
Provincial Level Taxes				
1	Motor Vehicle Tax	Motor Vehicle and Sea Vessel Tax	Motor Vehicle Tax	Titles changed in 2009 but sea vessels remain subject to taxes
2	Motor Vehicle Transfer of Ownership Tax	Motor Vehicle and Sea Vessel Transfer of Ownership Tax	Motor Vehicle Transfer of Ownership Tax	
3	Motor Vehicle Fuel Tax	Motor Vehicle Fuel Tax	Motor Vehicle Fuel Tax	No change in 2009
4	Surface and Ground Water Tax	Surface and Ground Water Tax	Surface Water Tax	Transferred to local level
5	NA	NA	Cigarette Tax	New tax as of 2014
Local (Kota/Kabupaten) Taxes				
1	NA	NA	Rural and Urban Property Tax (PBB P2)	Transferred from central to local level
2	NA	NA	Property Transfer Tax (BPHTB)	
3	Hotel and Restaurant Tax	Hotel Tax	Hotel Tax	No changes in 2009
4		Restaurant Tax	Restaurant Tax	
5	Entertainment Tax	Entertainment Tax	Entertainment Tax	
6	Advertisement Tax	Advertisement Tax	Advertisement Tax	
7	Street Lighting Tax	Streets Lighting Tax	Street Lighting Tax	
8	NA	Parking Tax	Parking Tax	
9	Non-metal and non-rock mineral tax	Non-metal and non-rock mineral tax	Non-Metal and non-rock mineral tax	
10	NA	NA	Ground Water Tax	Transferred from provincial level
11	NA	NA	Swallow Nest Tax	New Tax in 2009

Source: Adapted from Kelly and Gyat (2011).

In addition to specifying the allowable revenue sources, Law 28 also defines the bases and a maximum or range of allowable rates on the base. In a few cases, portions of revenue proceeds are intended for spending on particular services. Tables 2 and 3 summarize, for provinces and local governments respectively, the rates on individual subnational taxes and, where applicable, expenditure requirements.

Table 2: Rates on Provincial Taxes under Law 28 (2009)

Tax	Tariff Range*	Earmarking
Motor Vehicle Tax	1-2% on first vehicle 2-10% on each additional vehicle	At least 10% for development and/or maintenance of roads and public transportation
Motor Vehicle Transfer Tax	Up to 20% on new vehicles Up to 1% on used vehicles	NA
Motor Vehicle Fuel Tax	Up to 10%	NA
Surface Water Tax	Up to 10%	NA.
Cigarette Tax	10%	At least 50% for health services and law enforcement

*The actual tariff is set by regional regulation

Table 3: Rates on Kota/Kabupaten Taxes under Law 28 (2009)

Tax	Tariff Range*
Rural and Urban Land and Building Tax (PBB)	Up to 0.3% Valuation deduction: 10 Mio Rupiah
Land and Building Transfer Tax (BPHTB)	Up to 5% Transaction threshold: 60 Mio Rupiah, 300 for bequests
Hotel Taxes	Up to 10%
Restaurant Tax	Up to 10%
Entertainment Tax	Depending on type: up to 35 %, up to 10 %, or up to 75 %
Advertisement Tax	Up to 25%
Street Lighting Tax	Up to 10% (lower for certain sources and own produced electricity)
Parking Taxes	Up to 30%
Non-Metal and Non-Rock Mineral Tax	Up to 25%
Ground Water Tax	Up to 20%
Swallow Nest Tax	Up to 20%

*The actual tariff is set by regional regulation

Shared Taxes

Although the rural and urban components are now being devolved to local governments, the land and building tax (PBB) has long been a central government revenue substantially shared with subnational governments. Law No. 12 (1985) embraced major reforms, consolidating multiple property related taxes and adopting many typically recommended property tax reforms. The center returns 62.8 percent and 18.2 percent of total receipts based on origin to local and provincial governments, respectively. The center initially keeps 10 percent and charges 9 percent as a collection fee. In 1994, the center started

allocating its 10 percent share to local governments, 6.5 percent in lump sums to all places and 3.5 percent to those meeting the previous year's property tax revenue target.

Law No. 18 (1997) introduced revenue sharing of fuel tax and the land and building transfer tax (BPHTB). The provinces collected the former but substantially shared it with local governments (90 percent), while the latter was collected by the central government, which kept 20 percent (but allocated this share equally among all local governments) and shared 16 percent with provinces and 64 percent with local governments.

Some important changes to tax sharing occurred under Law No. 34 (2000). Provinces were given more control over the base and rate of the motor vehicle and motor vehicle transfer taxes, but instead of keeping all of the proceeds they now had to significantly share them with local governments (70%). In addition, the personal income tax, which had previously been fully retained by the central government, started to be shared with provinces (8 percent) and local governments (12 percent).

Law 28 (2009) was principally about local taxes and charges, but it has some relevance for tax sharing. First, although the law provided for the devolution of rural and urban PBB, the PBB levied on the plantations, forestry and mining sectors remain central government shared taxes. Second, in addition to providing for the continued sharing of existing provincial taxes, the new tax devolved to the provinces the cigarette tax (as of 2014), which must be substantially shared (70%) with kota and kabupaten.

Table 4 summarizes the tax sharing arrangements that will be in place after the implementation of the provisions of Law 28 (2009). Certain non-tax revenues (including natural resource related) are also shared with subnational governments, but these are being covered in another paper.

Table 4: Tax Sharing with Provincial and Local Governments after Law 28 (2009)

Central Taxes	**Subnational Shares**	
	Province	Kota/Kabupaten
Personal Income Tax	8% (residence)	12% (8.45% on residence, 3.6% lump sum)
Rural and Urban Land and Building Tax (PBB): Forestry, Mining and Plantation Sectors	18.2%	72.8% (62.8% on origin, 6.5% lump sum, 3.5% incentive)
Provincial Tax	**Kota/Kabupaten Share**	
• Motor Vehicle Tax	30%	
• Motor Vehicle Transfer of Ownership Tax	30%	
• Motor Vehicle Fuel Tax	70%	
• Surface Water Taxes	50%	
• Cigarette Taxes	70%	

Retributions

Various forms of retribution—user fees, permits, licenses, etc.—have been part of the subnational fiscal landscape for a long time. The authority and parameters for such

revenue sources is codified in Law 28 (2009). It specifically provides for three types of retribution: public services, business services and permits.

Public services include activities provided "in the public interest" and constitute a wide range of targets (14 categories) that cover traditional sectoral services, such as health, sanitation and education, as well as fees for an array of tests, inspections and printing of official documents. Business services include activities with more private characteristics (11 categories), such as wholesale markets, auction venues, terminals, slaughterhouses, parking, and recreation centers, among others. Permits (5 categories) are issued for the purpose of monitoring the use of space and natural resources and for other public interest matters. These include building permits, alcohol sales permits, permits to engage in activities that might cause public disturbance, routing permits for private providers of transportation, and fishing permits.

The legislation provides fairly specific definitions of each of the types of retribution, each of the targets within each type, and principles to be used for setting the retributions. It does not, however, set specific retribution levels or ranges of values, as it does for taxes.

III. Assessment of Own Source Revenues and Shared Taxes

The system of own source revenues and shared taxes can be assessed on a number of fronts. One consideration is the national policy trajectory and the extent to which the central government has supported the development of a coherent subnational revenue system that meets basic principles. Another key consideration is the actual performance of the system in generating revenue.

The System Structure and Trajectory of Policy Evolution

The overall subnational revenue system should be evaluation both in terms of its components and how they work together. On broader access, transfers (reviewed in another paper) are prominent (See Tables 5 and 6 for summaries of provincial and local revenues).[5] The DAU provides a generous source of general revenue, and the DAK (conditional transfers) has become more important (if unevenly) after a slow start. The center shares major individual tax and non-tax revenues with subnational governments and requires provinces to share revenues with local governments. There are issues with the transfers and revenue sharing, but there is no doubt that they are significant.

With respect to subnational and shared taxes, an important concern is how the system fares from the perspective of conventional tax (including fiscal federalism/spatial) evaluation criteria (buoyancy, stability, efficiency, equity, administrative ease, political

[5] Tables 5 and 6 are reported in constant 2008 rupiah, but the same general pattern of growth with some unevenness is also evident for revenue figures reported in current rupiah.

acceptability, etc.)[6] Bahl and Bird (2008) argue that good subnational taxes should in principle meet two primary criteria. First, they should collectively allow the richest subnational units to be fiscally autonomous. Second, they should ensure that subnational governments behave in a fiscally responsible way at the margin. In practice, this latter point requires allowing them to set tax rates on at least some of their major taxes.

Subnational own-source revenues in Indonesia do generally favor richer governments with major urban or natural resource bases). They tend to be more fiscally autonomous than other subnational governments, although they still rely receive significant transfers.[7] The subnational revenue system also allows provinces and local governments some degree of control over rates (to a maximum) on most taxes, but a number of caveats on the practical meaning of this provision are explained below.

With respect to how individual revenue sources meet the standard evaluative criteria, there have been a number of analyses of this topic for Indonesia.[8] There is no need to repeat the details, which are in any case not backed up by much empirical evidence. Suffice it to say that each of the local and shared taxes has both advantages and disadvantages. On balance, the major provincial sources are appropriate for an intermediate level of government. There are not major issues with local taxes either, except that they do not collectively constituted a critical mass of autonomous revenues.

In reviewing the basic system structure, it is important to recognize that the Government of Indonesia has adopted many of the conventionally recommended steps for system reforms intended to improve subnational government access to revenue in general and local revenue generation specifically. First, there has been a much-needed consolidation of allowable own source revenues. As indicated above, prior to Law No. 18 (1997), there were many unproductive nuisance taxes that yielded little or no revenue. Law No. 18 dramatically reduced the number of local taxes and retributions, and subsequent legislation narrowed the ability of local governments to create new taxes.

Second, the central government has made efforts to allow local governments more autonomy in revenue generation, albeit with mixed effect. In the spirit of the "big bang," Law 34 (2000) allowed local governments flexibility to create new taxes and retributions subject to criteria, as noted above. The failure of many local governments to adhere to the criteria and an unwillingness or inability of the central government to enforce them led to problematic results and a pull back of authority. Although Law 28 (2009) limited local governments to a specific list of options, they retain scope within ranges to adjust rates on most sources and to set user charges, permits and license fees according to guidelines.

[6] Many authors have reviewed these criteria in general and in individual or comparative context. Recent summaries of the principles and their practical application in developing countries are Bahl and Bird (2008), Bahl and Cyan (2011), and Bird (2011).
[7] The differential position of urban areas is documented Lewis and Suharnoko (2009), who also make the point that mixes of urban and rural areas are prevalent in both kota and kabupaten.
[8] See, for example, Devas (1989), Shah and Quereshi (1994), Ahmad and Krelove (2000), Mahi (2002), and Simanjuntak and Mahi (2004).

Third, the subnational revenue sources that have been added over the years, such as the fuel tax for provinces and the PBB and the BPHTB for local governments, are genuinely productive sources and also exhibit other positive characteristics. The urban and rural PBB devolution came after many years of resistance from the central government despite repeated recommendations to take this step. Since the PBB reform in the mid-1980s, considerable attention has been given to improving the structure and administration of the tax, including the adoption of some innovative practices.[9] Thus, much is known about how to make the property tax work more effectively, and the kota/kabupaten receiving access to this tax base can benefit from earlier system and capacity development.

System Performance

In the aggregate, provincial and local revenues have risen dramatically since the "big bang" decentralization (Tables 5 and 6). Own source revenues have generally grown in absolute terms (aside from a few years) for both provinces and local governments. Provinces are more fiscally independent, raising 46 percent of their revenues from own sources in 2008 (compared, for example, to 33-37 percent in the mid to late 1990s). Local governments, on the other hand, raise a smaller percentage of their revenues from own sources than they did prior to decentralization. Since 2001 own-source revenues have been mostly in the range of 6-8 percent of total revenues (compared to 10-12 percent in the mid to late 1990s).

Shared taxes, which the subnational governments of course have no control over, are more important for provinces than they were before decentralization, ranging from about 15-19 percent in recent years (compared to 5-11 percent in the 1990s). Local governments, on the other hand, are somewhat less dependent on shared taxes that they were before decentralization, with the revenue share from this source ranging between 7-11 percent.

Several factors have apparently contributed to these basic trends. Clearly the level of the DAU and shared non-tax revenues after decentralization produced more resources for local governments, but also increased fiscal dependence. In addition, when DAK started to be used more, these conditional transfers began to account for a nontrivial share of local revenues. Since own revenues generally continue to grow[10], local governments are not ignoring their independent revenue handles, but they also have not been able or

[9] See Kelly (1993), Lewis (2003a), Kelly (2004) and Kelly (2011) for detail on property tax reform.
[10] Calculations made from Ministry of Finance data indicate that own source revenues of local governments grew by an average of 21.7 percent in current rupiah and 11.4 percent in constant rupiah from 2001-2008.

willing to reduce their dependence on national revenues. These aggregate numbers, of course obscure considerable variations across kota and kabupaten.[11]

A few additional observations and issues may be raised about the structure and performance of own-source revenues. First, for a period in the 1990s, retributions accounted for a larger percentage of own-source revenue than local taxes.[12] By the late 1990s this position had reversed. Immediately following decentralization, the two had evened out, with each accounting for about a third of the total. This continued until 2006, when both sources started to decline in relative importance, with retributions accounting for a slightly greater share. This situation resulted from the growth of "other" own source revenues (38-40 percent of the total from 2006-2008) and a more modest increases in profits from enterprises (in the 6-7 percent range). The other category is believed to be growing because of increases in income earned on local government savings.[13]

Second, although Law No. 28 (2009) provides considerable clarity about the revenue sources of subnational governments, with the exception of the newly devolved PBB and BPHTB and a few of the existing taxes continued under Law No. 28, such as the street lighting (electricity) tax and the hotel and restaurant tax, the local taxes allowed under

[11] Disaggregate data were not available for this version of the paper, but other work has documented variations, e.g. Lewis (2003a) and Kelly (2011) on the property tax.
[12] Lewis and Suharnoko (2009) document the trends in own-source revenues from 1994-2003. Later percentages were calculated from data obtained from the Ministry of Finance.
[13] This is elaborated in Lewis (2005) and Lewis and Suharnoko (2009).

Table 5: Provincial Revenues Pre- and Post- Decentralization (2008 Rupiah)

Provinces	**Pre-Decentralization**				**Post-Decentralization**					
Year	**1994***		**1999***		**2001**		**2004**		**2008**	
	Absolute value	**% of total revenue**	**Absolute value**	**% of total revenue**	**Absolute value**	**% of total revenue**	**Absolute value**	**% of total revenue**	**Absolute value**	**% of total revenue**
Own Source Revenue	15,245	33.1	9,331	37.3	18,498	39.3	33,119	49.3	44,514	46.0
Balancing Fund	30,721	66.7	15,660	62.6	26,710	56.7	28,927	43.1	42,989	44.4
Shared Taxes	2,432	5.3	2,730	10.9	8,039	17.1	12,783	19.0	14,906	15.4
Shared Natural Resources Revenue	1,409	3.1	1,916	7.7	6,223	13.2	4,134	6.2	9,434	9.8
Autonomous Region Subsidy/SDO	20,499	44.5	4,743	19.0	-	-	-	-	-	-
(Development) Presidential Grants/INPRES	6,381	13.8	6,271	25.1	-	-	-	-	-	-
DAU	-	-	-	-	12,156	25.8	11,991	17.9	17,942	18.6
DAK	-	-	-	-	292	0.6	19	0.0	706	0.7
Other Revenue	143	0.3	11	0.0	1,910	4.1	5,081	7.6	9,217	9.5
Total Revenue	**46,109**	**100**	**25,002**	**100**	**47,118**	**100**	**67,127**	**100**	**96,720**	**100**

*Data are from Arze del Granado, Martinez-Vazquez and Simatupang, 2007, p. 18. Post-decentralization data are from the Ministry of Finance.

All absolute values in constant 2008 Billion Indonesian Rupiah

Table 6: Kota/Kabupaten Revenues Pre- and Post-Decentralization (Billion 2008 Rupiah)

Provinces	**Pre-Decentralization**				**Post-Decentralization**					
Year	**1994***		**1999***		**2001**		**2004**		**2008**	
	Absolute value	**% of total revenue**	**Absolute value**	**% of total revenue**	**Absolute value**	**% of total revenue**	**Absolute value**	**% of total revenue**	**Absolute value**	**% of total revenue**
Own Source Revenue	6,242	12.6	5,968	10.3	9,738	6.7	14,784	8.3	20,244	7.3
Balancing Fund	42,954	86.8	51,492	88.7	130,547	89.7	148,748	83.5	233,114	83.6
Shared Taxes	6,908	14.0	6,145	10.6	10,814	7.4	20,000	11.2	23,973	8.6
Shared Natural Resources Revenue	901	1.8	1,142	2.0	15,854	10.9	12,802	7.2	27,663	9.9
Autonomous Region Subsidy/SDO	17,268	34.9	30,187	52.0	-	-	-	-	-	-
(Development) Presidential Grants/INPRES	17,872	36.1	14,016	24.1	-	-	-	-	-	-
DAU	-	-	-	-	102,244	70.3	110,602	62.1	161,073	57.7
DAK	-	-	-	-	1,636	1.1	5,342	3.0	20,406	7.3
Other Revenue	312	0.6	599	1.0	5,218	3.6	14,673	8.2	25,749	9.2
Total Revenue	**49,504**	**100**	**58,057**	**100**	**145,504**	**100**	**178,203**	**100**	**279,107**	**100**

*Data are from Arze del Granado, Martinez-Vazquez and Simatupang, 2007, p. 18. Post-decentralization data are from the Ministry of Finance.

All absolute values in constant 2008 Billion Indonesian Rupiah

Law 28 are not very important sources of revenue.[14] The story is different for provinces, which benefit from a number of generally more productive sources enumerated above.

Third, although the details and guidelines on defining bases and determining fee levels are clearly outlined in Law 28, the set of retributions allowed to the subnational governments is a seemingly ad hoc collection of limited-yield fees and charges that to a significant extent maintain past traditions of local revenue generation. Previous studies indicate that health and building permit fees dominate both provincial (more than 60 percent) and local (about 45 percent) retributions, with market fees also important (approaching 10 percent) for local governments. All other retributions represent small percentages of the total yield. Collectively, however, the numerous fees and charges that are individually unproductive account for more than half of local retribution revenues.[15]

A final potential concern is the burdens imposed on citizens and firms by subnational revenue generation, both in terms of the amounts paid and the compliance costs involved. The relatively low importance of own source revenues suggests that the burden of local sources should not be excessive. Limited empirical evidence seems to confirm this, although there are some indications that certain types of revenue, such as licensing, can be burdensome.[16] On balance, however, it does not seem that local revenue sources are of a nature or at a level where they are likely to cause major efficiency effects.

Newly Devolved Taxes

Given the potential importance of the heralded devolution of the urban and rural PBB and BPHTB, it is worth raising a few points about the provisions and implications of the law. The first is that, as noted above, PBB is considered a well-structured tax, and there have been great efforts to develop systems and procedures since the tax was introduced. Local governments will thus benefit from the reforms that have already taken place.

Another key point is that while the addition of these revenue bases to the local government resources is important, only a portion of the PBB is being devolved. The urban share of PBB is substantial (a third or more), but the mining PBB, which is not being devolved, is the dominant portion of the base.[17] Subnational governments will still receive revenues from the other PBB bases, of course, but as shared tax rather than own-source revenues. In addition, despite the significance of the new tax devolutions, these policy measures alone are unlikely to dramatically reduce the dependence of most subnational governments on intergovernmental transfers.

A number of other issues have been raised about the PBB devolution, but most relate to administrative and logistical concerns regarding implementation rather then to the design

[14] Recent data were unavailable for this draft of the paper, but Lewis and Suharnoko (2009, p.227) report that the electricity tax and the hotel and restaurant tax account for +/- 80-90 percent of local tax revenues.
[15] Recent data were unavailable for this draft of the paper, but data from Taliercio (2005) and Lewis and Suharnoko (2009, p.227) indicate the dominance of health fees and building permits at the provincial level. This is also true for local governments but to a lesser extent.
[16] Lewis and Suharnoko (2009) review this evidence.
[17] More recent data were not available for this paper; these numbers are based on Lewis (2003a).

of the taxes.[18] First, since local governments may elect not to collect PBB and BPHTB, there are questions about the potential failure to maintain important property related information where they are not adopted.

Second, there are potentially challenging administrative issues. These include how to ensure local government capacity to exercise the new autonomy over PBB and BPHTB exemptions and tax rates and to develop the regulations needed to use these taxes; how to deal with taxable properties, such as toll roads, that cut across more than one jurisdiction (previously managed by central administration); the difficulties involved in ensuring that declaration forms (SPOPs) are filed for every property (currently not the case) and in making these forms the (apparently exclusive) legal basis for issuing a tax bill (SPPT).

Third, there are possible issues with how collection and enforcement provisions are framed in the law. For example, the PBB due date is based on date of receipt (rather than issuance) of the tax notice, and there are appeal provisions for the tax bill but not for valuations. In addition, the law does not provide details on enforcement matters, such as sanctions and penalties for noncompliance. Concerns have also been raised regarding provision of the law that rules out the contracting of collection. Some of these issues require central government clarification and action, while others could be dealt with through local regulations.

Finally, and perhaps most important, the time frame for implementing the PBB devolution is very short, with a deadline of December 31, 2013. A devolution strategy has been outlined to phase in the PBB according to local authority clusters based on degree of urbanization (Table 7). Although this on many levels seems to be an appropriate approach, there are some potential concerns to which we return below.

Table 7: Local Government Clusters for PBB Devolution Strategy

LG Group	No of LGs	% of LGs	% of PBB Revenues
Cluster 1. Highly Urbanized LGs These large LGs with have strong PBB revenue bases and stronger institutional, human resources and systems capacity. They are expected to adopt the PBB from 2012 onwards.	30	6%	70%
Cluster 2. Medium Urbanized LGs These LGs, with smaller but strong potential for further urban growth (secondary urban centers). These have tremendous potential for property tax revenue growth, but do with wide variation in institutional, human resources and systems capacity. They are expected to adopt the PBB from 2012/2013 onwards.	100	20%	20%
Cluster 3. Less Urbanized LGs These LGs have historically low PBB revenue collections and less apparent potential for PBB revenue growth. The PBB is these LGs are currently administered by KPP jointly with other LGs for reasons of economies of scale and LG capacity issues. They are expected to adopt the PBB (if they choose to) from 2014.	360	74%	10%

Source: Kelly, Gyat, Nordiawan and Harahap (2011), p. 25.

[18] A detailed treatment of the positive and potentially problematic aspects of the devolution of PBB and BPHTB is provided in Kelly, Gyat, Nordiawan and Harahap (2011).

IV. Major Issues for Moving Forward

A number of issues are key in thinking about the possible future of own source revenues and shared taxes in Indonesia. Based on the discussion above, it is fair to ask whether the revenue system reforms taken to date have succeeded in giving subnational governments the access to the revenues they need to meet their responsibilities and serve their constituents. On the one hand, as indicated above, revenues in the aggregate have increased substantially since decentralization and the government has adopted important policy measures, both with respect to intergovernmental and own source revenues.

On the other hand, although own-source revenues increase most years, they have not grown substantially relative to total revenues, and there are also concerns that service coverage and quality are not commensurate with the volume of resources available to subnational governments. Service performance of course varies across services and jurisdictions, but there are indications that Indonesia does not perform very well in regional perspective.[19] Frustrations with continued heavy fiscal dependence on the center and concerns about the potential negative impact of inadequate services have led to calls for various policy measures, including further increasing subnational revenues.

This raises several questions. First and most fundamentally, do subnational governments in Indonesia in fact need access to more revenues? Second, if additional revenues are in fact required, what options might be available? Third, if access to additional revenues is provided, is it likely to be well utilized?

<u>Need for Additional Revenue</u>

There are three aspects to the question of whether subnational governments need access to more revenues. The first concerns requirements to meet their obligations. Although local governments have considerable service responsibilities under decentralization laws, and it would be easy to say (as it is in most developing countries) that they need additional funds to provide these services adequately. But there is not at present a strong empirical case that more funds are needed to cover services currently being provided.

In fact, although there is considerable variation among local governments, in the aggregate they are often in surplus[20] and, as noted above appear to have been increasing savings and associated interest earnings. Local governments should not be faulted for running surpluses, but idle resources in the context of the above-noted unease about inadequate service performance merit investigation. It is, of course, not possible to draw conclusions about the behavior of individual local governments without knowing more about the distribution of unspent resources, fiscal capacity absorptive capacity, and service deficiencies, and there are undoubtedly struggling local governments. It is not,

[19] Service delivery concerns are summarized in Lewis and Smoke (2009) and Lewis and Smoke (2011).
[20] Based on data from the Ministry of Finance covering 2001-2007, the surplus of revenues over expenditures for provinces ranged from 2.2 to 15.9 percent. The comparable range for kota and kabupaten was 2.3-13.7 percent.

however, unreasonable to consider whether some local governments do not spend the resources available to them because they receive more transfers than they need/can manage and/or face limited pressure to deliver services. In either case, incentives for local revenue generation from new sources would be undermined.

The second aspect of this question is whether subnational governments have sufficient revenue autonomy as per the requirements of conventional fiscal federalism principles. On this matter, there is a more substantial case that they do not. The pullback of revenue autonomy as per Law No. 28 (2009) was broadly seen as justified by the problematic way the authority was used, and the autonomy situation has somewhat improved with the devolution of PBB and BPHTB. At the same time, virtually all subnational taxes are subject to rate guidelines, many of which appear to simply maintain previous parameters and have no evident justification. In the case of PBB, some observers have noted that the maximum rate could be considered relatively low. There are also reports that many subnational governments already levy maximum rates on revenue sources, indicating that they may have limited scope to increase their yields unless they can expand the base.[21]

A third critical concern is the extent to which existing sources of revenue are being exploited effectively. It does not seem that very much is known about this, although there is a common perception that they are not. Available evidence about the performance of PBB largely suggests the exploitation of PBB dramatically increased after the tax was created for the purpose of consolidating and improving land and property based taxes in 1985, but that it is still underperforming.[22] Of course, the argument could be made that this situation may (or should be expected to) change when PBB is devolved to the local governments by 2014, especially in the kota since urban areas have more productive bases. This remains to be seen.

Regarding other subnational revenues, especially at the local level, there do not appear to be robust estimates of tax bases or the activities, entities and services that are subject to retributions. It seems likely that many of the allowable bases are rather limited, and the potential problem of reaching rate maximums was noted above. Without more information, it is not feasible to understand how effectively existing powers of taxation are being used or whether observed variations in performance are due to fiscal capacity or the (productive or problematic) behavior of local governments. There are, however, some indications of system weaknesses and administrative ineffiency that suggest subnational revenue yields could be significantly improved.[23] In addition, the central government's concerted efforts to improve local tax and charge administration imply considerable concern about the performance of the local governments on this front.[24]

[21] This is reported, for example, in Kelly (2011).
[22] See the discussion in Lewis (2003a) and Kelly, Gyat, Nordiawan and Harahp (2011)
[23] See, for example, Lewis (2006).
[24] Oosterman (2005) outlines an agenda for this purpose.

Options for Expanding the Subnational Revenue Base

If it were determined that subnational governments require additional revenues, what are some of the options available? The challenges of raising subnational revenue are pervasive, substantial and persistent, especially in developing countries.[25] At the same time, there are often opportunities for improving on the status quo.

A few points about the potential for tapping additional sources of subnational revenues seem clear. First, having disposed of many unproductive local sources in the past, it does not make sense to consider offering new sources to subnational governments unless they are likely to yield substantial revenues. This rules out many, although not all of the kinds of local taxes that are commonly used at the subnational level in developing countries.

Second, the most productive sources of revenue are, as is typically the case in developing countries, already being used by the central government, suggesting that major new subnational sources would likely need to be shared taxes rather than independent local taxes. If any of these bases were considered for sharing with subnational governments, it would be critical to understand potential national fiscal consequences. Furthermore, there would obviously have to be political support for additional sharing to be feasible.

Third, in adopting new sources, a decision would need to be made about the relative importance of the two central objectives of increasing revenues and increasing subnational government autonomy over those revenues. This would be reflected, for example, in choosing between a shared tax fully controlled by the central government and a piggyback tax in which the subnational governments could add on (within limits) to an existing central government base.[26]

Two candidates that have been proposed for tax sharing in Indonesia are the value added tax (VAT) and a piggyback tax on the personal income tax base (which is already shared). There may also be some scope for considering a limited number of additional local sources.

VAT Share

The general argument for sharing VAT with subnational governments centers both on improving revenue adequacy and helping subnational governments to overcome the challenges of administering the types of taxes typically assigned to them. Some analysts also make the case that subnational governments are particularly well positioned to help expand the tax base.[27] Local officials have greater opportunity than central entities to identify economic actors in their communities and to gather knowledge about their activities, assets, scale of operations, etc. They are, of course, are more likely to assist

[25] There is an extensive literature on this topic. Recent synthetic reviews of theory and practice include Bahl and Bird (2008), Smoke (2008), and Bird (2011).
[26] In both cases administrative efficiencies would result from the tax being centrally administered.
[27] See, for example, the discussion in Bahl and Bird (2008) and Bird (2011).

with base identification if they have direct access to the resulting revenues. These realities have generated recommendations for central governments to share VAT in various ways.[28]

The sharing of VAT through a general intergovernmental transfer pool is not uncommon, and a number of countries have direct arrangements for sharing the dedicated proceeds of VAT.[29] To varying degrees and in different ways, VAT is shared in Australia (with states), Germany (with states), Russia (with regions) and Spain (with regions). Certain Canadian provinces receive proceeds of the federal VAT. China shares 25 percent of VAT with provinces, which also receive part of the central government's share of increases in VAT revenues. In Brazil, 25 percent of the state VAT, which is a dedicated state tax but with rates set by the federal government, is shared with municipalities, 75 percent on origin and the rest by formula. A subnational VAT can be complicated and there have been challenges in each of these cases, but there are ways to mitigate likely problems and the revenue generated can be important for subnational governments.

Proponents of sharing Indonesia's VAT argue that general consumption taxes, at 4.2 percent of GDP, are low compared to a regional average of 7.5 percent.[30] The claim is that, if properly structured, this tax policy move would substantially increase the level of subnational revenues without creating a major administrative burden on subnational governments. The possibility of merging the hotel tax and the restaurant tax into the VAT base is also raised as a possibility, thereby reducing by two the number of separate local government taxes and simplifying the overall tax structure.

Sidik (2011) developed estimates of the revenue impact of VAT sharing assuming that 20 percent of the national tax proceeds would be shared with subnational governments on the basis of consumption (using GRDP as a proxy for consumption). Of the total subnational share, 20 percent is proposed to be allocated to the provinces and the remaining 80 percent to the kota and kabupaten.[31]

In this formulation, the VAT share would exacerbate interjurisdictional disparities, but this could be offset by modifications to the DAU formula, or alternative tax sharing mechanisms could be devised. In addition, this version of VAT sharing increases the revenues of subnational governments, but it does not increase their revenue autonomy since they would have no control over the base or the rate of the tax. If the proposal to incorporate the hotel tax and the restaurant tax into the VAT base were realized, the local government would lose the (modest) autonomy they have over those revenues unless

[28] Subnational VAT is discussed in (Bird 1999, 2001, 2005, 2011), McClure (2000), and Bahl and Bird (2008). Bird also discusses the potential advantages of subnational business value taxes, a VAT levied on the basis of income (production, origin) rather than consumption (destination).
[29] More information on the country examples can be found in Bird, Ebel and Wallich (1995), Martinez-Vazquez and Boex (2001), Shah (2004), Martinez-Vazquez, Timofeev and Boex (2006), Bahl and Bird (2008), and Sidik (2011).
[30] The case for subnational sharing of VAT in Indonesia and a detailed discussion of a proposal for doing so is based on Sidik (2011).
[31] Additional assumptions are made in conducting the analysis as outlined by Sidik (2011), pp. 55-62.

those components were somehow structured as a local government add-on to the VAT, but that could increase administrative complexity.

Perhaps the most challenging obstacle to sharing the VAT is that this reform also reallocates a considerable amount of revenue from the central to the subnational governments. More consideration would have to be given to the impact on the national budget and the political receptivity to considering such a mechanism. On balance, the sharing of VAT and its likely and potential effects merit further study, but the need for these revenues would have to be demonstrated and a pragmatic method for sharing VAT that limits potentially problematic effects would have to be developed.

Personal Income Tax Piggyback

As indicated above, income taxes in Indonesia are a national level revenue source collected by the central government, which shares 20 % of the proceeds of personal income tax (PIT) with the provinces and kota/kabupaten on a derivation basis (See Table 4). Because of the way PBB and PIT are shared, PIT is more important for provinces. In 2007, for example, PIT accounted for nearly 60 percent of shared revenues at the provincial level and only about 10 percent at the local level. The idea of allowing subnational governments to add a surcharge on the income tax has been floated by proponents of devolution ever since the decentralization era began in Indonesia.[32]

A number of industrialized countries have experience with subnational governments piggybacking on income taxes of higher-level governments, including the US, Canada, the Nordic countries and Switzerland. This is practice is not common in developing and transition countries, but it is done, for example, in Brazil and Croatia.[33] Denmark, Norway and Sweden allow local governments determine a flat rate that is charged on the same base as the national income tax. Most Canadian provinces levy their surcharge as a percentage of the federal income tax liability. In Switzerland, local surcharges piggyback on income taxes that are levied and collected by the Cantons. Brazil and Croatia allow subnational governments to piggyback modestly on the personal income tax. Some other countries, such as Russia and Kenya, share the personal income tax to varying degrees with subnational governments, but they do not allow piggybacking.

An income tax surcharge offers several advantages. A key benefit is that subnational governments would enjoy more autonomy if they have an element of control over the tax rate. At the same time, increased autonomy does not substantially increase administrative burdens or compliance costs for taxpayers since the surcharge is based on the taxpayer's national income tax liability. The revenues are collected and administered by the central government, which returns the proceeds of the surcharges to the originating jurisdictions. Finally, access to the income tax gives subnational governments a way to offset the

[32] See, for example, Sidik & Kadjatmiko (2004) and Simanjuntak & Mahi (2004)
[33] Examples are discussed in Bird, Ebel and Wallich (1995), Shah (2004), Bahl and Bird (2008).

limited buoyancy typical of local tax bases, and some control over the rate would allow them to better cope with revenue volatility that may come from various sources[34]

A number of options for adopting a personal income tax surcharge could be explored in Indonesia, depending on whether such a reform must be revenue neutral from the perspective of overall public sector income.[35] The central government may be willing to accept the possibility of a higher overall tax/GDP ratio. If it were necessary to reduce national tax rates on various income categories to free up tax space for the subnational governments, the subnational rate range would have to be set carefully to minimize potential effects on the overall progressivity of the system and to limit possible efficiency effects. Other decisions would also need to be made, such as whether the tax rate is based on residence or employment. And of course subnational governments would no longer be entitled to the 20 percent share of the personal income tax that they currently enjoy.

Despite the advantages, there are clearly challenges involved. A key factor behind the reluctance of most developing countries to share the personal income tax is that central governments themselves face great challenges in administering income tax productively due to both administrative issues and base limitations. In addition, such an arrangement would further exacerbate interjurisdictional fiscal disparities. Thus, if an income tax piggyback were considered to be politically feasible, careful analysis would be required to frame possible options as well as the advantages and disadvantages of each, and decisions would need to be made about how to offset increases in fiscal disparity.

Additional Subnational Revenues

There does not seem to be great scope for adding additional productive local sources. As noted above, having taken steps to get rid of the most unproductive local revenue bases, it would be counterproductive to add more of the same in the quest to enhance subnational revenues. There are, however, a few sources that might be considered.

One source that may merit exploration is consolidated business licensing. On the one hand, various types of local licensing occur under the retribution provisions of the enabling legislation, and some analysts argue that much of the burden of local taxation also falls on businesses. On the other hand, licensing appears to be fragmented, sometimes burdensome in terms of time costs imposed on businesses, and potentially prone to corruption.[36] Businesses may need a wide range of permits and licenses in order to operate, and there may be some scope for further rationalization of the system.

There is reasonably broad agreement that local governments have a comparative advantage in licensing and regulatory activities, both because they can better identify local businesses than the central government and because the relative revenue potential

[34] Useful summary discussions can be found in Martinez-Vazquez, Timofeev and Boex (1996) and Bahl and Bird (2008).
[35] Sidik (2011) explores a number of options in more detail.
[36] See the discussion in Lewis and Suharnoko (2009).

for them is considerably greater. Business licensing/taxation at the local level is pervasive around the world. It takes many different forms, but in developing countries some form of licensing is very common.[37] Many of issues and challenged noted with respect to Indonesia are common, but there are ways to deal with them.

An approach that has been held up as a model way to approach business licensing, the single business permit (SBP), was developed and adopted in Kenya in 2000. Kenyan local governments had been suffering from the same types of local licensing issues faced by other countries.[38] The SBP consolidated a set of fragmented licensing requirements managed by both central and local government agencies into a single licensing framework under local government control. It decoupled licensing from complex regulatory requirements, broadened the base, eliminated the need for multiple licenses for a single premise, simplified the licensing process, and developed a simplified and systematized a rate structure to reduce inefficiencies and inequities (while still allowing local governments some discretion over rates).

Licensing rapidly evolved from being an arbitrarily structured, poorly administered and unevenly productive source of revenue to a more consistently productive and buoyant source of revenue for many local governments. In some local governments, SPB revenue yields grew to surpass the revenue yields from the property tax, and they are almost universally in the top two or three local own-sources of revenue.

It is not clear that the SBP model would be beneficial in Indonesia, and a decision to adopt something like it would require the amendment of Law No. 28 (2009). Given the problems identified with business licensing, however, it would at a minimum seem worthwhile to better document the licensing situation (i.e. mapping and analyzing licensing requirements and how and through which agency various licenses are issued). Depending on the results, there may be grounds to consider how the application of some of the principles embodied in SPB could help to improve the structure, administration and yield of local business licensing in Indonesia.

Other local options may also be worth considering, but some may not be regular sources of recurrent revenue or may involve piggybacking on existing sources. For example, betterment levies could be a useful way to capture some of the costs of infrastructure financing and improve the ability of creditworthy local governments to borrow. Although it may not be consistent with existing legislation, covering the costs of certain services with add-ons to the newly devolved PBB might be a better way to enhance own source revenue yields than establishing additional sources.

[37] Devas and Kelly (2001) provide a synthetic review of the practice of and the literature on local business taxation in developing countries. Other good treatments include Bahl and Bird (2008) and Bird (2011).
[38] This revenue source is discussed in Devas and Kelly (2001), Smoke (2008) and Government of Kenya (2011).

Using Revenue Authority

Having a well defined intergovernmental fiscal system that meets even the most demanding normative principles of fiscal federalism will not guarantee strong subnational government performance in general or with respect to revenue generation. Whatever the structure of the system, subnational governments must have the capacity to manage their responsibilities effectively and they must face adequate incentives, only some of which can be embedded in the intergovernmental fiscal framework.

Subnational government capacity has long been a target of the central government and has received considerable support from international development partners. Issues may be raised about the nature and adequacy of these efforts but there can be little doubt that subnational governments enjoy better systems and have greater capacity today than they did before decentralization.[39] At the same time, it is inevitable that some Indonesian subnational governments have less capacity than others and need addition support.

Even robust capacity requires the discipline of incentives for good performance to be realized. Incentives for subnational revenue generation and performance in general come from one of two sources—the central government or citizens/constituents. Conventional fiscal federalism frames local autonomy essentially as a right protected in constitutional provisions, laws or other enabling regulations.[40] In this view, the primary role of the center is to develop appropriate intergovernmental structures, systems and procedures. If the framework meets certain norms, e.g., devolves appropriate expenditure and revenue functions, establishes a hard budget constraint, provides for redressing fiscal disparities, etc., local accountability can be primarily driven from below through elections.

A more nuanced view frames decentralization as a complex and evolving process of managing an appropriately evolving balance between national goals and local autonomy. From this perspective, decentralization requires a capable center that not only develops and enforces systems and standards, but also supports local capacity development and helps to promote a climate for accountable local governance.[41] In such an environment, central incentives for local government performance can play an important role in furthering national priorities, promoting the adoption of fiscal reforms and stimulating behavioral changes needed to improve local processes and outcomes.[42]

[39] Concerns have been raised about fragmentation across types of capacity and providers of capacity building services, an imbalance between supply and demand driven capacity building, and excessive focus on classroom versus on the job training, among others.
[40] These arguments are developed more fully in Lewis and Smoke (2011). First generation fiscal federalism is outlined in Oates (1972) and second generation in Oates (2006) and Weingast (2009).
[41] Relevant literature includes Tendler (1997), Shah and Thompson (2004), Smoke, Gomez and Peterson (2006), Smoke (2007), Connerley, Eaton and Smoke (2010), Yilmaz, Beris and Serrano-Berthet (2010) and Martinez-Vazquez and Vaillancourt (2011).
[42] National political dynamics, of course, must be such that the center will create incentives for desirable behavior. The political economy of decentralization is reviewed in Eaton, Kaiser and Smoke (2011).

At the same time, citizens must be connected to (and have adequate information about) their local governments for the benefits of fiscal decentralization to be realized. Citizens are critical but often-neglected actors in the largely technical world of subnational public finance. Nobody likes taxes, but there is evidence from several developing countries that suggests individuals fail to pay local taxes in great part because they do not feel they are receiving adequate services and, more generally, that they simply do not trust their local government to act beneficially on their behalf. [43] Other factors—enforcement, avoidance of corruption, discomfort with moving beyond a culture of subsidy, inability to pay, etc.—also matter, of course, but the basic social contract between citizens and government is a fundamental consideration in effective revenue generation.

What does this broader discussion mean for Indonesia? The central government has provided only very limited incentives for subnational fiscal performance in general or for subnational revenue generation specifically.[44] The few incentive features of the revenue system include the use of a minor incentive for PBB collection, which was noted above, and a weak revenue incentive used for allocating part of the DAU. There have also been some modest efforts at expenditure side incentives, e.g. the earmarking of a share of oil and gas revenues for education and incentives built into the structure of the DAK.

There is some evidence that increases in transfers in Indonesia are associated with higher levels of own source revenues.[45] It seems likely, however, that this results not from the stimulative effects of transfers, but from the interest earnings on the increased reserves associated with the growth of transfers.[46] There is also some evidence that higher transfers are associated with reduced cost efficiency in local tax administration, suggesting that transfers may undermine effective revenue collection.[47]

On the downward accountability side, despite the service delivery issues noted earlier, many Indonesians claim to be satisfied with services provided by their local governments and express little appetite for paying more for them.[48] A number of explanations can be advanced to explain this apparent paradox. Citizens may simply have low expectations. This could result from a general lack of faith in the ability and incentives of local governments to improve services, perhaps due to past experiences with poor responsiveness or corrupt practices on the part of local elected officials and staff. In addition, citizens may have limited information about what they are entitled to, and they may have no basis for comparing the types and quality of services provided by (and the revenues raised by) other local governments in Indonesia, much less in other countries.

[43] These issues are reviewed in Brautigam, Fjeldstad and Moore (2008) and Smoke (2008).
[44] These incentives are discussed in more detail in Lewis and Smoke (2011).
[45] See Lewis (2005) and Fadzil and Nyoto (2011).
[46] Lewis and Suharnoko (2009) suggest that increased interest earnings on unspent balances may explain up to half of own-source revenue growth in the post-decentralization period. Lewis and Oosterman (2009) caution that this requires further investigation but not policy action at the present time.
[47] This evidence is presented and discussed in Lewis (2006).
[48] This evidence is presented and discussed in Lewis and Pattinasarany (2009) and Lewis (2010).

Taken together, these realities raise concerns about taking a "hands off" traditional fiscal federalism approach to expanding subnational revenues in Indonesia. In the absence of national incentives for increasing revenue generation to improve service delivery and with the possibility of weak pressure from citizens to provide better services, increased subnational government access to revenues may not be effectively utilized, the proceeds may not be spent well, and citizens and businesses may be reluctant to comply.

V. Looking Forward

In thinking about the possible future of own-source revenues and shared taxes in Indonesia, a number of efforts would be worthwhile. First, it would be valuable to collect additional information and conduct some additional applied policy research about the present situation and possible additional revenue options. Second, the central government could examine possibilities for developing incentives to promote effective use of the additional resources. Third, means to assist the subnational governments in adopting new revenue sources could be organized. Fourth, ways to better connect citizens to subnational revenue generation could be devised.

Additional Information and Policy Research

Although some revenue reforms could be undertaken right away, it would be useful for multiple purposes to better document subnational government expenditure needs and fiscal capacity. As noted above, beyond a few sources, information on subnational government revenue bases appears to be limited. There is some evidence of issues with collection efficiency, but to fully understand the extent to which existing sources are being exploited, broader and more systematic information on bases, rates and collection performance is needed.

A number of possible sources of additional revenue were outlined above. Several advantages and disadvantages of each source were discussed, but on the basis of general principles and limited information. Further information on and analysis of each source would allow policymakers to take more informed decisions about feasibility and requirements.

Some individual subnational governments in Indonesia perform better than others in revenue generation. It would be valuable to study these cases in depth to understand how they have managed to attain better results than some of their peers. In some cases, of course, stronger performance will simply result from better fiscal capacity. In other cases, however, subnational governments may have adopted innovative technical and governance approaches to better exploit their available revenue bases.

Further information on how citizens view subnational government revenue generation and service delivery may also generate ideas about how to proceed with reform. The various survey results referred to above provide information on the attitudes of citizens and firms, but apparently not much on the reasons for these views and what that implies

for how to get their support—as the people who elect local governments and pay local revenues—for improved collection or policy changes on revenue generation that ultimately require their cooperation to be successful.

Strategy and Incentives

Revenue generation incentives for subnational governments are notoriously difficult to implement. Most fundamentally, they are unlikely to work unless they are properly designed and other aspects of the subnational system are improved. For example, local governments may be unwilling to increase revenue effort if they feel they can get by on transfers, citizens are unlikely to pay more revenues to local governments if they do not see the service benefit of doing so, etc.

The typical fiscal mechanism for incorporating revenue incentives is the transfer system. As noted above, the DAU and the DAK only weakly serve this purpose. DAU could be a relatively powerful instrument in this regard, but realizing its potential faces the powerful dual challenges of securing appropriate data and overcoming possible political resistance to a major overhaul of the general transfer system. This option obviously merits exploration, but it seems unlikely to proceed quickly or easily. Increased public debate about issues with the current system may help build an eventual consensus for reform.

A different option is to consider how to better use the DAU for this purpose. At present, DAK schemes require local contributions, but not in a way that is likely to lead to institutionalized revenue generation improvements. If one condition of providing DAK resources for particular sectors were, for example, improving design and enforcement of particular revenue sources, such as associated user charges, this could contribute to a process of more sustainable local resource mobilization. Perhaps there could even be a DAK structured specifically to deal with operation and maintenance challenges and the systemic regularization of the resources required to meet these needs. This will only work for places that need or want DAK revenue, but not every incentive mechanism needs to be applicable for all subnational governments.

Another avenue to provide incentives for revenue generation could be in the way that new policies are implemented. Subnational governments in Indonesia clearly differ in terms of both capacity and performance. If additional tax sharing, piggybacking or own source revenues were allowed, requirements could be attached on rolling them out. For example, there could be minimum conditions of access to the use of a new source and/or a series of conditions intended to trigger progressively greater access to revenue sources through additional components of a base, allowing more latitude with setting rates, etc.

This kind of approach will be challenging and controversial. Designing such reform efforts would require considerable information and a system for measuring progress and performance once new authority has been granted. There is a danger that such efforts could become overly bureaucratic, that subnational governments could end up stalling where they started, and that the process of authorizing additional authority and autonomy

could become arbitrary or politicized. To reduce these risks and establish credibility, careful thought would need to be given to the management structure for such a process, which may need to include actors beyond the staff of central government ministries.

In addition to the implementation challenges, there is no doubt that many decentralization enthusiasts will strongly oppose this type of approach on the conventional grounds of the inviolability of subnational authority and autonomy in a devolved system. (The attendant asymmetric treatment of subnational governments under such an approach, of course, also faces political challenges). Such conceptual purity, however, may be increasingly difficult to defend in an environment where revenue performance and service delivery performance are, in the aggregate facing great challenges after more than a decade of devolution. There is increasing concern and some evidence that unbridled and non-strategic decentralization in developing countries can result in poor outcomes, and over time even lead to a shift in national political momentum that allows the central government to nontrivially claw back the established rights of subnational governments.[49] Thus, if there is genuine concern about performance, development and preserving significant decentralization, a case can be made that subnational government authority and autonomy must to some extent be earned.

In framing further revenue decentralization in this way, there are also opportunities to tie capacity building to the rolling out of reforms. The proposed program for implementing the PBB mentioned earlier is an example of such an approach (Table 7). In that case, the implementation strategy is based on clusters of local governments organized by level of urbanization and presumed capacity (fiscal and technical) to benefit from the devolution of PBB. One question is whether there is sufficient strategic differentiation in the rollout that recognizes likely variations in capacity and past performance within each cluster. Such fine-tuning of the process may not be feasible for PBB because of the legislatively imposed deadlines for implementation, but there may be some scope for strategic asymmetry, and efforts along these lines could be considered for future reforms.

One more type of incentive that may be of interest is based on recognition of performance and may but need not involve financial rewards. There has been considerable interest in tournament approaches in developing countries, for example, in which subnational governments receive awards for superior performance on a wide variety of fronts.[50] Acknowledgment of achievement for revenue generation probably does not have the same appeal as an award for being an exceptionally environmentally conscious or highly innovative local government, but there may be ways to tie exceptional revenue generation improvement to the ability of a local government to improve services or provide some other visible output.

[49] This literature is reviewed in Smoke, Gomez and Peterson (2007), Dickovick (2011) and Smoke (2012).
[50] A conceptual framework for thinking about incentive programs and case studies of a wide variety of experiences (not only subnational governments) is provided in Zinnes (2009).

Subnational Government Action and Support

Although there is, as noted above, a possibility that some subnational governments will not be interested in improving the use of existing revenue sources or raising revenues from new sources, others surely will be. They may need support to better tap their revenue bases, and an important role of the central government is to offer such assistance.

There have, of course, been many efforts over the years to support Indonesian local governments to improve revenue generation, but many have been relatively supply driven and some have been attached to donor projects that have come and gone. In a devolved system, it makes more sense to offer resources and support—for analyzing local revenue potential, adopting new mechanisms for revenue administration, developing education and consultation processes around revenue improvement, etc.—where it is requested. Stronger incentives for local revenue generation should increase demand. Setting up a mechanism for local governments to share positive experiences in revenue enhancement and how they were achieved could also prove valuable.

Connecting to the Public

Ultimately most of the above suggestions are primarily technical fixes that are unlikely to have a sustained impact without support from the public. Decentralization does not work unless citizens come to expect more of their local governments and learn how to hold them accountable. This requires a degree of awareness, capacity and interest on the part of citizens, and such conditions do not typically emerge spontaneously or automatically.

The design and implementation of subnational revenue systems rarely pays much to connecting with taxpayers beyond technical mechanisms, such as the use of self-declaration for property tax purposes or adoption of appeal processes. Much more effort has been given to engaging citizens on the expenditure side, for example through participatory planning and budgeting. Such mechanisms could potentially also be employed to gauge citizen views about local revenues and to provide them with information about how the resources they contribute to the local treasury are used, but participation in such exercises is self-selected and usually limited.

Broader public awareness-raising programs and access to reports and data can help to keep citizens better informed, make them aware of their rights and responsibilities, and provide them with information that can help them to understand how revenue rates are set and how revenue proceeds are used. In some cases, it may be feasible and appropriate for a higher level of government to take this a step further and robustly promote citizen activism for holding their local governments accountable for resource use. Such efforts are unusual, in large part because of the political sensitivities involved, but they have the potential to be very effective.[51]

[51] Tendler (1997) examines a case in which a reformist state government in Brazil took unusual measures, including steps to energize citizens to place demands on their municipalities.

It would be particularly beneficial to link new efforts to generate local revenue as directly as possible to service delivery expansion and quality improvements. Sometimes this can simply involve public education campaigns, but it may in some instances be feasible for local governments to negotiate certain types of revenue increases with affected groups. For example, efforts could be undertaken to negotiate improved tax compliance with chambers of commerce and citizen groups seeking specific service improvements or with user associations over user charges for a specific service or facility.[52] Such activities are not part of typical local revenue reform programs, and they do not represent systemic changes. But if some efforts are successful in bringing positive results (e.g. simultaneous public facility improvements and increases in PBB collection rates or cost recovery through user charges), they could create a demonstration effect that promotes a gradual alteration of the fiscal relationship between subnational governments and their citizens. They will, however, only be suitable for certain types of revenues.

The need for such approaches and the extent to which they would be useful likely varies across Indonesia. There are already many citizen engagement mechanisms, and some might be adapted to pay more attention to the revenue side. It could also be productive to explore how to use lower tiers, such as kecamatan, in moving forward. The Program Nasional Pemberdayaan Masyarakat (PNPM) has been a powerful force in empowering communities and delivering services in Indonesia.[53] It is not clear, however, that the learning from PNPM has translated into better citizen engagement with elected local governments, the entities with legal authority and regularized resources to sustain local service delivery. Closer cooperation between local governments and PNPM has the potential to yield considerable benefits, perhaps including more kecamatan involvement in educating people about local revenues and perhaps even assisting in some way with collection efforts.

VI. Concluding Statement

Indonesian subnational governments have received additional revenue authority and experienced fairly consistent growth in revenues since decentralization, including those from own sources. Despite this, many of them, especially kota and kabupaten, remain fairly dependent on resources provided by the central government. Even with the devolution of PBB and BPHTB, there is a need for additional revenue autonomy and probably some need for additional revenue sources.

At the same time, a few points of caution are in order. First, the expansion of the subnational revenue system needs to be based on adequate information and a systematic evaluation of options. Second, decisions about devolving or sharing new revenues should be assessed in the context of the broader fiscal system—the potential impacts of new sources on incentives to collect existing sources, the influence of the volume of transfers on inclinations to take advantage of new sources, the incentives and capacity of

[52] Smoke (2003) reports some instances of this in Kenya.
[53] PNPM evolved out of the internationally celebrated Kecamatan Development Program (KDP) and Urban Poverty Project (UPP).

subnational governments to deliver services for which they are collecting revenues, and so forth. Third, factors beyond the traditional concerns of fiscal decentralization analysis, such as the extent to which the constituents of subnational governments feel adequately served and how this affects their willingness to pay new revenues, could be productively incorporated into some aspects of the analysis. Something is known about all of these issues, but almost certainly not enough to provide insight for major reforms.

Assessing revenue expansion in this way requires thinking beyond the standard analyses used to define revenue reforms and the mechanisms typically used to implement them. Building better incentives into transfer systems and processes for implementing new revenues and creating better linkages to the citizens who pay subnational taxes and fees have been suggested for additional consideration, and no doubt other ideas could emerge through further discussion. There will be debates about which approaches are legitimate and how to deal with the additional effort involved. Doing more about connecting to citizens regarding revenue generation where appropriate, for example, would require reformers to think outside of their comfort zone, and designing appropriate initiatives will not be easy. The need to improve subnational revenue generation on various fronts, however, suggests that gains could be realized from pursuing broader and more innovative approaches to crafting reforms and making them work on the ground.

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