

# SUBNATIONAL OWN-SOURCE REVENUE: GETTING POLICY AND ADMINISTRATION RIGHT

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Once countries decide to decentralize—whether gradually, as in Thailand and Vietnam, or with an initial dramatic change, as in the Philippines and Indonesia—they must get the fiscal design right. Critical to effective fiscal design is the ability of local governments to adjust budgets and thus respond to community preferences regarding the quantity and quality of public services. Ideally, and according to theory, subnational governments provide services to their constituents up to the point at which the cost—in terms of taxes—equals the benefit, in terms of the value of the services. To satisfy this condition, local governments must have the authority to exercise own-source taxation, and be in a financial position to do so. This is the essence of accountability and efficiency under decentralization, and that is why decentralized revenue policy matters.

The design of a local revenue system includes three central dimensions: the assignment of revenue sources among types of government, the degree of autonomy with which subnational governments can exercise their assigned authority, and the efficiency of the revenue administration system. For a decentralized system to meet expectations, policymakers must ensure coordination between these dimensions.

This chapter follows this logic. It begins by analyzing the links between revenue assignment and autonomy by country and type of revenue, and then assesses the region's revenue performance. The ensuing two sections take up the question of revenue administration and address the politics of local taxation, highlighting issues of policy implementation. The last section offers final comments on the implications of these findings for both policy and administration.

The chapter's overarching conclusion is that East Asian countries reveal many inconsistencies and contradictions vis-à-vis commonly accepted criteria for a “good” intergovernmental revenue system. However, this newly decentralized region is also seeing rich experimentation and innovation, which bodes well for further reform.

## **The Setting and Normative Framework**

Except in the Philippines and perhaps Indonesia, subnational governments in East Asia make little use of own-revenues to finance local services (see table 6.1). That is, the region is not characterized by significant fiscal decentralization. The implications

**TABLE 6.1 Estimated Own-Source Revenue of Subnational Governments**  
(as percentage of total subnational government revenue)

Country	Percentage
Cambodia (2003)	< 5
China (2003)	< 5
Indonesia (2002)	15.4
Philippines (2002)	31.1
Thailand (2002)	10.9
Vietnam (2003)	< 5

Sources: Indonesia (Ministry of Finance), Philippines (Department of Finance), and Thailand (World Bank 2004c). World Bank staff estimates for Cambodia, China, and Vietnam. Note: Most recent year available. Figures include only official, legal revenues.

of this are considerable. The fact that subnational governments have both limited powers to raise revenues and limited capacity to collect them poses profound questions about the actual benefits of decentralization. Can local governments respond to local preferences in taxation and thus service delivery, thereby achieving greater accountability and efficiency? Are fiscal tools and capacities sufficient to generate sustainable own-source revenues? Has a reliance on transfers, in their myriad forms, made subnational governments dependent on national governments and weakened subnational incentives to improve own-source collections?

The three dimensions of revenue policy provide a framework for addressing these questions:<sup>1</sup>

Which taxes should be authorized or assigned to central governments and which to subnational governments? The decision should be legal and transparent, occurring through both constitutional and legislative processes. However, as discussed below, governments sometimes assume “authority” illegally. That such illegality and informality are undesirable will become clear; nonetheless, in some countries, particularly China, these approaches are commonplace. Focusing on assignment of revenue sources among governments stresses the importance of understanding decentralization as an intergovernmental partnership.

Numerous public finance economists have provided guidance on how to think about assigning taxes between national and local governments, and

many of the resulting perspectives place a high priority on economic efficiency. The first principle of revenue assignment—summed up by the “finance-follows-function” refrain—is that it should be based on assigned expenditures. A second principle, given the matching of revenues to expenditures, is that local taxation should avoid introducing economic distortions by inappropriately taxing the factors of production. The third general principle—subsidiarity—holds that revenue-raising powers should be assigned to the lowest-possible level of government, except where such assignment would produce economic distortions or negative externalities.<sup>2</sup>

These three principles provide a general framework for assessing revenue assignment, which—when fleshed out with more specific considerations—offers a set of practical guidelines. According to Norregaard, governments should not levy “local taxes” on very mobile factors lest they encourage taxpayer migration (though what constitutes “very mobile” is largely an empirical issue) (Norregaard 1997). Such taxes should not be unevenly distributed among jurisdictions (as in the case of natural resource taxation), should raise enough revenue to avoid large vertical fiscal imbalances, should not be exportable to nonresidents (which would weaken the accountability link), and should be based on the benefit principle. Taken one step further by Bird, these principles suggest a number of major tax sources usually prescribed for subnational governments, “more or less in order of preference—user charges, property taxes, excises, personal income taxes, payroll taxes, general sales taxes, and business taxes” (Bird 2003b, 4–5). The following sections address each of these options.

### *Autonomy and Policy*

The decentralization literature can be surprisingly unclear about the fundamental question of what constitutes a subnational tax. However, if terminology is not clear as to what constitutes subnational own-source revenue, policymakers will not have the conceptual tools needed to design fiscal systems and appreciate their consequences. Such a situation will also obfuscate debate over the policy changes needed to allow a jurisdiction to realize the efficiency benefits promised by decentralization.

Subnational revenues may be divided into categories of decreasing local autonomy (see table 6.2).

**TABLE 6.2 Classification of Subnational Taxes by Degree of Central vs. Local Control**

Local autonomy in revenue policy	Subnational government (SNG) sets tax rate and base. SNG sets tax rate only.	Greatest access to own-source revenues. These usually include fees and charges. Necessary and sufficient condition for “own-revenue.” Piggybacking and tax base harmonization permitted.
Limited autonomy	SNG determines the tax base.  SNG sets tax rate, but within centrally permissible ranges. Tax sharing, whereby central/local revenue split can change only with consent of SNG.	Refers largely to local authority to grant exemptions that erode the local base. In this case the center typically specifies a high/low tax range or caps the top rate. Can result when a local authority collects the tax and remits it to the center.
No local autonomy	Revenue sharing, with share determined unilaterally by central authority.  Central government sets rate and base of “SNG revenue.”	100% control by center; this is a source of misspecification of central vs. local revenue. (For example, the International Monetary Fund’s Government Finance Statistics includes this category as a “local tax.”) May accompany political decentralization.

Sources: Adapted from OECD 2002; Ebel and Yilmaz 2002.

If subnational governments have total or significant control over a tax, fee, or charge, as shown by control over the tax rate (that is, if it is necessary and sufficient), it is a subnational tax. If, in contrast, subnational governments have no control over the base and rate of a tax, as, for example, when the central government determines how to split revenues (“tax sharing”), it is not a subnational source of own-revenue.

This taxonomy of taxation serves the very useful purpose of setting out the basic definition of what is and is not a source of own-revenue. Thus, for example, the taxonomy makes clear that although a shared tax adds to subnational budget receipts, such revenue is not “own” taxation. Tax sharing occurs when the base and rate of a tax are centrally set and then some percent is returned, typically on a derivation basis, to the “originating locality.” To be an own-tax or revenue source, the subnational unit must, at the very least, legislate the rate.

More nuanced is the practice whereby a central government restricts the rate of an own-revenue source (such as the rate ceiling). This clearly limits subnational autonomy, and some would argue that once the cap is reached it fully eliminates local autonomy, as the subnational government loses its ability to raise taxes at the margin. Such rate regulation is particularly common in East Asia.

A typical argument for rate ceilings is that they prevent local governments from doing egregiously inappropriate things (though ceilings may simply be a nontransparent mechanism for central control). The practice, however, counters the accountability and efficiency arguments for decentralization. One might make a case for centrally imposed rate ceilings during the transitional period from centralization to decentralization, as they might allow local governments to develop policy and administrative capacity, but such limitations should be short-lived. Subnational governments build capacity by using their assigned powers.

### *Autonomy and Administration*

The third dimension of revenue policy—that subnational governments must have some control over revenue administration—matters for two reasons. First, control over some aspects of revenue administration is instrumental for controlling revenues at the margin, as this allows for changes in the effective tax rate (a ratio of actual tax collected compared with the size of the legal tax base). Local governments can change the effective tax rate by boosting compliance through audits and enforcement, or by lowering compliance costs for taxpayers through better services (such as more

**TABLE 6.3 Tax Assignment by Local Government in the Philippines**

Revenue source	Provinces	Cities	Municipalities	Barangays
Real property tax	✓	✓	✓ 40% of provincial collections	✓ 25% of provincial or 30% of city collections
Transfer of real property tax	✓	✓		
Tax on sand, gravel, and other quarry resources	✓	✓	✓ 30% of provincial collections	✓ 40% of provincial collections
Amusement tax	✓	✓		✓ 50% of provincial collections
Business taxes		✓	✓	✓
Franchise tax	✓	✓		
Community tax		✓	✓	✓ 50% of collections

Source: Local Government Code (R.A. 7160), 1991.

user-friendly tax forms and payment processing, and access to information).

This dimension is relevant in all cases, especially in China and Vietnam, where subnational governments collect taxes whose rates and bases are determined centrally. Second, and conversely, this consideration suggests that subnational governments need not have full control over administration to call a tax or fee an own-source revenue. Devolved responsibility does not necessarily imply fully devolved administration, especially in the context of weak local capacity. National governments, for example, might take responsibility for certain administrative functions, such as assessing property, or assist local governments with core functions related to information and communications technology. This opens up a much-needed discussion of the appropriate division of labor between national and subnational jurisdictions, and of the options for assisting low-capacity subnational governments with revenue administration (see below).

### **Review of Current Practice and Initial Evaluation**

Whereas several East Asian revenue systems rely on central controls, countries are also showing a willingness to review the twin features of assignment and autonomy. This represents an important policy crossroads: if, as shown, assignment and autonomy can be reinforcing, the opportunity to combine

political with fiscal decentralization promises more efficient delivery of public services.

The Philippines has the region's longest-running record of an explicit decentralization policy and is also the most revenue decentralized of all the focus countries. Yet, as the Philippines example also attests, the decentralization sorting-out process takes time, and even the Philippines is a "young" decentralizing state. The country has clear opportunities for further reform.

In the Philippines, primary responsibility for subnational taxation rests with provinces, municipalities, and cities (see table 6.3). Cities are the most autonomous: they are authorized to impose the full set of local taxes, while provinces and municipalities can levy only subsets. In some cases the revenues collected by provinces and cities are allocated to municipalities and *barangays*. The latter are also responsible for collecting miscellaneous taxes and fees and charges.

But again, whereas this assignment suggests a well-designed system of revenue decentralization, the Local Government Code is not fully consistent with the autonomy criteria (see table 6.2). The central government sets tax rate ceilings, leaving local governments little control over one of the main levers for mobilizing revenue, including the property tax, which is a large revenue generator. The code also fixes maximum rates for most other taxes and nominal per unit amounts (as in the case of the professional tax). The code further specifies that

local governments can adjust tax rates only once in five years, and not by more than 10 percent.<sup>3</sup>

In Indonesia, subnational governments have the authority within the framework of Law 34 of 2000 on regional revenue to levy a number of important but minor revenue sources. The central government controls the most potentially productive local revenues—those on real estate and personal income—and shares the receipt.<sup>4</sup> Less revenue-productive taxes are assigned to the provinces (motor vehicle registration, transfer and fuel taxes, and a water user fee, all of which are shared with cities and regencies), and cities and regencies (excise taxes on hotels, entertainment, advertisement, street lighting, mining of selected minerals, and parking).

The national government restricts this arrangement even further: subnational governments may not impose surcharges on national taxes, and Law 34 of 2000 sets maximum rates on those that are assigned.<sup>5</sup> Evidence suggests that most regions already charge the maximum rate, and that some would raise it further if allowed to do so. For example, the widely assessed hotel and restaurant rate is limited to 10 percent, yet a World Bank report concludes that some jurisdictions (such as Bali and Jakarta) could gain from rate increases (World Bank 2003a).

China overhauled its subnational revenue system under the 1994 Tax Sharing System reform. The tax structure now includes three tiers of taxes: those fully accruing to the national government, those shared between the national and subnational governments, and those fully accruing to subnational units. Allowable subnational own-source revenues include the urban land use tax, for which the local government can set the rate up to a ceiling; local option entertainment and slaughterhouse taxes; and a local option surtax on collective enterprises, for which the subnational government can influence the rate (Bahl 1999).

Revenues in Thailand are national, local, or shared. Shared taxes include the value-added tax and sales tax, the special business tax, the natural resource tax, excise taxes, and the vehicle tax, all of which accrue to local governments. Own-taxation is limited to the house and land tax, land development tax, signboard tax, petrol tax, tobacco tax, and hotel tax. Local governments may also collect user fees, charges, permits, license fees, and fines.

Cambodia is still at an early stage of decentralization: it has not yet assigned functions or rev-

enues to communes. However, communes and *sangkats* (urban communes) may collect four types of own-revenue. These include administrative fees for civil registry functions, agency fees for functions performed on behalf of line ministries and others, contributions to development projects to meet the matching requirement imposed by transfers from the Commune *Sangkat* Fund, and user fees and charges to cover the recurrent costs of providing services (UNCDF 2004). Data on actual collections are not available, but the amounts are thought to be quite small. Provinces—deconcentrated levels of the national government—may also collect own-revenues, which accrue to governors' budgets (the *Salakhet*).<sup>6</sup> These revenues, which are not proper own-source revenues, accounted for 48 percent of the total *Salakhet*, of which the tax on motor vehicles (17.4 percent), the excise on public lighting (12.3 percent), the wealth transfer tax (7.0 percent), and the business tax (6.8 percent) are the most significant (World Bank 2003b).

Vietnam, as a transitional country, reveals some similarities with China. The Law on State Budget, which took effect in January 2004, establishes three types of revenue assignments. These include revenues assigned completely to the central level, those assigned completely to the local level, and those shared between the central and subnational governments. Shared revenues—which include the value-added tax, enterprise (corporate) income tax, personal income tax, special consumption taxes, and gasoline and oil fees, among others—constitute the bulk of revenues at all levels. Own-source revenues are virtually nonexistent in Vietnam. The only exception is user fees, such as road tolls and select fees for schools and hospitals, which are not generally significant sources of revenue (World Bank 2000).

### Own-Source Revenue Practices and Options

Revenue assignment in East Asia is consistent with the framework's principles and guidelines in some ways and inconsistent in others. The next section further highlights specific regional practices for each revenue source. This discussion serves to stress that a well-designed subnational revenue system should rely on a mix of taxes, and also suggests further options for reform.

As table 6.4 reveals, there is no own-source revenue common to all six countries, though a number of countries make use of user fees and charge business taxes, excise taxes, and property taxes. As admirable as the user charge and property tax package is, international experience has shown that such taxes can be both difficult to implement and unlikely to provide an adequate fiscal base if subnational governments have major social spending responsibilities (Bird 2003b). Accordingly, several options are available to further mobilize own-source revenues.

### *Property Taxation*

Given the role of property taxes as revenue generators in the developing world, the fact that the property tax is not an own-revenue source in many countries raises concerns about sustainable revenue flows, subnational autonomy, and thus the promised benefits of decentralization. In the 1990s, property taxes accounted for 40 percent of all subnational taxes in developing countries, but only 12 percent in transition countries (Bird and Slack 2002). Except for the Philippines and Indonesia, East Asian countries do not come close to the benchmarks of either developing or transition countries, suggesting that property taxes could yet serve as a greater source of revenue in the medium term, and an important source in the longer term.

Vietnam, Thailand, and Cambodia diverge the most from international practice. Vietnam has no property tax in the modern sense of the term. The country does have taxes on land and housing, land rent, and transfers of land use rights, but local governments have little or no control over these taxes. Thailand imposes land taxes, but they account for only about 5 percent of subnational resources, and subnational governments lack authority over their rates and bases. Cambodia's land taxes are insignificant in revenue terms.

China has multiple taxes on property, often on the same base, which do not rest on market or updated property assessments. Thus, these taxes do not deliver on their revenue potential. Yet unlike in Vietnam, local governments can set the tax rate on urban land use subject to legislated maximums and minimums (larger cities can set higher rates, for example). In fact, the tax on urban land use is one of only a small set of own-source revenues in China. The tax base is the physical land area, not

the market value, as the country has no formal market for land transactions.

Indonesia provides another important example of limited local autonomy over the property tax. Subnational governments are not responsible for taxing property (or property transfers). While the central government shares about 80 percent of property tax revenues with the originating region, and distributes another 10 percent among all regions, policy and administration are firmly in central hands. This has led to two negative developments: a reliance on taxes that essentially substitute for property taxes, such as the street lighting tax; and the proliferation of nonbenefit taxes—user charges and service fees not linked to the provision of services.

The Philippines is the only country where a traditional property tax is a source of subnational own-revenue. The property tax accounts for nearly 37 percent of subnational own-revenues. However, the central government limits control over tax rates and bases. For example, the national government sets the real property tax rate (including the Special Education Fund levy) at 2 percent for provinces and 3 percent for cities and municipalities in metropolitan Manila. All provinces outside the capital region avail themselves of the maximum rate, while most cities are under the maximum.<sup>7</sup>

International experience suggests that subnational governments are likely to use discretion over property tax rates, so they vary widely. Bird and Slack report, for example, that the effective rate of property tax in the United States ranges from 0.4 percent to 2.9 percent for residential property and 0.7 percent to 6.0 percent for commercial property (Bird and Slack 2002).

Property tax reform can offer a source of revenue, perhaps modest in transition countries, and a source of autonomy and accountability across the region. Rationalizing land taxation in Vietnam—and moving toward a modern property tax with some local discretion over rates and introducing modest property taxes in Cambodia—would be first steps in those countries. Devolving authority over rates in China, Indonesia, the Philippines, and Thailand is also a reform option.

### *Business Taxation*

Some analysts regard business taxes as a potentially inefficient means of raising revenue. Often levied at high rates, these taxes can distort firms' investment



**TABLE 6.4 Own-Source Revenue Assignment**

	Cambodia	China	Indonesia	Philippines	Thailand	Vietnam
User charges?	Yes, provinces and communes can collect for some basic services.	No, but “informal” or “illegal” local extrabudgetary fees have proliferated in health, education, and roads. Some are “nuisance” charges.	Yes; these are numerous, and some have high administrative and compliance costs. Some are “nuisance” charges.	Yes; these are numerous, and some have high administrative and compliance costs. Some are “nuisance” charges.	Yes, on transportation, public utilities, and markets.	Yes, on roads, education, and health.
Property taxes?	No, but minor provincial taxes on unused land.	Yes, to an extent, in that SNGs can set the rate for the urban land use tax up to a ceiling. There are also numerous other taxes on the same property and land base.	No; revenues shared with SNGs, but they have no control over rates and little control over administration.	Yes; rates set by SNGs subject to a maximum. Administered by SNGs with little central assistance.	No, for the land development tax and the house and land tax. The central government sets rates.	No; some taxes on land and housing, land rent, and transfer of land use rights. But SNGs have no control over rates and little control over administration. No modern property tax.
Excise taxes?	No, but taxes on motor vehicles at the provincial level.	No, but taxes on vehicle and vessel use.	Yes, on motor vehicles and fuel, though assigned to provinces. Also on minerals, raising equity issues.	No; SNGs are prohibited from levying excise taxes, including on motor vehicles.	No; central government controls motor vehicle and other excise taxes.	No.
Personal income taxes (PIT)?	No.	No; a PIT is assigned to SNGs, but they have no control over tax policy.	No; a PIT is shared with SNGs, but they have no control over tax policy.	Not exactly, though the community tax is in the form of a poll tax.	No.	No, but central government and SNGs share PIT.
Payroll taxes?	No.	No.	No.	No.	No, though base of national PIT includes payroll.	No.
General sales taxes?	No.	No, but central government and SNGs share value-added tax.	No.	No.	No, but central government and SNGs share value-added and sales taxes.	No, but central government and SNGs share value-added tax.
Business taxes?	No, though business license charges and market taxes are assessed at the provincial level.	Yes; a business tax on gross receipts, an enterprise income tax, and other surcharges and surtaxes (e.g., urban maintenance and construction tax).	Yes, though officially limited to a few sectors. The number and type of “business taxes” are growing, raising concerns about “nuisance” taxation.	Yes; relatively large revenue source.	Yes, though limited to a small number of sector-specific business-type taxes.	No, but central government and SNGs share corporate income tax.

Source: World Bank staff.

Note: SNG = subnational governments. Own-source revenue defined as a legal tax or charge over whose rate an SNG has some control.

decisions (such as their debt-equity ratio). These taxes might also serve as barriers to new firms and the expansion of small ones. On the other hand, business taxes are potentially large revenue generators and more elastic than other traditional subnational taxes (such as the property tax), although they may also be more distortionary. Business taxes can be justified according to the benefit principle: firms are consuming benefits provided by subnational governments and thus should be charged for them.

This principle offers a rationale for differentiated business taxes at local and regional levels, such as user charges along with some form of business licensing tax, and perhaps a low-rate tax on gross receipts, either in place of or in addition to those options. At the regional level, the benefit case argues for a broad-based levy that remains neutral toward the factor mix, such as a value-added income tax or a business value tax (both options for taxing value-added income). One further option is to levy both a payroll tax and a tax on capital. Payroll taxes are easy to administer and productive at low rates. However, they can act as a barrier to employment in the formal sector—a concern that might outweigh their benefits in economies struggling to boost rates of formal employment.

Table 6.4 shows that China and the Philippines have formal business taxes, which are major subnational revenue generators. The business tax in China—levied on gross receipts not subject to the value-added tax—covers a wide range of sectors, including transportation, communications, and construction, and accounts for a large share of provincial tax revenues (22.6 percent, on average, in 2001). The business tax in the Philippines is similar, in that it is also levied on gross sales and accounts for a significant share of local revenues (29.8 percent, on average, in 2002, including business licenses). Giving subnational governments in China and the Philippines control over rate setting could be both revenue-productive and autonomy-enhancing.

Cambodia and Indonesia do not have local business taxes per se. Indonesia relies on taxes on specific sectors, including hotels, restaurants, and advertising. A growing number of subnational governments in Indonesia are also taxing specific sectors, mimicking business taxes. There is concern that the proliferation of these taxes will result in distortions and inefficiencies at the local level. This suggests the need to rationalize the taxes imposed on businesses to minimize distortions, such as by introducing a

simple low-rate, broad-based “single business tax” to replace sectoral and “nuisance” levies and fees.<sup>8</sup> Cambodian provinces levy business licenses, though it might be more appropriate to transfer business licensing to the commune level and introduce a standard business tax at the provincial level.

### *Personal Income Taxation*

No country in the region makes use of personal income taxes as a source of subnational own-revenue. China, Indonesia, and Vietnam use such taxes as shared revenues, however. Such taxes would thus appear to be a potential new source of revenue for Cambodia, the Philippines, and Thailand. Allowing regional (provincial) governments to piggyback taxes on national personal income taxes is an important option for boosting local revenues, and potentially for increasing autonomy. This assumes that subnational governments could set the rates, and that the central government would administer the tax to avoid burdening local administrative capacity.<sup>9</sup>

### *User Fees and Charges*

Official use of charges and fees is widespread in the region.<sup>10</sup> In Thailand, subnational governments levy user charges on garbage collection, public utilities, mass transportation, and medical and child-care. The Philippines has more than 33 different types of user fees and charges, ranging from animal and civil registration to garbage collection fees. Total collections from each major source are relatively small, reflecting the dispersion of revenue sources (see table 6.5). Moreover, a large number of fees and user charges together generate less than 0.10 percent of the total operating and miscellaneous revenue of subnational governments. It is important to note, however, that the main economic rationale for levying user charges is to promote efficient use of public resources through the pricing mechanism, not necessarily to raise revenue. Still, eliminating these extremely low-yield fees would reduce the administrative and compliance costs arising from the complexity of the system.

In Indonesia, the most significant provincial collections from user fees come from charges for health services. Collections from charges for building licenses are second in importance. At the city and district level, 62 percent of fee revenue comes from public service fees, 23 percent from licensing fees,



**TABLE 6.5 Highest-Yield Fees and Sources of Operating Revenues of Subnational Governments in the Philippines, 2000**  
(pesos)

	Pesos	% of total
Market receipts	1,568,806,000	15
Electrical light and power fees	738,108,000	7
Mayors' permit fees	659,004,000	6
Hospital fees	657,528,000	6
Rents	368,598,000	4
Building permit fees	361,172,000	4
Garbage fees	337,992,000	3
Total operating and miscellaneous revenue	10,218,000,000	100

Source: COA 2001.

**TABLE 6.6 Most Significant Charges by Local and Provincial Governments in Indonesia, 2002**  
(million rupiah)

Local government	Revenue	Share of total (%)
Charges for health services	745,903	33.25
Charges for building permit	240,547	10.72
Charges for market services	194,134	8.66
Charges for printing resident's ID card and birth certificate	128,072	5.71
Charges for use of regional property	96,259	4.29
Garbage disposal/sanitation levies	92,160	4.11
Bus terminal levies	87,353	3.89
Disturbance permit levies	62,824	2.80
Public roadside parking levies	60,387	2.69
Motor vehicle inspection levies	46,347	2.07
Provincial government	Revenue	Share of total (%)
Charges for health services	311,133	45.42
Charges for building permit	134,071	19.57
Charges for use of regional property	46,384	6.77
Motor vehicle inspection levies	36,259	5.29
Regional production sale levies	20,451	2.99
Wholesale market and shopping complex levies	15,607	2.28
Public roadside parking levies	12,603	1.84
Recreation and sports ground levies	11,774	1.72
License allocation of land use	10,711	1.56
Garbage disposal/sanitation levies	8,741	1.28

Source: Ministry of Finance.

and 15 percent from business service fees. All other provincial and local charges together contribute a very small percentage of total revenue. In fact, provinces levy 14 charges that generate less than 1 percent of charge revenues, and local governments levy at least 30 such charges (with at least 93 different

local charges throughout the country in 2002). Many of these low-yielding fees are levied on businesses, creating a heavy administrative burden and suggesting the need for rationalization (see table 6.6).

Bird and Tsiopoulos sum up the challenge of user charges as ensuring "that the *right* prices are

charged for the *right* services” (1997, 33). They also argue that central governments need to provide guidance—perhaps in the form of an overarching legal framework—to subnational governments on creating and managing user charges. Elements of such a framework include clear and transparent parameters for setting prices and a process for consulting with local stakeholders. National governments in countries with a particular concern in this area, such as China, Indonesia, and Vietnam, might be warranted in intervening—at least in the near term—with lists of allowable or prohibited charges.

### *Excise Taxes*

East Asian countries are split on excise taxes. The Philippines, Thailand, and Vietnam do not use major excises, which suggests another reform option for these countries.<sup>11</sup> Allowing local governments to impose excise taxes or fees on motor vehicle registration would give those governments an appropriate and potentially important source of revenue that would be relatively easy to administer.<sup>12</sup>

### **Significant Others: Fees, Other Taxes, Charges, and the Problem of Illegal Proliferation**

#### *Illegal Activities*

Lack of control over tax policy has encouraged local governments to seek other tax and nontax sources of revenue. In a number of East Asian countries, local governments have the authority to enact new taxes and fees, though their authority is regulated by law, and in some countries is subject to review by the central government. Central control has encouraged local governments to become entrepreneurial, with both positive and negative results. In China, this situation has led to the proliferation of “illegal” extrabudgetary fees, some of which have distortionary effects. Indonesia has seen the proliferation of nuisance taxes, which collect very little in revenue yet impose high administrative costs on local governments and compliance costs on taxpayers. In the Philippines, local revenue codes yield a tax system of great complexity, with a resulting loss of transparency and ability to monitor the system. Some subnational governments are avoiding collecting legal taxes and others are collecting “illegal” taxes, undermining the integrity of local governance and thus public support.

The Chinese case is particularly acute given the large number of “unofficial” charges. Because of a lack of autonomy, local governments have resorted to introducing fees not permitted by law, and these represent a significant percentage of local budgets.<sup>13</sup> The fees include surcharges on household utility bills, hospitals and school charges, road maintenance, advertisement, vehicle purchases and others (World Bank 2002). While these fees may introduce distortions and raise compliance costs imposed on taxpayers, the World Bank has argued that “fears of run-away local governments arbitrarily creating a jungle of local fees and charges do not appear to be justified.” Yet the growth of extrabudgetary financing among local governments has become a serious concern. The World Bank estimates that extrabudgetary funds and off-budget activities may represent 18 to 22 percent of gross domestic product (GDP) (World Bank 2002).

The Chinese government has had a policy of converting informal fees into official taxes, but it is implementing this policy unevenly. In Gansu province, for example, provincial officials reportedly approve all local fees at the prefecture, county, and township levels. But no one knows the extent to which local governments are staying ahead of provincial authorities by implementing new fees.

Similarly, Cambodia has had serious concerns about the proliferation of “informal” fees and charges at the commune/*sangkat* level. In fact, this proliferation seems to be impeding development of a system of own-source revenues for newly elected subnational governments. Evaluations of existing practices have been only exploratory, but there are reports of birth registration fees being “unofficially inflated” from US\$0.10 to US\$10 (UNCDF 2003).

In China, fees and charges undermine the tax system because they are not officially on the books. In the Philippines, a similar argument can be made—but with a variation. In the Philippines, numerous fees and charges on the books undermine the system because they are either not collected, or are not collected in accordance with the revenue code. In the city of Bacolod, for example, the mayor’s business permit fee has more than 200 different rates, which vary by type of establishment. This complexity adds greatly to administrative costs. Thus, putting revenues on the books and legalizing them does not necessarily solve the

problem or eliminate the need to develop the local capacity to manage user charges.

Overall, the proliferation of illegal, extrabudgetary revenues raises concerns about efficiency losses stemming from distortions and relatively high administrative (and possibly compliance) costs. At the same time, citizens of some localities may be willing to pay for off-budget services from local governments (in these cases, efficiency losses would presumably be lower). Some subnational governments collect these off-budget sources in response to limited autonomy, so the practice is somewhat understandable, if not justifiable. However, these levies can undermine public trust in the tax system, which cannot be good for long-term compliance. A policy of reviewing and converting illegal fees into official ones, as in China, is warranted.

### *Open Lists*

One of the issues around the use and abuse of user charges is the authority to enact new levies. In both the Philippines and Indonesia, local governments have formal authority to introduce some new taxes and fees. In the Philippines, the Local Government Code provides a range of tax and fee options for local governments, though the country should consider more options. The code gives local governments the option to levy other taxes, fees, and charges, provided that the code does not specifically prohibit them and the National Internal Revenue code does not already include them.<sup>14</sup> That all makes sense within the framework established above. But what is problematic is if subnational governments abuse this “open list” approach by levying taxes and fees in a nontransparent, illegal manner. Monitoring and enforcement of tax law matter.

In Indonesia, besides formally assigned taxes, Law 34 of 2000 allows cities and regencies to levy additional taxes if they follow a number of general criteria.<sup>15</sup> To ensure that governments meet these criteria, the central government requires them to submit regional regulations to the Ministry of Home Affairs for review. If the ministry, in consultation with the Ministry of Finance, finds that a tax violates legal provisions, the ministry may cancel the regulation, in which case the local government must rescind the tax.<sup>16</sup>

As noted, the “open list” approach has its merits. However, countries might not want to seize on it as a

major reform option for at least two reasons. First, the positive list of taxes provided in Indonesia (Law 34 of 2000) does not include any taxes that can generate significant revenue. This prompts many subnational governments to introduce taxes that do not necessarily generate much revenue either, as a way to assert their autonomy. As a result, nuisance taxes and charges abound. The Ministry of Finance found that more than 200 regulations submitted to the central government between August 2001 and January 2003 violated Law 34. Many are levied on agriculture, mining, and interregional trade. In Lombok, for instance, three local governments jointly impose a 5 percent tax on 174 products leaving the island (Ray 2003). Thus, the problem in Indonesia is not the open list itself but the fact that it does not include appropriate broad-based taxes.

Second, the review mechanism does not seem to work very well without adequate monitoring. For example, Lewis estimates that subnational governments send just 40 percent of all regional tax- and charge-related regulations to the Ministry of Home Affairs for review, so many potentially harmful taxes and charges remain in effect (Lewis 2003).

### **Revenue Assignment between Subnational Levels**

Revenue assignment between local governments in East Asia often seems to create incentive problems. These occur between provinces and subprovincial levels in China and Vietnam; between provinces, cities and municipalities, and *barangays* in the Philippines; and between provinces, cities and regencies, and villages in Indonesia. In China and Vietnam, the lack of formal revenue assignment creates unpredictability and reduces accountability. In the Philippines and Indonesia, the transfer of significant shares of collections from province to subprovincial levels may reduce provincial incentives for collecting own-revenue.

In China, provincial governments may assign revenues to local governments within their jurisdiction (see box 6.1). Most, if not all, provinces seem to follow the traditional hierarchical approach, assigning revenue between the province and the first layer of local government (cities and prefectures), and leaving each layer to work out arrangements with the one below it. As mentioned, while the lack of

### BOX 6.1 Revenue Assignment across Subnational Governments in China's Gansu Province

Gansu province is centralized, in that the provincial level retains a relatively large share of all local taxes and rebates. For example, the province retains the entire amount of the value-added tax shared with subnational governments (that is, 25 percent of total national collections). A number of important features characterize subprovincial revenue assignment:

- Revenues from the enterprise income tax and the value-added tax are allocated to the level of government that "owns" the enterprise.
- The city maintenance tax is shared 30 percent with the province and 70 percent with prefectures and cities.
- The resource tax is shared 70 percent with the province and 30 percent with prefectures and cities.
- The urban land tax is shared 40 percent with provinces and 60 percent with prefectures and cities.

- For all other local taxes, prefectures and cities have full discretion over sharing arrangements.
- For certain local taxes, counties have full discretion over sharing arrangements with towns and township governments. These taxes include the farmland occupation tax, the land appreciation tax, the housing property tax, the vehicle license tax, and animal husbandry charges.
- Given discretion at each level of government, a variety of other arrangements exist. For example, in some counties the prefecture government received a share of the county value-added tax despite the provincial rule that allocates the tax by ownership.

Source: World Bank 2002, pp. 57–58.

formal assignment may have some advantages for provinces, the disadvantage for subprovincial governments in terms of uncertainty would seem to outweigh the potential advantages.

### Revenue Performance

Own-source revenues in Indonesia and the Philippines have risen in nominal (and real) terms, but have not fared as well as a percentage of GNP. In the Philippines, own-source revenues rose significantly right after decentralization, but have been stagnant as a percentage of GNP—at 0.91 in 2001—ever since. In Indonesia, own-source revenues rose from 1.1 percent of GNP in 1995 to 1.4 percent in 2002. In China, in contrast, local taxes, which are predominantly shared revenues as opposed to own-source revenues (in fact, official own-source revenues are minimal), grew significantly as a percentage of GNP since the Tax Sharing System reform, from 5.0 percent in 1994 to 7.0 percent in 1999. Moreover, estimates of buoyancy in the post-reform period—a measure of revenue productivity as a result of economic growth—show that it is quite high.<sup>17</sup> Overall, these results indicate

that despite policy, administrative, and political challenges, own-source collection shows some positive signs, which augurs well for the future.

However, in most cases, own-source revenues compose a small percentage of total subnational revenue and their share has either not improved much or has actually declined. This means that subnational governments have not reduced their dependence on central government transfers. The next sections analyze that result for several countries.

### Composition of Own-Source Revenues

From 1992 to 2002, own-source revenues in the Philippines composed 34 percent, on average, of total resources available to local governments. However, own-source revenues declined from 38 percent in 1992 to 31 percent in 2002. Thus, these revenues, although nominally growing, have not kept up with the growth in transfers from the central government (the Internal Revenue Allotment).

In the Philippines, as in numerous developing countries, property taxes account for the largest single component of local revenues. In 2002, the

real property tax accounted for 36.5 percent of subnational own-source revenues, while business taxes and licenses accounted for nearly 30 percent, and operating and miscellaneous revenue accounted for 22 percent (see table 6.7).<sup>18</sup> These percentages have remained stable over time.

In Indonesia, own-source revenues accounted for about 39 percent of total revenue at the provincial level, but only 7 percent at the city and regency level (see table 6.8). Moreover, the percentage of own-source revenues to total revenue at the city

and regency level declined from 12 percent to 9 percent from 1995 to 2000, and dropped further to 6 percent in 2001, after decentralization. Transfers rose in relative importance over the same period, from 84 percent to 87 percent of total revenues.

### *Trends in Own-Source Revenues*

Both the Philippines and Indonesia show a clear trend: own-source revenues have risen slowly but steadily. In the Philippines, nominal and real

**TABLE 6.7 Own-Source Revenue Composition by Type of Local Government in the Philippines, 2001**  
(percentage distribution)<sup>a</sup>

Sources	All SNGs	Provinces	Cities	Municipalities
Real property taxes	36.5	47.3	36.8	30.3
Business taxes and licenses	29.8	0.3	36.3	26.3
Other taxes	11.2	22.4	10.0	9.0
Operating and miscellaneous revenue	22.3	29.2	16.9	34.3
Capital revenue	0.1	0.7	0.0	0.1

Source: COA 2002.

Note: SNGs = subnational governments. Totals may not sum to 100 percent because of rounding.

**TABLE 6.8 Composition of Regional Revenue in Indonesia, 2002**  
(millions of rupiah; percentage of total revenue)

	Provinces	Cities/regencies
Own-source revenues	14,207,830 38.46%	7,454,629 7.19%
Taxes and charges	12,500,929 33.84%	5,109,501 4.93%
Other	1,706,901 4.62%	2,345,128 2.26%
Grants	7,393,745 20.02%	64,100,112 61.83%
Revenue sharing	8,084,119 21.89%	17,310,428 16.70%
Carryover	6,307,652 17.08%	9,752,994 9.41%
Other	944,849 2.56%	5,052,425 4.87%
Total	36,938,196 100.00%	103,670,588 100.00%

Source: Ministry of Finance.

Note: Figures are projections based on data for 28 provinces (including Jakarta) and 324 cities and regencies.

**TABLE 6.9 Annual Nominal Growth in Local Own-Source Revenue in Indonesia, 1996–2002**  
(percent)

Annual increase	1995/1996	1996/1997	1997/1998	1998/1999	1999/2000	2001	2002
Regional tax	31	22	20	48	26	21	23
Regional charges	18	14	11	–12	20	32	32
Profits—enterprises	18	33	–2	20	26	10	89
Other	40	0	15	75	–1	155	93
Total	24	16	14	20	20	40	42

Source: BPS and Ministry of Finance.

collections have grown steadily in all major categories: property taxes increased nearly fourfold from 1993 to 2000, while taxes on goods and services rose fivefold. Taxes on goods and services recorded the highest average annual increase, followed by the property tax. Growth rates for all categories slowed during the latter part of the period.

In Indonesia, decentralization spurred a 40 percent nominal rise in local own-source revenues between fiscal years 2000 and 2001.<sup>19</sup> While revenues from taxes and charges grew by 21 percent and 32 percent, respectively, the largest increase occurred in the category of “other,” which rose by 155 percent (see table 6.9). In 2001, locally raised taxes contributed 43 percent of own-source revenues, while charges raised 33 percent and the share of “other” revenues grew to 21 percent.

Between 2000 and 2001, provincial tax revenue more than doubled in Indonesia. Several factors may explain this sudden jump. One factor seems to be that provinces received additional taxing powers under Law 34 of 2000 (even though the law abolished some nuisance taxes). Another factor is that tax collections, especially from the vehicle transfer tax, rose considerably. Third, changes in revenue-sharing arrangements may have created stronger incentives for provincial governments to increase collections.

Fuel and motor vehicle–related taxation dominate provincial own-source revenues in Indonesia. Provinces also appear to levy taxes that are formally assigned to local governments, such as the hotel and restaurant tax and the street lighting tax. Despite their insignificant expenditure responsibilities, provinces raise almost twice the own-source revenues as cities and regencies. In 2001, for example, revenues from local taxes and charges

were less than half those from provincial taxes and charges.

Street lighting and hotel and restaurant taxes account for over two-thirds of own-source collections among cities and regencies. “Other” taxes—which most likely include a large number of nuisance taxes that local governments have introduced since Law 34 of 2000—represent only 6 percent of tax revenue, indicating that the new taxes do not generate significant additional revenue.

### Own-Source Revenue Administration

Arrangements for tax administration vary throughout the region, ranging from highly decentralized in the Philippines to highly centralized in Vietnam, with Indonesia and China between these two poles. Yet in all cases the relative roles of local and national governments have not been well designed, resulting in both capacity and incentive challenges. The Philippines, for example, is highly decentralized with respect to tax administration. The Bureau of Internal Revenue (BIR) administers national taxes, while each local government administers its own-source revenues according to the Local Government Code and local revenue codes. Moreover, the law provides for little formal cooperation: the BIR operates independently of local tax administrations, and the national government provides little support to local governments.<sup>20</sup> Meanwhile, local tax administrations usually operate independently of one another.

At the other extreme is Vietnam. The General Taxation Department—operating under the Ministry of Finance, with offices at the provincial and district levels—is responsible for collecting all internal revenues. Local governments have no



tax administrative responsibilities. However, tax administrators operate under a system of dual subordination, in that they are responsible to their ministerial management as well as to representatives of local governments.<sup>21</sup> Thus, the system is characterized by built-in tensions. Martínez-Vázquez notes that administrative centralization may reduce incentives for revenue collection, as central officials have fewer incentives to collect local revenues compared with local administrators, who would have greater incentives to collect local revenues. On the other hand, he notes, provincial authorities have been known to pay bonuses to tax administrators who improve their collection performance (Martínez-Vázquez 2003). In this sense, subnational governments have some administrative control at the margin.

In Indonesia and China, the central government administers all shared taxes, while local governments administer revenues assigned to them. In Indonesia, local revenue agencies administer the taxes for which they are responsible, with little support from the central government. As in the Philippines, the result is that administrative capacity and collection costs vary widely by locality. China's Tax Sharing System reforms of 1994 created two separate tax administrations—one at the

national level to administer national and shared revenues, and a provincial tax administration tasked with all subnational revenues. According to the World Bank, "de facto dual subordination" of central tax administrators to local governments is still a problem, owing to old allegiances and the fact that local governments provide bonuses and assess penalties to stimulate collection, thus creating potential conflicts of interest (World Bank 2002).

### **Local Revenue Administration: Models and Options**

Tax administration can also be assessed from the perspectives of autonomy and efficiency. Vehorn and Ahmad (1997) offer four models for tax administration in decentralized polities. These include central tax administration with revenue sharing, central tax administration with assignment of taxing powers to different levels of government, multilevel administration with revenue sharing, and self-administration by each level of government. Mikesell (2002) stresses another dimension: the extent to which national and subnational authorities cooperate or operate independently. Table 6.10 reveals a great deal of diversity in the region on the administrative side, with transition

**TABLE 6.10 Tax Administration Models in East Asia**

Models	Countries	Observations
Central administration with tax sharing	Vietnam Cambodia	Highly centralized, but dual subordination of tax administrators gives SNGs some control at the margin.
Multilevel administration with tax sharing	China	Formally separate administrations for national and provincial levels, though dual subordination in practice.
	Indonesia	Formally separate administration, though some cooperation between central and SNG tax agencies, including on property tax.
	Thailand	Formally separate administration at the national, municipal/city, and subdistrict levels.
Self-administration by each level of government	Philippines	Separate provincial, municipal/city, and <i>barangay</i> administrative levels; little cooperation between central and SNG tax agencies.

Source: World Bank staff.

Note: SNG = subnational government.

economies closer to the centralized pole and Indonesia, the Philippines, and Thailand closer to the decentralized pole.

Guidance from the literature on good practice in tax administration in decentralized contexts is less clear. No consensus has developed on the principles of devolved administration.

The efficiency criterion would argue for reducing total administrative and compliance costs by taking advantage of economies of scale and scope. The Philippines, for example, includes hundreds of small-scale tax administrations collecting revenues throughout the country. Their ability to attract and retain qualified personnel is limited, as is their access to information technology. This limited capacity has direct consequences for taxpayers in terms of higher compliance costs. Variations in local capacity also mean that taxpayers do not receive uniform treatment throughout the country.

The key question is whether it is possible to centralize some administrative functions to reduce costs while not curtailing local autonomy. That is, to what extent is local tax administration a *sine qua non* of autonomous local governance? One could argue that since some functions of tax administration effectively control marginal revenues, subnational governments must have control over these functions in order to have—by definition—own-source revenues. Looking at administration as a bundled set of functions rather than a homogeneous process allows one to think about differential treatment of administrative functions. For example, the level of enforcement activity will have a direct bearing on the level of tax arrears collections. Thus, a subnational government that controls enforcement activities would be able to increase revenues at the margin. The same holds for taxpayer registries, which can be managed more or less aggressively, and taxpayer services. The argument is less true for other functions. Take property valuation. If valuation relies on market methods, there is not much scope for differences in implementation. The point is that administrative as well as policy levers can affect marginal revenues (though some administrative effects might be quite small).

Local governments do not, in theory, need to control all tax functions directly if they control the administration of those functions. The law requires tax administrators, as bureaucrats, to do as their political principals say. One definition of a good tax

administration is one that simply follows the tax code, leaving aside the question of whether the law is good policy. In the Philippines, bureaucrats are employees of the local government and therefore agents of local executives. But bureaucratic agents of higher-level governments could also be responsible to the local chief executive. The point is that tax administrators do not need to be local government employees to ensure accountability to local governments. Devolved responsibility does not necessarily imply devolved administration, especially in the context of weak local capacity.

A number of options would preserve local autonomy while improving efficiency. These options need not be universal for all subnational governments in a given country. Rather, subnational governments could consider the options on a case-by-case basis, which would imply asymmetrical treatment. Depending on local conditions, asymmetry might make sense, and would likely generate useful pilots for more comprehensive reforms.

A similar approach would encourage local governments with greater capacity to perform, for a fee, some functions for other local governments with less capacity. That occurs with Lima's Tax Administration Service, which collects property taxes for two other Peruvian municipalities (Ate and La Victoria) for a 5 percent commission. The critical issue is whether subnational governments would control administration at the margin.

Another option would be to establish a tax agency that would assist local governments—on a case-by-case basis, for a fee—with core administrative functions: registration, collection, and compliance. Such a subnational tax agency would allow economies of scale and scope, which could lower administrative and compliance costs. At present there are no known examples of this approach.

Yet another approach is for the national government to take responsibility for functions such as property assessment, or to help local governments with core functions. National governments assist with core functions in many countries. In Colombia, the central government maintains the property register and updates property valuations. In Cyprus, Estonia, Jamaica, Malawi, and Pakistan, the central government is responsible for assessing property and collecting taxes, even though property taxes are assigned to local governments (Vehorn and Ahmad 1997; McCluskey and Williams 1999, cited in

Mikesell 2002).<sup>22</sup> To add a dynamic element to this approach, one could envision local governments progressively taking over more functions as they develop capacity in these specialized areas. All local governments would not necessarily perform all tax administration functions, as some undoubtedly make more sense administered centrally.

Some East Asian countries have already taken advantage of economies of scale and scope. Responsibilities for administration vary among subnational levels of government, with larger jurisdictional levels having some responsibility for collections for

smaller jurisdictions in many countries. For example, in Indonesia and the Philippines, provinces collect and transfer some revenues to lower levels. This option—provided that higher jurisdictions are given adequate incentives—is worth exploring as a way to rationalize administrative arrangements between national and subnational governments, and between subnational governments themselves.

Though there are some success stories in the region (see, for example, box 6.2), the administrative capacity of subnational governments is weak in many cases, and is the binding constraint on

### BOX 6.2 Improving Tax Administration in Quezon City, Philippines

Quezon City—the largest city in metropolitan Manila in land area and population—faced a serious budget deficit in 2001. The administration of Mayor Feliciano Belmonte, Jr., who assumed office in July 2001, inherited outstanding obligations of ₱1.4 billion and bank debt of ₱1.2 billion. The city decided to improve its revenue collection.

The mayor's first step was to convene a search committee, headed by the dean of the College of Public Administration of the University of the Philippines, to recommend candidates for treasurer. The mayor settled on Dr. Victor Endriga, who quickly implemented reforms over the next 18 months designed to reverse the city's fiscal course. Treasurer Endriga adopted a "carrot-and-stick approach." The "sticks" include the following:

- Property auctions for delinquent property taxpayers. The city conducted three auctions in 2002—the first postcode auctions in Quezon City. (Although delinquent taxpayers have sued the city, they do not phase the treasurer: "it's part of the game.")
- Delinquency letters sent to recover the estimated ₱10.7 billion owed the city. (Each staff member must send out at least 20 letters daily, as staff had sent few before.)
- The use of presumptive minimum levels of gross sales for the business tax and for markets.
- A requirement that all business establishments with gross receipts over ₱500,000 submit their previous year's financial statement, as well as information on monthly tax payments from the Bureau of Internal Revenue.
- A requirement that all payments of real estate taxes include confirmation of payment of

other taxes, including the business tax and mayor's permit fees.

- Direct withholding of taxes from city contractors and suppliers, which rose from 12 percent to 75 percent of gross collections.

The "carrots" include the following:

- An increase in the discount on early payment of property taxes, from 10 percent to 20 percent for annual payers, and from 5 percent to 10 percent for quarterly payers.
- Improved taxpayer facilities, including modern air-conditioned lounges with automatic queuing systems, free coffee and tea, free local telephone calls, and televisions.
- Plaques from the mayor presented in a public ceremony to the 10 most "outstanding" taxpayers.

The city also computerized its property and business tax registries and collection processes, hired an outside firm to input all paper records, instituted new security features, raised tax rates, and reassigned employees within the treasurer's office to avoid familiarization. The city now rewards (such as with overseas trips) and punishes revenue examiners based on actual collections, and conducts house visits of delinquent taxpayers.

This reform program has paid off. Own-source revenues rose from ₱2.3 billion in 2001 to ₱3.9 billion in 2002, and the city closed the year with a surplus of ₱0.5 billion.

Source: Endriga 2003.

improving revenue performance throughout the region (see box 6.3). As Bahl has argued regarding China, “Tax administration shortcomings plague Chinese fiscal policy” (1999, 66). The principal problems include the following:

- The prevalence of stop filers, nonfilers, and late filers, owing to low local capacity to register taxpayers. This results in delinquent payments and the accumulation of arrears, especially in the Philippines.
- Infrequent audit and enforcement (temporary closures and property auctions), resulting in low compliance. This seems to be a problem in both Indonesia and the Philippines.
- The limited availability of taxpayer services, although some local governments in Indonesia and the Philippines offer important examples of good practice.
- The low professional qualifications of staff in all three countries.
- Inadequate support from and coordination with the national government.

Overall, the East Asian experience suggests that the multilevel administration model (with tax sharing) may hold the most short-term promise. The advantage of this model is the possibility that different levels of administration could assume different functions, and it could also facilitate assistance to subnational governments. Assigning complex tasks with economies of scale (such as property valuation) to either a central government agency or an agency dedicated to subnational support would reduce administrative costs and likely improve service quality. East Asian countries could further explore the idea of a subnational tax support agency, funded by subnational governments and under their control. Other solutions, such as for subnational governments to contract out to other local governments or piggyback on national taxes, are also worth consideration.

### *The Politics of Local Taxation*

While policy and administrative constraints on local taxation are critical, political constraints also affect performance. Several local governments in the Philippines, for example, reported that “political intervention” underlay their limited use of the power to auction or close businesses. Other governments

reported that instead of confrontation, mayors used their “charisma” to persuade businesspeople to pay taxes. One government reported active opposition from the chamber of commerce to the General Revision of Assessment, and another reported intense lobbying from the private sector against increases in tax rates, which resulted in compromise. Other localities report that businesses have taken legal action against property auctions and tax increases. Taxpayers sued Quezon City, for example, over “confiscatory” tax rates.

While no one knows the precise impact of political constraints on local taxation, a number of hypotheses—focusing on incentives—may be posited. One possibility is that politicians simply weigh the net impact, or political tradeoff, of higher revenues against greater expenditures. Simply put, officials decide to increase taxes (either through higher rates or better administration) when the discounted benefits of greater expenditures are higher than the discounted costs of higher taxes. Many officials seem to decide that the political costs of higher taxation are greater than the expected benefits. There are several possible reasons. First, the expected marginal benefit is small compared with the political cost of unhappy constituents. Inefficiencies in delivering services (such as patronage or padded projects) might also outweigh the impact of greater revenues, “wasting” the tax increase.

Another possibility is that the incidence of benefits and costs—in terms of expenditures and revenues—might undercut local elites. Increases in property tax collections would most likely harm the wealthy from a distributive standpoint, while increases in service delivery would most likely favor lower-income groups. However, politicians may not weigh these impacts equally, and may be reluctant to use higher tax collections to fund pro-poor service delivery.

Other explanations focus on the timing of benefits and costs, the extent of executive control over spending, and the electoral strength of the incumbent. Term limits on local executives—which limit them to two terms of three years each in the Philippines, for example—might also make them reluctant to invest in tax improvement programs that would yield fruit over the long term.

Property tax collection by local governments in the Philippines may be particularly problematic. As in most former Iberian colonies, landholding in

**BOX 6.3 Local Revenue Administration in Action in East Asia***Evidence from Indonesia:*

- Revenues are administered according to a multilevel model:
  - The central government administers national taxes.
  - Local tax agencies, generally known as DIPENDAs, play a minor role in administering the property tax.
  - Vehicle and vehicle transfer taxes are jointly administered by the provincial DIPENDA, the national police (as the coordinator), and a state-owned insurance firm.
- Own-source revenues are administered directly by DIPENDAs of the cities, regencies, and provinces, except for street lighting and fuel taxes. However, by issuing permits and licenses, local departments actually collect the user charges coordinated by the DIPENDAs.
- The administrative performance of the DIPENDAs varies widely.
- DIPENDAs have few cooperative agreements or information exchanges with other agencies within the same government, except for property tax field offices of the Directorate General of Taxation.
- DIPENDAs may use a certain percentage of total tax revenues to pay allowances to staff, though these bonuses are not usually based on performance.
- The quality of tax administration varies. Most DIPENDAs receive taxes directly in their offices, while others use partially government-owned regional development banks.
- One of the highest priorities of most DIPENDAs is developing the ability to professionally audit taxpayers, considered the weakest link in the system. The approach to taxpayer auditing varies by local government. DIPENDAs tried to introduce information technology in the early 1990s, but few local governments are still operating the computer systems because of lack of training.
- A lack of automated registers.
- Low-quality record keeping.
- Business tax registers are known to be incomplete, given frequent changes in registered establishments, which results in low levels of control and compliance.
- Problems undermining property tax collections include:
  - Collection efficiency for property taxes is low, resulting in the hemorrhaging of the most important source of local revenues. Local governments seem to be in a weak position to collect the taxes. Improving the efficiency of collection can raise these revenues significantly.
  - Property assessments have not kept up with changes in market values. Most local governments have not performed the General Revision of Assessment since 1991, resulting in significant undercollection of property taxes.
  - Noncompliance with the requirement for regular assessment requires urgent attention. The country could revise the code to allow the national government to do the assessments for local governments that do not comply.
- The compliance function seems inadequate. Major constraints include:
  - Infrequent exercise of local audit authority.
  - Infrequent exercise of local enforcement authority, in the form of temporary closures of firms and auctions of property.
- The difficulties of local governments in enforcing compliance suggest the need for presumptive taxation in some cases, especially for the business tax and some fees and charges.
- The principal constraint on taxpayer services is their limited availability. The lack of even the most basic taxpayer services and written materials means high compliance costs are likely to be the norm across the country.
- One main cause of underperformance is weak administrative capacity, owing partly to the low professional qualifications of staff. Inadequate coordination with the Bureau of Internal Revenue, and low levels of support from the Bureau of Local Government Finance, which might establish information-sharing protocols, are also factors.

*Evidence from the Philippines:*

- Principal constraints on taxpayer registration include:
  - A lack of regular maintenance and validation of the property tax and business registers.

that country has been concentrated. This legacy pits powerful landowners—some of whom have diversified their wealth into other assets—against weak local governments, some of which have been run by local elites for generations. Not surprisingly, the ability of local governments to enforce compliance with local revenue codes is weak in the face of elite resistance.

### Conclusions and Implications

This review of experiences in Cambodia, China, Indonesia, the Philippines, Thailand, and Vietnam finds that local governments have limited authority and ability to raise their own revenues at the margin. As a result, own-source revenues are low as a share of total subnational resources, and in some cases have been declining as a share of total resources. Limited revenue-raising power and capacity raise questions about the supposed benefits of decentralization in improving accountability and allocative efficiency. Reliance on transfers in their myriad forms creates dependence on the national government and may weaken subnational incentives to improve own-source revenue. Four key messages merit emphasis.

First, local governments have limited control over tax policy, including the ability to set rates and define the tax base. Decentralization is thus more political than fiscal. Lack of control over taxation at the margin breaks the tax-accountability link, undermining the expenditure efficiency promised by decentralization. While the general limit on own-source revenues is not the only constraint, policy autonomy is essential for significant improvement to occur over the medium term.

Second, the lack of authority over tax policy seems to have spurred local governments to seek unofficial tax and nontax sources of revenue, with deleterious consequences. In a number of countries, local governments have the authority to enact new taxes and fees and thus engage in entrepreneurial behavior, yielding both positive and negative results. The resort to informal and illegal fees is even more unfortunate considering that subnational governments in the region are unable to avail themselves of many taxing options open to governments in other regions.

Third, despite the lack of opportunity to raise revenues and the apparent interest in “unofficial”

avenues, subnational governments do not appear to have exhausted all their options. In some countries and for some taxes, local governments appear to prefer a lax collection strategy (property taxation in the Philippines, for example). Moreover, to the extent that the quality of local tax administration reflects both capacity and interest (according to the “revealed-preference” line of thought), then many subnational governments “prefer” weak administration.

Incentives thus play a role in determining collection levels of own-source revenues. This chapter suggests that two kinds of incentives play a role. The first is the systemwide incentive. For example, inherent in the intergovernmental fiscal transfer system are incentives that affect own-source collections. In Indonesia, the fact that the principal intergovernmental grant is based on the difference between fiscal needs and revenue capacity, rather than actual revenues, gives subnational governments incentives to raise collections to close the gap. The opposite is the case in Vietnam, which bases transfers on the difference between expenditure needs and forecasted revenues, which are based on previous collections. This formula could provide negative incentives, since higher collections result in lower transfer amounts (World Bank 2004b). Second, rational politicians might not prefer to increase own-source collections under certain circumstances.

Fourth, improvements in local tax administration would greatly strengthen subnational finance systems. Tax administrations vary throughout the region, ranging from highly decentralized in the Philippines to highly centralized in Vietnam, with Indonesia and China between these two poles. Yet the relative roles of local and national governments have not been well designed, resulting in both capacity and incentive challenges. Local governments tend to underperform on own-source collection and administration, reducing the credibility of the local tax system and contributing to a culture of noncompliance by raising compliance costs for taxpayers. Local administrative capacity is thus quite weak in many cases, and the binding constraint on improving revenue performance.

This chapter points out that the lack of development of significant own-source revenues in many countries is limiting the extent to which subnational governments can finance decentralized service



delivery and make decisions about taxation and service levels. However, it must be noted that local governments in some East Asian countries receive relatively large shares of national income. Thus any efforts to boost own-source revenues would need to occur in the broader context of matching total resources—including transfers and shared revenues—to expenditure responsibilities.

Challenges remain for improving local tax policy and administration. The lack of autonomy undermines the ability of local governments to realize the benefits of decentralization by tapping significant revenue sources to satisfy local preferences regarding the level and quality of services. Fiscal sustainability requires improvements in own-source revenue collection and administration more generally. Weak administration undermines local tax systems by contributing to high rates of noncompliance, high compliance costs for taxpayers, and high administrative costs for local governments. Getting the relationship between the national and local governments right—in both policy and administrative terms—is pivotal.

## Endnotes

1. For further discussion, see Bird 2003b; and Martínez-Vázquez 2003.
2. For further discussion, see Mikesell 2002. Many of these papers and others are available at [www.decentralization.org](http://www.decentralization.org).
3. Local Government Code, Sec. 191.
4. The percentage split for the Land and Building Tax (excluding mining and plantations) is: center (9 percent), which is intended to cover administrative costs of the deconcentrated revenue offices; provinces (16 percent); originating local government (65 percent); 6.5 percent equally across regions; and 3.5 percent to regions that exceed their previous year's revenue target. A Land and Building Transfer tax is also shared: provinces (16 percent), originating local government (64 percent), and the remainder to all local governments. The personal income tax is 80 percent central, 8 percent provincial, and 12 percent originating local government. See Law 25/1999, GR 115/2000, GR 104/2000.
5. Reference to Indonesia's "regions" generally means provinces and regencies and cities, while the term "local governments" refers to regencies and cities.
6. The *Salakhet* refers to the portion of the provincial budget that is under the control of the provincial governor, not the budgets of the deconcentrated line ministries at the provincial level. Nationally, the *Salakhet* represents about 20 percent of the total provincial budget allocation.
7. Only 7 cities charge the maximum 3 percent rate, and only 21 cities charge rates greater than or equal to 2.5 percent (outside the National Capital Region). No cities or provinces in the NCR charge the maximum allowed.
8. For example, countries could impose the business tax on gross receipts or rely on a subtraction method value-added tax. Note that this will require interjurisdictional apportionment of the tax base. However, the process need not be complex as in

Pakistan, where small towns (*tehsils*) adopted levies on gross receipts in 2002 (and contracted out collections).

9. It is noteworthy that the region has no cases of piggyback taxation with local rate setting.
10. User charges are defined here, following Bird and Tsiopoulos (1997, 39), as "charges levied on consumers of government goods and services in relation to their consumption," when consumption is voluntary (such as public water charges). Fees are defined, in contrast, as cost recovery for a mandated public service (such as automobile licensing).
11. In fact, provincial councils will set the rate for Thailand's vehicle tax as of 2005.
12. However, the Local Government Code in the Philippines prohibits local excise taxes (Sec. 133 (h)) as well as levies on motor vehicle registration and driving (Sec. 133 (l)).
13. Ahmad et al. (2000), report that extrabudgetary funds represented nearly 40 percent of all local revenues in 1999.
14. R.A. 7160, Sec. 186.
15. For any taxes not listed in Law 34, local governments can decide on appropriate tax bases and rates, as the central government establishes only general principles.
16. The regional parliament must pass these regulations to authorize the introduction of a new tax or charge.
17. The World Bank calculated the buoyancy coefficient of local taxes at 1.6 for the 1994–1999 period (2002, 55).
18. However, a significant share of property tax revenues is earmarked for education spending. On average, over the period 1992–2000, the Special Education Fund, which is earmarked for education, accounted for 44 percent of total property tax collections, which is quite high considering that property taxes are the main source of subnational own-revenue. Earmarking is another form of reduced subnational autonomy.
19. This is based on annualized data for fiscal year 2000 (which lasted nine months). In general, observers agree that the quality of fiscal year 2000 data is questionable, since—besides being shorter—this year was the transition to decentralization. Thus, it would not be appropriate to place much emphasis on comparisons involving fiscal year 2000 data.
20. The only notable exception, in some ways, to this rule is that subnational treasurers are employees of the Department of Finance.
21. Still, the General Taxation Department is responsible for appointing, promoting, and transferring departmental staff. To what extent local officials have input into these processes is unknown.
22. See also Mikesell 2002 on intergovernmental tax administration compacts in the United States.

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