The political cost of local revenue mobilisation:
Decentralisation of the property tax in Indonesia*

Christian von Haldenwang**

March 2015

Abstract
Taxes on real estate property have been identified as a source of income whose potential is currently underused by many countries. Indonesia has recently decentralised the property tax to the local level, but has this led to a better use of the tax potential from this source? A look at revenue figures provided by the Indonesian Ministry of Finance suggests that reforms may have boosted tax collection at an aggregate level. However, closer scrutiny of seven local cases reveals that local governments are still far from tapping the full potential of the property tax. Most of them are struggling with deficient data, low public acceptance of the tax and huge amounts of tax liabilities. More importantly, local governments shy away from the political costs associated with more active revenue mobilisation.

Keywords:
Taxation, Indonesia, fiscal decentralisation, property tax, political economy

* This paper is partly based on empirical research carried out in Indonesia between February and April 2014. Members of the research team were Alice Elfert, Tobias Engelmann, Samuel Germain, Gregor Sahler and Amelie Stanzel Ferreira, and their fundamental contribution to this study is gratefully acknowledged.

** Christian von Haldenwang is a senior researcher with the German Development Institute / Deutsches Institut für Entwicklungspolitik (DIE) in Bonn, Germany.
1. Introduction

Mobilising domestic revenue is a key issue on the international financing for development agenda (for instance, see OECD, 2014). In their efforts to tap hitherto underused sources of revenue, some governments have turned their eyes to the taxation of real estate property. Property tax has been labelled “the number one un-exploited potential source of public revenue globally”.

It is also considered a typical local tax since it is relatively difficult to avoid due to the immobile character of assets, and collection is based on locally available information (Bird & Slack, 2004; Fjeldstad & Heggstad, 2012). In localities with dynamic changes in the real estate market, for instance due to high urbanisation or economic growth rates, granting local authorities the right to tax property should lead to rapidly rising revenues from this source.

Recent contributions to the debate acknowledge the revenue potential of property tax in developing countries while identifying several factors that make collection of this tax a challenging task for local governments (Fjeldstad & Heggstad, 2012; Kelly, 2014; Monkam & Moore, 2015; Norregaard, 2013; Slack & Bird, 2014): First, property taxation requires administrative capacities (for instance with regard to valuation and enforcement) many local governments do not possess. Second, central government transfers may create powerful disincentives to local revenue generation, leading to moral hazard behaviour of local authorities (Weingast, 2014). But perhaps most importantly, effective property taxation can be hampered by political settlements where local politics or tax administrations are captured by powerful groups and any decision to tax is taken in the light of the political costs it entails (Di John & Putzel, 2009; Everest-Phillips, 2009; Jagger & Shively, 2014; Slack, 2013).

With all these observations being widely discussed by now, it is fair to say that the underlying microtheoretical mechanisms have hardly been studied so far. How do administrative constraints, incentive structures and political settlements express themselves in everyday tax policy and tax administration? Some papers explore this question with reference to the USA and other OECD member countries (Alm, Buschman, & Sjoquist, 2012; Asatryan, Baskaran, & Heinemann, 2014; Ashworth & Heyndels, 1997; Cabral & Hoxby, 2012; Gill & Haurin, 2001; Makowsky & Sanders, 2013; Presbitero, Sacchi, & Zazzaro, 2014; Slack & Bird, 2014). Several interesting lessons can be drawn from this research, as will be shown in the next section of this paper. Beyond the world of industrialised countries, however, evidence remains scant (for instance, see Bird & Slack, 2004).

Researchers note of course that developing countries rely to a much lesser extent on direct taxation of personal income and property than the industrialised countries. As a recent study observes: “Perhaps political economy problems are more severe among developing countries, and some important domestic constituency gains from the policies that standard [optimal tax] models find perverse. Yet these puzzling policies are found under many different types of governments, drawing their support from many different constituencies” (Gordon &

---

Li, 2009, p. 856). While Gordon and Li (2009) seek to solve this puzzle by changing the model to account for higher enforcement costs due to large informal sectors in developing countries, other authors broaden the scope by looking at the strength and stability of political institutions as a key determinant of the tax structure (for instance, see Besley & Persson, 2014; von Schiller, 2015). If the local taxation of property is supposed to play a more important role in mobilising domestic revenue in developing countries, it appears to make sense to gain insights in the political economy (including the institutional setting) underlying property tax reform and collection. In the absence of reliable comparative data, qualitative case study analyses or small-N comparisons appear to be appropriate approaches to deepen our knowledge.

The present study aims at contributing to this endeavour by addressing the question whether the decentralisation of the ‘land and building tax’ (pajak bumi dan bangunan) in Indonesia has led to a better use of the revenue potential this tax entails. Despite the recent character of reforms – the tax was decentralised in a gradual process between 2011 and 2013 – Indonesia is a case that offers several interesting insights into the political economy of tax decentralisation. After more than three decades of autocratic rule under General Suharto, the country embarked in 1998 on a political transition towards democracy that included several bold decentralisation measures (Horowitz, 2013). This so-called ‘big bang decentralisation’ (Hofman & Kaiser, 2004) has led to the transfer of many new responsibilities to the nearly 500 cities and districts (kota and kabupaten). Both the transfer system and the local revenue system were changed several times, with the decentralisation of the land and building transfer tax in 2011 and the land and building tax in 2011-2013 being the latest major reforms.

Based on empirical fieldwork carried out between February and April 2014 (von Haldenwang et al., 2015), this paper observes that local governments appear to have raised the revenue collected from the land and building tax after decentralisation. A more detailed look into seven cases located in different parts of the country reveals, however, that local governments are far from using the new competences to their fullest potential. Of the seven tax policy and administration measures at their disposal, local governments seem to systematically shy away from those associated with higher political costs. Measures that are less costly in political terms are used more frequently, but still far from the levels observed in other countries (de Gramont, 2015; Jibao & Prichard, 2013; von Haldenwang, 2010). The paper provides several explanations for this observed behaviour, thus shedding light on the challenges of promoting local revenue collection in developing countries.

The next section builds the case of the political economy of property tax reform. By looking at the available literature it introduces the concept of ‘political costs’ and identifies the variables and their assumed causal relationships that guide the empirical inquiry. Section 3 introduces our empirical case, Indonesia. Section 4 describes the research design while section 5 presents the main research findings. Section 6 concludes.
2. The political economy of property tax reform – building the case

Paying taxes is never popular. Every tax reform – and for that matter, taxation in general – comes at a political cost.\(^2\) The definition of political costs used in this paper is based on the political economy literature, in which decision-makers are assumed to be rational actors aiming to secure political support in order to stay in power (Bueno de Mesquita, Smith, Siverson, & Morrow, 2003). In a democratic setting where politicians depend on electoral support, a ‘political cost’ is thus represented by an expected loss in votes in the following election (Hettich & Winer, 1988, 1999). In that sense, politicians weigh the expected political benefits and costs before enacting public policy reforms, and their perception of public opinion and possible opposition restricts their choices on tax policy and administration (Garcia & von Haldenwang, 2015).

Several studies provide evidence for this hypothesis. Based on a survey among local politicians in Belgium, Ashworth and Heyndels (1997) observe that vote-maximising political actors choose reform paths which minimise political costs. Tax levels are chosen so as to reduce the opposition of popular vote. Perceptions of political costs are shaped by tax policies in neighbouring jurisdictions. In a study on 20 OECD countries, Bonfiglioli and Gancia (2013) show that political reform is not necessarily punished by voters and that uncertainty about electoral outcomes does not need to discourage reforms.

However, the revenue effect of tax reforms (property tax in particular) is often more visible and immediate than the benefits arising from spending that revenue. Voter discontent can be triggered by a direct loss of disposable income, which stands against an indirect and less transparent improvement in the provision of services through increased public expenditure (Kenny & Winer, 2006). In such a setting, property tax is more likely to meet resistance due to its salience and broad tax base (Cabral & Hoxby, 2012; Rosengard, 2013). In line with this argument, Presbitero et al. (2014) observe that in a sample of 22 OECD member states a higher recourse to property taxes at the subnational level is associated with higher primary fiscal surpluses (i.e., more fiscal discipline), while a larger share of property taxes in the overall government tax take does not have any statistically significant effect on the fiscal balance.

Even when the overall tax take is not the main issue, political conflict and opposition may arise with regard to the composition of the tax structure. This is shown, for instance, by Asatryan et al. (2014) who observe that greater reliance on direct democracy at the local level in the German federal state of Bavaria leads to higher taxes in general, but to a relative shift from the broad-based property tax to the narrow-based business tax. To deal with pressure from specific groups, politicians may have an interest in diversifying the tax base and using a variety of channels to increase or maintain revenue. On the other hand, if certain

\(^2\) Obviously, this statement applies above all to reforms that aim at increasing tax revenue. Tax cuts will likely cause much less opposition, or no opposition at all. In some cases, they may be unpopular (for instance, due to equity concerns), but in many other cases tax cuts are employed to boost the incumbent’s popularity (Prichard, 2014). In this paper, however, the focus is principally on reforms aiming at tax revenue growth.
societal groups dominate the political power game (a ‘winning coalition’), one would expect a political support-maximising government to tailor its policy accordingly (Ashworth & Heyndels, 1997; Bueno de Mesquita et al., 2003). This is shown by Gill and Haurin (2001) who find that the influence of strong interest groups (farmers, business) drives the choice of tax instruments in a sample of Ohio school districts, with the former preferring income taxes and the latter, property taxes.

As a particular feature, tax collection at the local level almost always takes place in context with substantial fiscal transfers from the central government. With the exception of a few highly decentralised OECD countries the worldwide situation is characterised by few, if at all, rich cities being able to finance themselves and the majority of local governments being critically dependent on central government transfers. This is certainly true for Indonesia, where the average local government finances less than 10 per cent of its budget with revenues from own sources. The risks of moral hazard behaviour associated with reliance on central government transfers have been extensively treated in the fiscal decentralisation literature (Bird & Smart, 2002; Boadway & Shah, 2007; López-Laborda & Zabalza, 2012; Poeschl & Weingast, 2013; Weingast, 2009).

Tax potential

Yet, taxation is not all about political costs. Taxes also produce important benefits: Above all, they provide rulers with fiscal means to achieve specific distributional goals and to satisfy the demands of their constituencies (Alm et al., 2012). In addition, they enable authorities to meet certain revenue targets and stabilise public revenue, thus facilitating longer-term expenditure planning. A decentralised property tax may offer local governments access to substantial revenue. This is especially true for urban settlements and high-growth areas. In contrast, rural districts with mainly agricultural activities and low growth potential may find it difficult to achieve a sustainable balance between the costs of tax collection and the revenue obtained.

Political decision-makers need to be able to assess the revenue potential this source of income has for their jurisdiction. In general terms, ‘tax potential’ refers to a maximum tax take that can be defined with reference to the legal framework alone or against a set of relevant factors. Pessino and Fenochietto (2010, p. 66) distinguish “tax capacity”, defined as “the maximum tax revenue that could be collected in a country given its economic, social, institutional, and demographic characteristics” from “potential tax collection”, defined as “the maximum revenue that could be obtained through the law tax system”. To identify the maximum level the authors use a stochastic frontier model (see also International Monetary Fund, 2011, p. 59). This is different from other studies, where the average is taken as a benchmark and countries can achieve ratings above 1,0 (or 100), as for instance in Stotsky and WoldeMariam (1997); Le, Moreno-Dodson, and Rojchaichaninthorn (2008); OECD, AfDB, and ECA (2010).

---

3 Averages for fiscal years 2008-2013, data provided by the Ministry of Finance (MoF) of the Republic of Indonesia.
More specifically, the revenue potential of the property tax in any given setting may be computed by using a formula that accounts for (i) the legal tax base, which defines the kind of objects to be taxed, and (ii) the nominal tax rate, while setting (iii) the coverage ratio (registered taxable objects versus total taxable objects), (iv) the valuation ratio (assessed values versus ‘real’ market values), and (v) the collection ratio (real collected amounts versus total liabilities billed) at a value of 1 (Kelly, 2014; Norregaard, 2013). The market value of a property can be determined using different methods (for an in-depth discussion, see Walters, 2013). In addition, the actual costs of tax collection would have to be taken into account to determine the true (net) revenue potential of the tax.

Getting access to all the required data can be difficult even in OECD countries. The real costs of tax collection in particular are often hard to come by. In developing countries, these data are often unavailable, or they exist only for some years and some municipalities. A standard procedure for the assessment of the effectiveness of local property tax collection has consequently been to look at the collection ratio alone, implying that the tax potential equals the total amount of issued liabilities. From a conceptual viewpoint, this approach is hardly convincing. There is no compelling reason to assume that deficiencies of tax collection present themselves only at the stages of collection and enforcement, and not already with regard to assessment, valuation and billing. Still, with access to data restricted, such an approach could be the best available option.

3. The case of Indonesia

Many of the causal linkages introduced above seem to apply to Indonesia. Decentralisation reforms were introduced in a political transition phase triggered by the Asian financial and economic crisis in 1997/1998. The transition period, called “reformasi”, was characterised by a crisis of legitimacy, a weak central government and widespread distrust of public institutions. The influence of sub-national demands for autonomy on the Indonesian decentralisation process has been important during the whole transition process. The secession of East Timor in 1999 and aspirations for independence in the provinces Aceh, West Papua and Papua provided another important background for decentralisation. Granting local (rather than provincial) constituencies greater autonomy was seen as a means to hold the highly diverse nation-state together. As a consequence, cities and districts received a broad range of responsibilities as well as access to important fiscal transfers from central government (Bunell, Miller, Phelps, & Taylor, 2013; Horowitz, 2013; Korte, Dutzler, & Hallerberg, 2013; von Luebke, 2009).

Several quantitative research papers study the impact of (fiscal) decentralisation on poverty and economic growth in Indonesia by making use of data from private sector or household surveys (McCulloch & Malesky, 2010; Pal & Roy, 2010; Pepinsky & Wihardja, 2011; Sumarto, Vothknecht, & Wijaya, 2014; Tirtosuharto, 2010; von Luebke, 2009). In most cases, studies explore the impact of governance on development outcomes, for instance by looking at corruption or the selection of local leaders. Results are not always consistent with regard to the relevance of specific governance factors. For instance, von Luebke (2009) finds ‘government
leadership’ to be a better explanatory variable for government performance than ‘societal pressure’, while local elite capture appears as a relevant factor influencing the performance of local governments in several other studies. The significance of local government features is often overshadowed by other factors, such as for instance natural resource endowments. In addition, poor data quality at the local level can play a role in spoiling statistical analysis. Most importantly, however, issues of endogeneity (omitted variable bias, reverse causality) and sample selection are often difficult to control for in econometric studies at subnational levels.

In explaining local revenue efforts, the fiscal transfer system installed after decentralisation is a key factor. By far the most relevant transfer fund is the General Allocation Fund (Dana Alokasi Umum – DAU).\(^4\) It distributes a minimum of 26.5 per cent (currently more than 35 per cent) of the national budget to subnational governments. One component of the DAU, the so-called Basic Allocation covers ca. 88 per cent of the municipal wage bill. The second component is a block grant scheme distributed according to the gap between the fiscal needs and the fiscal capacity observed in each locality. The formula determining this ‘fiscal gap’ is re-calculated every year in order to bring the distributional impact in line with the political objectives underlying the budget law.

Since own revenue efforts are an indicator for fiscal capacity, growth in local tax collection should *ceteris paribus* lead to a relative decline of a local government’s share in DAU transfers in the following fiscal year. This perverse incentive to local tax collection efforts built into the Indonesian transfer system has apparently been mitigated by the fact that high economic growth rates have increased overall government revenues in recent years, thus ‘enlarging the cake’ for all. In addition, the central government has transferred more than the legal share to the subnational levels in the years following the global financial crisis, according to official budget figures.

All in all, the Indonesian transfer system has shaped local accountability mechanisms in different ways (Sjahrir, Kis-Katos, & Schulze, 2013): On the one hand, the Basic Allocation promotes an inefficient use of public employment, as local governments finance their wage bills almost completely with central government money. On the other hand, local governments can count with a dependable and even steadily growing flow of funds from the central government, based on a formula that does little to encourage own revenue collection, to say the least. Following the political cost-arguments discussed above, it seems fair to assume that both factors operate against local revenue mobilisation.

\(^4\) Other, less important funds are the Special Allocation Fund (Dana Alokasi Khusus – DAK), which finances subnational investment projects, the Shared Revenue Fund (Dana Bagi Hasil – DBH), which distributes revenue from natural resources as well as shares of the income tax, the Special Autonomy Fund (Dana Otonomi Khusus) for the three regions with special autonomy status (Aceh, Papua, West Papua) and the Adjustment Fund (Dana Penyesuaian) which pursues similar objectives as the DAK. See von Haldenwang et al. (2015) for a detailed discussion. The information given in this paragraph is principally based on material provided by the MoF and interviews with MoF officials in February 2014.
Prior to decentralisation, the land and building tax was part of the Shared Revenue Fund (DBH). Of the revenue collected, the local government received 64.8 per cent, while 16.2 per cent were transferred to the respective province. Another 10 per cent were distributed to all cities and districts nation-wide. The central government kept the remaining 9 per cent as a collection fee.

Under the decentralised regime, all revenue stays at the local level. Law No. 28 of 2009 re-organised both the provincial and the municipal tax regimes. Most importantly, the property transfer tax and the land and building tax were decentralised to cities and districts. With regard to the latter, the law established a four-year transition period in which local governments could freely decide whether (and when) to assume the new responsibility. As a legal requirement, local councils had to issue a municipal by-law (perda) regulating tax rates, exemptions, etc. This regulation had to be approved by the central government. Surabaya, Indonesia’s second largest city, took the lead in January 2011. Another 17 local governments followed in January 2012. In January 2013, a total of 104 local governments (including Jakarta) took over. In January 2014, central government stopped collecting the tax and another 334 local governments were ready to assume this task. Of the (then) 491 cities and districts, 35 had not yet issued the local regulation required for starting property tax collection in 2014 – meaning that no property tax was collected in these 35 localities in 2014, as there was no legal basis to do so.

More specifically, Law No. 28 of 2009 granted local governments authority over the following tax instruments:

- Local authorities can decide on setting tax rates of up to 0.3 per cent of the assessed value of the property (the maximum tax rate was 0.2 per cent under the previous centralised regime). They are also free to establish different tax rates to account for different social or economic conditions. The minimum legal property value exempted from taxation was set at IDR 10 million (ca. EUR 595 as of 1.1.2014), but local governments are free to choose a higher threshold value.
- Local authorities can adjust the assessed values of the properties using different mechanisms: (i) update of the tax roll through data cleaning and actualisation, (ii) changing area-based assessments (‘zoning’), for instance by adjusting milling rates or by moving the geographical limits of zones and (iii) implementing value-based assessments of individual properties.
- Local authorities can devise measures to increase tax compliance, either promoting voluntary compliance, for instance through public campaigns or improvements of taxpayer services, or raising the stakes for non-compliance, for instance by increasing the frequency of on-site visits or by linking other services to tax compliance.
- Local authorities assume the responsibility to collect unpaid tax liabilities from previous years. Due to a deficient administration of the property tax under centralised management, some local governments inherited rather large arrear portfolios.
Regarding the range of options local governments in Indonesia have at their disposal it appears evident that not all mechanisms entail the same kind of political costs. Table 1 summarises the instruments and their properties with regard to political benefits and costs.

Table 1: Overview: Property tax policy instruments at the local level in Indonesia

<table>
<thead>
<tr>
<th>Instrument</th>
<th>Mechanisms</th>
<th>Properties</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Setting tax rates and granting exemptions</td>
<td>Local council regulation</td>
<td>Transparent, can be used flexibly to adjust the tax burden, direct impact on revenue <strong>But:</strong> Highly visible, tedious process, highly political</td>
</tr>
<tr>
<td>2a Tax roll update: Data cleaning</td>
<td>Complaints management, visits on site, improving IT systems</td>
<td>Low profile administrative process, also linked to better taxpayer services <strong>But:</strong> Investments not always directly linked to higher revenue</td>
</tr>
<tr>
<td>2b Tax roll update: Area-based assessments</td>
<td>Adjustment of zone limits and/or zone values (zone-specific or across-the-board), adjustment of construction values</td>
<td>Administrative process (but politically sensitive), important step in narrowing the gap between assessed and real market values, direct impact on revenue <strong>But:</strong> Protests if values are adjusted too quickly, across-the-board adjustments may lead to skewed distributions of the tax burden</td>
</tr>
<tr>
<td>2c Tax roll update: Value-based assessments</td>
<td>Individual assessments</td>
<td>Administrative process (but politically sensitive), important step in narrowing the gap between assessed and real market values for high-value properties, direct and sizeable impact on revenue <strong>But:</strong> Rather costly and demanding in terms of administrative capacity, could stir protest by powerful groups (wealthy people, major companies)</td>
</tr>
<tr>
<td>3a Tax compliance: Promoting voluntary compliance</td>
<td>Awareness-raising and public education campaigns, rewards for timely payments, improving taxpayer services</td>
<td>‘Soft power’ instrument, proven to be effective internationally, linked to better services <strong>But:</strong> Draws public attention to the issue, immediate costs not always directly linked to higher revenue</td>
</tr>
<tr>
<td>3b Tax compliance: Raising stakes for non-compliance</td>
<td>Overdue payment letters, linking other services to tax payments, visits on site</td>
<td>Administrative process, direct impact on revenue <strong>But:</strong> Protests if robust tax collection is taken too far.</td>
</tr>
<tr>
<td>4 Active arrears collection</td>
<td>Debt notifications, linking other services to debt payments, improving IT systems, amnesties for older debt against payment of newer debt, fines, seizure of property</td>
<td>Administrative process, high immediate revenue potential, linked to concepts of equity and fairness <strong>But:</strong> Likely to stir protests due to low acceptance of the tax so far, may lead to excessive tax burden in individual cases, amnesties may undermine credibility of tax collection</td>
</tr>
</tbody>
</table>

How do these instruments impact on the political costs of tax collection? In the light of the literature discussed above, we identify four indicators that are likely to affect public opinion and the level of popular opposition to tax reform, thereby influencing the expected loss in votes in the following election:

- **Number of voters:** We assume that the larger the share of voters affected by a given tax policy, the larger the potential for increased opposition.
− **Political influence:** The social, political and economic influence of the affected taxpayers is considered an important factor. Elite segments and well-organised groups are better able to react to adverse policy reforms than ‘average’ citizens.

− **Impact of the measure:** The higher the impact of a policy on the disposable income of taxpayers, the higher the level of expected opposition. Also, an immediate impact is supposed to generate higher (immediate) political costs compared to an indirect or incremental impact.

− **Visibility of the measure:** Individual executive decisions or single administrative acts are usually less politically visible, and therefore less conflictive, than, for instance, legislative processes involving many stakeholders over an extended period of time.

4. Research design

Given the constraints discussed in the preceding section, our research addresses the use of property tax potential in Indonesia combining a macro and a micro perspective. Empirical fieldwork took place in Jakarta and seven other cities and districts between February and April 2014. Information on tax collection and transfers was gathered at the central government level, provided above all by the Ministry of Finance, and at the local level, provided by the municipal tax administrations and other local actors (for instance, local banks).

At the macro level, none of the tax potential approaches discussed above seems applicable to the Indonesian case. Even though references to “tax potential” can be found at all government levels, no comprehensive account of the underlying data appears to be available. Hence, this paper explores the dynamics of property tax collection in the years 2008-2012 using descriptive statistics. More specifically, revenue growth rates of those cities and districts that have taken local tax collection responsibility in 2011 and 2012 are compared to growth rates from previous years and to figures from those local governments where property tax is still collected by the local tax office of the central government (*Kantor Pelayanan Pajak* – KPP).

Results from this exercise, though telling, are obviously far from robust. Longitudinal comparisons are influenced by additional factors, above all the economic cycle, while cross-sectional comparisons are subject to sample selection bias: it is fair to assume that local governments with a more dynamic real estate sector will be inclined to start their own tax collection early, whereas those with lower growth rates or mostly rural settlement patterns will be more reluctant to assume this new task.

As a consequence, the indicative findings from the macro level analysis are complemented by a total of seven case studies. The case studies seek to explore the degree to which local governments make use of the legal instruments at their disposal to raise revenue from the land and building tax. This exercise provides a much richer picture of the use of tax potential than the macro-level analysis.

Cases were selected based on a most-similar research design (Gerring, 2006; Sekhon, 2008) among those 122 local governments that had taken the responsibility to collect the property
tax at the beginning of 2013 or earlier, thus having at least one year of collection experience at the time of the field research (February to April 2014). A pilot study was conducted in the city of Depok near Jakarta. Then, three pairs of local governments were identified.\footnote{See von Haldenwang et al. (2015) for further details. Three pairs were constructed to reflect three different research questions: Apart from the political costs of reform, the study explored the influence of administrative capacity restrictions and palm oil production on the local use of property tax potential. The cases chosen for the political cost dimension were the cities of Banjarmasin (Kalimantan) and Denpasar (Bali), but relevant information for the assessment of the political cost dimension was gathered in all seven cases. The other municipalities visited were Rokan Hulu and Rokan Hilir (two palm oil-producing districts in Sumatra), Tanjung Pinang (Riau Islands, Sumatra) and Lombok Barat (Lombok). Please refer to Table 5 (Appendix) for further details.}

For the dimension of political costs, we controlled for local GDP per capita as a proxy for state capacity (see Tranchant, 2008), and population density as a proxy for urbanisation, while allowing the share of transfers in total income (variable of interest) to vary. The choice of variable follows the assumption that local governments with high levels of central government transfers are more sensitive to the political costs of local tax collection. This is so because possible gains through higher local tax collection are comparatively small, but associated with significant increases in the local tax burden. To give an example, if a local government with a transfer share of 90 per cent of the local budget (an average value in Indonesia and roughly the value of Banjarmasin) wanted to diminish its dependence by 10 per cent, it would have to double the local tax burden from 10 to 20 per cent of the budget. For a local government with a transfer share of 60 per cent (roughly the value of Denpasar), diminishing its dependence by 10 per cent would lead to an increase of just 25 per cent of the local tax burden.

5. Findings

Macro level

As the aggregate figures show, local governments registered higher annual growth rates of revenue from the land and building tax after they had taken over tax collection. Table 2 gives the average growth rates for local governments (LG) grouped according to the year they have started local tax collection. The median was chosen to measure the average in order to account for the high degree of within-group heterogeneity. It should be noted, however, that at the time of empirical research for this study, only 24 cases had provided data on revenue collection before and after decentralisation. Hence, even though the tendencies point to the same direction, they do not reflect universal patterns, nor longer-term developments in local property tax collection.

Still, some additional insights can be drawn from the aggregate data. First, the assumption that the richer and more dynamic local governments would be, on average, more interested in assuming tax collection early, is supported by looking at average pre-decentralisation growth figures of the five different groups: Those less eager (or less prepared) to take over are at the same time those with less dynamic property tax revenues.
Second, pre-decentralisation revenue data also reveal that central government performance in collecting the land and building tax was far from solid. Given the immobile character or real estate property and the continuity of collection efforts, the tax should in principle provide a rather steady flow of revenue. Yet, year-to-year oscillations are surprisingly high before decentralisation in many local governments. To give an example, the group of 18 cities and districts that started local property tax collection in 2011 (Surabaya) and 2012 provides 54 observations of annual growth rates from 2009 to 2011. Of these 54 observations, 17 register growth rates of more than 20 per cent (with a maximum of 62.3 per cent) and three observations show a decrease of more than 15 per cent. It should be noted that the variation is even higher in the other groups. Also, tax collection in the year before decentralisation was low compared to previous years, suggesting that the central government may have lost interest in collecting this tax in the face of imminent decentralisation (see Table 3).

Table 3: Annual revenue growth rates from the land and building tax (median)

<table>
<thead>
<tr>
<th></th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>2011 (1 LG)</td>
<td>11.93</td>
<td>10.92</td>
<td>14.51</td>
<td>14.54</td>
<td></td>
</tr>
<tr>
<td>2012 (17 LG)</td>
<td>22.70</td>
<td>11.56</td>
<td>6.11</td>
<td>15.01</td>
<td></td>
</tr>
<tr>
<td>2013 (104 LG)</td>
<td>12.94</td>
<td>5.99</td>
<td>8.78</td>
<td>4.38</td>
<td>27.23*</td>
</tr>
<tr>
<td>2014 (334 LG)</td>
<td>13.29</td>
<td>3.85</td>
<td>5.55</td>
<td>2.89</td>
<td></td>
</tr>
<tr>
<td>No local regulation (35 LG)</td>
<td>3.44</td>
<td>10.06</td>
<td>-5.42</td>
<td>-0.27</td>
<td></td>
</tr>
</tbody>
</table>

Note: * Data for 2013 refers to six cases only. Based on annual collection data provided by the Ministry of Finance and by local tax administrations of the case studies (for 2013). Cells shaded grey = decentralised tax collection.
As a final sign of low central government performance, central government tax collection accumulated huge amounts of unpaid tax liabilities before decentralisation, as mentioned above. In the seven cases visited in 2014, these arrears amounted to between 2.07 and 8.90 times the mean annual property tax collection of 2008-2012 at the moment when the responsibility was transferred. Not only does this show the low performance of central government tax collection, but it indicates above all the low public acceptance of the tax.

**Case studies**

Local governments were granted new competences with Law No. 28 of 2009, but they also faced important challenges. Among these, the poor quality of tax registers (both in terms of infrastructure and content), the high amounts of unpaid taxes and the low acceptance of the tax by the local constituencies were most often mentioned in the interviews with tax administration officials, mayors and local council members.

Against this background, most local governments of our case studies developed a rather rudimentary phasing-in strategy. In the first year (or two years in some cases), the basic approach was to keep overall revenue roughly at pre-decentralisation levels. Taking into account that this already meant an increase in local revenue (since the local revenue share grew from 64.8 per cent to 100 per cent after decentralisation), few local governments had elaborated concrete plans for obtaining more revenue from this tax at the time when the empirical field work took place.

What use did local governments make of the new tax policy and tax administration instruments at their disposal?

**Tax rates and exemptions:** In all but one of the seven cases, tax rates were kept at pre-decentralisation levels. Only in Rokan Hulu, the maximum rate was marginally raised from 0.2 per cent to 0.22 per cent of the assessed property value. Also, all municipalities kept the two-rate structure inherited from the central government, with a lower tax rate of 0.1 per cent (0.11 per cent in Rokan Hulu) applying to properties with values below 1 billion IDR (ca. EUR 59,500 as of 1.1.2014). With regard to the threshold value of property exempted from the tax, only one local government, the city of Denpasar, used its legal competence to raise the threshold above the legal minimum, from 10 to 15 million IDR.

This appears to be a fairly general finding: Very few Indonesian cities and districts seem to have raised the tax rates to the legal limit in the first years after decentralisation (Jakarta being the most prominent case), and in at least one case (Medan in Sumatra) authorities were apparently forced to re-establish the previous rates after popular protests. None of the cases that form part of this study presented plans to raise the tax rate in the coming years. To justify this policy, authorities alluded to the tax burden of ordinary citizens and to a possible negative impact of tax hikes on investments. Most frequently, however, they mentioned fear of taxpayer protests and, thus, of the political costs linked to this instrument. It should be noted that any changes in the tax rate and exemption structure require issuing a new municipal by-law (*perda*) – a process which invariably draws a lot of public attention to the issue.

13
**Tax roll update:** As a common complaint, local governments mentioned the poor quality of the tax registers that were transferred to them from the central government tax agencies. Key problems are (i) redundant data (more than one tax object number per object, numbers for non-existent objects), (ii) missing data on tax objects or payments and (iii) erroneous data on property values or ownership. Consequently, updating tax registers is high on the agenda in all but one of the cases. In three cities (Depok, Denpasar and Tanjung Pinang), parts of this task (above all, setting up and running the respective IT systems) were outsourced to external consultants. All in all, this issue has been taken on as a rather technical, low-profile administrative task. However, it is also linked to managing taxpayer complaints, as these are an important source of information for improving the quality of tax rolls.

A related issue refers to updating the assessed values of properties, either through area-based assessments or through value-based assessments of individual, usually high-value properties. Even though local tax administrations were ready to acknowledge that assessed property values often failed to reflect real market values, only few municipalities had already started adjusting the assessed values. Those who did opt for an incremental adjustment, either of specific zone values following visits on site (for instance, Tanjung Pinang) or of all local property values (for instance, Denpasar). In the latter case, the adjustment is quite small (one step on a 100-step scale of zone values) in order to avoid protests.

With regard to individual value-based assessments, only one city (Tanjung Pinang) had already enacted a work schedule roughly in line with the total number of special and high-value properties. It should be noted, however, that some of the poorer districts do hardly possess any high-value properties. Individual assessments bear a high potential of immediate revenue gains, but they are comparatively costly (Tanjung Pinang estimated costs of 1.6 million IDR or ca. 95 EUR per property) and demanding in terms of technical expertise.

As a policy, pushing individual assessments bears the risk of alienating larger private sector companies and wealthy citizens who own most of the high-value properties. In principle, it could also lead to increased popularity of a local government, if voters perceived the policy as fair. However, this point was not raised in any of the interviews conducted at the local level. Moreover, issues related to fairness or equity of the property tax were almost completely absent from the political campaigns that were staged at the time of empirical fieldwork, in preparation of local council elections in April 2014. As it appears, none of the political parties campaigning for seats were interested in bringing this issue to the public.

**Tax compliance:** As implied by the high amounts of uncollected debt in the years before decentralisation, local governments face a situation where compliance with the property tax tends to be rather low. To give an example, roughly one third of the tax bills issued in Denpasar in 2012 (before decentralisation) and 2013 (first year of local collection) were still overdue by the end of the year. To change this picture, authorities try to promote voluntary compliance, but they also aim at raising the stakes of non-compliance. In general terms, however, local governments preferred to maintain a low profile and shied away from an overly robust tax collection.
To promote voluntary compliance, local governments staged public campaigns, informing taxpayers about the new situation, but there was no evidence of massive campaigns, neither at the local nor at the national level, to achieve a real change in tax culture. In individual cases, tax administrations cooperated with village heads to promote compliance in areas with particularly high evasion rates. In rural districts, tax administrations or local banks used lotteries as a means to incentivise payments on time. In the cities, authorities put more emphasis in improving taxpayer services, in particular with regard to payment channels (including e-banking in one case) and the management complaints.

With regard to robust collection, the legal fine for overdue debt is two per cent per month for a period of up to 24 months. After that, no additional fines can be imposed. As a last resort, local governments could seize the property and put it to auction after five years of unpaid liabilities, but this has not happened in any municipality visited in this study. As a common approach, some local governments appear to deny other services to non-compliant taxpayers. In those cases the applicant has to provide proof of tax payment in order to obtain, for instance, a business licence, a construction permit or a credit from the local bank. More frequently, tax authorities send overdue payment notifications or rely on door-to-door collectors to increase pressure on taxpayers.

Arrears: As a result of low levels of tax compliance in pre-decentralisation years, local governments inherited large debt portfolios. In five out of seven cases, this debt amounted to more than five times the average yearly collection for the years 2008-2012. Local governments have been particularly reluctant to deal with this issue, out of several reasons: First, some governments feared that assuming these liabilities would lead to negative audit reports from the National Audit Agency. Second, cleaning and updating tax registers showed that parts of the debt were due to redundant or erroneous data. In some cases, this led to considerable downward adjustments of debt values. Third, many local governments feared that collecting arrears at the time of current tax payments would lead taxpayers to abstain from paying property taxes at all and that robust collection of old liabilities would cause major taxpayer protests. As a result, only one local government was engaged in active arrears collection, while the other cases assumed a rather passive stance. This is shown, for instance, by the fact that local budgets contained no targets for the collection of arrears.

Summarising the discussion, Table 4 presents an assessment of political costs and usage of the instruments local authorities have at their disposal to collect the land and building tax. To visualise the assumed political cost, the four dimensions introduced above (number of voters affected, political influence of those affected, impact and visibility of the measures) were aggregated in one single ordinal scale with three values (‘low’, ‘medium’ and ‘high’). In a similar fashion, the degree to which local authorities make use of the instruments is also ranked as ‘low’, ‘medium’ and ‘high’. In the latter case, both the number of local govern-

---

6 In most cases, collection of the property tax is managed jointly by the tax administration and the local branch of the bank daerah. These are public banks owned by the province or a group of municipalities, or a combination of both.
ments and the intensity to which instruments are used are taken into account. To give an example, while four out of seven municipalities report some activities to enhance voluntary tax compliance, the study finds that the overall level of activities is low and local governments in general prefer to keep a low profile regarding the land and building tax.

It should be noted that both rankings entail a certain degree of discretion, as the available data and information from the interviews do not allow for a completely formalised definition of the variables and their aggregation. Given the complexity of concepts it is plausible, but obviously not beyond any doubt, that a specific political cost or use should in fact be classified as shown in Table 4. Also, in empirical settings other than the one chosen for this study, the assessment could arrive at different rankings.

Table 4: Political cost of property tax policy instruments in Indonesia

<table>
<thead>
<tr>
<th>Instrument</th>
<th>Number of voters</th>
<th>Political influence</th>
<th>Impact</th>
<th>Visibility</th>
<th>Total political cost</th>
<th>Use of approach</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Setting tax rates and granting exemptions</td>
<td>+</td>
<td>+</td>
<td>+/-</td>
<td>+</td>
<td>high</td>
<td>low</td>
</tr>
<tr>
<td>2a Tax roll update: Data cleaning</td>
<td>-</td>
<td>-</td>
<td>+/-</td>
<td>-</td>
<td>low</td>
<td>high</td>
</tr>
<tr>
<td>2b Tax roll update: Area-based assessments</td>
<td>+/-</td>
<td>+/-</td>
<td>+/-</td>
<td>+/-</td>
<td>medium</td>
<td>medium</td>
</tr>
<tr>
<td>2c Tax roll update: Value-based assessments</td>
<td>-</td>
<td>+</td>
<td>+</td>
<td>-</td>
<td>medium</td>
<td>low</td>
</tr>
<tr>
<td>3a Tax compliance: Promoting voluntary compliance</td>
<td>+</td>
<td>-</td>
<td>-</td>
<td>+</td>
<td>medium</td>
<td>low</td>
</tr>
<tr>
<td>3b Tax compliance: Raising stakes for non-compliance</td>
<td>-</td>
<td>-</td>
<td>+</td>
<td>+</td>
<td>medium</td>
<td>medium</td>
</tr>
<tr>
<td>4 Active arrears collection</td>
<td>-</td>
<td>+</td>
<td>+</td>
<td>-</td>
<td>medium</td>
<td>low</td>
</tr>
</tbody>
</table>

Still, it appears that two general messages can be derived from Table 4 without overstressing the approach. First, a clear relation emerges between the political costs of an instrument and the degree to which it is employed by local governments. This is particularly evident with regard to the first two instruments, setting tax rates and data cleaning. Second, even accounting for the political costs attached to each instrument, they are not always fully used. We would perhaps expect high-cost instruments to be used less (as in the case of setting tax rates) and low-cost instruments to be used more (as in the case of data cleaning). However, several of the instruments with medium political costs are not really used in the seven municipalities under review. One tentative conclusion could be that a combination of high numbers of affected voters and high visibility of the measure would make that instrument less attractive for local authorities. Similarly, the combination of powerful groups being (potentially) affected and higher impact on disposable income also seems to discourage local governments from using the respective instruments more actively.
Finally, a closer look at the two cases specifically chosen to tease out the effect of political costs on property tax collection (Denpasar and Banjarmasin) reveals that the share of transfers in total revenue does not seem to play a major role in this specific context. No significant differences in tax policy and administration were discovered between both cases. In fact, Denpasar authorities seemed to be more satisfied with current revenue levels from the land and building tax than their counterparts from Banjarmasin. In 2014, Denpasar opted for a very small across-the-board raise of zone values. This cautious approach could be motivated by already increased levels of conflict over payments of taxes and fees in the touristic centres of the city. In contrast, Banjarmasin took a more active stance, even discussing a robust enforcement regime by which billing taxes would be linked to billing water services – meaning that without proper tax payments households could be cut off from water supply.

6. Conclusion

This paper has discussed the political costs of property tax collection with reference to recent reforms in Indonesia. Initial evidence suggests that after decentralisation local governments raise more revenue from property taxes, but it has become evident that local governments fail to fully tap the revenue potential from this source. In particular, results suggest that the set of instruments available to local decision-makers is not fully used out of political considerations. Local governments take the political costs of tax policies into account, and they systematically shy away from using instruments associated with higher political costs.

The observation of wide-spread underuse of tax potential at the local level may not come as a total surprise to those studying fiscal decentralisation efforts in developing countries. Even though some papers show that local governments may experience considerable boosts in tax revenue following reforms (for instance, see Jibao & Prichard, 2013; von Haldenwang, von Schiller, & Garcia, 2014), most studies would argue that above all deficits in local administrative capacity make quick (and sustained) revenue gains following decentralisation rather unlikely. In supporting tax decentralisation reforms, donors and international organisations have consequently put much emphasis on capacity development (Asian Development Bank, 2009; Kelly, Gyat, Nordiawan, & Harahap, 2011).

This paper holds that capacity restrictions do exist in the Indonesian case, but they are not the main bottleneck for effective property tax collection. This interpretation is based on several observations: First, local governments finance their pay roll almost completely with central government transfers (the so-called “basic allocation”). This may cause inefficiencies in public employment, but it also ensures that even the poorest municipalities are reasonably well staffed. Second, outsourcing of more complex tasks (for instance, value-based assessments or the development of IT-based cadastres) is possible and has been used in several of the cases. Third, some tax instruments discussed above do not require additional administrative capacities. Fourth, with the exception of one case, none of the local tax administrations interviewed referred to capacity restrictions as a major concern.
Could the findings presented in the preceding section perhaps be interpreted as initial difficulties following decentralisation? “Since property tax reform is expected to result in major tax shifts within or among property classes, some form of phase-in mechanism is almost invariably politically necessary to cushion the impact, at least in the short run” (Slack & Bird, 2014, p. 24). As Kelly (2014, p. 353) notes, “there are two basic sequencing strategies to undertaking a property tax reform process. Countries either tend to start with strengthening property tax collections (ie, the collection ratio) through a ‘collection led’ strategy or they tend to start with strengthening the fiscal cadastre (ie, the coverage and valuation ratios) through a ‘valuation-pushed’ strategy”. At a global level, most property tax reforms focus on adjusting property values and modernising fiscal cadastres, according to the author.

In fact, this strategy has also been followed by most of the cases under review in this study, but there are few observations that would point towards a more active use of the revenue potential of the property tax in the near future. As a consequence, local governments in Indonesia still struggle with a tax that is hardly accepted by the public and, in general terms, does not seem to generate the revenue it could produce in principle. Against this background, it may come as no surprise that some central government ministers and members of parliament have recently suggested that the land and building tax should be revised and that private properties should be exempted from paying this tax. Future research will show how the internal dynamics of local revenue collection play out against the pressure of elite segments against “the tax everyone loves to hate” (Rosengard, 2013).

References


### Appendix

#### Table 5: Indicators of case study selection

<table>
<thead>
<tr>
<th></th>
<th>Start date of tax collection</th>
<th>Local GDP per capita (in Mio. IDR)</th>
<th>Share of transfer in total income (in per cent)</th>
<th>Population density (inhabitants per km²)</th>
<th>Palm oil land area to total land mass (in per cent)</th>
</tr>
</thead>
<tbody>
<tr>
<td>City Depok</td>
<td>2012</td>
<td>11.30</td>
<td>70.96</td>
<td>8,836</td>
<td>0</td>
</tr>
<tr>
<td>City Denpasar</td>
<td>2013</td>
<td>19.33</td>
<td>62.92</td>
<td>6,299</td>
<td>0</td>
</tr>
<tr>
<td>City Banjarmasin</td>
<td>2013</td>
<td>19.78</td>
<td>88.28</td>
<td>8,851</td>
<td>0</td>
</tr>
<tr>
<td>District Lombok Barat</td>
<td>2013</td>
<td>8.06</td>
<td>88.53</td>
<td>676</td>
<td>0</td>
</tr>
<tr>
<td>City Tanjung Pinang</td>
<td>2013</td>
<td>32.11</td>
<td>89.62</td>
<td>1,362</td>
<td>0</td>
</tr>
<tr>
<td>District Rokan Hulu</td>
<td>2013</td>
<td>33.14</td>
<td>95.05</td>
<td>65</td>
<td>49.7</td>
</tr>
<tr>
<td>District Rokan Hilir</td>
<td>2013</td>
<td>78.40</td>
<td>95.44</td>
<td>65</td>
<td>25.8</td>
</tr>
</tbody>
</table>

*Note: Cell shaded grey = variable of interest*