The impact of regulating inadequate local tax types on fiscal independence

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Abstract

The autonomy of a region is measured by its ability to generate and finance income without relying on the central government. The effective operation of the government necessitates a budget and different regions possess the authority to impose taxes in generating revenue. This is stipulated in Law Number 1 of 2022 pertaining to the Financial Relations Between the Central and Local Governments. In this Law, local governments are prohibited from levying new types of taxes. Furthermore, only the specified types can be selected and should be established in the form of local regulations (Perda). The selection requires that the tax objects exist and have sufficient potential to increase Local Revenue (PAD) and fiscal independence. Therefore, this study aimed to understand and analyze the meaning of regulating tax types for autonomous regions and to analyze the implications of inadequacy on fiscal independence. Normative-juridical research type is used with legislation, conceptual, and historical approaches. The result shows that the implication of inadequate tax types to be collected can weaken fiscal decentralization. This is because the inadequate tax object does not make a significant contribution to increasing PAD. Therefore, a study in the form of a feasibility study is needed to map the potential of local taxes before stipulating the type in the regulation.

A. Introduction

Indonesia is a unitary state, as emphasized in Article 1, paragraph (1) of the 1945 Constitution. Moh Kusnardi and Bintan R. Saragih reported that “A unitary state is referred to when the powers of the central and local governments are not equal or similar. The power of the central government is
prominent within the country, and there is no rival to the legislative body in the formation of laws. The power of the government in the regions is derivative (indirect) and often takes the form of extensive autonomy. Therefore, there is no recognition of equal legislative bodies at the central and local levels.¹

The existence of local governments is due to the devolution of authority from the central through a decentralization system. The transfer of authority establishes a relationship between the central and local governments, including financial relations.² The rights and obligations of finance are regulated by a management system using a fair, accountable, and transparent approach.³ The devolution of authority from the central to local governments to govern and manage affairs is based on Article 18, paragraph (2) of the 1945 Constitution, where “Local governments of provinces, regencies, and cities govern and manage their affairs based on the principles of autonomy and delegated tasks. The granting of autonomy to regions is accompanied by financing for the administration of governance. In this context, financing is required to realize the welfare of the people in each autonomous region.”

A typical source of local revenue is PAD, which includes taxes, levies, revenue from the management of separate local assets, and other legitimate income. Local taxes are compulsory contributions to the region owed by individuals or entities, imposed by law, without receiving direct compensation, and used for the benefit of the region and the prosperity of the people.⁴ The coercive nature of taxes, based on the law, requires the prior regulation of tatbestand⁵ or object before impositions. Taxes must be based on legal sources, as stipulated in Article 23A of the 1945 Constitution. The law that serves as the basis for determining local taxes is Law Number 1/2022 concerning the Financial Relations between the Central and Local Governments. The types of taxes levied in the regions, including both provincial and district/city taxes, are defined under this law.⁶ Local Governments are not permitted to charge taxes other than those listed in Article 6, Paragraph 1. Levy may be introduced when the potential for the

³ Republic of Indonesia.
⁴ Republic of Indonesia.
⁶ Republic of Indonesia, “Law Number 1 of 2022 Concerning the Financial Relationship between the Central Government and Local Governments.”
listed sorts of taxes is insufficient or not imposed. Meanwhile, not all taxes have the capacity to be collected locally, particularly in districts. The novelty of this study will make a significant contribution to determining the means, size, and function of local taxes in fiscal equality. The background of this writing identifies the problem, what is the meaning of the regulation of specified types of local taxes in Law Number 1/2022? Furthermore, what are the implications of potential inadequacy in collecting certain types of local taxes for fiscal autonomy? This will be answered using normative-juridical research type, as well as legislation, conceptual, and historical approaches.

B. Discussion

1. The Concept of Local Taxes

According to Rochmat Soemitro, local taxes are defined as “levies collected by autonomous regions, including provinces, cities, and regencies” Kesit Bambang Prakosa states that local taxes are collected by provinces, regencies/cities to finance the respective households. These taxes are administered by provincial and regency/city governments, and their benefits are aimed at supporting the revenue of PAD, with the resulting funds being included in the revenue and expenditure budget.

The concept explains the taxes handed over to the regions and the revenues are used to finance the administration of local government which supports the realization of people’s welfare in the region. Therefore, taxes serve as a cornerstone for local governments, signifying the important essence of the region. Different challenges are encountered in securing the necessary funds for developmental initiatives without taxes. Local taxes play a crucial role as a source of revenue for the PAD. Regions with low PAD cannot be considered self-sufficient in managing their households, including carrying out development activities, unless sufficient natural resources are possessed to sustain local governance. The characteristics show the nature and purpose of local taxes in ensuring financial sustainability and improving the welfare of the population. The inclusion of the populace in contributing to the tax revenue reflects their participation in financing local governance and development. The imposition and regulation of these taxes are established through the authority of law, crafting a legal framework that oversees their

collection and utilization. The funds are allocated to address the region’s requirements and enhance the well-being of the local population.

Taxation carries a negative connotation, except when considering the benefits derived from using tax revenue for development financing. Taxes place a burden on society, offering no immediate rewards for taxpayers and many individuals prefer to evade their obligations. However, taxes play an important role in enabling state and local governments to fund public expenditures and support developmental endeavors. As an intentional process, development strives to attain an improved state and order of life compared to previous conditions. The intricate challenges posed by the disparities present significant complexities for the Indonesian nation. These imbalances have led to the concentration of outcomes in specific regions, including substantial consequences. To address these disparities and achieve more equitable development, the allocation and utilization of tax revenue play a crucial role. It is essential to allocate resources and investments in a manner that prioritizes bridging the development gaps between different regions and sectors. By directing tax revenue towards development initiatives and ensuring efficient and effective utilization, disparities can be reduced to promote balanced and inclusive development throughout the country.

2. *Ius Constitutum* and Historical Regulation of Local Taxes

Constitutional clauses and historical settings have influenced the historical evolution of local tax laws. The 1945 Constitution of the Republic of Indonesia, specifically Article 18 Paragraph (6) and Article 23A, stipulates that taxes should be based on laws and serve the purpose of benefiting the welfare of the people and supporting local development. Therefore, local tax regulations are a matter of administrative procedures and a constitutional basis that reflects the principles of justice, accountability, and local autonomy. Taxes must have a legal basis, a collection mechanism, a tariff amount, payment, and objections submission. Local Regulations (*Perda*) serve as one of the legislative regulations in the region, based on Article 18 paragraph (6) of The 1945 Constitution, which grants the authority to implement autonomy and supporting tasks. Legislative rules must be in written form, convey universally applicable legal standards, be established or enacted by authorized state institutions, and follow the procedures outlined in law.

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Perda regarding provincial and municipal/local taxes is established based on Law No. 1/2022. Each region is given the authority to determine the types of taxes to be levied within their respective territories through local regulations. These provisions clearly define the specific types of taxes that provincial and district/city governments have the authority to levy. The diversity reflects the varying sources of revenue for local governments and their role in financing public services, infrastructure development, and regional welfare. Furthermore, the allocation of taxing powers between provincial and district/city governments aims to ensure a balanced distribution of fiscal responsibilities and resources, facilitating effective governance. By having a comprehensive range of taxes, local governments can generate the revenue necessary for sustainable development and the fulfillment of public needs. There are seven and nine types of provincial and district/city local taxes. The types that can be imposed are limited since regions are prohibited from establishing new taxes.

Autonomy is one of the front lines in safeguarding the unity of the state, bearing the burden and responsibility of implementing democratic governance. This is based on the rule of law to realize equal prosperity, welfare, and justice in the economic, political, and social spheres while respecting and upholding the differences between regions. The recognition of these differences is crucial to show that the presence of regions remains important amidst the demands for unity. Sudiman Kartohadiprodjo referred this concept to as “unity in diversity and diversity in unity.”¹³ To accommodate these differences, various types of taxes are determined. The prohibition on establishing new types is by the authority norms, where regions can only establish the types of taxes that have been determined. This prohibition is related to the history of local regulations based on Law Number 34 of 2000. Meanwhile, regions were given the authority to create new types of taxes after the meeting. Several criteria are specified in the law and the regulations concerning new taxes during the period faced issues due to their contradiction of higher-level legislation, economic costs, and conflict with public interests. The PDRD Law was nullified while Law Number 28/2009 was enacted to stop the taxation regimes. Law No. 1/2022 replaced Law No. 28/2009 on PDRD in 2022 and the modification was made because of the adaptation to modern period and fiscal decentralization.¹⁴

The provision in Article 6, paragraph (2) of HKPPPD Law states that a tax type may not be levied when its potential is insufficient, and a policy is designed to prohibit its collection. According to Hamrolie, potential refers to the economic capacity existing in a region that is feasible and possible to

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¹⁴ Republic of Indonesia, “Law Number 1 of 2022 Concerning the Financial Relationship between the Central Government and Local Governments.”
develop, thereby becoming a source of livelihood for the local population and stimulating development autonomously and sustainably. This includes local taxation, where tax potential must be developed to enhance PAD.\textsuperscript{15}

Adequate potential is a prerequisite for levying taxes in a region. Under the HKPPPD Law, not all regulated tax types can be designated by the local government for collection. A region is not obligated to establish a specific local tax type when the object lacks potential. This norm is important, guiding each region to refrain from establishing a tax object or its tatbestand without the potential for collection. A proficient local tax should ideally generate revenue for the region in line with its level of fiscal autonomy.\textsuperscript{16} An example of local taxes that are inadequate or have no potential is the Swallow’s Nest (\textit{Sarang Burung Walet}). The tax is governed by North Lombok Regency Local Regulation Number 3 of 2010 Concerning Local Taxes.\textsuperscript{17} The tax on swallow’s nests, which had no chance of getting collected since its revenue realization was continually nil, was determined for collection. In this context, the region was unable to generate additional revenue for its PAD through the swallow’s nest tax because the revenue realization was consistently zero. This issue arose when the region insisted on establishing a tax type even though there was no potential or tax object related to the jurisdiction. This shows the need for a feasibility study to determine the viability of a tax object for collection.

The collection of taxes is a means to achieve one of the state’s objectives stated in the fourth paragraph of the Preamble to the 1945 Constitution to promote the common welfare and prosperity of the Indonesian society.\textsuperscript{18} In line with the goal of local autonomy, which aims to bring government services closer to the people, the function of local taxes goes beyond filling the local treasury (\textit{APBD}). Even though the primary function of taxes is defined as revenue generation for the region, with a focus on the


budgetary function, there are also regulatory (regulerend) functions. In the 18th century, Adam Smith, in his book “The Wealth of Nations”, laid down the principles for the formation of a good tax system, famously known as The Four Maxims. The state and local governments should ensure that the cost of tax collection is kept low and does not exceed the revenue generated for the state treasury when enacting tax law. With the application of the principle of economy in the collection process, the provision that does not mandate the introduction of insufficient types of taxes is considered. The principle of economy in the collection would be violated when a region insisted on enacting a particular tax type for collection regardless of the established prospective tax base.

The potential of local taxes can be accessed using the Klassen typology analysis. The classification of tax types is determined when the ratio is below the average value of the proportion of local taxes. Meanwhile, high share classification is determined when the ratio of proportions is above the average value. To avoid significant costs in enacting local regulations related to taxes, the governments are expected to conduct feasibility studies beforehand. These studies are useful in assessing whether the designated types of taxes in the HKPPPD Law have the potential to be collected in each region. The procedure for local regulations (Perda) is interchangeable with the process of enacting laws, starting with an academic manuscript and the most important element is the sociological aspect. However, the existence of academic manuscripts does not fully address the issue of how societal participation serves as an initial gateway to accommodate all forms of aspirations and

becomes a manifestation of public legitimacy for the resulting law products.\textsuperscript{24} In the process of determining local tax regulations, mandatory participation should be implemented. Participation can be understood as a condition in which all members of a community are included in determining policies that relate to their interests. With this understanding, participation becomes a mandatory condition within a nation whose members are larger than a community. The state’s responsibility should be evident when passing laws required by the people.\textsuperscript{25} Community inclusion plays a crucial role in the creation of local tax laws because the people bear the tax burden. From a sociological perspective,\textsuperscript{26} taxes are a social phenomenon that only exists within the lives of the community. Therefore, the relationship between taxes and society is closely related. Taxes should be collected according to the needs of the community, considering the circumstances and situations in the relevant area.

\textbf{3. Inadequate Tax Potential Weakens Fiscal Independence}

Taxes are expected sources of revenue to enhance \textit{PAD} by the local government. The concept represents the income that reflects the capacity of an autonomous region to collect revenue sources. \textit{PAD} is the backbone of local financing and fiscal independence is an important aspect of autonomy. Fiscal decentralization is a consequence of the implementation of local autonomy and increases the region’s capacities in terms of finances.\textsuperscript{27} In addition, \textit{PAD} has played an integral part in identifying financial and budgetary independence. According to Tjip Ismail, the sources of financing for regions in the implementation of fiscal decentralization are \textit{PAD}, Inter-Governmental Transfers, Local Loans, and other legitimate receipts. Local taxes and fees, which are components of \textit{PAD}, should be the primary sources of revenue. Therefore, the dependence of the region on the central government decreases, leading to the expectation that the region will have high accountability. Machfud Sidik's assertion states that an element of the

\begin{itemize}
\item Picauly, Picauly, and Lainsamputty, “Kearifan Lokal: Tinjauan Unsur Sosiologi Pembentukan Peraturan Daerah.”
\end{itemize}
expression of fiscal decentralization is dictated by different sources of income and expenses exploited based on local capacity.\textsuperscript{28} Fiscal decentralization is granting autonomy to generate revenue, particularly in the form of taxes, and flexibility to spend. In this context, fiscal autonomy can be achieved, which leads to local independence (\textit{zelfstandigheid}). Local taxes are one of the sources of revenue that can increase \textit{PAD} when their objectives have potential. Types of taxes without the potential for collection can weaken fiscal decentralization.

The function of local taxes has not been fully realized because not all autonomous regions have their local revenue derived from tax collection used to finance their governance. The taxes in districts/cities do not immediately yield results since several types have no potential for collection in each autonomous region. The budgetary function can be applied when accompanied by granting the authority to collect reliable types of taxes tangibly. According to the World Bank (1994), fiscal independence is the key indicator to measure the ability to finance activities without relying on external assistance from the central government.\textsuperscript{29}

Adolf Wegner\textsuperscript{30} stated that the correct determination of the tax object is one of the principles of tax collection. The accuracy of object determination directly affects tax collection because incorrect determination prevents the collection process. This also applies to tax collection at the local government level because the types are limited by the central government. Therefore, the regions must precisely determine the tax objects to realize the aspects of legal certainty for the citizens. There are three traditional grounds for evaluating tax policy, namely efficiency, fairness, and administration.\textsuperscript{31} In the context of tax collection at the local government level, the efficiency aspect is directly related to the types of taxes as regulated in Law 1 of 2022. The imposition by the local government needs to be analyzed from various perspectives due to

\textsuperscript{28} Tjip Ismail, \textit{Pengaturan Pajak Daerah Di Indonesia} (Jakarta: Yellow Printing, 2007), p. 12.
its nature of compulsion on the citizens. Indonesia currently consists of 38 provinces and in terms of development and implementation, consistent regional autonomy has not shown an increase in regional independence. An area of local autonomy theoretically measured is the achievement of PAD, which is derived from tax revenue, levies, and regional wealth management. The collection of taxes helps to achieve one of the objectives of the state as stated in the fourth paragraph of the 1945 Constitution’s Preamble. The concept includes the welfare of the public, with the core objective of improving Indonesian society. Granting autonomy due to revenue and the authority to spend is part of fiscal decentralization. In this context, fiscal autonomy can be realized, which leads to local independence (zelfstandigheid).

C. Conclusion

In conclusion, the local governments were limited to collecting only specific types of taxes due to the restrictions in Law Number 1/2022. The law required that only types of taxes whose objects had the potential to be collected in the area could be regulated by local regulations (Perda). The implications weakened fiscal decentralization because uncollected tax objects would provide inadequate results without making a significant contribution to increasing PAD. Therefore, further study could be carried out in the form of a feasibility analysis to map the potential for regional taxes before determining the type in regional regulations.

References


