

Decentralization of Authority and Local Government Finance in Three Asian Nations

(Research on the general revenue sources of local government finance in the Philippines, the Indonesia and Japan¹)

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I Introduction

Since the 1990s, decentralization reform has become a major trend as well as a significant domestic policy issue in the Asian nations. The decentralization reform can be divided into three elements; transfer of authority, organizational restructuring (including transfer of civil servants) and enhancement of local government finance autonomy. This paper focuses on the third element, local government finance autonomy. In order to secure the fiscal autonomy of local governments, it is imperative to expand their general revenue sources², that is, independent revenue sources mainly composed of a general grant, local tax, etc. Therefore, this paper discusses the issues concerning the decentralization of authority and local government finances, selecting three countries among the East Asian nations, the Republic of the Philippines (the Philippines hereunder), the Republic of Indonesia (the Indonesia hereunder) and Japan, where a general grant plays a major role in the local government finance structure.

II Comparison of Local Government Finances

1. Sizes of local revenue base and expenditure

Among the Asian nations, Japan has the largest local expenditure in addition to a high ratio of public investment by the local governments. Besides, within the local revenues, general revenue sources have a high ratio in the Indonesia and Japan. In addition, the ratio of local tax revenues is distinctively high in Japan. (Table 1).

<Table 1> Relative Size of Local Revenue and Expenditure³

Country	Total public expenditure a) as % of GDP b) € per capita	Local public expenditure (local and meso level only) a) % GDP b) € per capita	Ratio Local Public Expenses/Total Public Expenses	Ratio local public investment exp/ total civil public investment expenditure	Tax shares + general grants as % of the total LG Income	Local tax revenues (= tax revenues subject to a local tax power) as % of total LG income
China (2004)	a) 27% b) €291	a) 22% b) €235	81%	n/a	32%	29%
Indonesia (2006)	a) 19% b) €189	a) 6% b) €62	33%	36%	70%	<10%
Japan (2004)	a) 22.9% b) €7,243	a) 12.3% b) €3,903	53.6%	n/a	69%	34%
Korea, Rep. of (2005)	a) 36% b) n/a	a) 16% b) n/a	44%	n/a	53%	34%
Thailand (2002)	a) 21% b) €376	a) 2% b) €34	9%	15%	45%	12%

2. Division of Administrative Roles between National and Local Governments

As shown in Table 2, basic public services are provided by local government authorities except for the development and supply of electric power in the Indonesia and Japan.

¹ This is a translated and altered paper: Shunsuke Kimura, 'Comparative Study of Research on the general revenue sources of local government finance in the Indonesia, the Philippines and Japan', *Hitotsubashi Law Journal*, vol 14-1, 2015, Hitotsubashi University, 2015, pp.81-120.

² Financial resources without any specific usage identified.

³ Source: "Decentralization and local democracy in the world 2008" (The World Bank (2008) hereunder), The World Bank and UCLG (United Cities and Local Governments), 2008.

<Table 2> Public Services Provided by Local Government⁴

Country	Planning	Basic education	Basic social welfare	Basic health services	Water supply	Electricity supply	Public transport	Business development support
China	Yes	Yes	Yes	Yes	Yes	Yes	No	Yes
Indonesia	Yes	Yes	Yes	Yes	Yes	No	Yes	Yes
Japan	Yes	Yes	Yes	Yes	Yes	No	Yes	Yes
Philippines	Yes	No	Yes	Yes	Yes	No	No	Yes
Korea, Rep. of	Yes	Yes	Yes	Yes	Yes	No	Yes	Yes
Thailand	Yes	Yes	Yes	No	Yes	No	Yes	Yes

Moreover, in the Indonesia many of the local administrative services overlap with responsibilities of the national government. Meanwhile in the Philippines, administrative services provided by the local government authorities are more limited; local governments are not responsible for such administrative services as the development and supply of electric power, basic education and public transport.

Separately, Table 2 was prepared by compiling the survey results in the relevant countries concerning the main administrative services of the local governments. In terms of local expenditure (Table 1), although Japan has markedly higher spending at 7,243 euro per capita as opposed to 189 euro per capita of the Indonesia, there is not much difference between the two countries in the main administrative works assigned to them. Accordingly, it is natural to consider that the quality and quantity of public services have a larger implication on the scale of local government expenditure rather than the type of administrative works assigned.

3. Size of Local Government Personnel

The number of local public employees accounts for more than 60% of total number of civil servants in the Indonesia and Japan. In contrast, their share is in the 20 percentile range in the Philippines and Thailand (Table 3).

<Table 3> Number of Government Personnel⁵

Country	Local government personnel	Total public sector personnel	Share of local government personnel in total public sector employment
China	5,000,000 (est.)	n/a	92%
Indonesia (2006)	2,781,476	3,635,816	77%
Japan	1,432,494	2,311,920	62%
Philippines (1999)	390,561	1,445,498	27%
Korea, Rep. of (2006)	345,989	611,219	56%
Thailand	n/a	n/a	20%

This is because a large number of civil servants was transferred to the local governments in the Indonesia as a result of the transfer of administrative work from the national government to the local government authorities pursuant to two acts of legislation in relation to the decentralization of authority enforced in January 2001⁶, and because a wide range of administrative work is performed by the local government authorities in Japan.

⁴ Source: The World Bank (2008).

⁵ Source: The World Bank (2008).

⁶ In the Philippines, in accordance with the enforcement of the Local Government Act in 1991, various administrative services including those related to the agriculture, forestry and fishery industries were transferred from the national government to the local government authorities. Accompanied by this transfer of responsibilities, more than 70,000 public servants in total were moved to various local government authorities from the central ministries and agencies, including approx. 45,000 from the Department of Health, approx. 17,000 from the Department of Agriculture and approx.

III Significance of General Revenue Sources

General revenue sources of local government mean those funds which can be allocated to any expenditure item without any limitation imposed on the use of such financial resources. Specific revenue sources have a pre-identified usage for the application of fund.

Significance of the general revenue sources can be summarized as follows:

- (A) The relevant government authority can determine the use of general revenue sources (i.e. expenditure item) in accordance with the policy measures of such government authority. Namely, the authority can establish political priorities and implement such prioritized policies,
- (B) For an incidental administrative demand such as the occurrence of a disaster, the general revenue sources can be flexibly deployed to satisfy such demand,
- (C) If there is no latent pressure to spend or exhaust the revenues and no need for an expenditure of high priority, the general revenue sources can be appropriated to the internal reserve of the relevant government authority (i.e. contribution to the fund),
- (D) The general revenue sources have no uniform binding restrictions imposed on the budget implementation, different from the subsidiary conditions of a national subsidy, and
- (E) Cost consciousness may not always be strong for a promotional grant by the national government; however, the sense of cost is more clearly and steadily felt in the case of applying the general revenue sources.

Due to the circumstances described in the paragraphs above, it is a significant challenge for each local government to secure general revenue sources in order to execute fiscally independent activities. General revenue sources are mainly made up of grants from the national government to local governments and local taxes, etc.

IV Characteristics of the Three Countries

In conducting a comparative analysis of the local government finance systems of the Asian countries, the following four conditions can be pointed out as common features of the Philippines, the Indonesia and **Japan** (hereunder, collectively referred to as the “**relevant countries**”).

- (A) Among the macro level revenues of all local governments (hereunder, referred to as the “local revenues”), grants (hereunder, referred to as the “**general grant**”⁷) and financial resources which local governments are able to collect independently in accordance with the authorities assigned to them as the right of taxation (local taxes and non-tax receipts. Hereunder, referred to as the “local **independent revenue sources**”) represent major components as the general revenue sources.
- (B) In recent years, decentralization of authority has progressed in each of the relevant countries and the transfer of power from the national government to local governments has been implemented to a large extent. Thus, from the perspective of local governments, it has become a significant policy challenge to **secure local finance sources** in order to execute without hindrance administrative tasks assigned to them.
- (C) The current states of local government finances show a wide gap between local revenues and spending (hereunder, referred to as the “fiscal gap”), and **fund transfer from national government (transfer from external revenue sources in the local government’s perspective)** is playing an important role.

41,000 from the Department of Social Welfare and Development. Refer to “*Changing Local Government and Governance in Southeast Asia*” by Tsuruyo Funatsu and others (Institute of Developing Economies, 2012), pp. 179-180. (<https://mavi.ndl.go.jp/asia/entry/link-phl02.php>)

⁷ IRA in the Philippines, DAU in the Indonesia and the local allocation tax (LAT hereunder) in Japan fall under this category.

(D) While assuming that these local finance sources are adequately secured as described in the above paragraph 2), it is widely accepted as necessary to **strengthen the fiscal independence of local governments** in the mid-to-long term by way of enhancing local internal revenue sources and other means as part of the decentralization of authority.⁸

Therefore, taking into consideration the characteristics discussed above, the relationship between the decentralization of authority and the local government finance system will be examined hereafter through a comparative analysis of the relevant countries which share several common features in relation to the local government finances among Asian nations.

V General Remarks

1. Revenue and Expenditure in Local Government Finance

Distinctive characteristics of the relevant countries among Asian nations are discussed below. As presented in Table4, the Philippines, the Indonesia and Japan all show a large fiscal gap⁹ as mentioned in paragraph (3) above.

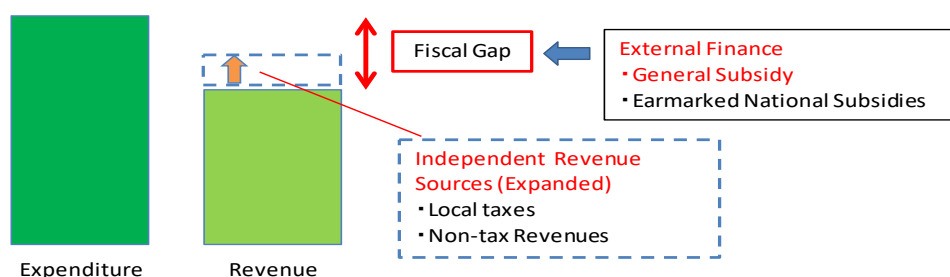
<Table4> Fiscal Gap¹⁰ of Local Government Finance in Asian Nations

Vertical Fiscal imbalance

	Local own revenue share in total revenue (%)	Local expenditure share in total expenditure (%)
China (2002)	45.1	69.3
India (2002-03)	41.4	57.5
Indonesia (2003)	6.08	26.51
Japan (2002)	42.1	61.9
Philippines (2004)	8.1	20.48

With respect to the fiscal gap, the external revenue sources such as the general grant and national government subsidies are to be applied to fill such fiscal discrepancies and keep a balance between revenue and expenditure as indicated in Figure1.

<Figure1> Fiscal Gap of Local Government Finance



(Source: Prepared by the author)

As we discussed in paragraph 2) above, in order for the local authority to smoothly execute the administrative tasks (public services) transferred to its jurisdiction, it is critical to secure financial resources to fund such administrative tasks above all. In securing these financial resources, both general grants and local internal revenue sources play major parts.

Furthermore, the critical issues in the next step to be taken are to expand local independent revenue sources and apply such expansion to reduce the fiscal gap in order to establish independent local government finances (i.e. local autonomy).

⁸ As part of the decentralization of authority, emphasis is placed on the establishment of a local government finance system where the revenue size is finely balanced with that of expenditure. Accordingly, at least theoretically, the improvement in the local internal source revenues is accepted as essential in every country despite a varied degree of awareness in the practical level.

⁹ Regarding the Indonesia, it is commented that the “the revenue shortfall in the Indonesia’s local government finances is notable even in comparison with the international standards” in Anwar SHAH, ‘Indonesia and Pakistan: fiscal decentralization - an elusive goal?’ *“Fiscal Decentralization in Developing Countries”*, Cambridge, 1998, p.118.

¹⁰ Source: B. Raksaka Mahi, ‘Local Finance System and Decentralization’, 3rd Meeting of GRIPS Research Committee of Decentralization in Asian Countries, June, 2012. As for Japan (2002), the ratio is calculated of local tax revenues of 33.4 trillion yen to the total tax receipts of 79.2 trillion yen.

2. Decentralization of Authority and Local Government Finance

Reform of various institutions related to decentralization has had significant implications for the local government finance system of each country.

As for the Philippines and the Indonesia, the Local Government Act and two legislative acts in relation to the decentralization of authority were passed respectively in each country, transferring administrative services from the national government to the local government authorities, and the general grant has continued to increase; those moves are the common features in two countries. Furthermore, neither country has experienced a noticeable increase in local tax revenues as local independent revenue sources. (Table 5)

<Table 5> Decentralization of Authority and Local Government Finance

Country Name	Decentralization	Local Finance Systems	
		General Subsidy	Independent Revenue Sources
The Philippines	1991 Local Government Law	Increase of IRA	Tax revenue remains at the same level
Indonesia	1999 Decentralization Laws • Decentralization Law • Revenue Allocation Law (National government and Local governments)	Increase of DAU	2009 Increase of tax items Tax revenue remains at the same level
Japan	1999 The Package Decentralization Law (enforced) 2004~2006 Trinity Reform (Reform of local tax, National Subsidies and Local Allocation Tax)	Reform of local allocation Tax The amount of LAT Amount of LAT △5 T yen	2007 Transfer of tax revenue Income Tax ↓ Individual Resident Tax 3 T yen

(Source: Prepared by the author)

In Japan, following the Omnibus Decentralization Act in 1999, the so-called Trinity Reform was implemented over 2004 and 2006. Through this reform, tax resources worth three trillion yen were transferred to local independent revenue sources and the total amount of the local grants was reduced by 5 trillion yen as result of LAT reform. Accordingly, a marked transformation was brought to both the local independent revenue sources and the general grant.

3. General Grant and Local Independent Revenue Sources

Table 6 below presents the current situations of the general grant and the local independent revenue sources in the relevant countries.

<Table6> Comparison of Relevant Countries (Current Status of General Grant and Local Independent Revenue Sources)

Country Name	General Subsidy	Independent General Revenue (Local Tax etc.)
The Philippines	(IRA) ① Amount: 0.5 T yen (2011) ② Share of revenue: 48~78% The largest share ③ Recently the size has been expanded Amount 2011/amount 2008 = 1.41 (cf. GDP 1.13) ④ Dependency	① Share: For Provinces and municipalities – Second to IRA (16%, 18%) For Cities – Largest Share (53%) ② Recently the amount has been expanded. Amount 2011/amount 2008 = 1.22 The size of the amount is not so large
Indonesia	(DAU) ① Amount: 2 T yen (2011) ② Share of revenue: 60% The biggest share ③ Recently the amount has been expanded Amount 2011/amount 2008 = 1.25 (cf. GDP 1.18) ④ Dependency	① Share: Second to DAU (19%) ② Recently the amount has been expanded. Amount 2011/amount 2008 = 1.35 The size of the amount is not so large
Japan	(LAT) ① Amount: 24.2 T yen (2011) ② Share of revenue: 18% Second to Local tax ③ Fixing the amount is a crucial decision in the local financial crisis ④ Recently the size is stable ⑤ Mature system ⑥ Dependency (Small local bodies)	① The largest share (34%) ② Incentive to stimulate local governments to expand local tax revenue • Standard tax rates in calculation of LAT • Extra-legal local taxes • Competition among local governments to strengthen the revenue fund

(Source: Prepared by the author)

4. General Grant

In each of the relevant countries, a general grant represents a significant part of the general revenue sources among all revenue sources. Table7 shows the characteristics of general grants in each country.

<Table7> Comparison of General Grant in Relevant Countries

Country Name	Revenue	Expenditure
The Philippines	General Subsidy: IRA ① 0.5 T yen (2012) ② The size has been remarkably expanded as a result of the 1991 local government law. ③ Share of the revenue (2012): Province 77%, City 49%, Municipality 76%	① More than 20% of IRA is stipulated as earmarked for regional development projects. (Local Government Law) ② Share of labor cost borne by municipalities is 51.5%. (2008)
Indonesia	General Subsidy: DAU ① 2.0 T yen (2012) ② Share in the revenue: 60% (2012) ③ Dependency in all local governments ④ Adopting a technique that stresses Labor costs ⑤ Essential resource for small or outland local bodies	① A half of the expenditure is on labor costs. ② DAU is substantially appropriated to meet labor costs. ③ Incentives to expand capital expenditure have not been so huge.
Japan	General Subsidy: LAT ① 24.2 T yen (2012) ② Share in the revenue: 24.3% (2012)	① Breakdown (2012) Labor costs 23.9%, Social assistance expenditure 12.5%, Debt expenditure 13.5%, Capital expenditure 13.9% ② Cost containment of labor costs and capital expenditure for rehabilitation ③ Social assistance expenditure has been increasing. 2012 cost / 2007 cost = 1.47 (Expenditure amount 1.08)

(Source: Prepared by the author)

In the Philippines and the Indonesia, the general grant is the biggest revenue source, playing a central role; in the Philippines, the general grant accounts for 48-78% of total revenues while it is 60% in the Indonesia. It is also pointed out that the local governments of both countries have increasingly become dependent on the general grant. In Japan, local allocation tax is the 2nd biggest revenue source after local tax receipts, and amount to as much as approximately twenty four trillion yen in recent years (24.3% of total revenues in FY 2012), a huge general grant in scale.

Herein we compare the calculation policy for the general grant of each country. The Philippines have adopted a methodology to distribute the total internal revenues among the state and four levels of local governments. Therefore, the size of aggregate internal revenues basically determines the IRA amount to the individual authorities. Next, in the Indonesia, although the total amount of DAU is statutorily calculated, an individual grant is calculated based on the estimate of individual fiscal needs. At the moment in practice, since the total amount of DAU falls short of the statutory limit, fiscal needs which are estimated by an accumulation format are important determinants in calculating the grant for individual authorities. In Japan, the total amount of the general grant, real amount of LAT (local allocation tax and extraordinary financial measures loan), is calculated based on the policy to balance on a macro level the revenue and expenditure of local government finance in accordance with the relevant local finance plan. Consequently, the fiscal discrepancy on a macro basis between revenue and expenditure is the most important determinant of the amount given to the individual local authorities.

5. Local Independent Revenue Sources

Local independent revenue sources can be divided into local taxes and non-tax receipts. In this section we discuss the details of local taxes, the central source of local independent revenues, and their major issues.

5. 1. Local tax items

Specific items of local taxes in the relevant countries are shown in Table 8.

<Table 8> Local Tax Items¹¹

Country	Major local taxes
China	Collective enterprise, agricultural and real estate
Indonesia	Hotel and restaurant, entertainment, advertisement, electricity (street lighting), non-strategic and non-vital mining, parking, groundwater and environment. In addition, proceeds from taxes on land and property, motorized vehicles, vehicle transfer and fuel are shared with provinces.
Japan	Individual inhabitant, business, local consumption and automobile, property tax, city planning tax, local tobacco tax
Philippines	Property, business, amusement, sand and gravel, printing and publication, franchise and community
Korea, Rep. of	Property, business, acquisition, registration, license, inhabitant, farmland, butchery, leisure, tobacco consumption, urban planning, regional development, motor fuel and local education
Thailand	Property, land and building, land development, signboard, slaughter duties, swallow nest duties, tobacco, petroleum and hotel

In the Philippines, there are property tax, business tax, amusement tax, sand and gravel tax, printing and publication taxes, franchise tax, etc. The Indonesia has a local tax base such as hotel and restaurant taxes and entertainment tax as well as shared taxes with the national government such as land and property taxes. In Japan, we have an individual and corporate inhabitant taxes, local consumption tax, automobile tax, fixed asset tax, etc.

¹¹ Source: "Decentralization and local democracy in the world 2008"

5. 2. Local tax issues

Table9 lists major issues involved in each of the relevant countries.

<Table9> Local Tax Issues

Country	Issues over Local Tax Revenue	Other Issues
The Philippines	• Sluggish growth of local tax revenues.	• It is accepted that ideally the local governments should become fiscally independent by way of local independent revenue sources.
	• Some opinion that a high dependence on the general grant (IRA) reduces the incentives to increase local tax revenues.	• Despite numerous non-tax receipts items (charges, etc.), tax receipts per item are scarce.
	• Since the local tax base is small with very little impact on the local revenues, interest in increasing the tax receipts is low.	
The Indonesia	• Sluggish growth of local tax revenue.	• In spite of numerous local tax items, tax receipts per item are scarce.
	• Some opinion that a high dependence on the general grant (DAU) reduces the incentives to increase local tax revenues.	• Meanwhile, there are examples of taxation or compensation collection on crude oil, cement, fertilizer, airports, farms, etc.
	• Expandable direct and indirect taxes are national taxes. Generally existing local tax items have a low prospect of growth.	Necessity to provide the local governments with the incentives to increase their tax revenues. (Consolidation of tax items, etc.)
	• Tax collection is basically a national responsibility. (To ensure the efficiency of tax collection and integrity of taxation system).	
	• National government is cautious about creating a new local tax due to its possible adverse effects on regional economies.	
Japan	• Systematic assurance of incentives for expanding local tax revenues.	• Uneven distribution of tax sources among local government authorities. • Oscillation in tax revenues in accordance with the economic circumstances.
	• Reserved revenue sources for the local allocation tax.	
	• Overassessment (Taxation at a higher rate than the standard rate), discretionary tax rates	
	• Tax not stipulated in laws, etc.	
	• Overlapping taxable objects between the national and local taxes.	
	• Impacts of the national taxation policy on local tax.	
	• Meticulousness of statutory tax items.	
	• Highly difficult to create a tax item not stipulated in laws	

(Source: Prepared by the author)

Both the Indonesia and the Philippines share the same problem of sluggish growth in local tax revenues. In addition to an opinion that the provision of a general grant discourages efforts to expand local independent revenue sources in a certain aspect, it is also pointed out as reasons for sluggish growth of local tax revenues that the existing tax items have a limited prospect of increasing receipts, that the administrative authorities are not so much interested in making efforts due to the very small revenue base of each tax item, and that the enhancement of tax collection by local governments is difficult since under the current system the national government is mainly responsible for tax affairs.

In Japan, the most salient feature is that the incentives to increase local tax revenues are institutionally established (existence of the reserved revenue sources for the local allocation tax, overassessment (taxation at a higher rate than the standard tax rate), discretionary tax rates, tax not stipulated in laws, etc.). Then their challenges for expanding the independent revenue sources include that the state taxation policy easily affects local tax revenues (for example, probable effects on the state of corporate enterprise tax caused by the reduction in the national corporate tax rates) since taxable objects often overlap

between the national tax and local tax, as well as that the meticulousness of existing tax items makes it very difficult to create a new tax item not stipulated in laws. Above all, the most urgent issue at the moment is to solve the problem of uneven distribution of tax sources among the local government authorities.

5.3. Ratio of local independent revenue sources¹²

The ratio of local independent revenue sources to the aggregate revenues in each of the relevant countries is presented in Table 10.

<Table 10> Ratio of local independent revenue sources(%)

Country	Share of Independent General Revenue in Total Revenue
The Philippines (2008~2011)	Province 16.8% City 53.1% Municipality 18.6%
Indonesia(2011)	34.6%
Japan(2012)	51.4%

Although it is problematic to make a simple comparison because of the varied fiscal scales and different circumstances of the relevant countries, it is generally accepted that efforts to enhance local independent revenue sources are important to achieve fiscal independence, and a higher ratio should be pursued in the medium to long term.

However, in the meantime, the ratio may decline even further if the general grant (external revenue sources) continues to increase and local tax revenues remain flat. Separately, in the Philippines, reflecting a lower allocation of the IRA to the Cities among the Provinces, Cities and Municipalities, the ratio of local independent revenue sources is markedly high in the Cities. Thus, the ratio of local independent revenue sources is greatly influenced by the structure of finance sources pertinent to each level of local government.

VI Discussions

Hereafter we discuss particularly crucial features concerned with the general grant and local independent revenue sources of the relevant countries.

1. The Philippines

1. 1. Overall Issues of Local Government Finances

As shown in Table 11, the number of local governments continues to rise in the Philippines.

<Table 11> Number of Local Governments

Level of Government	1979	1981	1991	1998*	2001	2003	2008	2011
Provinces	75	75	76	78	78	79	81	80
Cities	60	60	66	84	96	115	137	138
Municipalities	1,484	1,497	1,540	1,540	1,513	1,497	1,493	1,496
Barangays	n.a.	n.a.	41,820	41,820	41,943	41,971	41,994	42,026

Source: National Statistical Coordination Board; DILG; as of June 2011.

¹² Prepared by the author from the following sources. For Japan, FY2012 National Account Statistics. The sum of local tax receipts, charges and allotments, rents and fees, property revenues, donations, transfers from other accounts and accounts brought forward and miscellaneous receipts, divided by total revenues. For the Indonesia, survey results conducted for this study (2011). The sum of local tax receipts and shared tax receipts, divided by total revenues. For the Philippines, refer to "Decentralization and Local Finance in the Philippines" by O. Tiu Sonco, II. Own source revenues divided by total revenues.

The IRA (Internal Revenue Allotment) represents approximately 76% of the total governmental revenues of the Provinces and Municipalities respectively. Cities have a relatively higher proportion of local tax receipts with the IRA accounting for approximately 44% (See Figure2). Since major revenue items (income tax, excise duty, VAT, etc.) are national taxes and the revenue base of local tax is small, the local government authorities are forced to rely on the IRA. Without the IRA, local government finances cannot be balanced, and their expenditure items are provided for just by the IRA (Table 12 and Figure2).

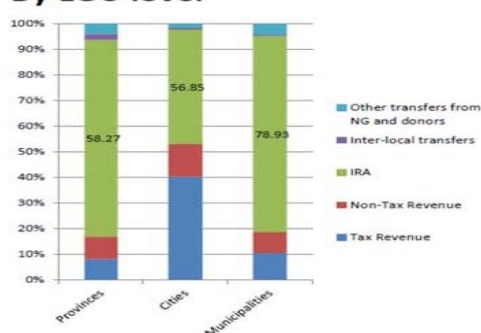
<Table 12> Revenues Trend¹³

Revenue Source	2008	2009	2010	2011
Internal Sources	90.94	95.71	101.63	110.98
Tax Revenue	62.82	66.99	67.19	76.58
Non-Tax Revenue	28.12	28.72	34.44	34.40
External Sources	180.33	211.37	211.96	223.76
Internal revenue allotment	171.86	198.38	196.89	209.05
Other Shares from National Tax Collections	4.70	3.13	9.92	7.27
Inter-local transfers	1.25	4.51	2.98	3.31
Extraordinary Receipts/Grants/Donations/Aids	2.52	5.34	2.86	4.08
Total	271.27	307.08	313.59	334.74

<Figure 2> Composition of Revenues¹⁴

By LGU Level: Composition of Local Revenues, 2008-2011 Average

By LGU level



% Shares of Revenue sources

Revenue Source	Provinces	Cities	Municipalities
% of IRA	76.90%	44.46%	76.64%
% of own source revenues	16.84%	53.09%	18.59%
% Other transfers from NG and donors	4.18%	1.67%	4.35%
% of Inter-local transfers	2.07%	0.79%	0.42%
Total	100.00%	100.00%	100.00%

Source of basic data: DOF-BLGF.

1.2. General Grant

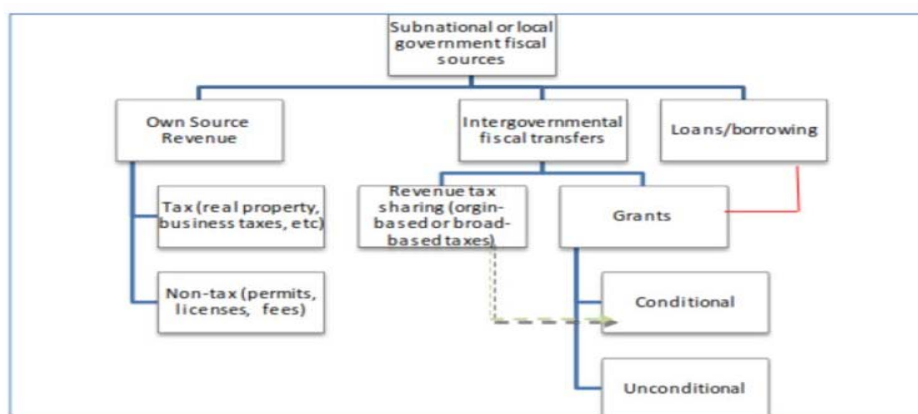
1.2.1. Outline of IRA

As revealed in Figure3, the IRA is playing a central role in the revenue stream of the local government authorities.

¹³ Source: O.Tiu SoncoII, "Trends and Patterns: Local Operating Income/Revenues and Current Operating Expenditures, 2008 to 2011", Source of basic data: DGF-BLGF.

¹⁴ Source: O.Tiu SoncoII, "Decentralization and Local Finance in the Philippines"

<Figure3> Revenue Sources of Local Government Authorities



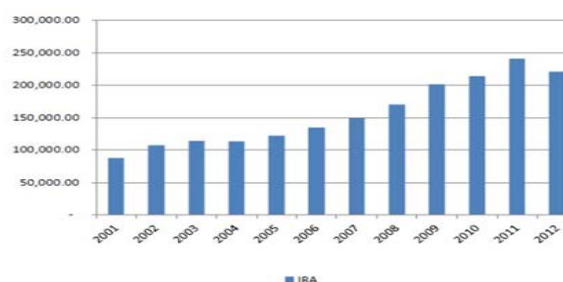
Source: Tiu Sonco 2009; updated in 2013.

As revealed in Figure4, the amount of IRA continues to expand, especially since 2004.

<Figure4> Change in the Scale of IRA

IRA Share of LGUs, 2001-2012 (in million Php)

Year	IRA in Million Php
2001	87,146.09
2002	107,063.80
2003	113,917.46
2004	113,103.88
2005	121,241.84
2006	134,468.37
2007	148,445.41
2008	169,879.38
2009	201,286.37
2010	213,937.18
2011	239,850.65
2012	219,942.96



Furthermore, as shown in Table 13, the share of IRA allotted to expenditure items (so to speak, dependency on IRA) has been gradually on the rise since 2004 in each of the Provinces, Cities and Municipalities.

<Table 13> Change of IRA's Proportion of Aggregate Revenues

Share of IRA on LGU Total Income and Total Expenditure, 2001-2007

LGUs	2001	2002	2003	2004	2005	2006	2007	Average
	Percentage Share of IRA to Total Income							
Municipalities	78	80	78	78	78	78	76	78
Cities	51	50	49	45	46	44	49	48
Provinces	78	82	70	77	76	79	77	77
Percentage Share of IRA to Total Expenditures								
Municipalities	89	94	91	85	86	88	92	89
Cities	51	55	52	46	49	46	55	51
Provinces	76	91	74	79	77	82	81	80

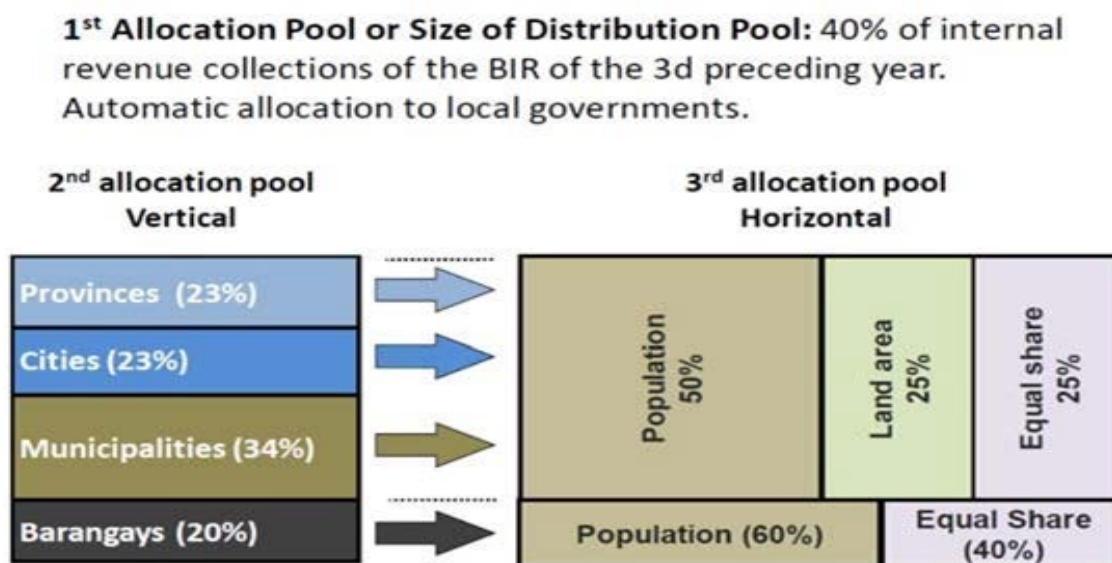
Source of Raw Data: DBM's BESF, various years

Source: Adapted from 11 RFA by The Asia Foundation, 2010.

1.2.2. Calculation of IRA

IRA is determined based on the following formula. (Republic Act, known as Local Government Code of 1991, Articles 284 and 285; Figure5)

<Figure5> Calculation Formula of IRA



Source: Based on LGC and adapted from JICA-DILG 2008 with modifications.

- (A) 60% of the internal revenue collections over the latest three fiscal years will be allocated to the national government and the remaining 40% to the local governments.
- (B) Within the different levels of local government, Provinces receive a 23% share, Cities 23%, Municipalities 34% and Barangays 20% respectively (Table 14).
- (C) At each government level, 50% of the allocation is distributed in accordance with the population size, 25% in accordance with the land area and 25% distributed equally. (As for Barangays, 60% of the allocation is distributed in accordance with the population size, and 40% distributed equally.) Since this allocation formula favours cities of large population even at the moment, some argues that the allocation should favour local governments with poor financial resources.¹⁵

<Table 14> Allocation Criteria of IRA

Allocation of IRA	Province	City	Municipality	Barangay
Old Act (till FY1991)	30	25	45	10
New Act (from FY1992)	23	23	34	20

As a result of the Local Government Act of 1991, the allocation method of IRA was modified as well as the responsibilities of national government being drastically transferred to the local governments. According to the new allotment formula, both Provinces and Cities receive the same share of 23%. However, since more responsibilities were transferred to the Provinces while few responsibilities were transferred to the Cities, consequently the Provinces have suffered a relative lack of funds and Cities have become fiscally wealthier. (Table14)

¹⁵ Hirotune Kimura, "Philippines: Development • Nation • NGO" (1998), p.155

1.2.3. Local independent Revenue Sources

(A) Local tax

(a) Local tax items

Local taxes can be roughly divided into three categories; first Property Taxes (asset tax), secondly Taxes on Goods and Services (tobacco excise tax, tax on delivery trucks & vans, tax on peddlers, etc.) and lastly Other Taxes (mining tax, amusement tax, and sand & gravel tax, etc.) (Table 15)

<Table 15> Local Tax Items

REVENUE SOURCE	
I. TAX REVENUE	
a. Property Taxes	
Real Property Tax – Current	
Real Property Tax – Preceding	
Real Property Tax - Penalty	
Real Property Tax - Transfer	
b. Taxes on Goods and Services	
Share on Tobacco Excise Tax	
Taxes on delivery trucks and vans	
Tax on Peddlers	
Occupation Tax	
Franchise Tax	
c. Other Taxes	
Mining Tax	
Local Government Share on IRA	
Miscellaneous - Amusement Tax	
Miscellaneous - Sand and Gravel	
Others - Immigration Tax	
Loc. Gov't Service Equalization Fund	
d. Fines & Penalties on Tax Revenues	
Taxes on Goods and Services	
TOTAL TAX REVENUE	

(b) Allotment of local tax revenues

With respect to the local tax receipts, the allocation share to the Cities is notably high (Table 16). In addition, since the number of cities is small (138 cities in 2018), tax revenue per city is relatively large.

<Table 16> Allocation Ratio of Local Tax Revenues

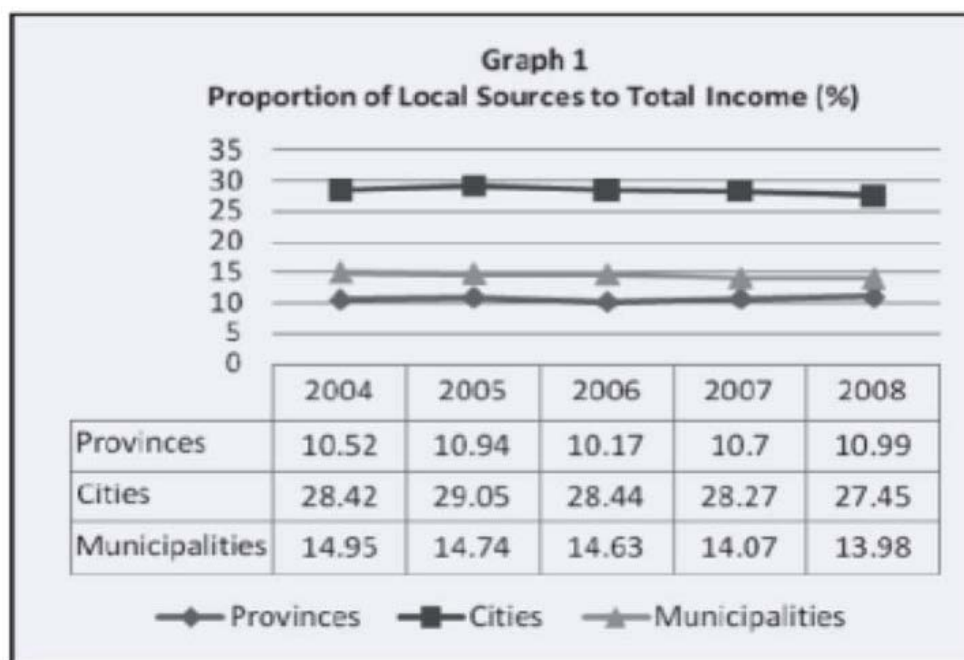
By LGU Level: Local Revenues by Source, 2008-2011 Average

Revenue Source	Provinces	Cities	Municipalities
LOCAL SOURCES	13%	68%	19%
TAX REVENUE	9%	75%	16%
Real Property Tax	15%	69%	16%
Tax on Business	2%	82%	16%
Other Taxes	17%	70%	13%
NON-TAX REVENUE	21%	52%	27%
Regulatory Fees (Permit and Licenses)	4%	65%	31%
Service/User Charges (Service Income)	27%	50%	23%
Income from Economic Enterprises (Business Income)	25%	44%	31%
Other Receipts (Other General Income)	25%	57%	18%
EXTERNAL SOURCES	30%	29%	41%
Internal Revenue Allotment	30%	29%	41%
Other Shares from National Tax Collections	31%	17%	52%
Inter-Local Transfer	52%	34%	14%
Extraordinary Receipts/Grants/Donations/Aids	34%	30%	36%
TOTAL CURRENT OPERATING INCOME	25%	42%	34%

Source of basic data: DOF-BLGF.

Local tax revenues have remained flat for some time (Figure6).

<Figure6> Share Trend of Local Tax to Total Income



(Based on BLGF Data 2004-2008)

One of the reasons is said that local government authorities tend to rely on the IRA, which diminishes the local governments' motivation to expand the local independent revenue sources (motivation to seek new taxable objects). Meanwhile, others suggest that local governments should naturally receive a certain share of the IRA since a distribution of the IRA to the local governments is a legal responsibility of the national government.

On the other hand, the national government insists that "the local government authorities should be responsible for local residents and independently identify their own financial resources if they seek to increase services such as water supply, housing assistance, provision/maintenance of parks, road works, etc."

Concerning these issues, Alinio (2008)¹⁶ commented, "an establishment of the structure is required to balance the local independent revenue sources and intergovernmental transfers."

Separately, another challenge as regards to the local tax is that the principle of neutrality is essential for local tax and that it is deemed desirable for such taxation to have a minimum impact on the enterprise invitation and investment, employment and consumption in the relevant area. However in reality, with some competition among the local governments to lower tax rates experienced, some believe that such competition may possibly cause damage to the overall national economy.¹⁷

Understanding these issues, the national government is expected to implement a policy that encourages local governments to develop local independent revenue sources.

(B) Non-tax receipts

There are various types of non-tax receipt items such as fees for registration and inspection, hospital fees, rentals, and others (Table 17).

¹⁶ Source: Buenafe F Alinio, "Philippine local government officials perceptions of decentralization and its effects on local governments' administrative capabilities", (2008, ProQuest), p.106

¹⁷ Refer to "Local Government in the Philippines", (1998, University of the Philippines), pp. 271 & 272.

<Table 17> Non-tax Receipts¹⁸

a. Government Services	b. Government Business Operations
Registration	Rentals
Inspection Fees	Sale of Plant and Other Farm Products
Certification or Secretary's Fees	Income from INWD (2%) in Lieu Share
Building Permit Fees	Receipts from Rizal Park
Governor's Permit Fee	Interest on Time Deposits
Occupancy Permit Fee	
Hospital Fees	c. Income from Public Enterprises
Permit Fee for Bangus Fry	Interest on Loans
Miscellaneous - Bid Proposal	Dividends on Private Enterprises
	Stocks
	Dividend on Treasury Notes/Bills
	Miscellaneous - repayment of loans
	d. Miscellaneous Income
	Sale of Waste Materials/Real Property
	Miscellaneous

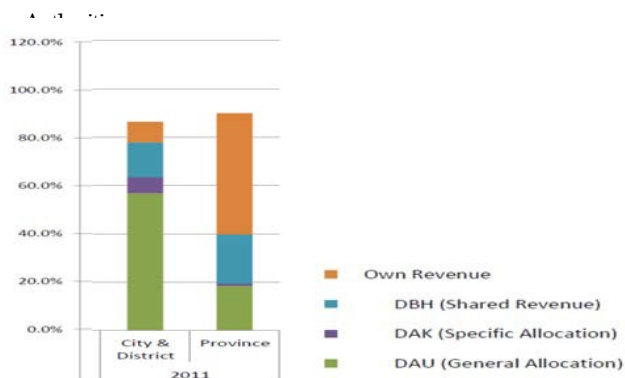
However, the revenue base of these items is negligible in scope and has little impact on the total revenues of local governments. In this regard, Alinio (2008) commented, the "local independent revenue sources will remain negligible in future unless local governments identify new financial sources."¹⁹

2. Indonesia

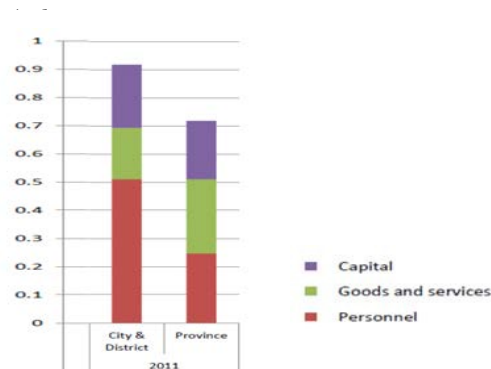
2.1. Total revenues

Figure 7 and Figure 8 show the breakdown of revenue and spending structure, while Figure 3 indicates that, in addition to the DAU (general grant), DAK (special subsidy), DBH (shared tax) and local taxes are also major sources of local revenues.

<Figure 7> Revenue Structure of Local Government



<Figure 8> Expenditure Structure of Local Government



(Source: Local Finance System and Decentralization)

Specifically, the DAU accounts for just below 60% of total revenues in the Cities and Districts, proving fiscal dependence on the DAU. Figure 7 reveals that personnel expenses are the biggest expenditure item. Table 18, while demonstrating the transition pertaining to the size of intergovernmental transfers for fiscal balance (funds transferred from the national government to the local governments), indicates that the growth in the intergovernmental transfers has exceeded that of the local independent revenue sources.

¹⁸ Source: Ibid, p.181

¹⁹ Source: Alinio (2008), pp.104 & 111

<Table 18> Revenues of Local Government²⁰

(Unit: 1 billion yen, 1 rupiah=0.008 yen)

Item	2007	2008	2009	2010	2011	Proportion (average (%))
Local Independent Revenue Sources	284	518	540	575	701	17
Intergovernmental Transfers for Fiscal Balance	1,669	2,209	2,250	2,338	2,418	73
Other (Statutory) Receipts	189	192	355	311	418	10
Total	2,143	2,919	3,145	3,224	3,538	100

Continued increase of the DAU explains this trend. In addition, the breakdown of intergovernmental transfers over the years shows that the DAU has recorded the biggest rise among the intergovernmental transfer items. (Table 19)

<Table 19> Intergovernmental Transfers of Funds²¹

(Unit: 1 billion yen, 1 rupiah=0.008 yen)

Item	2005	2006	2010	2011	2012
I. Intergovernmental Transfers of Funds	1,146	1,557	1,444	1,538	1,663
Shared Tax	404	455	421	428	416
Ordinary taxes	190	198	214	186	229
Natural Resources	214	258	206	242	186
DAU	710	1,022	929	998	1,138
DAK	32	82	96	111	110
II. Special Municipal and Adjustment Fund	58	28	128	288	296
Special Municipal Fund	14	25	42	46	50
Special Adjustment Fund	44	3	86	242	246
III. Total	1,203	1,586	1,572	1,826	1,960

1.2. General grant

1.2.1. DAU (General Subsidy)

DAU is calculated by applying the following formula (This formula has been utilized for some time since FY2006.)

$$\text{DAU} = \text{Equivalent amount of fiscal discrepancy} + \text{Amount of basic allocation}$$

$$\text{Equivalent amount of fiscal discrepancy} = \text{Amount of fiscal demand} - \text{Amount of fiscal capacity}$$

$$\text{Amount of fiscal demand} = \text{Amount of average expenditure in the region} \times (\alpha_1 \text{ vital index} + \alpha_2 \text{ areal index} + \alpha_3 \text{ construction cost index} + \alpha_4 \times 1/\text{human development index} + \alpha_5 \times 1/\text{GRDP})$$

$$\text{Amount of fiscal capacity} = \text{Local independent revenue sources} + (\text{property tax} + \text{property transaction fees} + \text{individual income tax} + \text{natural resource revenues})$$

²⁰Source: Prepared by the author based on the Directorate General of Fiscal Balance, Ministry of Finance, Indonesia.

²¹Prepared by the author based on the charts from B. Raksaka Mahi and Suahasil Nazara, "Survey of Recent Developments", "Bulletin of Indonesian Economic Studies vol. 48, No. 1", 2012, p.21.

<Reference> Framework of DAU

(A) Calculation formula and official statistics

Data used in the calculation formula above are from the official statistics prepared by the authorities as listed below. (Table20)

<Table 20> Data used in the calculation formula of DAU

Population	BPS (Indonesian National Bureau of Statistics) (from census)
Area	Ministry of Home Affairs
Construction Cost	BPS
Relative poverty index	BPS
Local independent revenue sources	Regional Budgets Bureau of the relevant authority
GRDP (Gross Regional Domestic Product)	BPS
Shared Tax (Ordinary taxes)	Tax Bureau, Ministry of Finance
Shared Tax (Natural resources)	Bureau of Engineering, Ministry of Energy and Mineral Resources

(B) Amount of basic allocation

Basic allocation, while being calculated on the basis of the “personnel expenses who were transferred from the national government agencies to the local governments”, in addition until 2008 a “mark-up so as to ensure that the DAU did not fall short of the actual amount of the previous year” had been added.²² This provision was stipulated in the Hold Harmless Clause.

(C) Hold Harmless Clause

Prior to 2008, the Hold Harmless Clause ensured that each local government received a larger DAU than that given in the previous fiscal year. Even though this Clause made it easy to forecast the revenue of each local government in a way, it was indicated that the shared tax did not play sufficiently its role of adjusting the fiscal revenue disparity among the regional authorities²³. This Clause was abolished in 2008, and the DAU has come in principle to be calculated based on the fiscal discrepancy equivalent, etc. Consequently, DAU is expected to be reduced for the government authorities with ample fiscal capacity while being raised for the government authorities with limited fiscal capacity. In order to resolve the financial instability of government authorities which receive a smaller DAU than in the previous fiscal year, the national government has newly established the “Equilibrium Fund”. This fund will be allocated to some government authorities that receive a smaller DAU than in the previous fiscal year. The funds are divided into the policy fund pertinent to the personnel expenses (Special Fund I) and a fund pertinent to the improvement of fundamental services and social welfare (Special Fund II).

(D) DAU and personnel expenses

Essentially there is no legal provision which obligates government authorities to appropriate the DAU to wages and salaries as a priority. However, in practice, since most of the government authorities do not have financial resources sufficient to pay the wages and salaries of their employees, the DAU ended up being appropriated for such expenditures. On an average, each government authority allocates over 80% of the DAU to wages and salaries. Some government

²² Kazuhisa Matsui, “Decentralization of Authority in Indonesia”, Institute of Developing Economies, 2003, p. 46.

²³ Yuri Sato, “Reorganizing Indonesian Economy”, (2003, Institute of Developing Economies), refer to p. 358.

authorities not only allocate all of the DAU to wages and salaries but also receive further supports for such expenditure from the national government. Therefore, although the DAU should be general revenue sources by nature, it also possesses characteristics of specific revenue sources because some government authorities appropriate it solely to wages and salaries in reality. Generally, most local governments believe that the scale of DAU is not sufficient to cover their expenditures. Similarly, the scale of shared tax composed of ordinary tax and natural resource tax is considered to be far from providing for the wages and salaries.

(E) Challenges of DAU

As revealed in the Table 21, statutorily calculated amounts and actual budget amounts do not match. Although efforts have been made continuously for improvement, satisfactory financial resources have not been identified yet from the perspective of local governments.

<Table 21> Transition of DAU - Statutory Amount and Actual Budget

(Unit: 1 billion yen, 1 rupiah=0.008 yen)

DAU	2008	2009	2010	2011
Statutory Amount (Law No. 33/2004)	1,874	1,604	1,874	2,222
Actual Budget	1,436	1,491	1,629	1,804
Difference	△ 438	△ 112	△ 245	△ 418

- (a) Among all the expenditures of local government authorities, wages and salaries account for 50% in the Cities and Districts (Chart 4). In its calculation philosophy as well as in actual practice, the DAU is treated solely as resources to provide for the wages and salaries of civil servants. Accordingly, it is pointed out that there is a lack of functionality to promote efficiency to the local government authorities. Moreover, it should be mentioned that the inefficiency of local public authorities' spending remains a challenge today.
- (b) DAU is literally a general subsidy without any subsidiary conditions attached by the national government. Nonetheless, since it is predominantly appropriated to wages and salaries in practice, it is sometimes claimed to be "actually more like a distributed fund of which use is designated."
- (c) Local government authorities themselves have rarely adopted the idea either that they "endeavour to secure a fund for the provision of other administrative services by reducing the amount of wages and salaries for civil servants (or at an expense thereof)". Besides, given the traditionally low rate of capital expenditures, local government authorities tend to have little interest in infrastructure investment, etc.
- (d) The number of local governments is on the rise as result of division. Newly established government authorities have little choice other than to rely on the DAU for their fiscal management and the fiscal gap has increasingly become evident in comparison with wealthy government authorities in urban areas. Such disparity among the local authorities is expected to continue in the future. In addition, further division of local authorities will lead to an inevitable rise for DAU demand, also likely to affect the national budget.
- (e) Fiscal disparity among local government authorities has been a long-term problem without noticeable improvements over the past 40 years. Wealthy government authorities represent about 10% of all local government authorities, being in Jakarta, West Borneo, Riau, etc., and the rest of the local authorities are dependent upon the national government for approximately 90% of their financial resources.
- (f) It is indicated that the DAU and local independent revenue sources have a negative correlation. High dependency on the DAU reduces the incentives to enhance local tax collection. While excessive local taxation would have adverse

implications for the investment environments of the relevant region, local governments are expected to fulfil their obligations of securing optimal revenue level through the appropriate tax collection efforts.²⁴

1.2.2. DAK (Special Subsidy)

DAK has developed in that more government sectors deliver the subsidies (from 9 sectors in 2003 such as education and road to 19 sectors in 2009), as well as that the number of recipient government authorities has also risen. However, it has some issues whereby the grant amount per government authority is on the decline, and its functions have become similar to those of the DAU among the financial resources of local government authorities due to an increase in the number of the government authorities which receive such grant.

Initially, the DAK was mainly allocated to such areas as education, welfare, infrastructure, etc., but in recent years it has spread to other administrative fields like sanitation, forestry and others (Table 15).

<Table22> Application Areas of DAK (Source: Indonesian Ministry of Finance)

Education	Forestry
Health	Village facilities
Roads	Trade
Irrigation	Hygiene
Government Facilities	Rural Electricity
Marine and Fishery	Housing
Drinking water facilities	Land transportation safety
Agriculture	Rural Transportation
Environment	International Border Facilities
Family Planning	

Though the DAK is small in a monetary term, it is being applied selectively as an effective tool in implementing a policy of high priority from the viewpoint of national government and is recognized to continue to be applied as such in future.²⁵

1.3. Local independent revenue sources

1.3.1. Local taxes

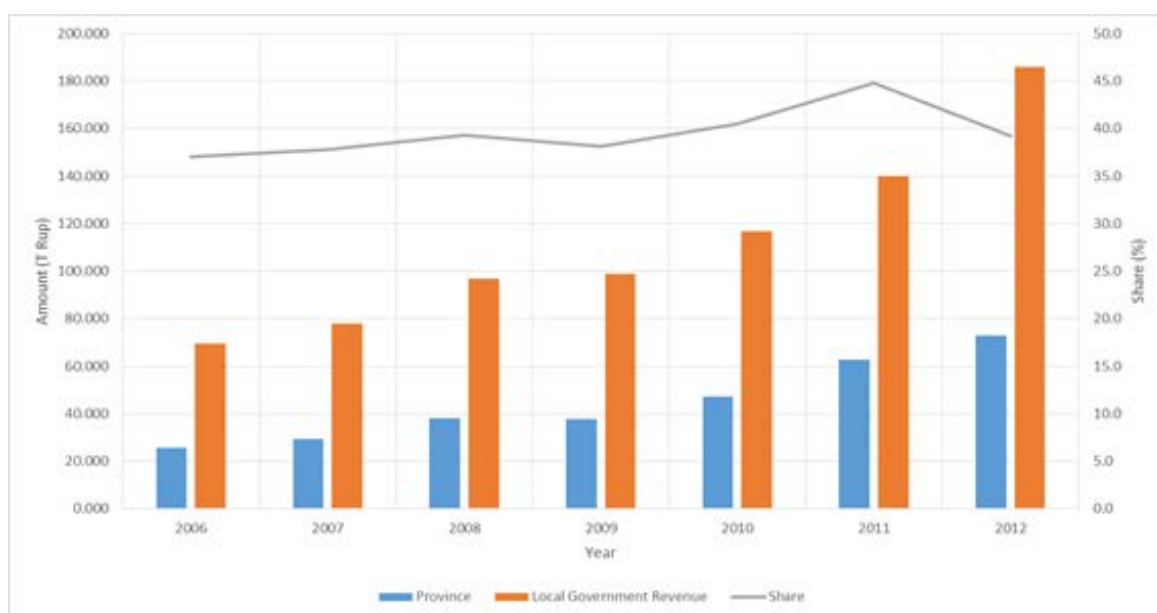
(A) Current status

As indicated in Figure9 and Figure10, both of the Provincial tax and the City & District tax have been growing since 2006. The scope of provincial tax is substantial and is an important revenue source for the provinces.

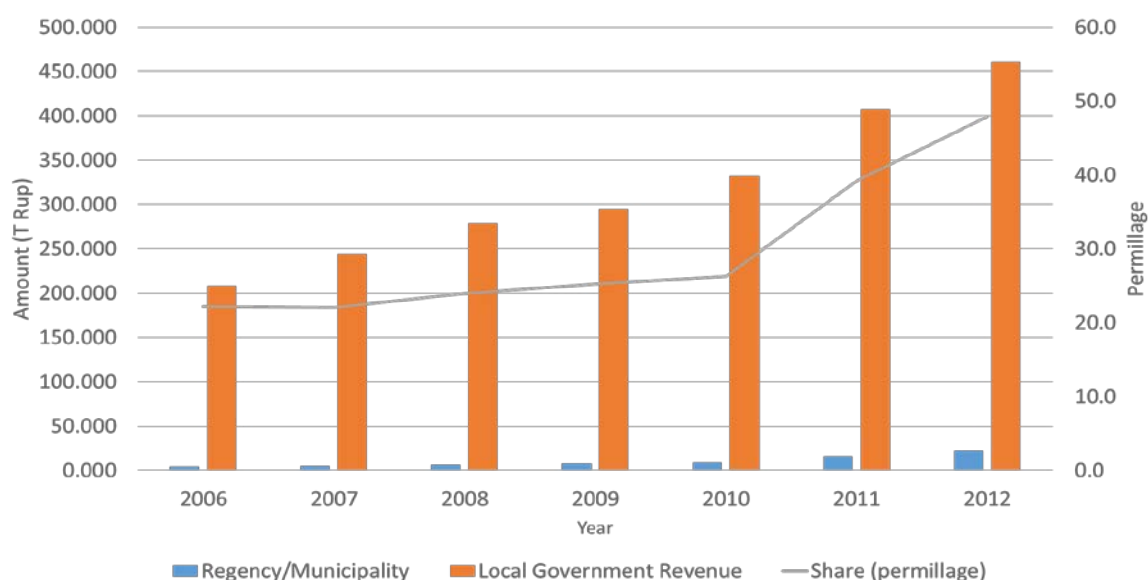
²⁴ Quote from Bambang Brodjonegoro, "Fiscal decentralization and its impact on regional economic development and fiscal sustainability", *Decentralization and Regional Autonomy in Indonesia, Implementation and Challenges*, (2009, IIAS, ISEAS), p.203. Other researchers and practitioners provided similar comments.

²⁵ Comment by the responsible officer of the Indonesian Ministry of Finance interviewed in March 2014 as a part of this study.

<Figure9> Scale of Provincial Tax



<Figure10> Scale of City & District Tax



(B) Expansion of local tax items

Act No. 28 of 2009 provided for the expansion of local tax items which local government authorities can establish.

(Note) A local government authority wishing to create a new tax item applies to the national government for the introduction of such tax, and the national government will grant approval as long as the tax complies with the pertinent provisions of the relevant laws.

Provincial taxes: 4 items²⁶ → 5 items

City & District taxes: 7 items²⁷ → 11 items

²⁶ Provincial taxes are motor vehicle tax, motor boat tax, transfer tax on ownership of motor vehicle & motor boat, petroleum tax, tax on intake and use of ground water and spring water.

²⁷ City & District taxes are hotel tax, restaurant tax, entertainment tax, advertisement tax, street lighting tax, mining and processing tax of C-type resources, parking tax.

(C) Sluggish growth in local tax revenue and background thereof

However, local tax receipts have not recorded any significant increase recently. Following circumstances provide the background.

- ① Growth potential of tax revenue: few tax items have prospects for increasing the collections.
Expandable direct and indirect taxes are classified as national taxes, and generally speaking, existing local tax items have limited prospects of revenue growth.²⁸
- ② In order to ensure the efficiency of taxation and integrity of the tax system, the national government is charged with collecting all of the shared tax revenues and royalties for natural resources. Consequently, local governments are reluctant to increase their administrative burden through establishing new tax items, and the incentives for increasing tax collection through taxation are hard to make work.
- ③ If a local government tries to introduce its own local tax, it requires approval from the Ministry of Home Affairs.²⁹ National government seems to be taking a cautious approach to the introduction of new local tax items for fear of causing adverse effects on the regional economy resulting from the imposition of tax and public dues on the local residents if the introduction of new local tax items is easily permitted.
- ④ In the Indonesia, there are examples of taxation on or compensation collection for, crude oil, cement, fertilizer, airports, farms, and others, by the relevant local government. In such instances, one of the challenges is to establish a fair local tax system which satisfies various conditions taking into accounts such factors as the rationale for taxation and the impacts on the relevant regional economy.³⁰
- ⑤ A local government not only has a right of local taxation but also possesses powers of licensing and authorization for natural resource development. Accordingly, there is the possibility that they give permissions excessively for resource development projects if the relevant local government focuses on expanding tax revenues in a short time. On the other hand, there is another argument that the local government would be cautious about giving an approval for resource development projects when they believe that excessive exploitation of natural resources by business eventually leads to a future reduction of their tax revenues.³¹
- ⑥ Because the local tax base is small, there is a thought that their impact on local revenue is marginal whatever the efforts to increase the tax receipts may be.

²⁸ Quote from Anwar SHAH, "*Indonesia and Pakistan: fiscal decentralization- an elusive goal?*" p. 120. In addition, a similar comment was obtained from the officer of the Indonesian Ministry of Finance mentioned above.

²⁹ Local government is permitted to introduce a new local tax item other than those statutory local tax items if they are accepted to satisfy specific conditions (e.g., taxable objects and a unit of taxation do not damage public interests, etc.). In such case, the relevant local legislature must enact a local legislative decree and submit it to the Ministry of Home Affairs. If an approval is obtained, the local tax item can be enforced.

³⁰ An example of the taxation on state enterprises, resource development industries such as mining and forestry, farms, in West Sumatra Province etc. is presented in P. 29 of Keiichi Oguro, "Indonesia: Uneasy Departure for Decentralization of Authority", *Asia Market Review 2001.2.15*.

³¹ Refer to P. 28 of "*Decentralisation and Environmental Policy in Asian Countries*" by Tadayoshi Terao and others eds., (2008, Institute of Developing Economies).

(Note) Even though the local tax system includes about 50 taxable objects, it is worthwhile to note that 90% of total tax revenues of the Provinces are raised by only two tax items and 85% of total tax revenues of the Districts are raised by as little as six tax items.³² Therefore, one suggestion is to rationalize the number of tax items and concentrate the taxation efforts on the major local tax items in order to raise local tax receipts.

⑦ In general, local tax receipts account for a small share of total revenues and those tax sources are unevenly distributed.

Taking hotel and restaurant tax as an example, there are almost no hotels and restaurants subject to taxation on the minor islands in the eastern part of the country. Therefore, local government officials do not have a strong interest in local tax.³³

1.3.2. Shared tax (Revenue sharing)

Shared taxes, applicable to natural resources such as oil, natural gas, mineral products, forestry products, aquatic products and others, are collected by the national tax agency and then distributed to the local government authorities. Therefore, it is also called revenue sharing. Then afterwards, there is another revenue sharing of other taxes. Additionally, a part of the land and property taxes is collected by the Cities. Shared tax accounts for approximately 18-20% of the aggregate revenues for each of Provinces and Cities & Districts. Shared tax is a system created on the back of the claim by the resource rich provinces that a return of the revenue to the local governments of the resource-rich provinces should be prioritized rather than levelling out fiscal distribution among the local governments.³⁴

In this regard, one policy challenge in Indonesia is to coordinate two different requirements: reduction of fiscal disparities among the local government authorities, and return of financial resources. Shared tax is considered to be an attractive financial resource for local governments since it provides a certain scale of financial resources for little administrative effort.³⁵

3. Japan

In Japan, the total amount of general grant was 125.6 billion yen in FY of 1954 when the system was established, and kept growing during the period of high economic growth, reaching 10 trillion yen in 1988 and in excess of 20 trillion yen in 1999. Then, its reduction started being debated in the context of LAT reform, and subsequently the Trinity Reform saw its amount reduced to approximately 17 trillion yen in 2007. However, since 2008, the amounts of the substantial LAT, the aggregate amounts combining LAT and the bonds for the extraordinary financial measures have been stable at around 23-24 trillion yen. Therefore, LAT in Japan has likely reached a stable phase in their scale. (Figure 11)

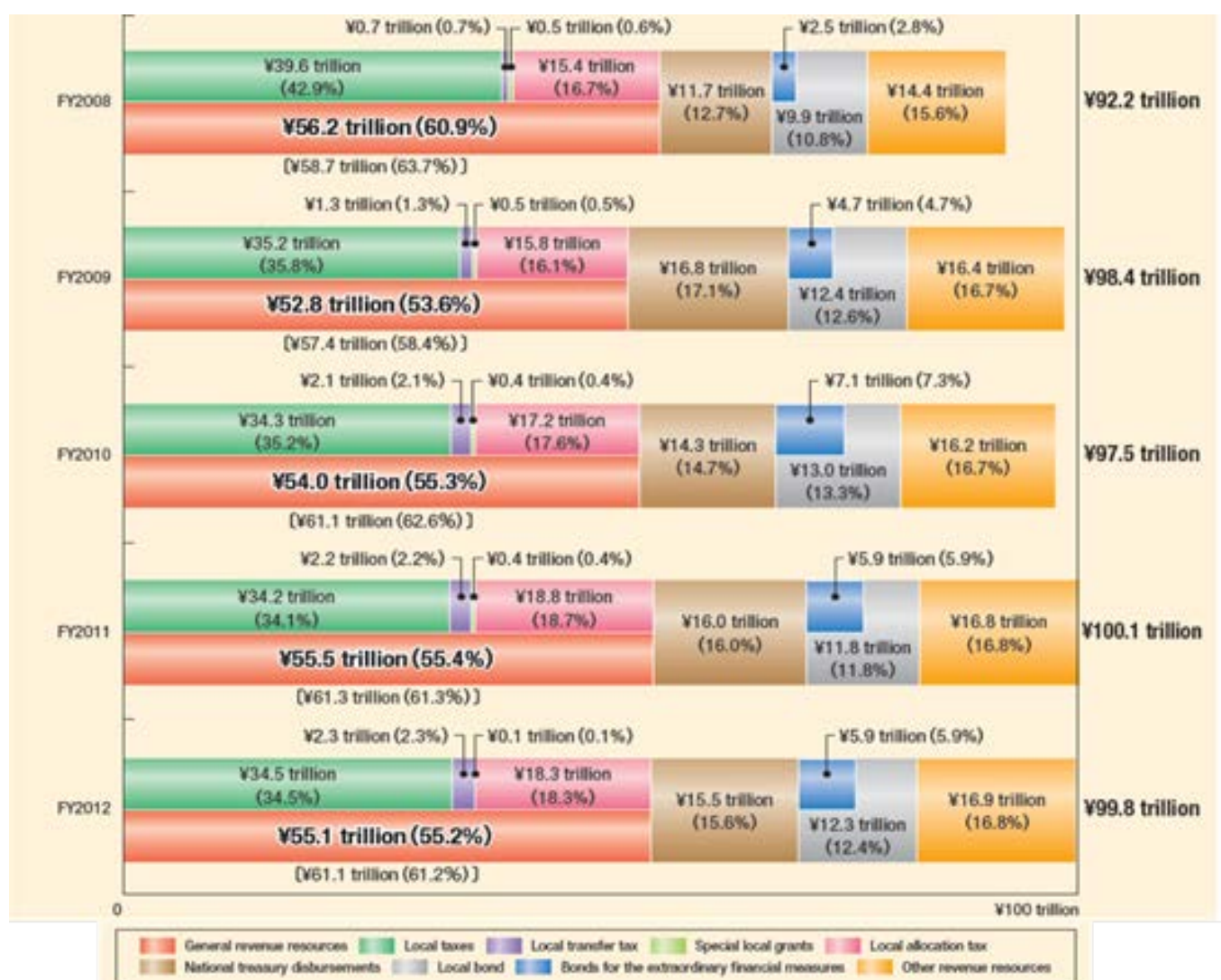
³² Two main items of the Provincial taxes are motor vehicle registration tax and property transfer tax. District taxes are hotel and restaurant tax, street lighting tax, entertainment tax, advertisement tax, business registration tax and animal farm tax. Source: BIRD, *"Fiscal Decentralization in Developing Countries"*, p.121.

³³ Comment obtained from the same officer of the Indonesian Ministry of Finance as cited above.

³⁴ Yuri Sato, *"Economic Giant Indonesia"*, p.51: "Conversely the tax system was designed during the terms of the Suharto Government in a manner to even out the distribution nationally so as not to produce a development discrepancy between regions due to the size of natural resources therein. Then, the resource-based revenue was absorbed by the national government and distributed across the country in proportion to the population of the relevant region. This has produced smouldering discontents among the resource-rich provinces that 'we are only to be exploited by the central government'. After the collapse of the Suharto regime, the trend has shifted towards a decentralization of authority. The policy that 80% of the resource-based revenues from mining, forestry, marine products industries, etc. shall be returned to the pertinent regions was prescribed in the Law on Fiscal Balance Law of Central and Local Governments in 1999 and came into effect in January 2001.

³⁵ Refer to the footnote 20.

<Figure 11> Transition of Total Amounts of LAT



(Source: Ministry of Internal Affairs and Telecommunications)

*The real amount of LAT equals to the aggregate amounts combining LAT and the bonds for the extraordinary financial measures.

VII Conclusions

As indicated in the beginning of this research paper, the relevant countries share the following features in common.

- Among the aggregate revenues, **general grants and local independent revenue sources** represent major components.
- It has become a significant policy challenge to **secure local finance sources** in order to respond to the transfer of responsibilities.
- There is a wide fiscal gap between the local revenues and expenditures, and **fund transfer** from the national government is playing an important role.

It is necessary to expand the local independent revenue sources in the mid-to-long term as part of the decentralization of authority. Secondly, among the relevant countries, there are structural differences as regards to the local government finances between Japan, and Indonesia and the Philippines (hereunder referred to as “other two countries”). Main differences are listed below.

- The general grant in Japan is large in its dimensions and most likely has reached a stable and mature phase, remaining at the scale of 23-24 trillion yen per year in recent years. In contrast, its size keeps growing in the other two countries. Therefore, their reliance on the general grant is getting stronger.

(B) Although among the local independent revenue sources, local tax is the biggest contributor to the local revenue stream in Japan, in the other two countries it is the 2nd biggest finance source after the general grant among the local revenues, and considerably smaller than the general grant in its dimensions. Reflecting such circumstances, while the importance of enhancing the local independent revenue sources is being recognized from a mid-to-long term perspective, the interest is still limited in expanding local independent revenue sources in the other two countries at the moment. Additionally, there are concerns over the adverse effects on the regional economy to be caused by excessive local taxation.

In the Philippines, the allotment of the IRA, the biggest revenue item, favours major cities due to its allocation method in which 50% is determined by the size of population. With respect to the disparity of financial resources among the local governments, in Japan, the disparity among the different government authorities concerned in local tax, the biggest revenue item, has been consistently a crucial issue of the local government finance. In contrast, there is an issue over the shared tax between the government authorities in resource-rich regions and those of resource-poor regions in Indonesia. In this manner, each country has presently its own problems regarding the disparity of financial resources despite their varied frameworks.

We need to consider the future directions of the relevant countries in view of the circumstances discussed so far. First, in the relevant countries key requirements for the stable management of local government finances are governmental fund transfers and enhancement of the local independent revenue sources in order to fill the fiscal gap. Namely, in addition to making efforts to reduce the size of the fiscal gap by way of expanding the local independent revenue sources, it is desirable to adapt the method of governmental fund transfer in a manner which 1) is stable, and 2) reduces the final fiscal disparity among the local governments.

A general grant plays a central role in such governmental fund transfer in each country. While the scale of general grant is determined by the relevant national government and it is an external revenue source to be allocated by the national government, it can be basically regarded as general finance resources without any limits imposed on their expenditures and an essential resource from the perspective of fiscal autonomy of local governments.

The scale of the general grant has reached a mature stage in Japan, stabilizing around 23 trillion yen every fiscal year. However, in the other two countries, it is still expanding and their characteristics should be taken notice of. It is considered meaningful both to focus on strengthening the local revenue sources and to proceed smoothly with the increase of general grant from the viewpoint of local governments during the phase in which importance is placed on enriching the general grant as a national policy initiative. If an instance is identified, where the enhancement of external revenue sources pertinent to such a policy initiative is diminishing the incentives to seek more local independent revenue sources, in order to develop the fiscal autonomy further in future, it is necessary to investigate measures which will nurture the incentives to seek the enhancement of local independent revenue sources.

Specifically, measures should be considered, including the reorganization of the tax system such as an introduction into the local tax regime of such an extendable tax as income tax and a convergence of existing local tax items into fewer relatively extendable tax items. In the case of Japan, on one hand the resolution of finance source disparity seems an urgent agenda as exemplified in the review of local taxation to corporations in recent years, but on the other hand such initiatives as the joint administrative processing of delinquencies and as the lifting of underperformed collection of taxes not stipulated in law have been introduced to expand internal revenue sources.

Separately, concerning the evening-out of fiscal resources among the local governments, in Japan, the regime of local tax, the biggest revenue item, is being employed for such efforts through the reform of corporation local special tax, local corporate tax, etc. Probably, one of the measures to be adopted in the other two countries should equip the biggest revenue item of general grant (IRA and DAU) with the functionality to level out the disparity in fiscal resources.

The relationship between decentralization of authority and fiscal autonomy is critically important, and multiple challenges need to be tackled, which include securing the financial resources for local governments, solving the problem of excessive reliance on the external revenue sources and eliminating the fiscal disparity among local governments. To that end, it should be considered extremely meaningful to continue to explore further in future the individual problems and an appropriate balance between the general grant and local independent revenue sources in the revenue framework of the relevant nations from the perspective of administration comparison.

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