BACKGROUND PAPER

Tax Assignments: Options for Indonesia[1]

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[1] This paper is based on Chapter 3 of E. Ahmad, G. Brosio, P. Desai, R. Krelove, J. Ma, Z. Qureshi, "Indonesia: Redesigning Intergovernmental Fiscal Relations" Fiscal Affairs Department, February 1999

Contents

A. Existing Tax Assignments
B. Principles of Revenue Assignment
C. Options for Sub-national Taxation
E. Sequencing of Reforms

Indonesia is moving toward greater decentralization with the legislation introduced in 1999 (the Laws on Regional Governance 22/1999 and Fiscal Balance 25/1999), The legislation permits inter alia the development of own-tax sources for regional governments, although it does not specify these. However, land and property taxation remains as a shared revenue, and sharing of oil and gas revenues has been introduced in the legislation.

In order to ensure that regional governments bear "responsibility" for their additional expenditures at the margin, it is imperative for good governance that they have "own-source" revenues—i.e., tax handles on which they have the right to vary rates (this may be subject to upper and lower bounds to prevent excessive tax competition or extortion).

In this paper we survey the revenue assignments that existed prior to the legislation in 1999, and largely continue to the present time, and the options that the authorities face in designing own and shared regional revenues for greater "regional accountability."

This paper makes the following recommendations:

- Assign authority over the rate structure for the land and property tax to districts;
- Review the sharing arrangement for oil and gas revenue, and consider more transparent assignment of taxes and charges to regional governments, including royalties, production excises and a piggy-backed corporate income tax;
- New sources of own-revenues for districts, include: betterment levies; business license taxes; and user charges (particularly for telephones);
- New sources of own-revenues for provinces could include piggy-backed income taxes (both on personal and corporate income); and excises;
- The sequencing of revenue devolution should be carefully coordinated and that of expenditure responsibilities, and should not precede the latter.

A. Existing tax assignments

A summary view of tax assignments and revenue sharing in force in Indonesia at the end of 1998 is provided in Table 1. The table illustrates a number of important characteristics of revenue mobilization, including:

- The central government's importance in revenue raising is overwhelming. The central government raises about 93 percent of total own-source revenues of all governments, dominated by the income tax, VAT and luxury tax, and oil and gas receipts. Provinces (Dati I) raise about 5 percent of total own-source revenue of all levels of government, mainly from taxes on motor vehicles. Districts (Dati II) raise about 2 percent of total own-source revenue, with taxes accounting for about one-third of that, and charges the rest.

Table 1. Indonesia: Assignment of Taxes and Charges by Level of Government 1997/98 Budget

(In billions of rupiahs)

	Own-Source Revenues (OR)		OR and Revenue Sharing 1/	
		Percent in total		Percent in total
CENTRAL GOVERNMENT				
Taxes and charges	87,811.5	93.4	84,513.1	89.9
Oil and gas receipts	14,871.1	15.8	14,871.1	15.8
Non-oil receipts	72,940.4	77.6	69,642.0	74.1
Income taxes	29,117.7	31.0	29,117.7	31.0
VAT and luxury tax	24,601.4	26.2	24,601.4	26.2
Import duties	3,321.7	3.5	3,321.7	3.5
Excise duties	4,436.3	4.7	4,436.3	4.7
Export tax	100.0	0.1	100.0	0.1
Land and building taxes	2,505.0	2.7	153.0	0.2
Other taxes	632.5	0.7	350.0	0.4
Non-tax receipts	8,225.8	8.8	7,561.9	8.0
DATI I (PROVINCES)				
Taxes and charges	4,370.0	4.6	4,370.0	4.6
Provincial taxes	3,723.3	4.0	3,723.0	4.0
Vehicles tax	1,191.7	1.3	1,191.7	1.3
Vehicles transfer tax	1,980.2	2.1	1,980.2	2.1
Other taxes				
Provincial charges	551.4	0.6	551.4	0.6
Other provincial receipts	646.7	0.7	646.7	0.7
Tax and non-tax shares	287.0	0.3	287.0	0.3
Tax shares				
Land and building tax			1,260.2	1.3
Other taxes			773.3	0.8
Non-tax shares			773.3	0.8
Royalties from forestry			0.0	0.0
Fees from forestry concession			486.9	0.5
Aid on copra rehabilitation			204.1	0.2
			7.3	0.0
			14.6	0.0

Copra rehabilitation fee			0.0	0.0
Government land concession fee			106.3	0.1
Oil compensation			0.0	0.0
Land rent shares			137.8	0.1
Others			16.8	0.0
Taxes and charges	4,370.0	4.6	4,370.0	4.6
Taxes, charges, tax and non-tax shares			5,630.2	6.0
DATI II				
Taxes and charges	1,827.1	1.9	1,827.1	1.9
District taxes	635.8	0.7	635.8	0.7
Development tax 1	252.2	0.3	252.2	0.3
Entertainment tax	39.5	0.0	39.5	0.0
Advertisement tax	27.0	0.0	27.0	0.0
Tax on street light	271.7	0.3	271.7	0.3
Other taxes	45.4	0.0	45.4	0.0
Local charges	858.4	0.9	858.4	0.9
Other local receipts	332.9	0.4	332.9	0.4
Tax and non-tax shares			2,038.2	2.2
Tax shares			1,861.2	2.0
Land and building tax			1,578.7	1.7
Other taxes			282.5	0.3
Non-tax shares			177.0	0.2
Royalties from forestry			90.9	0.1
Fees from forestry concession			0.1	0.0
Aid on copra rehabilitation			3.4	0.0
Copra rehabilitation fee			0.0	0.0
Government land concession fee			11.7	0.0
Oil compensation			2.0	0.0
Land rent shares	1,827.1	1.9	68.9	0.1
Taxes and charges			1,827.1	1.9
Taxes, charges, tax and non-tax shares			3,865.3	4.1
Total own-source revenues	**94,008.6**	**100.0**	**94,008.6**	**100.0**

Source: MOF.

1/ Excludes development receipts and borrowing. Another important characteristic of central government taxation is the unequal regional distribution of tax revenue, as illustrated in Table 4, which gives the collections of the major non-oil and gas taxes by province. Over 65 percent of these tax revenues were raised in Jakarta, including 72 percent of income tax revenue, and 62 percent of VAT and luxury tax revenue.

- The major shared revenue source is the land and property tax. While revenue sharing from this source is a large part of subnational government revenues, it is a small part of total revenue. The major central tax sources (income taxes and VAT) are not shared. Oil and gas sharing was introduced with the legislation in 1999, and has not yet been implemented.

- Revenue sharing flows mainly from the center to district governments. The provincial share of revenue increased from 4.6 percent to 6 percent by sharing, while the local revenue share doubles to about 4 percent of total revenue.

In addition to dominating revenue, the center has primary responsibility for setting rates and bases and administering the taxes, as illustrated in Table 2.[2] The center controls the tax base for all taxes, and sets the rate for all central and provincial taxes. Districts have been given statutory responsibility over the rates of the taxes allocated to them, but that autonomy is restricted in the law through specified ranges for rates, and the requirement that local tax rates be approved by the central MOHA, after consultation with the MOF. Provincial and district governments also have administrative responsibility for administering their assigned taxes.

The fuel tax is collected by the national oil company, Pertamina, which distributes the revenue to provinces according to a formula. Provinces in principle distribute the bulk of the revenue to their districts. In addition, district governments have begun to participate in collecting the land and buildings tax, together with the central tax administration.

The main central tax bases, particularly the income tax and VAT, are also concentrated in particular regions. For instance, DKI Jakarta accounts for 72 percent of income tax collections and 62 percent of the VAT. For the personal income tax, approximately 95 percent of revenue comes from about 5 percent of the 2 million taxpayers (and 90 percent of that comes from one half of one percent of all taxpayers), and also that about 95 percent of revenue comes from residents of Jakarta. The collection data for corporate income tax is skewed because it allocates revenue to the location of the head offices, which are predominantly in Jakarta, and in addition allocates revenue for all foreign companies and joint ventures to Jakarta province. The excise tax revenue (collected by Customs and not by the tax department) comes predominantly from 5 companies; and that on-shore oil and tax revenue is generated overwhelmingly in 10 provinces.

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[2]Table 2 describes 1998 tax assignments and revenue-sharing arrangements, including the real estate transfer tax and the fuel tax, both of which are new taxes introduced during 1998, and are not reflected in Table 1. The new sharing arrangements for oil and gas and mining introduced in 1999 are not reflected in Table 2.

Table 2. Indonesia: Tax Assignment and Revenue Sharing, 1998

Revenue	Responsibility			Disposition Revenues		
	Base	Rate	Adm.	Center	Province	Local
Oil and gas receipts	C	C	C	100	0	0
Income taxes	C	C	C	100	0	0
Value-added taxes	C	C	C	100	0	0
Import duties	C	C	C	100	0	0
Excises	C	C	C	100	0	0
Export tax	C	C	C	100	0	0
Land & buildings tax 1/	C	C	C	9	16.2	74.8
Real estate transfer tax 2/	C	C	C	20	16	64
Forestry royalties	C	C	C	55	30	15
Forestry licenses	C	C	C	30	56	14
Mining land rents	C	C	C	65	19	16
Mining royalties	C	C	C	30	56	14
Vehicle tax	C	C	P	0	100	0
Vehicle transfers tax	C	C	P	0	100	0
Fuel tax 3/	C	C	P	0	10	90
Hotels and restaurants tax	C	L	L	0	0	100
Entertainment taxes	C	L	L	0	0	100
Advertisement tax	C	L	L	0	0	100
Street lighting taxes	C	L	L	0	0	100
Exploration tax of mine type C 4/	C	L	L	0	0	100
Exploration tax of surface and underground water 5/	C	L	L	0	0	100

Source: MOF.

Note: C = Central government
P = Provincial governments (Dati I)
L = Local governments (Dati II)

1/ Center retains 9 percent as collection cost of the tax.
2/ Introduced July 1998.
3/ Introduced January 1998.
4/ Base minerals.
5/ Base excludes basic household and agricultural usage.

Subnational taxes and charges

Provincial and local taxes and charges are principally regulated by Law № 18 of 1997 (Law on Regional Government Taxes and Charges) which came into effect during 1998. The assignments in the new law are close to previous practice, although the law introduced a provincial fuel tax and eliminated a number of nonproductive taxes and charges. Under the law, the following three taxes are assigned to provincial governments: motor vehicles transfer tax; motor vehicles registration tax; and fuel tax. The rates for these taxes are set by the central government, within ranges specified in the law. The motor vehicle transfer tax, the largest source of provincial tax revenue, is levied at the time of resale of a motor vehicle. Currently, the first sale is taxed at 10 percent of the value, while subsequent sales are taxed at 1 percent of the value. The motor vehicle tax is an annual tax on the value of the vehicle. The current tax rate is 1.5 percent. For both taxes, the determination of value is done by the MOHA periodically and made available to provincial governments who then collect the tax. The fuel tax, a new provincial tax introduced in the law and designed to be shared with district governments, taxes the retail price of fuel (but excluding VAT) at the rate of 5 percent.

District governments are authorized under the Law to levy the following six taxes: hotel and restaurant tax; entertainment tax; advertisement tax; street lighting tax; base mineral extraction tax; and water tax. The current maximum tax rate for the hotel and restaurant tax is 10 percent. The entertainment tax is imposed as a percentage of the ticket price of cinemas and theaters, etc., and the maximum rate specified in the law is 35 percent.

The advertisement tax levies a maximum rate of 25 percent on the annual value of advertising. The street lighting tax is a tax on electricity consumption, at a maximum rate of 10 percent. The tax is collected by the National Electricity Company on behalf of local governments as part of the monthly charges for electricity. The base mineral extraction tax levies a maximum rate of 20 percent on the market value of extraction. The water tax levies a maximum 20 percent levy on a complicated base involving water usage (but excluding basic household needs and agricultural use of water). Districts have some flexibility in choosing rates for these taxes within these maximums, but changes must be approved by the MOHA after consultation with the MOF.[3]

The complicated sharing arrangements for the land and property tax are designed to introduce "equalization" elements into the tax. However, this equalization function becomes redundant when there is a much larger general allocation transfer (far exceeding the combined revenues

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[3] In addition, Article 2 of the law allows local and provincial governments to introduce new taxes by local regulation, subject to approval by the MOHA, provided they meet a number of criteria.

from the land and property tax) that is also to be distributed on the basis of "equalization" principles.

The Fiscal Balance Law 25/1999 also introduced revenue sharing for oil and gas. For onshore oil, 15 percent of non-tax revenues will be distributed to subnational governments, of which 3 percent to the producing province, 6 percent to the producing district and 6 percent to be shared by non-producing districts in the producing province. For on-shore gas, 30 percent of the non-tax revenues is to be shared, of which 6 percent to the producing province, 12 percent to the producing district and 12 percent to the non-producing districts in the producing province. This formulation is relatively opaque, and the discussions as to whether the on-shore element extends to six or 12 miles into the ocean suggests that the producing provinces and districts are not particularly satisfied with the legislation. Also, the non-producing provinces may need to be compensated by an "equalization" transfer system that reduces the inter-regional disparities created by the oil and gas sharing formula.

This arrangement is opaque, subjects the local producing governments to the full variance in oil and gas prices, and may be implemented before the expenditure devolution is effective, thereby threatening the macroeconomic stability that has so far been achieved.

B. Principles of Revenue Assignment

The theory of fiscal decentralization establishes a number of criteria for assigning functions to the various levels of government, including principles that should govern local taxation. The five major principles and their implications for local taxes are the following:

Accountability

Local decision makers should be responsive to the preferences of their constituents. This is the basic principle of accountability, and it is essential both for economic efficiency and democratic representation. The principle calls for own-tax bases of local governments, rather than financing through grants or tax sharing with higher levels of government. The principle also supports policy discretion of local decision makers and assemblies, and it entails the right to determine their own tax rates.

Accountability is a complex concept, with many dimensions. Political accountability requires political leaders at all levels to be responsive and responsible to their constituents, and those constituents to be fully informed about the consequences of their (and their leaders') decisions. Administrative accountability requires a clear legal framework with respect to who is responsible for what, what financial reports are to be made in what form, to whom, and when, and so on. Economic accountability requires that local residents are responsible for paying for local services, which in turn requires that local authorities can set some tax rates. *The critical point in this respect is accountability at the margin*. It is perfectly possible (in principle) for a local government to be 90 percent dependent on central transfers and still be fully accountable—to its citizens and/or the central government, depending on circumstances.

Discretion in local tax policy is a necessary, but not sufficient, condition for accountability. Accountability also implies that local taxes be borne by local residents. There must be an equivalence between the provision of local public goods and the tax borne by local residents. If taxes can be exported onto taxpayers in other jurisdictions, accountability is reduced. That is, to ensure accountability at the margin, local spending decisions should relate to local, not exported, revenues.

The accountability criterion favors a local personal income tax or a property tax.

Benefit-tax link

The benefit-tax link principle emphasizes efficiency aspects of local taxation with respect to the provision of public goods. 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 market transaction. This would enhance individual and collective welfare in the provision of public goods. While market prices will automatically emerge in functioning markets for private goods, a tax price for public goods is more difficult to establish. Yet for many local services, fees and user charges can be defined and employed successfully.

Local businesses taxes, including levies on natural resources, would conform with this principle whenever local services are perceived as factor inputs by local firms and hence are "purchased" through the tax. Although one can object to the business tax on grounds that it can be exported to other jurisdictions and thus fails to strengthen accountability at the local level, this argument is weak under the benefit-tax principle. Moreover, the objection rests on a very narrow assumption as to the shifting of the tax. Local business taxes may thus be used to finance local infrastructure for business, or to lower the firm's operating costs through communal services. Cost-reducing effects might also show up indirectly, for instance in labor productivity when the quality of the local labor force improves through education, recreational facilities, or health care.

Similarly, the benefits of local public service provision come to be reflected in property prices, and a local property tax establishes a benefit-tax link. So does local taxation of residents' incomes, when one must be a resident of the jurisdiction to derive benefits from the provision of the local public services in the jurisdiction.

Neutrality

Taxes should be as neutral as possible vis-à-vis allocation decisions of the private sector. At the district level, the criterion has a particular significance since taxpayers can always avoid a high level of local tax by shifting the tax base to low-tax jurisdictions. This may lead to horizontal tax competition among local governments with potentially ruinous consequences for the districts' ability to raise tax revenue.

Horizontal tax competition among jurisdictions has two dimensions: (a) it imposes discipline regarding the level of tax rates; and (b) it restricts taxation to tax bases that cannot easily be transferred to other municipalities.

The first point is not an issue if all municipalities impose the same tax rate. This could either be achieved through national legislation or through cooperation. Yet uniform rates are potentially in conflict with the accountability principle and should be avoided under that principle. Furthermore, some regional variation in tax rates is likely to be tolerated by taxpayers, provided such rate variations reflect the regional pattern of demand for public services. Thus, variation in tax rates among localities is desirable and—within the limits imposed by the benefit-tax principle—also feasible. Ruinous competition—by which local governments undercut each other through lowering tax rates until they reach a zero level—can be prevented by national legislation that imposes a floor on local tax rates [4]

The second point is usually addressed by selecting an immovable local tax base. As long as the tax base cannot be shifted to other jurisdictions, taxation is neutral and efficient. This argues in favor of a local property tax and a local income tax based on the residence principle, and to a lesser extent, a local business tax.

While real property is indeed physically immobile, the tax base of a real property tax may be eroded when local governments have the right to establish their own valuation rules or to grant tax preferences and exemptions. Under these circumstances, the tax base may be eroded although the physical base is immobile.

This calls for national legislation or coordination regarding the definition of local tax bases. Valuation rules, tax incentives, and exemptions relating to local tax bases should be uniform throughout the nation in order to avoid the erosion of a physically immobile base. The only incentive for the private sector to reallocate resources among regions should be the differences in tax rates.

Regional equity and long-term efficiency

Local taxation should ideally reflect a regionally equitable revenue distribution pattern. On these grounds, taxes on bases that are unevenly distributed across jurisdictions (like natural resources) are not suited for local use because they usually give rise to large regional inequities. The regional-fairness principle is difficult to fulfill in practice since the regional distribution of most tax bases can be expected to be uneven to some degree. A local turnover tax, is, however, closely linked to local economic activity, and it would rank higher, on this scale, than most other taxes.

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[4]This approach was adopted by the European Union with regard to its member countries in the case of VAT and excise taxation.

The principle of regional equity contradicts the neutrality argument, which considers the local immobility of the tax base as efficiency-enhancing. But this is often perceived as unfair by those regions that are devoid of such resources.

Also, while natural resource taxation at the local level can be justified to the extent that it is consistent with the benefit-tax link principle, it is likely that resource rents generated would greatly exceed business benefits received. For this reason, several countries, including Indonesia, have adopted a scheme by which forestry is appropriated by the national government and shared with their regional governments. This arrangement is fully in line with these principles and should be retained.

Administrative simplicity

Local taxes have to be administered by all districts and provinces alike, whether large or small. Since smaller jurisdictions face potentially higher administrative costs per unit of revenue raised than larger ones, the local tax system as a whole is constrained by the former's ability to administer the taxes. This calls for a simple local tax system.

The principle of administrative simplicity would argue against many of the taxes that rank high according to other criteria of local taxation. A local income tax, a local VAT, or a local business tax may all be commendable under certain criteria, yet they are cumbersome to administer at the local level. Even a property tax, the ideal local tax candidate for most local governments, can be difficult to administer since it requires considerable (and costly) administrative effort to be implemented effectively.

In many instances, however, *there are solutions to administrative problems.*

First, the design of local taxes can be tailored to administrative conditions. For instance, a local business tax can operate under a nationally standardized tax base which is broad, based on simple cash-flow accounting, and focused on easily identifiable criteria such as turnover or wages paid (that is, levied on a presumptive basis).

Second, local tax policy can make use of existing administrative procedures and government or nongovernment institutions. For example, a local income tax could be imposed as a surcharge on the income tax levied by the central government. More complicated valuation procedures, like those required under a local property tax, could be administered at the state rather than the local level—eventually by delegation. And some taxes can take the form of surcharges on services rendered by private or semi-private companies and utilities, like surcharges on electricity or telephone bills, or on the cost of water supplied.[5] All such levies can be

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[5]A surcharge on the water bill would also be closely related to the cost of sewerage. It can thus be considered a user charge in accordance with the benefit-tax principle, enhance local service efficiency, and also finance the protection of the environment.

administered at low cost by the companies that provide the service, and the rates of the surcharges can be tailored to the local preferences of the district.

Third, the local jurisdictions can exploit the fact that the central government can inherently collect many taxes more efficiently than can local governments. If local governments are to have major expenditure responsibilities, then some form of surcharge on national taxes seems necessary. In this case, most of the desired aims of decentralized revenue policy can be achieved by allowing variation of the rates of such surcharges, perhaps subject to a constraint on minimum rates to restrict competition for tax base.

C. Options for Subnational Taxation

In this subsection, we examine a number of options that might be considered as relevant for Indonesia—these include the determination of regional tax bases, potential own-source revenues for districts and provinces, and then revenue-sharing alternatives.

Establishing autonomous regional tax bases

The case for autonomous local taxes is made in Section B above. Currently, provincial and local governments together levy nine taxes. However the degree of subnational autonomy is limited for these taxes. The requirement that the central government must authorize most changes to taxes acts as a disincentive for local governments to make frequent changes, thereby limiting their flexibility in raising additional revenues. The authorities could reevaluate the scope for further devolution of control to provincial and local governments for these taxes. Of these taxes, the fuel tax is currently effectively centrally administered with revenue apportioned by formula that only approximates jurisdiction of origin. The tax may have to be maintained in this form (with consequent uniformity of the rate) until the capability to administer the tax at the provincial level is developed. However, there is scope for changes in the uniform rate, perhaps determined by provincial government consensus, to raise more revenue from the tax if it is needed at the provincial level.[6]

District-level Taxes

Property taxation

Property taxes, especially on urban and commercial land and structures, are widely used as local taxes, for various reasons: administration costs can be relatively low compared to other

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[6]Internationally, excises on petroleum products are usually major revenue producers, and the revenue potential of the Indonesian tax would be similarly high. However, the administered price of fuels will need to be raised in parallel with any increased tax if the central government wishes avoid increasing the subsidy to Pertomina to cover the loss on domestic sales of petroleum products.

taxes; the tax yield is quite predictable (albeit considerably lower than the major tax bases—such as the VAT or the income tax); the tax can be considered as the price of local services, such as road and other infrastructure services; and the tax base is relatively immobile. It also fulfils the criterion that to spend at the margin local administrations use a tax instrument that directly affects local residents.

A problem is that there are significant difficulties in the measurement of the tax base, and in updating to keep the measurement current in the face of changing market valuations.[7] One innovative approach to the assessment problem, adopted by in some countries, is to allow self-assessment, where the local jurisdiction maintains the option of purchasing the property at some proportion (e.g., 150 percent) of the stated value. Where this approach has been adopted, valuations, and revenue, have increased significantly. In general, to avoid abuses, this approach works best in cases where local governments have strong accountability.

In Indonesia, the land and building tax, is currently a central tax in Indonesia, with revenue shared with the provincial and district governments. The tax, as it is applied to urban and agricultural property and plantations and estates, raises only limited revenue. This tax, in particular the tax on rural and urban property, and on plantations and estates, can be a more productive revenue source, and is a good candidate for decentralization in Indonesia.

The **sharing arrangements under the land and building tax are made redundant** by the general allocation proposed under the Fiscal Balance Law 25/1999. We recommend that the land and building tax be assigned to the district level, with local control over rates (which may be bounded by national legislation). This is critical in ensuring local accountability, but will require the amendment of Law 18/1997.

The authorities should consider **converting the shared land and buildings tax into an assigned local tax** by passing the **setting of rates** down to the district level. To start, the central land tax administration can continue to use current methods of valuation as a service to the subnational governments, while those governments are given autonomy on the rate of tax, initially within a range set by the central government. Over time administrative capacity at the local level should be enhanced. To exploit economies of scale, it may eventually be worthwhile for the provincial government to provide the service of tax base valuation to the localities within its borders. Over the **medium term, consideration should be given to introducing self-assessment of the base** (especially in the large metropolitan areas with better technical and administrative capabilities).

[7]The frequency and method of assessment of property values is a major issue. In some countries, infrequent updates of values lead to large and abrupt increases in tax liabilities when updating does take place, and reduce the global yield of the tax. However, there exist approximate solutions to these technical problems.

User charges and utility levies

Taxing public utility bills may be an effective way to raise local revenue.

The tax has three distinct advantages: (1) consumption of these services can act as a proxy for income; (2) the costs of administering such taxes are low; and (3) the tax can be tailored to local jurisdictions of every size. District governments in Indonesia already raise revenue with a levy on electricity bills. Another potential base of this form is on telephone bills.

Business license taxes

A number of local jurisdictions around the world levy local business taxes. Under this heading are included a wide range of taxes whose aim is to allow local governments to generate revenues from the economic activities located within their jurisdiction, establishing a benefit-tax link between the local firm and the provider of local infrastructure, the local government. Business activities may be assessed for tax purposes on the basis of local turnover, local value added, the local wage bill, local business capital, or local profits. Sometimes, actual cash or accrual accounting figures are used. Sometimes the tax base is defined in legal terms that are independent of business decisions (for instance standard valuation rules). In some cases, the business tax is similar to a minimum tax on notional capital or returns. Taxes of this form are levied by a number of developed countries, including Germany, France, Spain, and most recently, Italy.

For developing countries, a simple form of business license tax at the local level based on objective criteria would be appropriate. A license tax would be a flat tax on businesses that varies according to different activities and sectors. It could also take account of other characteristics, for example surface area of business premises. Its most attractive features are the simplicity of administration and its wide coverage that ensures potentially a substantial revenue.

Small, family-type establishments often do not keep good records of their transactions, but can be taxed on the basis of presumptive principles. For example, the business license tax may be applied to small traders on their presumed total turnover, using two or three simple indicators to establish turnover, for example, floor space in which the activity takes place, or the number of employees. For these types of businesses, local jurisdictions often have as much, or more, information than the national government. As a consequence, these taxes can be imposed more efficiently at the local level. However, they require careful controls on the officials that determine the taxes in order to minimize abuses and corrupt practices.

Property betterment levies

In some countries (e.g., Colombia), a tax is imposed on the increased value of property attributable to public investment projects. The investment projects can be financed in part by taxing the increase in property values. Such a tax is not only a benefit tax but can be viewed as a true earmarked tax in the sense that the revenue is reserved to the financing of a specific

expenditure, and the base derives from the realization of this expenditure. It presents some advantages with respect to the other types of property taxation, namely its ability to secure payment during or even before the investment is made, and the fact that the tax recovers only the benefits from public investment that enhance the value of the land.

The administration of the tax presents some difficulties that can be solved by appropriate skills and procedures. Experience suggests that successful implementation of the tax requires the following elements: (1) careful study of projects to determine those that will create an increase in site value at least equal to the cost of the projects; (2) careful costing of the projects; (3) freedom in establishing formulas for apportioning the tax among property owners; (4) prompt construction projects; (5) prompt collection of all taxes assessed on the property owners during the execution of the project; and (6) for new construction, issuance of licenses are made conditional on the payment of the tax.

Developing new autonomous district tax handles

With the current tax assignments and even with the decentralization of a more productive property tax, local own-source revenues will still fall far short of likely expenditure assignments. We therefore recommend that the authorities search for additional revenue sources for local governments. On the basis of the discussion above, the authorities could undertake an assessment of the advisability of introducing the following potential new taxes at the district level:

- tax on telephone bills;
- business license tax;
- property betterment levy.

Experience in other countries indicates that these taxes can potentially be administered at the local level, and can raise significant revenue. In the short term the tax on telephone bills would be easiest to establish. The other taxes can be established with the further development of local administrative capability. The property betterment tax requires considerable administrative sophistication and has yielded revenues mainly in large urban centers (e.g., Bogotá).

As described above, the property and land tax should be assigned in entirety to the district level. This will involve an amendment to the existing legislation.

Provincial taxes

A number of options exist for devolving tax bases to the provincial level—either to finance their own expenditures, or to pass on the districts, if there is a greater eventual assignment of functions at the latter level.

Motor vehicle taxes

Automotive taxation, that is taxes related to motor vehicle ownership and use, constitute another potentially important source of revenue for subnational governments. There are three main arguments in favor of this kind of taxation: (1) it refers to a rapidly growing tax base; (2) it allows local governments to match the costs imposed on them due to automobile use; and (3) automobile taxes may also be appealing from an equity point of view. Provincial governments in Indonesia currently use three forms of automotive tax: a fuel tax, levied at the centrally imposed rate of 5 percent and collected centrally, a tax on sales and transfers of motor vehicles, and annual license taxes.

Income taxation

Personal income taxes, particularly when they are levied on a schedular basis, can be used by regional jurisdictions (both provincial and district-level, as in Canada and most US States) without great difficulties, especially if the taxes on some income sources such as wages and salaries are withheld at the source by those who pay these incomes and the taxes withheld are considered as final taxes. In this case, the taxpayer does not need to present a tax declaration and has no further tax liability. If these taxes are not considered final, but are related to the particular situation of the taxpayer, and especially if the incomes received come from jurisdictions other than the one where the taxpayer resides, then administrative problems arise because the tax authorities in the jurisdiction of residence may not receive the necessary information to be able to levy the tax.

On the other hand, the schedular tax on wages and salaries does not possess these problems to the same degree, and could become a good candidate for tax sharing with subnational governments.[8] One problem, is that the revenue from the tax may be quite unevenly distributed geographically. In part, this may be the result of a reporting anomaly, arising from assigning the origin of the revenue to the jurisdiction where head office of the enterprise that submits the tax to the authorities is located. Alternatively, it may be the case that the tax falls primarily on the minority of the highest-income individuals in the economy, and these are disproportionately located in Jakarta. It appears that the tax captures only a small proportion of all wage and salary earners, in part because of the high exemption levels.

It is likely that the schedular tax on wages and salaries will become a more important revenue source with the continuing development of the economy, and that the regional biases in distribution will fall over time. As this occurs, the attractiveness of the tax as a revenue source for subnational governments will increase, and we recommend that consideration be given to investigating the scope for using the tax over the medium term as a revenue source for these

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[8]Individual income taxation in Indonesia is based on the principle of global income taxation, although extensive use is made of final withholding, which introduces schedular elements into the tax.

governments. Consideration could be given to local governments to choose their own tax rate (say up to five percentage points) to apply to a centrally defined base,[9] with the tax continuing to be collected by the center to exploit economies of scale in tax collection. Arrangements of this form have been set up and work well in a number of countries.

The tax on wages and salaries is appropriate for use by subnational governments, particularly provincial governments, since taxpayers tend to earn wages and salaries more in the jurisdiction of residence. The regional governments may be given the option of levying a certain percentage (e.g., up to five percentage points) on the central tax base. The ***regional personal income tax would piggy-back on the central income tax, with assessment, collection and enforcement by the central tax department.***

Corporate income taxes can also be imposed by regional governments on the piggy-back basis described above. To avoid burdens on taxpayers, the tax is usually on the centrally determined bases, and there is a provincial line on the central tax form. If the intention is to keep the overall corporate tax within a level determined by the center (say 30 percent), then in order to introduce up to a five percentage point regional corporate income tax, the center would need to make space by reducing its own rate to 25 percent.

Despite the fact most registered companies are located in Jakarta, it should be relatively straightforward to apportion income accruing from provinces. However, applying a piggy-backed tax on corporate income at the district level may not be feasible.

Excise taxes

For administrative reasons, excises on consumer goods such as tobacco and alcoholic beverages and other goods are usually levied at the producer level or, less frequently, at the wholesale level. The tax then represents a cost element which is incorporated in the price of the good and borne by the final consumer. A local excise tax on the producers located in the jurisdiction would in this case reflect the locational pattern of the production of excisable goods. It would therefore lead to an unequal regional distribution of revenue and would be totally unrelated to local consumption. For this reason, local excises on the producer (or wholesaler) are poor candidates for local taxation.

Some countries attempt to approximate the local consumption of taxable goods by distributing the excises paid by producers among jurisdictions according to the producer's record of the destination of sales. However, experience in these countries shows that, if tax rates are allowed to vary to any significant extent across regions, "smuggling" across jurisdictions will arise. Additional problems arise with international trade in excisable goods, as imports of excisable

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[9]In some countries, a flat rate is levied on the national tax base (the rate depending on the expenditure assignments and revenue needs), but where the rate is as high as 5 percent to make room for the local tax.

goods will need to be taxed to avoid according them an advantage over domestic production, and exports will need to be exempted from tax, which opens possibilities for tax evasion. All of this creates enormous administrative complications. For these reasons, local excises that are regionally distributed on the basis of delivery accounts of producer firms possess serious weaknesses as viable local revenue sources.

A selective tax on goods can also be levied at the retail level. The administrative problems of such a tax depend on the characteristics of the good. For example, sales of cigarettes by street vendors would be difficult to monitor and tax. And for other distributors, it is difficult for the tax collectors to separate out sales of taxable goods from all sales. On the hand, administrative problems would be fewer with the distribution of gasoline. In this case, the distributor is easily identifiable. Sales are relatively homogeneous and could eventually be controlled on the basis of documentation provided by the supplier. Therefore, a local tax on gasoline consumption is a viable option. The major drawback is cross-border shopping if rates vary widely; this can be mitigated if a floor tax rate is set.[10]

In Indonesia, the central government currently levies selective excise taxes on alcohol and tobacco products, imposed at the point of production or import, and collected by the Customs and Excise Department.[11] In addition, in conjunction with the VAT, the central government imposes a luxury sales tax on an extensive list of goods, including, for example, alcoholic beverages, motor vehicles, soft drinks, household appliances, cosmetics, electronic goods, carpets, and imported footwear. The tax is levied as a final tax at only one point in the chain of production and distribution—either at importation or the domestic manufacture stage—at rates between 10 and 35 percent. These taxes are thus functionally equivalent to selective excises.

The best practice would be to levy excise taxes on a limited number of goods—tobacco products, alcoholic beverages, petroleum products, and motor vehicles. Excises generally should not be applied to goods that are low-revenue producers. By this standard, the number of goods subject to the luxury tax in Indonesia is excessive, and should be reduced.[12]

The scope for natural resource taxation at the subnational level

Pressures currently exist in Indonesia to give local governments a greater amount, through **tax sharing**, of certain natural resource revenues on oil and gas, mining, forestry, and fishing.

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[10]This problem is less serious when the tax is levied at the provincial rather than the district level.

[11]The excises on alcoholic beverages have been in place for only two years.

[12]Although data are not available, most of the revenue from the luxury tax likely comes from motor vehicles, subject to rates of between 20 and 35 percent, and from alcoholic beverages, subject to the 35 percent rate.

However, in essence such taxes do not form not an ideal candidate for local taxation, even under a tax sharing arrangement. The major problems are the following: (1) the resource rents are unevenly distributed geographically; (2) the revenues are volatile; and (3) they are not a buoyant long term source of revenue. Assigning forestry revenues to regional levels introduces incentives to utilize the resources more intensively—these need to be carefully modeled, and we have not attempted to address this issue in the present note. The first-best solution would be to tax these bases centrally, and ensure that the general allocation transfer system provides adequate financing for the intended decentralized expenditures.

If regional governments provide significant amounts of services and infrastructure for the exploitation of the natural resources, some charges may be considered a compensation for the associated costs, justifying that some share of the revenues (e.g., a proportion of royalties) could be returned to the regional governments under the benefit-tax linkage principle. There could also be production excises or severance taxes, in addition to the property tax (which is actually imposed on oil and gas production and hardware in Indonesia).

Given the political economy considerations in Indonesia, as in countries such as Canada, it is inevitable that recognition of the demands of residents for a share in the resource rents be accommodated in some fashion—indeed the Indonesian Fiscal Balance Law 25/1999 legislation introduces a distribution of the oil and gas revenues to residents of producing provinces. Unlike in Indonesia (which is a unitary state), in Canada and the United States the provinces own the natural resources and the have the right to tax earning from these resources.

The state of Alaska, for example, *inter alia* levies a property tax (at 20 mills or two percent on appraised value), a severance tax ranging from 12.25 to 15 percent on oil, subject to a minimum tax per barrel, royalties, a production tax surcharge for hazardous spill, and a corporate income tax. The corporate income tax is based on corporation world wide net income apportioned to Alaska under a three factor formula involving: (1) percentage of corporate sales and tariffs from Alaskan operations; (2) percentage of production from Alaska; and (3) percentage of property represented by Alaska holdings—at a maximum marginal rate of 9.4 percent. All State taxes and royalties are deductible for Federal Income Tax purposes.

Canadian provinces also levy a range of taxes (including minimum taxes) and royalties on natural resources. [13] However, it is noted that oil and gas royalties have led to a heavy taxation of these industries (possibly deterring investment) relative to other industries. Thus, Canadian scholars would prefer to reallocate natural resource taxes from provinces to the center, but

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[13] For a discussion of the role of natural resource rents on the design of the transfer system in Canada, see Robin Boadway and Paul Hobson, 1993, *Intergovernmental Fiscal Relations in Canada,* Canadian Tax Paper No.96, Canadian Tax Foundation, Toronto.

recognize that this is unlikely to happen given the political constraints and the constitutional rights of the provinces. [14]

In Indonesia, oil and gas production is very unevenly distributed across the regions. Moreover, revenue from this source is highly volatile.[15] For these reasons, as discussed above, oil and gas production is not a good subnational revenue source. However, political economy realities might dictate that some form of regional taxation on natural resources is inevitable if there is distrust that the center will provide sufficient untied grants for regional expenditures. There are also a number of economic arguments (based on the benefit principle and externalities) that may justify the levy of taxation on such resources. Also, oil and gas is subject to income taxation, and there could be a piggy-backed arrangement with this and other sources (this might be quite attractive and might not exacerbate regional inequalities if applied across all income sources). There may thus be ***a number of taxes or charges on oil and gas that could accrue to regional governments.***

A charge on oil and gas could be interpreted as a payment for services provided in the production of the resources. In this case, it is likely that the appropriate local share is limited to a proportion of the rents (royalties) generated by the resource, and a combination of severance taxes and production excises to compensate for environmental damage caused by the oil/gas extraction. However, for oil and gas, what is described as a royalty in Indonesia may be more commonly understood as the "government take" from the sector. It is the government's production-share less taxes paid, and does not correspond to the traditional definition of a royalty. Thus, as suggested by some regions in Indonesia, ***a royalty which could be shared or assigned should be defined for oil and gas.***

If the demand for additional oil and gas revenue is the expression of a demand for greater revenue sources at the subnational level, the demand could be met by a more comprehensive tax package, covering property taxes at the district level, and additional taxes at the provincial level (e.g., excises) and the redesign of the equalization transfer system.

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[14] See Irene Ip and Jack Mintz, 1992, *Dividing the Spoils, The Federal-Provincial Allocation of Taxing Powers,* C.D. Howe Institute, Toronto.

[15]For example, as of mid-December 1998, the price of benchmark Minas crude oil stood at about US$10 per barrel, compared with an assumed price of US$13 for the purposes of the central budget, causing monthly average revenue to fall to US$600 million in the third quarter of 1998, compared with US$1,000 million per month in the fourth quarter of 1997. The rupiah's strengthening to about Rp 7,500 to the dollar from the Rp 10,600 assumed in the central budget has compounded the fall in revenues. The revenues from oil have risen dramatically during the rebound of oil prices in 1999/early 2000. It is not clear what the benchmark for local governments should be for budgeting purposes, given the extreme volatility seen in the past two years.

If the regional taxation from natural resources has to be maintained for political solidarity reasons, then it may be desirable to consider the creation of a royalty and production excises that would provide an equivalent amount of base year revenue for the regional government as the revenue-share stipulated in the Regional Balance Law, but in a more transparent manner. As argued elsewhere, non-oil/gas producing provinces would need to be given "equalization transfers" in a manner that does not discourage investment and exploration in the oil/gas-producing regions.

Development of shared tax bases

While it has been used for regional taxation in some Latin American countries, the VAT is not a good candidate for revenue sharing or for use as a shared tax base, as the determination of the origin of the value added is administratively difficult (and could lead to high compliance costs), given the manner of collection of the tax.

D. Sequencing of reforms: coordinating revenue and expenditure devolution

The devolution of responsibilities being contemplated by the government can ultimately strengthen local political accountability and foster citizen's participation in public decision making. It has also significant potential for enhancing economic efficiency in allocating resources through the public sector. However, caution should be exercised to ensure that the devolution on the revenue side does not precede the effective decentralization of expenditure functions.

Care should also be taken in defining an appropriate sequencing of reform steps. In the short run, priority should be given to strengthening the institutional framework within which regional governments operate. On the tax side this involves strengthening the capacity for tax administration at the regional level. Both the central tax department, which has considerable experience of self-assessment and modern tax collection methods, and the international agencies may be able to assist in this regard.

With regard to revenue functions, priority should be given to providing regional governments with greater own-source revenues at the margin. In further legal changes, consideration should be given to giving districts greater autonomy with regard to the land and property tax. Options for other own source revenues, including business licenses and additional utilities charges (e.g., on telephone bills) should be examined. At the provincial level, the scope for greater revenues from excises (including the fuel tax) and luxury taxes should be examined. Then, the legislation to support these new assignments needs to be prepared, and an examination of the tax administration implications of the new assignments for both provinces and districts has to be undertaken. Over the medium term, the center should be involved in assisting subnational governments to assume the new revenue assignments. This will likely involve central backup programs for poorer provinces and districts (including promoting horizontal cooperation where

existing subnational experience could be brought to bear on a wider scale), and the promotion and financing by the central government of innovative projects to serve as pilot studies.

Even with the augmented revenue sources at the regional level as indicated above, it is unlikely that this will be enough to remove the need to design an intergovernmental transfer system.