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International Studies Program
Andrew Young School of Policy Studies
Georgia State University
Atlanta, Georgia 30303
United States of America

Phone: (404) 651-1144
Fax: (404) 651-4449
Email: ispaysps@gsu.edu
Internet: <http://isp-aysps.gsu.edu>

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DRAFT

MANAGING LOCAL REVENUE IN INDONESIA

Raksaka Mahi ^{*)}

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Introduction

The role of local owned revenues had been very small for a long period of time. In the past, almost ninety percent of total district's revenue came from central government transfers and subsidies. Moreover, those transfers were mostly for specific purposes; such as Presidential Instruction Fund (INPRES) and salary expenditure fund (SDO). Therefore, there was a little freedom of local governments in their financing policy. Such a situation is expected to change with the implementation of regional autonomy laws. Both Laws, No.22/1999 and No.25/1999, are supported by other laws and the implementing regulations. Law No.34/2000 is considered one of the most important laws that support regional autonomy. It is basically a revision of Law No.18/1997, which regulates types, tariff and administration regulation of local taxes and other local revenues (retribution, local state owned revenue and others). Under Law

^{*)} **Dr. Raksaka Mahi** is Vice Dean for Academic Affairs at the Faculty of Economics, University of Indonesia (FEUI). The author is also Senior Research Associate at LPEM-FEUI, and member of the Assistance Team for fiscal decentralization policy to the Minister of Finance, Republic of Indonesia. This

No.34/2000, there is more flexibility of local government in generating their local revenues.

The implementation of Law No.34/2000, however, does not guarantee that local government revenue will increase significantly. Those depend on *types of revenue* permitted to be collected, and *the local government revenue optimizing strategy*. Law No.34/2000 still limits local taxes to seven major taxes, which are considered as non-buoyant taxes. It means that the tax base is not elastic and relatively small. Moreover, local revenue strategy is still considered not optimal; hence, actual revenue is far from the potential one.

This paper attempts to elaborate the problems and strategies of local government to achieve more local revenue from the available taxes and user charges. It also evaluates the economic consequences of illegal local government regulations. Based on the past performances, this paper also suggests several improvements on local tax policy and administrations. Finally, this paper ends the analysis with suggestions and recommendations for improving the role of local revenue in the regional autonomy era.

Local Revenue Generation Under Law No.18/1997

Local owned revenue comprises mainly revenue from taxes, charges, profit from local government enterprises, and revenues from technical units (“Dinas”). Local owned revenue has never been important revenue for local governments, except for few regions that have a good local tax base, such as regions with many hotels and restaurants. Most local revenue has a narrow tax base. From 1998, local revenue has been guided by Law No.18/1997. This law was enacted to answer inefficiency problems related to the

implementation of previous taxes and user charges. The Law No.18/1997 has abolished some taxes and user charges that created economic distortion in the past. The followings are the main features of Law No.18/1997:

- Some distorted taxes and user charges are completely abolished. Some taxes/user charges were abolished due to a high distortion on the economy. Such taxes/user charges include fees on interstate transportation.
- Reduction on tax base. There are some taxes that their tax base had been limited by Law No.18/1997, for example, the tax on hotel and restaurant. Previously, the name of “Pajak Pembangunan” (development tax) was applied to any hotel, restaurant and other food services, including home food service delivery (catering). Law No.18/1997 has reduced the tax base into hotel and restaurants only. Since it has been limited to hotel and restaurant, the name of “development tax” is replaced by tax on hotel and restaurant.
- Tariff (fee) adjustment. The same types of charges are still present; however, tariff rates have been deregulated to reflect the cost of delivery for some services. According to Law No.18/1997, a tariff imposed on services must reflect only the provision cost of the service. As a result, some services require a significant adjustment on their tariff rates. In most cases, those lead to a lower tariff rate. For example, building renovation fee is calculated based on the number of paperwork needed to provide the license. In the past, the size of renovation has been the basis for determining the fee.
- Introducing revenue sharing from gasoline and land/building transfer tax to compensate revenue reduction. A reduction on some taxes/user charges was expected to reduce fiscal capacity of most regions. To help the local government adjusting with Law No.18/1997, two shared taxes were introduced for local governments; gasoline and land/building transfer taxes. Central government collects the taxes and allocates the shared-taxes to local government by using indicator variables, such as the length of local roads.

The implementation of Law No.18/1997, however, has restricted local governments from previous broader taxing power. The design of Law No.18/1997 requires that a decrease in local revenue would be compensated by gasoline tax sharing. Unfortunately, such compensation did not work well. Gasoline tax sharing allocation to the local governments often came late. Moreover, the amount allocated was mostly

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sharply reduced from the original amount promised by central government. With such a condition, most local governments tend to direct their tax policy by optimizing their own local taxes. Unfortunately, the crisis came and hit the Indonesian economy. Many companies and working people were out of business. Such a situation reduced local revenue bases. The impact of the crisis and the implementation of the law came at the same time. In order to understand the impact of the crisis separately from the impact of the Law, one should distinguish them. A study by LPEM in 1999 shows a heterogeneous impact of the crisis and Law No.18/1997 on local financial position.

By comparing the “impact of economic crisis” and the “effect of the Law”, we find some interesting patterns of how crises actually affect local government revenues:

- There are regions that enjoy an increase in revenues due to the Law, and the crises apparently give additional boost to their revenues.
- There are regions that enjoy an increase in revenues due to the Law, but the gains were being made marginal by the crises
- There are regions that experience a decrease in revenues due to the Law, but crises made them experience an increase in revenue.
- Finally, there are regions that experience a decrease in revenue due to the Law, and the crises made them suffer even more.

As we can see, crises affect both Java and non-Java local governments. More than half of sample local governments suffers from the crises. Generalization, however, should be made carefully on the basis on this finding.

It may be interesting to outline several examples to illustrate the way crises reduced the gains that the Law No. 18/1997 had produced.

- In general revenue from taxes on hotels and restaurants are declining. Field interviews suggest that this due less number of people eating outside and less official travels as a result of business slowdown.

- We see a sharp decline in revenues from IMB (or, building license) and this mainly attributed to credit squeeze, sharp increase in the prices of building materials, and the sharp contraction in the property sector.
- We see a moderate decline in revenues from TPR (a charge on bus terminal). This is mainly attributed to the reduction in the vehicles running time (due to high operating costs) and a drastic decline in the number of passengers (especially during the evening).
- Our field interviews also suggest that the decline in revenues from Pajak Tontonan (taxes on shows and cinemas). The explanation is purported to be due to real and or perceived fears of personal safety from travelling in the evening. Of course the fall in real personal income contributes to the fall in the revenue base of this levy.

As a consequence of fiscal decentralization policy, as mandated by Law No.25/1999, there are some revisions required for Law No.18/1997. The revision relates to the weaknesses of the Law, among others are:

1. *Narrow Local Tax Base.* The role of local owned revenue is considered small in total local revenue. Moreover, most of taxes and user charges are not buoyant and derived from a narrow tax base. It is also complicated with weak revenue planning and administration. According to Law No.25/1999, regions with small revenue capacity are obligated for a block grant transfer (“Dana Alokasi Umum”) from central government. However, high dependency on transfers from central government in the past had created unstable flow of revenue for local government. In the past, a late transfer or “uncorrected amount of transfer” had caused a significant problem for local government, especially in their budgeting process.
2. *The Decreasing Role of Provinces.* According to Law No.22/1999 and its implementation regulations, the role of province might be reduced. Provincial role will be limited to coordinating activities, and most of project implementation will be delegated to regencies and municipalities (“kabupaten” and “kotamadya”). This leads to relatively a higher spending need for regencies and municipalities than provinces. Therefore, regulations are needed to increase local taxing power of regencies and municipalities, also to increase the amount of shared tax for municipalities and regencies.
3. *Urban-biased revenue.* According to Law No.18/1997, tax bases of current local taxes and charges are not fairly distributed among regions in Indonesia. Urban local government (“kotamadya”) has a relatively larger tax base compared to rural local government (“kabupaten”). Therefore, improvements on Law No.18/1997 are needed to give more tax bases for rural local governments.

4. *Uniform taxes and charges.* Law No.18/1997 has introduced uniformity of taxes and charges among regions in Indonesia. To some extent, this regulation does not support the decentralization process, where regions basically should have some freedoms in determining types of revenue collected within their territory. In a limited scope, the improvements of Law No.18/1997 can be done to open possibilities of local governments in determining their own types of revenues.
5. *Instability of Gasoline Tax Sharing Allocations.* The design of Law No.18/1997 has assured that no regions will be worst off from the implementation of the law. Shares from gasoline and building/land transfer taxes have been estimated to be enough to compensate a reduction on local revenue. However, the amount allocated was not as predicted by local governments. Some of them received less than targeted revenue. Therefore, reliance on tax sharing, to some extent, can create instability in local government budgeting process. To support decentralization, additional local own taxes/user charges should be granted to local government, to assure stability in local budget.
6. *Little incentive effect to the investment.* Having evaluated taxes and user charges of Law No.18/1997, we found that no taxes or charges are strategic enough to stimulate local economy. Most taxes and charges are considered as consumption taxes, and have little effects on business decisions, such as investments. Therefore, to attract the competitiveness of regions for investments, a strategic tax should be introduced to the local governments. In developed countries, property tax has been used by local government to attract the flow of investment to their regions.

Local Revenue Development under Law No.34/2000

In 2001, the Government issued Law No.34/2000, which meant to respond to the weaknesses of Law No.18/1997 and to support the implementation of Law No.25/1999. Although Law No. 34/2000 has added more rooms for local taxing power, the figures of local revenue in 2001 shows that no sharp change in the structure of local government revenue in Indonesia. By the end of 2001, most of local governments still rely on the transfers from central government, mainly from general-purpose grant transfer. On the other hand, the role of local revenue in total is not significantly improved from the condition before the regional autonomy era. **Table 1** summarizes the consolidated total of local revenue (Regencies and Municipalities) in Indonesia for the year of 2001.

Table 1. Consolidated Indonesia Local Revenue, 2001

Revenue Category	Rupiahs	Percentages
Previous Balance	900,179,005,394	1.85
		0.00
Total Local Revenue	2,884,136,836,612	5.94
- Local Tax	1,245,162,512,594	2.57
-Local User Charges	1,205,316,117,515	2.48
-Local State Enterp.	80,105,385,729	0.17
- Other Revenues	353,552,818,773	0.73
		0.00
Balancing Fund:	43,370,393,815,797	89.37
- Tax Sharing	2,337,014,769,502	4.82
- Natural Resource	4,306,089,559,049	8.87
- General Purpose Grant	35,723,640,655,278	73.61
- Specific Grant	610,458,918,269	1.26
-Other	357,065,334,044	0.74
		0.00
Borrowings	129,704,849,461	0.27
		0.00
Other Revenues	887,067,643,841	1.83
		0.00
Total Revenue	48,528,547,485,150	100.00

Source: Calculated from MoF Data, 2001.

From the table, it appears that the role of central government in financing the decentralization is still a major theme. Roughly, about 89 percent of local finance is supported by central government through the balancing fund; consisting of tax sharing from tax and natural resources, and general purpose grant and specific transfers. “Dana Alokasi Umum (DAU)”, the general-purpose grant, is accounted for 74 percent of total revenue.

Taxes and user charges are the main components of local owned revenues. Based on Law No.34/2000, there are seven categories of taxes belong to the local governments; taxes on hotel, restaurant, entertainment, advertisement, street lightning, “mineral type

C”, and parking. For the user charges, there are three categories; user charges on general services, business licensing, and special licensing.

In addition to those types of taxes and user charges, local government is allowed to collect other taxes, as long as those are not violating the criteria of tax collection. The criteria, as described by Law No.34/2000 article 2, are as follows:

- (i) It is a tax in nature, and not a user charge.
- (ii) The tax object should be residing in the area of the region, with low mobility, and residential based population.
- (iii) The base and object of the tax should confirm the social justification.
- (iv) Local tax object should not overlapping with those owned by Central and Provincial governments.
- (v) Tax potential is significant.
- (vi) The tax should not distort the economy.
- (vii) Equity and the ability to pay tax should be the concerns of the tax policy.
- (viii) Environmental consideration should be in the priority.

Those criteria are considered standard from the perspective of tax theory. Unfortunately, the implementation of the criteria is far from what to be expected. As a result, many local governments create tax regulations that confront the basic criteria of tax collection.

Managing Local Revenue

The success of local revenue generation is closed related to the management of local revenue in the region. Basically, there are five major categories of local tax policies that could be implemented by local government. Those categories include; enlarging local revenue base, controlling, tax collection requirements, administration and better revenue planning.

Enlarging local revenue base

One of the ways to improve revenue performance is by enlarging local revenue base.

There are four types of action that should have been taken by local authorities in order to achieve that. They are:

1. Identifying new or potential taxpayers and ratepayers.
2. Improving object databases.
3. Improving valuation (reassessment of tax objects).
4. Calculating the revenue capacity for each type of levy.

Tax Collection Requirements

Three aspects are considered important to enhance revenue collection process: (1) optimum rate structure; (2) appropriate rules and regulations – in the form of good regulations (PERDA); (3) human resource capacity.

Increasing control to reduce leakage

To reduce revenue leakage, local government may perform some or all of the following actions:

1. Surprise audit to complement self-assessment procedure
2. Improving the control process
3. Efforts to enforce a strict and heavy penalty for non-compliance
4. Administrative discipline to financial staffs that may have contributed to leakage in local revenues.
5. Efforts to link tax payment with services provided by local government.

Improving administrative efficiency to reduce collection costs

Improvement in revenue performance is also critically dependent upon the ability of local authorities to minimize the cost of collecting revenues. There are four possible actions could be taken by local government to improve their administrative efficiency:

1. Improving the existing tax administration procedures through administrative simplification.
2. Efforts to calculate collection efficiency for each type of revenue.
3. Efforts to reduce cost of collection.
4. Efforts to eliminate the identified factors in the field that has contributed to sub-optimal revenue.

Revenue capacity improvement through better planning

We often observe a situation whereby “Dispenda”, “Bappeda”, and “Bagian Keuangan” do not work together in order to improve the existing revenue planning system. In fact, in such a crisis it is important for them to ensure a good revenue planning strategy. In the absence of coordinated and systematic planning, it is difficult to expect local revenue to increase.

A study conducted by LPEM FEUI and the US Clean Urban Project in 1999 found that local government had a very limited creativity in revenue collection strategy. Among 27 regions in the sample of the survey, only three major “classical actions” were basically taken by local government in managing local revenue strategy; such as improving object database, speed up the PERDAs to confirm with the Law, and to simplify some administration procedures. Much could be done by local governments, such as improving revenue planning. The findings help to explain why most local taxes are not buoyant and cannot function as a built in stabilizer.

Table 2
Summary of Actions on Revenue

ACTIONS	Quite Often Used	Moderately Used	Rarely Used
1. Tax Base			
a. Identifying new/potential taxpayers & bring them into tax net		X	
b. Improving object databases	X		
c. Improving valuation (reassessment of tax objects)		X	
d. Efforts to calculate more rationally the revenue capacity for each type of revenue			X
2. Controlling			
a. Surprise audit to complement self- assessment procedure			X
b. Improving the control process (to reduce leakage)		X	
c. Efforts to enforce a strict and heavy penalty for non compliance			X
d. Administrative discipline to financial staffs that may have contributed to leakage in local revenues			X
e. Efforts to link tax payment with services provided by local government (in order to increase tax compliance)			X
3. Tax Collection Requirements			
a. Altering tax rate to bring about more revenues (increase tax rate or decrease tax rate to incentive people to pay)		X	
b. Training or retraining of financial staff in order to improve revenue performance			X
c. Speed up with the formulation of new PERDA in the anticipation of Law 18/1997 (in order to avoid revenue losses)	X		
4. Administration			
a. Improving the existing tax administration procedures / administrative simplification	X		
b. Efforts to eliminate the identified factors in the field that has contributed to sub-optimal revenue			X
c. Efforts to calculate collection efficiency for each type of revenue			X
d. Efforts to reduce cost of collection (assuming they know their cost of collection for each type of revenue)			X
5. Planning			
a. Setup a new, or improve the existing revenue planning system			X
b. Setup coordination with BAPPEDA with the new objective to create new (potential) revenue bases			X

Source : LPEM FEUI, 1999.

A Good Local Tax

Before discussing some possible alternatives of local revenue, one should note the principles underlying a good local tax. Literatures have explored many principles regarding a good local tax. Musgrave, using equity principles, suggests the following criteria for local tax:

- Progressive redistributive taxes should be centralized.
- Taxes suitable for economic stabilization should be centralized; lower level taxes should be cyclically stable.
- Unequal tax bases among jurisdictions should be centralized.
- Taxes on mobile factors of production should be centralized.
- Residence-based taxes, such as excise, should be levied by local authorities.
- Benefit taxes and user charges can be levied appropriately by all levels.

Shah applies the following rules for good local taxes. As far as efficiency in administration concerned, then the level of the government that likely to have the best information on the tax base would be the level responsible for levying taxes on such a base. On the other hand, if fiscal need is the concern, revenue means should be matched as closely as possible to expenditure needs.

Spahn have the following principles to assign a local tax:

- *Local accountability*: local politicians and parliaments should be given discretion in local tax policy, and local taxes should be borne by local citizens.
- *The Benefit-Tax Link*: If a link can be established between a tax and the willingness to pay for a public service, the tax plays a role similar to a price in a quid-pro-quo market transaction.

- *Non-distortion principle*: Taxes should not affect allocation decisions in the private sector.
- *Regional equity and long-term efficiency*: Local taxation should ideally reflect a regionally equitable revenue pattern for reasons of distributional justice among jurisdictions.
- *Reliability and stability of tax bases*: as local government must provide service on continuous and reliable basis, sources of revenue to finance the service must also be reliable and stable.
- *Tax-sharing as implicit insurance*: Local governments have an interest in stabilizing their revenue bases, and they may be willing to trade violation sources of revenue for more reliable and steady elements.
- *Administrative simplicity*: Local tax system as a whole is constrained by the ability of the small jurisdictions to administer taxes.

For the case of Indonesia, however, the following principles are important for considerations:

- The potential revenue should be much higher than collection cost. The cost of collection may include not only operating costs, but also some possible “revenue losses” due to a weak tax administration system.
- The spillover effect should be taken into account in assigning types of taxes. Taxes are commonly applied based on the benefit principle. If local government build facilities that benefit not only local citizens but also the surrounding neighborhood, local tax should be adjusted to tap payments from neighboring local governments. On the other hand, if an activity results in large negative externalities, such impacts should be able to be taken account in the tax system.
- A local taxing power is a necessary requirement in the fiscal decentralization. The characteristics of decentralization can be reflected not only from the freedom in local spending, but also in revenue mobilization. Such a freedom can be obtained when the local government has its own authority in determining its own potential taxes and tax rates.
- The sustainability of national budget should be put in the first priority. A national economic agenda such as financing banking restructuring is considered important for the recovery process of Indonesian economy. Without reducing the importance of fiscal decentralization, such a national agenda must be put as a constraint to an optimal level of fiscal decentralization in Indonesia.

Possible New Local Taxes and Tax Sharing Schemes

The key to the success of local financial reform is by increasing taxing power of the local government, as far as possible, without violating rules and norms in public finance theory. Therefore, having evaluated the condition of local taxes in Indonesia, there are some possible candidates for local taxes, some of them also the candidates for shared taxes between central and local governments.

1. Gasoline tax (PBBKB), property tax (PBB) and land/building transfer tax (BPHTB) are reformed as local tax.

One and four months of the implementation of fiscal decentralization, we can acknowledge some problems related to the public service delivery at local level. Some infrastructure, such as roads, have been badly maintained by local government. The classic answer is that the local government has no longer enough funding for road maintenance. Such an issue gives raise to the possibility of transferring the gasoline tax to the authority of local government.

In addition to the maintenance, there is little intentions of private sector to do investment to the local level. One reason is the lack of tax incentive for investment offered by local government. This is understandable since there is no significant tax can affect the investment behaviour. Taxes such as hotel and restaurant taxes, are not significant to affect the investment flow. It is quite different situation if the property tax incentive can be offered by local government to the investor. To accomodate such regional macroeconomic policy, it is possible for property tax to given to local government, and becomes local taxes. According to the criteria of local tax, such a policy does not violate the local tax principles.

2. Building Permit fee will be reclassified as Local Tax

Building license fee is calculated based on the costs of providing the building permit. In the past, it was considered potential revenue for local government. To capture local potential in paying this building license fee, the above user charge (retribution) needed to be reclassified as a tax. Since it becomes a tax, there is no requirement to set the tariff at the cost of providing the permit. There are some reasons can be offered regarding this reclassification option:

- Building or renovating activities can create (negative) externalities to the neighbors and environment. Roads may be used in more frequent times due to the construction process. To capture the externalities created, taxes are the answer.
- Since only limited households can afford building renovation, a tax may be more suitable to show the ability to pay of households.
- The building permit tax may be buoyant, although it is not stable.

3. Plantation will be included in natural resource revenue sharing

There is a need to increase the tax base of “kabupaten” (rural local government). In some “kabupatens”, plantations have played a major role in the economy. However, local government cannot obtain revenue derived directly from the activity. Therefore, there is a room for rural local government to increase their tax potential if share from plantation is given to them.

4. Surcharges or Piggy-backing on Personal Income Tax (PIT)

Radical changes might be needed to reform tax assignments among the levels of government. With improvements in tax administration at local level and improvement in macroeconomic condition, additional tax sharing polices are expected to be done. To

implement this policy, more political support, especially from Directorate General of Taxation, are needed to share buoyant national (central) taxes with regional governments. Currently personal income tax is shared between central and regional governments, with the sharing of 80: 20. Although such a tax sharing mechanism has been a significant contribution to local revenue, the scheme is still lack of clarity and certainty in the amount allocated to local government. The sharing from the personal income tax is not directly transferred to local governments, but it is distributed by provincial authority. A report from the field shows that the allocation to the “kabupaten” and “kota” has encountered problems, such as a smaller allocation than expected.

To replace the system of personal income tax sharing, it is proposed to adopt a surcharge on personal income tax (PIT) or applying a piggy backing PIT. The possibility of placing surcharges upon the income tax seems to be broadly accepted (Shah, 1994). It is a good candidate for increasing local revenue, as Indonesia experiences sufficient increases in income tax revenue for the time being. Applying surcharges upon income tax base may offer hope to local governments to improve their local revenue capacity. Due to small revenue generated by personal income tax, when the administration permits, a possibility to place surcharge upon corporate income tax must be on the considerations. To implement such a policy, a proposal can be offered by adjusting the current Indonesian Tax Law to comply with, for example, piggy backing personal income tax. In order to implement such a policy, local government should be allowed to collect taxes on PIT by applying certain tax rates. When using the piggy backing mechanism, taxes paid by household should be at most the same as the rates implemented by the Tax Law 2000. However, the local governments are given taxing power to decide whether they will use

the opportunity to increase revenue from PIT directly, or they will not respond to the scheme. The following table illustrates how the mechanism could work within the scope of the Law.

Table 3. The Scheme for Piggy-backing Personal Income Tax

Tax Bracket (Rupiahs)	Current Personal Income Tax Bracket (Percent)	Adjustment on tax brackets	The maximum rates on PIT collected by Local Government
0 - 25 million	5	4	1
25 – 50 million	10	8	2
50 – 100 million	15	12	3
100 – 200 million	25	20	5
Above 200 million	35	28	7

5. Introducing local business tax

Another feature of local taxation that should be emphasized is the importance of developing “less harmful local business taxation”. Most forms of local and regional business taxes found in developing countries – corporate income taxes, trade taxes, business taxes, differentiated heavy nonresidential property taxes, and even so-called “retail” sales taxes - may introduce serious economic distortions in a variety of ways. Nonetheless, there is both an economic (benefit) cases for some regional and local taxation of business. An overwhelming political support for local leaders to impose such taxes is needed. An introduction to what is in effect another form of VAT – often called as “ business value tax” may be taken as a consideration. Variants of such taxes already exist in some developed countries. The practical case for replacing the present

“unorganized” of taxes imposed on business by such a tax seems even stronger in the context of developing countries, including Indonesia.

Conclusion

Local owned revenue generation has become a key issue of regional autonomy and decentralization policy in Indonesia. Before the implementation of fiscal decentralization, local taxing power had played a minimal role in supporting local revenue. Law No.18/1997 was the guide for improving the performance of local tax management. However, the implemented regulations and actions did not give support to the policy. This results in the problems of implementing Law No.18/1997. In order to answer the problems of local tax regulations, Law No.34/2000 is established, which gives local government a freedom to plan their local own revenue.

The implementation of Law No.34/2000 has not changed the structure of local revenue in Indonesia. Most of local governments still rely on transfers from central government. Therefore, some improvements on tax assignment in Indonesia are necessary, such as; to implement piggy-backing PIT, to increase local own revenue. Hence, the policy will reduce the problem of vertical imbalances.

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