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Specific Case of Indonesia

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This paper mostly conducts literature review on sub-national taxes in developing countries with specific case of Indonesia. Similar to many developing countries that experience process of fiscal decentralization, central government in Indonesia devolves mostly expenditure task to sub-national governments after 2001.

This paper focuses on the concept of managing local revenues and which taxes should be assigned to different kinds of government. Providing literature review of the concept of managing local revenues, describing process of decentralization in Indonesia, and showing the performance of sub-national tax in Indonesia.

At the end of the sections, this paper recommend a primary agenda to solve the mentioned problems to improve current tax administration system. This system is the most important government instrument to mobilize resources, reduce disparity in income and wealth in the country, and as a tool to stabilize the economy.

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1. Introduction

THEORY OF PUBLIC FINANCE STATES THAT EACH POLICY THAT WILL BE TAKEN SHOULD CONSIDER EFFICIENCY (ALLOCATION), EQUITY (DISTRIBUTION), AND STABILIZATION GOALS.

This paper mostly conducts literature review on sub-national taxes in developing countries with specific case of Indonesia. Similar to many developing countries that experience process of fiscal decentralization, central government in Indonesia devolves mostly expenditure task to sub-national governments after 2001. During the decentralization era, the capacity of sub-national governments to raise own-source revenues is way below their capacity to finance expenditure assignments, due that reason they rely heavily on intergovernmental fiscal transfers, such as from general block grant (*Dana Alokasi Umum*), specific allocation grant (*Dana Alokasi Khusus*), and revenue-sharing grant (*Dana Bagi Hasil*).

Further, a good sub-national tax system is critical to an effective and sustainable system of intergovernmental fiscal relations – a need that has become increasingly important around the world as more and more public services are being delivered through sub-national governments[1]. In many developing countries, for example, given the restrictions on residential property taxes and the unreliability of central transfers, business taxes have sometimes provided almost the only way in which sub-national governments have been able to expand revenues in response to perceived local needs[2]. According to Table 1, district or city mainly imposes property tax in addition to user charges. In other countries, regional or provincial governments may be permitted to impose retail sales taxes and a few excises as well as to piggy-back[3].

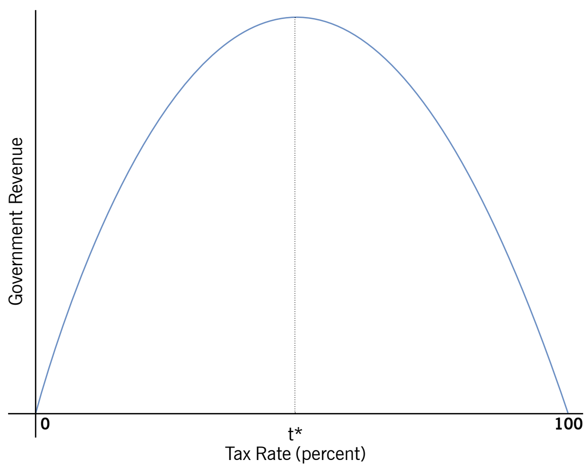
There are several reasons where most of heavily collected taxes are still managed by the central government. First, Musgrave[4] mentioned the need to achieve redistributive equity within countries as a whole. Second, most central government in developing countries seldom secures much revenue from the personal income tax so there is little PIT (personal income tax) base on which to impose surcharge[5]. Arthur Laffer, moreover, provides an analysis of the relationship between optimal tax revenue and tax rate. The main idea behind this model, as appear on Figure 1 above, is policy makers at both central and sub-national level should set and determine tax rate at which it will create an optimal revenue collection. Move further from t* (or tax rate at potential level), government revenue will fall leading to economic distortion. In most of economic literature, experts use the Laffer curve as one possible presentation of the relationship between rates of taxation and the hypothetical resulting levels of government revenue. In essence, there are two effects of changing tax rates on revenues: the arithmetic and economic effects. The arithmetic effect tells that if tax rates are increased, tax revenue will increase as

Table 1 - Tax Assignment in Different Government Level: the Standard Approach

Revenues	Central	Provincial	District/ City
Personal income taxes	Yes	Possible Piggyback	No
Payroll taxes	Yes	Possible Piggyback	No
Enterprise profit taxes	Yes	No	No
Natural resource taxes	Yes	Limited	No
Value-Added taxes	Yes	No	No
Retail sales taxes	Yes	Yes	No
Customs duties	Yes	No	No
Excise taxes	Yes	Possible Piggyback	No
Property taxes	No	No	Yes

Source: Bird, R,"Subnational Taxation in Developing Countries: A Review of the Literature", PREM, the World Bank, Oct 2010

Figure 1 - Laffer Curve



1. Bird, R and Roy Bahl,"Subnational Taxes in Developing Countries: The Way Forward", Institute for International Business, IIB Paper No. 16, August 2008.

2. Ibid.

3. Piggy-back tax is an additional surcharge to centrally-imposed personal income or payroll taxes.

4. Musgrave, R.A. (1983) "Who Should Tax, Where and What?" in C. McLure, ed., Tax Assignment in Federal Countries (Canberra: Centre for Research on Federal Financial Relations, Australian National University).

5. Bird, R.M. and E. Zolt (2005) "The Limited Role of the Personal Income Tax in Developing Countries," Journal of Asian Economics 16: 928-46.

well by the amount of the increase in rate. However, it will create a negative impact to the economy by reducing output and employment. Finding the best rate for each tax is crucial not only for government revenue and for the economy as a whole. Therefore, it is recommended that each local government constantly improve their tax administration.

More recent authors generally continue to emphasize that each level of government should be assigned taxes that are as closely related as possible to the benefits derived from spending them[6] which often relates to the property and business tax. It has great revenue potential, its burden rests with middle and upper income families, and it distors business and consumer economic decision less than do other taxes, as well as it could be an important part of a national fiscal decentralization strategy[7]. Specific to property tax, it has failed to become a significant revenue generator that only raise an amount equivalent to around 0.6 percent of Gross Domestic Product (GDP), on average, in developing and transition economies. In many developing economies, less than half of property value is taxed and complemented by marginally low rates.

The theory of public finance considers that each policy that will be taken should take into account efficiency (allocation), equity (distribution), and stabilization goals. Relinquishing some of the taxing power to local governments, unfortunately, will absolutely lead to a problem of widening income gap due to existing differences in needs and capacities between different governmental units at the same level of government. However, an improvement of public services at the region can only be achieved if sub-national government is also being provided by enough resources to cover its expenses. Nevertheles, central government's role in enhancing capacity of tax administration at the local level is still required to improve tax collection.

This paper focuses on the concept of managing local revenues and which taxes should be assigned to different kinds of government. Section 2 provides literature review of the concept of managing local revenues. Section 3 describes process of decentralization in Indonesia. Section 4 shows the performance of sub-national tax in Indonesia. Section 5 concludes.

6. Bird, R,"Subnational Taxation in Developing Countries: A Review of the Literature", PREM, the World Bank, Oct 2010

7. Bahl, Roy,"Property Tax Reform in Developing and Transition Countries" USAID, December 2009.

2. Concept of Managing Local Revenues

CAPACITY OF SUB-NATIONAL GOVERNMENT TO GENERATE OWN SOURCE REVENUES IS AMONG IMPORTANT FACTOR IN DETERMINING THE SUCCESS OF FISCAL DECENTRALIZATION.

Sub-national governments need to provide public goods[8] to its citizen. The cost of providing the services hopefully is covered through local taxes and user charges collection. The sources of revenue for sub-national governments vary across countries but generally include taxes, user fees and charges, and intergovernmental transfers. Other revenues may include investment income, property sales, licenses and permits. In terms of taxes, property and business taxes are probably the most often levied by sub-national governments around the world.[9] Other permissible local taxes include, but not limited to, income taxes, general sales taxes, and selective sales taxes (for example, taxes on fuel, liquor, tobacco, hotel room ooccupancy and vehicle registration) and land transfer taxes. These taxes are usually collected at the provincial level and shared with district or municipality according to predetermined formulas. In Indonesia, we call it as revenue-sharing grant.

Capacity of sub-national government to generate own source revenues is among important factor in determining the success of fiscal decentralization. An important rule of sound fiscal decentralization is that finance should follow functions.[10] Decentralization, in reality, is much easier to devolve expenditure sides rather than revenues. In many developing countries a major problem for sub-national government relates to insufficient funding for public investments. First, local governments have insufficient own-source revenues relative to intergovernmental transfer. It comprises of less than 10 percent of the total budgets. This is about the same as regional governments in India, Pakistan, and Thailand but considerably less than local governments in Philippines (30 percent), China (40 percent), Vietnam (50 percent), Japan (60 percent), and Korea (60 percent). International experience shows that relatively limited own-source revenues and

8. Public goods are goods where individuals cannot reasonably be excluded from their use, and their consumption by one individual would not interfere with consumption by another (e.g. national defense, park services, public lighting).

9. Freire, E.M and Hernando Garzon,"Managing Local Revenues", 2013.

10. Bahl, R."Implementable Rules of Fiscal Decentralization." In Development, Poverty and Fiscal Policy, edited by M.G. Rao, 253-77. New Delhi: Oxford University Press. 2002

subsequent over reliance on transfers make local governments fiscally lazy and reduce spending efficiency and accountability.

The recent decentralization of the urban and rural property tax to Indonesian regional governments has the potential to strengthen fiscal capacity of the regions. But property tax decentralization is not proceeding smoothly. As of 2012 only Surabaya has successfully taken on responsibility for administering taxes related to property and property title transfer[11]. By the end of 2013, which is the deadline for local governments to assume control over the relevant taxes, only a small number of additional, mostly large municipalities are expected to be actively collecting the tax. The vast bulk of subnational governments will apparently not assume administrative responsibility for the property tax before the deadline and collection of the tax may well be discontinued in those places. This would represent a significant missed opportunity to increase own-source revenues and enhance spending efficiency and accountability. According to Bird (2001), targeted and preferable local taxes have several features which are shown below.

Table 2 - A Recommended Local Tax

1) Tax base should be immobile, so that sub-national governments can vary the tax rate without the taxable base moving somewhere else.
2) The tax yield should be adequate to meet local needs, be stable, and be predictable.
3) Tax base should not be easy to export to nonresidents.
4) Tax base should be visible to ensure accountability.
5) Taxpayers should perceive the tax as fair.
6) The tax should be easy to administer

Source: Bird, Richard. 2001. "Setting the Stage—Municipal and Intergovernmental Finance." in Challenges of Urban Governments, edited by M. Freire and R. Stren. Washington, DC: World Bank Institute.

Furthermore, according to American Institute of Certified Public Accountants (2013), tax incidence should follow some criteria such as shownin Table 3.

Most of locally own-source revenue in Indonesia comes from the property and business tax[12]. However, in other countries, sales as well as income taxes also apply locally. As stated above, property tax is a good local tax because the base is immobile and the tax is visible; although, it requires technical capacity and political commitment. Much progress is still needed especially in developing countries, where the property tax represents a very small proportion of tax revenue and where the infrastructure for setting up a property tax is often not in place. There are some drawbacks of property taxes such as[13]

Table 3 - Criteria for Tax Incidence

1) Equity and Fairness: Taxpayers should be taxed equally
2) Certainty: Tax rules should clearly specify such as when tax is to be paid, how it is to be paid and how to be determine the amount that needs to be paid
3) Convenience of Payment: A tax should be due at a time or in a manner that is most likely to be convenient for the taxpayers.
4) Economy: The cost of collection should be kept minimum
5) Simplicity: The tax law should be simple so that taxpayers understand the rules and should comply with them correctly
6) Neutrality: The effect of the tax law on taxpayers' decisions as to how to carry out a particular transaction or whether to engage in a transaction should be kept to a minimum.
7) Economic growth and efficiency: The tax system should not impede or reduce the productive capacity of the economy.
8) Transparency and Visibility: Taxpayers should know that a tax exists and how and when it is imposed upon them and others.
9) Minimum tax gap: a tax should be structured to minimize noncompliance
10) Appropriate government revenues: The tax system should enable the government to determine how much tax revenue will likely be collected

Source: Bird, Richard. 2001. "Setting the Stage—Municipal and Intergovernmental Finance." in Challenges of Urban Governments, edited by M. Freire and R. Stren. Washington, DC: World Bank Institute.

- The high cost of accurate valuation of property values[14];
- The political difficulty of enforcement;
- The apparent inelasticity of property values with respect to GDP or national income (property values respond less quickly to changes in GDP than income or sales)
- The fact that few jurisdictions update property

11. Ibid.

12. In developing countries, property taxes seldom account for more than 20 percent of local current revenues- or less than 1 percent of total public spending (Bahl and Martinez-Vazquez, 2007).

13. Op.cit, Freire, E.M and Hernando Garzon, 2013.

14. Tax base is valued based on, to name a few: rental value, capital value of land and improvements, land value, and physical area. Most countries utilized toward capital value of land and improvements.

values on an annual basis. That means that to maintain property tax revenues in real terms local jurisdictions would have to increase the tax rate regularly and this leads to taxpayers resistance and discontent.

In order to improve property tax collection, city like Bogotá in Colombia has proved that political will, technical expertise and condusive investment climate can significantly increase property tax proceeds. The city was able to regularly update data on the property tax base, improve the structure of the property tax rate as well as conduct reformation to its tax administration. Tax officials should be able well-trained and knowledgeable to most of tax collection cases. Table 3 provides information in different countries on how to assess the property tax base.

3. Decentralization in Indonesia

UPON A RAPID AND OFTEN CALLED AS "BIG BANG DECENTRALIZATION", INDONESIA HAS TRANSFORMED AS MORE DECENTRALIZED ONES. THE IDEA OF "MONEY FOLLOWS FUNCTIONS" WAS CONSIDERED.

Before the Asian Crisis in 1997/98, Indonesia was recognized to have the centralistic government where all sub-national governments should follow direction from and responsible to the central government. After the crisis or during President Habibie, Law no 22 of 1999 on Regional Autonomy was enacted. In the new law, government functions are devolved to sub-national governments, except for six absolute powers (i.e. foreign affairs, defense, security, justice, national monetary and fiscal, and religion) that are still part of central government jurisdiction. Regional government is provided with authority to develop according to its preferences. However, in accordance to the concurrent functions, local governments are obliged to conduct mandatory functions such as the fulfillment of minimum service standards in the area of public health, food security, basic education, public works, transportation, etc.

Table 4 - Assessing the Property Tax Base

Tax Base	Definition	Measure used	Where Used	Tax Rate and The Range
Assessed unit value or area based	Size of property adjusted to account for quality and structures	M2 of land and building area, adjusted	Armenia, Belgium, Bulgaria, Denmark, Germany, Israel, Italy, Poland, Portugal, Spain	Portugal: LGs set the tax rate, within 0.7 percent and 1.3 percent.
Market value	Price of potential sale or purchase	Comparable sales	Australia, Canada, Hungary, Japan, Netherlands, South Africa, United States	Denmark: LGs within 1.6 percent and 3.4 percent. Spain, Poland, and Italy: LGs within a cap set up by central government. Germany: set up by local governments. Bulgaria: 0.15 percent of value of property.
Rental value	Value in current use	Net rental income	France, India, Ireland, Morocco, Pakistan, United Kingdom	In Hungary, set by local government.
Self- assessment	Sales price	Determined by owner of property	Peru, Turkey	In United Kingdom, as function of a cap. In France, local governments with a cap.

Source: Slack 2009, DEXIA 2008.
Note: LG – local government

In many developing countries, the national government may set the rates for property taxes, in the form of either a cap or a range of rates. Sub-national governments may vary rates by class of property, for example, residential, commercial, and industrial. Often sub-national government can establish their own tax rate, within a range of values agreed with the central government. Billing, collection and enforcement have a substantial impact on the performance of the property tax. Public awareness of simple and effective payment procedures and enforcement such as judicial sale or arrest usually induces voluntary compliance[15].

At the end of Megawati Soekarnoputri presidency term, there was a single event that is very influential in determining the future of decentralization

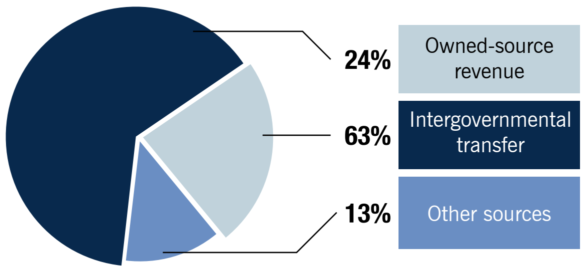
15. Roy Bahl (Property tax reform in developing and transitional countries, 2009) summarizes way of administrative reform to increase property taxes collection: a) increase coverage (GIS, mapping); b) upgrade valuation (training, procedure); c) unified record keeping (interagency cooperation and unique numbering system); d) improve collection rate (reduce preference, reduce compliance cost, thoughen enforcement).

in Indonesia: the parliament's approval of the revision of Law 22 of 1999 on local government and Law 25 of 1999 on intergovernmental fiscal relationship. The key features include greater autonomy of local governments by dissolving the hierarchical relationship with the province. Local government leaders would only need to report to local parliaments instead of the provincial governor. In addition, four categories of local government revenues were defined: own sources; balanced fund; local loans; and others[16]. Law 32 of 2004 was then revised again under President Susilo Bambang Yudhoyono to become Law 23 of 2014 where it describes in details about the direct election of local leaders[17].

Upon a rapid and often called as "big bang decentralization", Indonesia has transformed as more decentralized ones. The idea of "money follows functions" was considered. Or in other words, the central government is responsible of providing necessary capital grant to local governments to cover thier expenditure and to achieve the minimum service standards. The transition to a significantly more decentralized mode of governance was smooth.[18] Intergovernmental transfers, through General Allocation Grant, Special Allocation Grant, and Revenue-Sharing Grant, have grown, both in relative and absolute terms. Further, in 2004 the second round of democratic elections, at both national and sub-national levels took place without any major interruptions. However, there still exist some critical issues that come into consideration such as highly dependent on central government transfer, weak local taxing power, and unachievable minimum local service delivery. Table 2 clearly defines highly dependency of subnational governments, on average, to central government transfer (63 percent). Meanwhile, the share of owned source revenue (OSR) to total revenues are about 24 percent, on average. This figure varies between high, medium, and low fiscal capacity regions. DKI Jakarta, for example, has the ratio of OSR to total revenue of about 50 percent. This figure will increase further once they receive full authority to collect property tax.

On average, both provinces and districts relied on the intergovernmental transfer to fund their expenditure of around 63 percent on average. The figure shows that regions relied on the intergovernmental transfer. This condition has created moral hazard and crowds out subnational government's willingness to actively generates owned source revenue and to invest in public infrastructure[19]. Furthermore, the dependency on the central government has increased since the start of decentralization. This conclusion is strengthened due to proliferation of new local governments. Currently, there are 34 provinces and around 491 districts and municipalities in Indonesia. Recent devolution of property tax receipt to subnational governments brings positive effects to their financial condition. This will bring more fiscal space to be used to invest in public infrastructure.

Figure 2 - Composition of Local Revenues APBD 2014



Source : 2014 APBD (Local Budget)

In addition, fiscal decentralization, from political economy perspectives, should be viewed as a comprehensive system that involves in a) local election; b) locally appointed chief officers; c) significant local government discretion to raise revenue; 4) a division of spending responsibilities or competencies among types of governments; 5) sub-national own-taxing authority and 6) rules and regulation relating to local borrowing and debt management; and e) a special status for capital cities. Moreover, the other conditions comprise: 1) freedom from excessive central expenditure mandates, 2) unconditional transfers from higher-level governments and 3) borrowing powers.

Voters will hold their elected officials more accountable if local public services are financed to a significant extent from locally imposed taxes, as opposed to the case where financing is primarily done through central government transfers. To do so, the tax must be visible to local voters, large enough to impose a noticeable burden, and the burden must not be easily imported to residents outside the jurisdiction. Moreover, to capture the benefits of fiscal decentralization, it is suggested

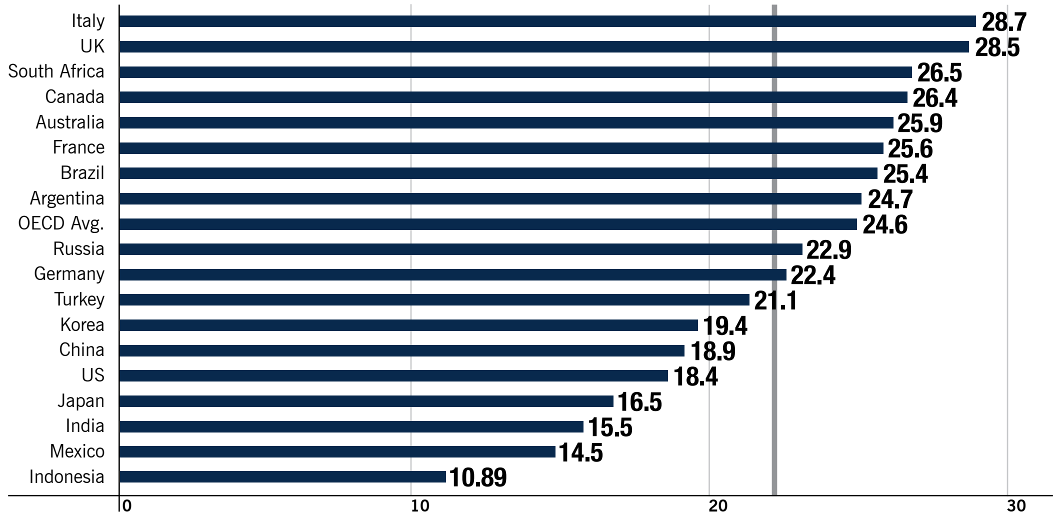
16. Brodjonegoro, B,"The Indonesian Decentralization after Law Revision: Toward a Better Future? See http://www.econ.hit-u.ac.jp/~kokyo/APPPsympo04/PDF-papers-nov/Indonesianpaper.pdf

17. Law 33 of 2004 is currently under revision

18. Suhendra, M and Hidayat Amir,"Fiscal Decentralization in Indonesia: Current Status and Future Challenges", Jurnal Keuangan Publik, Ministry of Finance RI, September 2006

19. However, some local governments perform much better than their peers in collection owned source revenues. Municipalities such as Surabaya, Semarang, Balikpapan, and Denpasar have increasing ratio of locally source revenue to capital transfer over the period of 2010-2014. This figure means that they tries to generate more owned revenue and less dependent to central government transfer.

Figure 3 - Tax Base Across G20 Countries



that there must be significant local autonomy given not only on the expenditure side but also on the revenue side. If local governments do not have the power to set tax rates, then their officials cannot be held fully accountable by voters for the quality of public services delivered. In addition, it is also necessary for local councils and chief officers to be elected. Otherwise, they will not be accountable to the local voting population, and the efficiency gains of decentralization will be lost[20]

4. Performance of Sub-national Taxes

IN GENERAL, LOCAL TAXING POWER IN INDONESIA CONSIDERED WEAK DUE TO THE ABSENCE OF MAJOR TAXES AT THE LOCAL LEVEL.

From Figure 3, it depicts that a total tax-GDP ratio of Indonesia is around 10.89 percent in 2010. Indonesia is one of the lowest tax bases among G20 countries well below South Korea (19.4 percent), China (18.9 percent), Japan (16.5 percent) and even India (15.5 percent) and Mexico (14.5 percent)[21]. Frankly to say that Indonesia performance is at the bottom whereas Italy performs much better than all developed G20 countries with figures as high as 28.7 percent. Hence, it can be concluded that there is an urgent need to expand the tax base in Indonesia as well as reform tax administration through enhancement of identification of properties, valuation, recordkeeping, collection and enforcement[22].

Moving to the case of Indonesia, sub-national taxation is regulated by Law 28 of 2009 on regional taxes and user charges. There are four provincial taxes namely 1) motor vehicle tax, 2) motor vehicle transfer tax, 3) fuel excise tax, and 4) ground water extraction and use tax. Moreover, there are seven kinds of taxes for local government, 1) hotel tax, 2) restaurant tax, 3) street lighting tax, 4) advertisement tax, 5) entertainment tax, 6) mining tax for class c minerals and 7) parking tax.

In general, local taxing power in Indonesia considered weak due to the absence of major taxes at the local level, even through the *piggy-backed* system. The current fiscal decentralization system, through Law 33 of 2004, still emphasizes on the tax revenue sharing of property tax, land transfer tax, and personal income tax[23]. While the local governments receive certain part of the respective tax revenue, they do not have authority in setting tax rate and base. As a result, the local governments have little room to provide incentive for local investors. Based on Table 5, central government is still collecting and managing major source of revenues from taxes and mining in order to support horizontal equalization agenda. Under the current fiscal decentralization law (Law No 33 of 2004), which currently is under revision, central govenment keeps 80 percent of revenue from Personal Income Tax. Meanwhile, for property tax (P2 – urban and rural), central government has reliquished its authority to collect to subnational government starting in 2014.

20. Bahl, Roy, W., 1999, "Implementation Rules for Fiscal Decentralization", Published of the World Bank, New York.

21. Current Tax-GDP ratio in Indonesia is about 12.5% however the number is still below its G20 counterparts.

22. City of Barranquilla in Republic of Colombia is able to double tax collection between the course of 6-7 years by improving its property tax administration.

23. Op.cit, Suhendra and Amir, 2006

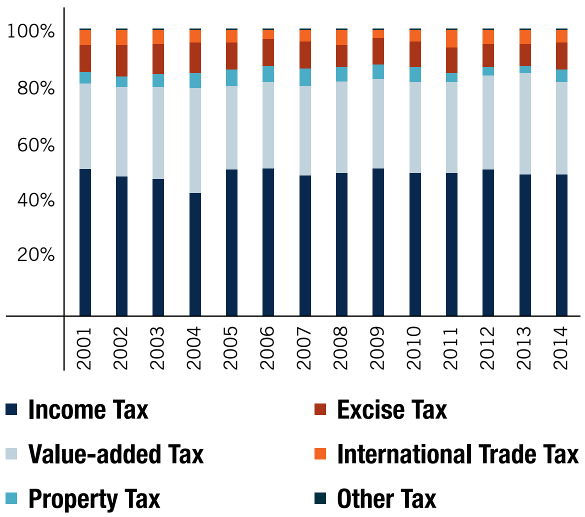
Table 5 - Revenue Sharing based on Law 33 of 2004 (in percentage)

Revenue-shared Sourced	Central Gov	Prov	Originating LGs	Other LGs in the same Prov	All LGs
Personal Income Tax	80	8	12	-	-
Property Tax	9[a]	16.2	64.8	-	10[b]
Land & Building Transfer fee	-	16	64	-	20
Forestry: land-rent	20	16	64	-	-
Forestry: resource rent	20	16	32	32	-
Forestry: reforestation	60	-	40[c]	-	-
Mining: land-rent	20	16	64	-	-
Mining: Royalty	20	16	32	32	-
Fishery	20	-	-	-	80
Oil	84.5	3 0.1[d]	6 0.2[d]	6 0.2[d]	
Gas	69.5	6 0.1[d]	12 0.2[d]	12 0.2[d]	
Geothermal	20	16	32	32	

Notes: [a]) 9 percent of the revenue collected from property tax is defined as administration costs and distributed equally to all local government; [b]) 10 percent of the revenue collected from property tax is allocated to all local governments based on the actual property tax revenue collection at the current year. 6.5 percent is distributed to all governments, and 3.5 percent is given as incentive to all local governments, which have revenues exceed the target of collection from the previous year. Currently, Central Government has relinquished all property tax receipt for household to local governments; [c]) Revenue Sharing from reforestation is an ear-marked grant to rehabilitate forests in originating local governments; [d]) 0.5 percent of the revenue sharing from oil and gas is allocated to Provinces and vertically below local governments as additional fund for education (ear-marked grant).

As mentioned above, revenue sharing is part of the intergovernmental transfer that currently implements. It is also a tool to address the problems of vertical fiscal imbalances between central and local governments. As in many developing countries, major taxes are still remains at the central level, i.e. Personal Income Tax (PIT), Value added tax, and most of property tax. Almost all money obtained from property tax collection is allocated to local governments through revenue sharing. Looking on the decomposition of tax revenue for 2014 National Budget, revenue collected from value added and income tax is substantially larger than the other taxes. For example, revenue combined from property tax, excise tax, international trade tax, and other tax is still lower to revenue coming from value-added tax.

Figure 4 - Decomposition of Tax Revenue in Indonesia



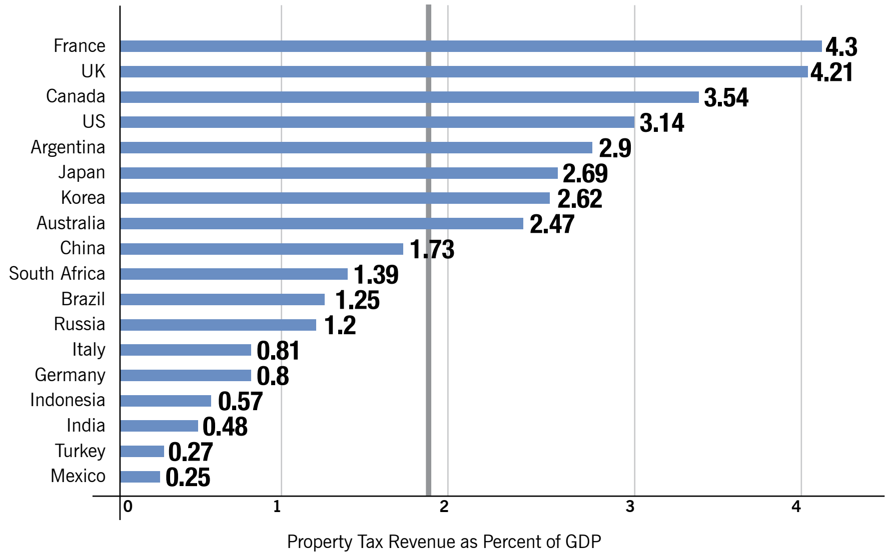
Source: APBN 2014

From Figure 5 on the next page, at macro level, Indonesia has a property tax to GDP ratio of around 0.57 percent, which is one of the lowest among G20 countries as compared to G20 and BRICS averages of 1.21 percent and 1.90 percent respectively. The number is also not different to when comparing property tax revenue as % of total taxes revenue where the figure for BRICS on average is 4.85 percent and 7.60 percent for G20 on average. India, Turkey and Mexico are below Indonesia with the figure of 0.48 percent, 0.27 percent, and 0.25 percent, respectively. Indonesia's Property Tax Base comprises mainly recurrent immovable property tax.

Property is assessed in two ways: first the land is valued, then any development that is present on that land is valued. Property taxes are therefore calculated on both the land's worth and any buildings that might occupy it. Property tax in Indonesia is thus defined as Land and Building Tax or *Pajak Bumi dan Bangunan*. Land and Building Tax is paid annually and is administered by the local offices of the Directorate General of Taxes rates vary by region, but are generally between 0.1 percent to 0.2 percent of the property's value. Tax re-assessments take place every three years, except in fast-growing areas where re-assessment takes place every year.

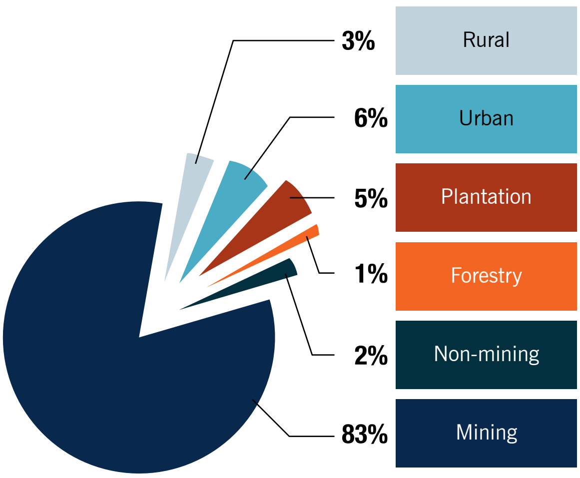
Figure 6 shows that property tax revenue in Indonesia mainly comes from PBB P3 (plantation, forestry, mining, and non-mining – 5,1, 2, 83 percent, respectively). Meanwhile, property tax of urban and rural is only 9 percent of the total property tax revenue or around 0.4 percent of total tax revenue (or even less than 0.06 percent

Figure 5 - Property Tax Structure and Progressivity across G20 Countries



Source: Prakash, P,"Property Taxes Across G20 Countries: Can India Get it Right?" OXFAM India Working Paper Series, January 2013.

Figure 6 - Share of Property Tax Revenue in Indonesia



Source: Financial Note and Plan National Budget (RAPBN) 2014

of GDP). As stated above, property tax (for urban and rural) is fully regionalized in 2014. Although, in practice only limited number of sub-national governments such as city of Surabaya that has been able to execute the mandate due to readiness of the tax administration.

The development of the property taxes revenue collection, as shown in Table 6 on the next page, moves at nearly the same level after the enactment of Law No. 28 of 2009 on Local Taxes and Levies, where PBB of Rural and Urban object has been handled by the City/District Government. In 2012 fiscal year contribution for each sector are as follow 4.0 percent (rural), 21.1 percent (urban), 3.8 percent (plantation), 0.9 percent (forestry), 2.0 percent (mineral) and 68.3 percent (oil & gas). Similarly, the growing collection as shown in the same table with remaining classification Rural, Urban, Plantation, Forestry, Minerals and Coal and Oil and Gas Mining respectively 3 percent, 5.4 percent, 5.2 percent, 1.2 percent, 2.5 percent, and 82, 8 percent.

Table 7 below depicts the percentage of each business tax to locally owned-revenue in the district and city throughout Indonesia for the year of 2009 to 2012. The biggest contributor to the local tax revenue is street lighting tax with an average of 14.9 percent for the city and 12.83 percent for the district. The second largest contributor is the restaurant tax in the city area that reached 7.33 percent. Percentages for hotel tax to PAD in the city and district are not much different at around 5 percent.

Sensitivity analysis was also conducted in this paper to find out the effect of property tax revenue reduction to Gross Domestic Product. It is understood that property tax will decrease at the level of around 10 percent minimum in the near future. As identified from previous literatures, Marginal Propensity to Consume (MPC) in Indonesia is around 0.686 and, as a result, tax multiplier will about -2.2 (=-0.686/0.314). This means that for one rupiah increases in tax revenue will put downward pressure to Gross Domestic Product by 2.2 rupiah. Additionally, property tax multiplier is -0.08 or about 4 percent of tax multiplier (0.04*-2.2). In aggregate, there is a positive effect of reducting property tax to GDP. The effects are larger as the percentage of property tax reduction increases. Furthermore, property tax buoyancy in Indonesia over the course of 2001 – 2013 is around 2.98% meaning a one percent increases in GDP growth affects an increase in property tax revenue by 2.98%.

Table 6 - the Growth of Revenue from Property Tax during 2011-2014

Description	2011		2012		2013		2014	
PBB	Real	%	Real	%	Real	%	Real	%
Rural	1.2	3.9	1.1	4	0.8	3	0	0
Municipal	6.6	22.1	6.1	21.1	1.4	5.4	0	0
Plantation	1	3.3	1.1	3.8	1.3	5.2	1.4	6.5
Forestry	0.3	0.8	0.3	0.9	0.3	1.2	0.3	1.3
Mineral	0.4	1.3	0.6	2	0.6	2.5	1.1	5.1
Oil & Gas	20.5	68.5	19.8	68.3	20.9	82.8	18.9	87.1
Total	29.9	100	29	100	25.3	100	21.7	100

Source: APBN-P, 2014

Table 7 - Tax Revenue as a Percentage of Locally Owned Revenue (Pendapatan Asli Daerah – PAD)

Types	Area	2009	2010	2011	2012	Average
Hotel tax/PAD	City	6.96	3.86	6.10	5.33	**5.56**
Hotel Tax/PAD	District	7.27	6.64	1.86	1.81	**4.40**
Restaurant Tax/PAD	City	8.82	5.23	7.77	7.51	**7.33**
Restaurant Tax/PAD	District	1.37	1.09	0.91	1.03	**1.10**
Amusement Tax/PAD	City	2.29	1.29	2.05	1.79	**1.85**
Amusement Tax/PAD	District	0.62	0.70	0.75	0.43	**0.63**
Billboard Tax/PAD	City	4.36	2.38	3.07	2.48	**3.07**
Billboard Tax/PAD	District	0.90	0.84	0.98	0.77	**0.87**
Lighting Street/PAD	City	10.74	12.11	14.68	13.12	**14.91**
Lighting Street/PAD	District	15.30	11.98	11.51	12.54	**12.83**

Source: : TADF, 2014, unpublished.

Tabel 8 - Sensitivity Analysis for Reduction in Property Taxes in Indonesia (Figure in Billion Rp)

Year	GDP	Tax Revenue	Case A. -25% Property tax reduction	Case B. -50% Property tax reduction	Case C. -75% Property tax reduction	Case D. -100% Property tax reduction
2009	5,613,440	619,900				
2010	6,446,851	723,300				
2011	7,422,781	873,900				
2012	8,241,864	980,200				
2013	8,695,167	1,139,300				
2014	9,173,401	1,207,658	9,199,969	9,231,851	9,253,106	
2015	9,677,938	1,280,117	9,706,100	9,734,263	9,762,425	9,790,588
2016	10,210,224	1,356,925	10,240,077	10,269,929	10,299,781	10,329,634
2017	10,771,787	1,438,340	10,803,430	10,835,074	10,866,717	10,898,361
2018	11,364,235	1,524,640	11,397,777	11,431,319	13,879,892	11,498,403
2019	11,989,268	1,616,119	12,024,822	12,060,377	12,095,932	12,131,486
2020	12,648,678	1,713,086	12,686,365	12,724,053	12,761,741	12,799,429

Source: : APBN 2009-2014, own calculation.

5. Concluding Remarks and Policy Recommendation

Tax policy is the most important government instrument to mobilize resources, reduce disparity in income and wealth in the country, and as a tool to stabilize the economy. To be more precise, taxation policy is also an important tool to address the problem of vertical and horizontal inequality for country that exercises fiscal decentralization like Indonesia. The existing reliance on unconditional transfers (general allocation grants-DAU) to finance sub-national government operations creates incentives that potentially undermine accountability of sub-national governments[24]. Therefore, making local tax bases broader has a number of potential benefits. If service delivery is more closely linked to local tax payments, citizens face greater incentives to monitor government performance and demand accountability from local governments. At the same time, it can further enhance inter-jurisdictional competition and people choosing low tax – low spending jurisdictions over high tax – high spending jurisdictions could create powerful incentives to increase spending efficiency. If Indonesia wants to benefit from these effects greater, the local taxation autonomy is indeed a necessary institutional prerequisite. In conventional Keynesian economics, it is stated that an increase in tax could hamper GDP if it is not properly managed. Government budget especially in Indonesia still relies heavily in tax collection to finance its expenditure. The decision to reduce collection of property tax especially for the poor one is a good steps toward improving the whole economy.

According to Law No 28 of 2009, two taxes previously managed by the central government, i.e. Land and Building Transfer Fee (*Bea Perolehan Hak atas Tanah dan Bangunan – BPHTB*) and Property Tax P2 (*Pajak Bumi dan Bangunan untuk sektor Perdesaan dan Perkotaan*) were transferred fully to local governments. Based on calculation conducted by TADF team (Assistance Team of Fiscal Decentralization to the Minister of Finance), there was an increase in the ratio of locally owned resource (Pendapatan Asli Daerah – PAD) to Local Revenue. However, tax ratio and tax per capita are considerably low. This leads to a conclusion that after the enactment of Law 28 of 2009, there is still a big tax gap between the potential and actual tax receipt.

Primary agenda to solve the above mentioned problems is to widen the tax base by improving current tax administration system. As explained in the previous section, local govenments need to utilitize more sophisticated technology, for example by utilizing GIS (Geo-Spatial Information System) and not soley relying on the date from the sale of property, as part to increase tax base and determine rate structure. Local government is also required to establish a monitoring activity and toughen enforcement[25]. For business taxes, local leaders firstly should create a more conducive business environment and develop a system that could generate and record accurate information on business transactions.

24 Rodden, J. (2002), "The Dilemma of Fiscal Federalism: Grants and Fiscal Performance around the World", American Journal of Political Science 46 (3), p. 670-687.

25 Several cities across the globe use media to strengthen enforcement in property taxes.

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