ABSTRACT

Local tax revenue is a key source of income for supporting regional economic development. Tax revenue performance is generally assessed based on the achievement of revenue targets and the local tax ratio. However, these two indicators do not provide information on the causes of differences in tax revenue among local governments. Performance evaluation should be based on tax capacity and the government's ability to achieve that capacity, using the tax effort approaches.

This study aims to estimate tax capacity, analyze the role of institutional quality and the implementation of fiscal decentralization on tax effort through changes in the level of tax collection inefficiency, and measure the level of tax effort in 113 regencies/cities on the island of Java for the period 2017–2024. The Stochastic Frontier Analysis (SFA) method was used to simultaneously estimate the tax frontier and the effects of inefficiency using the maximum likelihood method. The tax frontier function incorporates regional economic characteristics, while the inefficiency model incorporates institutional quality and the level of fiscal decentralization.

The findings in frontier model indicate that the accommodation and food and beverage services, real estate, construction, and manufacturing sectors have a positive and significant effect on tax capacity, whilst the agricultural sector has a negative and significant effect. GRDP per capita has a non-linear, inverted-U relationship with tax capacity. In the inefficiency model, the Indonesian Democracy Index (IDI) and the degree of fiscal decentralization have a significant negative effect on local tax collection inefficiency, whilst the maturity of the Government Internal Control System (SPIP) and the Government Agency Performance Accountability System (SAKIP) index do not have a significant effect. The level of inefficiency and tax effort have an inverse relationship; thus, a reduction in the level of inefficiency will increase tax effort.

The findings indicate that levels of democracy and fiscal decentralisation play a role in enhancing local governments' ability to optimise their tax capacity. The average tax effort shows that the actual tax revenue of regencies and cities amounts to only around 34.3 per cent and 59.35 per cent of their achievable tax capacity, suggesting there is still scope to maximise local tax revenue. The results of this study have policy implications for local governments to use tax effort as a basis for evaluating local tax performance, to strengthen transparency and public participation in the management of tax revenue, and to improve the quality of tax services in order to increase public trust and optimise local tax collection.

Keywords: *tax effort, tax capacity, institutional quality, fiscal decentralization, tax collection inefficiency, stochastic frontier analysis*