

Reforming Intergovernmental Fiscal Relations and the Rebuilding of Indonesia

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Edited by James Alm, Jorge Martinez-Vazquez and Sri Mulyani Indrawati

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1. Introduction

James Alm, Jorge Martinez-Vazquez and Dana Weist

Indonesia is currently facing some severe challenges, both in political affairs and in economic management. One significant part of this challenge is the decentralization program, whose laws were first passed in May 1999 and subsequently put in operation in January 2001. For political reasons, this program was enacted and implemented in an extraordinarily short period of time, and has often been referred to as the ‘Big Bang’ decentralization. With the resignation of President Suharto in 1998, many provinces and regions in Indonesia demanded more decentralized governance. In its own transition from a corrupt and highly centralized dictatorship to a democratic market economy, the process of decentralization in Indonesia was perceived by many as a new bridge to democracy and to a more efficient and fairer government. The process of decentralization is now well underway, and it promises to have many wide-ranging effects. However, there remain numerous questions about this program. This edited volume is a collection of original papers, written by a group of scholars with direct experience in Indonesia and policy makers who have been personally involved in the decentralization process. The chapters in the volume take a hard look at the many effects of decentralization on economic and political issues in Indonesia.¹ They cover the wide impacts of decentralization: the political and economic forces that contributed to the passage of the decentralization laws, the assignment of expenditure and revenue functions across levels of government, the design of intergovernmental transfers, the control of local government borrowing, natural resource revenue sharing, and an assessment of the progress that has been made in the initial years of the decentralization.

Part I discusses the history and politics of the ‘Big Bang’ decentralization. In Chapter 2 Bert Hofman and Kai Kaiser trace the history behind the laws from a political economy perspective. They characterize the decentralization as ‘radical’ in its speed and breadth, with the government of Indonesia (GOI) facing huge challenges in implementing the ‘Big Bang’. They also show that many of the initial policy recommendations for decentralization were not firmly grounded in fiscal analysis, in large part because much about

decentralization was unknown or uncertain and detailed information on expenditure needs and regional revenues was unavailable. However, they emphasize that the many fears expressed by insiders and outsiders have not in fact been realized: surprisingly little went wrong in the logistics of this program. Further, as decentralization has proceeded, the government has increasingly relied on detailed fiscal analysis as part of the design and implementation of the decentralization. Technical teams were established, with representation among government departments, leading academics and research institutions; substantial time was devoted to coordination across departments; and considerable effort was channeled toward strengthening analytical capabilities – including improving the quality of fiscal data and developing simulation models. This analytical base and monitoring of outcomes is to be commended, and should be continued, emulated in other ministries and departments, and strengthened in the future. However, Hofman and Kaiser also conclude that several key issues have now started to emerge, some of them touching the very nature of decentralization itself. In addressing these issues, the government needs to carefully balance its desire to maintain a unitary state with the aspirations of the regions and the opportunities offered by a more decentralized system of government, and it also needs to continue to utilize the analytical capabilities that have been established.

In Chapter 3 Dwight King reviews the basic decentralization laws, including the ones passed since May 1999, and then tests some hypotheses about the relationships among administrative decentralization (deconcentration), political reform, and decentralization using a district data set, in particular trying to answer why political reform, decentralization, and governance reforms have progressed further in some districts than in others. Strikingly, he concludes that the ongoing decentralization presents a paradox. There is undeniable evidence of heightened social conflict, increase in lawlessness, persistent economic stagnation, and continued political instability, which some take as evidence that Indonesian democracy is a mirage. However, there is also undeniable evidence that central government power has been peacefully and constitutionally transferred, that the military has refused to intervene despite provocations, and that the democratically elected parliament has made steady progress on major constitutional reforms ever since it was seated in 1999. King believes that these developments suggest that the conflict and instability that have marked Indonesia during the past three years are less manifestations of democratic backsliding than they are of a second struggle to consolidate and deepen democracy while simultaneously identifying and removing the non-democratic elements from the previous regime.

Ryaas Rasyid brings an insider's perspective to the decentralization in Chapter 4. As a former Minister of Regional Autonomy in the GOI, he was a main proponent – perhaps the main proponent – of the decentralization.

Rasyid traces the history behind the passage and implementation of the decentralization laws, and concludes that central government was woefully unprepared to enact the reforms. Indeed, he believes that many of the problems that have emerged surrounding the decentralization reflect a general and widespread lack of support for the decentralization itself from many at the center. Many ministers considered the policy to be a ‘threat’ to their own ministries, and attempted on many occasions to slow down, delay, or even reverse the reforms. Rasyid concludes that decentralization can only succeed if the central government strengthens its commitment to decentralization.

It is well recognized that intergovernmental fiscal relations are a system, and all of the pieces must fit together. We can generally think of intergovernmental fiscal systems as being composed of four pillars: expenditure assignment, local revenue mobilization, intergovernmental transfers, and local borrowing. The next two parts examine the details of these pillars.

In Part II, Chapter 5 by Paul Smoke traces the details of the expenditure assignment of the ‘Big Bang.’ Smoke identifies expenditure assignment – clearly stating the set of functions that local governments can and should undertake – as a key preliminary step in the decentralization process in Indonesia. In his chapter, Smoke reviews the basic principles of expenditure assignment; outlines the experience with expenditure assignments in Indonesia, both from a historical perspective and in light of the new arrangements; and highlights a number of outstanding expenditure assignment issues that Indonesia has yet to address.

The recent Indonesian experience clearly shows that expenditure assignment is not purely a technical matter. This step cannot be separated from the broader process of decentralization and many of these decisions are ultimately of a highly political nature. Because of political reasons, mainly the fear of centrifugal separatist forces at the provincial level in the periphery of the country, Indonesia’s new decentralization assigned practically all decentralized services to the local governments, which at the time practically emasculated any incipient political power of provincial governments. But as Smoke points out, this is nothing new. Concerns for political unity have historically dominated the design of government institutions in Indonesia.

The sharpest distinguishing feature of the new expenditure assignments is that the law explicitly sets a limited number of functions for both the central and provincial governments and assigns all other residual functions to local governments. Currently there is a lack of clarity on the assigned functions and practically no guidance on how to share some of the functions among levels of government. Subsequent regulations have attempted to clarify assignment issues but there is still a need to provide definite authority lists for the local governments. More recently, the GOI has been working on the

introduction of minimum service standards (SPM) for all decentralized services as a way to more clearly specify and enforce local statutory functions. It is far from clear that the ultimate result of the SPMs will be those intended.

In Chapter 6 Robert Simanjuntak and Raksaka Mahi focus on the revenue side of the decentralization. They present evidence that the local tax base in Indonesia has been unproductive in its yield and unfair in its incidence, and the decentralization has had little impact on local taxes. Local governments remain highly dependent on central government for the vast bulk of their revenues. Consequently, Simanjuntak and Mahi conclude that reform efforts should concentrate on some combination of looking for alternative additional local taxes and improving administration of the existing taxes. However, recent reform efforts have not resulted in any real improvements. Simanjuntak and Mahi examine common criteria for 'good' taxes and then apply these principles to a long list of possible local government taxes in Indonesia. They recommend in particular the abolition of 'nuisance' local taxes, improving the existing local taxes (e.g. entertainment tax, street lighting tax), improving administrative capacity, and looking for new local taxes. In this regard, they believe that the land and building tax, the land and building transfer tax, the building permit fee, and the business registration tax are especially good candidates for assignment from central government to local governments. They also recommend the consideration of allowing local government 'sur-charges' on some existing central government taxes. These various reforms would increase revenue autonomy of local governments and thereby improve the decentralization process.

In Chapter 7 Machfud Sidik and Kadjatmiko bring both the revenue and the expenditure sides together in their analysis of the decentralization, in the process cutting across many substantive issues. They argue that, given the institutional complexities in Indonesia, any reform of fiscal decentralization policy will be a painstaking process, and its implementation will take some time. Nevertheless, they believe that an initial phasing-in of reforms program could begin right away. Indeed, they note that the Ministry of Finance has already mapped out a work plan that incorporates the necessary transitional arrangements, including building the alliances and coalitions that will prove so important in implementing this far-reaching agenda.

Part III moves on to measures that can close the 'fiscal gap' left between the tax and the expenditure assignments. Bambang Brodjonegoro and Jorge Martinez-Vazquez contribute to the ongoing debate on intergovernmental fiscal reforms in Indonesia in Chapter 8. They note the need to expand local revenue autonomy rather than substantially changing the existing tax sharing system; they also identify the achievements and additional reforms needed for the main formula-based equalization transfer, the *Dana Alokasi Umum* (DAU), the need for developing a carefully designed conditional transfer

system (the *Dana Alokasi Khusus*, or DAK), and the importance of an overall decentralization strategy. These recommendations are founded both on empirical analysis and on a systemic view of intergovernmental fiscal relations.

As Brodjonegoro and Martinez-Vazquez note, Indonesia has achieved significant progress in designing and implementing a new system of transfers, albeit with ample scope for further improvement. In relatively short order, a stable, formula-based, equalization transfer – the DAU – was designed, implemented, and subsequently improved. The DAU is one of the most important components of Indonesia’s intergovernmental fiscal system. Its significant funding (25 percent of government revenues) and general purpose nature provide the fuel for regional autonomy. Equally important as the achievements in designing and implementing the DAU were the use of quantitative (fiscal) analysis to assess outcomes and recommend reforms for the policy process, and the emphasis on transparency and consultation. They note that continued effort must be directed to improving the quality of indicators of fiscal capacity and expenditure need. It would also be worthwhile to reconsider the adequacy of the weights applied in the formula, including the split between provinces and regions, as well as the weights of the component factors. For example, it appears that population is relatively underweighted in comparison to other factors.

A second hallmark of the design and implementation of the DAU was consultation with stakeholders and transparency, which complicated the process but also contributed to better understanding among stakeholders (including regional governments, the DPOD, and other departments and ministries.) Consultation and transparency should be developed further, including in the design and implementation of the conditional transfer system (or DAK). Simplicity is an element of transparency that is often overlooked. In developing the conditional transfer system, effort should be devoted to avoiding a proliferation of transfers.

Brodjonegoro and Martinez-Vazquez point to the need to consider a more formal institutionalization of the analysis and consultation in the form of a Grants Commission or other body, as used, for example, in Australia, India, and South Africa. In addition to formalizing the institutional responsibility for monitoring and improving the allocation of the DAU, it is also necessary to formalize some of the rules of engagement, perhaps through the decentralization strategy that they note is sorely lacking. For example, the following concerns need explicit decisions:

- Under what procedures and criteria should the government change the key DAU parameters in the future (e.g. the 25 percent share of revenues, the split between provinces and regions, the factors included in the formula, and their weights)?

- What are the government's equalization objectives, and how will it know that it has achieved these objectives?
- Will resource-rich regions always receive a DAU allocation?
- How long will the transition period last? Especially, how long will the 'hold-harmless' and contingency fund provisions remain in force?

A Grants Commission would assure that the demanding activities of monitoring and enhancing the equalization system were done on a regular basis by an objective body.

One of the most politically charged and divisive issues in fiscal decentralization in Indonesia is how to share fiscal revenues from the extraction of natural resources between the regional governments where these resources originate and the rest of the nation. In Chapter 9 Roy Bahl and Bayar Tumennasan evaluate the system of sharing natural resource revenue in Indonesia against the criteria that are most often discussed in international forums. The share of 'mining and quarrying' in GDP is quite large in a number of countries, exceeding 10 percent in 29 of 100 countries for which they find data and accounting for more than one-fifth of GDP in 13 countries. The share in Indonesia is especially large, at 10.1 percent or about five times higher than the international median. Of the countries in the East Asian region, only Mongolia and Papua New Guinea are more heavily dependent on natural resources than is Indonesia.

Bahl and Tumennasan evaluate the arguments for and against sharing natural resource revenues with regions. On the one hand, these payments may be seen as compensation for the economic and social costs of natural resource extraction; a share of natural resource revenues may also be justified as payment for using up an exhaustible resource. On the other hand, some policy analysts and political leaders argue against natural resource revenue sharing, largely on the basis that it is the national government that is assumed to 'own' the natural riches. There is a concern about tying the finance of essential local government-provided services to an unstable revenue flow, and a fear that local governments could not efficiently spend such a large revenue windfall. These arguments are often based on political notions of fairness, and are almost always emotionally charged. These issues are even more complicated in Indonesia because the revenue sharing argument is confounded by the ethnic and cultural differences between the natural resource regions and the rest of Indonesia.

Although few policy analysts or politicians believe that there should be no natural resource revenue sharing, an important issue is the magnitude of the share. In addition, there is much debate on whether – and how – natural resource revenue sharing should affect the DAU transfer, and there are concerns that local governments with large mining sectors will make unwise use

of, and rely too heavily on, the windfall revenues that come from an unstable source of natural resource industries. There are few accepted answers to these questions. Bahl and Tumennasan evaluate these issues in the specific context of Indonesia, and then examine various reform options in terms of the specific fiscal instruments that might be used.

Given the significant deficiencies in local infrastructure in all regions of Indonesia, finding ways to finance new capital investment at the sub-national level has become a critical component of the new decentralization system. In Chapter 10 James Alm and Sri Mulyani Indrawati note that Laws No. 22 and No. 25 grant much flexibility to provinces and local governments in borrowing (although government has prohibited regional borrowing except from central government through end 2002). Regional governments are allowed to issue long-term debt to finance local infrastructure, and short-term debt to manage cash flow requirements, subject to certain controls. These controls are particularly important in Indonesia, since past regional borrowing was often managed improperly (with particularly weak repayment rates for the RDA), and substantial contingent liabilities may arise from regional borrowing. Controls on regional borrowing include a formula-defined borrowing limit for each jurisdiction; a minimum debt-service coverage ratio for each jurisdiction; and Ministry of Finance approval for foreign loans (but without a central government guarantee.) Alm and Indrawati conclude that these controls are acceptable in the transition period, but that in the long run effort should be directed to developing functioning local capital markets that impose their own discipline, as well as promoting other activities to develop a strong intergovernmental fiscal system (e.g. transparency, standardized fiscal information, accounting standards, and regular audits). This is a rich agenda of reforms that will require considerable effort to implement.

In this regard, it is worth mentioning that two technical issues deserve further discussion in developing Indonesia's borrowing framework: the use of 'intercept' mechanisms to strengthen repayment schemes, and assigning appropriate risk weights to subnational debt. While intercept mechanisms have been successfully used to enhance repayment rates in other countries, the danger is that they may be perceived as an 'automatic' payment mechanism that weakens incentives for thorough assessment of creditworthiness. Mexico's federal government recently discontinued its use of intercept provisions because the practice had transferred repayment risk entirely to the federal government, which was expected to bail out state governments who did not repay their debt.²

Establishing prudential regulations that limit (and/or apply a risk weighting to) the share of bank assets held in regional loans can also restrict the supply of regional debt to more creditworthy entities. Risk-weighted capital adequacy ratios defined by the Bank of International Settlements are being

used increasingly by countries such as Colombia, South Africa and Mexico to regulate the supply of local borrowing that is issued, and held by development banks or commercial banks.³

Three general issues merit further consideration in Indonesia's borrowing framework: (1) strengthening the framework to avoid central government bailouts of regional governments that borrow irresponsibly; (2) removing restrictions against on-lending of donor funds for development projects; and (3) establishing a financing framework that clearly defines the mix of loan and grant financing, and imposes greater uniformity in terms and conditions (e.g. interest rates, repayment terms, commitment fees, feasibility standards).

With regional autonomy, central government must be prepared for local governments to fail, without giving them a bailout; that is, government should impose a hard budget constraint on sub-national governments, so that these sub-national entities cannot expand expenditures without bearing their full costs. Avoiding a central government bailout typically requires defining legal remedies for creditors and the central government (possibly including local bankruptcy regulations); providing technical assistance to weak local governments to avoid fiscal failure; and establishing a control board or other oversight mechanism to work out loan repayments, service delivery arrangements and other issues arising from fiscal failure. Colombia, Hungary and South Africa have formal, legislatively determined workout procedures for sub-national entities that have either defaulted or are about to default on their debt service payments.

Legal restrictions against on-lending impede the flow of donor assistance to local governments, which accounts for 50 percent of development spending. While such restrictions have been overcome through legal technicalities, the regulations should be changed to permit on-lending and to strengthen the terms and conditions under which it is practiced so that economically and financially viable projects are financed, market-based interest rates are used, and loans are repaid promptly and consistently.⁴

With regional autonomy, investment projects will move to the regions, which have substantially different capacities to finance investments. Regional governments can use their own resources, borrowing (presumably through a revised on-lending mechanism) or special purpose transfers (DAK) to finance these projects. The government should establish a clearly defined financing framework that specifies the loan-grant mix of financing for these projects, based on the creditworthiness of the regional government and type of project. For example, regional governments with strong creditworthiness might only be eligible for loans for investment projects, whereas poorer local governments would be eligible for capital grants and loans. Without a consistently defined financing framework, capital grants might 'crowd out' potential local borrowing, or poorer regional governments may not provide

adequate infrastructure because of an inability to borrow. The financing framework could also provide consistency in financing terms among government and donor financing, including interest rates, repayment terms, commitment fees, conditionalities and covenants, and other financial details that would promote the development of a market-based financing system.

Part III of the volume offers an initial assessment of progress of the new decentralization process in Indonesia by three Indonesian policy makers and experts closely linked to many of the decisions made early on laying down the basic architecture of the system. In Chapter 11, Marsillam Simandjuntak assesses the existing risks in the decentralization process despite its unavoidability. For him, decentralization has become one of the few solutions to the Indonesian national problems, if not the only one, left. Simandjuntak examines in some depth the current Indonesian belief that decentralization presents a solution to various national problems because it allows the use of local means to cope with local challenges. There are many potential pitfalls behind that position, but as Simandjuntak puts it, recent history demonstrated well that national problems could never be solved by national efforts or by centralized policies. His conjecture for the future is that under decentralization and competition among sub-national governments, each national problem may be solved in terms of manageable regional portions. The important question remaining is, of course, what will make all that possible, since the current decentralization effort was started more as a declaration or an affirmation of intent, than as a planned set of steps. But, according to Simandjuntak, the lack of preparation was not due to a lack of understanding what is required, but simply because there was not enough time to do it. Thus we can remain optimistic about the future, provided policy makers continue to give priority to decentralization policy and that there is sufficient stability and effectiveness at central government level. Successful decentralization will require a strong and self-confident central government. Simandjuntak is not overly optimistic that the current government under President Megawati will meet the necessary requirements. Some of the challenges ahead, Simandjuntak identifies, include electoral reform, formation of the Constitutional Court, and the role of the police and the military in a decentralized Indonesia.

In Chapter 12 Made Suwandi takes a longer term perspective on the decentralization process, and asks whether Indonesia can learn from its already long experience with decentralization. In particular, he asks what should Indonesians do and how should they react as the demand for decentralization increases over time. He concludes that answering this question will require a 'delicate balance' between local autonomy and nation building.

More specifically, he believes that the government has already provided an adequate legal framework and has issued sufficient regulations. Of course, additional detailed regulations are likely still to be required as the decentralization

proceeds, but the existing regulations are more than enough to provide a legal basis for local governments to provide required services. Instead, he argues that if there are still problems and delays in delivering services, they are caused mainly by the inability of local governments to use the existing regulations to carry out their role. To deal with this issue, it is important to support all tiers of government in understanding their new roles in a reformed public sector. In particular, he believes that it is necessary – and urgent – to improve local governments' capacity to carry out their functions, in arranging and managing local government functions, institutions, personnel, finance, representation and service delivery. The improvement of these capacities should be the most important item in promoting decentralization reform in Indonesia at the present time.

For Anggito Abimanyu in Chapter 13 the sustainability of decentralization policy, indeed of the entire Indonesian economy, will depend heavily on whether the government of Indonesia can deliver a sustained economic recovery through 2004. The issue that could derail the process is the lack of fiscal sustainability. What rings the alarm bells for Anggito Abimanyu is that Indonesia has very little tradition for showing concern about the sustainability of government finances prior to the economic crisis of 1997. His chapter assesses the major components of a fiscal sustainability strategy for Indonesia, focusing on the potential impact of decentralization on the central government accounts and the ability of the central authorities to conduct macroeconomic stabilization policies.

As others have stated at other times and for other countries, decentralization is not an end but a process, not a destination but a journey. Indonesia has started on this process with many successes and also significant problems that demand attention. In the final part of the volume, Chapter 14 by Anwar Shah and Theresa Thompson reflects on the 'silent revolution' in public sector governance sweeping across the globe, which has aimed to move decision making for local public services closer to the people. Shah and Thompson examine the different motivations for decentralization, assess successes and failures in decentralization across continents and draw lessons for the future of decentralization in Indonesia. They find the program of decentralization implemented by Indonesia commendable on a number of counts, including by-passing the provinces, given the fragile nature of the Indonesian union; or providing resources to match responsibilities in an unconditional manner, thus promoting flexibility and autonomy of decision making at local level. Shah and Thompson also applaud the significant efforts to redress historical grievances of the resource rich regions. However, in their opinion, the long-term success of decentralization in Indonesia is not assured as the program has failed to recognize and provide incentives for local governments to be accountable and responsive to their residents.

The last chapter is a postscript by Jorge Martinez-Vazquez and Jameson Boex. Since all other chapters in the volume were papers written for the conference held in Atlanta in May 2002, an update was needed. In the year after the conference was held several important changes took place and several other changes did not occur as expected. In their review, Martinez-Vazquez and Boex emphasize the major obstacles to progress and suggest the main priority areas for successful decentralization reform. The authors identify as the most formidable obstacle to continued progress in decentralization reform the lack of overall vision and the weak commitment to the decentralization agenda by the country's top leadership. Much has been achieved in the implementation of decentralization reforms in Indonesia since 1999, but despite the advances, there is a clear slow-down in the reform agenda. Fortunately, none of the challenges ahead is insurmountable and thus there are reasons to remain optimistic about the future of decentralization in Indonesia.

NOTES

1. The chapters in this volume were originally papers presented at a conference entitled 'Can Decentralization Help Rebuild Indonesia?', held in Atlanta, Georgia in May 2002, at the Andrew Young School of Policy Studies, Georgia State University.
2. During the 1995 economic crisis in Mexico, states suffered a debt crisis and all states received bailouts from the federal government; some states received subsequent bailouts for particular infrastructure projects. In Mexico, state debts were guaranteed by their *participaciones*, which were collateralized and only partially intercepted by the federal government.
3. For example, South Africa recently increased the credit factor for sub-national debt from 0.1 to 1.0. Higher capital adequacy ratios require lenders to increase their ratio of net worth to loans to sub-national governments, and to make provision for potential non-performing sub-national debt, based on debt-service-to-savings ratios.
4. The characteristics of financially viable and sustainable financial intermediaries are described in George Peterson and Sonia Hammam, *Building Local Credit Systems*, World Bank Urban Management Program Policy Paper, August 1997.

PART I

The History and Politics of the ‘Big Bang’ Decentralization

2. The making of the ‘Big Bang’ and its aftermath: a political economy perspective

Bert Hofman and Kai Kaiser¹

INTRODUCTION

Indonesia’s 2001 decentralization is rapidly moving the country from one of the most centralized systems in the world to one of the most decentralized ones. Law No. 22/1999 gives broad autonomy to the regions in all but a few tasks that are explicitly assigned to the center. With the authority come the resources, lots of them. In the first year, the regional share in government spending jumped from 17 percent to 30 percent, and over time, with the current assignments of functions, this share is likely to rise to over 40 percent, a sharp contrast with the average 15 percent of spending in the 1990s. This share is also much larger than can be expected on the basis of Indonesia’s size, whether measured by population or geographical size. In addition to spending, much of the apparatus of government was put under the control of the regions. Over two million civil servants, or almost two-thirds of the central government workforce, were transferred to the regions, and currently, out of a civil service of 3.9 million, some 2.8 million are classified as regional employees. In total, 239 provincial-level offices of central government, 3933 local-level offices,² more than 16 0000 service facilities (e.g. schools, hospitals, health centers) were transferred lock stock and barrel to the regional governments throughout Indonesia.

In this chapter we examine the ‘Big Bang’ decentralization from a political economy perspective. We first discuss the history of decentralization efforts in Indonesia, leading up to the events of the Big Bang. We then assess various administrative aspects of the decentralization. Finally, we analyze several key issues that have begun to emerge, issues that touch on the very nature of decentralization itself. We argue that the government of Indonesia (GOI), in addressing these issues, needs to carefully balance its desire to maintain a unitary state with the aspirations of the regions and the opportunities offered by a more decentralized system of government.

A BRIEF HISTORY OF EVENTS LEADING UP TO THE 'BIG BANG'

Decentralization makes much sense for a country as diverse as Indonesia. Spread out over 5000 kilometers and 13 000 islands, the country has more than 300 identified languages and about 20 distinct cultural groups. Its geography ranges from the swampy flatlands of coastal Java to the steep mountain peaks of Irian Jaya, the extensive rainforests of Borneo to the dry islands of East Nusa Tenggara. Economic development differs as widely. Jakarta's level of income per capita fits that of a higher middle income country such as Brazil, and it has the towering high rises to match this. At the other end of the scale, regions such as West Lampung or the regency of Grobogan in West Java have barely one-tenth of Jakarta's per capita income. Similarly, about 10 percent of the students in Sambang, East Java make it into senior high school, while over 85 percent of the young in North Tanapuli on Sumatera do so. Resource-rich regions such as Aceh Utara, Riau and East Kalimantan would by themselves be some of the major oil-exporting countries in the world, while other regions such as NTB remain predominantly agricultural.

Such diversity in geography, culture, natural and human resource endowment suggests a large variety in the need for government services, and an equally large disparity in the costs of delivering these services. These are the classic arguments that make decentralization an attractive proposition. At the same time, this diversity could argue against decentralization if government wants to ensure a certain minimum level of welfare as an expression of the unity of the country. Thus the government of Indonesia (GOI) must strike a balance between unity and diversity.

The New Order regime (1966–98) clearly did not strike the right balance in its closing decade. On the back of the oil boom, it built up a strongly centralized government apparatus that controlled the bulk of government resources. Yet, in this, the New Order was hardly alone.

Decentralization Prior to the 'Big Bang'

The 2001 Big Bang was hardly Indonesia's first attempt to decentralize. Starting in colonial times, there have been numerous attempts to do so, but none was successful. Still in colonial times, the first municipalities were created in 1905, followed by the first districts (*gewesten*) in 1910, and the first provinces on Java in the 1920s (De Jong, 1970). After the proclamation of independence, Indonesia's first law (Law No. 1/1945) dealt with regional autonomy, which was also specified in Article 18 of the 1945 constitution that established the Republic of Indonesia as a unitary state.³ Meanwhile, the Dutch started to set up several Indonesian republics on the islands outside

Java, all united under the Dutch crown. This was largely a political move against the Republik Indonesia as a means to argue that the Republik Indonesia was only one part of Indonesia seeking independence from the Dutch. This move resulted in the handing over of sovereignty to the United Republics of Indonesia, a federal state within a commonwealth with the Netherlands. The United Republics lasted for less than a year, and the 1950 constitution reverted to a unitary state.

Law No. 1/1957 tried to revitalize regional autonomy, but these attempts were aborted after the outbreak of regional unrest on Sumatra, Sulawesi, and West Java. Presidential Decision No. 6/1959 brought back the 1945 constitution, and effectively abolished the 1957 autonomy law by the passage of Law No. 18/1965. It was not until Law No. 5/1974 that the issue of regional autonomy was raised again. This law was never fully implemented. Although the authorities of the regions did not differ much from the current decentralization law, the regions had to prove they were ready for implementation, and the center was the judge and the jury. In 1996, an experimental implementation in 26 local governments took off, an experiment that was fraught with difficulties not least because resources and facilities were not handed over together with the tasks. The experiment was overtaken by events, when in the aftermath of the 1997 economic crisis and the fall of Suharto's New Order two new laws on regional autonomy were passed, Law No. 22 and Law No. 25 in May 1999.

The Politics of the 'Big Bang'

The failure of the earlier attempts to decentralize, combined with the extraordinary political circumstances in 1998, helped establish fertile ground for a 'Big Bang' approach to decentralization. The call for democracy had driven out Suharto, and had discredited the heavy-handed centrist ways of the New Order. Long-suppressed regional separatist tendencies reappeared, and, especially in regions with long-standing armed conflicts such as Aceh and East Timor, the clamor for independence became louder and louder. Added to this was the resentment that resource-rich regions felt against the central government who were seen as having 'stolen their natural resources.' Suharto's successor, President Habibie, had no intention of remaining just an interim president or of one presiding over a disintegrating Indonesia, and he was actively seeking the support of the regions. Regional autonomy seemed the instrument of choice. The instruction from cabinet to develop new laws on regional autonomy was picked up by a group of bureaucrats in the Ministry of Home Affairs, who were charged with drafting the administrative law.

Those who produced the early drafts were simply good bureaucrats who wanted to implement the presidential orders. However, they were later joined

by strong political proponents for decentralization, including Ryaas Rashedy, who was to become the State Minister for Regional Autonomy.⁴ Increasingly, regional autonomy was considered to be, and presented as the natural complement to, the emerging democracy at central level. Nevertheless, the drafting of the law remained largely bureaucratic, with little feedback from the politicians and even less consultations with the regions. By the time the first drafts saw the light at the end of 1999, the basic structure for a radical decentralization was set.⁵

Tight deadlines and revenue assignment made Indonesia's decentralization even more radical. By law, within a year from approval, all implementing regulations were to be prepared, and by January 1, 2001 – a year and a half after parliamentary approval – the laws had to be implemented. These deadlines undoubtedly entered the law to prevent Law No. 22/1999 from becoming just one more decentralization law that never was implemented. The aggressive assignment of revenues to the regions added to the pressure on government. Although the Ministry of Finance, on the advice of the IMF and the World Bank, had removed the specific assignment of revenues to the regions, parliament brought this issue right back in.⁶ For central government, the choice was now either to break the law or to devolve as much expenditure as possible in order to minimize the impact on the central government deficit.

In this process, the provinces survived largely by chance. The President's intent was to decentralize rapidly and radically to local governments, but to eliminate the provinces entirely. The provinces had been the center of the regional unrest in the 1950s, and the military only wanted to go along with regional autonomy if there was no chance of a rerun. In their eyes, local government was easier to control than the larger, and thus potentially more powerful, provinces. However, by the time the decentralization laws saw their first drafts, new election laws had also been finished that specified in detail how the provincial parliament and the head of the province was to be elected. Since one could not have a parliament and a head of region without a government, it was decided to put the provinces back in, albeit with a limited role.

The Countdown

The tight deadlines and radical decentralization required a highly focused effort for implementation. Yet, this never came about. Key politicians and bureaucrats were first distracted by the parliamentary elections of July 1999, and subsequently by the presidential elections of October 1999. A presidential decree set up an interministerial implementation team (*'Tim Keppres 157'*), but this team never really functioned, not least because of the significant rivalry between the constituting agencies, especially the Ministries of

Home Affairs and of Finance. Decentralization almost died when the coordinating Ministry for State Organization, which was in charge of Tim Keppres 157, was abolished itself when President Gus Dur assumed power.

The key line ministries were outright obstructionists. They felt they had everything to lose from decentralization, as the laws would abolish their deconcentrated apparatus, and with it their control over projects, resources and perks. While the newly elected president set up a State Ministry for Regional Autonomy in November 1999, it was not until April 2000 that it obtained the authority to take the lead in implementing decentralization. Throughout its existence, it lacked the apparatus and the people to make it work. It was therefore no surprise that by the time of the first deadline only one of the numerous implementing regulations was actually ready, leaving much uncertainty in the regions about things to come. Moreover, because of the attitude of the line ministries, the regulation that was supposed to further specify administrative responsibilities of the various levels of government lacked the sectoral details necessary for the regions to understand their task. The legislator itself did not help clear up this confusion. A decree of the MPR, the consultative assembly and the highest constitutional body of Indonesia, that was passed in the autumn of 2000 called at the same time for implementation of the decentralization laws and a revision of those very laws.

Ironically, only after the abolishment of the Ministry of Regional Autonomy in August 2000 did preparation pick up again. The Ministry of Home Affairs became yet again the lead agency, and the GOI now started to issue implementing regulations in quick succession: on organizations of the regions, on civil service, on financial management, on revenue sharing, and on the general grant distribution.

Safeguards

In the run-up to January 1, 2001, some key safeguards were put in place. First, the central government banned regions from new borrowing in 2001, except through the center. Although Law No. 25/2001 allowed the regions to borrow and Government Regulation 108 provided affordability limits for borrowing by individual regions, these would not have assured that aggregate regional borrowing was in line with macroeconomic requirements. In the 2001 budget, the GOI also included a contingency fund of Rp 6 trillion, of which half was used by mid-September. The speed of decentralization and the new intergovernmental fiscal framework made it virtually impossible to match decentralized expenditures with the needed revenues, and, despite transitional elements in the general grant allocation formula, mismatches were going to be inevitable. The contingency proved to come in handy,

especially at provincial level. Finally, central government decided to continue to pay the formerly central civil servants for a transitional period of five months, while deducting the wage bill from the general grant allocation to the regions. This assured a much smoother transition of personnel than many anticipated.

The safeguards were, however, not enough, and the GOI had to apply an emergency brake to save central finances from getting out of control as a result of decentralization. The emergency brake applied was to disburse the transfers to the region as *per budgeted amount*, not as *per actual revenues*, as Law No. 25/1999 and PP 104/1999 had prescribed. This little observed measure saved the center more than Rp 10 trillion, and was implemented because central government had underestimated the new budget dynamics that resulted from decentralization. Before decentralization a rise in the oil price and depreciation worked out positively for the central budget; however, after decentralization, it worked out negatively. The reason for this was that the increased revenues from depreciation and oil had to be shared with the regions, whereas the increased spending on fuel subsidies that also resulted were to be borne solely by the center.⁷ Fortunately for the center, hardly any of the regions noticed.

One Year After

One year into Indonesia's decentralization, it was fair to say that the program started off much better than many – including the World Bank – expected. There were no major disruptions of services, civil servants got paid, and, with the exception of some teachers striking for the pay-out of the retroactive wage increases, little of the feared unrest was substantiated. Although a significant part of the regulatory framework was still outstanding, regional governments did generally muddle through, and service delivery units did what they used to do before decentralization, both good and bad. In fact, many regions started to pursue the possibility for experimentation that decentralization offered. For example, several local governments started experimenting with school funding based on numbers of students attending the school rather than the previously centrally mandated fixed amounts per school, thereby saving money and fostering competition for better schooling to attract students.

Yet all was far from perfect. In some of the core areas of decentralization, the hasty preparation showed, and those not necessarily in favor of decentralization were all too willing to exploit the confusion to their own advantage. Some central agencies even managed to hold on to powers that by law should have already been devolved to the regions. Some of the anecdotes on egregious local taxes, corruption in the *Dewan Perwakilan Rakyat Daerah*

(DPRDs), or fish in need of an ID card caused a backlash against decentralization itself. But despite the debate on possible revision of the law, the second and third amendments of the constitution have now firmly embedded regional autonomy in Indonesia's system of government, and, with the establishment of a regional chamber of Parliament (DPD), it will also be embedded in its system of politics. Whether this is for the good of Indonesia will depend on how the country deals with some of the administrative and fiscal issues to which we now turn.

ISSUES IN ADMINISTRATIVE DECENTRALIZATION

Law No. 22/1999 devolves most functions of government to Indonesia's regions – currently 30 provinces and over 348 districts and cities. The key exceptions (Art. 7) are for national defense, international relations, justice, police, monetary, development planning, religion and finance. The local governments must perform important functions (art. 11), including health, education, environmental and infrastructure services. The province as an autonomous region has only a minor role, mainly in coordinating activities and in backstopping districts and cities that cannot yet perform their functions. Law No. 22/1999 explicitly states that there is no hierarchical relationship between the province as an autonomous region and the district. The province will also continue to perform deconcentrated central tasks, and is the central government representative in the regions. Implementing regulations (PP 25/2000) further specify the remaining roles of the central and provincial governments, including setting standards for service delivery.

The regional councils directly elect the head of region, although this election needs confirmation by the president (Art. 40). The DPRD can dismiss a head of region as well, but unlike the situation at national level, the DPRD and the heads of regions are supposed to be partners of the regional government (Art. 16) following the collegial model that exists for instance in the Netherlands. Central government can annul regional bylaws and regulations that conflict with national laws and regulations (Art. 114), but the regions can appeal to the Supreme Court against the center's decision, at least according to the law. Urban areas (Art. 92) are obliged to include community and private parties in development planning; no such obligation exists for rural areas. The intergovernmental regional autonomy advisory board with representatives from the center and the regions is to advise the president on issues concerning decentralization, and approves requests for new regions that can be originated from the government of existing regions.

This new structure raises several important issues. Each is discussed in turn.⁸

Assignment of Functions

After more than one year into decentralization, much remains unclear on what exactly has been decentralized. Law No. 22/1999 does not define local government functions directly, but only indirectly by specifying what the center (Art. 7) and the province (Art. 9) do. Article 11 specifies local government obligatory functions, but not to a level of operational detail. PP 25/2000 is not much help here, as it focuses on the remaining functions of central and regional governments. This legal framework of 'general competency' rather than ultra vires definition of function as embedded in Law No. 5/1974 is unusual for local governments. It is also more radical than the subsidiarity principle, which was apparently the inspiration of the drafting team (Ferazzi, 2002). Subsidiarity as a principle would not call for a limited list of central functions in the law, but for a process by which decentralization or centralization is determined, while specifying the principles that guide the process.

Omission of a general clause in the law to state that local government is bound by national law (omitted because the drafting team felt it was obvious⁹) further obscured the exact extent and nature of decentralization. This confusion was further increased by TAP MPR III, which determined the hierarchy of laws but omitted the ministerial decree as a legal instrument.¹⁰ Unfortunately, much of the detail on government functions is contained in such ministerial decrees. Moreover, even though regional regulations (PERDAs) are placed below central government legal instruments such as government regulations and Presidential Decrees, arguably organic regional regulations (i.e. based directly on a law that delegates regulatory responsibility to the regions) should take precedent over central regulations and decrees without a direct basis in the law. Worse, some central agencies, notably those for Land Management and for Investment Approval, have managed to get a Presidential Decree issued that exempts their authorities from decentralization as Law No. 22/1999 calls for. Finally, the revised Art. 18 of the constitution now calls for central functions to be regulated by law, and the question is whether that is covered by Law No. 22/1999 or whether a separate law is called for to specify these functions.

The bottom line of all this is that the distribution of functions, let alone the expected performance in exercising the functions, is still far from clear. Beyond causing utter confusion in the regions, this situation not only undermines the accountability of the regional government but also hampers judgment on the vertical distribution of fiscal resources (see the discussion that follows). This confusion has not stopped the central government from embarking on an effort to have the regions 'recognize' their functions in a positive list that is to be cleared by Presidential Decree.¹¹ Without deeper understanding

and agreement on the functions themselves, and the minimum standards for these functions, recognition of these functions seems distracting at best.

One way forward is currently under debate in Indonesia. First, international agreements and sectoral laws could be screened on commitments on service delivery standards already made; for instance, the Education Law guarantees nine years of education for all. Second, central government and regions could embark on a process that would establish agreed standards of services in key areas, while taking into account the regions' fiscal and human resource capacities. Standards thus agreed could then become the basis for monitoring and supervision, and possibly sanction. In all likelihood, these standards will vary widely by region, given Indonesia's wide diversity in capacity. Meanwhile, a process to align sectoral laws with Law No. 22/1999 could start, and the revisions could further specify the functions and service standards, as well as which of those standards are to be considered as binding and sanctionable under PP 20/2001 Art. 16. Those sanctionable standards are likely to be few.

Levels of Government, Size of Local Governments and Economy of Scale

Law No. 22/1999 assigns most responsibility to local government level. The provincial level only has coordinating functions, a role in issues that surpass district boundaries, or the assumption of local government functions for those otherwise unable to perform the functions. The province has a potential role in performing tasks on behalf of the local governments, but little initiative has been undertaken to exploit this possibility under the law.¹² The fact that the law explicitly states that there is no hierarchical relation between provincial and local governments does not help the provinces in gathering local governments together to plan for joint operation of functions and facilities. As a result, tasks with large externalities and significant economies of scale, such as watershed management, sea management, communicable disease control, and others, are likely to be left unperformed or underprovided.

Scale economies are also at risk because of the size of local governments. This is likely to get worse in the near future due to the apparently unstoppable tendency to create new regions, both provinces and local governments. The number of local governments since Law No. 22/1999 passed increased from less than 300 to 348 in 2002, with over 20 new ones expected for 2003, and the number of provinces has increased from 26 to 32 (including the apparently defunct new provinces on Irian Jaya). The regions already show a wide variety in population size. Provinces range from fewer than 800 000 inhabitants (Gorontalo) to over 35 million (East Java), and local governments from 24 000 to 4.1 million. The creation of new regions, which requires a law, is

driven by several considerations, including historic and ethnic ones. But the wish to create a new region is likely to come from fiscal incentives as well. For one, if a district has a significant amount of natural resource revenues, it will be better off by becoming a province, as it then no longer needs to share the revenues with surrounding local governments, or with the originating province. Urban areas are more likely to receive a share of the personal income tax than rural areas, and they have an incentive to split off from the kabupaten they are part of. In the new DAU system, every region gets a lump-sum amount, thus creating incentives for each region to split up.

Creating more and more regions is not without consequence. Information on the wage bill of local government per capita of the population seems to point at sharply decreasing efficiency at the level of about 500 000 people (Figure 2.1). Local governments with fewer than 100 000 people have about twice the wage bill per capita that local governments with 500 000 people have. Some of the difference could perhaps be explained by geography or a negative correlation between population size and density, thereby necessitating a larger civil service to supply the same amount of services. But suggested scale economies would argue for consolidation of regions rather than the creation of new ones.

Governance and Accountability

The potential benefits of decentralization depend crucially on governance. By all accounts, the jury on the link between decentralization and the prospects for improved governance at local level is still out, and there are several concerns about the prospects of decentralization/devolution in developing countries.¹³ On the one hand government closer to the people reduces monitoring costs of the electorate, and competition among local governments could drive out corruption. On the other, local governments seem to be more prone to elite capture.

The fall of the New Order regime in 1999 and the subsequent 'Big Bang' decentralization of 2001 promised to fundamentally change the locus both of responsibility and of accountability for public service delivery in Indonesia. By 'bringing government closer to the people,' decentralization can serve as a driving force towards generating improvements in Indonesia's notably poor governance environment. Symptomatic of this governance environment is that Indonesia continues to be perceived as suffering from one of the internationally highest levels of corruption. This has proven corrosive to both public service delivery and the private-sector environment.¹⁴

Numerous governance issues have received public attention in Indonesia. These include money politics (*'politik uang'*), centered especially on concerns that local elections for regional heads have been increasingly bought.

Chart 2.1: Wages per capita relative to population – 336 daerahs – 2002

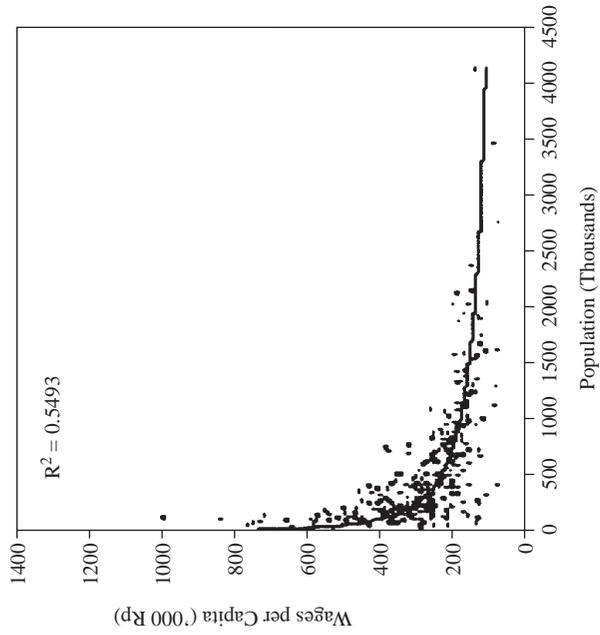
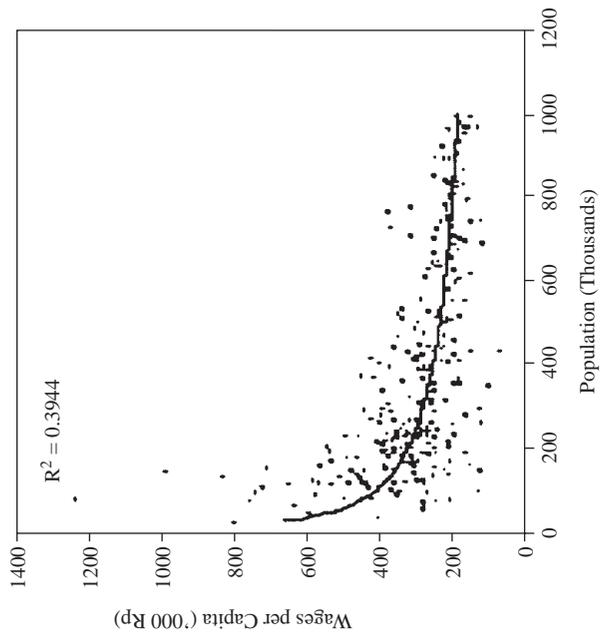


Chart 2.2: Wages per capita relative to population – 284 daerahs – 2002; average populations less than 1 million inhabitants



Source: Maurice Gervais (2002). 'Background Note on Civil Service Issues for Apkasi' Jakarta, March.

Figure 2.1 Diseconomies of scale

Local political elites in executive and legislature has to the political aspirations of the wider populations (*'politik elit'*). The new local heads have increasingly started acting a little kings (*'raja kecil'*) who are neither accountable to central authorities nor to their local constituencies. Meanwhile, rent-seeking has proliferated in many regions due to the proliferation of these new actors and increased the dangers of overgrazing (many hands of *'campur tangan'*).¹⁵ This problem is accentuated by the belief among some parts of the executive and legislative that their tenures are limited, and hence their access to rents is limited as well.

To blame decentralization per se for these weaknesses seems far fetched. Moreover, the weaknesses in governance at regional level should be considered relatively to those taking place at the center. Whether these incidences of weak governance are systematic remains to be seen. In part, weak accountability of the head of region could be temporary: many heads of regions have not yet been elected, but were appointed by the government before local elections took place. The vaguely defined authorities and functions of the regions undermine accountability as well, but these are likely to become clearer over time.

However, other and more fundamental causes seem to be at work as well. One issue is Indonesia's strong party system that limits the interest local councilors take in their local constituents. Another is that government regulations on the accountability of the head of region have strengthened the position of the head, such that it has become almost impossible for regional parliaments to fire him. Finally, the absence of formal accountability mechanisms such as external audits of regional governments also undermines accountability.

ISSUES IN THE EMERGING INTERGOVERNMENTAL FISCAL SYSTEM

Indonesia's new intergovernmental fiscal system devolves on aggregate enough resources to cover the devolved expenditure responsibilities. But this system is far from ideal. The distribution of resources and tasks has caused budgetary problems in some of the regions, especially at provincial level. The regions' high dependence on central transfers could undermine local accountability. Inadequate provisions for local taxes create risks of inappropriate taxation and unhealthy tax exporting. The system has few means for central government to finance national priorities at local level. This section looks at several basic issues in the design of the new system.

Does the New System of Intergovernmental Transfers Make Sense?

Law No. 25/1999 meant fundamental reforms of Indonesia's intergovernmental fiscal relations. The reforms strongly increased the regional government's share of government resources, moved the transfer system from one dominated by earmarked grants to one largely relying on general grants supplemented by revenue sharing, and, with the reforms introduced by Law No. 34/2000, gave broad taxing authorities to local government.

Before the 2001 decentralization, most resources were transferred from central to regional governments through earmarked grants. The largest of these was the SDO (*Subsidi Daerah Autonom* or Subsidy for Autonomous Region) grant, which covered all civil service salaries and recurrent expenditures for the regions. In addition, INPRES (*Instruksi President*) grants were used to finance development spending in the regions. The INPRES grants started as a block grant for development spending in the 1980s, but gradually evolved into an array of specific grants for purposes ranging from reforestation to the construction of public markets (Silver, Azis and Schroeder, 2001).

In the new system, central–regional transfers remain the dominant means of financing, but the earmarking is gone. The bulk of regional government spending is financed by transfers from the center (see Table 2.1). Well over

Table 2.1 DAU dominates regional revenues 2001 and 2002 (Rp trillion)

	FY 2001	FY 2001 adjusted	FY 2002
DAU	60.5	60.5	69.1
DAU contingency	6.0	3.1	2.0
Shared taxes	20.3	21.2**	24.6
Special autonomy	–	–	1.3
Special allocation fund (reforestation)	0.9	0.7	0.8
Total transfers	87.7	85.4	97.8
Regional own revenues (PAD)	7.0	7.0	7.6

Note: **Although national summary budgets reflected a higher value than the original budget, the regions appear only to have actually received the budgeted amounts in 2001.

Source: FY 2001 budget as per Law 35/2001; adjustments are based on the preliminary outcome as per 1 December 2001. FY 2002 is based on Parliament's approved budget as per 23 October 2001. Figures for own revenues are preliminary estimates from compiled local budgets by Ministry of Finance based on annualized regional FY 2000 data, and used in the final DAU 2002 simulation. Figures for 2002 have been adjusted upwards by 9.3 percent to reflect predicted inflation as per the 2001 adjusted budget. Estimates of regional relative to central expenditures are based on total transfers plus own revenues (PAD) divided by central expenditures

90 percent of regional revenues come from the Balancing Fund (*Dana Perimbangan*), which includes a general grant (the *Dana Alokasi Umum* or DAU), shared taxes, natural resource revenues (SDA or *Sumber Daya Alam*) and a special allocation grant channel (DAK or *Dana Alokasi Khusus*). Local governments have limited own revenues (PAD or *Pendapatan Asli Daerah*), which constitute less than 7 percent of their total revenues. Since 2002, the center has also made additional special autonomy transfer arrangements with two provinces.

Dana Alokasi Umum (DAU)

The DAU, or general grant, is the mainstay of the new intergovernmental fiscal system. The DAU adds up to some 65 percent of regional revenues, and to a little over 70 percent of the Balancing Fund. The DAU is by law a minimum of 25 percent of central government revenues after tax sharing.¹⁶ For 2001 and 2002 this minimum allocation has been maintained by government and parliament. However, as noted earlier, although the law and the regulations suggest that the 25 percent is the share of *actual* revenues after revenue sharing, for FY 2001 the *budgeted* amount was disbursed. In all, this cost the region some Rp 10 trillion in revenues, or 15 percent of the total DAU for that year.¹⁷

Local governments receive the lion's share of the DAU. Of the total DAU, the provinces receive 10 percent of the DAU and local governments 90 percent. Neither the 25 percent of total revenues, nor the division of the DAU between provinces and local governments, seems to have been based on thorough analysis of expenditure needs. The provincial and local government allocations are determined by a formula, which according to the law, is based on the regions' needs and economic potential. For 2001, the formula was largely based on past spending levels. The GOI realized that the distribution of the DAU according to 'objective factors' only could cause a major mismatch between devolved expenditure responsibilities and revenues. To avoid this, the GOI introduced a 'hold harmless' element in the formula related to past SDO and INPRES grants. Because the 'hold harmless' element was interpreted to be a minimum DAU allocation rather than a guaranteed amount, this element took almost 80 percent of the total DAU. In 2002, the minimum DAU was reduced to 50 percent of the total amount, but rather than relating it to past SDO and INPRES, it became a minimum amount per region, plus an amount related to the actual wage bill of 2001. However, 'hold harmless' obtained a new meaning: parliament objected to the proposed distribution of the DAU, because the richer regions stood to lose compared to the 2001 distribution.¹⁸

The formula part of the allocation relies on the notion of expenditure needs and own fiscal capacity, and the share in the DAU pool for a region depends

on the difference between its fiscal needs and its fiscal capacity. For 2001, these concepts were interpreted different from 2002, in part due to practical reasons and in part due to more analysis done for 2002. In 2001, at the time the formula had to be presented to the Regional Autonomy Advisory Council, the data on shared revenues were not yet available, and it was decided to ignore them. For 2002 these data were included, but natural resource revenue shares were included for only 75 percent. As indicators for expenditure need the formula includes population, the poverty rate, land area, and the construction price index as an indicator of 'geographical circumstances.' The formula must include these variables, as they are mentioned in the elucidation of Law No. 25/1999. In the 2001 formula each of the variables was included with equal weight, whereas in the 2002 formula population and area both received higher weights than the others.

Contingency fund

The DAU allocation was supplemented by a 'contingency fund' to absorb any mismatches between devolved expenditure responsibilities and revenues. Of a budgeted amount of Rp 6 trillion in 2001, some Rp 3 trillion was disbursed. The first tranche of Rp 1.1 trillion related to genuine mismatches caused by decentralization. A process of application, review, and allocation set out in a Presidential Decree was followed for this tranche. The second tranche, however, became necessary because of the centrally mandated salary increase, which pushed up the regional wage bill by some 15–30 percent.

Shared revenues

The 2001 decentralization greatly increased the importance of shared revenues. The most important factor was the inclusion of oil and gas revenues and personal income tax in the taxes to be shared. The former were included to accommodate long-standing dissatisfaction of natural resource-rich regions that felt that 'Jakarta' took their resources and they did not get anything in return. True or not, with the implementation of Law No. 25/1999, they now get a significant share of those revenues (see Table 2.2). In addition, personal income tax was included for sharing through Law No. 17/2000.¹⁹ For each of these shared taxes, the province gets a minor part, and the bulk of revenues goes to the local governments.

The sharing formulae for most of the shared revenues contain an additional element of equalization. For oil and gas, mining and forestry, the local governments of regions neighboring the producing region receive a share as well. For fisheries, property tax and land transfer tax, a small percentage of the revenues is shared by all local governments in Indonesia. Whereas the underlying motivation may well be one of equalization, with the initiation of a formula-based DAU these complex sharing mechanisms may well be redundant:

Table 2.2 Revenue sharing (shares of revenues to central, provincial and regional government)

Item	Central government	Provincial government	Originating local government	Other local governments in the same province	All local governments in Indonesia (equal share)
Oil (non-tax, onshore)	85	3	6	6	—
LNG (non-tax, onshore)	70	6	12	6	—
Mining: Land rent	20	16	64	—	—
Mining: Royalty	20	16	32	32	—
Forestry: Land rent	20	16	64	—	—
Forestry: Resource rent	20	16	32	32	—
Fishery	20			—	80
Property tax	9 ^a	16.2	64.8	—	10
Land transfer fee		16	64	—	20
Personal income tax	80	8	12	—	—

Note: ^aThe government's share in the Property tax is supposed to cover administrative costs.

Source: Law 25/1999, Law XXX 2000 (Income Tax) Government Regulations 104/2000 and Bambang Brojonegoro (2001) Fiscal Decentralization in Indonesia, background paper to a ASEM-WBI Conference on Decentralization in East Asia, Bali, January 10–11 2002.

whatever a region gets from those shared taxes is counted as own fiscal capacity and reduces the allocation of the DAU.

Own revenues

Law No. 34/2000 greatly expands the scope for local government revenues. The law amended Law No. 18/1997, which intended to stop the then-prevailing local government practice of issuing a plethora of local government taxes, many with little revenue potential and most with high costs to the taxpayer and the economy. Law No. 18/1999 therefore restricted regional taxes to a closed list, and made any additional taxes conditional upon approval of the Ministry of Finance.

Law No. 34/2000 reverses the burden of proof. The law still gives a list of regional taxes, but regional governments can add taxes through regional regulations approved by the regional government council, as long as it abides by the principles mentioned in the law. These principles are sound, but supervising them has turned out to be problematic, not least because the law has tight deadlines that the central government must meet if it wants to cancel a local tax. An added complication is the way supervision is structured. Law No. 22/1999 gives the Minister of Home Affairs the authority to cancel regional regulations, including those on regional taxes. Up until now, the Minister has been hesitant to invoke these powers, not least because regional governments have the right to appeal his decision to the Supreme Court. As a result, there has been little to check the regional governments' creativity in taxation, and, although the damage still remains limited, 84 out of the more than 1000 regulations on local taxes have been found to be in conflict with the law. Among them are taxes on the import of goats into kabupaten Bogor and an advertisement tax on Coca-Cola bottles in Lampung province. Meanwhile, the Minister of Home Affairs has as of now formally cancelled only one regional tax.

Do the Regions Get Enough Revenues?

A key question for the new intergovernmental fiscal system is whether the regions on aggregate receive enough resources. This question can be considered in three ways:

1. Do the regions receive enough resources to cover the expenditures needed for the tasks they are expected to perform?
2. Do the regions receive an amount compatible with what government as a whole can afford?
3. Do the regions receive enough to cover the spending obligations they inherited from central government in the course of decentralization.

Considering each in turn, method 1, sometimes labeled the *costed minimum standards* approach, has practical and theoretical issues. To begin with, as was argued previously, Law No. 22/1999 does not clearly define the functions of the regional governments, as the functions are defined negatively; that is, a local government does everything that the center and the provinces do not do. As for the obligatory functions of local government defined in the law, it does not clearly define what part of the function local government performs, and it also does not establish what minimum standards of services should be delivered. Even if these issues could be overcome, the information to cost out the functions is lacking at present, and determining what the functions cost at present may not be very telling for what the functions should cost if efficiently delivered. Even apart from these practical objections, there is a more fundamental objection against this method: unless carefully managed, minimum standards are only a wish list of spending, developed independently of what government as a whole can afford.

Method 2, or the *affordability approach*, faces several issues as well. This method requires the Indonesian government to make choices for the nation as a whole about what it wants to spend its scarce resources on. If the priorities so determined are the tasks of regional government, then more resources would need to be devolved, whether through grants, revenue sharing, or devolution of more tax bases to regional governments.²⁰ Although the method is to be preferred over the costed minimum standard, there are numerous practical impediments, not least the lack of information in the current budget and accounting system that does not allow a link between policy goals and spending.

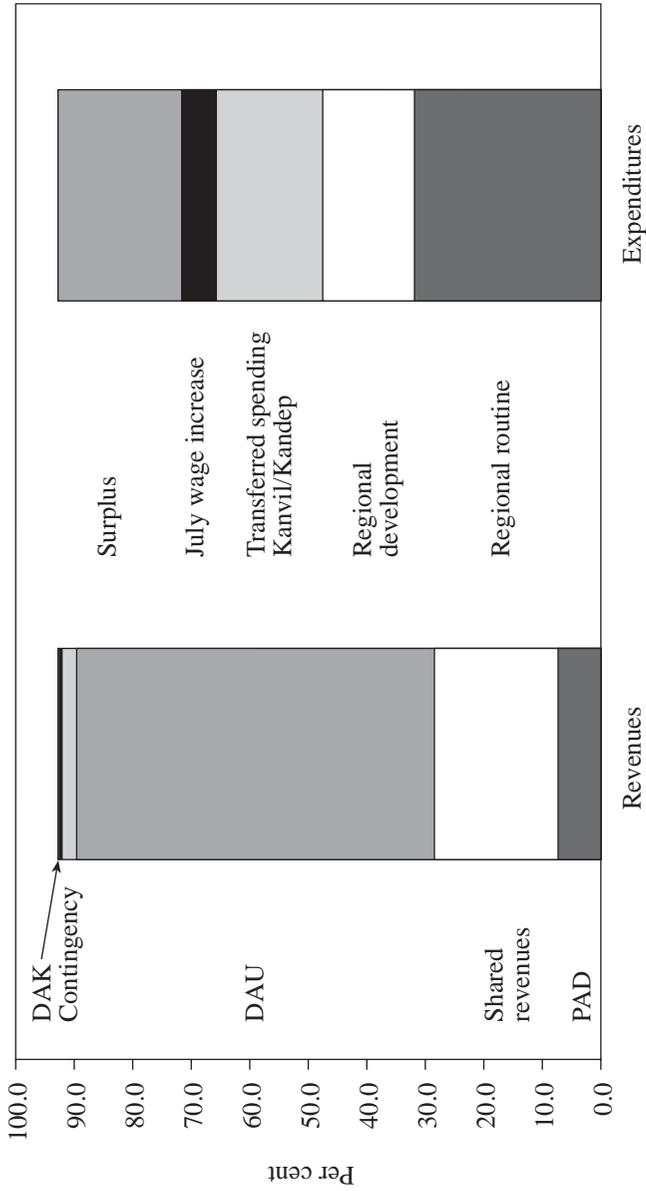
The central government could devolve more resources if it wanted to do so. Currently, a significant part of its spending is devoted to tasks that could be considered local government tasks. Taking the 2002 budget as a guide, the development budget still contains as much as 10–20 trillion, 1 percent of GDP, in spending that could be further devolved to the regions, together with a corresponding increase in revenues. Note that implementation of these projects is already largely done at the sub-national level. However, since the financing is done from the central budget, there is no local scrutiny over the spending. On the recurrent budget, the wage bill probably offers further scope for savings, as not all civil servants who ought to have been decentralized actually were. Moreover, the GOI has already decided to phase out the fuel subsidies over time, and this will further free up resources that could be made available to the regions. Finally, the GOI is determined to increase the ratio of taxes to GDP over time. One-quarter of that increase will already be automatically transferred to the regions through the DAU, but more could be made available to the regions.

Whether increased resources should be made available remains to be seen. First, there are several areas of central government's own responsibility that have been chronically underfunded, most notably operations and maintenance. Second, central government is aiming for a zero budget deficit by FY 2004, and achieving this goal is likely to absorb much of the savings and additional revenues mobilized. Third, local governments may not be ready to absorb additional spending at this time: they have almost doubled their levels of spending, their local planning, budgeting and financial management systems may already be stretched, and accountability at local level is still weak.

As for method 3, in the aggregate more than enough revenues seem to have been devolved to match the transferred revenue responsibilities. This holds even if we take account of the July 2001 wage increase and adjust the regions' own development spending for inflation. In total, the regions received surplus revenues of some Rp 21 trillion in 2001, or 1.5 percent of GDP (see Figure 2.2).²¹ One could therefore argue that decentralization 'cost' the center this very same amount. If central government could have perfectly targeted the devolved resources, it could have transferred Rp 21 trillion less than it actually did. Lewis (2001) estimates an even higher surplus of Rp 27.5 trillion, but this was before the wage increase and the subsequent disbursement of the contingency fund. He also estimates separately the surpluses of the provincial level and local level. His judgment is that whereas at provincial level the extra revenues more or less just covered the extra expenditures, local governments received most of the surplus. This finding is also in line with the disbursements from the contingency fund, of which a disproportional amount was disbursed to the provinces.

Further evidence for the finding that more than enough resources were transferred can be found in development spending. Budgeted regional development spending made a significant jump in 2001, from an (annualized) Rp 14 trillion in FY 2000 to a planned Rp 26 trillion in FY 2001 (see Table 2.3). The regions may have been forced to cut back slightly on these plans after the July wage increase, but there is every reason to believe that development spending in the regions rose significantly. This is good news for government development spending as a whole. Because of the increase in regional development spending, the drop of central development spending as a percentage of GDP did not lead to an overall decline.

Thus the regions as a whole do not seem to be short of funds. The increase in development spending in the regions also suggests that there is more than sufficient to cover the (recurrent cost of) functions transferred. Therefore, the often-heard argument that the regions spend mostly on 'bureaucrats' and have too few resources for 'services to the people' seems to be a red herring. In fact, on aggregate, wages make up a little over 50 percent of regional spending (see Table 2.4). Moreover, it is a misconception that only



Note: Regional routine and PAD taken from SIKD; Regional development from SIKD, corrected for 10 percent inflation; Deconcentrated agencies from Lewis (2001); July wage increase estimated as 15 percent wage increase over the total wage bill. The regional government wage bill is estimated from SIKD (budget 2001); the wage bill for the transferred workers taken from MOF payroll data January 2001.

Figure 2.2 More than enough on aggregate (Regional revenues, expenditures and transferred expenditures Rp tr)

Table 2.3 Consolidated government development expenditures 1996/97–2002 (Rp trillion)

	1996/97	1997/98	1998/99	1999/2000	2000	2001	2002
Total central expenditures	77.90	111.54	168.10	231.08	298.55	340.33	344.01
Central own account development spending	35.95	38.36	52.82	57.64	55.47	45.46	52.30
Central regional development transfers (INPRES/IPEDA)	6.47	7.51	13.58	12.45	20.55	–	–
Central own account development expenditures	29.48	30.85	39.24	45.19	34.93	45.46	52.30
Regional development expenditures (APBDs)	9.34	10.41	8.66	12.69	14.0	26.18	30.46

Note: Central own figures through 1999/2000 are audited actuals. Figures for 2000 are provisional revisions, and provisional for 2001. FY 2000 figures are annualized for comparability. Figures for 2002 are budgeted as approved by parliament. Estimates for regional development expenditures through 1999/2000 are drawn from the BPS Local Government and Provincial Financial Statistics (excluding village budgets). Figures for regional development expenditures reflect provincial development expenditures net of transfers to lower levels, plus local government development expenditures (including net transfers to lower levels). FY 2000 are estimates are from the MOF SIKD database, and adjusted to reflect missing observations and onward provincial transfers. FY 2000/2001 are as per Annex Table ???. Note that prior to FY 2001 figures for central regional development expenditures should have exceed regional development expenditures, as these were earmarked. Actual regional development expenditures could have been further increased from own revenues (PAD). For 2001, certain central government development expenditures may still appear as transfer to the regions (e.g. parts of KDP). The 2002 regional development expenditures assume that regions spend 28.9 percent of total revenues (central + PAD) (see World Bank, 2003).

Table 2.4 Summary regional expenditure estimates (2001)

	Local governments (Rp tr)	Provinces (Rp tr)	Local governments (%)	Provinces (%)	Total (Rp tr)
Total revenues	74.098	18.190	100.0	100.0	92.288
Wages	40.55	6.90	54.7	37.9	51.4
Other routine	15.52	2.76	20.9	15.2	19.8
Development	18.03	8.53	24.3	46.9	28.8

Source: MOF SIKD, authors' estimates.

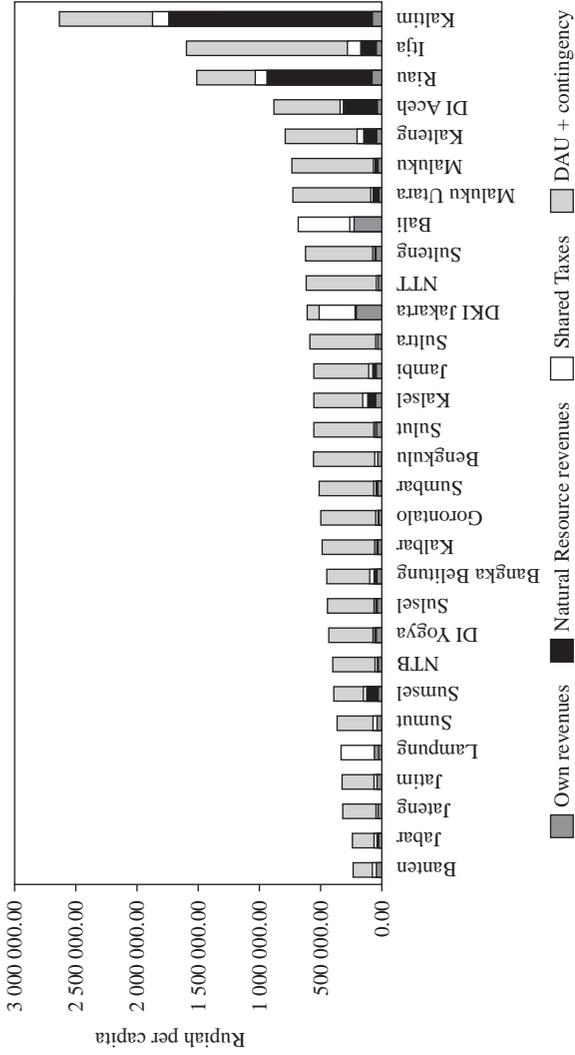
development spending can be considered as service delivery. As civil service numbers suggest, some 70 percent of the wage bill is paid to teachers and health workers, who are civil servants that provide direct services to the people.

In conclusion, on aggregate more than sufficient revenues were devolved to cover the additional expenditure responsibilities of the regions. Little can be said about whether this was enough to cover expenditure levels that were sufficiently large to provide some minimum standard of services in the regions.

How Equalizing is the New Intergovernmental Fiscal System?

Sufficient resources for the regions on aggregate disguise large variations among the regions in fiscal capacity. Even after redistribution through the DAU, in FY 2001 the richest local government had more than 50 times as much revenue per capita as the poorest one. Further, the poorest region has only 20 percent of the per capita revenues as the average. The variation among the regions as measured by the Gini coefficient for the per capita revenues for the regions is some 0.39.

Some of this variation can be explained by the small size of the units of local government in Indonesia.²² But even if one aggregates revenues at provincial level, the variation in revenue capacity remains large, with the richest province having about 10 times as much revenue per capita as the poorest one and the poorest having only some 40 percent of the revenue capacity of the average one. For comparison, in the US the poorest state has about 65 percent of the revenues of the average state. In Germany, any state falling below 95 percent of average is subsidized. The variation in the 56 Russian oblasts is more in line with that of Indonesia: the richest of the 89 regions has revenue per capita some 40 times higher than the poorest, which



Note: The numbers for consolidated province are aggregates of the local level and the provincial level within the same province

Source: SIKD, authors' calculation.

Figure 2.3 Some are more equal than others (per capita revenues after DAU, 2001, consolidated province, Rp)

is still considerably less than that among Indonesian local governments although larger than among the provinces (Martinez-Vazquez and Boex, 1998). In Brazil, the richest state has 2.3 times the revenues per capita of the poorest state (World Bank, 2001a). In China, expenditures per capita in the richest province are some 17 times that of the poorest one; however, excluding the city provinces of Shanghai, Beijing, and Tianjin, the disparity falls to 5.5 to 1 (World Bank, 2001b) (see Figure 2.3).

Why are inequalities in fiscal capacity so high among Indonesia's regions? After all, the Law on Fiscal Balance promised a system that would equalize fiscal capacity among the regions, taking into account the regions' own fiscal capacities and fiscal needs. Two causes of inequality stand out: the large variation in own fiscal capacity among Indonesia's regions, and the imperfections in the equalization mechanism of the DAU.

Disparities in own fiscal capacity

The own fiscal capacity among the regions varies widely. Much of the variation is due to revenues from natural resource sharing. The few regions that are eligible for revenue sharing receive substantial amounts, but not all regions are eligible. The distribution of the personal income tax share is highly unequal as well, with some regions receiving no revenues at all from this source. Relative to these two sources of revenues, variation in own taxes (PAD) per capita is relatively small (see Figure 2.4).

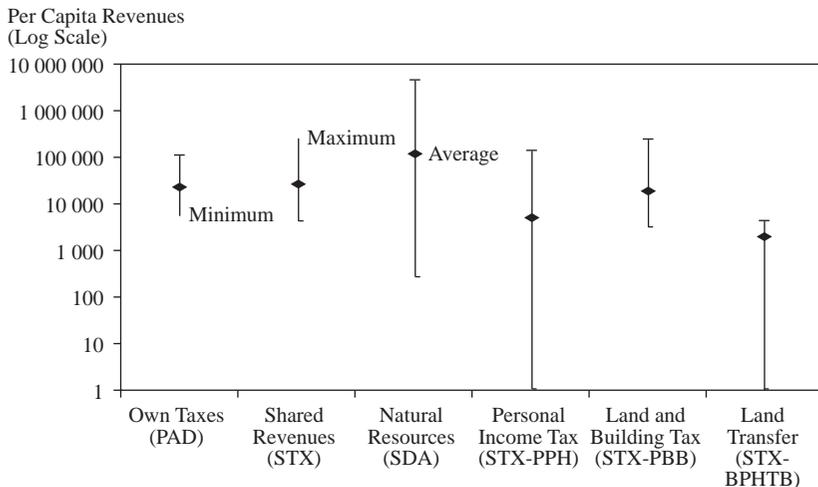


Figure 2.4 Large dispersion in several regional revenue sources (2001, Rp per capita)

Equalizing properties of the DAU²³

The DAU allocations reduce disparities in fiscal capacity among the regions. Whether it does so by enough is hard to tell, in part because the concept of equalization itself is left vague in the law, the regulations, and even in the political debate surrounding the DAU allocation. Law No. 25/1999 requires the DAU to be allocated such that it reduces the disparity between expenditure needs and 'economic potential.' The allocation is to be done by means of a formula taking objective factors of needs into account and own fiscal capacity. The elucidation of the law mentions explicitly the factors population, area, poverty, and geographical condition, the latter of which was later interpreted as cost differences. There are several reasons for this, but the key ones are that the allocation of the DAU was restricted by the need to give regions enough finance to pay for the devolved government apparatus, and that the resulting 'hold harmless' clause was misinterpreted.

In the run-up to 2001, the authorities had to solve the intractable issue of matching the new expenditure assignments with the new intergovernmental fiscal system. Expenditures landed in those regions where the government apparatus that was to be decentralized was located. To avoid the potential problem that the bulk of the money (or the DAU) would land somewhere else, with the consequent risk that civil servants would go unpaid and services would break down, it was decided that the DAU allocation should hold regions harmless compared to what they received before in SDO and INPRES and the extra they had to spend on the devolved government apparatus. This became known as the 'base amount,' equal to 130 percent of SDO and 110 percent of INPRES of the (annualized) FY 2000 amount. A true hold harmless clause would have ensured that regions would not fall below that amount. Instead, it became a minimum, absorbing some 80 percent of the total DAU.

The DAU allocation for 2001 therefore became strongly correlated with the past distribution of grants. This favored the resource-rich regions, because the old INPRES system was implicitly compensating these regions for the revenues generated by them. On top of the base amount, each region received an amount based on a formula that included fiscal needs and own fiscal capacity. But because information on revenue sharing was not yet known at the time of formulating the DAU, natural resource revenue shares were not counted as own fiscal capacity.

'Hold harmless' took on a different meaning in 2002. The Ministry of Finance had proposed a more equalizing DAU allocation for 2002, mainly by taking natural resource revenues into account, and the Regional Autonomy Advisory Board had approved the proposal. But the regions that stood to lose lobbied hard with Parliament, and, even though according to Law No. 25/1999 parliament had no formal say in the distribution of the DAU (as opposed to

the aggregate amount), it insisted that each region would get at least as much DAU as in 2001.

The result is that the DAU allocations are less equalizing than one would expect based on the law. Regression analysis in Hofman, Kadjatmiko and Kaiser (2002) shows that the DAU is positively correlated with own fiscal capacity, and shows a strong relationship with the wage bill. Nevertheless, the DAU still equalizes in the sense that variation in revenue per capita as measured by Gini coefficient or coefficient of variation is reduced by the DAU (Table 2.5). The reason for this is that regions with high own fiscal capacity do receive less DAU as a proportion of that own fiscal capacity even though in absolute amounts they may receive more than regions with low own fiscal capacity.

Table 2.5 Cumulative variation in revenue per capita FY 2001

	Coefficient of variation	Standard deviation of logarithms	Gini coefficient
PC cumulative			
Own source revenues	3.22	0.87	0.63
+ Shared taxes (SXT)	2.55	0.91	0.58
+ Natural resource revenues (SDA)	2.66	1.34	0.77
DAU	0.820	0.587	0.350
DAU + contingency	0.797	0.583	0.345

Note: Results are for 336 local governments, using DAU 2001 simulation data received from Ministry of Finance.

As for fiscal dependency, historically Indonesia has had one of the most centralized tax systems in the world (Ma Jun, 1997). The recent fiscal decentralization actually increased regional fiscal dependence, as measured by the share of own revenues (PAD) in total revenues. International evidence suggests that this high degree of dependence is inversely associated with governance outcomes (de Melo, Luiz and Barenstrein, 2001). Fiscal dependence should therefore be a concern for Indonesia.

Law No. 34/2000 on regional taxes should have addressed the issue of fiscal dependency. However, the approach taken in that law led to another set of problems. Law No. 34/2000 allows regions to issue their own tax regulations, as long as they abide by certain (sound) principles. This is far more liberal than Law No. 18/1997, which only allowed a limited number of taxes specified in the law and with high hurdles on additional taxes. At the same

time, Law No. 34/2000 did not devolve a tax most suited for regional governments: the land and real estate tax.²⁴ Arguably the approach of Law No. 18/1997 may be better, even though it did perhaps not encompass an appropriate tax base for the regions. 'Nuisance' or 'predatory' taxes have received some attention during the first year of decentralization. Many of those taxes are technically illegal, and improved central supervision is clearly one important remedy for this problem. However, a more fundamental solution to the 'revenue hunger' of the regions will probably include enhanced local tax bases and marginal levels of revenue discretion. The trouble with this solution is that those taxes that may be most lucrative from a revenue basis are also likely to be less desirable from an equalization of fiscal capacity perspective (e.g. natural resources or property/service based taxes that will disproportionately benefit urban areas).²⁵

CONCLUSION AND DIRECTIONS FOR REFORM

Indonesia's intergovernmental fiscal system can be much improved. The broad orientation of reforms is to have the relatively rich regions 'fend for themselves' with own tax base, shared taxes, and commercial borrowing. The poorer regions are to get support through DAU, DAK and access to well-managed central lending and on-lending facilities that will enable them to provide similar quality services at similar local tax rates throughout Indonesia. In particular, improving the intergovernmental fiscal system in this direction requires, among other things:

- Moving to a more equalizing DAU by phasing out the transitional elements in the allocation.
- Restricting local taxes to a closed list over which the regions have tax rate autonomy – possibly within centrally set limits. This list of taxes should include property taxes, and could include a local surcharge in personal income tax and payroll taxes and selective business taxes. Expanding motor vehicle use or fuel taxation is a further option.
- Deciding on a transparent and consistent treatment of natural resource revenues in revenue sharing and in the equalization formula.
- Introducing a selective system of specific grants – combined with an (on)-lending window – to promote the financing of national priorities at local level. A larger DAK could be financed from a gradual reduction in the center's own development spending on regional functions.

NOTES

1. The findings, interpretations and conclusions expressed in this chapter are entirely those of the authors. They do not represent the views of the World Bank, its Executive Directors, or the countries they represent. This chapter draws on the forthcoming World Bank Regional Public Expenditure Review for Indonesia, and on Hofman, Kaiser and Kajatmiko (2001). The authors wish to express thanks to Jorge Martinez-Vazquez, Roy Bahl, Richard Bird, Roy Kelly, Dana Weist, Blane Lewis, Bernd May and Machfud Sidik for the many helpful discussions on the topic of the chapter. We also thank Fitria Fitriani for excellent research assistance.
2. This report uses 'local government' and 'local level' to indicate the second level regions, or *kabupatens* (districts) and *kotamadjahs* (cities). 'Regions' refers to provinces, districts, and cities together.
3. Indonesians usually use the term 'regional autonomy' rather than 'decentralization'. This chapter uses the terms interchangeably, except in sections where the difference matters.
4. Although Ryaas Rashyed (and his expert staff Andi Malarengeng) became the figurehead for decentralization, it was Mr Oentarto, expert staff in Home Affairs, who drafted the first version of the administrative decentralization law. The drafting team was subsequently led by Rappioeddin. In fact, at some point there were two versions of the administrative law, but Rappioeddin's version largely prevailed.
5. The World Bank commented on the draft laws in December 1999, together with the IMF. The two main concerns at that time were that expenditure assignments were extremely vague and that revenue assignments were very specific. Taken together, it was felt that the laws provided significant risk for macroeconomic stability and service delivery.
6. The World Bank and the IMF feared that, because there was hardly any clarity on the extent to which expenditures were to be decentralized, the government risked large deficits and macroeconomic instability by putting specific revenue assignments in the laws.
7. See World Bank (2001c), a brief to the meeting of the CGI in Jakarta in November 2001.
8. Some of these issues are discussed by Alm, Aten and Bahl (2001).
9. This observation was made by Bernd May in a conversation with the authors.
10. The then Minister of Justice argued in a letter to all ministries that the MPR decision (constitutionally higher than a law) does not apply as far as ministerial decrees are concerned.
11. The 'positive list' approach came from an idea mentioned in an IMF technical assistance report in the year 2000. The report argued that no judgment on assignment of revenues could be made without a detailed costing of expenditure assignments.
12. One exception familiar to the authors is the two Provincial Health Projects financed by the World Bank. These projects create province-level cooperative structures among local governments to develop and implement province-wide health policies.
13. See, for example, Crook and Sverrisson (1999) or Azfar et al. (2000).
14. See for example O.B. Server (1996) and Partnership for Governance Reform (2001).
15. In December 2001, the Head of the DPR budget commission, Benny Pasaribu, created a stir when he claimed that 40 percent of the General Block Allocation Grant (DAU) was wasted, implicitly arguing that more control and oversight from the center was needed (*The Jakarta Post*, 2001). Arguably, capacities differ widely by islands. On islands like Java and Bali, capacities can generally be argued to be sufficient, while the situation is more difficult in local governments in some of the outer islands.
16. Law No. 25/1999 is not specific on whether the 25 percent is before or after revenue sharing. PP104 has taken the interpretation that it is revenues after revenue sharing, which has apparently been accepted by Parliament and the regions.
17. Revenues in the approved budget for 2001 were Rp 263 trillion and revenue sharing was Rp 20 trillion, which yields a DAU of Rp 60 trillion. Actual revenues as per preliminary outcome data suggest revenues of Rp 299 trillion. Assuming the same amount of revenue sharing, this would result in a DAU of Rp 69 trillion.
18. This parliamentary involvement in the distribution seems to be against Law No. 25/1999,

- which specifies that the Regional Autonomy Advisory Council should propose the distribution of the DAU to the president, who approves it by Presidential Decree.
19. The sharing of personal income tax on a derivation basis was decided at the last moment, and inspired by a conversation the Minister of Finance had on a trip to disseminate the decentralization laws. Art. 31C of Law No. 17/2000 describes the sharing. However, the article is unclear whether the sharing of personal income tax is based on the residence principle or the place of work.
 20. South Africa is operating such a system. The constitution prescribes functions for the provinces and municipalities, and orders the government to give each level of government its 'equitable share' of the national revenues. The equitable share is determined in the context of budget preparation, which in the case of South Africa is based on a medium term expenditure framework. If, say, more priority is put on health care, the equitable share of the province, which is responsible for it, will be larger.
 21. One caveat here is the assumption that all development projects implemented by the *kanwils* and *kandeps* continue to be financed from the central budget. This seems to have been the case, but the center is now trying to find ways to devolve this financing responsibility.
 22. This point was made by Richard Bird in a comment at the Bali conference on Decentralization in East Asia, January 10–11, 2002.
 23. For more detail on this issue see Lewis (2001) and Hofman, Kadjatmiko and Kaiser (2002).
 24. The thinking in the Ministry of Finance on this has already shifted in the direction of devolving this tax.
 25. Zhuravskaya (2000) argues that the intergovernmental fiscal system prevailing in the Russian Federation in the 1990s provided no incentives to increase the local tax base or provide public goods. Shared revenue allocations effectively penalized regions that raised their own revenues. When regions effectively have no opportunity to increase local revenues, they will also have little incentive to increase the local tax base and will over-regulate local business.

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APPENDIX 2.1 SUMMARY OF LOCAL GOVERNMENT MEASURES, 2001

	Units	Mean	Minimum	Maximum	Variation	Gini coefficient
<i>Expenditure needs indicators</i>						
Population		581 000	24 000	4 147 000	0.953	–
Area	km ²	5 763	16	119 749	1.859	–
Poverty gap	%	5	0	35	1	–
Construction costs	Index	135	113	259	0.141	–
PC wage bill	Rp*	282 960 207 780	68 830 –	1 239 510 –	0.510 –	0.255
PC household expenditures	Rp*	1 923 704 1 938 202	970 773	5 465 882	0.335	–
<i>Fiscal capacity indicators</i>						
Per capita RGDP	Rp*	4 901 200 4 068 320	856 500 –	147 676 700 –	2.116 –	0.461
Per capita own taxes (PAD)	Rp*	22 415 18 640	302 –	855 251 –	2.245 –	0.518
Per capita shared taxes (STX)	Rp*	28 480 18 800	4 340 –	265 360 –	1.308 –	0.508
Per capita personal income tax	Rp*	5 600 4 120	0	146 570	2.20	0.611
PC land and building tax (PBB)	Rp*	20 870 12 520	3 360 –	243 020 –	1.45	0.516
Per capita land transfer (BPHTB)	Rp*	2 000 2 170	0 –	4 820 –	2.41 –	0.783
Per capita Natural resources (SDA)	Rp*	128 640 47 720	270 –	4 609 570 –	3.35 –	0.878
Per capita total revenue	Rp*	638 944 371 550	133 837	7 034 325	1.132	0.427
Per capita gross borrowing capacity	Rp	479 208	100 378	5 275 744	1.132	0.427
Total gross borrowing capacity	Rp billions	162	37	1 091	–	–

Sources: * = Average of local government figures followed by national averages. Data are same as used for 2002 DAU final simulations, and refer to 336 local governments. Population refers to 2000 BPS (195.1 million, excluding Jakarta), whereas poverty gap estimates are drawn from SUSENAS 1999, and construction costs refer to BAPENAS indices. RGDP data are from BPS 1999. Own revenues (PAD) are annualized figures from FY 2000. Total revenues include own taxes (PAD), shared revenues (SDA + STX), DAU 2001 including contingency. Regional borrowing capacities are derived using Government Regulation 107, but exclude adjustments for outstanding borrowing. Largest potential borrower is Kabupaten Kutai, East Kalimantan. PC expenditure measures are from SUSENAS 2001 ($N = 327$, including Jakarta but excluding Aceh) based on monthly recall. See: dau_tab04_tk2.do

APPENDIX 2.2 SUMMARY OF PROVINCIAL MEASURES, 2001

	Units	Mean	Minimum	Maximum	Variation	Gini coefficient
<i>Expenditure needs indicators</i>						
Population		6 784 000	778 000	35 501 000	1.398	–
Area	km ²	64 569	662	414 040	1.266	–
Poverty gap	Index	6	1	25	0.667	–
Construction costs	Index	135	116	212	0.138	–
Per capita wage bill	Rp*	46 930 32 450	4 260 –	176 950 –	0.721 –	0.343 –
Per capita household expenditures	Rp*	1 995 386 1 938 202	1 244 601 –	3 733 311 –	0.268 –	– –
<i>Fiscal capacity indicators</i>						
Per capita RGDP	Rp*	4 556 350 3 900 720	1 429 580 –	23 465 080 –	0.864 –	0.311
Per capita own taxes (PAD)	Rp*	22 890 21 320	1 740 –	201 900 –	1.663 –	0.497
Per capita shared revenues (STX)	Rp*	17 420 18 020	3 070 –	289 010 –	2.974 –	0.680
Per capita personal income tax	Rp*	8 730 9 700	840 –	172 570 –	3.56 –	0.678
Per capita land and building tax (PBB)	Rp*	6 560 5 780	1 570 –	67 370 –	1.85 –	0.550
Per capita land transfer (BPHTB)	Rp*	2 130 2 540	10 –	49 070 –	4.17 –	0.868
Per capita natural resources (SDA)	Rp.*	24 720 12 600	0 –	376 830 –	2.99 –	0.851
Per capita total revenue	Rp*	133 760 86 960	36 270 –	594 460 –	1.030 –	0.426
Per capita gross provincial borrowing capacity	Rp	100 320	27 200	445 850	1.030	0.715
Total gross provincial borrowing capacity	Rp billion	491.64	73.38	3 738.37	–	–

Sources: * = Average of LG figures followed by national averages. Data are same as used for 2002 DAU final simulations for 30 provinces. Population refers to 2000 BPS (203.5 million, including Jakarta), whereas poverty gap estimates are drawn from SUSENAS 1999, and construction costs refer to BAPENAS indices. RGDP data are from BPS 1999. Own taxes (PAD) are FY 2000, annualized, although refer only to 27 provinces. Total revenues include own taxes (PAD), shared revenues (SDA+STX), DAU2001 including contingency. PC expenditure measures are from SUSENAS 2001 (including Jakarta but excluding Aceh) based on monthly recall.

3. Political reforms, decentralization and democratic consolidation in Indonesia¹

Dwight Y. King

INTRODUCTION

Decentralization of power was one of the main demands of the reform movement that took shape in 1998. After Suharto resigned many regions began voicing their discontent. The interim Habibie administration responded to these developments with a policy of wide-ranging regional autonomy with special additional arrangements for the provinces of Aceh, Irian Jaya, the capital region of Jakarta and East Timor. Accompanying and reinforcing these decentralizing efforts were others intended to democratize the political system. In this chapter I begin by briefly summarizing the effects on decentralization of new political laws passed by the House of Representatives (*Dewan Perwakilan Rakyat* or DPR) and promulgated in 1999. I then examine aspects of the second wave of reform consisting of constitutional amendments passed by the People's Consultative Assembly (*Majelis Perwakilan Rakyat* or MPR) in 2000–02 and of proposals for amendment of the Law on Regional Government (*Undang-Undang Pemerintahan Daerah* or UU 22/1999). Next I identify factors that help explain interdistrict variation, or why political reform, decentralization and good governance have progressed further in some districts than in others. I conclude with speculations on the likely future evolution of decentralization reforms in Indonesia.

HABIBIE'S INITIATIVES

Several aspects of the new political laws proposed by interim President Habibie had implications for decentralization.² The Law on Political Parties (*Undang-Undang Partai Politik* or UU 2/1999) stipulated that, in order to contest the election, a party had to have an organization (executive committee) in at least nine provinces and in half of the districts in each of those nine provinces. To compete in the following election (2004), the law also required

that a party must have gleaned at least 2 percent of the votes in the 1999 election. The effect of these requirements was to make it highly unlikely that a regionally based party pushing a regionalist agenda could emerge.³

A government regulation negotiated simultaneously (*Peraturan-Pemerintah* or PP 12/99) prohibits civil servants from serving concurrently as party functionaries. The intention was to keep the governmental apparatus neutral in the competitive electoral arena and to insure that civil servants render service to the public without regard to partisan sympathies or affiliations. This restriction on the political rights of civil servants was the most intractable and difficult issue in the entire package of laws on electoral reform, and for good reason.⁴ It probably contributed more than any other single factor to the defeat of Golkar in the 1999 election. Since Golkar was a highly centralized (and centralizing) organization, its defeat helped open up the political space for implementation of decentralizing policies.

The Law on the General Election (*Undang-Undang Pemilihan Umum* or UU 3/1999) adopted a unique version of proportional representation by province combined with some elements of a district plurality system. Every candidate for a legislature at any of the three levels had to be publicly identified with a particular territorial constituency, in addition to a party. Rather than assigning seats to particular candidates based on parties' provincial vote totals and candidate priorities stated in party lists as in previous elections, candidates were supposed to be assigned to seats on the basis of how well the parties performed at the district level. This had potential for strengthening the hand of the regional party leaders vis-à-vis the national party leaders. However, the General Election Commission's (*Komisi Pemilihan Umum* or KPU) decision to give central party leaders considerable discretion in filling their party's seats (as in the old system) brought about a substantial diminution of the significance of the district element in the new hybrid electoral system. It turned out that 97 of 462 elected House members (21 percent) 'represent' districts other than those to which they were originally assigned.⁵

At least three features of the Law pertaining to the Legislatures (*Undang-Undang Susunan dan Kedudukan DPR, DPRD, MPR* or UU 4/1999) were relevant to decentralization. First, 'reserved domains' or appointed seats for the military and police in the legislatures were cut in half. Theoretically this weakened one of the main mechanisms of centralization at all three administrative levels. Second, under the previous government, 16 out of 27 (59 percent) electoral districts were over-represented, all of which were located outside the island of Java. The new law continues this malapportionment. How it impacts decentralization may depend on the level of development and how much the government is controlled by a dominant party.⁶ Third, the law provides for a continuation of regional representatives (*utusan daerah*) in the Assembly,

although now they have to be selected by the provincial legislatures instead of being appointed by the executive. However, these representatives were denied their own separate faction in the organization of the Assembly until November 2001. As a result they were integrated into parties and voted with party factions rather than as a block articulating and defending regional interests. The political reforms having the greatest influence for decentralization, of course, are the Law on Regional Government (UU 22/1999) and the Law on Financial Balance between the Center and the Regions (*Undang-Undang Perimbangan Keuangan Antara Pemerintah Pusat dan Daerah* or UU 25/1999).⁷ The previous law (UU 5/1974), formulated by General Suharto's New Order government, emphasized the mobilization of regions in the effort of national development. Although the law gave lip service to regional autonomy, implementing instructions were more oriented to the promotion of national stability through the establishment of an authoritarian, hierarchical structure reaching down from Jakarta to the provinces, the districts, and ultimately to the smallest villages. Thus there was no mention of the rights of regional governments or subjects living in a particular administrative area. The experience of implementing the law provoked a great deal of controversy among many observers within the government calling for greater real autonomy to be given to districts or for a more meaningful balance between provinces and districts. The hesitancy in pursuing decentralization aspects of the law more forcefully was caused in part by a lack of confidence that the district had the human and fiscal resources for the task, and the fear that autonomous provinces would always tend to push for independence.⁸

The new Law No. 22/1999 marks a radical departure from the structures of governance built up over the preceding quarter century. It recognizes two basic levels of governance, the central government and the autonomous district governments (*kabupaten, kota*) whose relationship involves a division of responsibilities and powers and is not strictly hierarchical. District governments are given both rights and duties, including the duty to support the initiatives of the citizens within their jurisdictions. They no longer double (*merangkap*) as an administrative area of the central government. In other words, the head of a district is responsible to the district representative assembly (DPRD-II) rather than to the president through the provincial governor as previously.

However, under the new law, provincial governments are constituted as autonomous units but at the same time as extensions and administrative regions of the central government. In other words, provincial governors continue to wear two hats, as head of a region and as representative of the central government in a province. They are responsible both to the provincial representative assembly (DPRD) and directly to the president. Hull explains the intent of the new law as follows:

The decision to give provinces this contrasting, and in some ways contradictory set of functions was justified as a way to maintain a strong link between central and district governments in the context of the constitution of a unity state. The institutional duality is also designed to allow the provincial government to serve both central and local interests by assuming representational duties of the former and residual duties of the latter. For instance if for reasons of efficiency or effectiveness the central government cannot carry out activities directly from Jakarta [the seat of central government], the provincial government can be given such responsibilities as a part of “de-concentration” of administration (Article 1 (f)). On the other hand, if the regional [district] governments are unable to carry out all their duties the province has limited autonomy to take on these responsibilities.⁹

Under the new law, the district legislatures (*Dewan Perwakilan Daerah* or DPRD-II) are established as political institutions separate from district government. They have the duties to legislate, monitor and supervise the executive and channel the aspirations of the citizenry, including the responsibility of choosing and dismissing the executive (*bupati*, *walikota*) without any involvement of central government. The candidate who obtains the most votes is declared the winner and is ratified by the president, who is obliged to approve the legislature’s selection. The executive is fully accountable to the legislature; although in theory coequal, this accountability feature elevates the legislature above the executive. The legislature, in turn, is accountable to the voters every five years. The devolution of power over executive selection and termination was intended to make the executive more attentive to the needs, interests and politics of his jurisdiction. The new laws do not recognize the right of recall, previously held by the party organizations over their representatives in the legislature, which was intended as a protection of free speech and, perhaps, political independence. Unlike the old law on regional government, Law No. 22/1999 more clearly specifies the range of functions over which regional governments have authority. Chapter 11, verse 2 mentions public works, health, education and culture, agriculture, transportation, industry and trade, investment, environment, agrarian (land) affairs, cooperatives and employment. However useful the specification may be, the division of authority between the central government and the regions is open to a variety of interpretations and thus continues to provoke controversy.¹⁰

The new law also improves the qualifications required for regional government executives. The previous law required experience in government, which resulted in priority being given to candidates from the bureaucracy and the armed forces. This requirement is erased in the new law and replaced with a weak residence requirement. Now a candidate must have lived at least one year in Indonesia (for provincial governor) or in the province (for district chiefs, *bupati* and *walikota*).

Article 8 of the new law on regional government explicitly links it with the new law on financial balance. It reads as follows: ‘the authority of the government

which is devolved to the region must be accompanied by the transfer of funds, means and infrastructure, together with human resources appropriate to the authority being transferred.' Several provisions of the financial law are noteworthy. One is the recognition of types of revenues the regional governments are allowed to collect, including their own funds (*pendapatan asli daerah* or PAD) and production sharing tax (*pendapatan bagi hasil* or PBH). The proportion of the tax given to the regions has increased quite dramatically (see Table 3.1). If we focus on the column labeled 'central government' and compare percentages in the 'old' and 'new' columns, we see a decline or decrease in virtually every revenue item. A similar situation obtains with the column 'provincial government,' except for revenues on oil (3 percent), natural gas (6 percent) and reforestation funds (40 percent). Conversely, the 'new' column under 'district government' registers an increase on virtually every type of revenue. The new law provides special autonomy for the provinces of Aceh and Papua, shown in the bottom half of the table. There large increases in the share of revenue go to the provinces which are given discretion over district governments' share. Another provision allows regional government to borrow money from either domestic or international sources with the agreement of the legislature. It seems clear that the law was intended to lessen the dependence of regional governments on subsidy from the center.

PROBLEMS IN THE LAWS ON REGIONAL AUTONOMY AND PROPOSALS FOR AMENDMENT

The laws on regional autonomy are a main component of political reform in Indonesia. Although broad and far-reaching in their concepts, they were drafted hurriedly and in the hope that both the expected and unanticipated problems to emerge would be manageable or correctable. But the new laws have provoked intense, widespread and surprisingly comprehensive debate.

In order for Law No. 22/1999 to take effect, a large number of implementing regulations had to be issued. This process proved to be both drawn out and controversial. Arguments arose relating to the lack of hierarchy between authorities, the relative authorities of the DPRD and the head of the region (*kepala daerah*), the powers of local authorities to introduce taxation, the validation of new regional regulations, the arrangements for cooperation between authorities, the management of natural resources and its impact on the environment, the powers relating to ports, airports and maritime questions, the recruitment of civil servants at regional level, and a wide range of other issues. The definition of minimum service standards proved to be a lengthy exercise in which suspicions arose that some central government sectoral ministries were attempting to retain decentralized powers.¹¹

Table 3.1 Comparison of the old and new central–local government revenue sharing

Local revenue items	Central govt		Provincial govt		District govt		All district govt in the same province		All district govt in Indonesia	
	Old	New	Old	New	Old	New	Old	New	Old	New
Land and building tax	19	9	16.2	–	64.8	90	–	–	–	1
Land and building entitlement fees	–	16	–	–	–	80	–	–	–	4
Forestry licenses	30	20	56	16	14	64	–	–	–	–
Forestry	55	20	30	16	15	32	–	32	–	–
General mining (land rent)	65	20	19	16	16	64	–	–	–	–
General mining (royalty)	30	20	56	16	14	32	–	32	–	–
Fishery	–	20	–	–	–	–	–	–	–	80
Oil	100	85	–	3	–	6	–	6	–	–
Natural gas	100	70	–	6	–	12	–	12	–	–
Reforestation funds	–	60	–	40	–	–	–	–	–	–
Oil	100	30	–	70	Aceh provincial government will decide the allocation for each district					
Natural gas	100	30	–	70						
Oil	–	50	–	50	Aceh provincial government will decide the allocation for each district					
Natural gas	–	50	–	50						

Fishery	-	20	-	80	Papua provincial government will decide the allocation for each district through Perdasus
Forestry	55	20	30	80	
General Mining	30	20	56	80	
Oil	100	30	-	70	
Natural Gas	100	30		70	
Oil		50	-	50	Papua provincial government will decide the allocation for each district through Perdasus

Source: Compiled by Anies Baswedan using Shah, Anwar, 1994; UU No. 25/1999, Perimbangan Keuangan Antara Pemerintah Pusat dan Daerah; UU No. 18/2001, Otonomi Khusus Bagi Provinsi Daerah Istimewa Aceh Sebagai Provinsi Naggroe Aceh Darussalam; UU No. 21/2001, Otonomi Khusus Bagi Provinsi Papua.

In January 2002 the Ministry of Home Affairs proposed revisions to Law 22/1999 that have been strongly attacked as an attempt to re-centralize and return to authoritarianism. The latter criticism usually mentions Article 41 that gives the president the power to dissolve a regional legislature. Some observers, however, argue that the overall effect of the proposal is less re-centralization than a shift of power from the elected members of the regional legislature to the (indirectly) elected Head of Region and his/her officials (i.e. executive).¹² If one of the problems with the original (UU 22/1999) has been that some regional legislatures have misunderstood the nature of their relationship to the regional executive, the elucidations to the draft revision offer questionable solutions. They reject the concepts of 'legislative,' 'executive' and 'judiciary' which are used universally in specifying the relationships among the components of democratic regional government,¹³ deny the legislature's roles of supervision and oversight¹⁴ and give unclear power to the head of region to formulate regional policies.¹⁵ A more logical (and simpler) solution would be to clarify the actual powers of the legislature. Another example of shift of power to the executive is the contention that the legislature's funds are part of the regional government budget and therefore not independent (Article 25). But there would seem to be better ways to control budgetary irresponsibility.

A second tendency in the proposed revisions is for major and potentially sensitive areas to be left to subsequent clarification by government regulation. A case in point is the provision for withdrawal of regional powers in the event a region fails to undertake obligatory functions (Article 14). Both the criteria for judging regional failure and the process for carrying out a withdrawal are left up to a government regulation. Another example concerns the mechanism for recalling a member of the legislature (Article 21). Once the required signatures have been obtained, the process is left entirely to government regulation. A step which has such significant implications for the status of elected representatives should be further defined in the Law itself.¹⁶

In any event, on May 29, 2002 the government announced that revisions to the law had been postponed.¹⁷ Then on January 9, 2003 a government official reaffirmed its commitment to a partial revision of Law No. 22/1999, indicated that discussion of revisions with the House of Representatives (DPR) was scheduled for late 2003, and that it would include the introduction of direct election of heads of regional governments (i.e. governors, regents and mayors).¹⁸

CONSTITUTIONAL AMENDMENTS AND OTHER LEGISLATION

Despite the concessions by the central government as represented in the laws on regional autonomy, many regions remained dissatisfied because they believe that their autonomy was based only in laws that could be rescinded at any time by a decision of the central legislature and the president. Hence pressure mounted for the decentralization of power to be enshrined in the Constitution, making it harder to reverse in the future. When the sovereign Assembly (MPR) met in its annual session in August 2000, it amended Chapter VI of the Constitution on regional authorities in ways that captured the spirit of the laws on regional government and financial balance.

Known as the Second Amendment, several aspects of the amendment are of particular interest here. One is the strongly regionalist character conveyed by

the principle that regions may act on any subject that is not reserved by law to the central government. There is a constitutional provision for special legislation and/or special status for particular provinces. There is a requirement for justice and equity and regard to local distinctiveness and diversity in the financial arrangements for regions.¹⁹

The amendment also stipulates that regional executives be democratically elected, with the precise method (direct or indirect) to be determined by law. The alternative of enshrining universal direct election of regional executives was not accepted, although the special legislation for Aceh passed by the House provides for direct election of these positions.

The Assembly also passed MPR decree IV/2000, entitled 'Policy Recommendations in Implementing Regional Autonomy.' This decree criticized the central government for failing 'to view the implementation of regional autonomy as a constitutional mandate so that the decentralization process has tended to become bogged down.' It noted 'wide discrepancies exist between the center and the regions and among the regions themselves in respect to the control of natural resources, cultural resources, economic infrastructure and the quality of human resources' and that 'the interests of various parties obstruct the implementation of regional autonomy.'

To remedy these weaknesses, seven recommendations were addressed to the government and the House. One of them was the instruction to issue all remaining implementing regulations to the laws on regional autonomy by the end of December 2000. If this was not done, then regions that were fully capable of implementing autonomy were free to produce their own regulations. Also recommended was justice in financial equalization among regions and the possibility of using the local profits of state-owned enterprises in

regions where natural resources are limited. The decree also recommended the development of regional autonomy master plans in each region to define the process of transition, the establishment of coordination teams in each region to smooth the implementation of autonomy and a requirement for a fundamental (medium-term) review of the two laws on regional autonomy to bring them into line with the amended Constitution, especially in relation to the hierarchy between different levels of regional government, something that had been specifically rejected in Law No. 22/1999.

The Assembly convened for its next annual session in November 2001 and enacted the Third Amendment to the Constitution which 'addressed and provided answers to a large number of the questions relating to the structure of the Indonesian state.'²⁰ Especially relevant here was the decision to establish a second, regionally based chamber of the national legislature, the Regional Representatives' Council (*Dewan Perwakilan Daerah* or DPD). Its members will be elected as individuals, not openly linked with any political party, from every province through the general election. The total membership of the Council may not exceed one-third of the House (currently 500), and each province will have the same number of representatives. The Council may propose to the House bills related to regional autonomy, center-regional relationship and financial balance, and management of natural resources. It also has the duty to provide consultation to the House over bills on the state budget and on draft laws relating to tax, education and religion. It has no role in foreign policy, defense or security. It is, thus, a minor chamber and not analogous to the US Senate. Further statutory definition of this body is underway and is expected to be completed in time for the 2004 general election.

The Third Amendment clarified that the state will be structured as a conventional presidential system, which has implications for decentralization. By providing for a direct presidential election, the amendment creates political pressure to elect governors, regents and mayors directly as well. Recall the announcement, mentioned earlier, that the government will propose revisions of Law No. 22/1999 to the House in late 2003, including direct election of regional executives.

Another article in the Third Amendment with implications for decentralization states, 'all taxes and other levies for the needs of the state of a compulsory nature shall be regulated by law' (No. 23A). This article arose out of concern that a brake was needed on regions becoming too liberal in levying charges and retributions.

In the internal organization of the Assembly, as was previously noted, regional representatives (*utusan daerah*) have always been denied their own faction. But in 1999 during the first post-Suharto meeting of the Assembly, regional representatives began to press for their own faction as a way of

increasing their influence. They finally prevailed in the 2001 annual session of the Assembly on condition that regional representatives relinquish their connections with political parties and agree that the regional representatives faction would not be entitled to its own deputy speakership of the Assembly.

At its 2002 annual session, the Assembly ratified another round of changes, collectively known as the Fourth Amendment. Perhaps most noteworthy was the decision to abolish all appointed seats in the legislatures including, *nota bene*, those of police and armed forces after the next general election in 2004. Further, the Assembly reached agreement on the role and composition of the Assembly which henceforth will consist entirely of the two chambers, the House of Representatives and the Regional Representatives' Council. A final change with implications for the regions pertained to rules governing the election of the president and vice president. The winning pair must have 51 percent of the votes cast as well as at least 20 percent of the vote in half the provinces.

Since the passage of the laws on regional autonomy in 1999, an issue that has periodically occupied the attention of central government has been the establishment of new regions (*propinsi, kabupaten, kota*). Five new provinces and hundreds of districts (*kabupaten* and *kota*) have been created from existing provinces and *kabupaten*. Most of the bills creating these new regions were initiated by the House to accommodate political aspirations of local elites and new power linkages for national political actors.

EXPLAINING INTERDISTRICT VARIATION

Why have political reform, decentralization and good governance reforms progressed further in some districts than in others? What is the source of demand for decentralization? Are the sources mainly political or economic? These questions intrigue us but answers are elusive and tend to be highly localized and idiosyncratic. Both policy makers and social scientists are in need of more generalizable knowledge that holds with high probability across districts (nationwide). But lacking appropriate and comprehensive information that can be systematically analyzed, we tend to fall back on anecdotes or (deductive) theorizing, neither of which are very reliable. In the remainder of this chapter I want to suggest some tentative answers to these questions that are suggested by recent empirical research, including my own analysis of available, district-level quantitative indicators as well as observations from field work in West Sumatra, Riau and East Java carried out in August 2002.

Administrative Decentralization (Deconcentration) and Democratic Decentralization (Devolution)

In 1995, the New Order government undertook the Pilot Regional Autonomy Project (*Proyek Otonomi Daerah Percontohan*, PODP), considered by some to have been its most significant attempt at administrative decentralization.²¹ Under this project, one district from each of the 26 provinces was selected for participation on the basis of logistical convenience (for monitoring purposes), their representation of a reasonable mix of local situations (e.g. poor and rich) and of advice of governors.²² What are the administrative, economic and political legacies of this project?

One method of answering this question is to divide all districts into two groups (PODP districts ($N = 26$) and non-PODP or other districts ($N = >265$) and then compare them on several indicators (see Table 3.2).

Table 3.2 Comparison of PODP and other districts on selected indicators (averages)

Indicator	PODP districts ($N = 26$)	Other districts ($N > 265$)
Electoral support for Golkar (%)		
1992	76.6	73.2
1997	82.4	79.0
1999	33.8	28.3
The effective number of parties		
1992	1.66	1.77
1997	1.44	1.55
1999	3.96	3.97
Fiscal decentralization ^a (%)	29.7	28.7

Note: ^a Percentage of total district government revenue obtained from local sources (excluding subsidies, contributions and loans), average for IFY 1994 and 1995.

Source: BPS, *Financial Statistics of the Second Level Local Government, 1994/95–1995/96*.

As a group, the PODP districts were slightly stronger in their support for the Golkar political party across all three general elections.²³ That support jumped between 1992 (prior to PODP) and 1997 (two years after PODP began) in both groups, so there does not seem to be any basis for inferring

that the PODP affected support for the political party associated with the government, Golkar (*Golongan Karya*). Another indicator that can be calculated with the election results is the 'Effective Number of Parties'.²⁴ It was lower for PODP districts in the 1992 and 1997 elections compared to non-PODP districts. Also, the effective number of parties declined in both groups of districts between 1992 and 1997.²⁵ Thus administrative decentralization in the PODP was accompanied by higher support for Golkar and less electoral pluralism. More generally, we find evidence of an inverse relationship between administrative decentralization and electoral pluralism under the previous New Order government. In the 1999 election, whatever differences existed between the two groups of districts in electoral pluralism were swept away as the effective number of parties more than doubled to near four (3.96 and 3.97).

My earlier argument will be recalled about three analytically distinct components in the definition of decentralization (see Note 2). Here is a case that demonstrates the utility of that distinction; under the previous New Order government, administrative and political decentralization were different phenomena. The former did not lead to the latter; clearly administrative decentralization is compatible with either authoritarian or democratic governance. Notice also the indicators of fiscal decentralization. Contrary to expectations that PODP districts had greater fiscal autonomy, there appears to have been little difference.

The Sources of Demand for Decentralization and Good Governance

One of the most urgent and interesting questions about Indonesian political reform since 1998 is, why have decentralization and/or good governance reforms progressed further in some districts than in others? From a variety of reports on recent research in Indonesia and my own interviews conducted with district executives, legislators and NGOs (including reporters) in the provinces of West Sumatra, Riau and East Java during August 2002, the following factors seem to be influential.

Administrative and fiscal decentralization

- a. Leadership of district executives. Whether or not decentralization in an administrative or fiscal sense has progressed depends heavily on the interest and commitment of regents and mayors. They set the tone for the governmental apparatus over which they have authority.
- b. Wealth and natural resources. Interest in decentralization is greater and implementation of decentralization has progressed farther in wealthy or natural resource-rich regions. In these regions, government officials and

civil society leaders want to retain a larger share of what they have or produce. A corollary is that the greater the proportion of non-routine (development) expenditures in a district government's budget, the greater the interest in and implementation of decentralization. Conversely, in those areas where routine (i.e. salary) expenditures are higher, officials' overriding concern tends to be maintaining or increasing central government's subsidy for routine expenditures

These findings echo those of the first Indonesia Rapid Decentralization Appraisal (IRDA):

Financial resources and executive leadership are the most important determinants of whether local governments are coping well under difficult circumstances and improving the overall quality of governance and public services that people demand.²⁶

Democratic (political) decentralization

- a. Land and labor. In Indonesia, public demonstrations (political contestation) more often concern land (in rural areas) and labor (in urban areas) than the delivery of government services.
- b. Popular participation affects decentralization. Contrary to the finding of some of the comparative literature (e.g. Manor, 1999) that a well designed devolution of authority can stimulate popular participation and good governance, Indonesia's experience reflects a different pattern. Regime change and explosion in the demand for participation and good governance (*reformasi*) occurred prior to (and largely independent of) the new policies on decentralization.²⁷ Suddenly, district government officials find themselves under scrutiny, being held accountable more than ever before. As noted in the first IRDA, local media play a significant role in increasing the awareness of the citizens about their right to participate in governance; civil society groups are demanding more open dialogue and consultation about budget allocations; and they have taken the initiative to try to participate, such as in drawing up development and strategic plans for districts. Why the media and civil society groups are more assertive in some districts than others depends heavily on the following factor.
- c. Relative economic and political strength of the private sector. It is frequently argued that, in a democratic society with a market economy and vibrant private sector, the stronger will be the pressures for decentralization and good governance. The theoretical reasoning goes something like this: the higher the level of economic development, the greater the role of private entrepreneurs in the economy and the less dependent they are

likely to be on the government, and the more pressure they will exert for political reforms and good governance.²⁸ Searching for empirical evidence pertinent to these hypotheses within the constraints of data availability, I found that a (Pearson's) correlation coefficient of 0.19 obtains between the level of economic development (GRDP per capita) and the extent of electoral pluralism (the number of effective parties).²⁹ There are also significant, positive correlations between economic development and the support for each of two 'pro-reform' political parties in the 1999 general election: a coefficient of 0.20 between development and support for the Indonesia Democratic Party of Struggle (*Partai Demokrasi Indonesia Perjuangan* or PDI-P) and a coefficient of 0.19 between development and support for the Nation's Revival Party (*Partai Kebangkitan Bangsa* or PKB). Adding further evidence was a negative coefficient between development and support for Golkar (-0.28), the old, 'status quo' party. Thus all these correlation coefficients lend support to the hypotheses already mentioned that in districts with higher economic development, support for political reform is higher as well, including decentralization and good governance.

CONCLUSION

This chapter has shown that decentralization is tied up with the major political reform agenda. Thus any analysis of decentralization faces the challenge that it is being implemented (or revised) simultaneously with a major overhaul of the entire regime. The previous New Order is giving way to a more democratic regime in a wide variety of dimensions. While this makes speculation on the future risky, it seems safe to predict that decentralization and good governance reforms will continue to be intertwined with the broader political reform agenda and that they will advance or decline in tandem.

In the three years since 1999, there appears to be growing concern about the 'disconnection' between democratization and decentralization (regional autonomy). The roles and responsibilities of parties, executives and legislators in the newly designed sub-national institutions seem unclear or poorly understood. Instead, the major dynamic in their interrelationship is collusion to protect their interests and enrich themselves.³⁰ There are calls for further reform, including direct election of district executives and switching to a district plurality electoral system for the election of legislators – both proposals intended to make politicians more accountable to citizen-residents.

As this chapter went to press, the House of Representatives was debating several bills that would affect the institutions of democratic representation and governance and provide the legal framework for the 2004 general election.

The debate on these laws will also have some bearing on decentralization since it

will sharpen local politics in the run-up and aftermath of the election, particularly on the issue of how local concerns can be accommodated in the political campaigns, how candidates for the DPRD will be selected, how those candidates will be elected, and the relationship between the legislative members and their political parties.³¹

As we attempt to comprehend Indonesia's recent political evolution and prognosticate about its future, we encounter a paradox: on the one hand there is undeniable evidence of heightened social conflict, increase in lawlessness, persistent economic stagnation and continued political instability, not to mention the disconnect already mentioned, leading some observers to conclude that Indonesian democracy is a mirage. On the other hand, (central) executive power has been peacefully and constitutionally transferred three times, the military refused to intervene despite provocations, and the (mostly) democratically elected Assembly has made steady progress ever since it was seated in 1999 on major issues of constitutional reform. For example, in 2000 it amended the Constitution to include many of the principles of regional autonomy which underlay the 1999 law on regional autonomy, including the principle that powers lay with the regions unless specifically reserved to the central government. These developments suggest that the conflict and instability that have marked Indonesia during the past three years are less manifestations of democratic backsliding than they are of a second struggle to consolidate and deepen democracy while simultaneously identifying and removing the non-democratic elements from the previous regime.

NOTES

1. For their timely, generous and thoughtful assistance in different but crucial ways, I am indebted to Anies Baswedan, I. Ketut Erawan, Arief Afandi and Adi Abidin. Professor James Alm gave constructive comments on an earlier draft and jointly, with Professors Jorge Martinez-Vazquez and Roy Bahl, provided the invitation and forum for the initial presentation of these ideas.
2. Following Parker (1995) and Manor (1999), I conceive of decentralization as involving three analytically distinct but empirically interrelated modes or processes: (1) administrative decentralization or deconcentration; (2) fiscal decentralization; and (3) democratic decentralization or devolution of authority. Being interrelated, we best not focus on one or two at the exclusion of another.
3. Following Indonesian parlance, I use region (*daerah*) as a general term that refers to either or both of two sub-national levels of the polity, province (*propinsi*) and district of which there are two types, regency (*kabupaten*) and municipality (*kota*).
4. For an analysis of the debate, see my (2000) 'The 1999 Electoral Reforms in Indonesia: Debate, Design and Implementation', *Southeast Asian Journal of Social Science* 28 (2), pp. 89–110.

5. The national leaders of most parties chafed at the district element of the electoral system that effectively reduced their power for two reasons. First, had they strictly followed the Law, the designation of winning candidates would have been an objective, arithmetical exercise and some top party leaders would not have been seated in the House. Second, some parties had specific reasons for taking advantage of the flexibility permitted by the Election Commission in the process of determining elected candidates. For example, in response to the criticism it had received during the campaign for nominating a disproportionate number of non-Muslims, the PDI-P took corrective action. In these ways, then, political imperatives often took priority over following the letter of the election regulations.
6. Under the New Order, over-representation of districts outside Java was a mechanism of Golkar domination. Given the generally lower level of development outside Java, and the central government's control over resources, it was easier for the government bureaucracy to mobilize votes for Golkar outside Java.
7. In order to avoid excessive repetition and wordiness, I will occasionally refer to these as 'the laws on regional autonomy.'
8. Terence H. Hull, 'Striking a most delicate balance', mimeograph, December 3, 1999.
9. Ibid.
10. For example, there are numerous accounts of central level departments arguing that the application of national standards demands the centralized organization of activities.
11. Andrew Ellis and Tony du Sautoy, 'Proposals for amendment of UU 22/1999 on regional autonomy', NDI, March 2002, mimeograph.
12. Ibid.
13. Revisions on UU 22/1999, Elucidations, Draft II, General, second paragraph 5.
14. Revisions ... Elucidations, General, second paragraph 6 and 7.
15. Revisions, Article 20.
16. Ellis and du Sautoy (2002).
17. *Decentralization News*, Issue No. 29, June 7, 2002.
18. *Decentralization News*, Issue No. 38, January 10, 2003.
19. National Democratic Institute, 'Indonesia's Road to Constitutional Reform: The 2000 MPR Annual Session', October 2000, mimeograph.
20. NDI, 'The Fundamental Changes that Nobody Noticed', January 2002, mimeograph.
21. Tasfin Marzuki, 'The Politics of Decentralization', 2002 (processed).
22. Christoph Beier and Gabriele Ferrazzi (1998) 'Fiscal Decentralization in Indonesia', *World Development* 26 (12), pp. 2205 fol. The names of the districts which were selected are listed in PP 8/1995.
23. My focus here is on the inter-column differences (i.e. between PODP districts and other districts), not on differences between rows (elections). This way of comparing controls as it were for major differences between the 1999 democratic election and the two previous ones in 1992 and 1997 conducted by the pseudo-democratic, New Order government.
24. Markku Laakso and Rein Taagepera (1979) 'The "Effective" Number of Parties: A Measure with Applications to West Europe', *Comparative Political Studies* 12, 3-27.
25. This decline provides empirical support for the contention that the 1997 election was less free and fair than the 1992 election. See Chapter 4 in my *Half-hearted Reform* (2003).
26. The Asia Foundation, 'First Indonesia Rapid Decentralization Appraisal (IRDA)', 2002a mimeograph.
27. Law 22/1999 has no specific provision on people's participation in governance.
28. This reasoning may well be based on a dubious assumption, namely, that local business people are not involved in relationships of patronage and corruption with local government officials.
29. Based on gross regional domestic product, 1998, from Indonesia's Ministry of Finance (<http://www.djpkpd.go.id/dp/dau/index.htm>) and on 1999 election returns from Indonesia's General Election Institute ($N = 289$, correlation significant at the .000 level).
30. The Asia Foundation (2002a).
31. The Asia Foundation (2002b).

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4. The policy of decentralization in Indonesia

M. Ryaas Rasyid

BACKGROUND OF THE POLICY

After the fall of Soeharto in May 1998, some significant changes in the Indonesian political and administrative system have taken place. One of them is the shift of policy from a highly centralized system of administration, which had been instrumental in supporting national development for more than 30 years, to a decentralized one. The then rigid and centralized system ultimately proved itself unable to respond to the financial and economic crises that attacked Indonesia from July 1997.

It was interesting to observe the reaction of Indonesian political and economic leaders to the financial crisis in Thailand in early July 1997. Most of them optimistically expressed their assessment that even if Indonesia should be affected by the seemingly unavoidable regional crisis, it would not be as bad as in Thailand. They said then that the fundamentals of the Indonesian economy were strong enough to guarantee our survival. However, this optimism could not be sustained longer than three weeks. When in August 1997 Indonesia got its own turn, it was actually much worse than the Thai experience of weeks before. At that time the rupiah lost 40 percent of its value, and by January 1998 it had lost a staggering 80 percent of its total value. This was a completely unexpected situation, a shock that brought Indonesia into confusion. Frankly such an economic earthquake would destroy the economic structure of any society. It was an embarrassing situation for the government and a source of desperate frustration and fear for the people. In a very short time, hundreds of industries which were dependent on imported materials closed down. Unemployment then became a political hot issue to be used by the opposition to delegitimize the Soeharto regime. Widespread social unrest erupted. Massive anti-government student demonstrations took place almost everyday in Jakarta and other big cities all over the country. Social violence as well as communal confrontation in some big cities, especially in Jakarta, was becoming uncontrollable. Faced with all this, the government could do nothing but try to prevent violence by applying security measures. However, when some students

were killed in Jakarta, a nationwide rejection of the regime significantly emerged. This situation soon brought the once mighty Soeharto down.

This illustration is crucial to explain the background of decentralization policy in Indonesia. The failure of Indonesia's political and economic leaders to anticipate the coming financial crisis, even after Thailand was being affected, and their incapability in managing and finding solutions to the crises, had brought us to a new understanding about our own weakness. We assumed that this failure was mainly caused by the lack of time to observe, learn and understand the global financial and economic tendencies. Our excessively centralized administration had taken most of our time and energy to deal with domestic and local affairs. This was the reason why the central government failed to respond to the crisis in creative ways. On the other hand, regional and local administrations which as a matter of fact only had very limited authorities, and had been for a long period of time put under the patronage of central government, could not be expected at all to help manage the impact of the crises in their own regions and territories.

Therefore, when the new President Habibie came to office, one of the policy priorities he endorsed to the parliament was decentralization. The new concept of regional and local autonomy was introduced, which was intended substantially to empower provincial and local governments.

With this new policy, some elements from the central government in domestic affairs are to be transferred down to the provincial, regent (county), and municipal administrations. Full autonomy is being placed at the regency (*kabupaten*) and municipality (*kota*) levels, while the province is given limited autonomy. Full autonomy means that they enjoy their own discretion to create and implement local policies as far as they do not violate national law and disturb public interests. It is assumed basically that all authorities that by law are not promulgated as the authorities of central and provincial governments become the authorities of local government. The central government representatives to operate at the local level are limited only to military, police, attorney general, religion, and national fiscal policy as well as the judiciary. Limited autonomy means that the authorities of provincial government are limited to what is promulgated in the law and can only make and implement policies in domestic affairs within that limit. At the same time, a wider area for central government operation at provincial level is provided through the principle of deconcentration. Based on this principle, the governor is given status as the representative of central government in addition to his/her position as the head of the region. This is different from the mayor and the regent who, as a consequence of the full autonomy status given to the municipality and the regency, are purely head of their own localities. Under the previous law, namely Law No. 5/1974, the mayor and the regent were also given the status and role as the representatives of central government.

The decentralization policy has reduced the authority of central government and extended the authority of provincial and local governments. In so doing, the provincial and local governments will be able to initiate policies and bring their people into a better life. In other words, they are to solve regional and local problems, which will free central government from spending its time and energy dealing with such problems as had occurred in the past. It is expected that the central government will have more time and energy to deal with globalization, to observe and creatively promote the interests of the country. The central government is also obliged to guard the unity of the country, to maintain national integration, to guide, supervise and control the implementation of decentralization policy. With this formula, it is clear that the implementation of decentralization policy needs a clear vision, strong leadership, and effective supervision as well as political authority from the side of central government.

THE FRAMEWORK OF REGIONAL AND LOCAL AUTONOMY

In principle, Law No. 22/1999 on Local Government determines that except for the authorities in the fields of security and defense, foreign affairs, fiscal and monetary, justice, and religious affairs, all other authorities can be decentralized. The exception then added by this law is that central government is also responsible for making policies to organize national planning and development, allocate financial subsidies to the regions, strengthen the national system of economic institutions and public administration, promote human resources development, control the exploitation of natural resources (including conservation), and determine the use of high technology and national standardization (Article No. 7, Law No. 22/1999).

More specifically Article No. 11 of Law No. 22/1999 determines that the municipality and regency (county) are obliged to execute authorities in the fields of public works, public health, education and culture, agriculture, transportation, trade and industry, investment, environment, land administration, cooperative and labor affairs. All of these need guidelines from central government in the form of government regulations and presidential decrees. Thus any provincial and local regulation pertaining to aspects of public services that are by law put under their authorities should be based on those guidelines. According to Government Regulation No. 25/2000, such guidelines should have been provided before November 7, 2000.

In the context of investment, it is clear in Government Regulation No. 25/2000 that except in the fields of oil, gas and mining materials that contain radioactive components, for which authority to give license remains with

central government, the authority to give licenses for all other fields of investment is in the hands of provincial and local governments. The provincial government has such authority as far as the location of the investment crosses regency or municipal territories. The regulation also stated that all existing licenses and contracts are valid and cannot be interrupted. They are to be respected by provincial and local governments. This gives a very clear and strong guarantee to the investors that regional autonomy will not disturb or burden their existing operations. Not only that, regional autonomy is also to avoid any kind of extra or double taxation on business activities.

In the field of politics, the local legislature is also given full authority in electing mayor and regent. This is quite different from the previous system when such authority was shared between central government and the local legislature. In the past, based on Law No. 5/1974 on Local Government, the provincial and local legislatures could only endorse candidates. It was for central government to decide both about who was going to be elected (normally three from five candidates endorsed by the provincial and local legislatures), and who among the three was to be inaugurated eventually. For that matter, the central government's decision was not subject to the votes received by candidates in the provincial and local legislature. Central government enjoyed discretionary power to apply its own conditions to justify any of its decisions. This was possible because under the previous system, the functions of the governor, the regent and the mayor were both as the representative of the central government and as the head of the region and locality.

With this new law, local governments are much more independent in electing their own leaders, promoting their own interests, developing their own institutions, initiating their own policies, managing their own financial resources, and mobilizing support from their own communities. Thus what we have here is a new system of governing local affairs, from which people might enjoy more room for developing their capacity and creativity. Under this new system, people could expect that their government would do better at bringing them into prosperity. However, this positive calculation or optimistic view on the issue of autonomy is not without challenge.

For more than 30 years, the centralistic system has affected the institutional formation and bureaucratic behavior of central government and local governments as well. The previous uniformity and hierarchical arrangement of organizational structures and civil service administration, for instance, was believed to be supportive to the principle of the unitary state and therefore consistent with the interest of preserving it. Now this old paradigm has changed. The administration now believes that organizational structures of local government should not be uniform. Every local government is free to develop its own institution building and organizational arrangement to respond to local needs. Civil service administration is also to be decentralized,

so that local government is free to organize its own manpower planning and human resources management.

In addition to the general rules of regional autonomy which are applied to all the provinces, regencies, and municipalities based on Law No. 22/1999 and Law No. 25/1999, there are two provinces, Aceh and Irian Jaya (Papua), which are given status through special autonomy. Within these two special provinces exist organizational arrangements and fiscal policies that are different from other provinces. In Aceh, the existence of the Council of Islamic Scholars (*Ulama*) as a part of provincial government structures is recognized to guarantee that there should be no violation of Islamic law in any policy that is to be passed by the provincial government. In Papua, such an organizational arrangement is also applied to the existence of the Council of the People of Papua, which may be seen as a tribal council since the members of this council are representatives of tribal leadership. This is to guarantee that there should be no policy that might violate the interest of the tribes of Papua being passed in this province. In both provinces we also find a special fiscal policy arrangement under which they receive 70 percent of total income being extracted from their regions. This will make them more able to cope with the need to build social and economic infrastructures.

In order to guarantee the success of policy implementation for regional autonomy, as I mentioned earlier, it needs a clear vision, strong leadership, and effective guidance, supervision and control from central government. Why? Because first this policy of decentralization is initiated by central government, and second because local governments lack the capacity to do all that independently, at least in the initial stages.

THE IMPLEMENTATION: PROBLEMS AND PROSPECTS

From the very beginning it was clear that central government under President Habibie was aware that this changing direction of central–regional–local administrative relations would certainly not make everybody happy. Therefore, two major approaches were applied. First, to persuade every one of the cabinet ministers to accept the reality that central authority in dealing with domestic and local affairs was going to be reduced. Second, to prepare regional and local government leaders to accept new and extended authorities in public affairs. Both are difficult enterprises to undertake. However, so far as the consolidation for implementing this new policy is concerned, the Habibie administration did well. With the assistance of some international agencies, especially GTZ of Germany and USAID, it had been successful in reaching consensus among the cabinet members on the list of authorities that are going to be placed at central and provincial government level, while

assuming that all others, which are not on the list, should be the authorities of local government. This material then was used as the main source in the drafting of what was later known as Government Regulation No. 25/2000.

When Abdurrachman Wahid was elected to replace Habibie in October 1999, Wahid moved ahead with a policy to form a new portfolio in his first cabinet to deal with decentralization, namely a State Minister for Regional Autonomy. I was appointed to take the job. For 10 months, this ministry worked all out to consolidate both central and regional as well as local resources for the implementation, which planned to follow three steps, that is: first, preparation of regulations needed to support the policy; second, institution building and reallocation of civil servants; and third, fiscal decentralization, and redistribution of assets.

Government Regulation No. 25/2000 enacted in May 2000, defines very clearly the authorities of central and provincial government in the context of regional autonomy policy. It was also considered as an umbrella for hundreds of technical guidelines that should be provided by all central institutions. The provincial and local government need such guidelines as reference points for them in the process of making provincial and local regulations in all fields of public services. At least 197 presidential decrees are needed to support the implementation, which according to Government Regulation No. 25/2000 should all have been passed in November 2000.

The institution building involved the processes of downsizing central government structures and creating a more effective organization at provincial and local levels. Both had been principally completed in December 2000. In August 2000, central government liquidated 11 ministries and in December 2000 it passed Government Regulation No. 84/2000 on the organizations of provincial and local government. The reallocation of about two million central government officials who have been working at various central agencies in the provinces, regencies, and municipalities was done at the end of January 2001. It was not so difficult to manage this personnel policy because basically there were no physical movements involved. The officials remained in their existing jobs, working in the same place and offices. Only the status of their offices was changed from central representatives to regional or local agencies. The redistribution of assets (offices, vehicles, and others) was also completed in the middle of 2001.

Fiscal decentralization came into force from January 2001. Central government allocates 25 percent of national income from domestic sources to be put in the general allocation of funds (Article No. 7, Law No. 25/1999), for which distribution is based on the consideration of five main factors: number of population, size of territory, geographical location, level of income, and natural resource potential. Some corrections are to be made on the way, I believe, since the formula that is being used has been potentially in conflict

with the real needs of some regions and localities. There are cases where we find excessive allocation in some regions whereas in others the allocation is far less than their basic needs. In addition to the general allocation, there is a smaller amount of funds provided to support specific projects in some selected regions. This is called Special Allocation and mostly targeted to help some regions and localities improve their services in the field of education, health, environment, transportation, water supply, and so on. Normally this special allocation goes to poorer provinces. However, special allocation is also used for funding post-social violence rehabilitation of infrastructures in some regions, such as Central Kalimantan, West Kalimantan, Central Sulawesi, Maluku and East Nusatenggara.

Both general allocation and special allocation of funds are subsidies from central government to support provincial and local government activities. For the general allocation fund (DAU) most of the funds (90 percent) are transferred down to the local government. Only 10 percent of the allocation is transferred to the province. This is confusing since the DAU grants are conditional.

Regional and local income are extracted from local taxes and revenue sharing received from some sources, such as property tax (10 percent national: 90 percent local), income from productions of forestry, general mining (non-oil and natural gas), and fisheries (20 percent national:80 percent local), income from the production of oil (85 percent national:15 percent local) and natural gas (70 percent national:30 percent local).

The main problems we face in the process of implementation are: first, from the central government side, the slow move of central government in preparing regulations and technical guidelines, and the reluctance of some ministers to share and decentralize their authorities. This makes central government looks unsupportive, half-hearted and inconsistent in implementing its own policy of decentralization. Second, from the regional and local government side, the lack of qualified human resources in the bureaucracy, low capacity of regional and local legislative members, and lack of funding sources to support their development projects. Most of them are still dependent on central subsidies.

In August 2000, after being removed from the Ministry of Regional Autonomy (the ministry was integrated into the Ministry of Home Affairs) to become Minister of Administrative Reform, I reminded President Wahid and the then Minister of Home Affairs Suryadi to pay attention to the need to provide guidelines for the implementation of the decentralization policy. I informed them that more than 100 presidential decrees are to be promulgated and it was the job of Minister Suryadi to coordinate other ministers and central agencies to work on this purpose. However, there was no positive response from any of them. In fact, it was President Wahid himself who one

time in December 2000 asked me to draft a presidential decree for the delay of the implementation that had been planned to be fully effective in January 2001. I refused to follow the order by reminding the President that half of the policy had been implemented since January 2000. What we were going to implement in January 2001 was fiscal decentralization, reallocation of civil servants, and the redistribution of assets. These three aspects were included in the Letter of Intent with the IMF, and I believed that once we tried to slow down the implementation we would instantly create suspicion from local and provincial government. After a short discussion, President Wahid backed off and hesitantly said that the implementation should be carefully managed.

Later on I realized that the President's idea was coming from some ministers, including Minister Suryadi, who considered the policy as a threat to their own departmental interests. One piece of evidence can be seen through the enactment of a presidential decree in January 2001, initiated by Minister Suryadi, which determined the delay of decentralization in the field of land administration. The delay was valid for two years. This move not only violates the grand rule in which a lower legal instrument (presidential decree) cannot change a higher one (law and government regulation), but also makes it difficult for the Minister of Home Affairs to coordinate and persuade other ministers to devolve their authority. This, in my observation, has been one of the reasons why until today most of the presidential decrees needed to support implementation, which were supposed to be initiated by every one of the ministers under the supervision of the Minister of Home Affairs, have failed to come into existence.

On the other hand, some of the provincial and local governments, after waiting long enough for the guidelines but failing to receive them, have gone ahead with their own way of interpreting Law No. 22/1999, Law No. 25/1999 and Government Regulation No. 25/2000. This has produced a lot of controversies, because with the lack of guidelines, leadership, supervision and control from central government, the provincial and local regulations might easily entrap themselves into potential conflict with the interests of central government. And that is what happens today. It is not a surprise to see hundreds or may be thousands of new licenses in the fields of mining, forestry, fishing, and trading given by the provincial and local government that might be in violation of existing law in their respective fields. At the same time, departing from a simple understanding of autonomy as an opportunity to generate more funds for the regional budget, many of the provincial and local governments have passed new extractive (nuisance) regulations. Only in early September 2001, the Indonesian Chamber of Commerce made a public statement about the existence of more than 1000 local and provincial regulations in the field of extraction (local taxes) that have caused high costs for production and therefore discourage investment. This is definitely a

deviation from the principle of autonomy, which among other things is providing a better climate for investments. This happens because of the lack of understanding of some local elites on how the autonomy is to be implemented.

In responding to this issue, the new Minister of Home Affairs, General Hari Sabarno, instantly declared the government's intention to revise Law No. 22/1999. This is another misunderstanding on the part of central government. He failed to see that the incapability of local elite to implement the policy was also caused by the lack of dissemination of information to the public, and the absence of internalization and supervision to those elites, all of which are the tasks of central government.

The persistent central government campaign for the revision of Law No. 22/1999 is now considered one of the hottest issues in Indonesia. It is true that the MPR itself has determined the need to initiate an intensive study to look at the possibility of revising the law in accordance with the amendment of Article No. 18 of the 1945 constitution. However, it should be very clear to the public what articles of the Law No. 22/1999 need to be revised. If the revision means a recentralization move, I have no doubt that it will create very great tension between central and provincial as well as local governments. Unfortunately, up to the time I prepared this chapter, central government has never explained to the public what articles that are going to be revised, why, and what kind of new formulation it is going to offer.

The Association of Regents and the Association of Mayors are firm in their statement that it is not proper to do the revision now due to the fact that the law has only been in place less than two years. What they need at this stage is supervision, not revision. They demanded that if the central government is persistent with its revision agenda, they should have been invited to discuss the idea. However, in responding to this demand, Minister Hari Sabarno stated that there was no need to involve them in the revision process. He accused both associations of playing politics and therefore he suggested they should go to the parliament if they have any objection of the revision. In other words, they have to wait until central government submits the draft for revision to parliament before being given opportunity to participate in the discussion.

In dealing with the issue of provincial and local regulations that are considered in violation to the law, it could have been avoided if the central government consistently fulfilled its obligation to provide guidelines to supervise and control the implementation. Even after the enactment of all those 1000 provincial and local regulations, central government still has the authority to invalidate them. In other words, if central government does its job well, the implementation of decentralization policy will be successful in reaching its destination to maximize public services at provincial and local levels.

Based on this brief description I may conclude that the prospect of decentralization policy in Indonesia can only be bright if central government is willing to strengthen its leadership, maintaining its commitment to continue supervising the implementation, correcting some of its unnecessary and improper decisions, and consistently preparing all the regulations and technical guidelines for local government. If not, I cannot imagine how messy the relationship between central and local government would be. The mood for autonomy is now very high in almost every region and locality, and therefore the central government should manage this policy carefully and consistently.

PART II

Expenditure and Tax Assignment

5. Expenditure assignment under Indonesia's emerging decentralization: a review of progress and issues for the future

Paul Smoke¹

INTRODUCTION

After decades of operating a highly centralized system, the government of Indonesia (GOI) embarked on a substantial program of decentralization in the wake of the financial and political crisis that emerged in 1997. Law No. 22 laid out a broad framework for general administrative and political decentralization, and Law No. 25/1999 (supplemented by Law No. 34/2000) outlined a system of fiscal decentralization. These laws particularly focused on defining a stronger role for local governments, or regions (*kotamadya* and *kabupaten*, the former Level II regional governments) as opposed to provincial (former Level I regional governments).

Indonesia has struggled during the past few years to move forward with the detailed design and implementation of the decentralized system outlined in the 1999 decentralization laws. One key issue is clearly identifying the set of functions that local governments can and should undertake – the so-called 'expenditure assignment' question. This chapter very briefly reviews relevant conceptual principles of expenditure assignment, summarizes the history of expenditure assignment in Indonesia and new arrangements under the emerging situation, and considers a number of outstanding expenditure assignment issues that Indonesia has yet to deal with.

BASIC PRINCIPLES

The conventional wisdom about expenditure assignment among levels of government from the fiscal federalism literature is well known.² Among the broad functions of the public sector – stabilization, distribution and allocation – the

first two are widely considered to be the responsibility of central government. Sub-national governments do not necessarily undermine stabilization, and they could potentially contribute in a positive way, but this would not be an appropriate expectation given the typical characteristics of local revenue and expenditure systems. Sub-national governments can also contribute to intra-jurisdictional redistribution, but there are limits on how far this can go because of the potential effects of significant interjurisdictional tax and expenditure differentials on location decisions. In addition, only central government can alleviate fiscal disparities across sub-national governments.

The fiscal federalism approach gives significant attention to the potentially important role of sub-national governments in allocation. This is considered to be substantial where demand for public services is not uniform across sub-national jurisdictions. Welfare would be enhanced through decentralization because residents in different jurisdictions could choose the mix of public activities that best matches their preferences. This could happen via movement of citizens to their preferred location and/or the articulation of public service demand through collective decision-making in each jurisdiction.³ Exceptions to the general rule of decentralizing to maximize allocative efficiency include services that exhibit economies of scale in production or that generate interjurisdictional externalities.⁴ Transactions costs involved in service responsibility transfers must also be taken into account.

There is a small literature that considers the extent to which the conventional literature on expenditure assignment, which was developed largely in the context of the United States and other industrialized nations, is relevant in developing countries.⁵ A number of explicit and implicit assumptions underlying fiscal federalism may be violated in some developing countries. The applicability of conventional models of public choice and the existence of an adequate legal basis for an effective intergovernmental system, for example, are among the potential concerns. Even if basic assumptions are essentially valid, local conditions that are fairly common in developing countries can substantially affect the way fiscal federalism principles should be interpreted. Widespread poverty, for example, may make preferences more homogeneous across local jurisdictions, justifying greater centralization. This could be offset, however, by substantial spatial diversity in local environments and economic bases, and/or by the existence of widely dispersed and poorly linked settlements. More generally, a variety of cultural, political and institutional conditions can influence the need and prospects for fiscal decentralization. Since these factors can vary widely across countries and can move the system in different directions, their relative importance must be understood in analyzing a specific case. In fact, it is generally recognized that there is no single best assignment of expenditure functions, and that what is appropriate could vary over time as a country develops.

The principles for assignment of services to local governments as developed in the fiscal federalism literature and summarized here at a very general level are fairly clear, and there is no need to elaborate on them further. Many countries, both industrialized and developing, generally do in fact follow these principles in a very broad way.⁶ A lack of formality and clarity in assignments among levels of government, however, is common in developing countries, and sometimes functions are co-provided among levels in ways that undermine accountability and complicate service delivery. In addition, a number of inefficiencies occur in developing countries with some frequency, such as the centralization of investment authority for services that local governments have operational responsibility for, and central provision of public utilities that are more appropriately sub-national functions. Less common is the practice of assigning major social services to sub-national governments, which is particularly problematic where adequate central financial support is not forthcoming.

OPTIONS FOR APPROACHING EXPENDITURE ASSIGNMENT AND FISCAL DECENTRALIZATION

In the real world, service assignment is not a purely technical matter, and it cannot be separated from the broader process of decentralization. A mature decentralized system has at least six principal characteristics:

- A basic enabling framework that assigns definitive legal or constitutional status to sub-national levels of government.
- Clearly defined functions and responsibilities for each level of government.
- Appropriate local sources of revenue over which sub-national governments are given some control to establish a link between benefits and costs of local services.
- Adequate development of the local political system, such that constituents can place appropriate demands on local governments and hold local officials accountable for their performance.
- Sufficient technical and managerial capacity to allow local governments to meet the legitimate demands of their constituents and any mandates essential to achieve key national objectives.
- An appropriately designed system of intergovernmental relations – including technical and fiscal support mechanisms – to bridge capacity gaps and to provide incentives for local governments to meet their responsibilities.

These characteristics of a decentralized system are, of course, closely interrelated. The principal benefit of decentralization, as noted, relates to the gains inherent in local governments having the ability to be more accurately responsive to the people than central government can be. For this to occur, basic political, fiscal, technical and managerial capacities are required. In early stages of decentralization, few of these features are typically in place in a developing country.

Two basic approaches can be taken to fiscal decentralization. One extreme is to focus on designing the structure and basic elements of the decentralized system – an enabling framework (including borrowing powers),⁷ expenditure and revenue assignments, and intergovernmental relations (including fiscal transfers, technical support and local performance incentives). It is then the responsibility of local governments, presumably under pressure from central sanctions/incentives and the local electorate, to meet the requirements. This ‘sink-or-swim’ approach favors more competent local governments. Weaker local governments may be much slower to meet the basic requirements of the system, and some of them may fail.

An alternative ‘developmental’ approach is to design a deliberate process in which these features of an effective decentralized system are developed together gradually with support from higher levels of government. Critics argue that such an approach requires substantial central capacity, can become excessively bureaucratized, and may be taken over by centralists who want to prevent genuine decentralization. Proponents argue that ‘sink or swim’ cannot work until local governments have reached some threshold level of capacity, and they consider both elaboration of an enabling framework for local governments and creation of a process to develop the capacity of weak local governments as central tasks of decentralization.

In terms of expenditure assignments, the basic normative principles outlined so far are not difficult to apply at the most general level in the context of a particular country (some complications are elaborated later). Similarly, principles of revenue assignment and intergovernmental transfers are relatively clear. Certainly there are trade-offs and complications involved in designing the elements of fiscal decentralization, but the greatest challenges arise in implementation; that is, exactly how and when to share multi-faceted functions and revenues among levels of government.⁸

These implementation challenges are relevant for both the ‘sink-or-swim’ and ‘developmental’ approaches to decentralization. No matter what a constitution or law says or how eloquently it says it, central government agencies rarely desire to decentralize services, particularly if this involves a loss of prestige and resources. Thus they almost invariably try to slow the process down. In addition, the developmental approach specifically recognizes that if too many sectors are decentralized too rapidly to inadequately capacitated

local governments, they will perform poorly. If this happens, central agencies against decentralization can use poor local performance as an excuse for keeping services centralized. Thus a decentralization strategy is critical for expenditure assignment and all aspects of decentralization. We will return to this later in the chapter, but we first outline some specifics of expenditure assignment in the Indonesia case.

A HISTORICAL PERSPECTIVE ON EXPENDITURE ASSIGNMENT IN INDONESIA⁹

Concerns for political unity have historically dominated the design of government institutions in Indonesia, with lower levels of government serving substantially as agents of central government. A number of efforts to delegate some responsibilities to sub-national governments have been instituted over the years through various statutes and regulations. One of the most important statutes prior to the recent 1999 legislation was Law No. 5/1974, which provided a general framework to guide the distribution of functions among levels of governments. The law named 19 functions to be in the local government realm.¹⁰ It also mandated that any transfer of power from the center to sub-national levels had to be specified by parliamentary regulation. Specific regulations to implement this legislation were very slow in coming or never materialized.

Nearly 15 years later, the 1987 GOI policy on urban development declared the provision of urban infrastructure a largely local responsibility.¹¹ Some attempts were made to clarify specific roles where service provision was a shared central and regional function, such as through regulations pertaining to health and public works issued in 1987. Responsibilities for public service provision, however, remained highly centralized, as indicated by the dominance of central government in total expenditures – more than 75 percent in the early 1990s, not including conditional transfers to sub-national governments. In addition, responsibilities varied substantially across different levels in different regions as a result of ad hoc, bureaucratic decisions of central and provincial governments. Some local functions were heavily managed by the center, and analysts argued that public sector accountability was compromised because citizens did not know precisely who was responsible for particular services.¹²

In the early 1990s, additional policy moves again suggested an intended further movement away from a strict view of centralization as necessary to preserve national unity and promote economic growth. There was an emerging perception that the highly centralized fiscal structure was imposing large political and economic costs on the country. Accordingly, Government

Regulation No. 45/1992 was issued to outline a broad framework for the transfer of responsibilities to sub-national governments, with an emphasis on Level II (*kotamadya/kabupaten*) regional governments.¹³

Perhaps the most innovative feature of Government Regulation 45/1992 was its call for a gradual transfer of resources and responsibility to Level II governments. The process was to be managed by the inter-ministerial Regional Autonomy Advisory Board (the earlier version of the present entity of the same name and Indonesian acronym DPOD), in consultation with regional governments and the central agency concerned. The transfer was to be based on a system developed by the Ministry of Home Affairs (MOHA) to assess the capacity, condition and needs of regional governments to assume responsibilities. The resulting ratings were intended to allow for a differentiated and gradual assignment of responsibilities. This approach recognized Indonesia as a vast and diverse country where sub-national governments have non-uniform capacity and interest in assuming new functions. All function transfers were to be accompanied by budget transfers at least equal to current expenditures. This rating process was problematic and did not work as expected, but it did recognize some previously ignored key dimensions and complexities of decentralization.¹⁴

Shortly after the passage of the regulation, the World Bank conducted a study that recommended various services for decentralization to all or selected local governments.¹⁵ Most of the recommendations were never adopted. The GOI moved slowly on developing its own regulations up to the time of the political and economic crisis of 1997, and some expenditure decentralization continued during the 1990s.¹⁶ Revenue collection, however, had become more centralized, and local elections attempting to create a more genuine decentralized system were not held until after the 1999 laws were passed.

THE NEW EXPENDITURE DECENTRALIZATION EFFORTS IN INDONESIA

Law No. 22/1999 prescribes a set of limited functions for both central and provincial governments and establishes a residual structure for functions of local government.¹⁷ Article 11 also names 11 sectors specifically under the jurisdiction of the local governments: public works, health care, education and culture, agriculture, communications, industry and trade, capital investment, environment, land, cooperatives, and manpower.

The provisions of Law No. 22/1999 are, like many similar laws around the world, fairly general. There is a lack of clarity about whether these assigned sectors are truly mandatory. There is no distinction among these 11 sectors, nor is there a range of possible authorities defined within each. Different

levels of government commonly carry out different aspects of many of these sectors in other countries, but the legislation does not provide much guidance on decomposing services into components or sharing them among levels. The idea that all local governments can fully undertake all aspects of all of the listed functions is unrealistic and undesirable. In some sectors, such as public works and communications, services need to be connected to larger networks to ensure the best possible performance. Other sectors, such as health and education, generate externalities and involve certain types of specialized services that typically require some role for higher levels of government. Still other sectors, such as capital investment and industry and trade, usually require some degree of central involvement to meet key national objectives and to reduce possibilities for non-constructive competition among the regions. There is little guidance in the legislation, but subsequent regulations attempt to take some account of these considerations.¹⁸

Other potential risks arise from the lack of differentiation and prioritization of the sectors to be decentralized. For example, left on their own, local governments may choose to focus on functions that generate revenues and neglect those functions that are difficult and costly to discharge. There is also the reality that local governments have very different administrative and political capacities, so that treating them all the same will lead to very different levels of performance, as discussed more fully later. Finally, there has recently been a rapid sub-division of *kotamadya* and *kabupaten*. In the past two years, the number of local governments has increased from 292 to 348. If this continues, it may complicate the process of expenditure assignment.

Since the passage of Law No. 22/1999, the expenditure assignment focus of the GOI has been on two issues. The first is on clarifying in a more detailed way the specific expenditure responsibilities of local governments. The second is on defining minimum service standards for the decentralized sectors. We now turn to a discussion of each.¹⁹

Clarifying Local Government Service Authorities

A number of clarifying regulations and decrees have been issued since the 1999 laws. Government Regulation No. 25/2000 more fully details specific sectors and authorities within those sectors that are the mandatory responsibility of central and provincial governments. Local governments are allowed to assume any unreserved functions. Presidential Decision Memo No. 5/2001 requires the MOHA to implement a process of acknowledgment of authorities by local governments. Under this process, sectoral agencies created model lists of authorities to be undertaken at the local level. Based on the model list, each local government was requested to propose a composite list

of authorities that would become its responsibility. These lists are reviewed, verified and revised by central government, with final acknowledgment by each local government.

Initially MOHA developed model lists of authorities in consultation with relevant sectoral ministries and distributed them to the local governments. This process predated their formal regulatory basis, Presidential Decision Memo No. 5/2001. There was some concern that consultation with the relevant sectoral ministries and guidance provided to the local governments was inadequate. As the local governments began preparing their lists, MOHA began a more formal process to revise the initial agency model authority lists with greater consultation with the sectoral ministries. Revised model lists were issued for each sector, usually in the form of instruction letters from each agency's secretary general, in 2001. Again, there has been some concern raised that MOHA did not provide enough guidance to the sectoral agencies and that the process and criteria by which MOHA evaluated the revised sectoral lists was not very clear.

While this was going on and subsequently, many local governments submitted their proposed lists of accepted authorities and formalized them through the issuance of local regulations. MOHA initiated a process to review these in June 2001 as per Presidential Decision Memo No. 5/2001. Concerns were raised that the submissions from the regions were based on the initial lists prepared largely by MOHA, but they were evaluated against the revised lists later prepared by the sectoral ministries. As of December 31, 2001, 316 of the 348 regions had submitted their lists of authorities. MOHA issued Ministerial Decree No. 130–67/2002 to acknowledge the lists of authorities prepared to date, in some cases with comments requesting changes. A number of problems have been identified with the outcomes.²⁰

- Certain sectors assigned to the local governments remain under the control of the center. A contentious example is land titling.
- A number of sectors are not clearly dealt with in either Law No. 22/1999 or Government Regulation No. 25/2000, so there continues to be debate over how to deal with them. Examples include family planning and the statistics bureau.
- In a few cases, sectoral laws and regulations conflict with Law No. 22/1999. Under the law, for example, capital investment is assigned to local governments, but existing regulations place it under the National Investment Coordinating Board (BKPM). Forestry is an example where the center has passed new regulations since Law No. 22/1999 to define a strong role for itself.
- A number of local governments have included on their list of authorities certain functions that are clearly identified as central authorities.

At the same time, some local governments have failed to include authorities that are supposed to be their responsibility.

Clearly, the process of defining and establishing the details of the authorities to be assumed under Law No. 22/1999 has been fraught with problems. In the haste to move forward with the definition of functions, there was an initial lack of direction from MOHA, and the local governments were asked to develop lists of authorities before models had been properly developed by relevant sectoral agencies. As a result, the local government lists were apparently more inconsistent in content and quality than should be acceptable.²¹ Now more formal model lists of authorities exist, but there is a sense that they are still uneven and have not been subject to clear criteria in being reviewed by MOHA. This negotiation-oriented process (as opposed to a standards-oriented process) has led to some inconsistencies and conflicts between local and national agencies. Some negotiation is inherent in such a process as absolute standards are difficult to define. Adequately detailed standards, however, are needed, and there must be clear rules and procedures to govern the negotiated aspects of the process. Another concern is that there is apparently no legal mechanism to require local governments to take on functions even if they are classified as mandatory by central government. Similarly, it is not clear what local governments can do to ensure that they can claim service authorities that are legally supposed to be theirs.

It appears that there has been and will continue to be additional review and modification of the model authority lists defined by the relevant central agencies for local governments by MOHA and central sectoral agencies. These will form the basis for further interaction with local governments with the goal of getting them to revise their individual lists of authorities. Exactly how this is happening and will continue to happen is not clear from available information.

Defining Minimum Service Standards

In addition to moving forward with defining authority lists for local governments, the GOI has been working on minimum service standards (SPM) for the decentralized services. These were not mentioned in Law No. 22/1999 and do not have a statutory basis, but some analysts argue that they represent a way to more clearly specify and enforce local statutory functions. Government Regulation No. 25/2000 mandates the development and implementation of SPMs to measure local service delivery performance as a responsibility of central and provincial governments.

Government Regulation No. 105/2000 indicates that local government budgets should be performance-oriented and include service standards that permit

measurement of budget performance. MOHA is assigned responsibility for the establishment of a general approach, technical guidelines and reporting procedures for local financial management.²² Government Regulation No. 108/2000 focuses more broadly on the evaluation of local government performance, particularly with respect to the responsibilities of local government heads in managing their responsibilities. The regulation specifically stipulates that performance standards should be developed based on a number of dimensions: impact, use, results, outputs and inputs.

Throughout these regulations, there is not much information regarding the specifics of the proposed standards and exactly how and by whom they should be developed and used. Logically, these standards could serve a number of purposes. First, they can provide some clearer definition to the service authorities discussed. Second, they provide information for planning local service delivery, and by logical extension, a benchmark for monitoring and evaluating service delivery performance. Third, these standards allow central government to weigh in on defining its expectations in terms of national priorities. Finally, the proposed standards provide one element needed for costing services through what the GOI calls standard spending assessments (SSA). These can assist with developing local budgets, assessing budget performance, and providing the Ministry of Finance with better information on which to develop an improved 'fiscal gap' formula for the *Dana Alokasi Umum* (DAU) revenue-sharing program. There is, however, a possibility that the use of minimum standards could lead to an unreasonably heavy demand on DAU funds. Thus the design of minimum service standards must take into account affordability concerns.

The GOI has followed a fairly centralized approach to the development of the SPMs, although there is recognition that standards cannot be uniform nationally because of different characteristics of local governments as well as differences in resource availability across regions and local governments. Thus there is a provision for adapting SPMs to local conditions, capabilities and past achievements. The adjustment of SPMs to local conditions is assigned to the provinces.

The process for developing SPMs to date has been very similar to the approach to service authority lists already discussed. In 2000, MOHA asked the central sectoral agencies to develop SPMs linked to their model service authority lists. As of December 2001, SPMs had been issued through ministerial decrees for agriculture, communications, cooperatives/small enterprises, education, fisheries, health, industry, manpower, public works and transmigration. As of the same date, SPMs for three mandatory sectors, capital investment, environment and land, had not been prepared, but MOHA was continuing to work with the relevant agencies. MOHA has also requested all of the sectoral agencies to continue development of the SPMs.

Many of the same concerns raised about the development of the service authority lists have also been raised about the SPMs. First, MOHA did not prepare technical guidelines for sectoral agencies to use in preparing the SPMs. Second, the submissions of the sectoral agencies were reviewed in 2001 by MOHA without any obvious set of appropriate evaluation criteria. Third, it is far from clear how and on what basis the provinces will be able to adapt the SPMs to better tailor them to differences across local governments, or if they have the capacity and resources to do so.

As a result of the process through which SPMs have been developed, they have apparently ended up looking very different from each other.²³ Some SPMs are general statements of goals, with no attempt to define specific indicators and standards. In other cases, conceptual indicators were developed without attaching quantifiable indicators to them. In still other cases, the standards are highly detailed technical specifications related to inputs that do not necessarily translate neatly to service delivery outputs.

A number of additional concerns have been raised about the SPMs and the process by which they have been developed. They include the following:

- Variability in terms of being based on international standards that are unrealistic for Indonesia versus local standards that may be too low to meet intended objectives. There is a particular concern that failure to attain unrealistically high standards could be used as an excuse for recentralization.
- Lack of clarity about whether the implementation of SPMs will be done nationally and for all sectors at the same time or whether this will take place in stages.
- Lack of attention to the actions that could be taken, if any, in case a local government does not achieve the standards.
- Lack of clarity about if and how SPMs should be adjusted over time to reflect changes in local conditions, budgetary resources and local priorities.
- How SPMs could be used to develop sectoral standard spending assessments to guide budget formulation and monitoring and assist the GOI with further development of the intergovernmental transfer system.

Like the process of developing local government lists of authorities, the process of defining and establishing minimum service standards has been uneven and problematic in terms of both process and results. Much additional work needs to be done to develop an appropriate set of minimum service standards for Indonesian local governments.

OUTSTANDING ISSUES IN INDONESIA'S ONGOING EXPENDITURE ASSIGNMENT

The GOI approach to the expenditure assignment dimension of the ongoing decentralization has centered on the development of local government lists of assigned authorities and minimum service standards. Both of these efforts are important, but both have been problematic, as already discussed, and together they are not sufficient to complete the expenditure assignment task successfully. A number of outstanding issues require further consideration by the GOI. Some of these are specific to expenditure assignment, while others are more generally relevant for the broader process of decentralization. Key considerations include: clarifying the general principles of sectoral decentralization underlying the expenditure assignment process in Indonesia; finding a balance between local autonomy and central priorities in making expenditure assignments; improving the development and use of guidelines and criteria for expenditure assignments; considering the possibility of asymmetric expenditure assignment based on local government capacity; taking into account the need to phase in the implementation of expenditure assignments based on a realistic schedule; and clarifying the role of the center in developing local government capacity to realize the potential benefits of sub-national service delivery, and more generally, fiscal decentralization. Each of these is discussed in turn.

Clarifying General Principles on Sectoral Decentralization

As noted, it does not seem reasonable that all the sectors laid out as the responsibility of local governments in Law No. 22/1999 can be fully decentralized to local level. This is recognized in subsequent regulations, but neither the law nor the regulations has clearly justified the selection of particular sectors for decentralization or clarified the basis for sharing responsibilities within individual sectors. Some formal elaboration of the most important general principles to be followed in making decisions in each sector would be extremely useful. These principles, which should be broader than the fiscal federalism generalities previously outlined, but less detailed than the guidelines that are needed for each individual sector, could be issued by MOHA. Broader deliberation, however, perhaps through DPOD or some other inter-ministerial forum, would be appropriate.

A second, equally critical element of the foundation for expenditure decentralization is a clarification of which services are truly obligatory and which can be provided at the discretion of local governments. There has been some debate on this issue in terms of the letter and intent of Law No. 22/1999, but the law itself is clearly too general to serve as a definitive guide on this

question.²⁴ Some apparently see the development of lists of authorities and minimum service standards as a proxy for establishing obligatory functions, but this is not appropriate. These mechanisms can be used to formalize service assignments and standards, but clearer direction on the specifics of obligatory functions would be desirable prior to the final development of the individual lists of authorities and minimum service standards.

Finding a Balance between Local Autonomy and Central Control

Inherent in decisions about local government expenditure assignment is a need to balance the local autonomy that is supposed to be characteristic of a decentralized system and the need for central government to establish standards to meet national priority service requirements adequately. These issues are particularly important in a developing system where some local governments may be able to adequately define service delivery, and local citizens may be uninformed about their rights as citizens and/or may be inadequately empowered to hold their local governments accountable to them.

It is certainly acceptable international practice for a central government to define obligatory expenditure functions.²⁵ Some local public services generate positive externalities and/or meet national redistributive goals. It is not necessarily reasonable, however, for the GOI to expect all of these obligatory functions to be provided immediately in all local governments on finalization of the local government lists of authorities, as discussed more fully later. The GOI thus faces the choice of whether to prioritize the phasing in of obligatory functions, or, alternatively, to allow individual local governments to exercise some autonomy in deciding which obligatory services are the highest priority among their particular populations. In this regard, it is important to recall that alleged benefits of decentralization are derived substantially from local governments' expected superior responsiveness to the preferences of local people.

Some might argue that allowing for differentiated preferences in a developing country with significant political, administrative and technical weaknesses at local government level is a secondary concern that should only be permitted after all basic obligatory functions that meet national priority needs are being provided. Others might worry that this maintains for a potentially long period of time 'administered' local governments that are more accountable to the center than to their constituents. If a more administered path is chosen, some way of developing accountability to local people must be adopted. Although the adequate delivery of basic services may be a significant enough improvement over the status quo to build the credibility of local governments in the eyes of their constituents, the importance of creating an environment in which citizens more actively engage their local governments cannot be overemphasized. People must learn how to hold their local governments accountable to

them if decentralization is to succeed. It is difficult to see the mechanism for doing this if local services, their levels, and their priority are entirely mandated by central government.

Similar issues arise with the development of minimum service standards. The GOI seems aware of the danger of developing standards that are too high to be met, but the issue of even relatively modest standards for a large number of obligatory functions raises questions about the ability of local governments to meet all of them according to some uniform schedule. It also raises other concerns regarding the degree of autonomy that should be allowed to local governments in modifying standards for at least certain types of services and the extent to which local governments should have discretion to choose at least some of the sectors in which they will first try to meet the standards.

Improving the Use of Guidelines and Criteria

Much of the foregoing discussion on the ongoing experience of expenditure assignment in Indonesia focuses on problems that have arisen because detailed standards were not used in developing model lists of authorities and minimum service standards. Clearer guidelines and criteria from MOHA based on decisions about the general principles advocated here would assist central sectoral agencies to develop more appropriate and fully articulated model lists of authorities and minimum service standards. The sectoral lists of authorities and minimum service standards should in turn provide a consistent and appropriate level of detail to guide local governments in systematically developing their individual lists. These guidelines can also serve as a benchmark against which to evaluate the acceptability of the individual local government lists of authorities and the performance of local governments in meeting minimum service standards. A number of issues are particularly important to take into account in improving and fine-tuning the guidelines.

- *Components of a sector:* Sectors are not single-stage homogeneous entities. In fact, most involve multi-faceted, multiple stage activities.²⁶ For example, providing 'health' includes a variety of activities ranging from simple local clinics to multi-function hospitals. Recognizing detailed sub-components of a sector is important because each may be subject to the limitations of decentralization outlined earlier, such that an individual activity may exhibit economies of scale, spillover effects, or be intended to yield substantial redistribution of incomes or wealth. Furthermore, the technical nature of some service components may be so great as to exceed the capacity that local governments should in

general have or be reasonably expected to develop. Even if many components of a sector meet the test for decentralization, a role for higher levels of government in coordination is extremely important if the components of a service partly spread across levels are interrelated. These factors are important considerations in developing lists of authorities.

- *Capital and recurrent expenditure responsibilities:* A critical dimension of many sectors that merits special mention is capital investment. In some sectors this has historically been a major item funded by substantial resources from both GOI and the international donor community. In considering principles for sharing sectoral responsibilities, it is important to recognize that the separation of capital investment responsibilities from recurrent expenditure responsibilities – whether across levels of government or at a particular level of government – has created problems in many countries. Centrally managed investment, for example, has resulted in a situation in which many completed infrastructure facilities have been turned over to local governments that either did not consider these facilities a priority or did not have the resources and expertise to operate and maintain them. This has certainly been the case historically in Indonesia, where public investment has been centrally driven and central agencies may be reluctant to give up their major responsibilities for infrastructure development. In addition, the ability to provide obligatory local services that meet some minimum standard clearly requires appropriate infrastructure facilities. Thus specific attention to arrangements for development expenditure responsibilities is essential.
- *Type and characteristics of local governments:* *Kotamadya* and *kabupaten* are typically rather different entities. Not only are they likely to have somewhat different general service needs, but appropriate assignments and standards for at least certain services or sub-components of services may be somewhat different between them. Their geographical location in the highly agro-ecologically diverse Indonesian archipelago and their degree of urbanization, among other characteristics, will influence the appropriate mix and level of public services.
- *Intra-jurisdictional differences:* Within a local government, there can be great differences in service needs and appropriate standards, such that a single type of service activity or a single service standard across an entire local government would not be appropriate, at least in some sectors. This is particularly true in a country like Indonesia, which has relatively few local governments for the size of the country and its population. This means that many local governments are large and extremely diverse. Not only can the specific set of appropriate local

services differ within jurisdictions, but the technologies used to provide individual services, appropriate service levels/standards and service cost guidelines can also vary widely. Heavily rural areas, for example, will require fewer and somewhat different services than cities, and even services common to both may have different standards. Equally important, there is a range of other settlement types between sparsely populated rural areas and densely populated metropolitan areas. These factors are relevant in making expenditure assignments and developing minimum service standards. Fortunately, Indonesia has an institutional structure below local government level – *kecamatan, kelurahan, desa* – that can provide a useful starting point for thinking about intralocal government service need differentials. Care must be taken, however, not to be too formulaic, as there may also be differences in needs across each type of sub-local institutions, at least in some local governments.

Available information suggests that none of these aspects of expenditure assignment – components of sectors, capital versus recurrent expenditures, types and characteristics of local governments, and intrajurisdictional diversity – have been adequately and consistently taken into account for all sectors in the Indonesian expenditure assignment process. Fuller consideration of at least some of these aspects would undoubtedly improve the local government lists of authorities and the minimum service standards.

Differential Treatment of Local Governments Based on Capacity

There are great differences among local governments, even among those of a particular type, in their capacity to assume expenditure responsibilities. Normative service assignments can be determined through more clearly articulated guidelines defined on the basis of local authority type and physical characteristics, as suggested, but it is questionable whether actual service assignments should be based solely on these factors. An asymmetric approach based on differential local government capacities would seem to be justified.

There is some broad recognition of the need for differential treatment in the way Indonesia is approaching the definition of expenditure authorities. The lists submitted by individual local governments are based on model lists prepared by sectoral agencies as adjusted to reflect the realities for each local government. As discussed previously, however, it is not clear that the differentiation is based on appropriate and transparent standards that adequately account for different needs and circumstances of local governments and their sub-jurisdictions. Equally important is whether the capacity of local governments to meet their responsibilities has been taken into account. Even if

target expenditure functions and standards are tailored to the conditions of a particular local government, this does not necessarily mean it has the ability to meet these targets. Although it can be politically and administratively difficult to treat local governments of a particular type and other similar characteristics differently, treating those with weak capacity as if they can handle the same normatively desirable responsibilities as stronger local governments invites failure. It is doubtful that this reality has been adequately or systematically considered in developing lists of service authorities in Indonesia, although local governments are allowed to voluntarily surrender to the provinces functions that they find themselves capable of providing. Thus far, this has not happened, suggesting that a different approach to the capacity issue is needed.

Developing a Strategic Process for Implementation

Even if a consensus can be forged on expenditure assignments, and service standards and capacity differences have been taken into adequate account, there is an enormous amount of hard work involved in implementation.²⁷ There appears to have been little consideration of the implementation problem in Indonesia's ongoing decentralization efforts. There are two critical dimensions that need to be considered. First, as suggested, agreeing on service assignments and standards does not mean that they can all be implemented at once. There are issues regarding priorities and sequencing, and there must be rules and a process for determining how to proceed with implementation. Second, there is the issue of capacity highlighted earlier. A local government with weaker capacity is going require a slower and possibly different schedule for phasing in the services it is expected to provide under decentralization and meeting the minimum service standards to which it is subject.

More generally, an effective fiscal decentralization program requires a strategic implementation approach designed to phase in reforms in a gradual, pragmatic way. Initial steps should probably be undertaken in sectors and functions for which rapid success is most likely. This requires prioritizing reforms, focusing on simple tasks that do not overwhelm local capacity. Even if initial reforms are defined modestly, however, they should be based on a broader conception of ultimate public service goals. In some cases, sequencing might need to be based on the most urgent priorities instead of those that are the easiest to implement, although this may risk taking advantage of an opportunity to establish that decentralization can work effectively.

Linking Expenditure Assignment with Other Elements of Fiscal Decentralization

Having argued for a strategic approach to expenditure assignment and implementation, it is important to emphasize that such an approach also requires that the various elements of fiscal decentralization programs be closely linked. These elements, as outlined earlier in the chapter, include not only expenditure assignment but also revenue assignment, intergovernmental transfers, political accountability, and administrative and technical capacity. There are a number of potential concerns in this regard for Indonesia.

- *Local access to revenues:* If decentralization of revenue authority and the development of intergovernmental transfers exceed decentralization of services and the development of service delivery capacity, there is no reason to believe that the revenues made available to local governments will be used effectively. This has happened in many countries. In the Indonesia case, enhancement of local own-source revenues has been modest except for the newly adopted sharing of natural resource based taxes, but there have been extremely generous intergovernmental transfer allocations provided under the DAU.²⁸ There is in fact a concern that some local governments are receiving more grant resources than they can productively use. The DAU is in part intended to be a fiscal equalization program, but developing such a program requires that it be possible to measure both the (reasonable) costs of meeting clearly defined (including affordability) expenditure needs and the revenue capacity of local governments. The development of minimum service standards and standard spending assessments, if appropriately defined and applied, will eventually assist the GOI with quantifying expenditure needs and improving some of the key information required to better target the transfer system.
- *Resources for local public investment:* Although the DAU has sometimes been depicted as a recurrent transfer system, it does in fact incorporate some non-recurrent functions by using former total APBD (budget) data, including routine and development expenditures of the dismantled deconcentrated offices, as one basis for calculating local allocations. This does not mean, however, that these resources are sufficient to cover the capital expenditure needs of local governments, which would need to be defined somehow in a reasonable way. Having taken few steps to develop the *Dana Alokasi Khusus* (DAK – the special allocation fund commonly seen as a way to conditionally or semi-conditionally finance sectoral capital investments), the GOI has not clearly established a transfer mechanism specifically for develop-

ment expenditures. The GOI must decide if the DAU is generally sufficient for both capital and recurrent expenditures.²⁹ If not, developing the DAK should be an important priority. Developing borrowing opportunities for local governments, which are currently very limited in Indonesia, would also provide access to another important source of funds for local governments to use in developing infrastructure. Government policy documents indicate a strong awareness of this need, but there has been little concrete action to date.

- *Local political development and accountability:* Fiscal decentralization mechanisms cannot be expected to work without an adequate degree of local political development and accountability. Educating citizens, elected local government officials and local government staff about their rights and responsibilities is a broader exercise. As noted previously in several places, some local choice in prioritizing expenditure assignments and implementation sequencing can support local political development, although technical support will be required in some local governments.
- *Local administrative and technical capacity:* The importance of taking local government capacity into account in initial expenditure assignments and service standards has already been highlighted. This starting point, however, must be progressively built on, and local capacity – and governance – must also be built up over time to the point where local governments can provide the full complement of local services that meet local preferences and national priorities at the highest appropriate standards possible.

Central government has considerable leverage to encourage the progression of an overall process of decentralization that gradually builds up all aspects of the system. In this regard, the GOI can strategically use access to grants, loans and technical assistance to encourage the gradual adoption of new responsibilities and procedures, the development of political mechanisms, and other key decentralization reforms.

CONCLUDING COMMENTS

Assigning expenditure responsibility, like other aspects of fiscal decentralization, is not just a technocratic exercise. Nor is it a fully political exercise in which the center should negotiate on an ad hoc basis a set of service assignments and standards with local governments. Well-defined technical guidelines for sectoral decentralization and service standards are needed, and GOI could clearly improve on what it has accomplished thus far. There should be

flexibility in the application of these guidelines, but the flexibility should be based on transparent rules and processes that allow for adaptation to the great differences among and within Indonesian local governments. This flexibility, however, should ideally be able to respond not only to the physical and demographic diversity of local governments, but also to their great differences in capacity to assume responsibility for services that would be considered normatively desirable based on other characteristics. In developing these rules and processes, it is important to carefully balance the need for some local autonomy with legitimate national priorities.

One danger of this type of approach is that the assignment of expenditure functions will be statically defined based on present capacities of local governments. Perhaps the greatest challenge for expenditure assignment in Indonesia is how to tie the process into a broader strategy for implementing decentralization. As local government capacity – technical, administrative, and political – improves, greater service responsibilities can be assigned with the expectation of adequate performance. Similarly, as local governments catch up with infrastructure investment backlogs, they should be expected to provide additional services at higher standards. The phasing in of additional responsibilities has obvious implications for revenue requirements, the appropriate structure and allocation of intergovernmental transfers, and the development of better local government access to credit.

This way of thinking about expenditure assignment, and fiscal decentralization more generally, may seem unduly and unworkably complex to some observers. It is certainly more demanding than simply defining normatively desirable expenditure assignments and leaving the local governments to ‘sink or swim.’ It does require central government to think more strategically about how to phase in the implementation of expenditure assignment and other aspects of fiscal decentralization, and it requires a degree of coordination that Indonesia has thus far been unable to achieve.

Some observers might also interpret this gradual, strategic approach as undermining Law No. 22/1999. In reality, it is an attempt to phase in the system outlined in the legislation at a realistic pace. Poor decentralization performance is often the result of giving local governments too much functional responsibility and/or control over resources too rapidly, and without appropriate capacity building and local governance development support from central government. By effectively slowing down the process of fiscal decentralization, this approach reduces the likelihood that some of the worst potential problems of fiscal decentralization will be realized. By providing local governments with support and incentives, it is much more likely to result eventually in a sustainable system that adequately delivers on at least some of the potential benefits of decentralization in most areas of Indonesia.

NOTES

1. I am grateful to Blane Lewis for comments on an earlier draft and to Romolo Isaia for research assistance. I also benefited from the discussions at the conference where this paper was presented, 'Can Decentralization Help Rebuild Indonesia?' sponsored by the Andrew Young School of Policy Studies of Georgia State University in Atlanta, May 1–3, 2002.
2. The theory of fiscal federalism is set forth in detail in W. Oates (1972). A more recent reflection is provided in W. Oates (1999).
3. Decentralization is also desirable because expenditure decisions are tied more closely to real resource costs in smaller jurisdictions, and there are said to be opportunities for greater experimentation and innovation when there are multiple service providers.
4. These should be provided at higher levels, although it is often more practical to pursue alternative policies with the same overall effect, including cooperative agreements among sub-national jurisdictions, or subsidy or regulation by a higher level.
5. Examples include: P. Smoke (1989); R. Bahl and J. Linn (1992); P. Smoke (1994); R. Prud'homme (1995); V. Tanzi (1995); T. Ter-Minassian (1997); R. Bird and F. Vaillancourt (1998); P. Smoke (2001a).
6. A. Shah (1994); E. Ahmad (1995); E. Ahmad, D. Hewitt and E. Ruggiero (1997); J. Martinez (1999).
7. An enabling environment for decentralization can begin with constitutional or legal mandates for some minimum level of autonomy, rights and responsibilities for sub-national governments. This provides a foundation on which to build decentralization, but it does not guarantee that it will be realized. Many countries with constitutional clauses and laws on sub-national government have not managed to decentralize successfully.
8. P. Smoke and B. Lewis (1996); J. Litvack, J. Ahmad and R. Bird (1998); Smoke (2001a, 2001b).
9. Much of this discussion is drawn from: A. Shah and Z. Quereshi et al. (1994); Smoke and Lewis (1996).
10. These included: smallholder agriculture; animal husbandry; inland fishery; small-scale rubber plantations; large plantations; sea fisheries; forestry; education and culture; public health; local public works; small-scale industry; small-scale mining and quarrying; housing; traffic management and transportation; general administration; labor welfare; social welfare; tourism; and local enterprises and projects.
11. Tim Koordinasi Pembangunan Perkotaan (1987).
12. See Shah and Quereshi (1994) for more detailed information.
13. Under the 1992 regulation, the following functions were reserved for the center: (1) defense and security affairs; (2) judicial system; (3) foreign affairs; (4) part of general affairs concerning heads of regions; and (5) other administrative affairs that could be implemented more effectively by the center as compared to other levels of government. All other functions were to be considered for transfer to sub-national governments. The regulation also specified functions for Level I governments: (1) interlocal (Level II) affairs; (2) affairs not central to development of a Level II government; and (3) affairs implemented more effectively and efficiently by Level I as compared to Level II regional government. 'All other affairs' of Level I governments were to be transferred to Level II governments. These regulations obviously left substantial room for interpretation.
14. An alternative interministerial local government rating system was being piloted under DPOD at around the same time, as discussed in Smoke and Lewis (1996). Both systems were reviewed and debated in: C. Beier and G. Ferrazzi (1998); and B. Lewis and P. Smoke (1998).
15. See Shah and Quereshi (1994). A number of services were recommended for assignment to all local governments, including fire protection, local police protection, primary education, refuse collection, neighborhoods parks and recreation, street maintenance, local transit services, traffic management, local libraries, and local by-laws enforcement. In addition, land-use planning and secondary education were recommended for decentralization

to larger local governments, and others were recommended for metropolitan areas (transportation, water supply, sewage disposal, refuse disposal, preventive health, hospitals, electric power distribution, air and water pollution, special police services, special libraries, regional parks, and regional planning). Finally, some functions were recommended for decentralization to provincial governments (college and university education, hospitals, public housing, social welfare, intermunicipal roads, and environmental protection.) Provincial governments were recommended to retain an oversight role for local governments and the central government to continue to develop overall policy and standards for both provincial and local governments.

16. Numbers from the World Bank and the Ministry of Finance indicate that sub-national expenditures as a percentage of total national expenditure grew from 16.62 percent in 1990 to 22.97 percent in 1995 to 27.78 percent in 2001. Over the same period, sub-national revenues as a percentage of total national revenues first rose from 4.69 in 1990 to 6.11 percent in 1995, then declined to 3.39 percent in 2001.
17. There are different views on whether the new system in Indonesia is 'ultra vires' (functions are legal only if legally specified) or 'intra vires' (functions not specifically prohibited or assigned to another level are allowed), also referred to as 'general competence.'
18. It was not possible to review all of the regulations and sectoral lists of authorities prior to drafting this chapter, so I cannot be more definitive on the extent to which these matters are properly taken into account.
19. The information used in this section is drawn largely from: Perform Project (2002); G. Ferrazzi (2002); *GTZ Decentralization News* (April 2002); Donor SPM Working Group (2002); and communications with a number of individuals working on issues related to expenditure assignment and fiscal decentralization in Indonesia.
20. The examples provided here and others are elaborated in Perform Project (2002).
21. Note that this has not necessarily translated into major problems or confusion at local level. In many cases there has apparently been a smooth transfer of functions and personnel from dismantled deconcentrated sectoral offices to local government sectoral departments. That does not mean, however, that the correct functions have been transferred or even that the new lists of authorities have been followed in effecting the transfers.
22. MOHA, however, does not have the power to dictate how regions must manage their finances, so guidelines produced by MOHA are only suggested standards.
23. See Perform Project (2002), Ferrazzi (2002) and Donor SPM Working Group (2002) for more details.
24. See Ferrazzi (2002) for a more detailed discussion of this issue.
25. Article 7 of Law No. 22/1999 gives central government the right to establish national standards.
26. A much fuller treatment of these issues is provided in: L. Schroeder and M. Andrews (2001) 'Sectoral Decentralization and Intergovernmental Arrangements'. Paper prepared for a Symposium on Decentralization and Local Governance in Africa held in Cape Town, South Africa, March 2001. This paper is available from the United Nations Capital Development Fund website (www.uncdf.org) and was printed in 2003 in condensed form in *Public Administration and Development*.
27. Recent attempts to consider the strategic design and implementation of fiscal decentralization programs include: Bird and Vaillancourt (1998); Litvack, Ahmad and Bird (1998); R. Bahl (2000); P. Smoke (2000); and Smoke (2001b).
28. The early experience with the DAU is examined in B. Lewis (2001).
29. This will be difficult to determine until local government expenditure and revenue assignments are more fully clarified and a sense of the recurrent fiscal situation relative to capital investment needs is known. This is far from a straightforward process, but greater progress in this regard is critical if Indonesia is to more fully rationalize its fiscal decentralization efforts.

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6. Local tax revenue mobilization in Indonesia's decentralizing era

Robert A. Simanjuntak and B. Raksaka Mahi

INTRODUCTION

One crucial element of any system of local government is the power to tax the local population in order to finance the provision of local services. Regional governments often regard the proportion of local taxes and charges in their total budget revenue as the main indicator of the degree of local autonomy they enjoy. The larger the taxing power, the larger the proportion of own-source revenue in the total budget, and the more autonomous they are. Nowadays many local government officials in Indonesia share this view.

However, the local tax base in Indonesia has been unsatisfactory for many years; that is, it is not yielding sufficient revenue, or its incidence is perceived as unfair. The evidence presented in Tables 6.1 to 6.3 shows that during the 1990s, for the majority of the provinces, own-source revenue represented less than 30 percent of their total budgets. The situation had been even less satisfactory for districts/municipalities. The implementation of regional autonomy since January 1, 2001 has had practically no effect in this situation. (see Tables 6.1–6.3.)

The local revenue problems can also be seen from the consolidated central and local governments budget. During the 1990s, regional governments raised only about 7 percent of total government revenues, which financed only about one-third of their expenditures. In the first year of regional autonomy implementation (2001), the situation was generally similar, with regional governments raising only about 8.29 percent of total government revenues, while their expenditure responsibilities were about 26.28 percent of total government expenditures (see Table 6.1). Such a gap between regional government revenues and expenditures in Indonesia has been very large; as cross-country studies in the early 1990s showed that sub-national governments in developing countries typically finance around 70 percent of their spending from own sources (Shah and Qureshi, 1994).

Table 6.1 *Indonesia: distribution of regions by ratio of own-source revenues to regional budget (average 1990–99)*

OSR/RB (%)	Provinces	Districts/cities
< 10	3	151
10–19.99	4	82
20–29.99	11	38
30–39.99	6	13
40–49.99	2	7
= 50	1	1
	27	292

Note: OSR = Own-source revenues, RB = Regional budget.

Source: Ministry of Finance.

Table 6.2 *Indonesia: 2001 budget of central and local governments*

Revenues	(Trillion Rp)	Expenditures	(Trillion Rp)
<i>Central government</i>			
Tax	185.26	Own expenditure	258.85
		Routine	213.39
Non tax	100.75	Development	45.46
		Transfers	81.47
		Revenue sharing	20.26
		General grants (DAU)	60.51
		Specific grants (DAK)	0.70
Total	286.01	Total	340.32
Deficits			54.31
Financing:			
Domestic	34.39		
(Privatization = 6.5)			
(Asset recovery = 27.0)			
(Bonds issued = 0.89)			
Foreign (gross)	40.09	Amortization	20.17
Total financing	74.48	Total financing	74.48

Table 6.2 *continued*

Revenues	(Trillion Rp)	Expenditures	(Trillion Rp)
<i>Local governments (provinces, districts and municipalities)</i>			
Tax	15.41	Own expenditure	92.32
		Wages	40.88
Transfers	81.47	Non wages	21.86
Revenue sharing	20.26	Development/investment	29.58
DAU	60.51		
DAK	0.70		
Borrowing	0.49		
Others	9.95		
Total	107.32	Total	92.32
Surplus	15.0		
Asset acquisition			15.0
<i>Consolidated budget</i>			
Tax	200.67	Central govt expenditure	258.85
Central	185.26		
Local	15.41	Local govt expenditure	92.32
Others (non-tax, etc.)	111.19		
Central	100.75		
Local (others + borrowing)	10.44		
Total	311.86	Total	351.17
Deficits			39.31
Total financing	74.48	Total financing	74.48

Source: Ministry of Finance.

This heavy financial dependence of local governments on the center entails adverse implications for the efficiency and accountability of local service provision – which is of course far from supporting the objective of recent intergovernmental reforms to achieve good public governance. Bringing local governments' own revenues into closer conformity with their expenditures raises at least three set of issues: assignment of tax bases between central and local governments; raising more revenues from taxes already assigned to or shared with local governments; and making fuller use of local user charges. This chapter focuses largely on the first two issues.

Table 6.3 *Indonesia: Regional government revenues composition 1999/2000–01 (in billion rupiahs)*

	1999/2000	%	2000	%	2001	%
<i>Province</i>						
OSR	4 338.58	37.22	3 438.79	32.30	5 745.70	32.23
Revenue sharing	2 174.91	18.66	1 697.05	15.94	4 615.34	25.89
Grant transfers	5 143.42	44.12	5 511.59	51.76	7 465.46	41.88
	11 656.91	100.0	10 647.43	100.0	17 826.50	100.0
<i>District/city</i>						
OSR	2 765.39	10.31	2 491.94	9.04	3 844.88	4.99
Revenue sharing	3 324.92	12.39	3 116.98	11.31	17 268.47	22.43
Grant transfers	20 743.68	77.30	21 950.35	79.65	55 883.31	72.58
	26 833.99	100.0	27 559.27	100.0	76 996.65	100.0

Source: Ministry of Finance.

Therefore, reform efforts can either concentrate on searching for alternative additional local taxes to strengthen their tax bases or on improving administration of the existing taxes. They can, of course, seek to do all of these things. However, this does not always produce the desired results since it may be easier to introduce new taxes than to improve the administration of existing ones. The last two years in Indonesia have witnessed many ‘improper’ regulations produced by regional governments with proposals for new local taxes, confirming the willingness of local governments to seek new local taxes rather than making efforts to improve the administration of existing local taxes.

In this chapter we look first at the common criteria or principles for evaluating many forms of local taxes, their advantages and disadvantages, and their application to Indonesia. The criteria will be used to review a rather long list of taxes that have been proposed or are already in use and include regional taxes (provincial and local) as stipulated in Law No. 34/2000, several taxes proposed by local governments through their regulations, and taxes which some government officials and others think suitable as local taxes. Our objective is to seek ways to improve the regional governments’ taxing power that, in turn, could enhance their financial capacities in the longer run.

THE EVALUATION CRITERIA AND TAX ASSIGNMENT PRINCIPLES

In order to judge the potential and performance of taxes, some criteria are needed. These are generally set out under six headings: adequacy and elasticity; equity; administrative feasibility; political acceptability; economic efficiency; and suitability as local tax/revenue (Davey, 1983). These criteria also can be interpreted further as principles to be used for the division of revenue sources among central and sub-national governments.¹ (See Appendices 6.1–6.3 for a discussion and application of these principles.)

Adequacy and Elasticity

The first and most obvious requirement for revenue sources is that they should be adequate to meet the costs of the services which they are intended to finance. However, costs of public services are not static. They typically increase because of several reasons, such as inflation, growing population (especially in urban areas), and rising standards of living that inspire demands for higher standards of services. National development plans often also expect services to be improved and expanded. Therefore, it is desirable that revenue sources should have some ‘elasticity’ so their capacity to yield additional revenue as income expands means they should be able to respond to increasing demands on public expenditure. Also, the tax base should grow automatically when prices rise, population increases, and the overall economy expands.

Equity

A second major requirement is equity – that is, the burden of maintaining public expenditure should be borne by sections of the community somehow in proportion to their wealth. By these standards, taxation is good if it is progressive, which means if the percentage of a person’s income paid in tax increases with the level of his or her income. It is tolerable if it is proportional (i.e. if the percentage of income paid in tax is constant at all levels), but it is bad if it is regressive (i.e. if the percentage of income paid in tax declines with rising income levels).

In terms of local taxation, the question of equity has to be seen in three dimensions. First, the incidence of the tax burden should be equitable between people of different income levels (‘vertical’ equity). Second, it should be equitable between different sources of income; a salaried person should not pay more than one with an identical income derived from business or agriculture (‘horizontal’ equity). Third, the incidence of taxation should be

fair between geographical areas; people should not be taxed more heavily simply because they live in one area rather than another (as may happen on the borders of a town), unless there are offsetting differences in the provision of services.

That is, equity has particularly to be seen in relation to both revenue and expenditure. It may be fair to tax people more highly if they live in an area which has quite an exceptional quality/level of government service. Equity will be worst when people are taxed more heavily in relation to their income and yet have a substandard level of services.

Overall, a progressive tax structure is quite desirable on the grounds of social justice. It means that people in the lowest income groups should be subject to very light taxation or totally exempt. However, this is easier to achieve in industrial (well-developed) economies. In developing (or least developed) countries, where most of the population is in the lowest income range, the tax base provided by the middle- and high-income groups may be too small to finance all required public expenditures.

Administrative Feasibility

Revenue sources vary in the amount of skill, integrity and determination required in their administration. They also vary in the amount of time and money involved in collecting them, compared with their yield. In many developing countries the majority of the population, especially in the cities, are self-employed, or working for small 'informal sector' businesses without clearly assessable income. The administrative costs of assessing and collecting any direct property or income tax from such a population are very high, although the average amount that can be collected per capita may be low. On the other hand, a substantial revenue may be collected through a duty on petroleum, for instance, at negligible administrative costs. In such economies there is a heavy bias of administrative convenience towards dependence on indirect revenues (which can be levied on formal sector commercial transactions through large manufacturers, importers, distributors, etc.). This is not necessarily consistent, however, with considerations of an equitable distribution of tax burdens.

Political Acceptability

No tax is popular. But some taxes are less popular than others. That is why political will is needed to levy taxes (i.e. to decide questions of liability and assessment, to collect them physically, and to enforce sanctions against evaders).

Sometimes political sensitivity focuses on particular questions of social values (e.g. should you tax land, or charge for water), or of sectional interests

(of landowners, civil servants, traders, the military, etc.). More generally, taxes are usually less sensitive politically if they are indirect (thus somehow concealed), and do not involve too many overt political decisions such as parliamentary/council decisions to raise tax rates.

Economic Efficiency

Taxation basically has two purposes: to provide money for public purposes, and to influence economic behavior. Taxes affect the cost of individual decisions. For instance, a property tax affects the profitability of building and renting a house, a sales tax affects the cost of buying a shirt, an entertainment tax affects the cost of going to the cinema. Therefore, taxes must be judged also in terms of their effect on the decisions of a taxpayer, on his or her propensity to work, consume, save and invest.

Economic efficiency criteria are generally more important in appraising national than local taxes. There are two arguments for this. First, it is usually the central government that is principally responsible for overall (macro)economic management and uses taxes to manipulate economic behavior. Second, the scale of local taxes is usually insufficient to make a significant difference to people's choices. However, it must nevertheless be of concern whether local taxes will have a significant effect (harmful or good) on local economic behavior.

Suitability as Local Revenue

Tax administration by local authorities raises specific questions of feasibility. Some relating to the availability of administrative skills have already been raised. Others will be mentioned here. The first is whether it is clear to which authority a particular tax liability is due. Second, and related with the first issue, is whether the feasible point for collecting a tax is necessarily the location where it is effectively paid. The third concerns the feasibility of local variation in tax rates or assessment rules. Ideally a local authority should have discretion to set its own tax rates, to make its own decision on the levels of taxation it raises and of services it offers. Fourth, local taxes, to the maximum possible extent, should follow the 'benefit principle' of taxation: economic efficiency is increased when there is a link between what people pay in taxes and what benefits they receive from public services. This means that local governments should make extensive use of user charges when feasible.

INDONESIAN LAW ON REGIONAL TAXES AND USER CHARGES

During its more than 50-year history, regional taxation in the Republic of Indonesia can be basically divided into three different periods: before the implementation of Law No. 18/1997; during the period of Law No. 18/1997; and during the period of Law No. 34/2000.

Law No. 18/1997

Before Law No. 18/1997, there were about 40 kinds of regional/local taxes and 180 user charges (see Table 6.4). But many of them were considered inefficient and sometimes created important distortions in the economy. Therefore the government of Indonesia decided to create a more efficient local tax system by abolishing some of those taxes. Law No. 18/1997 limited local government taxes to only 9 and user charges to 30. Through 2000, provincial and local taxes and charges were principally regulated by this Law.

The main features of Law No. 18/1997 were:

- *Elimination of some taxes and user charges.* These included fees on interstate transportation.
- *Reduction in some tax bases.* There are some taxes whose tax base was actually reduced by Law No. 18/1997, for example, the tax on hotels and restaurants. Formerly, the name *Pajak Pembangunan* (or ‘development tax’) was applied to a tax on any hotel, restaurant, and other food services, including home food service delivery (catering). Law No. 18/1997 reduced the tax base to hotels and restaurants only. Given this change, the name ‘development tax’ was replaced by ‘tax on hotels and restaurants’.
- *Adjustment of tariffs (or fees).* Although the same types of charges are still present, tariff rates have been deregulated to reflect the cost of service delivery only. According to Law No. 18/1997, a tariff imposed on services must reflect only the provision cost of the service. As a result, some services required a significant adjustment in their tariff rates. In most cases, those adjustments led to a lower tariff rate. For example, the calculation of the building renovation licensee fee was changed from the size of the renovation to the amount of paperwork needed to provide the license.
- *Introduction of revenue sharing for gasoline and land/building transfer taxes.* The reduction of some taxes and user charges was expected to reduce the fiscal capacity of most regions. To help local governments adjust to Law No. 18/1997, two shared taxes were introduced,

Table 6.4 *Indonesia: List of regional government taxes before Law No. 18/1997*

Provincial

1. Vehicle tax
2. Vehicle transfer tax
3. Household tax
4. Other provincial taxes (non-significant)

Local

1. Hotels/restaurants tax	22. Tax on lodging houses
2. Advertisement tax	23. Tax on storage of goods on public land
3. Entertainment tax	24. Businesses tax
4. Street lighting tax	25. Tax on boats
5. Foreigner tax	26. Harbor tax
6. Surcharge on household tax	27. Tax on salt manufacture
7. Tax on fishing in territorial waters	28. Tax on transport of salt from region
8. Road tax	29. Tax on pig farms
9. Slaughtering tax	30. Tax on removal of birds' nests
10. Dog tax	31. Tax on removal of turtles' eggs
11. Tax on sale of fireworks	32. Tax on tobacco storage buildings
12. Tax on sale of alcohol	33. Tax on fish auctions
13. Non-motorized vehicle tax	34. Other taxes
14. Tax on luxury burial monuments	
15. Temporary residence tax	
16. Tax on amusement machines	
17. Radio tax	
18. Tax for provision of drinking water	
19. Business registration tax	
20. Temporary residence permit	
21. Tax on ownership of land adjacent to highway	

Source: Ministry of Finance and Ministry of Home Affairs.

on gasoline and land/building transfer taxes. The central government collects the taxes, and then allocates the shared taxes to local governments by using various indicator variables, such as the length of local roads (see Table 6.5).

Although the impact of Law No. 18/1997 on local tax bases was anticipated by the government by introducing gasoline tax sharing, the implementation of the tax sharing did not work very well. The allocation to local governments

Table 6.5 Indonesia: tax assignment and revenue sharing, 1998

Revenue	Responsibility			Disposition revenues (%)		
	Base	Rate	Adm.	Center	Province	Local
Oil and gas receipts	C	C	C	100	0	0
Income taxes	C	C	C	100	0	0
Value-added taxes	C	C	C	100	0	0
Import duties	C	C	C	100	0	0
Excises	C	C	C	100	0	0
Export tax	C	C	C	100	0	0
Land and building tax (1)	C	C	C	9	16.2	74.8
Ld and bldg transfer tax (2)	C	C	C	20	16	64
Forestry royalties	C	C	C	55	30	15
Forestry licenses	C	C	C	30	56	14
Mining land rents	C	C	C	65	19	16
Mining royalties	C	C	C	30	56	14
Vehicle tax	C	C	P	0	100	0
Vehicle transfer tax	C	C	P	0	100	0
Fuel tax (3)	C	C	P	0	10	90
Hotels and restaurants tax	C	L	L	0	0	100
Entertainment taxes	C	L	L	0	0	100
Advertisement taxes	C	L	L	0	0	100
Street lighting taxes	C	L	L	0	0	100
Exploration tax of mines (type C) (4)	C	L	L	0	0	100
Exploration tax of surface and underground water (5)	C	L	L	0	0	100

Notes:

C = Central government; P = Provincial governments; L = Local governments (districts/cities); for provincial and local taxes, as stipulated in Law No. 18/1997.

(1) Center retains 9 percent as collection cost of the tax; (2) introduced July 1998; (3) introduced January 1998; (4) base minerals; (5) base excludes basic household and agricultural usage.

Source: Ministry of Finance.

often came late, and the amount allocated was much lower than the original amount promised by central government. Given these problems, most local governments directed their main efforts in tax policy to optimizing their own local taxes. Unfortunately, the 1997 economic crisis then hit the Indonesian economy. Many companies were forced out of business, and many people lost their jobs. The two events together – the passage of Law No. 18/1997 and

the economic crisis – combined to reduce significantly local government revenues.

Furthermore, Law No. 18/1997 was not considered suitable for local governments in the era of regional autonomy. Many perceived that the implementation of this Law did not really change local taxing powers. Some observers even stated that, during its short implementation, Law No. 18/1997 actually reduced the role of local own-source revenue in total local revenues. Since Law No. 18/1997 did not conform with the principle of real local autonomy, it was amended by a new law called Law No. 34/2000.

Law No. 34/2000

Under Law No. 34/2000, there are 11 local taxes, but local governments are also allowed to design and impose their own additional local taxes and charges. One argument for this may have been to fulfill the need for revenue choice for local government at the margin. It is very hard, however, to identify suitable additional taxes and charges which meet the criteria laid down in that law (which are based on widely accepted principles). That is why there was a tendency for many local governments to re-implement the ‘old taxes’ being abolished by Law No. 18/1997, or to propose new (potential but ‘nuisance’) local taxes. The criteria for the new taxes that local governments could introduce were described by Law No. 34/2000 Article 2, sub-article 4, as follows:

- They are taxes and not charges/levies in nature.
- Tax objects should reside in the area of the region, with low mobility, and with a residential-based population.
- The base and object of the tax should confirm to a social justification (do not conflict with the public interests).
- The local tax objects should not overlap with those used by the central and/or provincial governments.
- The tax potential should be significant (adequate).
- The tax should not distort the economy.
- Equity and the ability to pay the tax should be the concern of the tax policy.
- Environmental considerations should be a priority (or, environmental sustainability should be maintained).

Although the criteria are considered standard from the perspective of tax theory, their implementation quite obviously would be rather difficult. There has been little understanding by local officials with regards to these norms, and as a result they tended to create tax regulations that were in conflict with

Table 6.6 Indonesia: tax assignment and revenue sharing, 2001

Revenue	Responsibility			Disposition revenues (%)		
	Base	Rate	Adm.	Center	Province	Local
Oil and gas receipts	C	C	C	100	0	0
Income tax – corporate	C	C	C	100	0	0
Value-added taxes	C	C	C	100	0	0
Import duties	C	C	C	100	0	0
Excises	C	C	C	100	0	0
Export tax	C	C	C	100	0	0
Income tax – personal	C	C	C	80	8	12
Land and building tax (1)	C	C	CPL	Center 10% and regions 90%		
Ld and bldg transfer tax (2)	C	C	C	Center 20% and regions 80%		
Forestry royalties (3)	C	C	C	Center 20% and regions 80%		
Forestry licenses (4)	C	C	C	Center 20% and regions 80%		
Mining land rents (5)	C	C	C	Center 20% and regions 80%		
Mining royalties (6)	C	C	C	Center 20% and regions 80%		
Vehicle tax	C,P	P	P	0	30	70
Vehicle transfer tax	C,P	P	P	0	30	70
Fuel tax	C,P	P	P	0	10	90
Exploration tax of surface and underground water	C,P	P	P	0	100	0
Hotels tax	C,L	L	L	0	0	100
Restaurants tax	C,L	L	L	0	0	100
Entertainment taxes	C,L	L	L	0	0	100
Advertisement taxes	C,L	L	L	0	0	100
Street lighting taxes	C,L	L	L	0	0	100
Exploration tax of mines (type C)	C,L	L	L	0	0	100
Parking tax	C,L	L	L	0	0	100

Notes:

(1) From the center's share (10%): 6.5% will be distributed evenly to districts/cities and 3.5% are collection incentives; from the regions' shares (90%): 16.2% are provinces' shares, 64.8% local government shares, and 9% collection costs; (2) all the central government share (20%) will be distributed evenly to districts/cities; and 80% of the regions' shares: 16% for provinces and 64% for districts/cities; (3) 80% of regional share: 16% provinces, 32% producing districts/cities, 32% other districts/cities in the province; (4) 80% regional share: 16% provinces, 64% producing districts/cities; (5) and (6) 80% regional share: 16% provinces, 32% producing districts/cities, 32% other districts/cities in the province.

Source: Ministry of Finance, Law No. 25/1999, Law No. 34/2000, several government regulations.

the basic criteria. On the other hand, the Ministry of Finance staff tasked with evaluating local government revenue regulations tended to use only a few certain norms of those listed to annul possible taxes proposed by local governments. (See Table 6.6.)

In the following section we evaluate the local taxes as stipulated in Law No. 34/2000, several taxes which have been proposed by many regional governments to be added to the list of local taxes, and several additional taxes that seem to have some potential to strengthen local own-source revenues. The evaluation is summarized in Table 6.7 at the end of the section.

REVIEW ON EXISTING AND PROPOSED LOCAL TAXES

Motor Vehicle Tax (PKB) and Motor Vehicle Transfer Tax (BBNKB)

The yields of these two motor vehicle taxes (PKB and BBNKB) are always substantial, compared with the other taxes. These taxes are also elastic. Collection costs tend to be quite low, especially in the cities like Jakarta, Surabaya and Medan where the collection systems are computerized.

These taxes can be considered as reasonably equitable, especially since car ownership is generally limited to the high income groups. Regarding economic efficiency, there are no obvious negative effects. Actually, given the existing problems of traffic congestion and pollution in many urban areas in Indonesia, such taxes could be said to have a positive economic impact. These taxes are also relatively easy to implement, and despite the visibility of large lump-sum payments, they appear to be politically acceptable.

Finally, they are suitable as local/regional revenues since in most cases it is easy to identify the correct location of the tax object (although there may be certain problems of shifting registrations if tax rates vary significantly between regions – such as between Jakarta and Bekasi).

Fuel Tax (Tax on Gasoline, PBBKB)

This tax has many advantages. It is a buoyant tax, with a quite substantial yield, and collection costs that are negligible (since it is collected through Pertamina, the national oil company). Also, the tax has an equitable effect, because it bears mainly on car owners, and there is a clear relationship between the tax and local government's responsibilities for road maintenance. There is, however, the counterargument that concerns the effect on transport costs for passengers and freight. But the effect should be minimal (5 percent increase in the price of fuel), and could largely be avoided if the tax were applied to gasoline only.

Hotels and Restaurants Tax

Previously this was one single tax, but since the implementation of Law No. 34, it has been separated into two. Both taxes have similar characteristics. They are buoyant, and have a quite substantial yield. Since they are based on the percentage of turnover, the yield should be quite elastic. In practice, however, since most of the smaller establishments do not issue receipts, turnover has to be estimated, and this must be done regularly if revenues are to keep pace with inflation. These direct assessments increase administration costs.

There are no obvious economic efficiency issues, and the taxes can be regarded as comparatively equitable (since the rich are likely to spend proportionately more on hotels and restaurants than the poor). The taxes are also relatively easy to assess and collect, although for the bulk of establishments which produce no receipts, there is often a process of 'negotiation,' with all the scope for abuse which that implies.

As a regional source of income, these taxes are quite suitable. The tax object is clearly located, and the point of collection will normally be the same as the point of incidence. However, recently some issues have been raised about potential unfairness and inefficiency, due to the fact that hotels and restaurant services are not taxed in the current (national) VAT, but are subject to the local tax and there seems to be no coordination between VAT and local tax. Further discussion/study is necessary to settle this issue.

Entertainment Tax

For many districts/cities, this is among the top yielding tax. The yield is also quite elastic, since the tax is set as percentage of the admission price, and collection costs are relatively low.

This tax can be regarded equitable, since entertainment is relatively a luxury, and tariffs tend to vary according to the type of entertainment, with traditional performances usually having the lowest rates. Also, this tax has few economic efficiency effects, and certainly should not discourage work or savings.

The political problems are relatively minor, since the tax is relatively easy to disguise in the price of the ticket. Regarding the administrative capacity, the requirements are not complex, and evasion can be minimized if the local government prints the tickets.

Finally, this tax can also be regarded as highly suitable as a regional revenue source, since the location of the entertainment is easy to determine.

Advertisement Tax

Most local governments (especially in cities) levy a tax on advertisement signs and billboards in their area. Tax rates, however, are quite complex and are based on size and duration. The rates require regular revision to keep up with inflation. This tax is relatively buoyant, and the yield and growth rates have been reasonable. However, collection costs can be quite high.

The tax presents no particular equity or economic efficiency problems, and is relatively easy to implement. It is also suitable as a local revenue source, as the location of the tax objects can be clearly identified.

Street Lighting Tax (PPJU)

Generally, this tax is buoyant. Until the mid-1990s, it was the third largest local government tax. It is collected for the local authorities by the state electricity corporation (PLN), as a surcharge on electricity bills.

This tax is relatively equitable, since the basis – the installed capacity or consumption – is likely to be reasonably well correlated with ability to pay. The problem is, perhaps, concerning economic efficiency, because the tax (however small) may distort PLN's pricing policy.

This tax is relatively suitable as local revenue source and, with computerization, revenues can easily be assigned to the appropriate local authority.

Business (Registration) Tax

In the past, until the mid-1990s, this tax was the fourth largest local government tax. The name is actually quite inappropriate, since it is really just a tax based on the size of the business, while responsibility for registration of businesses rests with the Ministry of Industry and Trade rather than with local government. However, in this decentralization era, many local governments have assumed this function as their own.

It is levied on most businesses, using the area of premises and/or installed power capacity as the basis of assessment. Being based on physical characteristics, therefore, the yield tends to be inelastic, and regular reassessment is required. As a result, collection costs are quite high.

The equity effects of this tax are uncertain. There is generally a 'progressive' tariff structure, in that larger premises pay more. But this does not necessarily produce equity, since that will depend on who the final consumers are and what proportion of the tax is passed on to those consumers.

Regarding economic efficiency, such a tax is likely to have a negative effect on production and entrepreneurial activity. When it is based on installed power capacity, it discriminates against manufacturing industries, since

these are the main consumers of power. But implementation does not present serious political problems, because the tax burden can generally be passed on.

Basically the business (registration) tax is attractive as a local revenue source, as it provides a means for local governments to tap the economic base of their region. However, it presents a number of problems, including a conflict or overlap with national taxes on property, value added, and income taxes; and the point of ultimate tax incidence may be far from the point of tax collection, especially for larger enterprises.

Land Development (Betterment) Tax

This is a tax to recover the costs of providing new urban infrastructure from land owners. In Indonesia, the potential of this tax has yet to be exploited. It will never generate substantial revenues, but it can facilitate the financing of a crucial sector for which local government is responsible: urban infrastructure.

This tax may also have some equity advantages, since it may recover some of the windfall gains accruing to landowners. However, there seem to be quite a lot of practical problems, and such a tax should be applied carefully.

Tax on Slaughtering

This tax was levied by most local governments before it was abolished by Law No. 18/1997, and there is a trend with many local governments gearing to re-implement this tax. Its overall yield and rate of growth were actually quite reasonable.

However, since the rates are usually fixed, regular revisions are required to keep up with inflation. Meanwhile, collection costs should be fairly low since the tax is generally collected along with charges for the use of local governments' own abattoirs, where most of the slaughtering is undertaken.

This tax does not present any serious equity problems, except in that it represents a tax on only one small sector of the economy. On economic efficiency grounds, it can be argued that it discourages meat production, and may encourage unofficial (probably, substandard) slaughtering. From an implementation angle, it presents few problems, so is generally suitable as a local tax. However, large variations in tariffs between regions could cause shifts in the location of slaughtering.

Tax on Foreigners

This was a per capita tax on foreign citizens, notably the Chinese. Until the early 1980s the yield was relatively quite significant, but revenues had been

declining steadily as foreigners had been encouraged to take Indonesians citizenship. The yield, therefore, is inelastic, and collection costs are high.

The tax raises issues of equity between one ethnic group and another, especially because rates are not related to ability to pay. Although there are no important issues of economic efficiency or ability to implement, it is not particularly suitable as a local tax, since it is often difficult to locate the person on whom the tax is to be levied. Considering these issues it would seem much better to incorporate this tax within a progressive national income tax system.

Tax on Non-motorized Vehicles

Revenues for this tax have been virtually stagnant, and collection and enforcement costs probably consume a substantial proportion of the revenues. It also can be regarded as regressive, since users of bicycles and operators of *becaks* and similar vehicles are likely to be among the poorer members of society.

With regard to implementation, it has a considerable nuisance value, since it is generally levied in addition to fees for vehicle inspections, licenses and number-plates, which are separately administered by the police.

Radio Tax

This tax, probably once quite a significant local revenue source, had declined rapidly before the abolishment by Law No. 18/1997. A few regions are reintroducing the tax, since in these regions it probably still has a significant potential yield. But collection costs probably outweigh yields, since it involves house-to-house collections for trivial amounts. There are, however, no particular equity or efficiency issues. It presents problems of enforcement, since the tax object is easily hidden. For these reasons this tax is not suitable as local revenue source.

Land and Building Tax (PBB) and Land and Building Transfer Tax (BPHTB)

Land and building tax and land and building transfer tax (PBB and BPHTB) are two national taxes with great potential as local revenue sources. As international experience has shown, property taxes are usually assigned to local governments.

In terms of adequacy, equity, and its suitability as local revenue, these all score well. The assignment of these taxes to local governments would make a substantial contribution to increasing local fiscal autonomy and accountability.

The transfer of the taxes, however, would require attention to some practical problems, notably concerning the off-shore portions of the oil and gas sectors. Also, there is the problem of limited administrative capacity in some local governments, but none of these obstacles should prove insuperable.

Sales Tax

In its simplest form, such a tax on local sales would be confined to retail sales of goods (with an exemption for non-luxury food, clothing and other basic needs). This tax may be buoyant, and could be considered to be economically neutral, and the burden across the community reasonably equitable (if it is assumed that the real burden falls mainly on consumers).

However, for most local governments in Indonesia nowadays, capacities to administer such a tax effectively and fairly must be seriously in doubt. In practice, it is very likely that the collection effort would focus on large retailers, producing unfair discrimination and a disincentive to the formation of larger scale retail concerns. Finally, the tax would also be seen as a clear duplication with the national value-added tax, although it is quite suitable as local tax.

Payroll Tax

A payroll tax is clearly a levy on selected businesses, namely those which employ other than the owner(s). This may be levied as flat monthly amounts per employee, or as a percentage of monthly company payrolls.

The yield should be good, but it may be considered as inequitable, since the self-employed would escape liability. It could also act as a disincentive for formal employment, leading to avoidance of the use of contracts and to informal labor, and then adding to job insecurity. Therefore, the tax could be argued to be economically distorting. While assessment and collection would seem relatively simple, and within the capacity of, as well as suitable for, local governments, there could be problems with the effective and fair administration of a wage-bill related tax. This is because employers would tend to seek to minimize liability by keeping their wage scales low and hiding employees or hiring them only part time.

Other Local Taxes

Some of the 30 local taxes abolished by Law No. 18/1997 are going to be (or have already been) re-implemented by local governments. Most of these taxes, in general, are very unsatisfactory. The largest group was made up of

taxes on local products, most of which are important only in certain areas. Certain taxes such as the dog tax and the tax on sales of alcohol can be seen as having a regulatory function, but this is often totally ineffective. They may also overlap with a licensing system for which a separate charge is made, as in the case of the sale of alcohol, which contributes to a nuisance factor.

Apart from being less buoyant (and yielding very little revenue), many of these taxes cost more to collect than they actually yield. There are often problems of assessment and enforcement, while the effects in terms of equity and economic efficiency are frequently unsatisfactory. Another issue is, if the tax is buoyant, it does not usually comply with the other criteria, such as non-distortion to the economy, problems of double taxation, and discrimination among particular sections of the community.

The proposals made by local governments for such taxes have generally emerged as a result of a desperate attempt to try to find anything in their local area from which they can derive some revenue, but most represent highly unsuitable forms of local taxation. This situation is more desperate for local governments with a lack of natural resources and/or low economic potential.

EVALUATION RESULTS

Table 6.7 summarizes the broad pattern of performance, and shows that many local taxes (especially those being proposed by local governments) perform quite poorly. However, local governments seem not to be recognizing many of these issues. Their main concern has been simply to increase local tax revenues. This concern has been encouraged in the autonomy era by one misperception, that is, regarding the proportion of local taxes and charges in their total budget revenue as perhaps the only indicator of the degree of genuine autonomy they have.

MANAGEMENT OF LOCAL REVENUES

The success of local revenue generation is closely related to the management of local revenue in the region. Basically, there are five major categories of local tax policies that could be implemented by local governments. Those categories include enlarging the local revenue base, controlling tax evasion, improving tax collection requirements, increasing the efficiency of tax administration and planning.

Table 6.7 Evaluation of existing and proposed local taxes

Tax	Criteria					Total score
	AE	E	EE	I	L	
Vehicle tax	2	2	1	1	2	8
Vehicle transfer tax	2	2	1	1	1	7
Fuel tax	2	2	0	1	1	6
Exploration tax of surface and underground water	2	1	0	0	1	4
Hotels tax	2	2	0	1	2	7
Restaurants tax	2	2	0	1	2	7
Entertainment tax	2	2	0	2	2	8
Advertisement tax	1	0	0	0	2	3
Street lighting tax	2	1	-1	2	0	4
Exploration tax of mines (type C)	1	0	0	0	1	2
Parking tax	1	1	1	0	1	4
<i>Possible new taxes:</i>						
Land and building tax	2	1	0	0	2	5
Land and building transfer tax	2	1	0	0	2	5
Sales tax	1	1	0	-1	1	2
Payroll tax	2	-1	-1	0	1	1
Business tax	1	1	-1	0	1	2
Land development	0	1	2	-2	2	3
<i>Some proposed new taxes by regional governments:</i>						
Non-motor vehicles tax	0	-1	0	0	2	1
Sale of alcohol tax	-1	1	2	-1	-1	0
Slaughtering tax	1	0	-1	1	1	2
Foreigner tax	0	-1	1	1	0	1
Harbor tax	1	0	-1	0	-1	-1
Road tax	1	-1	-1	1	0	0
Dog tax	-1	0	0	0	1	0
Radio tax	-2	1	0	-1	1	-1
Tax on amusement machines	1	1	0	2	2	6

Notes:

Scoring: +2 = very positive (good) effect; +1 = positive (satisfactory) effect; 0 = neutral; -1 = negative (poor) effect; -2 = very negative (bad) effect.

Criteria: AE = adequacy and elasticity; E = equity issues; EE = economic efficiency effects; I = implementation (political and administrative) issues; L = suitability as local tax.

The 'methodology' used here is adopted from Devas (1989).

Enlarging the Local Revenue Base

One way to improve revenue performance is by enlarging the local revenue base. There are four types of action that can be taken by local authorities in order to achieve this goal:

1. Identifying new or potential taxpayers and ratepayers and bringing them into the tax net.
2. Improving object databases.
3. Improving valuation (e.g. reassessment of tax objects).
4. Calculating more rationally the revenue capacity for each type of levy.

Controlling Tax Evasion

To reduce revenue leakage from tax evasion, local government may perform some or all of the following actions:

1. Using a surprise audit to complement self-assessment procedures.
2. Improving the control process to reduce leakages.
3. Enforcing a strict and heavy penalty for non-compliance.
4. Improving administrative discipline on financial staff that may have contributed to leakage in local revenues.
5. Increasing efforts to link tax payment with services provided by local government.

Improving Tax Collection Requirements

Three basic requirements are considered important in enhancing the revenue collection process: (1) imposing an 'optimum' rate structure; (2) choosing appropriate rules and regulations; (3) improving human resource capacity.

Increasing the Efficiency of Tax Administration

Improvement in revenue performance is also critically dependent on the ability of local authorities to minimize the cost of collecting revenues. There are four possible actions that could be taken by local governments to improve their administrative efficiency:

1. Improving the existing tax collection procedures through administrative simplification.
2. Increasing efforts to calculate collection efficiency for each type of revenue.

3. Increasing efforts to reduce the cost of collection.
4. Taking steps to eliminate the factors identified in the field that have contributed to sub-optimal revenue.

Planning

We can often observe situations where the collection unit (*Dispenda*), the local planning agency (*Bappeda*), and the budget unit (*Bagian Keuangan*) do not work well together in order to improve the existing revenue planning system. In fact, in a crisis like that of 1997, it will be important for them to work closely to ensure a good revenue planning strategy. In the absence of coordinated and systematic planning, it is difficult to expect local revenues to increase.

Among the five categories of tax policies listed, there have been only a few actually implemented at local level. Most local governments adopt the 'classical strategies' only, such as enlarging local revenue bases by their improving object database. Other policies, especially those related to controlling and planning, have been rarely used.

In the future, the management of local revenue will require an attempt to maximize the potential tax collections that local governments have. This, no doubt, will require capacity building improvement at local level, by providing various training activities on all categories of tax collection strategies that have been discussed.

STEPS FOR REFORM

It would seem clear from the foregoing discussion that there is no easy way to increase the role of local own-source revenues in regional budgets. However, noticeable progress can be made. The following are suggested as possible steps for reform.

Abolition of 'Nuisance' Local Taxes

Law No. 18/1997 actually did a good job when it abolished many unsatisfactory local taxes. Most of these taxes should not be introduced again, with the exception of the few that are quite significant in certain areas. Some newly introduced local taxes (or charges) which do not comply with the criteria in Law No. 34/2000 (or the expanded criteria by the Ministry of Finance) should be abolished. Local governments should concentrate on only a few local taxes with revenue potential.

Improve the Remaining Taxes

Many of the local taxes listed in Law No. 34/2000 can actually be improved. For example, the entertainment tax could be broadened to cover other sorts of amusements and recreations, and the tariff rates for the street lighting tax could be increased somewhat without significantly affecting PLN's pricing.

Possible New Local Taxes

Given the present range of national and local taxes, there is relatively little scope for introducing good new local taxes with revenue potential. However, as discussed before, there are several taxes which could be good candidates. These are the land and building tax and transfer tax, which are currently national taxes; land development tax; sales tax; payroll tax; and business registration tax. More careful study, of course, is necessary to decide whether these taxes really comply with the desired criteria, including their appropriateness as local revenues.

There are also several other candidates which, for some, are believed to be quite appropriate sources for local government: the building permit fee (to be reclassified as a local tax); and the environmental (or production?) tax.

The building license fee is calculated on the basis of the costs of providing a building permit (Law No. 18/1997). In the past, this fee was considered a potential revenue source for local governments. To capture the local potential of the building license fee, the current building license permit fee needs to be reclassified as a tax; once it becomes a tax, there is no requirement to set the tariff at the cost of providing the permit as mandated by Law No. 18/1997 and Law No. 34/2000.

There are some compelling reasons for this option to reclassify the current fee:

- Building or renovating activities can create negative externalities to the neighbors and environment. For example, roads may be used more frequently in the construction process, with increased deterioration in their condition. To capture the externalities created, taxes may be the answer.
- Since only a limited number of households can afford building renovation, a tax may be more likely to reflect their ability to pay.
- The building permit tax may be buoyant, although it is apt to be unstable.

Meanwhile, environmental management in Indonesia is always an important issue. Although the environmental law has been enacted for some years,

environmental problems created by industries, such as industrial pollution, never decrease. In fact in the view of some, these problems have increased steadily in the last decade. Environmental problems can be localized, since a polluting manufacturer is likely to be located at a certain local area only. To reduce the pollution problem, the local government could introduce an *environmental tax* that is collected based on the production of the polluting manufacturers. The information on the pollution amount caused by a manufacturer is often difficult to obtain, therefore. In theory, this information could be collected on the basis of the production of the (polluting) manufacturer. Such a policy, to some extent, will create what we call a *production tax* with a limited perspective. In public finance theory, assuming that negative externalities (such as pollution) could be internalized, the first order condition (market solution of pollution) leads to a price for pollution that relates to the marginal production of output.

Improve Administration Capacity

There is, of course, plenty of room for improvements in terms of the administration of local taxes. They could include a unified register of taxpayers for all local taxes, with the facility to cross-check assessments and payments; computerization of motor vehicle taxes, and more effective enforcement against evaders, including closure of premises in certain cases.

One of the most important issues is a greater concern with the cost effectiveness of local revenue collection, taking into account not only the direct cost of tax administration but also the overall cost to the economy, including the compliance costs for taxpayers.

The Reassignment of National Taxes and the use of Surcharges

None of these proposals, however, will fundamentally affect the relatively weak position of local taxation within the overall local budget. Two further suggestions may have a greater impact. First, transferring some national (central) taxes to the local level. The strong candidates would be, as mentioned before, the land and building tax (PBB), and the land and building transfer tax (BPHTB). On the grounds of efficiency and effectiveness of public service deliveries, and local government accountability, these type of property taxes are certainly appropriate for local governments.

It should be mentioned here, however, that the main beneficiaries of these taxes would generally be urban and mining areas, since the scope for significant tax yields in agriculture are quite limited.

The second suggestion is the introduction of local surcharges on top of certain national taxes (also known as 'piggyback' taxes). The strong candidate

for a local surcharge appears to be personal income tax. In fact this tax is already shared with local governments and this should not be an obstacle for districts/cities to apply a surcharge. To avoid increasing the overall tax burden in the country, the current 20 percent regional share of personal income tax could be converted into the local surtax piggybacking on the national income tax. As for other possible new local taxes, a deeper study is clearly needed. Table 6.8 illustrates how the piggyback mechanism for personal income tax could work within the scope of the Law. Note that the piggyback rate in Table 6.8 is made progressive to reflect the existing progressivity in the national personal income tax. However, it may be more appropriate to simply charge a flat rate at local level. This would be in agreement with the traditional principles of public finance which assign the re-distributional function at central government level.

Table 6.8 A scheme for local government piggyback on the personal income tax (%)

Taxable income (millions of Rp)	Current law tax rates	Proposed central rates	Proposed local rates	Proposed combined rates
< 25	5	4	1	5
25–50	10	8	2	10
50–100	15	12	3	15
100–200	25	20	5	25
> 200	35	28	7	35

Note: The calculations assume a 25 percent surtax on central government tax liability.

Source: Ministry of Finance Task Force for Fiscal Decentralization.

In summary, revenue assignment still presents a significant challenge as a building block of a decentralized system of governance in Indonesia. However as we have reviewed in this paper there are practical avenues to increase revenue autonomy at the local level, increase the accountability of local governments, and strengthen the decentralization process in Indonesia .

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APPENDIX 6.1 EVALUATION OF PROPOSALS FOR MAJOR NEW LOCAL TAXES

Expanded and supplementary criteria (Law No. 34/2000 ++)	Sales tax	Payroll tax	Business tax
The tax must be suitable as a regional government tax, i.e. the tax base must clearly be located within, or arise from within, the regional government area, and relate primarily to economic activity from within the regional government area	Complies	Complies	Complies
The tax must be politically acceptable at national and regional levels	Doubtful	Doubtful	Doubtful
The tax must not overlap with that of another central or local tax or license fee having the characteristics of a tax (double taxation)	Fails	Doubtful	Doubtful
The estimated potential yield of the new revenue source should represent a substantial additional contribution to the present total of local revenues; it should also be founded on a buoyant revenue base	Complies	Complies	Doubtful (depends on base and tariff)
The gross costs (i.e. costs before deduction of any doubtful staff-related grant) of collecting the revenue must be acceptably small compared to the yield of the revenue	Complies	Complies	Doubtful
The tax must not prejudice national economic development	Complies (ignoring 'double taxation' aspect)	Doubtful (discouragement to employment; further burden on business)	Doubtful (further burden on business)
Except as matter of deliberate (and well-justified) policy, the tax must not seriously change the allocation of economic resources within the regional government area or between regions, nor disrupt intra- or interregional trade	Complies	Doubtful (discouragement to employment)	Doubtful (depends on structure)

APPENDIX 6.1 EVALUATION OF PROPOSALS FOR MAJOR NEW LOCAL TAXES (continued)

Expanded and supplementary criteria (Law No. 34/2000 ++)	Sales tax	Payroll tax	Business tax
The tax burden must be affordable, both by the majority of those directly liable to pay it, and by those on whom it would ultimately impact (through its effect on prices of the relevant goods and services)	Complies (with appropriate exemptions)	Doubtful (depends on structure and exemptions)	Complies (given sensible structure and tariffs)
The tax must not be regressive (i.e. disproportionate shares of the ultimate impact must not fall on the less well-off)	Complies (with appropriate exemptions)	Doubtful (depends on structure and exemptions)	Complies (given sensible structure and tariffs)
The tax must not unfairly discriminate between particular sections of the community	Complies (in principle, but not when poor administration is taken into account)	Fails (favours self-employment)	Complies
Regional governments must be able to administer the revenue effectively (i.e. to be able to identify all, or at least the vast majority of, liable revenue and payers; to assess each payer's liability accurately; and to effectively enforce for large proportion of the revenues assessed as payable)	Fails	Doubtful (depends on structure, wage bill-basis, tax would be open to large-scale avoidance)	Complies
The tax must not deter taxpayers from taking proper action to comply with environmental conservation needs	Complies	Doubtful (could discourage posts for environmental impact monitoring)	Complies

Source: 'Fiscal Decentralization: A Ministry of Finance Policy Agenda', Directorate General for Central and Local Financial Balance, Jakarta, 2002.

APPENDIX 6.2 TAX ASSIGNMENT RULES

In line with the criteria adopted in the chapter, some classical principles for tax assignments are as follows:

- *Progressive-redistributive taxes should be centralized:* Under this condition, a tax-promoting income redistribution across the country will be put under the supervision of central government. Income tax is the candidate to fulfill this criterion. With income tax, individual/company income groups can be distinguished based on their ability to pay tax. A progressive income tax should lead the rich people/companies to pay more.
- *Taxes suitable for economic stabilization should be centralized:* Lower level taxes should be cyclically stable. This criterion gives an opportunity for central government to use fiscal policy effectively as a stabilizer for macroeconomics. Stabilizing price level is commonly the primarily goal of macroeconomics. Taxes such as value-added and sales taxes are the candidates for complying with this criterion, as their effects are significant for the determination of price level.
- *Unequal tax bases among jurisdictions should be centralized:* This criterion limits the availability of taxes for local governments to those that are widespread and so available for all regions. Revenues from mining and other natural resources are not good taxes for local governments as they are available to only certain regions. Therefore, such taxes are in the scope of central government.
- *Taxes on mobile factors of production should be centralized:* This criterion is actually useful for reducing conflict among local governments on the ownership of taxes on mobile factors. Taxes on labor and capital are an example of this. In practice, however, such a rule is challenged by regions that have many labors and a lot of capital. Such regions often claim that those factors have utilized facilities provided by local governments, but do not pay enough to the local governments. Therefore, they ask for revenue-sharing from income tax. Unfortunately, some of these factors might be registered in other regions. Revenue-sharing based on mobile factors in the end will only benefit the regions where the factors are officially registered.
- *Residence-based taxes, including some excise taxes, should be levied by local authorities.*
- *Benefit taxes and user charges can be levied appropriately by all levels:* As far as efficiency in administration is concerned, the level of government that is likely to have the best information on the tax base would be the level responsible for levying taxes on such a base. On the

other hand, if fiscal need is the concern, revenue means should be matched as closely as possible to expenditure needs.

APPENDIX 6.3 AN EVALUATION OF THREE TAXES

This appendix uses the criteria laid out in the chapter for the evaluation of three types of taxes often recommended as feasible at local level in Indonesia: taxes on property, taxes on income, and taxes on expenditure.

Taxes on Property

Property tax revenues are relatively large, stable, and predictable. International experience shows that this is one of the most substantial tax sources for local (municipal) government. But the elasticity of property taxes is relatively poor in relation to growth in prices, population, and incomes.

Property taxes are relatively equitable in that there is usually a rough correlation between the income of individuals and businesses and the value of the premises they occupy. There are, however, some factors which impair equity such as: (1) market forces may result in considerable differences in rental or capital values which depend on location rather than the quality of premises or the income of the occupants, and (2) the rental or purchase costs of housing or business premises on which the tax is based, may represent a higher percentage burden on the income of the poor than on the rich.

Regarding administrative capacity, the great merit of property taxation is that the liability is, or should be, obvious. One cannot conceal a plot or a building. Even so, considerable effort is necessary to keep good surveys and tax rolls up to date.

However, property taxes are politically highly sensitive for two reasons. First, they have to be collected directly from taxpayers, and therefore are seen as even more of a burden than income taxes which may be deducted by employers. Second, any increase in the tax, whether by tariff revision or revaluation, is normally dependent on a deliberate political decision by ministers, members of parliament, mayors, or councilors.

Taxes on Income

(National) income taxes are generally buoyant, certainly so far as inflation and economic growth are concerned. This buoyancy would benefit local authorities, which choose to (and are allowed to do so), exploit it through surcharging or tax sharing. This taxation is also potentially the fairest form and can readily be made progressive. The problem, however, is to achieve horizontal equity; that is, to achieve equal taxation of people with equal incomes but from different sources. Assessing salary earners is easy, but assessing self-employed income is more difficult. Two devices are common here – self-assessment, or the use of presumptive income criteria.

Income taxation is relatively simple to administer so far as wage and salary earners are concerned (if employers are required to deduct at source). Assessment of and collection from the self-employed is far more difficult and collection costs can be high. Use of presumptive incomes here will help assessment, but the resulting inequity is only tolerable where the incidence of the tax is low.

In terms of political acceptability, income taxation is sensitive insofar as it is a direct tax. But collection at source mitigates this to some extent, and increases in payment take place automatically as income rises. Taxation of the self-employed, however, is more sensitive since much argument may arise in the assessment process, and effective collection may depend on enforcement.

Regarding the suitability as a local tax, some argument arises over (local) income taxation where an individual resides in a different jurisdiction from that in which she or he works. It is usually held that the area in which a person lives should get the tax, but some towns claim the right to tax commuters. The most difficult question arises over taxes on corporate incomes, where profits may be derived from operations in several locations. This may be solved by developing formulae for assigning these to different local authorities, but the process is quite complex. This means that a corporate income tax is not a good tax to assign to local governments either in the form of revenue sharing or as tax surcharging.

Taxes on Expenditure

Taxes on expenditure are perhaps the most buoyant of all, particularly if tariffs are expressed in percentages of prices and not on a unit price basis. The volume of business taxed (or of traffic in the case of vehicle taxation) should automatically reflect growth in population or personal incomes. Local tax sources such as motor vehicle tax in Indonesian provinces have proved extremely elastic.

However, the equity of taxes on expenditure is difficult to determine because of uncertainty as to who really bears the tax. So far as such taxes are passed on to the consumer, it can be argued that equity is preserved since expenditure is a reflection of ability to pay. But this is also questionable by conventional standards. As the usual argument goes, consumption taxes are regressive because the poor spend all their income while the rich have the opportunity to save (and therefore part of their income escapes taxation).

In terms of administrative capacity, these taxes raise very large revenues with very little cost or difficulty where they are collected through large marketing or manufacturing organizations, or, as with vehicle taxation, are imposed through forms of licensing which the public have a strong incentive

to obtain. These levies are much more costly and difficult to apply to commercial transactions conducted through small business, markets, and the 'informal sector.'

Taxes on expenditure are usually the least sensitive politically since they are normally indirect and subject to a measure of concealment. They may however encounter opposition where they are seen to contribute to price rises which foster discontent, or where an attempt is made to impose high rates on luxury items which affect political and business elites.

7. Combining expenditure assignment, revenue assignment and grant design in Indonesia's fiscal decentralization

Machfud Sidik and Kadjatmiko

INTRODUCTION

Indonesia has embarked on an ambitious program of fiscal decentralization. The effort has its genesis in two laws, both promulgated in May 1999, one on administrative matters (Law No. 22/1999) and the other concerning fiscal and finance issues (Law No. 25/1999). These two laws have been followed by a large number of implementing regulations and ministerial decrees. As a result of this legislation, provincial and local governments have assumed major new responsibilities, starting in January 2001.

These laws have transformed intergovernmental relations in Indonesia. Substantial service functions for provinces have been outlined in a recently issued government regulation. Local (e.g. *kabupaten* and *kota*) government responsibilities have been only vaguely defined via a 'negative list' of duties, but are nonetheless considerable. *Kabupatens* and *kotas* have become responsible for all public services that the central and provincial governments do not deliver, at least in 11 important areas: public works, health, education and culture, agriculture, communications, industry and trade, capital investment, environment, land, cooperatives and labor. However, despite the new expenditure responsibilities, regional governments have not been awarded new authority over any major tax bases. *Kabupatens* and *kotas* are now allowed to create their own taxes through local by-laws, given the requirement that these taxes satisfy a number of 'good' tax criteria and receive central government approval. The system of intergovernmental transfers has also been significantly restructured and expanded. Regional governments now gain greater access to substantial amounts of natural resource revenues than before, and, in addition, they now receive a share of the personal income tax. Two new and important intergovernmental grants have been created: *Dana Alokasi Umum* (DAU, or the General Purpose Fund) and *Dana Alokasi Khusus* (DAK, or the Specific Purpose Fund). These two transfers together replace the old

system of *Subsidi Daerah Otonom* (SDO, or Autonomous Government Subsidies) and *Instruksi Presiden* (INPRES, or Presidential Instruction) grants.

Tables 7.1 and 7.2 provide a view of the scope of the government's fiscal decentralization program. As can be seen from the tables, intergovernmental transfers have taken on a much increased significance since Fiscal Year 2001. Revenue sharing and grants together increased from around Rp 33 trillion in FY 2000 to Rp 81 trillion in FY 2001 (in the amended budget) and then to a budgeted amount of Rp 94 trillion in FY 2002.

Our purpose in this chapter is to discuss some basic issues related to fiscal decentralization policy in Indonesia. In particular, we outline the major dimensions of any decentralization policy, and we evaluate the ways in which the Indonesian program is performing in these dimensions. Possible options for reform of the current design and operation of the government's program

Table 7.1 State budget, FY 2000 and FY 2001 (in billion Rp)

Item	FY 2000	Percent of GDP	FY 2001 provincial account	Percent of GDP
Revenues and grants	204 942.3	20.6	299 851.2	20.2
Domestic revenues	204 942.3	20.6	299 841.6	20.2
Tax revenues	115 788.1	11.7	184 736.6	12.5
Non-tax revenues	89 154.1	9.0	115 105.0	7.8
Grants	–	–	9.6	0.0
Expenditures	219 953.3	22.3	354 578.2	24.0
Central government expenditures	187 057.7	19.0	232 796.1	18.5
Balance fund	32 877.6	3.3	82 400.4	5.6
<i>Revenue sharing</i>	4 251.2	0.4	21 183.1	1.4
<i>General allocation fund</i>	28 626.4	2.9	60 516.7	4.1
<i>Special allocation fund</i>	0.0	–	700.6	0.0
Primary balance	35 093.0	3.6	40 800.1	2.8
Surplus/deficit	–15 011.0	–1.5	–54 727.0	–3.7
Balancing	15 011.0	1.5	54 727.0	3.7
Domestic financing	5 438.7	0.6	44 188.9	3.0
Foreign financing	9 554.3	1.0	10 538.1	0.7

Source: Sidik (2002b).

Table 7.2 State budget, FY 2001 and FY 2002 (in billion Rp)

Item	FY 2001 (Budget adjustment)	Percent of GDP	FY 2002 (Budget)	Percent of GDP
Revenues and grants	286 006.1	19.6	301 874.3	17.9
Domestic revenues	286 006.1	19.5	301 874.3	17.9
Tax revenues	185 260.2	12.6	219 627.5	13.0
Non-tax revenues	100 745.9	6.9	82 246.8	4.9
Grants	–	–	–	–
Expenditures	340 325.7	23.2	344 008.8	20.4
Central government expenditures	258 849.2	17.7	246 040.0	14.6
Balance fund	81 476.6	5.5	94 531.8	5.6
<i>Revenue sharing</i>	20 259.3	1.4	24 600.4	1.5
<i>General allocation fund</i>	60 516.7	4.1	69 114.1	4.1
<i>Special allocation fund</i>	700.6	0.0	817.3	0.0
<i>Special autonomy and equalization fund</i>	–	0.0	3 437.0	0.2
Primary balance	35 250.0	2.4	46 365.4	2.8
Surplus/deficit	–54 319.7	–3.7	–42 134.5	–2.5
Balancing	54 319.7	3.7	42 134.5	2.5
Domestic financing	34 386.7	2.3	23 500.8	3.0
Foreign financing	19 933.0	1.4	18 633.7	1.1

Source: Sidik (2002b).

are highlighted throughout. Along the way, some of the empirical analyses carried out by the Ministry of Finance are presented in order to illustrate our various points. Following the introduction, we briefly outline the objectives of Indonesia's fiscal decentralization program and consider the status of decentralization of national revenues and expenditures. We then take up some of the important issues related to expenditure assignment, revenue assignment, and intergovernmental transfers. We conclude with some remarks about the enormity of the tasks ahead.

FISCAL DECENTRALIZATION IN INDONESIA: GOALS AND CURRENT STATUS

The general goals of Indonesia's fiscal decentralization program are to improve national and regional government operational efficiency; to improve the overall fiscal structure of governments, including an increase in regional and therefore national revenue mobilization; to enhance accountability, increase transparency, and expand constituent participation in decision-making at regional level; to mitigate fiscal disparities among regional governments and assure the delivery of basic public services to citizens across the country; to ameliorate the social welfare of Indonesians; and to support macroeconomic stability.

It is understood, of course, that it is not possible to achieve fully all these objectives, everywhere and at all times. Some goals may conflict with one another, and, to the extent that objectives are not consistent, hard choices will have to be made. These objectives have been outlined in a rather general fashion with a view to stimulating debate about precise intentions and relative priorities. In addition, these goals provide a basis for evaluating the relative success of the implementation of fiscal decentralization programs. It is too early, of course, to provide a comprehensive and rigorous evaluation of Indonesian decentralization *vis-à-vis* the aims of the decentralization. Instead, we provide a 'snapshot' of decentralization in Indonesia at various points in time, ending with its current status. In addition, we compare the Indonesian situation with that found on average in developing, transition, and OECD countries.

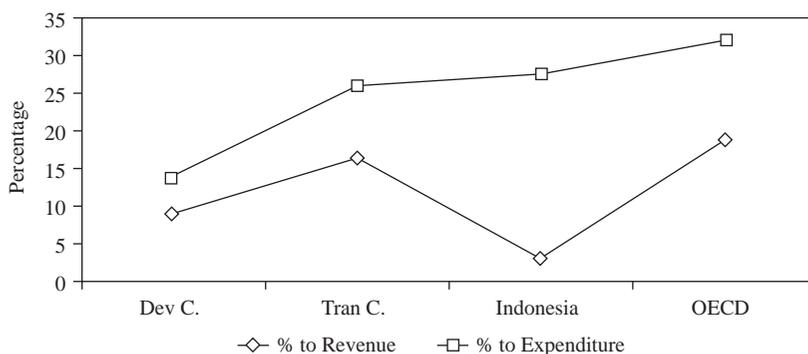
The snapshot comprises the extent of revenue and expenditure decentralization as measured by two frequently employed indicators: the sub-national shares of total national revenue and expenditure. While these two measures are far from perfect proxies of the degree of decentralization, their use is common and, within limits, can be instructive. Table 7.3 and Figure 7.1 provide the results. In this discussion, it should be noted that 'regional government' refers to both provincial and kabupaten/kota level government, while 'local government' refers only to kabupaten/kota governments.

This information suggests four basic points. First, on the expenditure side Indonesia is apparently now already quite decentralized. In FY 2001, an estimated 28 percent of total national expenditures were made by provinces and kabupaten/kota. This sub-national share is significantly greater than that for developing countries as a whole (14 percent) and even slightly larger than that for transitional countries (26 percent), although it is less than OECD countries (32 percent). Second, expenditures in Indonesia have become steadily and increasingly decentralized since the beginning of the 1990s up through FY 2001, rising from 17 to 23 to 28 percent during this

Table 7.3 Sub-national shares of total national revenue and expenditure

Country classification	Sub-national revenue as a percentage of total national revenue	Sub-national expenditure as a percentage of total national expenditure
Developing countries, 1990s	9.27	13.78
Transition countries, 1990s	16.59	26.12
OECD countries, 1990s	19.13	32.41
Republic of Indonesia, 1989/90	4.69	16.62
Republic of Indonesia, 1994/95	6.11	22.97
Republic of Indonesia, 2001	3.39	27.78

Source: World Bank and Government of Indonesia Nota Keuangan, various years.



Source: Sidik (2002b).

Figure 7.1 Local shares of national revenue and expenditure

period. Third, despite the expenditure decentralization, revenues in Indonesia remain still quite centralized. In FY 2001, it is estimated that less than 4 percent of total national revenues were collected by provinces and kabupaten/kota. This sub-national share of total revenues is substantially smaller than the average for developing (9 percent), transitional (17 percent), and OECD countries (19 percent). Finally, and perhaps somewhat ironically, it appears that the collection of total revenues may have actually become slightly less centralized in Indonesia with the start of FY 2001 than it was at the mid-point of the 1990s or even at the beginning of the decade. The sub-national

share of total revenues was 4.7 percent in 1989/1990, and fell to 3.4 percent in 2001.

EXPENDITURE ASSIGNMENT IN THE INDONESIAN DECENTRALIZATION¹

Some General Principles of Expenditure Assignment

As argued by Musgrave (1959), the overall public sector has three basic economic roles: stabilization, distribution and allocation (or public service provision). Within this framework, it is usually contended that, due to various comparative advantages, central government should assume the bulk of the responsibility regarding stabilization and distribution functions, while sub-national units of government should play a significant role in providing public services. This latter conclusion is largely due to the assumption that the demand for public services varies across space and to the belief that sub-national governments are best placed to discern such differences in service demand; it is also commonly thought that bringing service delivery closer to citizens allows them to better hold the government accountable for its actions.² If these various arguments are accepted, then the question becomes one of deciding how best to assign public expenditure responsibilities across the different levels of government.

Two different approaches are commonly observed in the assignment of expenditure functions in decentralization exercises. We may term these the 'expenditure-led' approach and the 'revenue-led' approach.

In the expenditure-led approach, functions are first designated as the clear responsibility of one or another level of government on a mutually exclusive basis, with the designation based on criteria such as the degree of localization of the impact of the particular function in question, considerations of policy and administrative uniformity, general technical and managerial capacity, the existence of spatial externalities or spillovers associated with the function, and the presence of economies of scale. Thus functions such as primary education, local general hospitals, and refuse collection would be assigned to local governments as having primarily a local impact and being within management capacities at that level; specialist secondary schools, regional specialist hospitals, and rivers and water resources management might be assigned to the provincial level, as having substantial interregional impacts; and religious affairs and justice would be reserved as central functions, as requiring policy uniformity with nationwide impact. Once the assignment of functions is agreed, revenue source allocations between levels of government and among sub-national governments are then tailored accordingly.

In contrast, in the revenue-led approach, public revenue resources are first allocated in a general way between levels of government, essentially as the result of a political bargain struck between centralist and regionalist power interests. Political trade-offs also strongly influence the allocation of resources among regional governments at each level, as reflected in the systems of intergovernmental transfers. In the subsequent assignment of functions, while consideration of the principles mentioned in connection with the expenditure-led approach are still relevant, regional fiscal capacities become a much more prominent consideration. Fiscal capacity disparities between individual regions may well mean that not all places can finance their designated functions, leading to direct higher level government interventions in services provision. As noted by Bahl (2002), the resultant blurring of responsibilities between levels is detrimental to the requirements of objectivity and transparency in resource allocation and to local accountability for service delivery performance.

Expenditure Assignment in Indonesia

In the case of Indonesia, elements of both approaches appear in the formulation of Laws No. 22/1999 and No. 25/1999. Nevertheless, few observers would disagree with the view that the revenue-led approach was the dominant consideration underlying the enactment of these two laws, in the political circumstances of 1998 and 1999. Indeed, many argue that the resultant package makes insufficient recognition of the revenue needs of regional governments and especially of the needs of less developed regions with few natural resources.

Contrasting approaches are also found internationally with regard to the manner in which regional government functions are specified in legislation. Many countries adopt the 'positive list' approach whereby the functions of each level of regional government are listed in detail for each relevant public service area. This appears to have been the basic approach of the former Law No. 5/1974, although that legislation left much to be specified in subordinate legislation, the formulation of which was long-delayed and not comprehensive. Under the converse 'negative list' approach, public services are specified for some usually higher level of government and then 'all other' functions are allocated to the remaining typically lower level of government. Again, elements of both approaches are reflected in Law No. 22/1999. Along the lines of the negative list approach, this legislation prescribes a very restricted range of functions that are reserved for the central level, another restricted set of functions reserved to provincial level, and a residual set of functions assigned to local level. However, the set of functions for local governments also includes a positive list of basic services reserved to the

kabupaten/kota level. Moreover, the broad terms in which the Law is formulated leave considerable room for interpretation, and thus uncertainty. Government Regulation No. 25/2000 has attempted to remove some of the uncertainty, by detailing functional areas for central and provincial levels on the positive list basis as the foundation for a negative list approach to local government functions.

Notwithstanding these provisions of Law No. 22/1999 and of Government Regulation No. 25/2000, the Ministry of Home Affairs and various technical departments appear to have begun to recognize the advantages of a positive specification of local government powers and responsibilities. Under the aegis of Presidential Decree No. 5/2001, technical ministries have prepared model positive lists of local level responsibilities under decentralization, and each local government has been instructed to prepare its own positive list of functions that it sees as its responsibility. A majority of local governments have now done so, most through formal regional regulations, and have submitted them for verification to the Home Affairs Ministry. Predictably, there is significant diversity among the proposals of individual regions. If the regions' expenditure assignment proposals are accepted, the government of Indonesia would clearly be heading down the path of an 'asymmetric' decentralization, albeit through the back door.

Legality of Regional Government Expenditure

A closely related issue is the general approach to the expenditure powers of regional governments and the legality of specific actions. Again, two contrasting basic approaches are found internationally. Under what is known as the 'ultra vires' approach, a regional government may exercise only those powers that are specifically assigned to it in legislation. For any particular item of expenditure (as well as for any action to raise revenue), it must be able to point to a legislative provision that authorizes it. All other actions and expenditure are illegal. Under the contrasting 'intra vires' approach, a regional government may legally incur any expenditure that it considers in the interests of its citizens, except activities specifically prohibited or reserved to another government level. It is unclear which regime applies in Indonesia.

We propose here that the revisions of Laws No. 22/1999 and No. 25/1999 should be founded on the expenditure-led approach, with expenditure functions being specified in positive lists and included in substantial detail in any revision of Law No. 22/1999 itself, rather than leaving the matter for subordinate regulation. Additionally, it would be helpful for the revision to Law No. 22/1999 to specify either the ultra vires or the intra vires regime for determining the legality of any regional government expenditure or revenue actions. An intra vires regime would approximate more closely to

Indonesian past and current practices as regards expenditures; if such an approach is accepted, it would still be desirable to accompany it with some prohibition on regional governments' engagement in activities that are properly the preserve of the private sector. On regional revenues, however, the strong preference, of the Ministry of Finance at least, is for an *ultra vires* approach.

REVENUE ASSIGNMENT IN THE INDONESIAN DECENTRALIZATION

In this section, we focus on the assignment of own-source revenues. The principal objectives of local revenues are:

- To raise revenues from the local communities under local legislation in order to finance locally delivered services, thus relieving the center from the full burden of financing such services through transfers.
- To reinforce local autonomy and democracy, by facilitating a degree of local choice and trade-off between levels of services and local tax and charge burdens.
- To promote local accountability of regional governments.
- To provide incentives for improved efficiency and effectiveness in local services delivery.

As discussed earlier, under an expenditure-led approach to fiscal decentralization, sufficient revenues should be allotted to each regional government to enable it to deliver its assigned functions to standards of quality and coverage consistent with overall national affordability. This principle is recognized at the margin in Law No. 25/1999, which provides that the decentralization of additional functions must be accompanied by financing sources. However, there has not yet been major research into the precise amounts of revenue (own-source or otherwise) needed by regional governments in order to carry out existing or prospective functional responsibilities. While admittedly not an easy task, some such research is highly desirable as a basis from which to evaluate the appropriateness of the present revenue assignments and to formulate proposals in the revision to Law No. 25/1999.

Table 7.4 provides some information on current amounts of own-source revenues as a share of regional budgets for provinces (excluding Jakarta), Jakarta, *kotas*, and *kabupatens*. Overall, regional government own-source revenues make up just 15 percent of total regional fiscal resources. However, there is quite a bit of variation around that average figure, with provincial

Table 7.4 *Estimated proportions of regional budget revenue, FY 2001 (in percentages)*

Revenue category	Provinces (excluding DKI Jakarta)				Overall
	DKI Jakarta	DKI Jakarta	Kota	Kabupaten	
Local revenues	44	30	15	5	15
Shares of national revenues	24	56	22	19	22
Grants	32	14	63	76	63
Total	100	100	100	100	100

Source: Republic of Indonesia (2001).

own-source revenues making up 44 percent of the total and kabupaten own-sources accounting for only about 5 percent of their total revenues.

Regional governments frequently regard the proportion of local taxes and charges in their total budget revenue as the main indicator of the degree of genuine local autonomy that they enjoy. Those holding such a view might say, in an approximate way, that a local government financing 75 percent of its total budget from local revenues is three times more autonomous than one financing only 25 percent of its budget from such revenues. Others would stress the degree of local discretion allowed in the deployment of the totality of local budget revenue, irrespective of source. For this purpose, the major part of revenue shares and grants given by higher government levels should be for general purposes, deployed as the recipient governments themselves choose. However, neither relatively large own-source budget shares nor significant local discretion is alone sufficient to serve accountability, efficiency, and effectiveness objectives. Both adequate own-source amounts and significant local discretion are needed.

With this in mind, local governments have now been given the authority to create their own new sources of revenue, given the satisfaction of so-called 'good' tax criteria. Several criteria were used, as determined by widely accepted principles, in the government of Indonesia's evaluation of candidate regional government taxes that were included in Law No. 18/1997 and in Law No. 34/2000.³

- The tax must be suitable as a regional government tax; that is, the tax base must clearly be located within, or arise from within, the regional government area, and must relate primarily to economic activity from within the regional government area.

- The tax must be politically acceptable at national and regional levels;
- The tax base must not overlap with that of another central or local tax or license fees having the characteristics of a tax.
- The estimated potential yield of the new revenue source should represent a substantial additional contribution to the present total of local revenues, and should be founded on a buoyant revenue base.
- The gross costs (i.e. costs before deduction of any staff-related grant) of collecting the revenue must be acceptably small compared to the yield of the revenue.
- The tax must not prejudice national economic policies.
- Except as a matter of deliberate and justified policy, the tax must not seriously change the allocation of economic resources within the regional government area or between regions, nor disrupt intra- or inter-regional trade.
- The tax burden must be affordable, both by the majority of those directly liable to pay it and by those on whom it would ultimately impact.
- The tax must not be unduly regressive.
- The tax must not unfairly discriminate between particular sections of the community.
- Regional governments must be able to administer the revenue effectively; that is, regional governments must be able to identify the vast majority of liable taxpayers, to assess each taxpayer's liability readily and accurately, and to enforce collection of the revenues assessed as payable.
- The tax must not deter taxpayers from taking proper action to comply with environmental conservation needs.

The criteria for additional local taxes set out in article 2 (4) of Law No. 18/1997 and as amended by Law No. 34/2000 represent a condensation of these 'good' tax principles. We believe that these are sensible criteria. It must be admitted, however, that these standards have been very loosely interpreted both by local governments and by those at central level charged with approving the use of newly created instruments. In the event, we believe that many inappropriate new taxes have been created at local level.

A better approach would be to assign to regional governments taxes of substantial potential yields for which they are allowed a wide degree of discretion in setting their own tariffs. The extent of such discretion must be sufficient to provide at least a marginal variation in total revenues, thus enabling regional governments the choice between better services and lower taxes. In particular, this would enhance regional government accountability by making them justify to their constituents the tariff levels, rather than

blaming them on central legislation. It also would provide incentives for maximizing efficiency in operations.

As Table 7.4 demonstrates, provinces already have relatively large amounts of own-source revenues at their disposal; however, provincial governments currently have no discretion at all over the tariffs for their largest tax revenues. We argue therefore that provinces should be given more discretion over tax rates. The grant of some tax rate discretion to provincial governments for all their major taxes would give them a substantial degree of the desired marginal revenue discretion.

Although local governments nominally control tariffs over the taxes assigned to them, in practice they have very little rate discretion because most governments are already levying tariffs at the maximum levels allowed. Local governments thus need more tariff discretion as well. However, the proportion of kota and kabupaten budget revenues represented by local taxes is presently so small that the award of additional tariff flexibility by itself would have very little marginal impact on total revenue. Kota and kabupaten governments thus need to be given one or more substantial additional local revenues with a wide discretion in setting the tariff.

The obvious means of so doing is to transform the land and buildings tax (PBB) into a local tax. Local governments already receive some 75 percent of PBB proceeds, most of which is returned to the region of derivation. PBB revenues on average represented about 4.8 percent of total local budget revenues in 2001, with substantial variations between regions. The full tax tariff permitted by the present law is 0.5 percent of property value, but the current effective tariff averages only about 0.15 percent, with high-value properties at 0.2 percent and other properties at 0.1 percent; high-value properties are thought to generate about half of the total PBB revenue. Transfer of the whole PBB tax to the kota/kabupaten level, with a local facility to set the tariff anywhere in the range of 0.1 to 0.5 percent, would make a substantial contribution to increasing local fiscal autonomy and accountability. The loss of the provinces' 16.2 percent share of the PBB could be made up for by compensating changes in the percentages of the provincial taxes that are shared with the local level; in changing the transfers, special attention would have to be given to some practical problems, notably concerning the offshore portions of the oil and gas sectors, but these problems should not prove insuperable.

The only other feasible candidate state tax for outright decentralization to regional level is the land and buildings transfer tax (BPHTB). Regional governments currently receive 80 percent of the proceeds; provinces receive 16 percent, and kota/kabupaten get 64 percent. In 2001 this amount represented on average 0.9 percent of both provincial and kota/kabupaten total budgets. Again, this tax should be transferred to local government level, and

the provincial losses compensated by adjustments to the provincial tax sharing provisions.

It is sometimes argued that local autonomy needs are sufficiently served by choice in whether to levy particular local taxes and in setting the tariffs, and that the administration of the collection of the taxes can often more effectively and efficiently be assigned either to another government level or to an independent agency. It is also sometimes argued that local tax administration can prejudice the independence of the assessment function, especially concerning the affairs of influential local people. Against these may be set the argument that agencies of the taxing regional government, being directly responsible to the chief executive and accountable to the local parliament, are more likely to be responsive to complaints from individual taxpayers, the community, the executive, and locally elected officials than are external agencies. In countries that have unified collection agencies for taxes at all government levels, local governments often complain of inadequate accountability to them of the agencies, especially concerning arrears, and believe that they have little power to influence their performance. In Indonesia's case, PBB tariff discretion only (and no administrative responsibilities) might be given to local governments; alternatively, the transfer of tariff discretion might precede the full transfer of the tax administration function. We believe that the latter would be best.

Another type of local taxation found in some countries is the imposition of local supplements on top of certain central government taxes, sometimes known as 'piggyback' taxes. The local supplements are collected along with the central tax elements by central government and paid over directly to the relevant local governments. This approach is feasible in Indonesia as an additional revenue source for kota and kabupaten governments in order to enhance local fiscal autonomy and accountability.

Central taxes subject to local supplementation must meet the same general criteria applying to 'good' local taxes. In particular, the tax base must genuinely derive from the local area for which the supplement is imposed, so that its burden falls on the local community rather than elsewhere. Accordingly, the only Indonesia state tax for which such local supplementation is feasible would appear to be personal income tax. The fact that this is already now shared with regional governments is no intrinsic barrier to giving kotas and kabupatens a further supplementation facility or, better, converting the present regional 20 percent share to a local supplementary tax on the national income tax. The national tax rates would then need to be reduced, while the kabupaten and kota governments would individually set the tariffs for the local supplementary elements, possibly subject to maxima laid down in national legislation. As in the case of the transfer of the PBB and BPHTB taxes, provinces would lose their 8 percent portion of the total 20 percent personal income tax share

on conversion of the latter to a local supplementary personal income tax, with the loss compensated for by appropriate changes to the sharing with the local governments of the main provincial taxes.

Table 7.5 provides our estimates of the impact of decentralizing property based taxes to local governments and of restructuring the personal income tax shares in the form of a piggyback tax for kabupaten/kota. While these would be a good start in getting regional governments the resources and discretion that they need, more will have to be done. In this regard, we propose that regional governments should first concentrate on achieving the as yet unrealized potential of some of the taxes over which they have (or will have) control. In the long run, regional governments may well be awarded with additional tax bases, but we believe that this is not yet the time to pursue this agenda.

Table 7.5 Estimated effects of decentralizing the PBB and BPHTB and of restructuring the share of personal income tax as a piggyback tax for Kabupatens and Kotas (in percentages)

	<i>Provinces (excluding DKI Jakarta)</i>	<i>DKI Jakarta</i>	<i>Kota</i>	<i>Kabupaten</i>	<i>Overall</i>
Before transfer (see Table 7.4)	44	30	15	5	15
After transfer	49	84	26	11	23

Source: Republic of Indonesia (2001).

INTERGOVERNMENTAL TRANSFERS IN THE INDONESIAN DECENTRALIZATION⁴

The system of intergovernmental transfers in Indonesia comprises three basic types of schemes: revenue sharing, a general purpose grant (DAU), and grants for specific purposes (DAK). The importance of intergovernmental transfers to regional government budgets has been indicated in Table 7.4. As shown there, transfers account for 85 percent of total regional revenues.

The transfer system has several main objectives:

- To address vertical fiscal imbalances between levels of government (revenue sharing, DAU).
- To equalize regional government fiscal capacities (DAU).

- To encourage regional expenditure on national development priorities (DAK).
- To promote the attainment of minimum infrastructure standards (DAK).
- To compensate for benefit/cost spillovers in priority areas (DAK).
- To stimulate regional commitment (DAK).
- To stimulate revenue mobilization (revenue sharing, DAU, DAK).

Revenue sharing is discussed next, followed by a review of general purpose grants (DAU) and specific purpose transfers (DAK).

Revenue Sharing

There are currently three main types of revenue sharing mechanisms, one for property-based taxes (PBB and BPHTB), one for natural resource revenues (forestry, mining, fisheries, oil and gas) and one for the personal income tax.⁵ Table 7.6 lists revenue sharing mechanisms, along with the old and new sharing arrangements. The revenue sharing schemes are intended to respond to regional aspirations for increased access to and control over revenues, to assist in the stimulation of increased regional revenue mobilization, and to address vertical fiscal imbalances.

One problem with the attainment of the first two objectives is that many in the regions remain unconvinced they are getting their fair share of the revenues in question. For natural resource revenues, this concern could be addressed by making payments directly to the regions, instead of first collecting total revenues at the central level and then distributing them to the regions, or at least by making more transparent the calculations of total natural resource revenues. The preferred solution for the income tax sharing problem would be to restructure the transfer as a tax base sharing instrument, via piggyback methods, as argued before.

A positive contribution to alleviating vertical fiscal gaps has indeed been made by revenue sharing schemes, as shown in Table 7.7 which presents the results of a standard comparison of central and regional expenditure and revenue shares before and after transfers have been made. Before transfers are made, sub-national governments are in substantial deficit; after revenue shares are distributed, the deficit is considerably reduced. Remaining fiscal imbalances at sub-national level are completely removed by the distribution of grants. In fact, sub-national governments experience a surplus balance after the transfer of DAU and DAK, and the central government moves to a deficit position. We will say more about this implied 'over-allocation' of transfers to regional governments.

A particular difficulty with the revenue sharing program in Indonesia is that the bulk of the shared revenues goes to relatively few regional governments.

Table 7.6 Proportion of sharing of state revenue before and after Law of Financial Balance (percentages)

No.	Revenue types	Before			After			Balance to other districts
		Central	Prov.	Districts	Central	Prov.	Districts	
1.	PBB	10	16.2	64.8	-	16.2	64.8(+)	+
2.	BPHTB	20	16	64	-	16	64(+)	+
3.	Forestry: IHPH	55	30	15	20	16	64	-
4.	Forestry: PSDH	55	30	15	20	16	32	32
5.	Mining: Land rent/Iuran Tetap	20	16	64	20	16	64	-
6.	Mining: Royalties	20	16	64	20	16	32	32
7.	Fisheries	100	-	-	20	-	-	80
8.	Oil	100	-	-	85	3	6	6
9.	Gas	100	-	-	70	6	12	12
10.	Personal income tax (PPh)	100	-	-	80	8	12	-

Source: Sidik (2002b) based on Law No. 25/1999.

Table 7.7 Vertical imbalances, FY 2001 (in percentages)

	Revenue share	Expenditure share	Surplus/deficit
<i>Own sources</i>			
National	96.6	73.2	23.4
Sub-national	3.4	26.8	-23.4
Provincial	2.1	5.4	-3.3
Kabupaten/Kota	1.3	21.4	-20.1
Total	100	100	0
<i>After shared revenues</i>			
National	89.9	73.2	16.8
Sub-national	10.1	26.8	-16.8
Provincial	4.0	5.4	-1.4
Kabupaten/Kota	6.1	21.4	-15.4
Total	100	100	0
<i>After grants</i>			
National	70.2	73.2	-3.0
Sub-National	29.8	26.8	3.0
Provincial	6.0	5.4	0.6
Kabupaten/Kota	23.8	21.4	2.4
Total	100	100	0

Source: Lewis (2002b).

This creates significant problems regarding the distributional equity of transfers. In principle, the inequitable nature of these transfers could be mitigated by an equalization grant. However, it must be recognized that such a transfer probably cannot completely compensate those regions without access to significant shared revenues, barring the use of 'negative grants,' and problems of inequity are likely to remain.

General Purpose Grants: Dana Alokasi Umum (DAU)

The DAU is intended in part to respond to regional aspirations for greater access to and more control over revenues. The DAU is also intended to address problems related both to vertical imbalances between different levels of government and to horizontal imbalances across regions.

Although the DAU has in fact assisted in meeting regional demands for greater revenues and more control over those revenues, its attempts to address

regional aspirations have recently been put at risk. A newly revised government regulation stipulates that regional governments must now report on a quarterly basis to the center on the precise uses of the DAU. This new regulation is contradictory to the intended discretionary nature of the grant. In any case, it is probably not practicable, given the fungible character of most regional revenues. Moreover, many fear that this regulation may be the first step towards implementing an agenda of formally tying the DAU to particular types of expenditures. We would argue that this new DAU reporting requirement should be expunged.

Initial evidence suggests that the total pool of finance available to the DAU (based on a minimum of 25 percent of net domestic resources) provides more than enough at the aggregate level to address vertical fiscal imbalances between central government and regional governments. Table 7.8 presents some evidence on the match (or mismatch) between provincial and kabupaten/kota fiscal capacities and their respective expenditure requirements. It should be noted that this conclusion can be stated with a good deal of confidence for kabupaten/kota governments; the extent of its validity for provincial level governments is somewhat more suspect.

Table 7.8 Estimated regional government fiscal capacities and expenditure needs, FY 2001 (in Rp trillions)

	<i>Level of government</i>		
	Provinces	Kabupaten/Kota	Total
<i>Revenues</i>			
Own source	6.4	4.1	10.5
Shared revenues	5.9	14.8	20.7
DAK	n.a.	0.7	0.7
DAU	6.2	54.3	60.5
Total revenues	18.6	73.9	92.4
<i>Expenditure needs</i>			
Routine, based on FY 2000	8.4	23.2	31.6
Development, based on FY 2000	5.5	9.4	14.9
From ex-Kanwil and Kandep FY 2000	3.2	15.0	18.2
Total expenditure needs	17.1	47.6	64.7
<i>Surplus</i>	1.5	26.3	27.7

Source: Lewis (2001).

We suggest that the over-allocation of grants to regions implied by the evidence in Table 7.8 be handled by an increased decentralization of expenditure responsibility to appropriate sub-national governments. We also propose to revisit the DAU sharing arrangement between provinces and kabupaten/kota, as the former appear to be given short shrift with regard to their relative share. It goes without saying that these important issues will require further study before hard decisions are made.

The DAU is allocated across regional governments by a formula where allocations are based on the relative size of the fiscal gap. The intent of the adopted allocation methods is to equalize fiscal capacities of regional governments to finance expenditures. The DAU has already achieved some success in terms of its equalization goals. Table 7.9 provides one illustration of the equalizing effects of the DAU transfers. Table 7.9 shows the variation in per capita revenues, as measured by the ratio of the maximum to minimum values in the distribution, and also shows the coefficient of variation. Variation in the distribution of revenues is smaller after transfers have been made than before, which suggests that the DAU allocations have an equalizing impact on regional fiscal capacities.

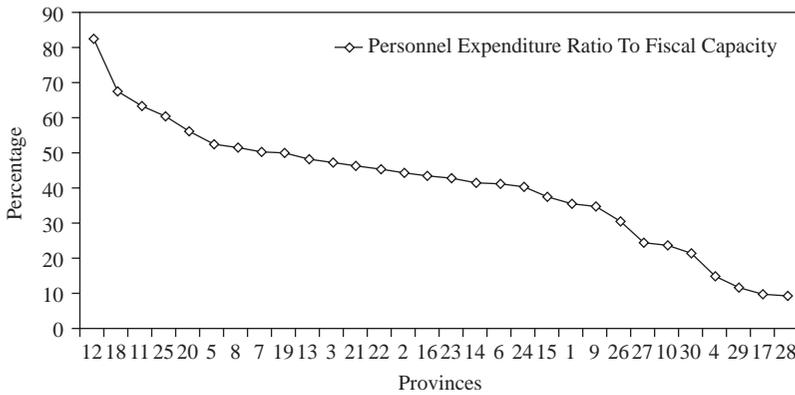
Table 7.9 Variation in per capita revenues across local governments, FY 2002

<i>Revenues</i>	<i>Maximum</i>	<i>Minimum</i>	<i>Maximum/ minimum</i>	<i>Coefficient of variation</i>
Own-source revenues	855.3	0.3	2 835.9	2.245
+ Property-related transfers	918.3	10.2	90.1	1.323
+ Personal income tax transfers	924.5	11.2	82.2	1.261
+ Natural resource revenue transfers	4 916.4	12.7	387.0	2.559
+ DAU balancing factor amounts	5 732.7	98.5	58.2	1.152
+ DAU formula amounts	7 108.8	160.4	44.3	0.958
+ 'Hold harmless' adjustments	7 090.9	154.9	45.8	1.030

Source: Lewis (2002b).

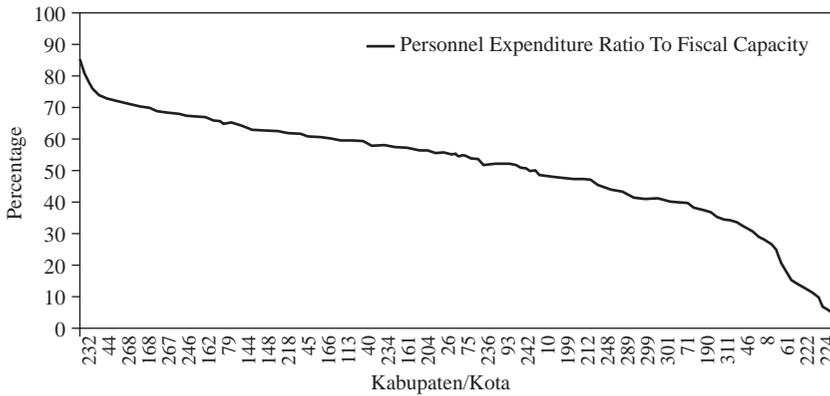
This picture of success notwithstanding, however, various recent analyses have shown that the performance of the DAU may still be quite sub-standard relative to its equalization goals. Figures 7.2 and 7.3 demonstrate the continuing significant variation among provincial and local governments in the general adequacy of their fiscal capacities to meet respective expenditure needs, where expenditure needs are measured by personnel expenditure.⁶

We believe that more work needs to be done at the technical level to improve the DAU formula. In the medium term, factors that better measure



Note: Fiscal capacity = Region’s natural revenue, sharing from tax and natural resources revenue, general allocated fund + equalization fund.

Figure 7.2 Provincial personnel expenditure ratio to its fiscal capacity



Note: Local revenue = Region’s natural revenue, sharing from tax and natural resources revenue, general allocated fund + equalization fund.

Figure 7.3 Kabupaten/Kota personnel expenditure ratio to its fiscal capacity

expenditure requirements and fiscal capacity need to be found and employed. In the long run, expenditure needs should be more precisely estimated for individual governments as a function of the real costs of achieving some specified standard of service delivery, and fiscal capacities should be more exactly derived as a function of the potential of local tax bases along the full

scope of transfers to which regions have access. A transition plan for removing the so-called balancing factor from the distribution formula gradually over time also needs to be specified. In this regard, the 'hold harmless' condition, which was useful in the first year of DAU operations, should probably now be relaxed.

Revisions to Law No. 25 should avoid specifying in great detail requirements of the DAU distribution mechanism. However, the revisions should reaffirm the use of the fiscal gap approach in allocating DAU resources, and should expand on that concept more precisely and accurately than is currently done in the Law. Details of the formula itself would be handled in the context of revisions to government regulations, as would the specification of a plan to gradually decrease the importance of the balancing factor in determining allocations.

Specific Purpose Transfers: *Dana Alokasi Khusus* (DAK)

There are numerous goals in the design of the DAK. In principle, the DAK is mainly intended to help fund important needs that cannot be estimated in a DAU formula and to assist with funding of expenditures that relate to national priorities. The DAK is also used to finance physical capital investment, although limited-period financing of operational and maintenance needs is permitted in special circumstances. Further, the DAK promotes the attainment of minimum standards, and compensates for benefit/cost spillovers related to priority capital investments. Finally, DAK transfers are designed as matching grants with a view to establishing regional government commitment to the investments.

However, it should be noted these goals are not yet in place in the DAK allocations. At present, the DAK allocations are based only on revenue derived from the country's reforestation program; currently 40 percent of these revenues are returned to the kabupaten of origin, and are to be used for local reforestation efforts. It is the priority of central government to speed up the further design and implementation of the full range of DAK activities.

CONCLUSIONS

The proposals that we set forth here form a substantial work program that cuts across many substantive issues. Moreover, the policy agenda that we have laid out is one that concerns many important and powerful institutions in the Indonesian bureaucracy, at central, provincial and local levels. The institutional setting in Indonesia is a complex one, and policy reform in any area requires the collaboration and cooperation of many individuals.

This reality suggests that the reform of fiscal decentralization policy will be a painstaking process and that its implementation will take some time. Still, a phasing-in of our reform program could begin sooner rather than later, given some important decisions and initial signs of cooperation among various parties. In fact, the Ministry of Finance has begun to map out a work plan that incorporates the necessary transitional arrangements.

Of perhaps most importance, many of our policy measures will require consultations with, and/or practical action by, a variety of agencies and groups outside the Indonesian government. We take seriously our role in developing the necessary partnerships with those groups outside the public sector. We have already begun building the alliances and coalitions that will prove so important in implementing this far-reaching agenda.

NOTES

1. Smoke (2003) discusses a wide range of issues in the Indonesian expenditure assignment.
2. See Oates (1972, 1999) for a detailed discussion of the appropriate assignment of expenditure responsibilities between levels of government.
3. See Bird (1999) and McLure (1983) for a discussion of tax assignment principles. Also, see Simanjuntak and Mahi (2003) for an analysis of the revenue potential of various local taxes in Indonesia.
4. Brodjonegoro and Martinez-Vazquez (2003) analyze the Indonesian transfer system.
5. See Bahl and Tumennasan (2003) for a detailed discussion of natural resource revenue sharing in Indonesia.
6. It should be admitted that the use of personnel expenditure as a proxy for expenditure needs is not without some problems.

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PART III

Closing the Fiscal Gap: Transfers, Borrowing and Natural Resource Revenues

8. An analysis of Indonesia's transfer system: recent performance and future prospects

Bambang Brodjonegoro and Jorge Martinez-Vazquez

INTRODUCTION

Since the mid-1970s, fiscal decentralization in Indonesia had been a slow-burning affair. However, with the 'Big Bang' of the 1999 reforms, in the space of one year Indonesia changed from one of the most centralized to one of the most decentralized countries in the world. It was with significant trepidation that observers saw the share of sub-national government spending in total government spending almost double from 2000 to 2001, to over 30 percent, and at the same time over two million civil servants and thousands of facilities were re-assigned to local level. However, the widespread concerns about chaos and disarray did not materialize. The transition to the new decentralized system had some bumps, but overall was fairly smooth.

In hindsight, there are many reasons for this largely successful transition. There is little doubt that, despite some defects, the institutional framework for fiscal decentralization, laid out in Laws No. 22/1999 and No. 25/1999, deserves much credit for the success. The centerpiece for the new fiscal decentralization institutions in Indonesia is the new system of transfers comprising *revenue sharing* of natural resources, personal income tax, and property taxes, the DAU (*Dana Alokasi Umum*) a large unconditional grant intended to fund sub-national governments in an equalizing manner, and the DAK (*Dana Alokasi Khusus*), a set of yet to-be-developed conditional grants.

In this chapter we examine the performance of this transfer system. We first discuss the history of transfers in Indonesia. We next review the structure and performance of the new system of transfers in Indonesia, and then focus on the unfinished agenda for reform. Our main conclusion is that, with the development and initiation of the DAU in 2001, the government of Indonesia (GOI) got the fundamental concepts right but also got many of the particular details wrong. The performance of the DAU was hindered by several choices

made in the implementation of the new system, the most important being an extremely rigid interpretation of the 'hold harmless' provision. The GOI proceeded to reform the DAU for 2002, and, although real improvements were made, some important issues still remain, including how the new system should move away from the suffocating grip of the hold harmless provision. Also, the GOI faces important challenges but also good opportunities in shaping and increasing the importance of the DAK conditional grant system. With respect to revenue sharing on a derivation basis, we recommend that the GOI should not develop it further, but instead it should focus on developing the revenue autonomy of sub-national governments.¹

A BRIEF HISTORY OF TRANSFERS IN INDONESIA

Transfer systems have a long history in Indonesia. From the time of independence in 1945, Indonesia's experience with intergovernmental fiscal finance can be classified into three periods: a pre-SDO period, an SDO period and the current DAU period.

The pre-SDO period extends from 1945 to 1972. During this time, there were many forms of intergovernmental transfers, often introduced to reduce tensions between central and local governments. Until 1956, the stated goal was to ensure local governments had the ability to finance their planned budget deficits through central government subsidies. Not surprisingly, central government was not able to operate the system and largely had to avoid its original commitment. In 1956, the government issued Law No. 32/1956 with a defined concept of intergovernmental fiscal transfers based on a formula. This proved to be too advanced for the time and never got off the ground, but the Law was not canceled until 1999.

From 1956 to 1964, the central government introduced a tax revenue sharing scheme in which local governments received some percentage of central government tax revenue. In 1965, the central government replaced the tax sharing system with direct subsidies that were based on the total wage bill of local governments. The scheme was called the 'intergovernmental subsidy system,' and it would become the basic concept later applied in the *Subsidi Daerah Otonom* (SDO), or Autonomous Region Subsidy. Over approximately the same period (1965–74), central government applied other types of intergovernmental transfers, such as central government contributions to local governments, development assistance funds, natural resources revenue sharing (in terms of royalties for forestry products), and land rent for mining activities. However, these other transfers often lacked an adequate legal basis.

The SDO system was first fully implemented in 1972/73. The core concept behind the SDO was that central government would fully support the costs of

local government employees. Two-thirds of the SDO was allocated to provincial governments, and the rest was for the district/municipality governments. The SDO is best classified as a specific purpose or conditional grant with no discretion at local government level. Aside from the SDO, local governments also received *Instruksi Presiden*, or *INPRES* transfers, which were earmarked for local development activities. An important objective of the *INPRES* system was to reduce regional disparities, and its allocation was based on several criteria such as population, local own revenue (PAD), a minimum transfer per local government, area, previous transfers, and so on. In reality, there were many types of *INPRES* grants. Some of them could be classified as specific purpose grants (e.g. *INPRES* for basic education, health services, reforestation, or small retailers). Others could be classified as general purpose or block grants (e.g. *INPRES* for provincial development, district/municipality development, or village development). General purpose (or block) *INPRES* grants generally had larger funding than specific purpose *INPRES* grants. Both SDO and *INPRES* were Indonesia's transfer system until the introduction of the DAU in 2001.²

THE CURRENT SYSTEM OF TRANSFERS IN INDONESIA

Law No. 25/1999 introduced three types of intergovernmental transfers: revenue sharing, the DAU, or General Allocation Fund, and the DAK, or Specific Allocation Fund. We will consider each in turn.

Revenue Sharing

Three types of taxes are currently shared between the central and sub-national governments on a modified derivation basis. These are natural resource taxes, personal income tax, and property taxes (the property tax or PBB, and the land transfer fee or BPHTB). The most significant of the three is natural resources revenue sharing. This is a new type of revenue sharing, introduced by Law No. 25/1999 with the intention of compensating natural resource-rich regions that had felt unfairly exploited during the Soeharto era and that more recently had demonstrated their aspirations to controlling and benefiting from the natural resources in their territories. There are four natural resource commodities whose tax revenues are shared between central and local governments: gas and oil, general mining, forestry and fishery. At the sub-national level of government, there is revenue sharing among the provincial governments, the producing district/municipal governments, and other district/municipal governments within provinces. The revenue sharing rates for natural resource taxes are shown in Table 8.1.

Table 8.1 Natural resources revenue sharing scheme (in percent of total revenues collected)

Item	Central government	Provincial government	Resource-producing local government	Other local governments in the same province	All local governments in Indonesia (equal share)
Oil	85	3	6	6	-
LNG	70	6	12	12	-
Mining: Land rent	20	16	64	0	-
Mining: Royalty	20	16	32	32	-
Forestry: Land rent	20	16	64	0	-
Forestry: Resources	20	16	32	32	-
Provision	20	-	-	-	80
Fishery					

Source: Law No. 25/1999 and Government Regulation No. 104/2000.

Revenue sharing of natural resources has remained controversial since Law No. 25/1999 because several of the resource-rich regions still seemed to believe that they were not getting a fair share. One part of the problem has been the lack of transparency in the calculations of total revenues from natural resources, and another has been the sharing rates.

In response to the tensions surrounding the sharing of natural resource revenues, central government approved in 2001 special regimes for the most politically assertive provinces, Aceh and Papua. These laws represented the first important instance in which central government legally accepted asymmetric treatment of subnational governments.³ Aceh's Special Autonomy Law No. 18/2001 gives this province an additional 55 percent of petroleum taxes and 40 percent of gas taxes, compared to the standard 15 percent and 30 percent, respectively. This means that the special autonomy scheme gives Aceh 70 percent of oil and gas revenue sharing. Papua's Special Autonomy Law No. 21/2001 applies a similar proportion.⁴ In both special autonomy laws, the whole additional revenue from petroleum and gas taxes will be received directly by their respective provincial governments and the provincial governments will be responsible for allocating the fund to all of their kabupaten and municipalities using their own formula.

Revenue sharing for personal income tax was first introduced with the 1999 reforms. Property tax and land transfer fee revenues were already shared between central and local governments prior to the 1999 reform. Through the revision of income tax law (Law No. 17/2000), central government added personal income tax (including payroll tax) to the tax sharing scheme, where 80 percent of personal income tax revenues are still retained by central government and the rest goes to provincial (8 percent) and district/municipal governments (12 percent).⁵ Table 8.2 gives the sharing rates for other taxes.

Revenue sharing on a derivation basis is helping with general funding of sub-national governments, and thus is being used as a way to address vertical imbalances in Indonesia. Revenue sharing is also being used to address the important political issue of redressing perceived past injustices toward natural resource-endowed regions. But revenue sharing can also be a source of problems, the most serious of which is increasing fiscal disparities; however, this is a problem that can be addressed through equalization transfers. It is notable that Indonesia has avoided so far the problems associated with revenue sharing arising from the difficulty encountered with the fair apportionment of taxes such as VAT or corporate income tax. It was a wise decision not to share those taxes with sub-national governments, and it should be kept that way.

Table 8.2 Other taxes revenue sharing scheme (in percent of total revenues collected)

Item	Central government	Provincial government	District/municipal governments in the same province	Collection fee	All district/municipal governments in Indonesia (equal share)
Property tax	-	16.2	64.8	9	10
Land transfer fee	-	16	64	-	20
Personal income tax	80	8	12	-	-

Source: Government Regulation No. 104/2000 and Law No. 17/2000.

Dana Alokasi Umum (DAU), or the General Allocation Fund

The DAU is by far the most important type of transfer in Indonesia, and finances approximately three-fourths of sub-national government expenditures. The DAU can be classified as a general purpose grant that gives full discretion to local governments to spend the funds according to their priorities. The DAU is a well-developed equalization grant system with explicit funding rules and formulas for the distribution of the funds. The overall pool of funds comes from 25 percent of net domestic revenues (or total domestic revenue minus revenue sharing) in the central government budget. From that amount, provinces receive 10 percent and district/municipal governments 90 percent. Details of the formula used for the allocation of DAU in 2001 and 2002 are shown in Appendix 8.1. The formula is practically identical for provinces and district/municipal governments.

The basic concept behind the DAU formula is the fiscal gap, or the difference between measures of expenditure needs and fiscal capacity for each local government. The expenditure needs for each jurisdiction are approximated by applying a weighted index of four variables (population, area, cost differences, and poverty) to the average expenditure for all jurisdictions. The fiscal capacity of each jurisdiction is approximated by adding an estimate of its own revenues to the actual revenues from shared taxes.

In fact, however, only 20 percent of the DAU overall funds were allocated through the formula in 2001; in 2002 this figure increased, but only to 40 percent. The rest of the DAU funds were allocated to the provinces and districts/municipalities on the basis of two additional sets of factors. The first factor was a lump sum or equal amount that each jurisdiction (province and district/municipality) received during the fiscal year. The lump-sum factor represented 10 percent of the total DAU funds in 2002, as specified by Parliament.⁶ The lump-sum factor has been justified as covering fixed or overhead costs of the jurisdictions. However, it is feared that this has given an incentive for the further fragmentation of local governments.

The second additional factor governing the final allocation of the DAU is the so-called 'balancing factor,' predicated on the basis of a 'hold harmless' condition. The balancing factor for 2001 was proposed by the Ministry of Finance and applied only to the districts and municipalities, and assured that every district/municipality received a minimum transfer equal to 130 percent of the SDO funds and 110 percent of the INPRES funds it got in 2000. This second factor took the bulk of the DAU funds in 2001. The interpretation of the hold harmless provision in 2002 was demanded by Parliament as meaning that no jurisdiction would get less than the funds it got in 2001. This meant that in addition to the 10 percent of the DAU going to the lump sum factor, an additional 50 percent of the DAU went to the balancing factor in 2002. The

funds of the balancing factor in 2002 were distributed among local governments in proportion to their relative wage bill for public employees.⁷ As will be discussed further, the balancing factor could have worked against the objective of equalization in the DAU,⁸ but also introduced in 2002 an incentive for local governments to hire more employees and to spend more on salaries.

Law No. 25/1999 emphasized the equalization role of the DAU, but in reality the DAU has served several objectives other than equalization. By virtue of the 'balancing factor,' all jurisdictions receive a DAU amount no matter how well off they are. This means that the DAU functions as a general funding mechanism to address vertical imbalances. The DAU is also being used as a way to redress historical injustices.⁹

A recent government regulation requires that local governments report on the uses of the DAU on a quarterly basis. This regulation raises the question of whether the DAU will remain an unconditional grant in the future. We will discuss the possibility of transforming some of the funds now used for the balancing factor into conditional grants. However, the question with reporting requirements and even more so with any conditionality is whether the central authorities have the means to monitor and enforce them.

Dana Alokasi Khusus (DAK), or the Specific Allocation Fund

Law No. 25/1999 introduces specific purpose, or conditional, grants for two types of objectives: to help fund important needs which cannot be incorporated in the DAU formula¹⁰ and to provide funding for activities which relate to national priorities or commitments.¹¹ A third category contemplated as part of the DAK is a mechanism for intergovernmental sharing of forest exploitation fees.

The DAK is still a minor part of Indonesia's system of intergovernmental transfers. The DAK is seen in law as a conditional matching grant, and local governments receiving DAK funds are supposed to provide at least 10 percent of the total amount of the project on their own.¹² The source of funding for the DAK is the central government budget, except for reforestation activities, which are covered directly by fees from the reforestation fund.¹³

Except for reforestation funds, the DAK system was not used in either 2001 or 2002. Two questions arise. First, from where is the funding for the DAK to come? One answer commonly offered is that some of the development expenditures now going through central government agencies could be transformed into conditional grants as part of the DAK (Hofman et al., 2002). Another possibility is to use some of the funds now used as the balancing factor in the DAU as funding for conditional grants in the DAK. This issue is not yet resolved. Second, on what basis should the DAK be allocated? The

approach for DAK allocation is vague in the Law, and this lack of transparency may eventually raise questions of arbitrariness. Several approaches are possible to bring transparency in the DAK. The funds may be distributed as part of national sectoral programs, which may include investments in capital infrastructure and could be distributed according to clear and objective criteria summarized in explicit formulas. DAK funds may also be used as contingency funds for natural disasters. Regardless, rules should be established for the annual allocation, the authority to disburse, and the final disposition. In general, DAK funds should be distributed to achieve central government goals such as stimulating regional spending on activities of national interest or addressing externalities across regional governments; redistribution need not be emphasized if the DAU does a sufficient job in equalizing fiscal disparities. In this regard, remember that during 2001 and 2002 the DAU was severely constrained in its equalization role. If these constraints continue in the future, then it may be necessary to consider an equalization role for the DAK.

Recent Changes in the DAU

A remarkable feature of the new system of transfers in Indonesia has been an officially guided process of rigorous examination and improvement. This is good because the short time available to put together the DAU in 2000, from principles to the most concrete details of implementation, inevitably meant that the new transfer system would have problems. These problems were indeed numerous. However, the DAU also got many things right, and these were in general the very fundamental aspects of the transfer system (Martinez-Vazquez, 2001).

The accomplishments of the DAU in 2001 were in three areas. First, the government used a transparent rule for how to fund the DAU, and also clearly established the division of the overall pool of funds between the two tiers of regional governments, the districts/municipalities and the provinces; this funding rule was kept for the second year. Second, the formula used for the DAU looked at the difference between estimated expenditure needs and revenue capacity as opposed to actual expenditures and actual revenues of regional governments. This avoided moral hazard problems of providing incentives to regional governments to spend more and collect too little in an attempt to increase their DAU allocations. Third, the DAU used a phased-in approach, although the 'hold harmless' provision was carried too far.

There were also in 2001 several questions and several problems with the DAU. There were questions about the adequacy of the DAU overall funding at 25 percent of central government domestic revenues, as well as questions about ways to improve on the variables used in the estimation of fiscal or

expenditure needs and the weights attached to them.¹⁴ Among other problems, the DAU formula lacked aggregate consistency because some of the variables in the definition of fiscal capacity and expenditure needs were not properly scaled. Another problem was that the computation of fiscal capacity applied an index of industry, natural resources, and human resources, equally weighted, both to 'local own revenues' and to 'shared revenues.' Instead, the index should have been applied only to 'local own revenues'; the other component, 'shared revenues', should have been entered in the formula directly as forecast by the government authorities. The reason for using an estimate for fiscal capacity is that there exists a moral hazard problem with using direct estimates of revenues. When direct estimates of revenues are used in the formula, local governments are given an incentive to collect less revenue by lowering tax enforcement and administration efforts, by lowering tax rates, or modifying the tax base (assuming they have discretion over any of those dimensions of actual revenue effort). In the case of Indonesia, local governments have some discretion over the level of tax effort they can exercise for local own revenues. However, they have no discretion at all over shared revenues. This of course raises the question of whether local governments with a negative fiscal gap would receive zero funds from the DAU.¹⁵

During the first few months of the implementation of the DAU in 2001, it became clear that the government would have to review an important issue related not to the structure of the DAU but rather to its implementation process. This was the 'hold harmless' provision. The analysis used to back up the quantification of the 'balancing factor' had been incomplete, and ultimately led to erroneous policy because the budgetary position of local governments in 2001 was very different from their respective position in 2000. There were big differences arising from major changes in expenditure assignments, as specified in Law No. 22/1999, and from changes in revenue assignments, including revenue sharing in natural resources. Therefore, providing regional governments with transfers at least equal to the SDO and INPRES funds they got in 2000 did not guarantee they were held harmless in the new fiscal environment of 2000. The 'hold harmless' provision should have been framed better by comparing the old plus new expenditure assignments (where the latter should have been costed at the level of funding required in the last year before those responsibilities had been decentralized) against own regional government revenues plus new resources from revenue sharing plus new transfers from DAU and special allocation grants; the DAU and special allocation grants should have been at least as large as the SDO and INPRES transfers in 2000. However, it must be noted that even this would not have been sufficient to hold harmless local governments; that is, the DAU transfers in 2001 may have exceeded the SDO and INPRES transfers in 2000, but the remainder may have been less than the funding required

for the new expenditure assignments net of revenue sharing. On the other hand, some regional governments may have received so much more funding through revenue sharing in 2001 that they would have been held harmless even without DAU transfers. In such cases, holding harmless would not have required the transfer of funds equivalent to SDO and INPRES received in 2000, when there was no revenue sharing.

Even though it was not possible to phase out the hold harmless provision in the 2002 DAU, the reformed DAU represents a marked improvement over the 2001 DAU. The major improvement occurred on the revenue side. In 2002, all revenue components reflected capacity coming either from actual revenue sharing or from estimated local capacity. On the expenditure side, progress has been slower due to limited data availability.

THE RATIONALES FOR TRANSFERS IN INDONESIA

There are several reasons for intergovernmental transfers, both in general and in the specific case of Indonesia. This section considers these justifications.

To Correct Vertical Imbalances

One of the most important objectives of the intergovernmental transfer system in Indonesia is to reduce vertical imbalances. The decentralization process has transferred significant expenditure responsibilities to sub-national governments, which now require more reliable sources of financing. The questions, of course, are whether there is a vertical imbalance now in Indonesia, and, if so, how significant this imbalance is.

There is no unique definition of vertical imbalances. Broadly speaking, a vertical imbalance arises when there is no correspondence between the expenditure responsibilities and the revenue sources assigned to each level of government. Several approaches are used to measure the presence and importance of vertical imbalances.

One approach is to identify the existence of persistent budget deficits at a particular level of government. Here, the size and persistence of the deficits is taken as *prima facie* evidence of such an imbalance. Independently of its accuracy, this diagnostic tool cannot be used for Indonesia because there is no information available on sub-national government deficits for recent years.¹⁶

Another approach is to quantify expenditure needs or requirements at different levels of government and then to compare them to available resources. One possible outcome here is that both central government and sub-national governments are short of funds, since there is inherent ambiguity associated with the expenditure levels (quantity and quality of services) that can be associated with

the assignment of expenditure responsibilities at each level of government. One way currently being debated in Indonesia of dealing with this ambiguity is to do an exhaustive listing of standards or norms for provision and to conduct an accounting of the expenditures required for explicitly stated and agreed upon levels and quality of public services. This approach is very costly and time consuming, and also requires a significant degree of intergovernmental consensus and communication. Without these, the listing and costing of expenditure norms can lead to intergovernmental friction and poor budgeting practice.¹⁷

A third approach to identifying vertical imbalances is to examine to what extent different levels of government are able to finance expenditures from their own sources of revenues. The attraction of this approach is that it bypasses the uncertainty surrounding any measurement of government needs. A simple and effective guarantee against vertical imbalance is to provide each level of government with enough revenue autonomy so that they can make their own decisions regarding what services to cover and at what level. By this measure, there is considerable vertical imbalance against sub-national governments in Indonesia.

Current local tax power only contributes a small proportion of the total tax revenue in Indonesia, and it is far from enough to finance most of the new expenditure responsibilities transferred to local governments. Table 8.3 shows that local own revenue (local taxes and charges) only contributed between 3–4 percent during the two fiscal years, 2000 and 2001. Clearly, it will be impossible for local governments in Indonesia to finance their basic needs or basic expenditures if their sources are only local own revenues.

Table 8.3 Central and local fiscal indicators, 1998–2001 (in percent)

Fiscal year	Local/total expenditure	Local own/total revenue	Intergovernmental transfer/total local expenditure
1998/00	15.81	3.31	97.19
1999/00	16.61	3.63	79.23
2000	17.88	3.10	85.87
2001*	24.82	3.80	103.04

Notes:

Total expenditure = National expenditures – Intergovernmental transfer + Total local expenditure

Total revenue = National revenue + Local own revenue

Local revenue = Local own revenue + Intergovernmental transfer

* Estimated data for 2001 using proposed budget.

Source: Authors' calculations.

The current practice in Indonesia of measuring vertical imbalances has been to examine whether the 25 percent funding for the DAU, together with own revenues (PAD) and shared revenues, has been enough to finance old and new expenditure responsibilities. Often, even this practice reduces to examining whether the cost of personnel attached to a level of government can be covered by the overall funds made available to that level of government. The most authoritative study of this question is by Lewis (2001), who concludes that, while provincial government may have been a bit short in 2001, the districts/municipalities were amply funded. Clearly, the transfer system, especially the DAU, plays a key role in reducing the possible vertical fiscal imbalances between central and local governments.

To Reduce Horizontal Imbalances

Horizontal imbalances arise from existing fiscal disparities across sub-national jurisdictions. Sub-national governments generally have different tax capacities because they differ in their economic bases. In Indonesia there are significant disparities in gross regional product per capita (GDRP 1999 per capita). At district/municipality level (Table 8.4), the coefficient of variation in 1999 was 2.12, and the maximum value was 172 times higher than the minimum value. At provincial level, the corresponding values are lower, with a coefficient of variation of 0.93 and a gap between maximum and minimum of 16 times (Table 8.5).

There are also significant disparities for actual revenues collected. For example, the coefficient of variation for districts/municipalities for own revenues per capita in 1999 (Total collection per capita in Table 8.4) is 2.24 and for shared revenues in 2001 (Revenue share per capita in Table 8.4) is 2.91. The coefficients of variation for these two variables for the provinces are a bit lower but still quite high.

Horizontal fiscal imbalances also may exist because of disparities across sub-national jurisdictions in expenditure needs. The differences in needs may arise from either different prices or costs of service provision or from different shares of the population with special needs. Tables 8.6 and 8.7 show that there is little variation in price levels as measured by the construction price index (Const index). However, there are significant disparities in the incidence of population living under the poverty level (Pct poor) and other expenditure need-generating features, such as the percent of the population of school age, the percent of the population that is elderly, and population density. Disparities in both fiscal capacity and expenditure needs highlight the important role equalization transfers need to play in Indonesia.

Table 8.4 District/municipality disparities in revenues and fiscal capacity (in thousands of rupiahs)

Variable	Mean	Standard deviation	Coefficient of variation	Maximum	Minimum
GRDP 1999 per capita	4 901.20	10 372.08	2.12	147 676.76	856.50
Total collection 1999 per capita	22.42	50.31	2.24	855.25	0.30
Revenue share 2001 per capita	157.12	457.23	2.91	4 853.57	6.41
DAU 2001 per capita	445.19	365.02	0.82	3 376.53	89.68
After DAU 2001 per capita	467.61	369.80	0.79	3 395.64	105.33
After all transfer 2001 per capita	624.73	721.56	1.15	6 984.57	137.76
Regional revenue 2001 per capita	637.39	719.41	1.13	6 984.57	142.46
DAU 2001 (% of expenditure)	96.95	23.97	0.25	203.67	42.74
DAU 2002 per capita	522.55	393.35	0.75	3 376.53	110.76
After DAU 2002 per capita	544.96	398.66	0.73	3 395.64	128.81
After all transfer 2002 per capita	702.08	727.77	1.04	7 041.28	160.19
Regional revenue 2002 per capita	710.83	729.76	1.03	7 048.95	162.53
Expenditures 2001 per capita	453.97	309.72	0.68	2 934.81	100.70

Source: Authors' computations. See Appendix 8.2 for a full definition of all variables.

Table 8.5 Province disparities in revenues and fiscal capacity (in thousands of rupiahs)

Variable	Mean	Standard deviation	Coefficient of variation	Maximum	Minimum
GRDP 1999 per capita	4 977.53	4 614.32	0.93	23 465.08	1 429.58
Total collection 1999 per capita	23.73	38.56	1.62	201.90	5.22
Revenue share 2001 per capita	42.14	93.79	2.23	412.51	3.14
DAU 2001 per capita	50.03	30.80	0.62	151.47	13.02
After DAU 2001 per capita	70.60	50.32	0.71	271.93	17.65
After all transfer 2001 per capita	112.74	132.72	1.18	572.30	25.88
Regional revenue 2001 per capita	125.96	132.75	1.05	594.46	26.08
DAU 2001 (% of expenditure)	62.66	87.43	1.40	414.19	18.26
DAU 2002 per capita	72.31	50.88	0.70	185.21	11.10
After DAU 2002 per capita	92.88	59.10	0.64	265.83	19.37
After all transfer 2002 per capita	135.02	121.40	0.90	566.20	27.60
Regional revenue 2002 per capita	140.46	131.80	0.94	594.50	27.60
Expenditures 2001 per capita	130.50	84.11	0.64	301.87	4.26

Source: See Appendix 8.2 for a full definition of all variables.

Table 8.6 District/municipality disparities in expenditure needs

Variable	Mean	Standard deviation	Coefficient of variation	Maximum	Minimum
Pct poor (%)	24.53	15.25	0.62	91.12	0.99
Pct labour (%)	39.85	7.37	0.18	77.05	13.25
Pct school age (%)	15.80	4.81	0.30	41.31	4.18
Pct old (%)	3.45	1.98	0.58	10.14	0.05
Pct young (%)	28.55	6.64	0.23	44.46	12.10
Area (km)	5 763.13	10 712.69	1.86	119 749.00	16.46
Density (per km)	976.75	1 894.20	1.94	12 744.48	0.86
Const index	135.27	18.51	0.14	258.90	113.20

Source: Authors' computations. See Appendix 8.2 for a full definition of all variables.

Table 8.7 Province disparities in expenditure needs

Variable	Mean	Standard deviation	Coefficient of variation	Maximum	Minimum
Pct poor (%)	24.58	12.64	0.51	55.81	4.53
Pct labour (%)	41.58	12.12	0.29	88.11	23.35
Pct school age (%)	17.58	6.51	0.37	44.71	9.12
Pct old (%)	3.18	1.54	0.49	7.96	0.88
Pct young (%)	30.68	10.59	0.35	73.14	16.34
Area (km)	64 569.1	81 718.08	1.27	414 039.95	661.62
Density (per km)	648.71	2 294.68	3.54	12 673.22	5.28
Const index	134.82	14.77	0.11	203.44	116.34

Source: Authors' computations. See Appendix 8.2 for a full definition of all variables.

To Address Externalities and Interjurisdictional Spillovers, Central Government Policy Objectives, and the Implementation of National Programs at Local Level

Indonesia currently has no conditional transfers. Most countries use some form of conditional transfers in support of sub-national governments for expenditure areas such as roads, water and sewerage treatment plants, transportation, housing, education, health, and so on. However, there is considerable variety across countries in the objectives pursued and the actual structural design of capital transfers. An important sub-category of conditional grants is that of capital transfers. The typical country has a variety of capital transfers that are closed-funded in the national budget, provide earmarked funds within

specific capital expenditures and, as is the case for the DAK in Indonesia, require some level of matching funds from sub-national governments.¹⁸ The funds are commonly allocated either by an objective formula or on a specific project basis.

Conditional transfers and capital transfers may be used for many different objectives. Common objectives for conditional transfers include:

- addressing externalities at sub-national level because of spillover effects of some services or infrastructure across sub-national jurisdictions;
- addressing vertical imbalances in the assignment of revenues in favor of central authorities;
- addressing limitations with borrowing at sub-national level either because of borrowing limits and other restrictions or because of lack of credit availability;
- rewarding sub-national expenditure in areas of particular national importance or in support of national programs actually implemented at regional and local levels.

In the case of Indonesia, expenditure responsibilities for health and education for example are at sub-national level as mandated in Law No. 22/1999. If these services produce positive externalities, it is likely that local governments may currently be under-spending on them. Since the DAU is not intended to accommodate specific central government objectives, the government will have to rely on the DAK. However, some parts of central government still feel strongly that it is not appropriate to promote the DAK mechanism in pursuing national objectives. Instead, they favor a deconcentration mechanism in the form of *Daftar Isian Proyek* (DIP), or Development Project List. The total deconcentrated fund is not very far behind the total funds allocated to intergovernmental transfers. The persistence of the DIP is seen by many observers as an indication that central agencies still want to show their power in the regions.

Note that the use of central government funds earmarked exclusively for capital investment at sub-national level means that central authorities have identified a need to enhance capital expenditures at sub-national level, as opposed to recurrent or ordinary expenditures. This need may arise from the existence of externalities across sub-national jurisdictions or from financing constraints sub-national governments face vis-à-vis lumpy capital expenditures.¹⁹ Often, central authorities have a bias toward earmarking a large share of central government transfers for capital expenditures at sub-national level. This reflects an ingrained belief that capital expenditures are always more efficient than recurrent expenditures. Of course, there are no sound bases for this extreme position. The production of public services requires different

recurrent and capital input mixes, and the optimal mix should basically reflect the prices of different inputs and the physical requirements of available technologies.²⁰ From an equity viewpoint, capital transfers may be used to redress inequities in the distribution of capital infrastructure that arose in the past.²¹

HOW HAS INDONESIA'S NEW TRANSFER SYSTEM PERFORMED TO DATE?

Has Budget Autonomy Been Preserved?

One of the basic principles in the Indonesian decentralization process has been to give greater autonomy to local governments in managing their own budgets. Although it is true that the vast majority of revenue sources for sub-national governments are under the control of central authorities, local governments seem to have a significant degree of discretion to spend the funds according to their budget priorities, once the money is in their hands.²² Ironically, local governments have been slow in moving away from past practices. Many local governments during 2001 appeared to have thought that the DAU was intended to pay all local civil servant salaries as the SDO did in the past. This misconception of course has been reinforced in 2002 by the computation of the 'balancing factor' on the basis of the past wage bill.

Has Revenue Adequacy for Provinces and Districts/Municipalities Been Maintained?

The new system of transfers has gone a long way toward ensuring 'revenue adequacy' during the past two years. As we have seen, the most significant component of the DAU allocations in 2001 and 2002 was the 'hold harmless' provision. These funds were supposed to allow local governments to pay all of their local civil servants, including the ones transferred from the central government offices in 2001. In addition, central government budgeted for a 'contingency fund' in 2001 and again in 2002 to allow for additional finance needed by local governments with a mismatch between transferred personnel and available fiscal resources.²³

The claims for additional resources by local governments during 2001 had several sources. First, the transfer of central government employees was not entirely smooth, and many provincial governments ended up with more transferred employees than expected. Second, there was a (convenient) misconception among local governments that only DAU funds could be used to pay local civil servants. Even though some local governments had additional sources of

revenues such as from revenue sharing, they refused to use those additional funds to pay their employees' salaries. Third, in the middle of 2001, central government suddenly mandated an increase in civil servant salaries, retroactive to January 1. This policy affected all civil servant salaries without any exception, and imposed an additional obligation on local governments. Because the DAU 2001 had been formulated using pre-2001 salary data, it was not surprising that some local governments had to ask for additional funds.

It has been argued there is still another reason why local revenues might not be adequate. This is related to how the DAU itself is formulated, especially on the expenditure need side. Due to the unavailability of minimum standards of public service, expenditure needs are approximated, not calculated. This means that the estimation of expenditure needs might not reflect the real needs of local governments. However, this argument again assumes that it is politically feasible and fiscally affordable to develop an exhaustive list of budgetary standards at local level. International experience shows that these are difficult tasks to perform.

Have Transfers Been Stable?

Stability of transfers is a desirable characteristic because it facilitates local government budgeting and planning. While flows from the DAU have been remarkably stable, the story is very different for revenue sharing transfers. The stability of the DAU has been based on the permanency of the funding rule (at least 25 percent of net domestic revenue), and also on the fact that central government allocated the funds anticipated in the budget as opposed to the funds actually collected by the tax authorities. This arrangement has allowed central government to transfer the DAU funds on time every month.

In contrast, for revenue sharing the transfer of funds has not been stable and has not been on time either. Central government originally promised to implement the actual transfer quarterly; instead, the first transfer received by local governments occurred after six months in 2001. A similar pattern was repeated in 2002, both for natural resources revenue sharing and for other tax revenue sharing, due in part to the difficulty of gathering full information on actual revenue collections in the regions. With these revenues there can be no guarantee that the amount of sharing will be stable or similar from year to year, but the central authorities need to make an effort to improve the frequency of the payments.

Is the Current System of Transfers Transparent and Simple?

The current intergovernmental system still cannot be considered reasonably transparent and simple. For the DAU as the major part of the transfer,

transparency has increased through different efforts such as book publication, dissemination ('socialization'), and, most importantly, the use of a standard formula to allocate the funds. However, the 2002 DAU was still not 'simple' enough because of the pressure exercised by natural resource-rich regions and the 'hold harmless' provision insisted upon by Parliament. The original formula might have been simple but the final formula became quite complicated and relatively difficult to be described even by specialists. The issue of transparency in revenue sharing is complicated by the fact that the supporting data needed to calculate the allocations are not the type of data that are widely available; in fact, some government agencies and ministries still keep the data secret. Local governments naturally have had some difficulties whenever they have tried to reconfirm the calculations. The calculation method itself is far from simple and relatively difficult to understand, especially for natural resource revenue sharing. As a result, except for personal income tax revenue sharing, it is difficult for local governments to predict their possible revenue from the revenue sharing scheme.

Have Transfers Distorted Expenditure Decisions and Discouraged Sub-national Tax Efforts?

The structure of the DAU formula takes special care not to introduce any distortion in the expenditure decisions of local governments. All the variables used in the estimation of expenditure needs are objectively defined and beyond manipulation by changes in local government behavior. The big exception, however, is the definition and computation of the 'hold harmless' provision for 2002, which, as we have seen, is defined in terms of the local government's wage bill for the previous year. This, of course, gives a significant incentive to local governments to increase their personnel expenditures at the cost of other expenditure priorities.

Law No. 25/1999 implicitly introduces a hard-budget constraint for local governments by designing DAU as a formula-based transfer and revenue sharing as an actual revenue-based transfer. In the new set up, there should be no room for local governments to be 'subsidized' by central government if they have problems with their budgets. The Law clearly states that, if a local government needs additional revenue, then it can borrow directly from financial institutions or by issuing municipal bonds. However, in 2001, the hard budget constraint was partially violated by the introduction of the contingency fund. As mentioned earlier, there were some good reasons why the contingency fund had to be used. A related fact was that because of macro-economic concerns central government, through presidential decree, prohibited all types of local borrowing.

What has been the effect of the new transfers on local tax efforts? Because the DAU formula uses estimates of fiscal capacity rather than actual revenues collected, the introduction of the new transfers should not have affected local government 'tax efforts,' defined as the ratio of own tax and fees revenues divided by regional gross domestic product. However, there was the possibility of an 'income effect' whereby the new transfers may have affected tax efforts. To test for the neutrality of the new transfer system on tax efforts, we ran a number of regressions of tax efforts at the provincial and district/municipality levels for 2001 and 2002 on the level of DAU transfers (as a percent of total expenditures), and several other control variables including gross regional product per capita. The results are shown in Tables 8.8 and 8.9, where we report only the results for 2002; the results for 2001 were very similar.

For provinces (Table 8.8), we find that the higher the DAU contribution in provincial government expenditures, the lower local tax effort. This is a surprising result because provincial governments were a bit shortchanged by the DAU system in 2001, and therefore they should have made an extra effort to collect more of their own revenues. Perhaps provincial governments were attempting to signal to central government there was a need for contingency funds. Also of note are the positive and significant relationships of population density and income tax revenue sharing to tax effort. Higher population density could indicate active economic activities that lead to higher potential tax revenue, while higher income tax sharing indicates higher economic capacity that should generate higher local tax revenue. For the case of districts/municipalities (Table 8.9), we find that the DAU is, as expected, an insignificant factor in local tax effort. Among the other control variables, income tax revenue sharing and population density contribute positively to tax effort.

Have Transfers Been Equalizing?

It appears that DAU transfers have in general been equalizing (e.g. they have helped dampen fiscal disparities), but not by very much, since fiscal disparities (measured in local revenues per capita) after the DAU remain high. The sharing of natural resource revenues, on the other hand, has been highly unequalizing, which was as expected given the uneven distribution of natural resource endowments across local governments. Other tax sharing has also contributed to fiscal disparities.

The desired extent of equalization is still an open policy question in Indonesia since there has never been a 'white paper' or master plan of decentralization reform with explicitly stated objectives. The DAU itself has lacked formalized performance criteria. This no doubt has complicated the evaluation of the system and its reform in 2002 and later years.

Table 8.8 Explaining provincial tax efforts in 2002

Independent variable	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Intercept	0.35635**	0.8565*	0.39940**	0.7072	0.34046**	0.7258*	0.341139**	0.7131*
GRDP 1999 per capita	0.00000566	0.00000916	-0.00001280	-0.00000994	-0.0000092	-0.00000591	-0.00001236	-0.00000959
DAU 2002 (pct of expenditure)	-	-	-0.0006429**	-0.0006456	-0.0007340**	-0.0007335**	-0.0006215**	-0.0006262**
Const index	0.0006708*	0.0006735*		-0.002374		-0.002951		0.00566
Density		-0.003837	0.00007117**	0.00006851			0.00008423*	-0.002335
Income tax (pct of total revenue)					0.024280**	0.023259**	0.00624	
R ²	0.205	0.255	0.532	0.551	0.425	0.454	0.536	0.554

Notes:

The dependent variable in all regressions is provincial tax effort.

* Indicates statistical significance at the 10 percent level; ** Indicates statistical significance at the 1 percent level.

Table 8.9 Explaining local tax efforts in 2002

Independent variable	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Intercept	0.5882**	0.1720	0.5310*	0.0008	0.4517*	0.0579	0.4469*	-0.0147
GRDP 1999 per capita	—	—	-0.00000615	-0.00000811*	-0.00000693*	-0.00000838*	-0.00000688	-0.00000853*
DAU 2002 (pct of expenditure)	0.00000593	0.0000074*	0.000211	-0.000723	0.000640	-0.000122	0.000631	-0.000261
Const index	0.000017	-0.000768		0.004715		0.003614		0.05757
Density		0.003792		0.00004532*			0.00001687	0.004209*
Income tax (pct of total revenue)					0.07912*	0.07743*	0.06686*	0.00002696
R ²	0.060	0.130	0.140	0.240	0.210	0.270	0.220	0.300

Notes:

The dependent variable in all regressions is district/municipality tax effort.

* Indicates statistical significance at the 10 percent level; ** Indicates statistical significance at the 1 percent level.

Another important complicating factor in the equalization performance of the DAU has been the introduction of the balancing factor or ‘hold harmless’ provision in the DAU. For example, using a public wage bill criterion to distribute the balancing factor funds in 2001 and 2002 contributed to fiscal disparities because of historical patterns of public employment.²⁴ Basing the balancing factor on the previous SDO and INPRES meant that local governments that used to receive big transfers continued to receive them.²⁵

Some empirical evidence on the equalization impact of transfers in 2002 is presented in Table 8.10 for provinces and Table 8.11 for districts/municipalities. These tables show the dispersion of revenues per capita (coefficient of variation and range between maximum and minimum values) for own revenues, the two main categories of shared revenues, and the DAU. The tables also show the dispersion for different cumulative arrangements of revenue sources. We also made these calculations for 2001, with very similar results.

In the case of the provinces, general revenue sharing and sharing of natural resources show more dispersion than own revenues, but the cumulative distribution of total revenues per capita after the DAU is added has a significantly lower dispersion. The coefficient of variation falls from 1.90 before the DAU to 0.90 after the DAU in 2002.²⁶ Similar results hold for districts/municipalities. The main contrasts are that the sharing in natural resource revenues appears to be much more unequalizing at local level and that the DAU distributions have a stronger equalizing effect. For example, in 2002 the coefficient of variation for revenues per capita before the DAU is 2.58, and drops to 1.04 after the DAU.

These results provide general evidence that the DAU has equalizing effects at provincial and district/municipality levels. However, even after the DAU, the coefficients of variation remain high, always with a value over one. The very large differences between maximum and minimum values of revenues per capita dramatize the fact that DAU is still not effective in reducing fiscal disparities to acceptable levels.

An additional way to examine the equalization performance of the DAU is to study whether it lives up to its promise of equalizing fiscal capacity and expenditure needs. With this objective in mind, we ran a series of regressions explaining DAU distributions at provincial level for 2001 and 2002 and at district/municipality level also for 2001 and 2002. Besides using the entire DAU allocation as the dependent variable, we also added two other dependent variables by breaking up the DAU allocation into the ‘balancing fund amount’ and the ‘formula amount.’ For explanatory variables, we selected the variable ‘gross regional product per capita’ (GDRPCAP) as a measure of fiscal capacity, and we also used as a control variable ‘tax effort.’ For explanatory variables on the expenditure need side, we selected some of the

Table 8.10 Equalizing impact of the DAU for provinces, 2002 (in thousands of rupiahs)

Variable	Mean	Standard deviation	Coefficient of variation	Maximum	Minimum
LOR 1999 (Local own revenue)	23.73	38.56	1.62	201.90	5.22
TS 2001 (Tax sharing)	17.42	51.81	2.97	289.01	3.07
NRS 2001 (Natural resource sharing)	26.49	76.25	2.88	376.82	0.01
DAU 2002 (General allocation fund)	72.31	50.88	0.70	185.21	11.10
LOR+TS	37.99	87.26	2.30	490.91	3.14
LOR+NRS	45.29	84.90	1.87	409.91	0.02
LOR+DAU 2002	92.88	59.10	0.64	265.83	19.37
LOR+TS+DAU 2002	110.30	97.89	0.89	554.83	27.57
LOR+NRS+DAU 2002	117.60	89.41	0.76	448.94	19.40
LOR+TS+NRS	62.71	118.85	1.90	502.27	3.91
LOR+TS+NRS+DAU 2002	135.02	121.02	0.90	566.20	27.60

Source: Authors' calculations. See Appendix 8.2 for a full definition of all variables.

Table 8.11 Equalizing impact of the DAU for districts/municipalities, 2002 (thousands of rupiahs)

Variable	Mean	Standard deviation	Coefficient of variation	Maximum	Minimum
LOR 1999 (Local own revenue)	22.42	50.31	2.24	855.25	0.30
TS 2001 (Tax sharing)	28.48	37.26	1.31	265.36	4.34
NRS 2001 (Natural resource sharing)	128.64	431.37	3.35	4 609.57	0.27
DAU 2002 (General allocation fund)	522.55	393.35	0.75	3 376.53	110.76
LOR+TS	50.89	67.88	1.33	924.48	6.21
LOR+NRS	151.06	435.98	2.89	4 630.49	5.44
LOR+DAU 2002	544.96	398.66	0.73	3 395.64	128.81
LOR+TS+DAU 2002	573.44	422.14	0.74	3 504.98	159.92
LOR+NRS+DAU 2002	673.61	699.13	1.04	6 797.27	129.08
LOR+TS+NRS	179.54	462.33	2.58	4 874.49	11.07
LOR+TS+NRS+DAU 2002	702.08	727.77	1.04	7 041.28	160.19

Source: Authors' calculations. See Appendix 8.2 for a full definition of all variables.

variables used in the DAU formula, such as the construction price index and the percent living in poverty; we also selected other variables that are reflective of need and are not strictly included in the DAU formula, such as percent of the population of retirement age, percent of population younger than working age, and population density. We report only the results for 2002, in Table 8.12 for provinces and Table 8.13 for districts/municipalities.

The regression results show that the DAU allocations generally do not equalize fiscal capacity. In fact, DAU allocations per capita tend to increase with gross regional product per capita, so that richer jurisdictions get higher allocations. This result tends to occur largely because of the impact of the 'balancing fund'.²⁷ On the expenditure need side, the regression results show that typically the DAU tends to increase with poverty and the construction price index, as expected from the role these variables play in the DAU formula. However, the effects of these variables in the DAU allocations per capita are often diluted, or not statistically significant. Importantly, we find that the 'balancing fund' component of the DAU not only increases with income, but that it also explicitly penalizes those jurisdictions with higher expenditure needs (holding income constant). This is manifested by the negative and statistically significant regression coefficients for the 'balancing

Table 8.12 Regression analysis of the DAU for provinces, 2002 (per capita in thousands of Rp)

Independent variable	DAU transfers	Regional expenditure	Balancing fund per capita	DAU formula per capita
Intercept	-8.6	-77.9	18.07	-26.68
GRDP 1999 per capita	-0.001495	0.007186*	0.0009881	-0.002483
Const index	0.1888	0.613	-0.1415	0.3303
Poor	1.6872*	2.882*	0.5761*	1.1111
Older	-5.841	-16.36	-1.925	-3.916
Younger	1.437	0.832	0.3186	1.1185
Density	0.004222	-0.008308	0.001386	0.002836
Tax effort	-21.03	159.54*	19.43	-40.47
R ²	0.310	0.473	0.319	0.426

Notes:

* Indicates statistical significance at the 10 percent level; ** Indicates statistical significance at the 1 percent level.

Older: Percentage of the populations older than working age; Poor: Percentage of the population in poverty; Younger: Percentage of the population younger than working age.

Table 8.13 Regression analysis of the DAU for districts/municipalities, 2002 (per capita in thousands of Rp)

Independent variable	DAU transfers	Regional expenditure	Balancing fund per capita	DAU formula per capita
Intercept	-837.5**	-477.2**	52.9	-890.4**
GRDP 1999 per capita	0.003749*	0.004521**	0.005085**	-0.001335
Const index	11.352**	7.5469**	3.4472**	7.9051**
Poor	-1.752	-2.130*	-2.2181**	0.4656
Older	-1.30	-3.804	-6.277	4.981
Younger	-5.104*	-1.523	-5.717**	0.614
Density	-0.016025	-0.018058*	-0.012169*	-0.003856
Tax effort	26.47	26.06	6.9	19.48
R ²	0.326	0.275	0.210	0.387

Notes:

* Indicates statistical significance at the 10 percent level; ** indicates statistical significance at the 1 percent level.

Older: Percentage of the populations older than working age; Poor: Percentage of the population in poverty; Younger: Percentage of the population younger than working age.

factor' on poverty and the percent of population with higher public expenditure needs, such as the young and the old.

In summary, the regression results provide evidence that the implementation of the DAU has been pushing for conflicting objectives. The 'formula amount' pushes for equalization, but the 'balancing factor' undermines equalization via its pursuit of addressing vertical imbalances. It is quite unlikely that this is something that the policymakers in the executive and the Parliament wanted, and it highlights the need to further reform Indonesia's system of transfers.²⁸

CONCLUSIONS: THE WAY FORWARD

Indonesia has made remarkable progress over the last two years in putting together an efficient and effective system of intergovernmental transfers. In this very short period Indonesia has achieved what has taken other countries a decade or longer to achieve. Progress has been most evident in the design, as opposed to the implementation, of the DAU system of equalization transfers. However, problems remain in a number of areas, including the DAU.

The most fundamental problem is that the GOI has relied on the DAU to pursue too many objectives. Although current legislation proclaims the essence of the DAU as an equalization grant, in practice the GOI has used the DAU to pursue other objectives, the most significant of which are closing the vertical balance between the central and sub-national governments and redressing perceived historical injustices in the allocation of revenues from natural resources. More recently, there have been noises in government circles about also using the DAU to ensure that certain national expenditure priorities are safeguarded under decentralization.

So far, the outcome of pursuing these many policy objectives with one policy instrument, the DAU, has been muddled or confused performance. The equalization results the DAU achieves through its 'formula component' are to a large extent undone by the implementation of its 'balancing factor component.' The GOI needs to develop within the system of transfers new tools to address important policy objectives other than equalization.

The recent reforms introduced revenue sharing as an almost new instrument of sub-national finance in Indonesia. However, revenue sharing plays a significant role for only a minority of sub-national governments, and those that benefit from revenue sharing seem to be powerless in predicting how much they are going to receive in funds during the fiscal year. The other instrument of sub-national finance introduced by the recent reforms, the conditional matching grants, has not been used at all.

These considerations lead us to make several general recommendations, as well as some specific suggestions for the DAU and the DAK.

Regarding *general recommendations*, we believe the future reform of the system of transfers should follow three fundamental thrusts. First, the GOI should expand revenue autonomy at sub-national level as the best way to address vertical imbalances. Politically, it will be hard to retrench from the current level of revenue sharing, especially in the case of natural resource revenues. However, little can be gained from expanding revenue sharing to address vertical imbalances. Providing provinces and districts/municipalities with more significant discretion over tax rates can achieve the same results with the added benefits of increased efficiency and accountability at sub-national level. Central government needs to evaluate the applicability of the 'piggybacking' system for personal income tax, but also of other taxes as a way to provide revenue autonomy at sub-national level. Property tax should be fully assigned at local level.

Second, the DAU must be used exclusively in the pursuit of the equalization objective. This will mean that addressing the issue of perceived historical injustices in the sharing of revenues from natural resources will have to be pursued through revenue sharing as is now the case, or even through special transfers. Similarly, the general funding or vertical imbalance issue, now

pursued with the 'balancing factor' within the DAU, needs to be addressed through more tax autonomy, more revenue sharing, or additional transfers. The DAU structure should be updated with the goal of improving on its equalization performance. The GOI will need to define explicitly its equalization target and to determine whether zero or even negative allocations will be allowed.

Third, there is widespread concern at central government level that local governments might not pay enough attention to national priorities such as basic education and primary health, poverty alleviation, or infrastructure provision. The GOI needs to develop a system of conditional grants under the legal umbrella of the DAK to pursue specific policy objectives regarding infrastructure or particular central government programs. Because of the importance of the health and education sectors in national priorities and the fact that these are now the responsibilities of local governments, the GOI could develop a system of per capita conditional grants that would ensure minimum expenditure standards at local level in these sectors. Funding for per capita conditional grants in health and education could come in part from the funds now spent on the balancing factor of the DAU. These conditional grants would provide help with a 'hold harmless' objective but would switch funding from budget inputs (e.g. public employees) to budget outputs (e.g. number of children educated and population at risk). The funding for conditional grants for infrastructure and other areas could come in part from the still largely deconcentrated funds now controlled by the line ministries in Jakarta.

It is important for the new set of reforms in the transfer system to be part of the comprehensive view of where the entire system of intergovernmental fiscal relations is going, and not just the system of transfers. But for these reforms to fit together well, it is still necessary for the GOI to produce an overall strategy, or 'white paper,' for reform.

Central government also needs to examine the current administrative organization. In particular, should the reformed equalization transfers and the new conditional grants flow directly from central government to local governments, or should they go through the provinces as the intermediate level of government? This decision should be congruent with the choice made on the overall approach to organizing intergovernmental fiscal relations.

The GOI should further consider the need for formalizing the management of the system of DAU and DAK transfers. There is a need to collect better statistics and to improve the existing ones. For the calculation of the DAU in 2002, for example, there are some variables still using 1999 data. Ideally, the data used for calculating the DAU should be for two years at most prior to the year of DAU (e.g. for DAU 2002, all data should be 2000 data). In addition, the reliability and consistency of data essential to the DAU are sometimes

doubtful, especially for population and area; the information on the construction price index is also of questionable reliability. There is also a need to update the equalization formula, introducing changes in the mechanism to keep within its objectives, and to maintain a dialog with sub-national governments and other stakeholders. Several government agencies currently are in charge of administering the DAU. One possibility is whether to imitate other countries such as Australia and India and to create a 'grants commission,' a semi-autonomous institution at central government level that is exclusively charged with the administration and upkeep of the transfer system. The advantage of a 'grants commission' is its greater impartiality and objectivity in administering the equalization grant system.

As for more *specific suggestions* regarding the DAU, the current practice of distributing the DAU pool of funds as fixed in the budget is a desirable approach because regional governments have more certainty about planning and executing their budgets once the central budget is approved. The actual rule of 25 percent of net domestic revenues can and should be changed in the overhaul of the system of transfers, but it is desirable that the new percentage should stay stable for a period of several years. Overall funding for the DAU needs to be decided in the wider context of intergovernmental fiscal relations and national priorities. How much of the available national resources should be dedicated to equalizing sub-national fiscal disparities is a political decision that requires the direct involvement of Parliament and the government. However, in order to reach the right level of funding, the DAU funding rule needs to be openly discussed and the country priorities reflected in it.

Equalization transfers in Indonesia are correctly conceived of as unconditional (or general funding) grants, with their final use left to the discretion of local governments. Pressure to impose conditionality on the use of those funds must be resisted. Conditional grants should be used for the pursuit of other objectives.

There is a need to remove the negative incentives that remain in the form of using the wage bill as the basis of the distribution of finance for the 'hold harmless' funds.

The introduction of explicit public service standards for the computation of expenditure needs may bring more problems than benefits. Clearly, expenditure norms defined by the Ministry of Finance or any other agency cannot in the present economic circumstances be anywhere near the level that sub-national governments would consider adequate; otherwise there would be a very significant budget deficit at sub-national or central levels. Thus the use of explicit standards may contribute to the feelings of insensitivity and injustice toward sub-national governments. The current approach now used in the DAU of using an index to approximate needs is used in many other countries.²⁹

There is a need for better data and improved measurements of fiscal capacity at provincial and local levels. Natural resources revenue sharing has to be considered 100 percent revenue to local governments and not just 75 percent as is now the case. Central government must not accept local government demands to switch to actual or collected own revenues in the measurement of fiscal capacity, as agreeing to this will certainly create negative incentives for revenue mobilization by local governments. Instead, there is a need to develop better estimation methods of potential local own revenue.

Finally, we have several *specific suggestions* for the DAK. First, if conditional grants for education and health are introduced, they should be computed on a per student and per inhabitant basis, respectively.³⁰ This offers the advantages of the grants being inherently equalizing, of them providing local authorities with budgetary autonomy in terms of expenditure priorities (within education and health), and of the grants providing the most efficient method of service delivery.³¹ These grants may imply, among other things, changes in revenue sharing and quite likely a reduction in the pool of funds dedicated to equalization under the DAU. Second, as is the case for the DAU, the design of conditional transfers must take into account the potential strategic behavior of sub-national governments and the incentive signals provided to them in the structure of capital grants. A good dose of realism will also be necessary. It will typically be desirable that DAK grants satisfy the requirement of ‘additionality,’ so that capital grants are not a substitute for capital expenditure that sub-national governments would otherwise have undertaken. For this reason, DAK transfers should keep the co-financing (or matching) requirements now in the law. Third, it will be more efficient and transparent to allocate conditional grant funds by using objective formulas. When a formula approach is not feasible, the allocation of funds and the selection process for the grants should still be made according to explicitly legislated criteria.

NOTES

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1. Revenue sharing on a derivation basis means that central government shares revenues with the sub-national governments where the revenues have been collected or derived.
2. See Silver, Azis, and Schroeder (2001) for an evaluation of the SDO and INPRES systems.
3. Of course, the common accusation outside Jakarta has been that central government has practiced *de facto* asymmetric decentralization policies by benefiting Jakarta and more generally Java at the cost of the other provinces. This is a complex issue. Before 1999, there was no revenue sharing from natural resources, but rural provinces such as Papua seem to have been favored under the INPRES system.
4. In addition, Papua gets a special grant equal to 2 percent of the DAU transfer. Another important asymmetric benefit for these two provinces is that the additional revenue sharing

provided in the special autonomy laws is not to be taken into account in the computation of fiscal capacity in the DAU formula. This benefit is on top of the general benefit that all natural resource producing provinces and local governments receive because the measurement of fiscal capacity in the DAU formula in 2002 only recognizes 75 percent of shared revenues, when all other shared revenues are recognized at 100 percent.

5. The current practice is to apportion PIT among jurisdictions by 'place of work' rather than 'place of residence.' This can lead to unfair apportionment of revenues among jurisdictions in large metropolitan areas where many individuals reside in one jurisdiction where they consume most of their public services, but have their place of work in different jurisdictions.
6. In 2001 the lump sum was determined in a residual fashion, as the moneys left after the funds distributed through the formula and the balancing amount. The latter is defined later.
7. The wage bill for each jurisdiction was computed as the money spent for that purpose in September 2001 times 12 months.
8. This clearly could be the case if public employees per capita were not evenly distributed across the territory. Historically, better off regions had more services and public bureaucrats.
9. Recall that revenue sharing from natural resources is not fully taken into account in the derivation of fiscal capacity of local governments.
10. Law No. 25/1999 seems to be referring here to the financing of physical capital investment. However, there is also the possibility of interpreting the DAK as a system of conditional grants for current and capital expenditures.
11. This is a much broader term, which would seem to allow all sorts of conditional grants for defined sectoral objectives in health, education, and so on.
12. This matching rule does not apply to reforestation funds.
13. The reforestation fees are distributed 40 percent to the producing regions while the rest is kept by central government for reforestation activities all over the country, especially in non-producing regions.
14. All four factors (population, land area, poverty, and geographical conditions as proxied by the construction price index) are mentioned in Law No. 25/1999. A general interpretation has been that the reference in Law No. 25/1999 does not mean that these variables need to be entered the way they were entered in 2001, or that other variables could not be entered. As for weights, the equal weights in 2001 were widely believed to be off the mark. For example, population seemed to be significantly under-weighted vis-à-vis the other variables. To arrive at the right weights, it is necessary to remember that the expenditure needs index serves as a substitute for a bottom-up approach that would estimate expenditure needs on the basis of the costs of delivering a standard basket of public services across local governments. This bottom-up approach would be more likely to reflect disparities in expenditure needs than a simple index. However, the bottom-up approach is more complex and is fraught with political complications.
15. Another possibility would be to introduce negative transfers or compulsory extractions from these local governments as payments to the pool of funds to be distributed through the equalization mechanism. This is essentially the approach adopted by countries that have horizontally funded (also known as 'fraternal') equalization grant systems. This approach would appear to deviate significantly from the spirit of the current DAU system.
16. The measure may be institutionally biased against sub-national governments since typically those governments are not as free as the central government to run budget deficits and to borrow to finance their expenditures.
17. The question of revenue adequacy at different levels of government must be answered politically. For any assignment of expenditure responsibilities among different levels of government, the revenue sources and other funding provided to sub-national governments is a question of establishing clear national priorities. How much of the national resources does the country wish to spend on education, health, and other sub-national expenditure responsibilities vis-à-vis other important services, such as national defense, assigned at the central level? These decisions about spending priorities are likely to change over time,

and they are most conveniently made within the context of a medium-term expenditure framework. Revenue adequacy and vertical balance should logically be interpreted within the context of the overall constraint on public sector resources. It is always helpful to have a national dialog on what constitutes 'adequate resources,' with participation of all stakeholders. Although perfect consensus is unlikely to be reached, the dialog can protect sub-national governments from central government using decentralization as a way to solve its own fiscal shortcomings, and can also be a way to facilitate the role of the central authorities by making sub-national governments more aware of existing fiscal constraints.

18. Matching arrangements help to obtain 'additionality' or 'maintenance-of-effort' in sub-national expenditures, and tend to increase ownership of projects at local level.
19. However, often the fundamental question remains of why central authorities would have better information than sub-national governments regarding the right input mix in the production of sub-national public services.
20. Clearly, there will not be good education services, for example, if there are no funds for books and basic supplies, regardless of the quality and newness of school buildings.
21. Unfortunately, this is fraught with difficulties in measuring the quantity and quality and because of the need to avoid rewarding sub-national governments that have made clearly voluntary decisions to spend less on capital infrastructure and more on other types of expenditures. Capital grants should not be a substitute for prudent borrowing policies by sub-national governments.
22. The most important limitations on local budget autonomy are inability to reduce personnel and to set wages.
23. The 2001 contingency fund was budgeted at Rp 6.2 trillion of which Rp 2.8 trillion was disbursed. In 2002 central government used the budgeted contingency fund of Rp 2.1 trillion to fund part of the 'hold harmless' funds mandated by Parliament.
24. See Hofman et al. (2002).
25. Despite the inertia introduced in the system by the balancing factor, it is interesting to note that the new DAU system is more equalizing than the old SDO and INPRES system. See Lewis (2001).
26. For 2001, the coefficient of variation falls from 1.90 before the DAU to 1.18 after the DAU.
27. It is interesting that the 'DAU formula amount' for 2001 was positively and statistically significant related to gross regional product per capita at district/municipality level, but that this relationship did not hold for 2002.
28. Our regression results are generally consistent with those obtained by Lewis (2001) and Hofman et al. (2002).
29. See Alm and Martinez-Vazquez (2002) for a discussion of expenditure norms.
30. The per capita basis could be modified, if needed, by some adjustment coefficient to reflect different costs of provision or needs.
31. It must be made clear that the conditional grants should not be made for economic categories of expenditure, such as wages and salaries. This would eliminate any of the advantages of a decentralized delivery and implementation system and the full centralization of those services would produce the same results. Naturally, for local governments to be able to increase efficiency in the delivery of services, it would also be necessary to reduce, if not eliminate, central government norms and mandates that interfere with their choices.

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APPENDIX 8.1 THE 2002 AND 2001 DAU FORMULAE

A. 2002 General Allocation Fund (DAU) Formula

I. *Fiscal Gap* = Fiscal (Expenditure) Needs – Fiscal Capacity

II. *Fiscal Capacity* = LORadj + (PT + LTF + PIT + 0.75*NRS)

LORadj: Local Own Revenue Adjustment (or Predicted) = a + b*GRDP
Services

PT: Property Tax Revenue Sharing

LTF: Land Transfer Fee Revenue Sharing

PIT: Personal Income Tax Revenue Sharing

NRS: Natural Resources Revenue Sharing

III. *Fiscal Needs* = ALE (0.4 PI + 0.1 AI + 0.1 RPI + 0.4 CI)

ALE: Average Local Expenditure

PI: Population Index

AI: Area Index

RPI: Relative Poverty Index

CI: Construction Index

$$V.DAU_i = AM + (LDW * DAU_n)$$

Local DAU Weight (LDW) = Local Fiscal Gap/National Fiscal Gap

DAU_i: DAU for each province or district/municipality

DAU_n: DAU total, for all province or district/municipality

AM: Minimum Allocation = LS + (a*CSS)

LS: Lump sum equal for each province or district/municipality

a*CSS: Proportion of Civil Servant Salary in 2001

B. 2001 General Allocation Fund (DAU) Formula**I. Fiscal Needs**

Fiscal Needs = Average Local Expenditures * 1/4(Population Index + Area Index + Construction Price Index + Poverty Index)

Fiscal Needs Variables:

a. *Average Local Expenditures*

$$\text{Average Local Expenditures} = (\text{Total Local Expenditures} + \text{Deconcentrated Funds}) / \text{Number of Local Governments}$$

b. *Population Index*

$$\text{Population Index} = \text{Local Population} / \text{Average Local Population}$$

c. *Area Index*

$$\text{Area Index} = \text{Local Area} / \text{Average Local Area}$$

d. *Construction Price Index*

$$\text{Construction Price Index} = \text{Local Construction Price Index} / 100$$

e. *Poverty Index*

$$\text{Poverty Index} = \text{Number of Local Poor People} / \text{Average Local Poor People}$$

II. Fiscal Capacity

$$\text{Fiscal Capacity} = \text{Average Local Revenue} * 1/3(\text{Industrial Index} + \text{Natural Resources Index} + \text{Human Resources Index})$$

Fiscal Capacity Variables:

a. *Average Local Revenue*

$$\text{Average Local Revenue} = (\text{Local Own Revenue} + \text{Tax Revenue Sharing}) / \text{Number of Local Governments}$$

b. *Natural Resources Index*

$$\text{Natural Resources Index} = (\text{GRDP of Natural Resources} / \text{GRDP}) / (\text{GDP of Natural Resources} / \text{GDP})$$

c. *Industrial Index*

$$\text{Industrial Index} = (\text{GRDP of Non Primary Sectors}/\text{GRDP})/(\text{GDP of Non Primary Sectors}/\text{GDP})$$

d. *Human Resources Index*

$$\text{Human Resources Index} = (\text{Local Labor Force}/\text{Local Population})/(\text{National Labor Force}/\text{National Population})$$

III. General Allocation Fund (GAF)

$$\text{GAF of a Local Government} = \text{Fiscal (Expenditure) Needs} - \text{Fiscal Capacity}$$

$$\text{Local GAF Weight} = \text{GAF of a Local Government}/\text{GAF of All Local Governments}$$

$$\text{GAF Distributed for a District/Municipality} = 0.9 * 0.25 * \text{Total Domestic Revenue in National Budget} * \text{Local GAF Weight}$$

$$\text{GAF Distributed for a Province} = 0.1 * 0.25 * \text{Total Domestic Revenue in National Budget} * \text{Local GAF Weight}$$

APPENDIX 8.2 TABLE OF VARIABLE DEFINITIONS AND UNITS OF MEASUREMENT

Variable	Definition	Units of measurement
POP	Number of people	Thousands of people
POOR	Number of people in poverty	Thousands of people
POVGAP	Poverty gap	Thousands of people
LABOR	Number of people in working age (age 15–59)	Thousands of people
SCHOOL AGE	Number of people in school	Thousands people
OLDER	Number of people older than working age (>59)	Thousands people
YOUNGER	Number of people younger than working age (<15)	Thousands people
PCT POOR	Percentage poor people of population	Percent
PCT LABOR	Percentage working people of population	Percent
PCT SCHOOL AGE	Percentage school age people of population	Percent
PCT OLD	Percentage older people of population	Percent
PCT YOUNG	Percentage younger people of population	Percent
AREA (KM)	Land area of local authority	km ²
DENSITY (PER KM)	Population/Area	People/km ²
CONST INDEX	Construction price index	–
GRDP 1999 PER CAP	GRDP/Population	Thousands of rupiahs
TAX EFFORT (1999)	(Local Tax+User Charges)/Population	Thousands of rupiahs
TOTAL COLLECTION 1999 PER CAPITA	Local Own Revenue/Population	Thousands of rupiahs
REVENUE SHARE PER CAPITA (2001)	(Tax Sharing+Natural Share)/Population	Thousands of rupiahs

Variable	Definition	Units of measurement
DAU 2001 PER CAPITA	DAU 2001/Population	Thousands of rupiahs
AFTER DAU 2001 PER CAPITA	(Local Own+DAU 2001)/Population	Thousands of rupiahs
AFTER ALL TRANSFER 2001 PER CAPITA	(Local Own+DAU 2001+ Revenue Share)/Population	Thousands of rupiahs
REGIONAL REVENUE 2001 PER CAPITA	(Local Own+DAU 2001 + Revenue Share+Contingency Fund)/Population	Thousands of rupiahs
DAU 2001 (PCT OF EXPENDITURE)	DAU 2001/Expenditure	Percent
DAU 2002 PER CAPITA	DAU 2002/Population	Thousands of rupiahs
AFTER DAU 2002 PER CAPITA	(Local Own+DAU 2002)/Population	Thousands of rupiahs
AFTER ALL TRANSFER 2002 PER CAPITA	(Local Own+DAU 2002 + Revenue Share)/Population	Thousands of rupiahs
REGIONAL REVENUE 2002 PER CAPITA	(Local Own+DAU 2002 + Revenue Share+Contingency Fund)/Population	Thousands of rupiahs
DAU 2002 (PCT OF EXPENDITURE)	DAU 2002/Expenditure	Percent
EXPENDITURES 2001 PER CAPITA	Expenditure FY 1999 (with adjustment)/Population	Thousands of rupiahs
TRANSFERS	Dau 2001 or DAU 2002	Billions of rupiahs
REVENUE SHARES	(Tax Sharing + Natural Share)	Billions of rupiahs
TOTAL COLLECTION	Local Own Revenue	Billions of rupiahs
REGIONAL REVENUE	(Local Own+DAU + Revenue Share+Contingency Fund/ Balancing Fund)	Billions of rupiahs
AFTER TRANFERS	Local Own Revenue + DAU	Billions of rupiahs
AFTER ALL TRANSFERS	Local Own Revenue + DAU + Revenue Share	Billions of rupiahs
REGIONAL EXPENDITURE	Routine Expenditure + Development Expenditure	Billions of rupiahs

9. How should revenues from natural resources be shared in Indonesia?

Roy Bahl and Bayar Tumennasan

INTRODUCTION

The share of 'mining and quarrying' in GDP is quite large in a number of countries, above 10 percent in 29 of 100 countries for which we could find data and accounting for more than one-fifth of GDP in 13 countries.¹ The share in Indonesia is especially large. At 10.1 percent, Indonesia's share is about five times higher than the international median. Of the countries in the East Asian region, only Mongolia and Papua New Guinea are more heavily dependent on natural resources than is Indonesia.

As we document later, we find that countries with larger mining shares tend to delegate more spending power to local governments. One possible explanation for this is that the pressures to devolve some of the rents extracted from the natural resource sector are irresistible. Based on our cross-section evidence, we can say that if the mining share of GDP is higher in one country than another by 100 percent (i.e. it is 20 percent versus 10 percent of GDP), the expected local government expenditure share will be higher by 13 percent. However, based on its mining share, per capita GDP, population and land area, Indonesia's local government expenditure share in the 1990s was 14.4 points below the expected level.² The 'Big Bang' decentralization of 2001 brought Indonesia close to the expected level, but the share of local government expenditure remains lower than in similarly situated countries.

The arguments for sharing natural resource revenues with regions are often based on political notions of fairness, and are almost always emotionally charged. The problem is even more complicated in Indonesia because the revenue sharing argument is confounded by the ethnic and cultural differences between the natural resource regions and the rest of Indonesia. Clearly, however, there are objective arguments, both in support of and against giving sub-national governments a claim on a share of these revenues. On the one hand, these payments may be seen as compensation for the economic and social costs of natural resource extraction; a share of natural resource revenues may also be justified as payment for using up an exhaustible resource;

that is, for replacing the heritage of the region. On the other hand, some policy analysts and political leaders argue against natural resource revenue sharing, largely on the basis that it is the national government that is assumed to 'own' the natural riches; also, there is a concern about tying the finance of essential local government-provided services to an unstable revenue flow, and a fear that local governments could not efficiently spend such a large revenue windfall.

Few policy analysts or politicians believe that there should be no natural resource revenue sharing. One important issue relates to the magnitude of the share. In addition, there is much debate in Indonesia on whether – and how – natural resource revenue sharing should affect the transfer of general revenue sharing from the DAU. There are also concerns that local governments with large mining sectors will make unwise use of windfall revenues and that these governments will rely too heavily on the financing of essential local services with an unstable flow from natural resource industries. There are few generally accepted answers to these questions.

The objective in this chapter is to evaluate the system of sharing natural resource revenue in Indonesia against the criteria that are most often discussed in international forums. The chapter has three parts. First, we examine the importance of the issue and try to place the practice in Indonesia in some comparative perspective. Second, we argue the case for and against decentralization of revenues raised from natural resources and consider the constraints to such a decentralization policy. Third, we examine the reform options in terms of the specific fiscal instruments that might be used. This research is exploratory and does not delve into the detail of the complicated system of mineral taxation and of the present system of natural resource revenue sharing in Indonesia. Only a few Indonesian scholars have addressed this subject, and we cannot find a comprehensive government policy paper on the subject.³

IMPORTANCE OF THE ISSUE

Natural resources constitute a great source of wealth in many developing economies. As may be seen from the data in Appendix A9.1 and from the frequency distribution in Table 9.1, the share of 'mining and quarrying' in GDP is above 10 percent in 29 of 100 countries for which we could find data, and accounts for more than one-fifth of GDP in 13 of these countries.⁴ Indonesia's mining share is 10.1 percent, about five times higher than the international median. Of the countries in the East Asian region only Mongolia and Papua New Guinea are more heavily dependent on natural resources than is Indonesia.

We also examine the 'connection' between the share of mining in GDP and selected fiscal variables. We ask two questions. Do the countries that rely

Table 9.1 Mining share as a percent of GDP in selected countries^a

Percent	Number of countries
10 or less	71
11–20	16
21–30	7
31–40	5
41–50	1
Above 51	0

Note: ^a Average for the period 1990–99.

Source: *National Accounts Statistics*, The United Nations.

more heavily on natural resource production show a greater ratio of tax revenue to GDP? Do the countries that rely more heavily on natural resource production choose more or less decentralized fiscal structures?

With respect to the first question, one might expect a positive relationship between the tax ratio and the mining share of GDP. This is especially true in developing countries where there are relatively fewer ‘tax handles’ to reach for. The mining sector is visible, relatively easily reached with the existing tax administration apparatus, and offers a lucrative revenue take. Bahl (1971) found that there was a significant, positive relationship between the mining share and the tax ratio in the 1960s.

We estimate a log–linear regression of the determinants of the tax ratio to GDP using the independent variables that have become standard in tax effort analysis: per capita GDP, the agriculture share of GDP, the level of openness of trade, land area and population size. We also introduce the mining share of GDP as an independent variable. The result of this analysis, reported in Table 9.2 for various specifications, is that we can find no significant relationship between the tax ratio and the mining share for the 1990s. When we specify the dependent variable as the revenue ratio, to include all tax and non-tax revenues of the consolidated government, we get the same result. One explanation for this is that other tax bases have emerged as economies have developed, and there is less reliance on the extractive sector. This finding is also consistent with the hypothesis that revenues raised from the natural resource base and those raised from other bases are substitutes. We find evidence of such substitution in Indonesia, and discuss this later.

The second question is whether countries that rely more heavily on the natural resource sector tend to be more or less decentralized. There is ambiguity here about what one should expect. One might hypothesize more

Table 9.2 Regression analysis of the level of taxation, revenue and decentralization against selected independent variables^a

Dependent variable:	Tax Ratio ^b	Revenue Ratio ^c	Tax Ratio ^a	Tax Ratio ^a	Decentralization ^d
Intercept	1.18 (5.90)***	2.06 (6.55)***	3.41 (7.63)***	2.39 (2.84)***	-4.71 (-3.58)***
GDP per capita	0.24 (9.61)***	0.17 (4.79)***			0.30 (4.35)***
Mining share of GDP	-0.02 (-0.87)	-0.05 (-1.70)	0.001 (0.06)		0.13 (2.14)***
Agricultural share of GDP			-0.25 (-5.04)	-0.29 (-8.08)***	
Openness ^e			0.07 (0.70)	0.21 (2.18)***	
Area					0.11 (1.55)
Population				0.03 (1.03)	0.20 (2.16)***
Estimation method	OLS	OLS	OLS	OLS	OLS
Number of observations	81	41	68	112	62
Adj R ²	0.54	0.46	0.27	0.43	0.37

Notes:

***, **, * denote significance at 1%, 5%, and 10% levels, respectively. t-statistics are shown in parentheses.

^a Data are averages for the years 1990–99.

^b Tax revenue as a share of GDP.

^c Total government revenue as a share of GDP.

^d Sub-national government share of total government expenditure.

^e Sum of export and import shares of GDP.

Sources: *World Development Indicators*, The World Bank; *National Accounts Statistics*, The United Nations; *Government Finance Statistics*, International Monetary Fund.

centralization. The revenue stakes are high, and countries that can tap natural resources for supporting central government expenditures can avoid imposing high general tax rates on the voting public. Central government officials, and parliaments, might be loath to give up this natural advantage. There are issues of political control over these resources that might discourage decentralization of governance. Finally, there are questions of corruption that might point to more centralization: both the central control over mining concessions and the fear of corruption associated with large sums of money passing through local government budgets.

On the other hand, natural resource wealth is not evenly distributed within countries, and those regions that house this natural wealth are likely to clamor for a larger and dedicated share of the returns. Debate over the sharing of natural resource wealth can seriously threaten national unity. This will push countries with more natural resource wealth towards a larger degree of decentralization.

We use a cross-country panel of data to test for a relationship between the mining share and expenditure decentralization. In Table 9.2, we present the results of a regression analysis of the determinants of decentralization, based on some other work in progress (Alm, Bahl and Tumennasan, 2002.) We can explain about 40 percent of the variation on the degree of decentralization across 62 countries, with per capita GDP, population, area and the mining share of GDP as significant explanatory variables. Countries with greater dependence on the mining sector, *ceteris paribus*, tend to be more decentralized.⁵

In summary, we cannot conclude that countries with larger mining shares raise more revenues to distribute among the various levels of government, but we do find that countries with larger mining shares tend to delegate more spending power to local governments. Apparently the pressures to devolve some of the rents extracted from the natural resource sector are irresistible. Based on this cross-section, we can say that if the mining share of GDP is higher in one country than another by 100 percent (i.e. it is 20 percent versus 10 percent GDP), the expected local government expenditure share will be higher by 13 percent. When one remembers that the average sub-national government share of expenditures is only about 17 percent, this may be seen as a fairly large response. It is of some interest that, based on its mining share, per capita GDP, population and land area, Indonesia's local government expenditure share in the 1990s was 14.4 points below the expected level.⁶ The decentralization of 2001 brought Indonesia close to the expected level: based on our estimation results, one could speculate that the nearly 10 percent mining share of GDP in Indonesia played some role in moving the government toward this more decentralized structure.

A related question that might be raised is the *potential* of natural resource revenues for financing local governments; that is, is the amount of money at

issue significant in terms of the expenditure needs of local governments? Put differently, how important can the sharing of revenues from natural resources be in the intergovernmental fiscal system? This is not meant to be a normative question, but rather a query about why local governments around the world look with so much interest on this question.

In Appendix A9.1, we report the results of a hypothetical calculation. For countries for which we have data, we have calculated the amount of revenue that would flow if 10 percent of the mining share of GDP were allocated to the sub-national governments. The allocation would take the form of a shared tax of this amount or a direct allocation from central government. The ratio we report in column (5) is this 10 percent mining share as a percent of the actual expenditures of sub-national governments. For example, we find in Indonesia that, if 10 percent of all the GDP generated in ‘mining and quarrying’ sector were allocated to sub-national governments, this would be equivalent to 43 percent of local government expenditures (in the 1990s) (Appendix A9.1). The distribution of this revenue potential among the 35 countries shown in Table 9.3, suggests that in five countries, the 10 percent share would be sufficient to cover one-half of local government expenditures.

Table 9.3 The potential of the natural resource sector as a source of financing decentralized governance^a

Percent	Number of countries
10 or less	25
11–20	2
21–30	1
31–50	2
51–100	2
101 or more	3

Note: ^a 10 percent of the mining share of GDP divided by sub-national government expenditures; average for the period 1990–99.

Sources: *National Accounts Statistics*, The United Nations; *Government Finance Statistics*, International Monetary Fund.

THE CASE FOR SHARING NATURAL RESOURCE REVENUES

The arguments for sharing natural resource revenues with regions are often based on political notions of fairness, and are almost always emotionally charged. The problem is even more complicated in Indonesia because the revenue sharing argument is confounded by ethnic differences in the natural resource regions. There are, in fact, objective arguments in support of giving sub-national governments a claim on a share of these revenues. We examine those arguments here, and then turn to the counter arguments in the next section.

The ‘Heritage’ Argument

Natural resource endowments are sometimes seen as the ‘heritage’ of the region. Unlike the beauty of Bali or the deep water port at Medan, these resources are exhaustible. The returns from fertile land in a region may be taxed in perpetuity; in contrast, natural resource regions may tax the returns from an exhaustible resource only over the finite life of the resource. Clearly the flow of tax entitlements from the exhaustible resource will be more front-loaded. To outside or casual observers, this front-loaded flow might be seen as exorbitant. To residents of the natural resource region, however, it may be seen as a payment for selling their heritage.

The region can make a strong claim on the returns from this natural endowment. McLure says it nicely: ‘Sub-national governments have argued strongly that they may have the right to tax natural resources located within their boundaries, to convert resource wealth (their “heritage”) into financial capital’ – to turn ‘oil in the ground into money in the bank’ (1994, p. 199). Link (1978) also reports a well-stated view of the sub-national governments, by the Governor of the US state of North Dakota regarding the justification of a severance tax as ‘just compensation for losing forever a one-time harvest.’

The heritage argument has found acceptance around the world. As we show in Appendix A9.3, countries that decentralize in fact share natural resource revenues with their regional governments. The tougher question is ‘Who owns the natural resources?’, which gives rise to the lightning rod question, ‘How much of the rents from natural resources ought to be devolved to local governments?’

The Cost Reimbursement Argument

There is also a cost reimbursement argument for natural resource revenue sharing (McLure, 1994). Natural resource extraction and processing can be a

'dirty business,' imposing both high social costs and high infrastructure costs. Oil and natural gas drilling and processing can pollute the environment and impose social costs as well as clean-up costs on the community. Harvesting timber and various kinds of mining can impose real costs of restoring the land to its initial condition, or social costs if the land is not restored. Though companies bear some of these costs, they do not bear all of them, hence there is a case for revenue sharing.

There is as well an infrastructure cost. Most natural resource extraction activity requires the provision of infrastructure facilities that must be constructed and maintained. These might include such things as roads, public utilities, port facilities and the like. The 'settlement costs' of servicing the larger population of workers, and perhaps a different mix of new citizens, might also impose additional pressure on budgets (e.g. education, clinics, law enforcement, general community services). Finally, there is a cost associated with hosting a population that is possibly 'different' and has behavior patterns that are far from the local culture. Required technical expertise and required capital investment make it unlikely that natural resource industries will be owned, managed, and operated solely by the local population. Some also see this cultural incursion as a social cost to the host community.

Rationalizing the Revenue Structure

Another advantage of formally decentralizing natural resource revenues may not be as obvious. Indonesia is decentralizing, and local governments are taking on new expenditure responsibilities and looking for new revenue opportunities. Giving them a share of natural resources revenue, by some transparent formulae, will forestall their looking for 'back door' approaches to revenue raising. These 'back door' approaches can be quite harmful to economic development, by discouraging investors and driving up transaction costs.

The informal approach to revenue raising will almost certainly lead local governments to the natural resource sector. The mining sector would be a good target for informal taxes, because it is a visible sector and because of the perception that the tax is exported to foreigners. There is a history of local governments using informal taxes when transparent approaches (e.g. formal local taxing power or transfer entitlements) are not part of the intergovernmental system. Chinese local governments have made heavy use of such taxes and fees and then allocated them to off-budget accounts (Bahl, 1999). In the first year of decentralization, Indonesian local governments imposed numerous ad hoc taxes that were discriminatory against activities where the perception was that the burden could be exported. The so-called business (registration) tax is an example of such a tax. It is imposed on businesses

based on their size, usually proxied by their installed power capacity, and thus it is discriminatory against manufacturing industries. However, it does not create serious political problems, because the tax burden can be exported (Simanjuntak, 2002).

Another response to a failure to allocate formal revenue raising powers to local governments is that they may, by one means or another, confiscate some of the natural resource rents for themselves. The Russian case is instructive here. The division of natural resource taxation is clearly prescribed between central, regional and local government levels. However, local governments end up keeping a significantly larger share than their entitlement (Bosquet, 2002). Central government finds it difficult to enforce the sharing arrangements it has prescribed.

Politics and National Unity

The politics of natural resource revenue sharing may be on the side of a larger regional government entitlement. The alternative – civil unrest and threatened secession – may be far more costly. Certainly this has been an important issue in the Russian Federation (McLure, 1994; Bosquet, 2002).

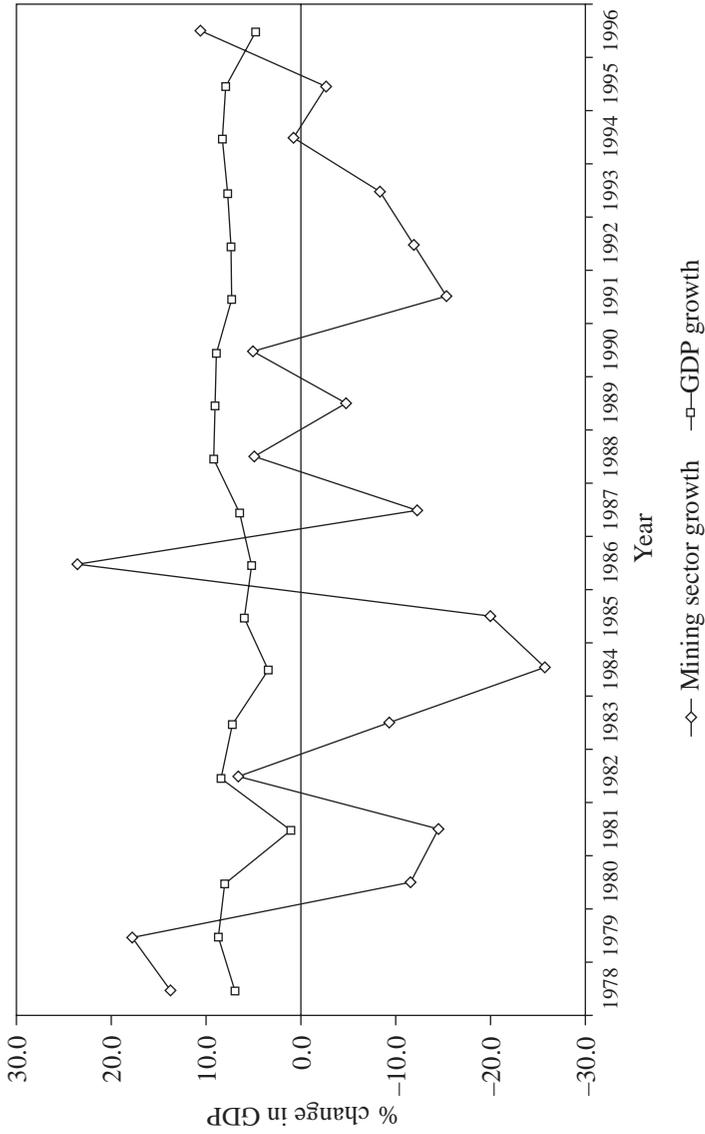
THE CASE AGAINST SHARING NATURAL RESOURCE REVENUES

Despite these arguments, some policy analysts and political leaders make a strong case against natural resource revenue sharing. A set of very solid arguments lead this group to recommend a smaller revenue share for sub-national governments.

Revenue Stability

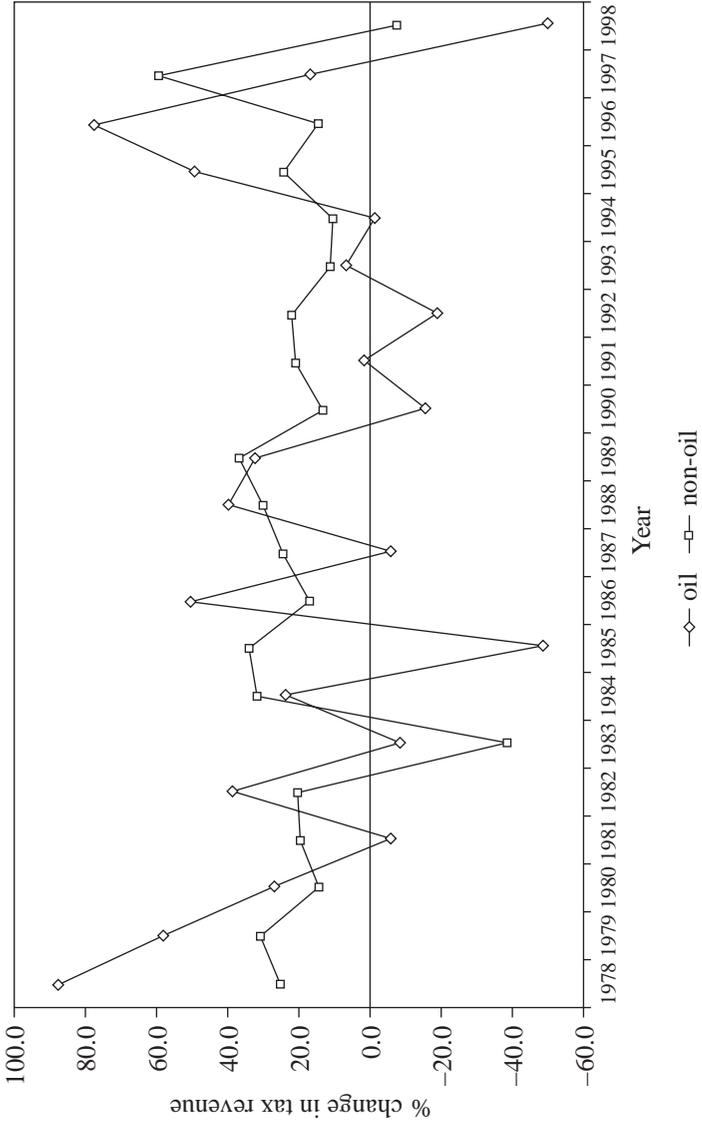
Natural resource revenues are inherently unstable, and, it is argued, the provision of essential local government services should not be tied to an unstable revenue stream. This seems a reasonable proposition. Central governments can accommodate such fluctuations because they can run deficits and finance these with borrowings. They also can postpone large capital projects. Deficit financing of current expenses is not an option that is, or should be, open to local governments.

How unstable are natural resource revenues in Indonesia? In Figures 9.1 and 9.2, we describe the relative stability of the natural resource sector. In Figure 9.1, the distribution of GDP originating in the mining sector is considerably more variable than the distribution of total GDP. In Figure 9.2, the instability of



Sources: Mining sector growth data are from *National Accounts Statistics*, The United Nations; GDP growth data are from *World Development Indicators*, The World Bank.

Figure 9.1 Percent change in mining sector and total GDP in Indonesia: 1979–97



Sources: Ministry of Finance. Data are posted at the World Bank Jakarta Office website <http://www.worldbank.or.id>

Figure 9.2 Percent change in oil and non-oil tax revenues in Indonesia: 1979–99

oil tax revenues is much greater than that in other revenues in the Indonesian financing structure. The revenue instability argument against natural resource revenue sharing would appear to have considerable merit in Indonesia. Any policy solution that ties revenue decentralization to natural resource tax revenues will require some feature that accommodates this instability.

Macroeconomic Considerations

Macroeconomic planning and growth considerations may dictate that revenues raised from natural resources be kept by central government. The government deficit is estimated in the range of 3 percent of GDP for 2001 and 2002. Receipts from oil and gas revenues, estimated at about 2 percent of GDP in these years, are essential for holding the deficit at this level. Without a tax increase, even an allocation equivalent to the 26 percent of oil tax revenues devolved in 2001 might be seen as threatening fiscal stability.

There also is a question about whether the devolution of natural resource revenues would lead to a replacement of national government investment priorities with local government investment priorities. Especially in the regions where natural resources are an important part of the economy, there are significant amounts of resources involved; in aggregate, the distribution in 2001 was about 0.6 percent of GDP. The result of decentralization could be a noticeable displacement of public investments.

Would this make any difference in the portfolios of investments? Presumably, national government officials plan infrastructure development according to a development program, and take into account local, regional and national benefits. Elected local government officials will be more prone to invest the proceeds of natural resource sharing in more visible projects with benefits weighted toward the very short run.

There also is the question of resource mobilization. Large amounts of natural resource revenue sharing may discourage some districts from increasing their effort with respect to raising their own source local revenues. For a country like Indonesia, with a low level of tax effort, this is a problem of some importance.

Equalization

Natural resource endowments are unevenly distributed in nearly all countries. For example, in Russia, about 10 percent of all metal production originates in 10 regions, and about half of all natural resource revenues are collected in three regions (Bosquet, 2002). If revenues are shared among local governments purely on a derivation basis, gross inequities in the revenue sharing system will occur.

The concentration of natural resource endowments is also the case in Indonesia, and it almost certainly follows that any derivation-based distribution will produce disparities in grant receipts. We study these disparities by examining the per capita distribution of natural resource revenue sharing across districts for 2001. One could evaluate this distribution of natural resource revenues in two ways. The first is according to what the law prescribes, and the second is according to the actual amounts received.

The legal distribution of natural resource revenue is based primarily on tax sharing, where specified percentages of the tax revenue raised from each extractive activity are divided between central and local governments, with different vertical shares for different components of the natural resource sector. For example, in the case of oil, the sharing rate is 85/15 (i.e. 85 percent to central government and 15 percent to local governments); in the case of natural gas, the sharing rate is 70/30. The actual base that is shared is a more complicated story. By formal regulation, the distribution among local governments is accomplished in two steps. First, a share goes to the local government where the extraction takes place; second, a share goes to all eligible jurisdictions in the province.

Does this method of distribution lead to inequities, and does it compromise the equalization of the overall system of intergovernmental transfers? The best way to answer this question is to study the actual revenue flows that result from this set of laws and regulations. The actual distribution of per capita natural resource revenue received by each district in 2001 shows an extremely large range, from Rp 271.3 million to Rp 4.6 million. The distribution of the per capita amounts received is summarized in the frequency distribution in Table 9.4. The variation reported in this table is striking: about an equal number of districts receive above Rp 1 million per capita as receive less than Rp 1000 per capita. No matter what the justification for this gap, and no matter that only about 10 percent of the districts are in the outlying

Table 9.4 Frequency distribution of per capita natural resource revenue sharing across districts in 2001

Amounts (in Rp)	Number of districts
1000 or less	16
1001–10 000	169
10 001–100 000	100
100 001–1 000 000	37
Above 1 000 000	14

Source: Government of Indonesia. <http://www.djpkdp.go.id>

categories, such disparities are likely to bring popular attention and criticism to the distribution.

Is this revenue sharing distribution out of step with the goals of the government for promoting equity among the districts in Indonesia? The regression results reported in Table 9.5 show an interesting pattern in the determinants of per capita natural resource revenue sharing. Districts with a higher per capita value added received more in per capita natural resource revenue sharing. Districts with a higher concentration of poverty received less, all other things held constant. Clearly, the distribution of natural resource revenue sharing is not equalizing, if either per capita GDP or the poverty rate is taken as the barometer of equalization. Interestingly, however, the distribution of per capita natural resource revenue sharing was positively and significantly related to the distribution of per capita DAU

Table 9.5 Regression analysis of per capita natural resource revenue sharing across the districts in Indonesia^a

Dependent variable	NRRSp ^b	NRRSp ^b	NRRSp ^b
Intercept	19.68 (8.29)***	11.03 (4.90)***	-2.85 (-18.25)***
Poverty	-0.24 (-1.61)*	-0.52 (-3.82)***	
GPRPpc	-0.15 (-1.01)	0.26 (1.98)**	
Population	-1.25 (-12.95)***	-1.25 (-14.83)***	
Area		0.50 (10.08)***	
DAUpc			1.81 (12.07)***
Estimation method	OLS	OLS	OLS
Number of observations	336	336	336
Adj R ²	0.33	0.49	0.30

Notes:

***, **, * denote significance at 1 percent, 5 percent, and 10 percent levels, respectively. t-statistics are shown in parentheses.

^a Data are for 2001.

^b Natural resource revenue transfer per capita.

Source: Government of Indonesia: <http://www.djkpkd.go.id>

(general purpose) transfers. The two transfer systems were reinforcing rather than offsetting.

Recall, however, that there are those who argue that the question of equalization is the 'wrong' question. There is no reason why natural resource revenue sharing should take on any particular pattern as regards the level of income or poverty, nor is there any reason to be concerned about inequities across regions in the distribution of these revenues. The purpose of this revenue sharing program is to compensate natural resource regions for costs incurred and for the use of exhaustible resources. Its distribution should be driven only by those two factors.

Windfalls and Inefficiency

The revenue gains to local governments from natural resource revenue sharing can be a mixed blessing. There is an analogy to the Dutch disease or 'resource curse' that has plagued many countries around the world (Corden, 1984; Auty, 1993). An abundance of mineral wealth, received rather quickly, can significantly improve the quality of life, as for example is the case in Brunei (Heeks, 1998), but it also causes perverse local effects that can retard longer term economic development. Most often cited are a spending effect, where a greater share of domestic resources is allocated to non-tradable sectors such as services and government, as well as the drawing of labor toward the higher paying mining sector and away from other economic activity in the region. The former crowds out development of a new export sector, whereas the latter drives up production costs in other tradable sectors.

There are even less pleasant possibilities. One is that the new-found wealth in resource rich districts may be squandered on ill-conceived projects. Another is that the great amounts of money involved may stimulate corrupt activities. Leite and Weidmann (1999) have argued that there is a positive relationship between corruption and natural resource abundance, and that this interplay retards economic growth.

We have no evidence on these effects for Indonesian local governments, but some would argue that their existence is a reasonable hypothesis. The introduction of natural resource revenue sharing in Indonesia surely produced a windfall problem. Some local governments were overnight beneficiaries of a new revenue sharing program, and the amounts received were in some cases quite significant. We might estimate the magnitude and relative importance of this windfall in the following way. We know that there was a 'hold harmless' provision on DAU so that in 2001 it was approximately the same size as the sum of the previous SDO and INPRES transfers in 2000. In Table 9.6, we show the distribution of the ratio of natural resource transfers to DAU transfers.

Table 9.6 *Ratio of natural resource revenue sharing to DAU transfers in 2001*

Ratio	NRRS/DAU
0.10 or less	268
0.11–0.25	24
0.24–0.50	14
0.51–0.75	2
0.76–1.00	5
1.01–2.00	13
2.00 or more	10

Source: Government of Indonesia: <http://www.djpkpd.go.id>

The larger this number, the larger the potential ‘windfall’ revenue from the natural resource distribution to the district.

The results of our calculations show that several districts received quite significant additions to the budget as a result of natural resource revenue sharing. As shown in Table 9.6, while 268 districts received natural resource revenue transfers that were less than 10 percent of their DAU transfers, 23 districts received amounts that were more than 100 percent of their DAU allocation. This is evidence of a revenue increment significant enough to be treated as a windfall. While some local officials may have recognized this revenue sharing for what it was – repayment for natural resource exhaustion – others almost certainly viewed it more as some would view a one-time revenue bonanza.

POLICY OPTIONS AND CHOICES

As is clear from the above discussion so far, there are no easy or correct answers regarding the ‘right’ way to share revenues raised from the taxation of natural resources. Nevertheless, a few policy directions do seem clear:

- There should be some sharing with the regions, if only because of the need to reimburse for the costs of being the home of natural resource activity. It may also be the case that national unity demands some sharing of the returns from natural resource extraction.
- Central government is in the best position to tax natural resources, since it possesses the major, appropriate instruments of taxation and the tax administration advantages (McLure, 2000).

Some other big questions are not so easily answered.

- What is the correct division of revenues between central and local governments (vertical sharing)?
- How should the natural resource revenues be distributed among the local governments (horizontal sharing)?
- Should local governments be allowed to tax the extractive industries?
- Are special, negotiated revenue sharing arrangements a good idea, or should there be a national policy that applies to all the provinces?
- If there is to be an allocation to local governments, should it carry restrictions as to the object of expenditure? Are ‘heritage fund’ arrangements a feasible option for Indonesia?

In the following discussion, we try to address these questions.

The Correct Vertical Share?

There are any number of ways that one might choose the ‘right level’ of vertical sharing of natural resource revenues. Either a bottom-up or a top-down approach could be used to determine the vertical share.

A bottom-up approach to determining the vertical share (VS) might be described by the following:

$$VS = \frac{CR + H + U}{NRR}$$

Ideally, the amount going to local governments would include a cost reimbursement component (CR) and a ‘heritage’ component (H). The latter would be compensation to recognize that an exhaustible natural resource, unique to the region, was being used up and needed to be replaced with investment to develop a new economic base. Another component in the calculation is the opportunity cost of avoiding civil unrest or secession (U); that is, how much of the natural resource revenue pie would it take to mitigate the call for independence by some of the natural resource provinces? The denominator would be total natural resource reserves (NRR). This ideal calculation is not easily turned into a transparent policy because we do not know how to calculate these amounts or even how to add them together to develop a ‘vertical share.’

We might also consider a top-down approach to measuring the vertical share, in which we might ask how much central government can afford to share. One hypothesis is this that central government can afford to replace its ‘excessive’ reliance on natural resource taxes with an increase in domestic

taxes. This increase could then be returned in the form of revenue sharing to the natural resource regions. To make this case, and to measure the 'affordable' vertical share, we must show two things: first, that mining sector taxes have been substituted for other taxes, and second, that tax effort is low.

There is some evidence that Indonesia has substituted taxes on the natural resource sector for taxes on the 'domestic sector.' We posit a structural relationship between oil tax revenues (OR) and non-oil tax revenues (NOR) as:

$$\begin{aligned} NOR &= f(Y_p, PO, OR) \\ OR &= F(PO, NOR), \end{aligned}$$

where PO = price of oil. Using quarterly data and a two stage least squares estimate, we find a negative relationship between 'domestic' tax revenues and oil tax revenues (Table 9.7).

Table 9.7 Regression analysis of oil revenue and non-oil revenue against selected independent variables

Dependent variable	Non-oil revenue ^a	Oil revenue ^a
Intercept	9.31 (4.57)***	9.70 (1.20)
GDRPpc	1.62×10^{-6} (1.02)	
Oil price	0.13 (0.23)	0.35 (2.15)**
Oil revenue ^b	-0.49 (-1.12)	
Non-oil revenue ^b		-1.06 (-1.76)*
Estimation method	2SLS	2SLS
Number of observations	67	67
Adj R ²	0.13	0.27

Notes:

***, **, * denote significance at 1 percent, 5 percent, and 10 percent levels, respectively; t-statistics are shown in parentheses.

^a As a percent of GDP.

^b Endogenous variable.

Sources: Quarterly per capita GDRP data are from the World Bank Indonesia Office. Oil prices are from the Energy Information Administration: <http://www.eia.doe.gov>. Quarterly oil and non-oil revenue data are drawn from government of Indonesia sources.

The second question is whether the overall level of taxation is low in Indonesia. Following the traditional method (Bahl, 1971), we estimate the taxable capacity of Indonesia using two different specifications of functional form, and the agricultural share of GDP and openness as independent variables. By either of these equations, Indonesia is found to be a low taxing country. Its estimated taxable capacity ranges between 19.6 and 19.9 percent of GDP, both estimates being well above its actual level of taxation of 15.2 percent of GDP in 1998 and 12.7 percent in 2001. Let us suppose, *ceteris paribus*, that Indonesia increased its level of tax effort to the international average while not increasing its taxation of the natural resources sector. The question we raise is the following: What share of natural resource revenue would this free up for distribution to the local government sector?

We have simulated an implied vertical share using this ‘affordability’ method, as reported in Table 9.8, for the late 1990s. For 1998, for example, the actual tax ratio was 15.2 percent of GDP, so to reach the target of 19.9 percent of GDP, a revenue ‘surplus’ equivalent to 4.7 percent of GDP would be created by some approach to increasing taxes to the international average. In 1998, oil tax revenues were equivalent to 4.2 percent of GDP. If the total amount of increased taxes were used to ‘replace’ oil revenues in the central government general budget, the entitlement of local governments in oil revenue collections would have been 111.9 percent in 1998. That is, all oil tax revenue collections would have been dedicated to the natural resource revenue sharing pool. During the 1994–99 period, the contribution would not have dropped below 87.5 percent of oil tax revenue collections, though it would have fluctuated widely. This is one view of a ‘normative’ vertical share. By comparison, the actual level of natural resource revenue sharing in

Table 9.8 Natural resource revenue sharing as a residual claim

Year	Actual tax ratio	Target	Surplus	Oil revenue	Potential ^a
1994	16.0	19.9	3.9	3.5	111.4
1995	15.8	19.9	4.1	2.9	144.3
1996	14.5	19.9	5.4	3.7	145.9
1997	15.0	19.9	4.9	5.6	87.5
1998	15.2	19.9	4.7	4.2	111.9

Notes:

^a Surplus as a percent of oil revenue.

All variables are shown as a share of GDP except ‘Potential’ in the far right column.

Sources: *Government Finance Statistics Yearbook*, International Monetary Fund and the government of Indonesia sources.

2001 was about 36 percent of oil tax revenues. One might conclude, using this criterion, that the present vertical share is low.

Horizontal Sharing?

Horizontal sharing refers to the distribution of natural resource revenues among the districts. Unfortunately, there is no clear ‘right’ way to do horizontal distribution. As is suggested in Appendix A9.3, countries choose a wide array of formula and derivation-type distributions. A ‘derivation’ approach allocates revenues back to the local government where they were collected. Some use ad hoc methods and others more transparent approaches. The approach a country chooses depends on its economic and social objectives, politics, history, and even an accident.

One set of questions to answer in designing a formula is whether the revenues should be assigned exclusively to those places where the natural resources were extracted, whether the formula should include local governments subject to immediate spillover effects, whether it should include local governments in general, or whether the sharing should be divided into pools to reflect all of these groups.

One part of the answer should be straightforward: the sharing is meant to compensate local governments both for the incremental costs of being home to extractive industries and for the using up of an exhaustible resource. This supports the argument that sharing should be on a derivation basis, and should be allocated to the affected regions. Any general revenue sharing should come under the general purpose transfer (DAU); that is, there is no case for special natural resource revenue sharing if it is to be allocated to all regions for general purposes.

However, allocation among local governments purely on a derivation basis is no easy matter. For one thing, the incremental ‘costs’ of the extractive activities may be borne in adjacent districts, as for example in the case of road construction and maintenance, water and air pollution, and the like. In other cases the ownership of the resource may not be clear. For example, the well may be drilled in district A but it may tap a pool that ‘belongs’ to both districts A and B. And then, there is the offshore issue. A more indirect effect is that labor in the region may be drawn to the extractive sector by higher wages, thereby siphoning off some of the productive labor in nearby districts and driving up wage rates in general. These problems might have been more easily handled in a world where provinces were major local government players, in Indonesia. The decentralization of 2001 relegated the provinces to a minor role in the intergovernmental fiscal system.

The solution to horizontal distribution that the Indonesian government settled on in 2001 was a sort of rough proration. The system is based on a

combination of derivation, formulae and ad hoc rules. While the rationale for this horizontal sharing is not all that clear, there is at least some transparency.

Local Taxes and Charges?

Should local governments be allowed to tax the extractive sector? The simple answer is that they should, but within the general framework for fiscal decentralization that Indonesia is now in process of designing and implementing.

The basic methods of taxing the extractive sector – personal and corporate income taxes, VAT, trade taxes – should remain with central government, as dictated by basic tax administration considerations.

Local governments could participate by raising fees and charges from the extractive sector. However, this should be done within the general framework of allowable local government revenue raising. Fees and charges should be general levies on all businesses, and should be aimed at recouping some of the cost of providing services. The targeting of one firm or one sector, for the purpose of exporting burdens, should be prohibited.

Local governments could also be allowed to levy taxes on broader bases. The property tax (PBB) is an appropriate local government tax. It is a levy on the wealth held by the owners of a company, and at least part of the tax may be borne locally. There is a good case for PBB revenues from the mining sector to be shared with local governments.

Another possibility is for local government to participate in the payroll tax. This power could be extended to all local governments in Indonesia, but those with large shares of employment in the higher paying extractive sector might benefit disproportionately. The tax revenue would belong to local governments where the employment was located (rather than where the headquarters firm was located). It could be levied as a piggyback tax where central government sets the tax base and collects the tax, but the local government imposes a special tax rate (within some specified limit). This piggyback income tax would be levied on all local firms and not just on those in the mining sector. This levy could replace the 20 percent individual income tax share that is now distributed as an intergovernmental transfer, on a derivation basis.

Some policy analysts have concentrated on identifying taxes that can be applied specifically to the natural resources sector. In an interesting analysis of the options for local taxation of mining activities, Otto (2001) suggests that good candidates might include royalties based on a unit assessment, licensing fees, surface rentals or land use fees, stamp duties, property tax and user fees. In terms of actual practice, he finds that property tax is the only levy on this list that is commonly used. McKenzie (mimeograph) argues for central taxing power over the natural resource sector as the most efficient

solution, but allows that political realism may make the case for sub-national government participation.

Special Autonomy?

Two Indonesian provinces, Aceh and West Papua, have negotiated a special revenue sharing agreement with the central government, and some would see merit in this approach. It certainly recognizes relevant differences as Aceh is nearing the end of its natural resource (natural gas) dependent era, and West Papua is in a much earlier stage of its exploitation of oil and minerals. Surely the revenue sharing arrangements should be different? Another advantage of negotiation is that it is bilateral and may be easier to bring to closure. To date, a protracted debate in Parliament seems to have been avoided.⁷

On the other hand, there are some major negatives to special revenue sharing agreements:

- Special negotiations never end. One option is that they must be renewed after a certain period of time. However, if a firm and binding agreement is not made on the life of the contract, or is not recognized, one of the parties will almost certainly try to renegotiate on a regular basis. In that case, certainty in the distribution of natural resource revenues will not have been gained, by either the central government or the recipient local government.
- Special negotiations encourage imitation, i.e. other provinces will seek the same type of accommodation. Soon, every local government becomes 'special' in terms of their expected revenue sharing. Local governments will also imitate one another in terms of the tactics they use to achieve a better agreement.
- If there are no transparent rules that bind all local governments, then there is no intergovernmental fiscal policy. Central government, as it moves from negotiation to negotiation, will be making it up as they go. This is not a desirable strategy. Each negotiation will set a new precedent, and the next local government will ask for at least as much as the one before. The situation may not be any more satisfactory from the point of view of local governments. They are in the early stages of decentralization in Indonesia and may not have the skills to bargain well in the early rounds, or their bargaining table may have been captured by local elites who do not speak in the best interest of the local population.

Heritage Fund?

One of the primary goals of natural resource revenue sharing should be to finance the replacement of an exhaustible resource with an alternative, sustainable economic base. In theory, the benefits of the program should accrue to present and future residents. However, the current system of natural resource revenue sharing in Indonesia all but guarantees that there will be no intergenerational transfer. Local politicians and other local elites will have a decided bias in favor of spending the money to benefit current voters or the current power structures. Though there has not yet been a thorough monitoring of these expenditures, many believe that much of the money has been squandered. This is a result that one might expect in the case of receipt of a large revenue windfall with little accountability to voters and little transparency.

A way around this 'windfall' problem is the creation of a heritage fund as the central mechanism for administering natural resource revenue sharing. The system might work as follows:

- The overall vertical share for natural resource revenue sharing would be a proportion of natural resource revenues, while the horizontal share would be according to some transparent method.
- Payments into the heritage fund would be prescribed as a percent of the natural resource revenue sharing allocation.⁸ Each local government would have an account.
- Annual and full payments to the heritage fund would be guaranteed.
- Expenditures from the fund would be earmarked for 'pre-approved' development projects. For those districts receiving small amounts, the natural resource transfer could be seen as augmenting conditional grants. In effect, the money would be used for hard and soft infrastructure projects that are consistent with a structural adjustment of the local economic base.
- Management of the heritage fund could be by an independent third party. Alternatively, payments to the fund could be treated as a dedicated revenue stream of payments to a sinking fund to service and repay a foreign loan. The lender would manage the sinking fund to accommodate the erratic revenue flow resulting from fluctuating oil and mineral prices, and could pre-fund certain projects. The dedication of a revenue stream from natural resources should defray both collateral concerns and foreign exchange risk.

The heritage fund concept has great merit as a policy for Indonesia. It at once addresses the revenue instability and windfall issues, and it also makes

possible an intergenerational transfer because it is earmarked for a capital project. Some governments have been successful with the management of oil and mining stabilization funds (Alaska, Norway, Chile), but a key to success seems to be the degree to which the government has a history of practicing fiscal discipline (Fasano, 2000). Whether such a fund could succeed in Indonesia is an open and interesting question.

CONCLUSIONS AND POLICY IMPLICATIONS

The sharing of natural resource revenues with local governments in Indonesia would seem unavoidable. It would also seem fair and efficient. Local governments incur a variety of private and social costs associated with natural resource extraction, they should be compensated for exhaustion of the resource, and there are political economy questions about the costs of civil unrest. The question would not seem to be whether there should be sharing of these revenues. Rather, the questions are 'how much sharing?' and 'how should it be done?'

Perhaps the most difficult question relates to the appropriate vertical share: how much of the shared revenue should belong to the center and how much should belong to the local governments? It would not seem possible to make a precise, direct calculation of the costs based on the factors that dictate revenue sharing. What should be done?

One option would be to let the government and the regions negotiate a general agreement, as was done in setting up the present arrangement. The basis for calculating the vertical share should be the best estimates that one can make of the 'costs' of natural resource extraction, and a calculation of a 'heritage' amount. This would move the decision towards a different vertical share for each region, as would individual negotiations.

There is no perfect way to calculate the 'heritage' compensation, or even the cost reimbursement amounts. However, hard analysis can significantly reduce the subjectivity in assigning the vertical (and horizontal) shares. One feasible option would be to appoint a high-level 'grants' commission to carry out the work and design a five-year 'contract' to recommend to the President and to Parliament.

A second option would be to let central government adopt an affordability approach, in which it raises tax effort to the international average (or computes what this amount would be) and then uses that 'surplus' to free up resources for a greater allocation of natural resource revenues to the regions. At 1998–99 levels, this would have resulted in a devolution of natural resource revenues of about 2.2 percent of GDP, which is above the present level of about 0.6 percent of GDP.

Once a method is in place for establishing the size of the vertical share (and horizontal share), one might take on the four questions that seem to plague the formation of a firm intergovernmental policy for natural resources.

1. Should the natural resource revenue sharing regime be linked to the general purpose grant program of the government (the DAU)? On a conceptual level, there is a strong argument that these two revenue sharing flows should not be linked as the transfers are for entirely different purposes. The DAU is to cover the minimum costs of local government provision of a decentralized set of expenditure responsibilities. Essential services, in natural resource regions and in other regions, should continue to be financed by DAU and local resources. Natural resource revenue sharing should be seen as an earmarked, conditional transfer. The purpose is to compensate local governments for the additional costs associated with natural resource activity, and for the 'exhausted' economic base of the region. So long as its use is formally limited to these purposes, it should not be seen as an enhancement of the general fiscal capacity of the district government. It is no more an addition to the ability to finance local government services than is an earmarked conditional grant. It would be incorrect to deduct revenues from natural resource transfers (or other conditional transfers) from DAU entitlements.

In fact, however, many policy analysts advocate deducting natural resource transfer from DAU allocations, on grounds that these are an enhancement to fiscal capacity. In the case of Indonesia, such deduction was actually built into the original formula. However, this is based on the presumption that natural resource sharing is no more than a second, general purpose transfer, and is being used for financing recurrent expenditures. If there is no special purpose justification for natural resource revenue sharing, why not simply combine it with DAU?

2. Should the natural resource revenue sharing system be based on a transparent formula (as for example, determination by a grants commission) or should it be negotiated on a province-by-province basis? While negotiation seems to have had the advantage of being more quickly and more easily accomplished, it is not a good long-run solution. It invites continued re-contracting, it is not transparent, it favors better negotiators and local governments that are in a stronger political position, and it is the antithesis of the development of a coherent government policy on intergovernmental fiscal relations. A better approach would be to allow a grants commission to factor 'special circumstances' into the allocation criteria.
3. Should local governments be able to tax the natural resource sector? One answer is that the center should lay down taxing and tax sharing rules for

all local governments in the country. Local governments with a strong mining sector should follow these general rules in the same way as local governments with strong manufacturing or tourism or agricultural sectors. Fees, charges and some form of sharing of local payroll taxes and property taxes are good candidates for local revenue raising. No special local taxes on the extractive sector should be allowed.

4. How does one deal with the twin problems of (a) unwise use of windfall revenues to local governments with large mining sectors, and (b) the revenue financing of essential local services with an unstable flow from natural resource industries? Local governments would seem ill-equipped to handle the lumpy revenue flows from natural resource revenue sharing. One solution to this problem is the creation of a heritage fund arrangement, which could be used to finance development expenditures that would produce benefits for the present and future generation. Payments into the heritage fund (or a sinking fund) could fluctuate with commodity prices without harming the provision of these programs. The fund could be conservatively managed by an outside, third party.

NOTES

1. The GDP category 'mining and quarrying' includes crude petroleum and natural gas production, and coal, metal ore and other mining.
2. Expected and actual levels of expenditure decentralization are reported in Appendix A9.2.
3. The one government paper that we did find that explicitly discusses and researches the topic of natural resource revenue sharing in Indonesia is BAPPENAS (2000).
4. The GDP category 'mining and quarrying' includes crude petroleum and natural gas production, and coal, metal ore and other mining.
5. We omitted 37 countries because data for all variables were not available. These countries have an average mining share of 8.2 percent, compared to the sample average of 7.8 percent.
6. Expected and actual levels of expenditure decentralization are reported in Appendix A9.2.
7. Herbst (2001, p. 5) makes the interesting point that Russia allocated resources among regions on an ad hoc basis largely to hold the federation together, but that 'if such systems of ad hoc allocations continue indefinitely, countries may not go beyond crisis management.'
8. The remainder would be to reimburse the incremental costs of natural resource extraction.

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APPENDIX A9.1 SELECTED CHARACTERISTICS
(COUNTRIES RANKED BY THE SIZE
OF MINING SECTOR IN GDP*)

Country name	Mining ^a	Decentralization ^b	Tax ratio ^c	Revenue ratio ^d	Mining/ sub. exp. ^e
United Arab Emirates	46.7	..	..	..	..
Nigeria	35.7	28.9	7.8	..	..
Botswana	35.6	4.8	33.8	..	198.5
Kuwait	35.5	..	..	..	..
Saudi Arabia	35.4	..	..	..	..
Ukraine	34.6	28.9	37.0	..	..
Mongolia	29.1	35.1	24.2	30.1	21.4
Bulgaria	28.2	18.1	33.1	42.4	2612.2
Macedonia, FYR	27.6	..	..	..	..
Algeria	27.3	..	..	..	..
Kazakhstan	25.9	37.0	14.5	23.0	..
Azerbaijan	24.7	24.1	22.4	23.1	..
Portugal	24.2	11.2	32.6	36.6	..
Costa Rica	19.4	3.0	21.2	20.6	..
Lithuania	18.4	26.2	30.1	32.2	..
Venezuela	18.3	..	..	..	..
Bahrain	17.8	2.9	..	28.1	220.3
Trinidad and Tobago	16.5	4.4	23.2	29.3	98.6
Croatia	16.0	10.8	44.6	48.5	0.6
Papua New Guinea	15.8	..	..	..	..
Iran, Islamic Rep.	14.2	0.0	7.2	..	..
Israel	14.0	13.6	35.3	42.3	..
Yemen, Rep.	13.3	..	..	..	..
Namibia	13.1	..	30.2	..	..
Norway	12.9	32.4	40.9	52.9	0.8
Ecuador	12.3	..	..	..	..
Guyana	11.6	..	..	..	..
Romania	11.1	11.6	30.3	34.6	..
Indonesia	10.1	12.2	15.8	18.2	43.3
Sierra Leone	9.4	..	11.2	..	..
Moldova	8.5	27.9	26.2	37.2	..
Chile	8.5	8.0	19.6	24.7	33.9
Bolivia	8.4	23.4	14.5	20.7	12.1
Colombia	8.2	43.5	..	..	..
South Africa	7.7	29.1	27.7	29.3	5.2
Sudan	5.9	..	6.3	..	..
Tunisia	5.3	..	..	..	..
Jordan	4.6	..	..	..	..
Australia	4.0	42.4	28.8	34.4	2.2
Suriname	3.8	..	..	..	..

APPENDIX A9.1 (continued)

Country name	Mining ^a	Decentralization ^b	Tax ratio ^c	Revenue ratio ^d	Mining/sub. exp. ^e
Canada	3.5	57.4	37.3	45.5	1.0
Dominican Republic	3.5	2.3	13.5	15.0	78.3
Kyrgyz Republic	3.2	25.5	14.0	..	..
Bahamas, The	3.2	..	15.6	..	..
Malta	3.1	..	26.8	..	..
Netherlands	2.9	24.0	43.0	50.4	1.7
Bhutan	2.2	..	6.1	..	..
United Kingdom	2.1	22.8	35.4	39.2	1.9
Morocco	2.1	..	..	..	..
India	2.0	45.5	14.5	19.2	1.4
Peru	1.9	18.9	12.8	17.0	13.9
Czech Republic	1.8	20.6	38.5	41.6	..
Estonia	1.6	25.2	34.8	38.4	1.4
United States	1.6	46.3	28.0	33.4	0.8
Georgia	1.6	20.0	8.2	..	..
Honduras	1.6	..	..	..	..
Mali	1.5	1.4	10.7	..	..
Mexico	1.5	26.1	16.7	19.3	3.0
Brazil	1.5	39.2	27.2	39.7	0.7
Swaziland	1.5	1.8	29.7	..	..
Thailand	1.4	8.0	17.2	19.4	8.3
New Zealand	1.4	10.1	36.7	..	3.7
Turkey	1.3	..	24.4	..	..
Sri Lanka	1.2	9.1	17.3	..	..
Greece	1.1	7.9	32.1	..	..
Philippines	1.1	7.9	..	..	8.7
Slovak Republic	1.0	8.9	38.6	39.8	2.6
Denmark	0.8	44.4	48.6	56.8	0.4
Burundi	0.8	..	15.2	..	..
Belize	0.6	..	..	..	..
Senegal	0.6	5.5	14.9	..	..
Myanmar	0.6	..	..	..	..
Pakistan	0.5	29.2	..	..	..
Spain	0.5	30.6	33.6	35.4	..
Nepal	0.5	..	..	..	..
France	0.4	17.6	43.0	46.5	0.7
Austria	0.4	30.9	42.4	49.1	0.2
El Salvador	0.4	..	..	..	..
Korea, Rep.	0.4	45.6	20.9	..	..
Paraguay	0.4	2.8	9.4	13.3	..
Finland	0.4	35.9	38.5	46.5	0.1
Cyprus	0.3	..	..	..	..

Country name	Mining ^a	Decentralization ^b	Tax ratio ^c	Revenue ratio ^d	Mining/sub. exp. ^e
St Vincent and the Grenadines	0.3	..	..	..	..
Sweden	0.3	33.8	51.7	57.2	0.1
Ethiopia	0.2	1.5	10.4	..	..
Japan	0.2	60.6	28.1	..	..
Côte d'Ivoire	0.2	3.2	16.7	..	..
Kenya	0.2	4.1	22.6	..	..
Uruguay	0.2	10.3	..	..	0.5
Cambodia	0.2	..	..	..	..
Latvia	0.2	24.0	32.7	38.6	0.2
Panama	0.2	2.5	18.6	27.1	2.5
Lesotho	0.1	..	39.2	..	..
Mauritius	0.1	4.6	19.2	22.0	1.1
Puerto Rico	0.1	..	..	..	..
Singapore	0.1	..	16.3	..	..
Hong Kong, China	0.0	..	..	..	..
Gambia, The	0.0	..	19.9	..	..
Bangladesh	0.0	..	39.8	..	..
Seychelles	0.0	..	34.4	..	..
Mean	7.8	20.6	25.5	33.8	
Median	1.9	20.0	26.2	34.5	
Variance	116.8	237.3	131.9	143.0	

Notes:

* The data are the average of 1990–99.

^a Share of mining and quarrying in GDP. Mining and quarrying include crude petroleum and natural gas production, coal, metal ore and other minings.

^b Sub-national government share of total government expenditures.

^c Ratio of total government tax revenues over GDP.

^d Total government revenue over GDP

^e 10 percent of mining GDP over sub-national government expenditure (%)

Sources: Mining data are from *National Accounts Statistics*, The United Nations; tax, revenue, expenditure data are from *Government Finance Statistics Yearbook*, International Monetary Fund.

APPENDIX A9.2 FISCAL DECENTRALIZATION EFFORT

Country	Decentralization ^a	Expected decentralization ^b	Decentralization effort ^c
Australia	42.4	43.1	1.0
Austria	30.9	17.7	1.7
Azerbaijan	24.1	9.3	2.6
Bahrain	2.9	6.8	0.4
Bolivia	23.4	12.2	1.9
Botswana	4.8	14.8	0.3
Brazil	39.2	36.9	1.1
Bulgaria	18.1	13.1	1.4
Canada	57.4	47.6	1.2
Chile	8.0	21.6	0.4
Colombia	43.5	22.7	1.9
Costa Rica	3.0	12.1	0.2
Côte d'Ivoire	3.2	7.0	0.5
Croatia	10.8	13.1	0.8
Czech Republic	20.6	13.1	1.6
Denmark	44.4	17.3	2.6
Dominican Republic	2.3	9.0	0.3
Estonia	25.2	7.4	3.4
Ethiopia	1.5	6.0	0.3
Finland	35.9	18.0	2.0
France	17.6	32.5	0.5
Georgia	20.0	5.2	3.8
Greece	7.9	16.9	0.5
India	45.5	23.5	1.9
Indonesia	12.2	26.6	0.5
Israel	13.6	18.3	0.7
Japan	60.6	38.1	1.6
Kazakhstan	37.0	21.6	1.7
Kenya	4.1	6.7	0.6
Korea, Rep.	45.6	18.4	2.5
Kyrgyz Republic	25.5	8.2	3.1
Latvia	24.0	5.6	4.3
Lithuania	26.2	11.0	2.4
Mali	1.4	7.1	0.2
Mauritius	4.6	3.4	1.4
Mexico	26.1	25.8	1.0
Moldova	27.9	7.4	3.8

Country	Decentralization ^a	Expected decentralization ^b	Decentralization effort ^c
Mongolia	35.1	9.5	3.7
Netherlands	24.0	23.6	1.0
New Zealand	10.1	16.9	0.6
Nigeria	28.9	17.2	1.7
Norway	32.4	30.2	1.1
Pakistan	29.2	12.0	2.4
Panama	2.5	6.1	0.4
Paraguay	2.8	8.1	0.3
Peru	18.9	16.8	1.1
Philippines	7.9	13.3	0.6
Portugal	11.2	23.9	0.5
Romania	11.6	15.1	0.8
Senegal	5.5	6.2	0.9
Slovak Republic	8.9	9.1	1.0
South Africa	29.1	26.8	1.1
Spain	30.6	25.5	1.2
Sri Lanka	9.1	7.5	1.2
Swaziland	1.8	4.4	0.4
Sweden	33.8	20.2	1.7
Thailand	8.0	18.5	0.4
Trinidad and Tobago	4.4	8.0	0.6
Ukraine	28.9	22.4	1.3
United Kingdom	22.8	32.9	0.7
United States	46.3	74.5	0.6
Uruguay	10.3	8.7	1.2

Notes:

^a Defined as the ratio of sub-national to total government expenditure. Data are an average for the 1990–99 period.

^b Estimates are based on equation shown in Table 9.2.

^c Ratio of actual to estimated expenditure decentralization.

Source: *Government Finance Statistics Yearbook, 2001*, International Monetary Fund.

APPENDIX A9.3 NATURAL RESOURCE REVENUE SHARING PRACTICES

Country	Vertical share	Distribution criteria
Brazil	<p>States: Taxes on minerals (45%) Local: Tax on gold (70%) 2.3% of revenues from crude oil production Taxes on minerals (50%)</p>	<p>Origin Origin Origin Origin</p>
China	<p>Provinces: Taxes on natural resources</p>	<p>For each province, the center determines what share of the tax revenues it collects that province may retain. The determination is made on the basis of a combination of derivation, formula, and negotiations and ad hoc decisions</p>
Estonia	<p>Local: Taxes on oil sale (50%) Taxes on construction material (70%) Water supply tax (80%)</p>	
Indonesia	<p>Provinces: Royalties on oil and gas sales, royalties on forestry and mining activities</p>	<p>Derivation: forest royalties: 65% federal (F), 35% state (S) and local (L), (28% S, 7% L); mining royalties: 30% F, 70% S and L (56% S, 14% L)</p>
Malaysia	<p>Import and excise duties on oil (30% to states) Export duty on tin (10% to states) Export duties on other minerals Export duties on timber and other forest products</p>	<p>Derivation Derivation (exclusively for the states of Sabah and Sarawak, which were granted special privileges as a condition for joining the federation)</p>

Mexico	States:	Import taxes and petroleum export duties	Shared with petroleum refining and exporting cities (derivation)
Nigeria	States:	Most revenues collected centrally into Federation Account (FA): 73% of government revenue is oil-based States Joint Account (SJA) 31.5% of FA.	5% of SJA distributed to mineral producing states on the basis of derivation
	Local:	10% of FA Population (75%)	Equal share (25%)
Pakistan	Provinces:	80% of excise duty and royalty on natural gas, surcharge on gas; royalty on crude oil and profits on hydroelectricity	Origin
Papua New Guinea	Provinces:	Royalties: mineral and petroleum, natural gas, timber, and fish	Derivation
Philippines		Tax on petroleum products	Derivation
Russia	Provinces:	Natural resource taxes (39%)	
	Local:	Natural resource taxes (36%)	

Sources: The source for Pakistan is The World Bank (2000); the source for Estonia is The World Bank (1995); the source for Russia is Frienkman and Yossifov (1999); the source for all other countries is Shah (1994).

10. Decentralization and local government borrowing in Indonesia

James Alm and Sri Mulyani Indrawati

INTRODUCTION

For much of its recent history, Indonesia's constitutional arrangements had established it as a multi-tier unitary state, with provinces as the second tier below the central government and local governments as the third tier. The centralization of authority in Jakarta was justified as a way of maintaining national unity in a nation of over 200 million people, spread across 14 000 islands and two million square kilometers; it was also in part a counter reaction to efforts by a previous colonial power, the Dutch, to assert the importance of federalism as a last effort to control the newly independent Indonesia. In May 1999, however, the government of Indonesia (GOI) started a major program of governmental decentralization with the passage of two laws on various aspects of decentralization, Law No. 22/1999 on Regional Government (UU PD) and Law No. 25/1999 on the Fiscal Balance between the Central Government and the Regions (UU PKPD). The implementation of these laws began in January 2001, and has already begun to transform intergovernmental fiscal relations in Indonesia.

One aspect of this decentralization that has been largely unexamined is its potential impact on local government borrowing. If local governments are given more independence in their tax and expenditure decisions, such independence may well extend to their use of borrowing. There is little question that, in principle, local government access to capital markets can provide significant benefits. Local governments can use borrowing to better match current expenditures with current tax revenues, allowing temporary and unexpected swings in revenues to be smoothed without undue disruption in service provision. More importantly, local governments can use borrowing to finance public capital projects that are lumpy in nature; finance of investment projects via current revenues is likely to be inefficient, and, since future generations will benefit from long-lived projects, finance via current revenues collected from current generations is likely to be inequitable as well. According to the well-known 'principle of subsidiarity,' responsibility for the

provision of government services should be at the lowest level of government compatible with the benefit area of the service, since decisions made by a level of government that is closer to its constituency are likely to reflect more closely the wishes of the voters. This principle applies equally to capital expenditures, as well as to current expenditures: local governments should take full responsibility for planning, financing and executing all capital projects whose benefit area corresponds with the geographic area of the jurisdiction.

However, there is also little question that local government borrowing has sometimes created, or at least contributed to, significant problems.¹ When local governments are given preferential access to capital markets, they may be encouraged to undertake capital projects whose economic justification is weak. More importantly, when local governments are unable to repay their loans, central government may be forced to assume responsibility for the debt service. If widely anticipated, this may in turn lead lenders to act imprudently by lending to local governments that are not creditworthy, it may encourage local governments to borrow excessively, and it may create unplanned and uncontrollable fiscal liabilities for central government. There is compelling evidence that decentralization has in fact contributed to macroeconomic instability in countries like Brazil, China and Colombia.²

In this chapter, we examine the decentralization reforms now underway in Indonesia, focusing on their effects on local government borrowing. Our general conclusion is that the laws and their implementing regulations seem designed mainly to deal with macroeconomic considerations of central government, and not to create a system to allow local governments to gain access to credit markets. Indeed, this seems likely to be a reasonable *immediate* goal, given that the pre-conditions for successful local government borrowing are not currently present in Indonesia. However, the *long-run* goal must remain the creation of a viable framework in which local governments face hard budget constraints but are still able to have access to capital markets. It is here where the current framework in Indonesia is inadequate. To this end, we suggest a number of policies that will help in a transition period from the current reliance on direct administrative control of local borrowing to a greater reliance on market discipline policy.

In the next section, we briefly discuss the current macroeconomic conditions of Indonesia, and outline the major features of Laws No. 22/1999 and No. 25/1999, including their provisions that deal with local government borrowing. In the third section we present a general 'framework' that establishes some conditions under which different approaches to local government borrowing can be successful, and we apply this framework to local governments in Indonesia in the fourth section. We conclude in the fifth section.

THE INDONESIAN CONTEXT

Current Political and Macroeconomic Conditions in Indonesia

Indonesia is a country with huge geographic and ethnic diversity. It is rich in natural resources (fisheries, forests, minerals and mining), which are in most cases located in the outer islands. For many years central government in the capital city of Jakarta took all significant revenues from all over the regions and then redistributed some of these revenues according to grant formulae based on both population size and geographical coverage. In reality, however, Jakarta enjoyed most of the benefits of these revenues. The striking and widening disparities across the regions, especially between Jakarta and the other regions, created deep resentment from local governments and their citizens outside Java. This resentment was especially deep in the oil and natural gas provinces such as Aceh, Riau, West Papua and East Kalimantan, where any potential benefits from the oil revenues were hardly felt.

The economic crisis that began in June 1997 brought down the centralized and authoritarian government of President Soeharto, and led to a radical political change toward a more democratic system. As discussed in detail later, the transition government under the leadership of President B.J. Habibie shifted decentralization policy also in a radical way, both as a natural response to pressures from local governments (especially from outer Java islands) and as a political maneuver to win the upcoming general election in June 1999. The passage of Laws No. 22/1999 and No. 25/1999 was designed as an extreme response to the previous local autonomy law based mainly on Law No. 5/1974. Despite the absence of many details and the lack also of much consistency with other related laws, these 'Big Bang' changes were easily passed by parliament because of both popular pressure and democratic euphoria. Eventually, President Habibie lost in the 1999 elections. However, the decentralization laws were already in place, and it became the responsibility of the new government of President Abdurrahman Wahid, and now President Megawati Sukarnoputri, to implement them.

The economic crisis seriously worsened Indonesia's economic conditions. During 1998, the economy contracted by 14 percent, inflation reached almost 80 percent, the exchange rate depreciated more than 80 percent, and unemployment and poverty rates more than doubled. All of this was accompanied by the decimation of the financial sector. Compared to other countries in Southeast Asia that experienced the same crisis, there is compelling evidence that Indonesia suffered the most. The crisis forced the government of Indonesia (GOI) to seek support from the International Monetary Fund (IMF), especially to bail out the banking sector that had collapsed from the very deep exchange rate depreciation and also from the political turmoil that

ignited systemic bank runs. During 1998 and 1999, the GOI had to issue domestic-denominated bonds in the amount of Rp 659 trillion, or about 70 percent of Indonesian GDP, in order to finance its banking restructuring and recapitalization program. This sudden and enormous issue of domestic bonds, together with increasing government external debts to the IMF and other multilateral and bilateral donors, created a huge public debt burden. Public debts jumped from around 45 percent of GDP before the crisis in 1996 to 110 percent in 1999, an increase that raised serious questions regarding the capacity of the national government to manage the fiscal risk and to sustain its budget.

With such perilous national economic and fiscal conditions, implementation of the new decentralization policies increased fiscal risk and threatened macroeconomic stability, primarily because of the fear that local governments with their new autonomy would not behave in a fiscally responsible manner and that central government would be forced to step in. This fear became a dominant consideration when the national government wrote the many regulations to implement the new decentralization laws, especially the local borrowing rules and the revenue sharing mechanisms.

The Nature of the Decentralization Reforms

Since the 1950s, Indonesia has been a highly centralized but multi-tier unitary state, with many governmental functions performed by deconcentrated central government agencies in provinces and districts (Shah and Qureshi, 1994; Booth, 1996; Aten, 1999).³ Before 1999, decentralization policy was largely based on Law No. 5/1974, which in its implementation made 'local governments' – taken here to include both provincial and district governments – almost totally dependent on the national government. This dependence was not only in terms of financial (or fiscal) support, but also in terms of political power. Expenditure decisions of local governments were generally dictated by central government, and nearly all local government revenues came from the center. Political dependence on the national government occurred via the appointment process of heads of districts, mayors of municipalities and governors at provincial level. Although local government institutions (e.g. the locally elected parliament) held in theory the power to appoint the local government head, in practice the appointment process was decided by a higher level of government. The governor's appointment was made directly by the President, and both the district head's and the mayor's appointments were determined by the governor.

The full implementation of Laws No. 22/1999 and No. 25/1999 has begun to change this organization of governments, in several fundamental ways.

First, Law No. 22/1999 eliminated the hierarchical relationship between provincial and district governments. The district governments – called *kota/*

kabupaten – have become more autonomous, so that the heads of these district governments no longer report to the governor of the province. Instead, the district heads are responsible to the locally elected assembly (*Dewan Perwakilan Rakyat Daerah*, or DPRD). In contrast, the provinces retain a hierarchical relationship with the central government.

Second, with some limited exceptions (e.g. defense and security, foreign policies, monetary and fiscal policies, judiciary affairs, and religious affairs), Law No. 22/1999 also made all deconcentrated central government ministries at the province and district level the responsibility of the respective local government. In the previous system, central government and its ministries had deconcentrated departments called *kepala kantor wilayah*, or *kanwil*, at provincial level; in some cases, the *kanwil* had a sub-branch at district (or subdistrict) level called a *kantor departemen*, or *kandep*. The province had its own planning agency (*Bappeda*) and various autonomous ‘decentralized’ departments (or *dinas*) under its own control at provincial level, generally consisting of departments for own revenues (called *dinas pendapatan daerah*, or *dipenda*), as well as *dinas* for education and culture, health, public works, traffic management, agriculture, livestock, fishery, forestry, plantations, industry, social welfare, labor, and tourism, all of which have central government counterparts in the deconcentrated *kanwils*; the province also sometimes had branch offices (called *cabang dinas*) at district level, although this was apparently not that common. Like provinces, districts had an autonomous decentralized department in charge of own revenues (again, called *dipenda*), and they generally had *dinas* for services like health and public works, although the range of these departments depends on the size and location of the district. Now, the deconcentrated central government departments at provincial level are the responsibility of the province, and those at district level have been turned over to the district. When complete, this change promises a major reorganization in the way in which public services are delivered in Indonesia.

Third, Law No. 25/1999 altered the transfers received by local governments from central government. The routine transfer that was largely used to pay the salaries of local civil servants (the *Subsidi Daerah Otonom*, or *SDO*) was eliminated; also eliminated were general development transfers known as block *Instruksi Presiden*, or block INPRES. These two transfers were combined into a general allocation fund (the *Dana Alokasi Umum*, or DAU) whose total amount is specified as at least 25 percent of central government domestic revenues and whose distribution among local governments is made by a formula (McLeod, 2000). Law No. 25/1999 also introduced revenue sharing for provincial and district governments, assigning each level of government its share of revenues from taxes on land and buildings, the transfer of land and buildings, forestry, mining, fisheries, oil and gas. Other local

government sources of revenues (e.g. own source revenues, fees and charges, profits from government enterprises) were largely unchanged, as were revenues from specific INPRES grants used to finance development projects in areas such as primary schools, health facilities, water supply, and roads; this feature of the decentralization is discussed in more detail later.⁴ Borrowing by local governments is to be permitted within Indonesia, although the IMF remains quite uncomfortable with this outcome. It is this feature that we focus on later. Table 10.1 summarizes the changes in local government revenues from the passage of Law No. 25/1999.

Table 10.1 Sources of local government revenues

Before Law No. 25/1999	Under Law No. 25/1999
1. Fiscal transfer from central government: <ul style="list-style-type: none"> a. Regional autonomous subsidy b. INPRES grants (for village, district, and provincial governments) c. Revenue sharing of property tax (on land and buildings) 	1. Fiscal transfer from central government: <ul style="list-style-type: none"> a. General block grant b. Specific grant c. Revenue sharing from natural resources and property taxes
2. Local own-revenues: <ul style="list-style-type: none"> a. Local taxes and retributions (Law No. 18/1997) b. Revenues from local state-owned companies 	2. Local own-revenues: <ul style="list-style-type: none"> a. Local taxes and retributions (Law No. 32/2001) b. Revenues from local state-owned companies
3. Local borrowing	3. Local borrowing

Until recently, most local governments in Indonesia have still depended very heavily on transfers from the national government. The new revenue sharing formula gives a huge increase in revenues for local governments with rich natural resources, especially in oil, gas, mining and forests, and for city governments with a relatively developed economy. Under this new formula, it is expected that the disparities across provincial and districts governments will widen, especially since the capacity of central government to lessen these disparities has been significantly reduced by the economic crisis.

Table 10.2 *The importance of local own-revenues in total local expenditures*

Ratio of local own-revenues to total local expenditures	Number (percent) of provincial governments	Number (percent) of district governments
< 10%	3 (11.1%)	156 (51.1%)
10% to < 20%	4 (14.8%)	86 (28.2%)
20% to < 30%	11 (40.7%)	39 (12.8%)
30% to < 40%	6 (22.2%)	14 (4.6%)
40% to < 50%	1 (3.7%)	8 (2.6%)
50% and above	2 (7.4%)	2 (0.7%)
Total	27 (100%)	305 (100%)

Source: LPEM-FEUI (1999).

Local own-revenues remain very limited. As shown in Table 10.2, the importance of local own revenue in financing local government spending is only around 20 percent for most provincial governments and less than 10 percent for district governments. Local taxes and retributions are based here on the new law of local government revenue, Law No. 32/2001, which replaced Law No. 18/1999. Under the new law, local governments still have very limited locally controlled sources of taxes. Nonetheless, many local governments are currently increasing their efforts to raise local revenues, by introducing many new local taxes, retributions and fees. Such efforts have generated many complaints from businesses and investors.

Faced with serious constraints on their sources of revenue, local governments will naturally look for other sources of finance, especially given their new and increased responsibilities. An obvious option is local borrowing. Under Law No. 25/1999, local governments are allowed to borrow to finance their deficit. However, the experiences of many other countries suggests that, without proper control and management, local borrowing can create a serious threat to prudent fiscal policy and thereby lead to macroeconomic destabilization.

In sum, the two decentralization laws are transforming intergovernmental relations in Indonesia. In particular, and together with the 1999 elections held at province and district levels, the laws and the related implementation process have the potential to increase significantly the accountability of local government officials. It is through this accountability that the major advantage of decentralization is obtained: moving government closer to the people (Oates, 1972, 1999). Because of Indonesia's democracy reforms, the leaders

of the local governments – the governor at provincial level, the bupati at *kabupaten*, and the mayor at *kota* – are now being chosen by the respective elected parliaments (although not directly by the voters), rather than appointed from above. As a result, their first responsibility is more directed downward to the elected assembly and then upward to central government. The assignment of significant new expenditure responsibilities to provincial and, especially, to *kota/kabupaten* governments has the potential to achieve the efficiency gains that come when governmental decisions are more responsive to the wishes of its citizens, so that public services are provided in amounts that correspond more closely to the preferences of the individuals in those jurisdictions, rather than at uniform national levels. Other potential gains include greater revenue mobilization because citizens may be more willing to pay local taxes to provide local public services and because local governments may be more familiar with, and so better able to tax, local tax bases. Overall, the decentralization laws and regulations are meant to carry out a proper sorting of the assignment of expenditure responsibilities. The ongoing process of implementation of the laws has the potential and eventual likelihood to generate significant gains for the people of Indonesia.

However, despite these potential benefits, the new decentralization laws and the implementing regulations also exhibit some crucial limitations.⁵ The laws are not accompanied by any well-articulated goals that their implementation is intended to achieve; indeed, the entire process by which the decentralization has proceeded seems ill-defined. The laws themselves lack many specific details that their implementation will require and that are being addressed in the implementation process. Of special importance here, the laws also fail to address many aspects of local government borrowing. Issues related to borrowing are discussed next.

Local Government Borrowing

Most local borrowing over the past 20 years has been carried out under central government mechanisms. Even so, the extent of borrowing has been quite modest, less than 0.5 percent of GDP; of this, most borrowing has been undertaken by the regional water authorities (PDAMs). The terms of central government loans have been very favorable to borrowers, with extensive grace periods, long terms to maturity, and significantly subsidized interest rates. Nevertheless, the repayment of loans has been poor, and at the end of 1999 the arrears rate was over 40 percent. Table 10.3 has some basic information on local government (and local enterprise) borrowing over the past two decades, as calculated by Lewis (2003).

Before the political transition in 1998–99, local government borrowing was controlled very tightly by central government under Law No. 4/1974.

Table 10.3 Regional borrowing (in Rp billions), 1978–99

Borrower	Number of loans	Disbursements	Arrears	Arrears rate
Province	82	841.0	10.1	0.029
Kota	115	513.8	181.6	0.553
Kabupaten	193	228.8	39.4	0.443
PDAM-Kota	187	2 151.3	481.3	0.470
PDAM-Kabupaten	237	865.0	130.9	0.599
Total	814	4 599.9	843.3	0.419

Source: Lewis (2003).

Under this law, regional governments were permitted to borrow only with the approval of the Minister of Home Affairs, who put limits on the amount that could be borrowed and also gave approval on the specifics of the borrowing proposal.

During this period local governments were faced with increasing pressures for local borrowing, based in part on greater demands for urban services stemming from accelerating urbanization. In 1985 only 26.4 percent of the population in Indonesia (or about 43 million people) lived in urban areas; within ten years the urban population had increased to 65 million people; by the year 2000 roughly one-half of the population – nearly 100 million people – were projected to reside in urban areas. This population growth created huge demands for new capital facilities. However, under Law No. 4/1974, almost all investments in urban infrastructures (e.g. roads, bridges, schools, and health facilities) were chosen, funded, and managed by central government through INPRES funding. With a negligible role played by local government and its citizens in this process, the result was often inefficient project choices, lack of local ownership and responsibility, and conflicting priorities with local government development programs.

There have been various efforts over time to integrate more fully local governments in the decision process of regional (urban) investment. One was made in 1985 with the establishment of the Integrated Urban Infrastructures Development Program (IUIDP). Among other things, this program changed the borrowing limit from no more than 15 percent of the debt service ratio (DSR), to an alternative and more lenient rule based on a debt coverage ratio (simply the reciprocal of the DSR) of less than 1.5. The program also changed the terms and sources of borrowing. Overall, however, the IUIDP was largely unsuccessful, mainly because central government continued to dominate all stages of the decision process.

In 1988 the national government established the Regional Development Account (RDA) as a further effort to unify the system of local borrowing in terms of process, lending, and repayment requirements. This account was under the Ministry of Finance, was run by the Director General of Financial Institutions, and was put in operation after the Director General of Financial Institutions created a formal account in the central bank (Bank of Indonesia account number 519.000.102). The RDA was intended to help make the transition from the previous system of local borrowing policy to a more market-based system, by establishing an institution (and an account) that was a pure lending and intermediary institution. The role of local government in borrowing was expected to increase and gain in importance, accompanied by an improvement in the capacity of local governments to plan and manage their investment projects and to mobilize their own revenue sources to repay their borrowing. However, the sources of funds of RDA were still primarily from the general budget of central government and from foreign government loans, and only a very small portion (e.g. less than 10 percent) of the RDA actually came from RDA repayment. With this narrow funding source, as well as with other administrative difficulties, the RDA was largely unable to respond to the demand for funds. Even after almost ten years, the RDA failed to transform local government borrowing practices in Indonesia to a more market-based approach.

Overall, the previous policy on local government borrowing relied heavily on administrative controls, which covered the total amount of allowable borrowing, the criteria for and purposes of borrowing, and the approval process. The dominant source of local borrowing in the past came from the central government budget via the RDA, and also from foreign government donors via the subsidiary lending agreement (SLA) and the SLA with pre-financing (SLAP). Both domestic and foreign loan sources were managed by the Ministry of Finance under the Director General of Financial Institutions. The consequence of such centralized control was a complex, long, and inefficient loan procedure that severely restricted the annual budgeting process of local governments.

It is nonetheless striking that, despite this centralized control, the borrowing terms given to local government were seldom uniform. For example, local governments often faced different interest rates. The rate from the RDA was determined annually as the most recent inflation plus a small margin; the SLA interest rate was similar to the central bank's six-month certificate, as representative of the market rate. Both loans imposed a fixed interest rate, but there were exceptions (e.g. the Surabaya Urban Development Project, which used a variable rate subject to a maximum 14 percent interest rate). There were also different commitment fees. The RDA charged 0.75 percent on any shortfalls of loan withdrawal under the plan; in contrast, the SLA financed by the Asian Development Bank (ADB) charged 0.25 percent on the same base

as the RDA, and the SLA from the World Bank was officially 0.75 percent but in practice was 0.25 percent based on the undrawn balance of the entire amount of the loan. Similarly, the grace and repayment periods varied considerably. The SLA gave a five-year grace period and 15 years for repayment. The RDA grace period was a maximum of five years, with a 3-year minimum common practice, and its loan repayment was a maximum of 20 years (including the grace period).⁶ Finally, the loan criteria, the conditionalities, and the restrictions that were applied under past borrowing policy also varied considerably. There were no common economic and financial feasibility standards applied in deciding the loan approval, and, despite the presence of a financial report, there were no significant conditionalities applied for RDA loans, and only some SLA loans required a financial covenant on the principal loan agreement. Both RDA and SLA loans were intended only for investment financing, but the RDA set restrictions for direct cost recovery of investment, while the SLA did not apply any restrictions.

Some efforts were made during the mid-1990s to move local borrowing policy from a heavy administration control to a more regulatory based or even a market-based mechanism. However, in order to achieve this objective, central government needed to transform the RDA and SLA borrowing mechanisms from their previous practices by imposing more prudential financial principles that mimicked market discipline. This required improving and applying a standard government accounting system on loan and debt repayment records, adopting a uniform lending policy, adjusting interest rates to market rates, and applying transparent and consistent (economic and financial) feasibility studies for loan approval. Fundamentally, such adjustments required a change in the institutional setting of loan mechanism and management.⁷ However, the progress of these efforts was very slow because of the economic and political crisis.

With such these somewhat unsatisfying experiences in local government borrowing policy in its past, and in the current macroeconomic and decentralization setting, the GOI has recently shifted to a new policy toward borrowing. On balance, local borrowing policy in Indonesia has changed in a mixed direction since the new laws of decentralization were passed in 1999 (Table 10.4). Broadly speaking, under Law No. 25/1999 local governments are given substantial latitude to borrow from domestic sources, and from foreign sources through the central government. Long-term borrowing (e.g. more than one year) is only allowed for investment spending to build infrastructure that can generate revenue for repayment. Short-term borrowing is permitted but only for the management of local government cash flow, and must be repaid by the end of the current year.

These general provisions are discussed in greater detail in the implementation regulations (Government Regulation No. 107/2000), which include:

Table 10.4 Local borrowing before and after the decentralization policy

Before decentralization	After decentralization
<i>Legal foundation</i>	
<ul style="list-style-type: none"> ● Law No. 5/1974 	<ul style="list-style-type: none"> ● Law No. 25/1999 ● Government Regulation No. 107/2000
<i>Institutional setting</i>	
<i>Approval</i>	<i>Approval</i>
<ul style="list-style-type: none"> ● Ministry of Home Affairs – imposed a maximum limit and gave approval ● Ministry of Finance – supervised the RDA and its approval 	<ul style="list-style-type: none"> ● Ministry of Finance ● Local parliament
<i>Limits on borrowing</i>	<i>Limits on borrowing</i>
<ul style="list-style-type: none"> ● 1982: DSR < 15% ● From Implementation and Decree MOH No. 96/1994: Minimum DCR = 1 Average DCR > 1.5 	<ul style="list-style-type: none"> ● Accumulated maximum < 75% general revenue of previous budget ● DCR > 2.5 for lifetime of project ● Maximum short term borrowing 1/6 of current spending
<i>Sources of funding</i>	
<ul style="list-style-type: none"> ● Foreign government lending ● Central government investment funding (RDI) ● Central government equity financing (PMP) ● Central government INPRES for building market ● Down payment IPEDA ● Others sources (regional banks and private sources) ● Central government RDA 	<ul style="list-style-type: none"> ● <i>Domestic Sources</i> ● Central government ● Banks ● Non-bank financial institution ● Households ● Other sources ● <i>Foreign sources</i> ● Bilateral sources ● Multilateral sources

- Sources of funding:
 - Domestic sources of funds include both government and private sources, including banks.
 - Foreign sources can only from government sources (bilateral and multilateral).
- Objective of borrowing:
 - Long-term borrowing is permitted only for capital investments that build infrastructure.
 - Short-term borrowing is permitted only for cash flow management.
- Terms of requirement and limitation:
 - Maximum cumulative debts cannot exceed 75 percent of total general revenue of local government.
 - Debt service coverage minimum is 2.5.
 - Short-term borrowing in total cannot exceed 1/6 of total current local government spending and repayment should be made within the current year.
 - Under special circumstances, the Minister of Finance can decide on another limitation for the maximum borrowing (Article 8 (2)).
 - Central government can prohibit local governments from giving a guarantee/collateral based on local government assets.
- Approval:
 - Any borrowing from sources other than central government requires the approval of the local parliament.
 - Any borrowing from central government sources requires the approval of the Minister of Finance.
 - Foreign borrowing can only be done through central government.

In principle, the new fiscal decentralization law (Law No. 25/1999) gives substantial freedom for local governments to borrow, and this new freedom has raised concerns about how they will respond. Local governments face huge pressures and demanding tasks in managing their budgets under the new fiscal decentralization. However, their capacity to manage their budgets – and their borrowing – has not changed. Given the high and unsustainable public debt (e.g. in excess of 100 percent of GDP), there are significant fiscal and macroeconomic risks that severely constrain the ability of the Indonesian economy to sustain additional borrowing even at local level. In combination with the limited capacity of local governments and the continuing economic crisis, there are pressures on central government to restrain local governments in their borrowing.

In practice, therefore, central government has maintained very strict limitations on local government borrowing – it has issued a government regulation on local borrowing (No. 107/2000), which imposes very restrictive rules on

local borrowing. For example, maximum accumulated debts must be less than 75 percent of general revenues from the previous budget, the debt service coverage ratio must be at least 2.5, and maximum short-term borrowing is 1/6 of current spending. Borrowing must also be approved by either central government via the Ministry of Finance or by the local parliament (depending on the source of borrowing), and commercial/private foreign borrowings are not allowed. Even after imposing these regulations, central government still felt the necessity – supported strongly and explicitly by multilateral institutions such as the IMF and the World Bank – twice to delay the implementation of the local government borrowing regulations. The first delay was issued in 2001 (No. 99/KMK.07/2001), and more recently the Minister issued decree No. 625KMK.01/2001, which further delayed the implementation of local borrowing regulation until the end of 2002.

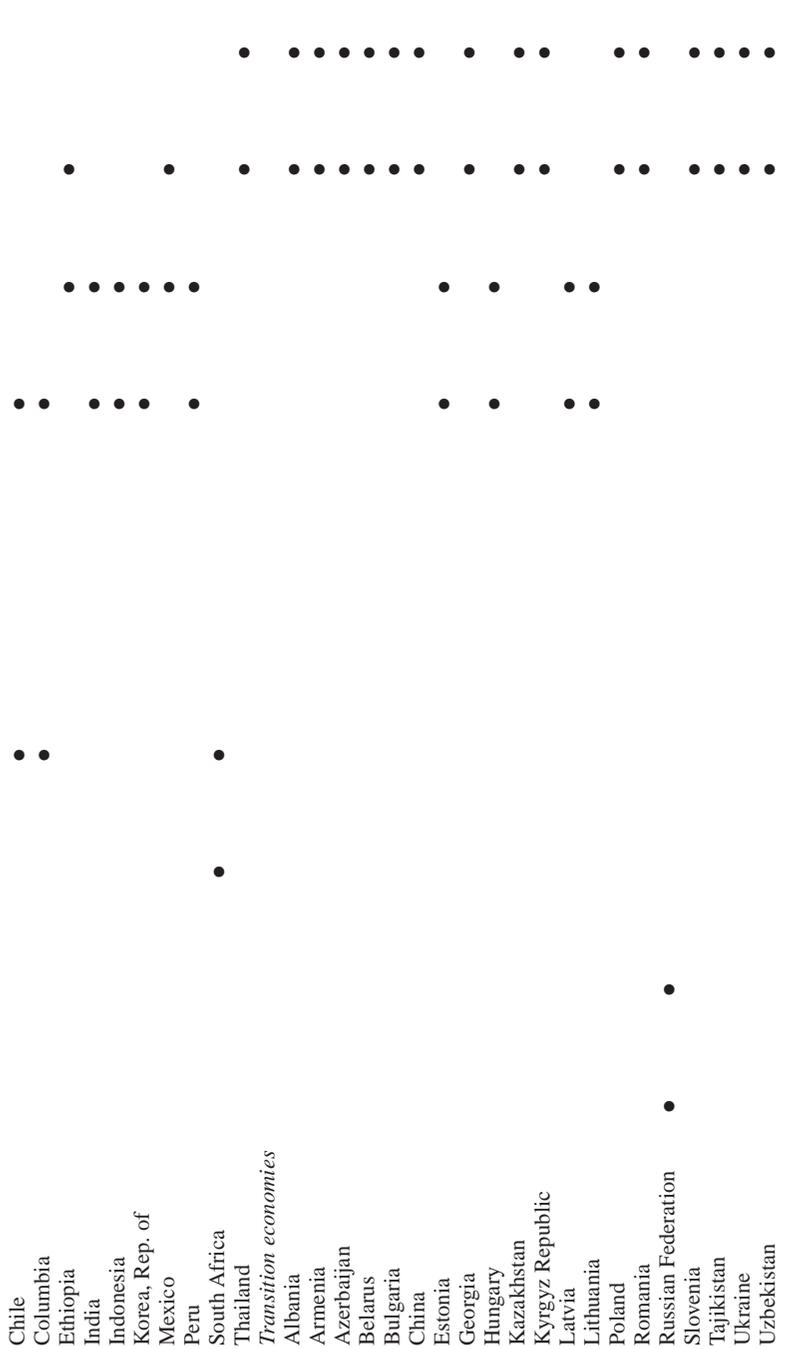
INTERNATIONAL EXPERIENCE WITH LOCAL GOVERNMENT BORROWING: A FRAMEWORK FOR ANALYSIS

As emphasized earlier, local government borrowing has the potential to generate significant benefits, by allowing local governments to synchronize unexpected swings in expenditures and revenues, and by allowing them to finance public capital projects that are lumpy in nature. However, there is little doubt that the notion of local government access to credit markets creates substantial uneasiness in many quarters, in large part because central government has often been drawn into the process, thereby creating significant moral hazard problems. In some cases, central government itself provides credit, either directly via central government funds or indirectly via intermediaries. However, it is now becoming more common for private sources to provide local government access to funds. The use of private financing requires the development of mechanisms to ensure that central government is not exposed to the risk of excessive local government debt. The practice in most countries is that local government borrowing is subject to a variety of controls.

As suggested by Ter-Minassian (1996) and Ter-Minassian and Craig (1997), these controls can be classified into four main categories (Table 10.5). The first is a reliance on *market discipline*. Here central government largely stays out of any involvement with local government borrowing, and instead assumes that market forces will ensure that local government debt is managed, controlled and disciplined. However, as emphasized by Lane (1993), markets will only be effective in providing appropriate discipline if several conditions are met: there should be free and open markets, information on

Table 10.5 Local government borrowing controls in selected countries

	Market discipline		Cooperative control		Rule-based control		Direct Administrative control		Borrowing prohibited		
	Overseas	Domestic	Overseas	Domestic	Overseas	Domestic	Overseas	Domestic	Overseas	Domestic	
<i>Industrial countries</i>											
Australia			•	•							
Austria							•	•			
Belgium			•	•							
Canada		•									
Denmark			•	•							
Finland	•	•									
France	•	•									
Germany						•					
Greece					•				•	•	
Ireland								•	•		
Italy						•					
Japan										•	
Netherlands						•					
Norway											
Portugal	•	•						•	•		
Spain	•	•									
Sweden											
Switzerland											
United Kingdom						•					
United States					•				•		
<i>Developing countries</i>											
Argentina				•						•	
Bolivia				•						•	
Brazil				•						•	



Sources: Ter-Minassian (1996) and Ter-Minassian and Craig (1997).

local government current debt and repayment capacity should be readily available, there should be no expectation that local governments will be bailed out, and there should be appropriate institutions in place to ensure that local governments respond to market signals before default or exclusion from credit markets (e.g. political accountability, local own-source revenue capacity). Although there are examples of developed countries that rely primarily on this approach – Canada, Finland, France, Portugal and Spain – these conditions are seldom met even in developed countries, and are especially rare in developing and transition countries.

At the other extreme is *direct administrative control* of local government borrowing, in which central government directly controls borrowing via such methods as limitations on the debt of individual local governments, restrictions (or bans) on external borrowing by local governments, required approval of specific local government investment projects and their terms of finance, and centralized control on all local government borrowing. This approach is often found in developed countries (e.g. Austria, Greece, Ireland, Japan, Norway, Spain, United Kingdom), and is also common in developing and transition countries, such as Argentina, Bolivia, Brazil, Chile, Colombia, Ethiopia, India, Republic of Korea, Mexico, Peru, Estonia, Hungary, Latvia and Lithuania. The advantages of this approach are several, especially regarding external borrowing. Central government should be able to coordinate overall country debt policy without undue concern that local government actions will be counterproductive, and it may be able to obtain better terms on external debt than it could otherwise. However, this approach also necessarily involves central government in the micro-management of local government investment decisions, contrary to the principle of subsidiarity.

In between these two extremes are several other approaches. One intermediate type is *cooperative control*, in which any limitations on local government borrowing are generated via a negotiation process between central government and local governments. During the negotiations, agreement is reached between the different levels of government on such issues as overall deficit targets and revenue and expenditure growth, with controls on local government debt emerging as byproducts of these broad goals. This approach is closer to the market discipline end of the spectrum than to the direct administrative control end. Belgium, Denmark, and, especially, Canada are examples of developed countries that rely mainly – and successfully – on such a cooperative approach to debt control. However, its effectiveness seems to depend on the prior existence of a ‘culture’ of cooperation and fiscal discipline. In the absence of this culture, this approach is unable to prevent excessive debt, as shown by the experience of such countries as Brazil and Colombia. More generally, the conditions for its success are unlikely to be found in many developing and transition countries.

Another intermediate approach to debt control is what might be termed *rule-based control*. Here the actions of local governments are proscribed in various rules written into the constitution, law, or regulations. These rules may establish limits on the level of allowable local government debt, they may specify rules similar to market-based approaches like limits on debt-service capacity, they may stipulate that borrowing can only be used for particular kinds of expenditures (e.g. capital projects), they may specify that borrowing for non-investment purposes be repaid at the end of the fiscal year, and they may prohibit certain kinds of borrowings. The rule-based approach is transparent, and it treats all local governments equally. However, it necessarily introduces an element of inflexibility, and it gives local governments an incentive to devise schemes that attempt to avoid or evade the rules.⁸ Its success depends crucially on the ability of central government to monitor compliance with the rules (e.g. accounting standards, financial information systems).

On balance, it seems clear that reliance on either of the two extreme methods of control – market discipline and direct administrative control – is not appropriate for developing countries pursuing fundamental decentralization reforms, such as Indonesia. Reliance on markets to discipline local governments requires preconditions that are unlikely to be met in Indonesia, and the exclusive use of direct administrative controls is inconsistent with the recent decentralization laws that attempt to give more autonomy to local governments. The cooperative approach also seems inapplicable to most developing countries, including Indonesia, given the absence of the ‘culture’ of cooperation and fiscal discipline required for its success. Instead, the approach that seems best able to combine the benefits of local government autonomy with the required limitations on local government behavior is rule-based control.

However, regardless of the specific approach that is used, any well-designed regulatory framework depends on several required elements: transparency (especially through better information systems and standardized accounting procedures), penalties for excessive borrowing (including bankruptcy provisions), local government access to own-source revenues, the separation of fiscal from financial systems, and local government accountability via the political process. There also needs to be scope for change, as circumstances and capabilities evolve.

It is of some note that the extent of local government borrowing is quite variable but generally remains low. Table 10.6 gives some selected information on the relative reliance of local governments on borrowing as a source of own-source revenues.

Table 10.6 Local government reliance on borrowing in selected countries

	Share of borrowing in local government revenues (percent)
<i>Industrial countries</i>	
Austria	8
Belgium	0
Cyprus	12
Denmark	0
Finland	6
France	9
Germany	9
Greece	4
Iceland	0
Ireland	5
Italy	7
Luxembourg	9
Netherlands	0
Norway	0
Portugal	7
Spain	13
Sweden	0
Switzerland	4
Turkey	0
United Kingdom	8
<i>Developing countries</i>	
Ghana	0
Malta	0
San Marino	69
Senegal	2
Swaziland	4
Uganda	0
Zambia	0
Zimbabwe	3
<i>Transition economies</i>	
Albania	0
Bulgaria	3
Czech Republic	10
Estonia	3
Hungary	7
Latvia	0
Lithuania	0
Macedonia	0
Poland	0
Romania	0
Russian Federation	0
Slovakia	4
Slovenia	0

Source: Selected publications.

APPLYING THE LESSONS TO INDONESIA

In this section, we apply these lessons from international experience to Indonesia. In particular, we first attempt to estimate the potential local government borrowing capacity. In this regard, the demand for local government borrowing is expected to grow rapidly in the near future because local governments are undertaking more functions and responsibilities under Law No. 22/1999 and, even aside from the decentralization, there are increasing pressures for public services from a rapidly urbanizing population. There will also be upward pressure on investment spending because of the transfer of financing of activities known as the DIK/List of investment activities from the center to local governments under the autonomy laws. Recall also that local governments are permitted to borrow short term to deal with cash-flow issues in their current budgets; such cash-flow problems could arise from routine expenditures for staff salaries because of the transfer of personnel from central to local governments. However, in the face of these demands, the revenue sources for local government are still limited due to the assignment of few productive tax bases to local governments and to the weaknesses of local tax administration.⁹ In response, local governments will face increasing pressure to borrow funds. It is therefore of some interest to have estimates of their borrowing capacity.¹⁰

Under Law No. 25/1999, local governments are allowed to borrow, under some specified administrative restrictions. Based on this law and the borrowing restrictions, LPEM-FEUI has made estimates of local government borrowing capacity for the year 2001. These estimates are based on projections of both revenue and expenditure.

Projections of the revenue side are based on the following assumptions and procedures:

- Local own revenues are estimated using their annual performance in 1999/2000.
- Revenue sharing from natural resources is based on Ministry of Finance calculations, which project distributions to local governments in 2001.
- Revenue sharing of property taxes and acquisition fee is estimated using LPEM-FEUI simulations.
- The general grant allocation is estimated using the LPEM-FEUI model, which will be used as a grant allocation formula in the government regulation.
- Provincial governments are assumed to receive revenue sharing from income tax (20 percent) that is not shared with district and city governments.

Projections on the expenditure side use the following assumptions:

- Routine expenditure is estimated using the figure for 1999/2000.
- Investment spending is calculated using the DIK/List of investment activities that was submitted by local governments to central government for the fiscal year 1999/2000.

The difference between projected revenues and expenditures is divided by 2.5 (or the debt service coverage ratio), and is assumed to equal the amount available for borrowing, repayment, interest, and other costs of borrowing. The total maximum borrowing is then estimated using the amount available for payments of principal, interest, and other costs of borrowing over the maturity period of borrowing (eight, 10 and 12 years). The amount of borrowing allowed can be calculated by subtracting outstanding borrowing from total maximum borrowing.

The estimation results are shown in Table 10.7. Under the current law, and based on past performance in borrowing, most local governments in Indonesia have wide room to initiate new borrowing. More than 80 percent of provincial governments, almost 95 percent of district/kabupaten governments, and roughly 50 percent of city governments have the ability to borrow above Rp 10 billion.

Table 10.7 Local government borrowing capacity in Indonesia

Ability to repay (in Rp)	Provincial government		Kabupaten government		City government	
	Number	%	Number	%	Number	%
> 100 billion	5	19.2	22	9.5	2	3.3
10–100 billion	14	53.9	171	73.7	17	28.3
< 10 billion	2	7.7	27	11.6	11	18.3
Not allowed to borrow	5	19.2	12	5.1	30	50.0
Total	26	100	232	100	60	100

Source: LPEM-FEUI (2000).

However, as emphasized earlier, the presence of enormous public debt, the continuing macroeconomic crisis, and ongoing concerns about the capacity of local governments to manage their budgets (and their debt) have led central government to restrain severely local governments in their borrowing. Central government has maintained very strict limitations on local government

borrowing, and has twice delayed the implementation of even these strict regulations. In the conclusions, we assess these new limitations.

CONCLUSIONS

There are clearly immediate short-term macroeconomic justifications for restricting local government borrowing, especially in the current economic environment. However, it must be recognized that such strong restrictions also impose significant difficulties on local governments. These restrictions will create limited opportunities and even less motivation for local governments to develop the necessary expertise to improve their borrowing skills. They will impose significant barriers on local governments for gaining funds directly from the capital markets. They will also be likely to contribute to longer and more uncertain periods of project execution, something that is especially true when projects require political approval from both the local parliament and central government. The restrictions will reduce the ability of local governments to respond to the wishes of their constituents in a timely and effective way. The intimate involvement of central government in the entire process of local government borrowing may well expose central government to high contingent risks, especially when the debts are defaulted and central government is asked to bail out the debt failures. The constraints will also create negative impacts on development of the necessary capital market infrastructure for local borrowing.

In order to reduce these negative impacts, we believe the central government must design a clear, realistic, and well-planned transition period to adjust from the current reliance on direct administrative control of local borrowing to a greater reliance on market discipline policy. The transition should cover the following activities and actions:

- Improving and implementing a government accounting system for fiscal management, including maintaining a full borrowing record and reporting.
- Imposing requirements of local borrowing that replicate market discipline (e.g. a proper and accurate feasibility study, a non-subsidized interest rate, grace and repayment periods that represent the real project life, financial covenants that capture realistically the risks and revenue flows of the project).
- Diversifying – gradually – the sources of any local borrowing fund, with less reliance on the central government budget and foreign government borrowing, and greater reliance on private market sources.
- Creating regulations and building competent institutions to support,

facilitate, supervise and safeguard the work of an efficient and prudent local borrowing market.

In short, the long-run goal must remain the creation of a viable market-oriented framework in which local governments face hard budget constraints but still have access to credit markets.¹¹

NOTES

1. See Tanzi (1996) for further discussion of the macroeconomic concerns stemming from decentralization.
2. For example, see Dillinger, Perry and Webb (1999) and Freire, Huertas and Darche (1999).
3. It may be useful at the start to clarify some of our terms. 'Decentralization' is used here to denote the transfer of significant degrees of authority and responsibility for governmental expenditures and revenues from the central government to lower levels of government. In contrast, 'deconcentration' occurs when central government functions are dispersed to central government offices located in provinces, cities, or other local areas, but these functions nonetheless remain the responsibility of the central government (Bird and Vaillancourt, 1998). Until the passage of the 1999 reforms, the practice in Indonesia had been largely one of deconcentration, not decentralization.
4. Provincial taxes consist mainly of a tax on motor vehicles, on the transfer of motor vehicles, and on motor vehicle fuel. District taxes include hotel and restaurant tax, entertainment tax, advertising tax, street lighting tax, mineral tax and water use tax. Under the plan, the major provincial taxes are being transferred to district level. Changes made to the Indonesian constitution in the middle of 2000 include the potential that the profits of state-owned enterprises located in decentralized regions will be shared with those regions; in addition, 20 percent of the individual income tax will be shared by the national government. As most income tax for employed persons is collected under corporate income tax, this latter change is not as significant a concession as might be thought.
5. See Alm, Aten and Bahl (2001) for a detailed discussion of these issues.
6. In principle, the grace period should be based on the period in which the project has not been able to generate cash or is still under construction, while the total time of debt repayment should not exceed the average economic life of the project. Both RDA and SLA finance did not follow this principle. The past policy also allowed the local government to defer interest payment during the grace period, a policy that encouraged the borrower to give a low priority for this obligation and even to defer it.
7. For example, loan administration could be delegated to a regional development bank (*Bank Pembangunan Daerah*), while loan approval and budgeting authorization could still be controlled by central government. These changes would shorten the administrative process, while continuing to provide discipline on financial criteria and controlling macroeconomic/fiscal risks.
8. These schemes are well-known, and include such actions as reclassifying current expenditures as capital expenditures, creating off-budget agencies and even government-owned enterprises, and relying on payment via arrears.
9. As discussed earlier, local government revenues mainly come from three sources: fiscal transfers from central government (e.g. general block grants, specific grants); revenue sharing from natural resources (oil, gas, forestry, mining, fishery), property tax (PBB), and user fees (BPHTB); and local own-source revenues.
10. An effort within the Ministry of Finance has been made in the past to estimate local borrowing capacity under the old law of local autonomy, in order to assess demands on

RDA funds, as well as applications for RDA loans and for SLAP arrangements under World Bank urban development projects in East Java, Bali, Sulawesi and Irian Jaya. However, these models have not been endorsed by the Ministry of Home Affairs.

11. For a detailed discussion of how to create local credit systems, see especially Peterson (2000) and Noel (2000).

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PART IV

An Initial Assessment of Progress

11. Indonesian decentralization: opportunities appear but risks abound

Marsillam Simandjuntak

INTRODUCTION

Let me say right from the beginning that the importance of the decentralization process would be assumed as an unavoidable necessity in Indonesia. It has become one among the few solutions to Indonesian national problems, if not the only one left. Hence the interrogative form of the question ‘Can decentralization help rebuild Indonesia?’ should be turned into a positive statement: the problems of rebuilding Indonesia can be solved through only decentralization. The emerging questions here are how will the decentralization itself be implemented, what is to be done, what are the requirements that must be fulfilled, and what are the obstacles that can impede the decentralization? It is these questions that I will examine in this chapter.

NATIONAL PROBLEMS, REGIONAL SOLUTIONS

I will try to formulate what seems to have become a kind of belief as follows: through decentralization various national problems can be solved at regional level by using local means to cope with local challenges. Of course, this belief immediately incites criticism, since factual observation in the regions that have recently enjoyed autonomy shows little evidence of low-level management’s ability to solve problems. What can be seen in many of the decentralized regions is a high level of administrative disarray, which in some cases has almost brought them to the brink of chaotic conditions, examples of which have been discussed elsewhere in this volume. If these accounts are correct, then they would seem to cast doubt on the necessity or, better, the effectiveness of decentralization. Thus a fundamental question is whether the promise of decentralization is credible and objective, or whether the rationale for decentralization actually lacks credible grounds.

Despite these doubts about decentralization, it has nevertheless been proven also for quite a long time (and not limited to the recent transitional period)

that national problems could never be solved by national efforts, or by a centralized method. Whatever reasons are behind it, many people in the past and quite a few in the present seem to persist in thinking that every national problem can only be solved from the center and with nationwide policies. For example, it is thought that the problem of corruption – which is indeed a national problem – should be solved via a national solution; that is, the eradication of corruption is to be on a national scale, and responsibility should rest on the national government. The same is often thought to be the case for reform in the judicial sector and law enforcement in general, and the problems of bureaucratic inefficiency and the need to improve administrative infrastructure are also to be handled by and from Jakarta. However, national efforts have failed or fallen short, repeatedly. Are these not reasons enough to force us to abandon the centralized paradigm and to opt for an alternative? And what other alternative is there if not decentralization?

In summary, the fact that decentralization has not yet proven itself to be a solution does not cancel another preceding fact: Centralism has failed and it is bound to fail again if we persist in that line.

If we continue with the decentralization paradigm, then what was construed as a regional level or local solution to national problems would result in different conditions in the various regions because of dissimilar levels of success between them. Eventually, there might be a region with, say, a relatively less corrupt administration, a better and more reliable police force, or good public control over its judiciary. Likewise in other areas of ‘national problems,’ one region will have a higher growth of its infrastructure development, another will have a more rational investment policy and tax administration, still another will have a better banking system and workable credit scheme for SMEs or a better educational system. Competitively, each national problem may then be solved in terms of manageable regional portions.

Nevertheless, an important question remains: what will make all this possible?

DECLARED BUT UNPREPARED

One thing that should not be overlooked is that the current decentralization effort has been started more as a declaration – an affirmation of intent, if you will – than as a well planned, well prepared, and orderly train of events. The process of decentralization in Indonesia so far has more spirit than managerial content. Without any intention to underplay the preparation of the regional autonomy law and the basic principle of autonomy, both of which began some time ago, we can still safely say that this time the drive toward decentralization has been an inseparable part of the post-Soeharto reform movement

(*reformasi*), or at least has been spurred by it. I mention this merely to emphasize the spontaneous character of the declaration to decentralize, as an instantaneous political decision, impatient to wait much longer. Consequently, it should be obvious that the requirements for a smooth devolution to the regions could not be met sufficiently and instantaneously.

However, it would be a mistake to conclude from this that the decentralization is doomed because at the moment its requirements have not been completely met. The reason these requirements have not been satisfied is not because of the lack of understanding of what is required, but simply because there has not been enough time to do it. There is a very thin line of distinction here, but it can be quite meaningful. This line of reasoning will help us decide whether there is enough basis to expect that improvements can continue to be made while decentralization is still being implemented.

I will briefly look at the present situation, and at the same time I will make an evaluation of whether there are still enough time and resources to make the needed improvements. My attention will focus basically on the aspect of political readiness, and will cover also some legal aspects (e.g. the constitutional foundations) that are relevant to the general preparedness for the establishment of regional autonomy. This is not to say that these are the only important aspects of decentralization that need attention. Fiscal and economic perspectives are admittedly vital, but those subjects are already covered in other chapters in this volume.

DIFFERENT POLITICAL IDEAS

'Decentralization' is an idea, made into a political decision. It is very clear that, besides paying attention to the *process*, attention should be given equally to decentralization as an *idea* because at the conceptual level a tension is already present, caused by the existence of different interests that will in turn influence the quality and direction of the entire decentralization process. The idea called 'decentralization' will then be given different interpretations, depending on the different interests that stakeholders harbor. The differences that sometimes are expressed in the form of rivalry can also end in a conflict of rights. The resolution of this conflict can take place either at national level or through local politics. As an idea alone, 'decentralization' can be perceived by some as quite risky, a potential threat to national integrity.

A sort of political map that shows who stands for what in the decentralization needs to be drawn here. This map will help to estimate the expected result of the interaction between contending influences (e.g. whether the balance is still in favor of decentralization, and in what quality it will be produced).

As we all know, in the wake of the transition from the authoritarian regime of Soeharto, the accepted consensus of the reform agenda consists of the following principles: freedom and openness, democratization, rule of law and human rights, anti-corruption and anti-collusion, demilitarization and liquidation of the dual role function, regional autonomy (decentralization), the rehabilitation of the economy, and the restructuring of the financial sector – listed here not necessarily in order of priority. All these principles have somewhat been implemented, albeit in different intensity and degree of satisfaction. This also applies to decentralization, manifested in the enforcement of the laws of regional government and on national–regional budgetary relations, with the ensuing government regulations. Additional powers were devolved to the regional authorities, and some new provinces and regencies were created in the process. And problems of course have started to emerge at this point. To avoid further complexity, I will deliberately exclude in this analysis the special cases of Aceh and Papua, although it must be stated these special cases are in no way irrelevant.

It is probably not controversial to state that the momentum for decentralization reform has already diminished considerably. Several factors can be listed as the cause of this. In general, the ‘push’ factor of the progressive elements – the reformers, the students – is fading, their role becoming insignificant, and in their place has come what can be called a ‘drag’ factor that is immobilizing change. Also, no substitute in the form of a ‘pull’ factor has yet been seen to succeed the disappearing force of the push factor. Logically, it is fair to expect that the newly elected national leadership should take over the role of leading the movement, using its official position to complete the just started reform agenda. However, up until the present government, there is no clear indication that this expectation is satisfied, or is even moving toward that direction.

In the devolution of the power once held by central government, it is obvious that the interest of the regions as the receiving side must be greater than the center that must hand over authority. However, in the current situation central government is still calling the shots: central government determines the extent of what is to be transferred, how it is to be transferred, and when it is transferred. Therefore it is important to know if central government has a role as a pull factor in the decentralization process in particular and in the reform process in general. Central government in this case would include the President as well as other political forces such as the political parties, the Parliament, the military, and the bureaucracy. Do these forces contribute to the pull factor or the drag factor in the decentralization process? This question needs to be clarified.

STABILITY, EFFECTIVENESS, CONFIDENCE

It is not necessarily a contradiction if the role of the center is considered important in the devolution process. In theory, the center could become either a positive pull factor by conducting decentralization as part of the reform agenda, or a negative drag factor by avoiding or becoming an obstacle. In practice, as of 2002, the role that the central government played had not been conducive or supportive to the process of decentralization. How can we explain this fact?

First, we have to remind ourselves that a government that will be capable of leading a decentralization program must fulfill the requirement of stability and effectiveness. Of course before everything else, such a government is presupposed to have the right motivation and the priority to decentralize. It is not difficult to recognize that stability is not an asset that the current government possesses; neither did Abdurrahman Wahid's government. The presidential system, which constitutionally provides a fixed executive term, apparently does not render an objective guarantee of stability. One reason is that in practice the existing system resembles more a quasi-presidential system, or, still more precisely, a semi-parliamentary system: the five-year fixed term clause of the President can be overturned by the power of the MPR (*Majelis Permusyawaratan Rakyat* or People's Consultative Assembly), which can unseat the President at any time by employing a rather circumventive procedure to cast a vote of no confidence.

The precariousness of the system is aggravated if the President does not win the majority of votes in the parliamentary election – recall that President Megawati's party won only a plurality in the last general election – something that forces the President to compromise in forming a coalition government. This instability will affect the degree of self-confidence needed, especially in leading a risky project of great change such as decentralization. To decentralize is then no more seen as an obligation in line with democratization. The lack of self-confidence stemming from the perception of instability then gives rise to a fear of the threat to the nation's integrity in implementing decentralization.

Self-confidence can only be reached if there is enough certainty in holding power. It can therefore be concluded that bringing about decentralization requires having a government comfortably backed by a majority, a genuine fixed executive term, a calculable system of transfer of power, and clear and reliable rules of the political game. In other words, it requires a new constitutional structure of government, a new system of presidential election, and a review of the position of the MPR. And all of these will have to wait for a better opportunity, perhaps after the next general election.

To be sure, a coalition government is usually more difficult to handle, but actually a coalition government can survive and become effective, if only the

political management is right. The other determining factor is the leadership capability of the President herself. What we have now is a deficiency in both counts: a coalition far from solid, and a quality of leadership that is not too impressive. The result of all this is an ineffective government, as starkly demonstrated in slow and frequent delays of decision making, unassertive and often ambiguous policy, and a sluggishness that affects the implementation of policies.

WEAK MOTIVATION

Besides being ridden with instability and ineffectiveness, the government's own attitude toward decentralization is not too proactive in transferring power to the regions. There are two reasons for this. First, this attitude is probably the result of a reaction against what is called 'the autonomy that went overboard', meaning that the decentralization is to be rectified by an ongoing effort to revise the Law on Regional Governance (Law No. 22/1999). The revision is now dubbed as a 'recentralization' attempt initiated by the government. Second, and far more important, it is often alleged that President Megawati does not belong in the category of those who favor decentralization, but instead is quite anxious about it. Her obsession for a unitary state – partly caused by discomfort with regional movements, perhaps an emotional legacy of her father, President Soekarno – her profound anxiety toward the possibility of Indonesia falling apart, and her nonchalance toward the unjust center–regional relationship all add up to make her someone who is not a motivated champion of regional autonomy.

In short, the government under President Megawati is not a pull factor for decentralization. Its record on other items of the reform agenda – suspicious of press freedom, reluctant to support a human rights tribunal, refusing to continue demilitarization – is not encouraging either. Although I cannot prove that this government dams the flow of the decentralization stream, the fact is that it cannot be relied upon. Consequently, a better decentralization process must wait for aid from a more stable and more effective government that has an earnest motivation to devolve power to the regions. Again, this should wait for the result of the next general election.

DISTORTED REPRESENTATION

In the same vein, not much can be expected from the political parties, who are in a state of confusion in establishing their platform, probably caused by their immature level of development. The lack of homogeneity inside the

party and the lack of standardized decision-making procedures add up to unpredictable behavior of party representatives in Parliament. Also contributing to the unclear and unpredictable behavior of the representatives is a representational system that is not based on electoral districts and a system of nominating candidates that is dominated by the leadership of the party, both of which remove direct association and accountability to the constituents.

Almost 100 percent of the political parties were founded in Jakarta, and the law on political parties does not yet allow establishment of regional political parties. Regional aspirations are only sporadically channeled through the legislative process in the DPR (Parliament). For example, President Megawati's PDI-Perjuangan is still attached to an identity of a nationalist ideology, with the implication that there is a reluctance to promote decentralization, fearing that it will threaten the concept of Indonesia's unitary state.

It may well be concluded that political parties have not played a positive role in promoting the development of decentralization in its early stage, and that they and their representatives in Parliament are on average a drag factor in the process of decentralization.

The single constituency electoral system, not yet adopted in Indonesia, is further complicated by the fact that a regional representative body does not exist in the Indonesian legislative system. The Third Amendment to the Indonesian Constitution in 2001 determined that there would be such an institution, *Dewan Perwakilan Daerah* (Council of Regions Representatives), which seems at a glance almost similar to a first chamber (e.g. the US Senate). However, to this day the Council has not been formed. Further, the powers to make law assigned to it by the Constitution are quite unclear. Nowhere is it expressly stated that this Council's approval is needed to pass acts or regulations, concurrent to that of the Parliament's (and equivalent to the relative function of the US Senate and House of Representatives). What is stipulated is only that this Council is to participate in discussion of the legislation of laws related to regional autonomy and is to monitor their enforcement. However, these articles do not stipulate what power is vested in the Council itself.

This situation was worsened when the PDI-Perjuangan, once again on the pretext of defending the unitary state, proposed to revoke the already declared effective constitutional amendment on establishing the *Dewan Perwakilan Daerah*, apparently seeing it as a threat based on the same 'nationalist' concern that this republic is liable to shatter into fragments at any moment. Such things are no small matter in evaluating the impeding factors in the progress of decentralization. It is not necessarily true that decentralization requires a two-chamber legislature. However, to object to everything and anything decentralized would ring a loud cry that signals the political spirit of the time.

INSUFFICIENT CONSTITUTIONAL AMENDMENTS

Another relevant constitutional amendment concerns the formation of the Constitutional Court, also determined in the Third Amendment. This Court would resolve conflicts of laws, and would decide the constitutionality of acts and regulations. The existence of such a Court is expected both to maintain the balance between regional and national policies and to preserve consistency and legal certainty. However, the Constitutional Court still requires regulations needed to start implementation, and is estimated to operate not earlier than in two years time.

Ideally, this momentum of constitutional amendment should also produce every necessary constitutional provision on the subject of autonomy, central–regional government relations, and the distribution of power. All these provisions, of course, must be defined only after careful consideration of every regional aspiration. The presently amended Constitution does indeed contain a few added extras compared to the previous constitution, but it is still far from adequate to set a clear standard.

One example of ambiguity is the mechanism in electing a regional head. The constitutional amendment only states that the head ‘will be democratically elected.’ Note that the way in which the head of a region is elected is crucial in determining the character of independence of a region on one hand, and the accountability of an elected official on the other. Why the legislators chose not to elaborate beyond the vaguely phrased ‘democratically elected’ requirement is unknown and is left unexplained. The tension and cost such a direct election would bring about cannot be truthfully denied, but are unavoidable. The result, however, is that political leadership with clear support and accountability would be worth far more than the cost it took to produce.

The regulation of regional autonomy in the form of an act (such as Law No. 22/1999 and Law No. 25/1999) is indeed necessary. But the absence of a fundamental tenet in the Constitution renders these acts and regulations not solidly founded, and, when faced with problems in its enforcement, the immediate response to it is to change the provisions of the law itself. Presently, the government-proposed revision of Law No. 22/1999 faces harsh reactions from regional authorities, which believe that the revision is hasty and suspect it is an attempt to take back the already transferred power.

Regardless of the reasons each party has, it remains the case that a remedy via revising a law can only bring new and possibly greater problems so long as there exists no constitutional rule to serve as a yardstick. Usually central government has the upper hand in matters of legislation because regional governments have relatively limited access to the legislature. However, regions might try to get their way by means of defiance or by mobilizing the local forces. Moreover, it will be quite a while before a

case can be brought to the Constitutional Court, and, even then, there would still be a lack of the necessary constitutional provisions on which to base any legal interpretations.

We have come to find ourselves running in an infinite circle with no beginning or end. This is truly the present reality of decentralization, which can hopefully paint a picture of what needs to be improved and changed. Things could actually be worse: even though constitutional reform (however hypothetical) is a must to promote regional autonomy, whatever process of amendment is taking place now has generated quite a commotion, which could fatefully end in total political gridlock. It is nearly impossible to imagine what type of crisis could arise from this, although many remain optimistic and try to convince themselves that a state of stagnation would never occur.

POLICE AND MILITARY CENTRALISM

If we continue to go down the list of drag factors that must be dealt with in the decentralization, another is the incomplete devolution of law enforcement power, especially the police force and the office of the public prosecutor. To this day, the police force remains centralized, and there seems to be no prospect from within of it shifting from the current concept of a national police system. The idea of placing the police force under the regional government, either the governor or the regent, was plainly rejected. President Habibie proposed this idea in 1999, and was openly rebutted by the police corps. This resolve to remain independent from the executive administration is not limited to a refusal to be under the regional government; it is also a wish to become free from central government as well.

There are two important matters to emphasize from what we observe in the police case: the spirit of centralization is greatly ever-present in the bureaucracy, and there remains a disparity in the stages of devolution at the various branches of bureaucracy. While many fields of governmental functions are already in the hands of regional authorities, matters of law and order remain under the jurisdiction of the central government organization hierarchy. This kind of discrepancy needs to be addressed, and addressed immediately.

Another influential factor that essentially (although not always directly) gives life to centralism is the role of the military. The military is by nature a central responsibility, under one command. But military dominance in more than half of Indonesian history unquestionably shapes the character of centralism in the nation's bureaucracy. Meanwhile, the fact that there exists no meaningful effort for a complete demilitarization in all fields of Indonesian politics and bureaucracy does not bode well for decentralization. The

role of the military in politics must unhesitatingly be reduced, and eventually eliminated. If this fails to occur, the spirit of centralism will still be very vibrant. The resounding concern about the imminent disintegration of *negara kesatuan* (unitary state) Indonesia was no doubt largely inspired by a military mindset. Although wariness of some sort of explosive centrifugal movement is not unreasonable, it must not be treated primarily with the extreme measure of centralism and monolithism of the military kind.

TOLERATING TEMPORARY CHAOS

As I discussed earlier, there are two ways of viewing the obstacles impeding decentralization. One highlights the factors that obstruct and impede it, while another emphasizes the need for correction and regulation to cope with the looming disorder. From the latter perspective, the expected change is a reassessment of the existing implementation and the application of reinforcements – in formal regulatory aspects and in institutions alike – to prevent things from getting worse. Many who observe the decentralization ‘overdriven to chaos’ spectacle feel the need to check the process of devolution. Foreign investors, for example, are puzzled by the myriad of new rules issued in the regions, rules that lead to uncertainty and to a lack of any protection whatsoever from central government.

Nevertheless, the question remains: Must reform really be conducted centrally or should it be delegated to each region in the spirit of consistent decentralization? There is no easy answer here. Any choice must arise from the courage to take a risk, since it is only based on a sort of faith or ideology.

Those who believe in the unconditionality of decentralization will accept chaos and commotion – an unavoidable necessary evil – as a temporary circumstance. They will do so for several reasons: because, so the belief goes, every region will reach a certain point where it must revamp itself and create its own popular control system, because ultimately it is a matter of a region’s own interest and survival. Chaos as a product of overboard enthusiasm in the regions is not viewed here as absolutely immovable and a constraint. Rather, it is deemed to be an unavoidable price that must be paid for the unpreparedness that we currently have. Decentralization in fact began with a spirited declaration shouted out by the *reformasi* movement, without the benefit of enough time for planning and preparation.

What we are facing now holds similarities to the early days of independence, where there was also a tug-of-war between two standpoints: is it justifiable to immediately declare independence unarmed with administrative capability and ultimately running the risk of chaos, or would the viable choice be to wait for an adequate preparation and then gradually gain independence

after the required capacity to organize and manage resources have all been safely fulfilled? Deciding on such a vital choice is difficult. Still, however hard it is to make a choice, it is even harder to retract a freedom once it is granted.

CONCLUSIONS: THE PARADOX OF THE CENTER

What must we conclude? What we have yet to see is political leadership, at both national level and most regional levels. When one regional leader succeeds in disentangling himself and makes his way through the gridlock, he will contribute as an exemplary model to encourage and inspire others. The delicate point, then, lies in calculating how much time we have before the signs of confusion eventually avalanche into a point-of-no-return devastation.

Judging from the present array of choices, it would be impossible to hang our hopes on the present national leadership. Besides being known to be ineffective and undermotivated, this leadership is currently faced with multi-tasking predicaments that are, in comparison with its known capacity and strength, too many and too burdensome. Even so, it is undeniable that a paradox arises from the obstacles and impediments facing us here. Decentralization will only come more within reach as the strength and self-confidence of the national leadership grows. The steadier and more stable central government becomes, the smoother the progress of decentralization will be. This is so, provided that the national leadership possesses the right motivation to democratize.

This paradox will have to wait patiently for the next turn of choosing a different leadership, if we are lucky. Meanwhile, what can be done is to slow the process of downsliding towards a state of confusion, by diligently doing more political negotiation with and persuasion of all stakeholders of regional autonomy.

12. The Indonesian experience with the implementation of regional autonomy

Made Suwandi

INTRODUCTION

Since the economic crisis in mid-1997, Indonesia has experienced several other crises of a political and governmental nature. Since the start of this new period for Indonesia, there have been continued demands for the reform of local governments and for the deepening of decentralization. From this perspective, the demand for local government reform in Indonesia has been driven by political pressures from the bottom up. These pressures have been a manifestation of democratic values and the widespread spirit of reformation of Indonesian society.

The government responded to these demands by issuing two important laws – Law No. 22/1999 concerning Local Government and Law No. 25/1999 concerning the Financial Balance between the Central and Local Governments. Those two laws marked a radical shift toward decentralization providing discretion to local government in managing their local affairs and away from decades of domination by central government of practically all local government arrangements.

This swing of the pendulum from bureaucratic deconcentration in the past to political decentralization in the present is not a strange phenomenon in the Indonesian context if we see it from a historical perspective. Since Indonesia's Independence in 1945, the issuance of various laws concerning local government, culminating most recently in Law No. 22/1999, has been marked by the political swing either favoring decentralization or centralization. These swings have tended to reflect the political situation in the national arena.

The question is whether Indonesia can learn from its relatively long experience with decentralization. In particular, what should we do and how should we react in anticipation of the higher demand for decentralization reform in the country, without allowing the euphoria of autonomy to disrupt the spirit of the reform itself? Answering these questions will require a delicate balance between local autonomy and nation building. It is these questions that are discussed in this chapter.

A HISTORICAL PERSPECTIVE ON DECENTRALIZATION IN INDONESIA

The argument of exploring the historical background for decentralization policy in Indonesia is based on the need to trace back the different reforms that have been conducted toward local governments, and to understand in the proper historical context both the fundamental reasons why these reforms were conducted and the lessons that we can learn from those experiences.

The formal creation of local government in Indonesia was initiated by the Dutch in the beginning of the century through the Decentralization Act of 1903. This Act intended to create some sort of elected local council to balance the deconcentration principle adopted at the time for governance in the regions. Additional reforms were taken through the Act of 1922 to give more autonomy to local governments by involving prominent native figures in the local Council.

Dutch colonialism in Indonesia was replaced by the Japanese occupation from 1942 to 1945. The administration was carried out through military command. The Japanese military administration, to a large extent, continued the local government system inherited from the Dutch. Units of local government were still administered under a deconcentration principle, and all political activities were prohibited. Japanese administration ended when they lost the war and surrendered to the allied forces. Indonesia proclaimed its independence on 17 August 1945.

The salient feature of local government right after independence was the conflict between the two paradigms of decentralization and deconcentration in different pieces of legislation pertaining to local government. As pointed out, each of the new laws that were issued reflected a change in the approach to local government that was quite closely related to the ongoing political changes at national level. Basically, there have been five main local government laws and one Presidential Edict since independence, each largely providing a quite different picture of the system of local government – these were Law No. 1/1945, Law No. 22/1948, Law No. 1/1957, Presidential Edict 6/1959, Law No. 18/1965, Law No. 5/1974, and finally Law No. 22/1999.

If Law No. 1/1945 wanted to put more emphasis on deconcentration, Law No. 22/1948 showed a marked swing toward decentralization. The central focus in this swing was the crucial role assigned to the *Kepala Daerah* (or Head of the Region). There is always a dual role assigned to the *Kepala Daerah*, as local representative and also as an agent of central government. Under Law No. 1/1957, the swing toward decentralization was increased by obliging the *Kepala Daerah* to be accountable exclusively to the DPRD (or Local Council). The reverse swing occurred with Presidential Edict 6/1959, which clearly favored a deconcentration paradigm; under this Edict, local

power rested mainly in the hands of the Kepala Daerah, who was appointed by central government mainly from the *Pamong Praja* (or civil servants).

With the passage of Law No. 18/1965, there was a marked swing back toward decentralization, which was to a large extent a reflection of the domination of political parties at the national power. In particular, the Kepala Daerah was allowed to hold party membership. Regions were given broad autonomy, and deconcentration functions became regarded as a supplement to those to be carried out under decentralization. There were at that time demands to create a third-tier autonomous regional government based on the *Kecamatan* (or sub-district) through which political parties expected to gain massive political support from the grass-roots. The failed coup attempt by the Communist Party (PKI) in 1965 ended the domination of the political parties and became the starting point of a regime dominated by the bureaucracy and the armed forces. The issuance of Law No. 5/1974 marked the dominant role of the center over local governments. In mid-1997, Indonesia fell into an economic crisis, which then was followed by a political crisis and finally a multi-dimensional crisis. The issuance of Law No. 22/1999 marked the swing of the pendulum toward decentralization, again reflecting the large political changes that were taking place at the center.

Two main points summarize Indonesia's policy toward local governments from the historical point of view. First, before independence, the basis of modern local government was laid down by the Dutch, although its character represented deconcentration rather than decentralization. Subsequently, elected councils were introduced with members who usually came from local figures and well educated persons, but the head of region was still appointed by the Dutch; the Dutch were trying to promote efficiency rather than pursuing political objectives. The Japanese military command who replaced the Dutch did not in general make any important changes to the inherited system.

Second, after independence, political objectives became much more prominent while administrative efficiency became at the same time secondary, and the system continued to a large extent to be the one introduced by the Dutch. In fact, most local government positions were held by officials who did not have sufficient education and experience due to the limited careers that existed for Indonesians before independence. Lack of professionalism combined with strong political ideals often resulted in inefficiency at local government level. Kuntjaraningrat (1987), a prominent Indonesian anthropologist, has said that there was a 'short-cut' attitude among Indonesian officials after the independence war. This character was inherited from the Japanese occupation when many high ranking positions previously held by Dutch officials were taken over by Indonesians without sufficient experience and professionalism. This important feature appears again during Sukarno's era that enabled inexperienced officials to jump to upper echelons. These officials tried to make

changes in the system by inserting democratic ideals, but the results were quite often disappointing at both national and local levels.

The critical issue since independence has been how central government exercises its control over local governments. Both Law No. 22/1948 and Law No. 1/1957 sought to avoid dualism at local government level between the DPRD (or Local Representative) and the DPD (or Local Executive Board), on the one hand, and the Kepala Daerah, on the other. Both laws required that local government should be in the hands of the DPRD and the DPD, and the Kepala Daerah should not hold the position of central representative in the locality. Nevertheless, in most cases central government proceeded to assign the Kepala Daerah as its central agent in the locality. As a result, the Kepala Daerah was often placed in a dilemma. He had to divide his loyalty between two different bodies: central government and local government. To win his loyalty, central government often interfered in the appointment of the Kepala Daerah under the justification that he was also the central agent in the regions. Often, the stronger bargaining power of the central government forced the Kepala Daerah to give more loyalty to the center.

After the 1955 election, there was overt and rising political unrest, territorial disintegration, and civil war. From the regional point of view, according to numerous observers, there was a widespread feeling of dissatisfaction during the parliamentary period. Jakarta was far away, and the center was unwilling to devolve much fiscal or decision making power to the regions. Civil servants from Java held many high positions on other islands. Government economic policies both directly or indirectly tended to subsidize the importers in Java at the expense of the exporters in the outer islands, particularly Sumatra and Sulawesi. Increasingly during the 1950s, these complaints were taken up by regional military officers who shared the perspective of their local civilian counterparts toward the center and often had grievances of their own, related to the declining welfare of their troops. Having participated in the revolution, many of these officers also felt that they deserved a more conspicuous role given parliamentary incompetence in local governmental policy issues.¹

In this situation, proposals for political restructuring could have been expected to find enthusiastic support. Sukarno established the Functional Group in February 1957 as an alternative to political parties; the term 'Functional Group' appears to be new terminology for a statement of his collectivism ideal that called for a 'guided democracy.' The Functional Group would consist of various representatives such as the armed forces, farmers, religious groups, and professionals that stood above ethnic, religious, and ideological cleavages. In an atmosphere of great tension and with the support of the army, on 5 July 1959 Sukarno abolished the Parliament and readopted the 1945 Constitution through a Presidential Decree. The era of guided democracy

had officially begun. At the most basic level, guided democracy became a set of relationships among three powerful forces: Sukarno as the President, the army, and the communists or PKI. There were strong rivalries between the army and the PKI, and Sukarno acted as the mediator (Reeve, 1985). During the guided democracy period, Sukarno tried to be the patron of the conflicting forces. All political parties and social forces behaved as clients, each trying to show its strong loyalty to Sukarno. The problem of such a patron–client relationship was how far Sukarno as the patron could keep the balance of relations among these conflicting forces.

Sukarno had achieved his ideal of creating a strong leadership but was faced with the problem of rivalry among all forces that surrounded him, and each party tried to be the most loyal and closest to him. The climax of this rivalry erupted on 30 September 1965, when the PKI launched a coup attempt. As a result, the PKI was dissolved. On 11 March 1966, Sukarno handed over the national leadership to Suharto, thereby marking the beginning of the ‘New Order’.

The Functional Group led by the army and the civil bureaucracy started to take a grip on political power. In the general election held on 3 July 1971, the Functional Group (Golkar) obtained 62.8 percent of the votes, giving them 236 out of 360 elected seats in the DPR (or Parliament). In addition, 100 seats were filled by members appointed by the government. Meanwhile, parties such as NU gained 18.7 percent, PNI gained 6.9 percent and Parmusi gained 5.4 percent. Political power swung from the parties to Golkar, and Golkar, supported mainly by the army and the civil bureaucracy, held a majority in the Parliament at the time.

Since the election campaign, the way in which the ‘New Order’ government was implemented by Golkar has been seen as characteristic of the new regime: the deployment of the resources of the Department of Home Affairs and the armed forces to ensure support for the government, the incorporation of all civil servants including the personnel of state enterprises into *KORPRI* (or the Civil Servant Corps), and the institution of a hierarchic, stratified, and centralized rule. All these efforts enabled Golkar to grow into a strong political power in a relatively short time (Reeve, 1985).

Another blow suffered by the parties was the policy of reducing their numbers. In January 1973, the parties were grouped into two: first, the Indonesian Democratic Party (PDI) intended to accommodate the nationalists (the PNI in particular) and the Christian groups; second, the Development Unity Party (PPP) to accommodate all Islamic opinion. Since then, there have been only three political powers in Indonesia, Golkar, PDI and PPP, and only these were allowed to contest the 1977 election.

Reinforcing the blow to the political parties was the policy of the ‘floating mass’ (similar to the silent majority in western countries), by which neither

parties nor Golkar were allowed to have branches below the level of the *Kabupaten* (the second tier of regional government), leaving the rural masses to float undisturbed by political conflicts between elections. The idea was to protect villages from any political interest or conflict to maintain them as the basis of uninterrupted development.

Golkar went on to win five more elections in 1977, 1982, 1987, 1992 and 1997, while the other two parties, PPP and PDI, have been racked by internal conflicts. The main reason for conflicts within the parties is the different interests among the groups that they contain. For instance, the PPP is potentially the strongest opposition to Golkar, but it consists of several Islamic streams whose political ideals are different from one another. There is also continuing pressure from the government on all parties and social organizations to adopt *Pancasila* as the sole ideology.

The predominant political power held by Golkar has resulted in no real opposition at almost any level of popular representation either at the central parliament (DPR) or in the regional parliaments (DPRD). Even if there was a coalition between PPP and PDI, their total power in Parliament would not match the power of Golkar. Traditionally, Golkar has used the issue of development as its political doctrine. There is almost no rival to this issue from the other political parties, which either have adopted this same doctrine or have been influenced by the development doctrine of Golkar. Eventually, it may be that Golkar and the other political parties share similar political attitudes. This condition may lead to a monolithic political system.

Jackson and Pey (1980) argue that since parliamentary democracy ended through the declaration of the Presidential Decree in 1959, the basic form of government has not changed fundamentally. The principal actors and policy emphasis have altered, but power since the 1970s is more concentrated than ever before in the hands of the President. Indonesia remains a 'bureaucratic polity': a political system in which power and participation in national decisions are limited almost entirely to employees of the state, particularly the officer corps, and the highest level of the bureaucracy, including especially the highly trained specialists known as technocrats.

The concept of a bureaucratic polity implies that the decision making process is insulated from social and political forces outside the highest elite echelons in the capital city. In practice, this insulation to a large extent also occurs in the localities. A bureaucratic polity is a form of government in which there is no regular participation of the people. Participation is confined to implementing rather than deciding policies.

Such a situation of strong bureaucracy compounded by weak political opposition tends to result in weak social control. Within the system there is no one to supervise the bureaucracy and keep it efficient, effective and accountable. In countries with a strong opposition, the opposition parties are

constantly examining the bureaucracy's performance at all levels and criticizing it in the national parliament and at local council meetings.

The widespread misadministration that occurred in the country is assumed to be related to the impact of diminishing political participation and the increasingly decisive role of the bureaucracy. At a time of decreasing revenues, the government will be faced with a two-sided pressure: pressure from the people to maintain the pace of development through the rapid proliferation of services, and pressure from the bureaucracy itself to keep the bureaucrats satisfied.

THE CURRENT IMPLEMENTATION OF REGIONAL AUTONOMY: THE MAIN PROBLEMS AND SOME SOLUTIONS

It is difficult to find a satisfying and holistic approach to answering the question of how regional autonomy is being implemented in Indonesia. From the legalistic point of view the government has issued many regulations to accelerate the implementation of wide autonomy. Although regulations have been issued, the question is whether these regulations are sufficient to enable local government to carry out its functions satisfactorily. Many complaints have been conveyed that central government, and particularly the Ministry of Home Affairs, have not been quick enough to produce the necessary further regulations to speed up implementation of this autonomy. Of course, it remains an open question how many regulations are actually needed to facilitate the implementation of so-called 'wide autonomy.'

Nevertheless, from the questions posed to government, and in particular to the Ministry of Home Affairs, it can be assessed that public opinion regards the implementation of local autonomy in Indonesia as not being fast enough because of the insufficiency of government regulations. Whether this opinion is really correct or whether the reverse is true may not be easy to determine, but clearly there have been other reasons that can explain the slow action in implementing local autonomy. To give a balanced view of the ongoing process is better to take a broader approach and recognize the potential role of a variety of issues.

First of all, we need to understand the fundamental elements of local governance, how each element is being implemented under Law No. 22/1999 and what the progress is to date. Local government consists of six basic elements:

1. *Function*: what kind of functions or authorities should be the responsibility of local governments, whether those functions fit in with the current

local condition and abilities, and whether these functions are in line with the needs of the local people.

2. *Institution*: whether local governments have established the necessary institutions to accommodate their functions accordingly.
3. *Personnel*: whether local governments have repositioned their personnel to enable them to have the right qualifications where they are needed in the local government organization structure.
4. *Finance*: whether local governments have been equipped with sufficient revenue sources to enable them to carry out their functions.
5. *Representation*: as locally elected bodies, whether local governments have a sound local representative (legislative body) to enable them to articulate the interest of the local electorate and to implement adequate checks and balances in their relation with the executive (the Head of Region).
6. *Services*: the end product of local government is services in the form of the provision of public goods and regulations. Thus the fundamental test is whether local governments have produced services according to the needs and interests of local people.

The roles of central government in the process of decentralization remain multiple, including supervision, control, monitoring, evaluation and facilitation. These central government activities are important to support local governments carrying out their new responsibilities under the progress of Law No. 22/1999. At this time of transition, central government is particularly key in promoting the capacity of local governments to be more independent to run their affairs. It is especially important that local governments carry out their new functions without central intervention and the accompanying patronizing and cooptation that existed in the past.

The question is whether at the present time central government has issued a sufficient regulatory framework to enable local governments to work within the six elements listed. To answer this question, we need to review what kind of regulations have been issued by central government so far, and then whether those regulations have fulfilled the minimum requirements to enable local governments to produce services as their main mission.

As far as the function of local government is concerned, Law No. 22/1999 has clearly stipulated the adoption of a general competence (or wide autonomy) principle instead of an *ultra vires* (or limited autonomy) principle in assigning functional responsibilities to local governments. By the general competence principle, this means local governments can carry out whatever functions they want, except those explicitly listed as belonging to central government.

According to Article 7 of Law No. 22/1999, the functions of foreign affairs, defense, fiscal and monetary issues, justice, and religion, plus strategic

functions with national externalities, are the responsibility of central government. Apart from those central functions, local governments may choose to exercise other functions as they fit into local needs. To avoid confusion between the functions of districts and cities and those of provinces, the government issued Government Regulation (PP) No. 25/2000. From these two pieces of legislation, it is clear that the function of central government will be more in terms of setting the norms and standards, monitoring and evaluation, and control of sub-national delivered services. Meanwhile the role of a provincial government, apart from running its regional autonomous functions, is to perform its role as central agent to supervise and facilitate districts and cities within their jurisdiction in running their autonomy. The province, as the central government representative, should play the role of supervisor and enabler to enable districts and cities to carry out their functions satisfactorily according to standards and norms set by central government.

The district and city governments, as the front line of the whole governmental structure, have the role of delivery of services according to the established standards and norms. Their closeness to the people and therefore their better knowledge of the needs and preferences of the people become the main argument for granting authority to deliver services to the districts and cities. In addition, their close position to the people will enhance the accountability and effectiveness in service delivery.

If those three tiers of government play their roles properly, there would be no problem in implementing decentralization policy, because every tier understands its position and its role in the whole structure. The problem is that it is a very rare occurrence for every tier of government to carry out all the functions within its authority or power, to deliver those services, and to do so in an accountable manner.

From the local government point of view, the situation varies from province to province and across districts and cities. There is in particular considerable confusion about what level of government exercises authority over natural resources within the jurisdiction. While Law No. 22/1999 stipulates that district/city level has authority over those resources, sectoral laws (such as the mining or forestry law) state that authority over those resources rests with central government. Disputes happen not only over forest and mining resources, but also over manmade resources including seaports, airports, and other similar facilities. Local governments think that they have responsibility or authority over those areas, as a consequence of the wide autonomy principle enunciated in Law No. 22/1999. This attitude in some way may be a reaction to the very limited autonomy granted to local governments in the past. Ultimately, it all depends on the proper interpretation of the mandate in Law No. 22/1999. What is clear is that most local people have

been willing to interpret the principle of 'wide autonomy' granted quite liberally as the right to claim whatever is available in the locality.

The reverse attitude has occurred at the center, or top layer of the administration. For the last three decades central government had enjoyed a wide range of powers in dealing with local affairs. Suddenly, many of those powers had (or should have) been transferred to local authorities. For many central government officials this was akin to losing all the privileges they had enjoyed for a long time. This has been the most powerful reason behind the great reluctance in some central government quarters to hand over power and authority to local governments. The cases of the National Land Agency (BPN), the Ministry of Forestry, the Ministry of Mining, the Coordinating Board of Investment, the Ministry of Manpower and state-owned enterprises are all very clear examples of this phenomenon.

From this situation we know that the problem of fulfilling decentralization is not merely one of a lack of regulations. The problem actually may be more driven by the inability to understand and to use the existing regulations for each layer of government to play its proper role. Of course, there is still a need for more detail and operational regulations when it comes to technical services, such as in the case of how to handle investments. What roles should be played by the center, the province and the district/city in investment arrangements? Is the center still to play the role of making standards and norms, the province to run the supervision, and the district/city to carry out the implementation? This is a good example of the further need for detailed assignments. And the past will not always be a proper guide, since in the past almost all investment arrangement was handled by the center.

From these analyses we can conclude that the delivery of basic services by the district and the city may not necessarily become a problem since the role of each layer of government is already specified. Instead, the problem may lie more in the inability of each layer of government to understand its role, as well as the lack of willingness to share authority that previously belonged to upper layers.

To improve on the current situation, there is a high need to promote mutual understanding, dialog, and cooperation among the different layers of government about the ongoing reform. The goal should be to support a successful transition to decentralization without blaming each other. To this end, the government issued Presidential Decree 157/2000, which established the Inter-Ministerial Committee to accelerate the implementation of local autonomy, and with authority to address all problems arising in the implementation of decentralization. However, there are significant difficulties in assuring the same perception among the different layers of government. In this respect, there are three types of constraints to more similar perceptions and beliefs on autonomy:

- Different perceptions among central government ministries or agencies particularly between the Ministry of Home Affairs and sectoral/line ministries.
- Different perceptions between central ministries and local governments.
- Different perceptions among local governments themselves, particularly between the province and the districts and cities.

The current system of decentralization lacks not only vehicles for more cooperation and coordination among different layers of government, but also lacks institutions to adjudicate disputes. In the past all matters were settled by the central government bureaucracy without any significant opposition from local government. Thus, at least on the surface, there appeared to be no problem. But in the new system where each local government may speak freely, many latent problems and disagreements will eventually emerge, and there will be a need to solve them fairly and squarely.

So far the perception of wide autonomy is more related to the authority vested in local governments to run their functions quite independently with less intervention from the center. To enable them to run their functions satisfactorily, local governments should have sufficient sources of revenues. In the past, under the support of predominantly specific grants called INPRES, local governments merely acted as implementers of central government programs without any significant discretionary power, although they had discretion to use their own money. The wide autonomy on the expenditure side provided by Law No. 22/1999 appears to have created the expectation among local governments that they should also be able to raise as much revenue as possible.

However, the authority to raise revenues can easily become a significant source of conflict among layers of government. Each layer tries to use any possible argument to maintain its authority. Some local governments have even refused the responsibility to handle mental hospitals as they think they will spend money rather than raising income from those hospitals. Local governments prefer to have authority over things that may generate revenues either through the issuance of licenses or through direct charges and taxes such as forest, sea, harbor, airport, mines, and so on.

At times, it seems as though the essence of decentralized authority to generate welfare through the provision of services is being neglected. The often fixed idea is how to have income without clearly linking it to services. If this kind of attitude were to be maintained, the conflict of interest would be perpetuated. In Indonesia it is quite urgent to change the perception among some local governments of decentralized autonomy from the authority to raise revenues to the authority to deliver services.

In terms of local government structure, the government has issued Government Regulation No. 84/2000, which gives guidance to local governments on

establishing their organization. There are two different types of behavior among local governments regarding the formulation of their organizational structure. First, there are ones with a 'prudential' attitude, who tend to adopt a slim structure. Second, there are local governments with an 'extravagant' attitude, who tend to adopt a 'big' structure copying the old paradigm to accommodate the bureaucracy. As far as structure is concern, there are two dilemmas now faced by local governments:

- PP No. 84/2000 facilitates the increase in echelons (within the local bureaucracy) in local government structure. Consequently, this increases the allowance and also the salary due to those who now have higher rank. On the one hand, these policies have caused bigger financial burdens for many local budgets. On the other hand, the increase in echelons increases the facilities which may also affect the budget.
- There was also a salary for the entire local government employee roles, as mandated by central authorities. This salary increase has also caused an additional burden to local budgets since revenue sources did not increase proportionally at the time.

The combination of those two pressures has caused significant stress on local budgets. As a result, they are allocated more to fund the local apparatus than to provide services. For many local governments, currently 70 to 80 percent of the budget is for salaries. This condition also has pushed many local governments to use any authority they have to raise revenues to add to the local budget. This push for higher local revenue in some cases has created a high-cost economy due to the overlap of charges and taxes applied.

In terms of local government personnel, there has been intensive consultation between central and local government, particularly in response to the change of status and deployment of the central officials employed in the locality due to the merger of central government field offices (or *Kanwils* and *Kandeps*) into local offices (or *dinas*). By the end of March 2001, close to 2.3 million central government personnel had been transferred to the local authorities. The salient problem in personnel or sub-national civil service is the authority for handling local government personnel policy; that is, does the policy authority rest with the center or with local governments? Article 76 of Law No. 22/1999 clearly mentions that the power to manage local personnel rests with local government. However, Law No. 43/1999 concerning 'The Basic Law on Personnel' stipulates that authority in managing (*Pembinaan*) personnel lies with central government. These two conflicting laws have caused uncertainty as to who is responsible for managing local personnel.

The reality is that local government personnel are managed by local governments. But since the funding for salaries is included in the block grant

(DAU) allocated to them, this has eliminated the possibility for the time being of transferring personnel to other local governments. The tendency is that personnel become very fragile in terms of security of tenure. Although they are required to be 'non-party alliance,' in practice they cannot avoid the influence from local political elites either in the executive or legislative branch. Therefore it is not uncommon for local personnel to tend to play it safe by allying themselves with particular local elites.

It would seem that there is a need to find a balance between the interests of central government and those of local governments in managing local personnel. It certainly would be impossible to completely devolve the power to manage the local civil service to local governments while local governments still rely on central government to cover the salary and pension of their personnel. Another problem is that the availability of skilled personnel is not evenly distributed throughout the country. Central government is still needed to guarantee an even distribution, to pay salary and pensions, to maintain an adequate professional standard, and to make the tour of area possible.

In countries like Indonesia, the role of the civil service is still regarded as the glue that helps bind national unity. Thus the role of the center in managing strategic personnel issues is needed to avoid the spirit of narrow regionalism by, for example, giving privileges to native people (or *Putera Daerah*) so that they hold important positions regardless of professional skills and experience. These kinds of behavior jeopardize the unity of the country. In this scheme for a local civil service, local governments would also be granted the power to refuse if they think the assigned officers do not fit into the local conditions. Some kind of checks and balances between the center and periphery should be applied in reforming the local civil service in Indonesia.

In terms of local government finance, the government issued Law No. 25/1999 as the basic arrangement for central/local financial relations and then followed it by Government Regulation 105 of 2000 concerning the Management of Local Government Finance. Also of importance in this area was the enactment of Law No. 34/2000 concerning Local Government Taxes and Charges; under this law, local governments are allowed to levy new taxes and charges based on a local government regulation (*Perda*). In the past local governments needed approval from the center to levy these new charges, in order for central government to exercise a preventive control if and when it was found that that the new proposed taxes and charges did not fulfill the criteria set by Law No. 34/2000. Under the new interpretation and application of Law No. 34/2000, preventive control has been replaced by repressive control. When the local government issues local regulations to levy new charges or taxes, the local regulation comes directly into effect. Under the terms of the repressive control, the center cancels the local regulation when the central officials find that it does not fulfill the criteria set by the Law No. 34/2000.

Another salient problem in the finance area is the conversion of previously specific grants called INPRES (to support development funding) and the *SDO* (to support recurrent expenses) into a block grant called DAU, which can be used at the discretion of local governments. An important problem arose when some local governments found that the amount of the DAU was not sufficient to cover the salary of personnel, let alone to fund development. For this reason, central government prepared a Contingency Fund to cover such potential deficits. The question with the DAU is whether local governments, with the high level of discretion provided by the law, could actually allocate their increased new budgets for the benefit of the people as they saw fit. But as we have discussed, the fact is that most of the local budgets, between 70 to 80 percent, are used to pay the salaries of local civil servants, whose salary rates are fixed by the center and who cannot be transferred or dismissed.

The other side of the coin of the lack of real local autonomy is the question of the lack of compliance of local governments. The government has issued Government Regulation No. 109/2000 and Government Regulation No. 110/2000 regulating the ceiling of spending of the Head of Region and the DPRD (Local Council), respectively. Almost none of the local governments have complied with these regulations. Local governments tend to spend above the ceilings under the argument that 'wide autonomy' means that they can use their funds with full discretion. Consequently, spending on the local executive and local council has absorbed high portions of local budgets. This has significantly increased the cost of local administration and decreased the available budget for public services. Since there is no clear penalty stipulated in Government Regulations No. 109/2000 and No. 110/2000, the central authorities have been unable to enforce them or introduce any significant measures to put a stop to the poor administration practices.

In terms of representation, in addition to what is stipulated in Law No. 22/1999, the government has issued Government Regulation No. 1/2001 concerning the Order of Local People Representative and Government Regulation No. 110 concerning the Budget for DPRD. By using these three regulations, the DPRD as the local legislature may improve its performance in running the local government together with the head of region. The problem that arises is that under Law No. 22/1999, the local representative (DPRD) as the legislative body is an equal partner to the mayor or regent in the executive branch. In the past such equality had never been granted since most of the councilors were in one way or another subordinate to the local executive. This equality has also triggered considerable euphoria within the DPRD to equal the powers of the executive in almost everything, including budget allocations, facilities, and so on. Thus, instead of concentrating their energy in the design of better services for the electorate, the DPRD's are busy in confronting the executive in many areas, raising tensions among both institutions.

There are also some other problems with representation. For example, there is no clear mechanism to demand accountability from the councilors. Since there is no recall mechanism, the councilors do not have any clear accountability either to their political party or to the people. In some cases, councilors have been dismissed by their party, but this does not necessarily mean that they can be recalled. Under the proportional election system, councilors are proposed by the party elites as representatives of the party in the council. However, neither the party nor the people can recall them once they have been appointed as councilors.

Supervision, monitoring and evaluation as well as facilitation are not being done in any systematic way by central government, although systematic monitoring and evaluation tools are being developed by central government agencies. The governor, who is expected to represent central government and conduct all these central activities thus far, has not played this role satisfactorily. The reason is that the bupati or mayors may believe that there is no relationship between them and the governor of their province, since Article 4 of Law No. 22/1999 clearly states that there is no hierarchy between the province and the district or city as autonomous regions. The bupati/mayor think that they are now free from the control of the governor, and the governors themselves do not think that they have a clear legal basis to control the bupati and mayors.

What complicates things somewhat is that actually the governor has a dual role as head of the autonomous provincial government and as the central representative in the region. As head of the autonomous region, the governor does not have commanding power over the bupati/mayor. But as the central representative, the governor clearly has the power of the center to supervise and to facilitate the district and city government in carrying out their functions satisfactorily. Central government has issued Government Regulation (PP) No. 20/2001 to clearly assign and empower the governor to run his functions as central representative in the locality to supervise the local government.

CONCLUSION

One main conclusion of this chapter is that the government actually has provided a legal framework and has issued sufficient regulations to enable local governments to carry out their functions in providing services to the people. If autonomy is interpreted more as power sharing without linking it to the delivery of services, then the decentralization process would need very many regulations since each power of government would need to be clarified for the three layers of government, the center, the province, and the district/city. However, if the authority devolved is seen more as the authority to

deliver services, then the arrangement can be much simpler. There are three parameters that can be used to guide the distribution of authority to render services: externalities, accountability, and efficiency. Under these three parameters, the authority to render services can be explicitly distributed among those three layers of government.

We have seen that from the six main elements that build up local government as a whole, the government appears to have issued the necessary regulations to enable each element to work. Of course, detailed regulations are still needed, but the existing regulations have been more than enough to provide a legal basis to local government to work in producing the minimum required services.

If there are still problems and delays in delivering services, they are caused mainly by the inability of local governments to use the existing regulations to carry out their role. In this case, it will be important to support every tier of government to help them understand their new roles in a reformed public sector. Activities to empower local governments to improve their capacity to carry out their functions become a necessity. There is an urgent need to improve the capacity of local government officials in arranging and managing local government functions, institutions, personnel, finance, representation, and service delivery. The improvement of those capacities should become the main agenda in promoting decentralization reform in Indonesia at the present time.

Decentralization reform becomes one of the main items on the national agenda set by the MPR as the representative of all of Indonesia. It is the duty and obligation of all public institutions to succeed in it. Therefore there should be a willingness among all stakeholders (public and community) to work hand in hand to participate in successful decentralization reform.

Furthermore, success in implementing the wide autonomy also lies in the supporting role played by central government. The center should supervise, facilitate, and intensify the monitoring and evaluation of the implementation of regional autonomy. In the time of transition, it is easy to make mistakes, but this does not necessarily mean that the spirit of autonomy should be cancelled.

During the implementation, there are at least three categories of problems faced by the government. First, there are problems caused by regulations that either overlap or conflict, particularly between the regulations on autonomy and those of sectoral ministries. This should be solved by creating legal certainty. Revision in this case is inevitable; the problem is when the revision should be conducted as it should not cause demoralization of local governments in their enthusiasm to run the regional autonomy. Second, there are problems caused by misperception. These can be solved by intensive consultation and socialization. Third, there are problems caused by 'excess,' either

because of misperception or on purpose. These can be solved through intensive supervision and socialization.

It is the duty of the government to identify problems during the implementation of the regional autonomy under Law No. 22/1999 and Law No. 25/1999. Problems can be identified if the monitoring has been done accordingly. Based on data and facts collected, the government can evaluate these problems and classify them into those three categories and find the best solution.

NOTE

1. See the articles in Jackson and Pey (1980) in particular the one by Liddle.

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13. Decentralization and the challenge for Indonesian fiscal sustainability

Anggito Abimanyu¹

INTRODUCTION

The success of the Indonesian economy will depend heavily on whether the government of Indonesia can deliver a sustained economic recovery through 2004. Recovery requires a wide range of successful policy reforms. However, an issue that could derail the whole process is fiscal sustainability. For much of the past 30 years, there was little concern about the sustainability of the government's finances. The economic crisis that began in 1997 changed everything. The government's decision to honor the deposit guarantee that was issued in early 1998 and to cover the liquidity support given to the banking system by Bank Indonesia (BLBI) has created over IDR 650 trillion in domestic debt (well over 40 percent of GDP) that must be serviced each year. The depreciation of the rupiah has substantially increased the value of the government's foreign debt in rupiah, further burdening the budget. The implementation of fiscal decentralization in response to demands for greater regional autonomy has also created significant new demands for expenditures. The government must decide how to balance these demands with the limited fiscal resources that it has at its disposal.

Actual realized budget deficits have in fact been lower than originally estimated. For example, in 1998, 1999 and 2000 the realized deficits were 2.0 percent, 1.5 percent and 1.1 percent of GDP, respectively, compared with predicted budget deficits for the same years of 8.0 percent, 5 percent and 5 percent of GDP. Since 2001, the drastic changes in the budget have been driven by changes in expenditures, particularly with the interest payments on the large stock of domestic debt and also the requirements of fiscal decentralization, which when combined amount to approximately two-thirds of total expenditures. Unfortunately, it is not possible to reschedule domestic debt service, nor is it feasible to delay the implementation of decentralization. As a result, the budget today leaves very little discretion for fiscal policy.

This chapter assesses the major components of a fiscal sustainability strategy for Indonesia, focusing on the potential impact of decentralization on

central government accounts. Thus the central question asked is: How can central government ensure fiscal sustainability in an environment in which it has very little discretion?

THE CURRENT BUDGET SITUATION

Over the long run, fiscal sustainability will depend on the ability of the government to use its rising tax revenues to finance its growing expenditures, including the repayment of the large stock of government debt and the obligations implied by the ongoing decentralization. While Indonesian tax revenues are fairly buoyant, growing more rapidly than GDP, the tax to GDP ratio is relatively low by international standards, especially in the context of the need to increase expenditures after the 1997 economic crisis. The low tax to GDP ratio has been recognized since the crisis, and the Megawati government has committed itself, as did the Wahid government, to raise taxes as a percentage of GDP to maintain fiscal sustainability. The intention is to increase revenues primarily by improving tax administration rather than by raising tax rates, as Indonesia's tax rates are at (or above) comparable levels in the neighboring countries. The Medium Term Program (*Propenas*) adopted in 2000 projected an increase in key tax ratios to balance the budget by 2004. If this can be accomplished and if expenditures on items like fuel subsidies and fiscal decentralization are contained, then fiscal sustainability can be assured.

To fund the sustainable deficit target, available funds have to be raised domestically, primarily through asset sales by the Indonesian Bank Restructuring Agency (IBRA) and privatization of state owned enterprises (SOEs). Market skepticism about the plausibility of achieving significant revenues from asset sales is understandable, given the likely failure to complete several key transactions this year.² On the external financing side, the budget assumes a combination of official creditor lending and debt rescheduling.

Tax Revenues

The most important policy change on the revenue side is designed to improve Indonesia's poor history in collecting tax revenue. Indonesia has one of the lowest (non-oil and gas) tax to GDP ratios among Southeast Asian countries. In addition, Indonesia's tax coverage has also been relatively low, with many exemptions given to taxpayers. For FY 2001, the tax revenue/GDP ratio was 12.6 percent, with only 10.8 percent coming from non-oil and gas taxes. The overall tax revenue/GDP ratio increased to 13 percent in the FY 2002 budget, with 12.1 percent coming from non-oil and gas taxes. This assumed increase of 1.3 percentage points of GDP in non-oil and gas tax revenues will pose a

significant challenge to the tax department, but, if accomplished, this increase will put the budget well on track to meet the medium term program deficit target.

In order to accomplish this, the tax department initiated four programs to improve tax administration. The largest of these programs was the establishment of a large taxpayer office to coordinate all tax administration functions for the 200 largest taxpayers in Indonesia. In addition, the tax department took steps to improve its information technology infrastructure, to rationalize its system of audits, and to improve its procedures on collecting arrears.

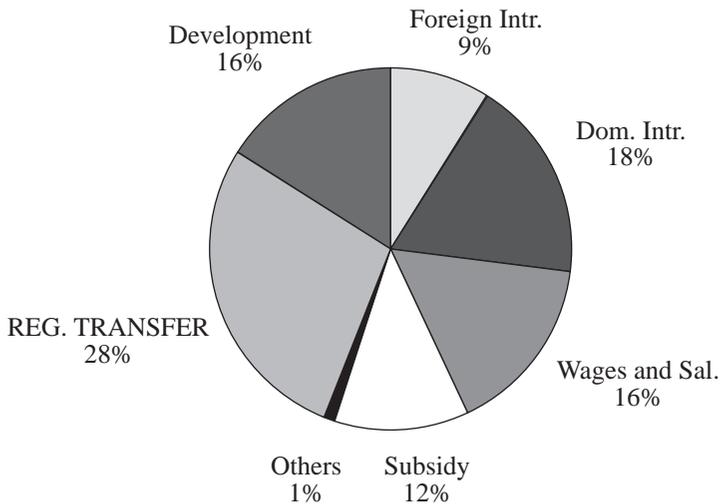
This new situation raises the importance of revenue mobilization. During the economic crisis that began in 1997, rising world oil prices (and the devaluation) came as a blessing to maintain adequate revenue levels; even though the crises also prompted the introduction of an oil subsidy, the overall impact of the oil prices left the budget at a net advantage. However, Indonesia cannot count on these blessings alone. Tax policy reform along the lines suggested thus becomes an important item on the fiscal agenda. Clearly, there is much room for improving tax administration and compliance. Although lessons from international experience suggest that the impact of such improvements is not felt very quickly, the efforts to improve tax administration will hopefully bear significant fruit over the long run.

Expenditures

Indonesia's changing fiscal landscape becomes most apparent when one examines the expenditure side of the budget. The most drastic changes in the budget during and after the 1997 economic crisis were in current expenditures. For 2002, the new budget allocated 54 percent of expenditures for interest on the government's debt and transfers to the regions, compared to less than 20 percent before the crisis. An additional 12 percent of expenditures was allocated for subsidies and another 15 percent for development spending. With over 80 percent of expenditures tied up in these items, controlling these expenditure items had to be a main focus of attention in developing and approving the budget. See Figure 13.1.

As noted earlier, rising oil prices in 2000 and higher prices in 2001 caused fuel subsidies to become a serious burden on the budget. While there is a recognition that the fuel subsidy is not well targeted toward the poor, the changes in prices that are required to eliminate the subsidy are so large that they must be implemented over a period of time. Thus the government has been systematically raising fuel prices, doing so three times in the past two years.

Interest payments are another key policy area but one over which the government has less control. High domestic interest rates continue to place



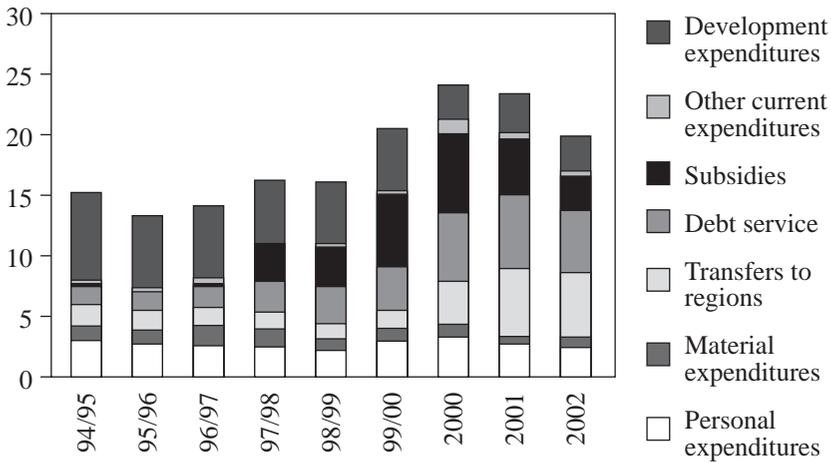
Source: Budget Allocation, Ministry of Finance, 2002.

Figure 13.1 Budget 2002: allocation of spending (in percent)

a significant burden on the economy and the government alike. During FY 2002, interest payments were expected to account for 26 percent of total expenditure, of which 3.5 percent of GDP would be used to cover domestic debt and 1.7 percent of GDP to meet the interest liability of the government's external debt.³ This highlights an important point: domestic debt, the stock of which is of the same magnitude as foreign debt, costs the government over twice as much in interest, even before the next Paris Club rescheduling of principal and interest. When Paris Club III is in place, interest expenses on foreign debt are predicted to fall to 1.3 percent of GDP. See Figure 13.2.

Development expenditures are another major component of expenditures, and one that the government has been seeking to increase. For FY 2002, the budget allocation increased by about IDR 7 trillion to IDR 52.3 trillion, or by 3.1 of GDP. This increase was well below pre-crisis levels, but it must be remembered that these magnitudes now represent only central government development expenditures. Expenditures that had previously been made by the regions are now part of the general allocation grant, the *Dana Alokasi Umum* (DAU).

Before the 1997 crisis, central government generally spent around 6 percent of GDP on development (capital) spending. In more recent years, this has fallen to around 3 percent of GDP. However, transfers to the regions have



Note: The structure of the budget has changed since the crisis (share of development and current expenditures in GDP).

Source: Budget Allocation, Ministry of Finance.

Figure 13.2 The structure of the budget, 1994/1995 to 2002

risen substantially, and, as noted, some of the transferred funds are available for capital spending. A key question is whether the amounts being transferred are adequate to finance capital spending. It has been estimated that approximately IRD 27 trillion of potential development spending in 2001 was available to the regions in the aggregate, assuming previous routine and development expenditure levels were maintained. This amount is almost 2 percent of GDP, and could be added to the estimated 3 percent of GDP spent by central government for comparison with pre-crisis capital spending.⁴ Overall, then, capital spending for the last two years is still below the pre-crisis level by about 1 percent of GDP, due largely to actions by the regions.

Transfers to Regions

The fiscal equalization law (Law No. 25/1999) puts considerable pressure on the central government budget, for several reasons. First, Law No. 25/1999 requires allocation of revenues in the form of a General Allocation Grant (DAU) of 25 percent of domestic revenues to sub-national government; it also established a conditional grant, the *Dana Alokasi Khusus* (DAK), although the DAK has not yet been implemented. Second, the law requires sharing of resource revenues with provinces and districts.

Table 13.1 Estimated impact of decentralization on 2001 budget

Budget item	Estimation result(s)					
	2000		2001		After decentralization	
	Nominal	% GDP	Nominal	% GDP	Nominal	% GDP
General grant (DAU)*	48.4	4.03	60.5	4.12		
Revenue sharing	4.1	0.34	20.3	1.38		
Other	0	0.00	0.9	0.06		
Total transfers to regions	52.5	4.37	81.7	5.57	29.20	1.99
Salaries	48	4.00	40	2.72		
Procurement	14.8	1.23	9.7	0.66		
Total routine expenditures	62.8	5.23	49.7	3.39	-13.10	-0.89
Net budgetary impact					16.10	1.10

Note: * Subsidy and INPRES (2000); DAU and DAK (2001).

Source: Ministry of Finance.

Revenue sharing and grant transfers (DAU and DAK) to regional governments are putting significant pressure on the deficit. In 2002, these transfers increased to IDR 96.5 trillion (5.8 percent of GDP) from IDR 81.5 trillion in FY2001 (5.5 percent of GDP). While part of the increase was simply due to inflation and higher oil prices, another part was due to the creation of a special fund for Aceh and Papua of IDR 3.4 trillion. In addition, the government and Parliament agreed to the creation of an IDR 1.5 trillion contingency fund to cover regions with shortfalls after the allocation of funding from other sources.

In total, the fiscal equalization funds require that central government devolve some 1.2 percent of GDP to sub-national governments, in addition to the revenue sharing already given to provinces and districts. If this revenue decentralization is not matched by concurrent expenditure decentralization,⁵ it risks increasing the central government deficit. Table 13.1 shows a net cost of decentralization to the central government budget of 1.10 percent of GDP. The total 'costs' to central government come from the DAU and revenue sharing (1.99 percent of GDP), with this being partially offset by central government receiving a smaller amount of savings from the transfer of routine salaries and procurement (0.89 percent of GDP). It is apparent that the principle of 'money follows function' has not yet been applied. At the same time, if regions and districts as the main beneficiaries of revenue decentralization do not carry out additional tasks, then they could waste these additional resources on non-core functions. As a result, central government needs to decentralize additional expenditure responsibilities to provinces and districts.

FISCAL DECENTRALIZATION – LOOKING AHEAD

Before the recent decentralization reforms, Indonesia was a fiscally highly centralized country. With the passage of the decentralization laws in 1999 and their subsequent enactment in 2001, Indonesia entered a momentous era of decentralization. There were several main features of the reform initiative.

First, as discussed earlier, central government transfers to regions jumped sharply, to 5.6 percent of GDP, and the regional share of government spending almost doubled to around 30 percent.

Second, some 1.9 million central government civil servants at the end of 2001, out of 5 million in total, came under the coordination of provincial governments where they were based. These civil servants include staff previously assigned to the departments of education, health, social welfare, domestic affairs and autonomy, agriculture, forestry, industry and trade, labor and transmigration, communications, and energy and mineral resources; 1.1 million

of these staff members are teachers. More than 16 000 facilities were also reassigned to the regions.

Third, several safeguards were put in place to contain the risks of macroeconomic imbalances and disrupted service delivery. These included a ban on regional government borrowing, a contingency fund to help under-funded regions meet newly devolved expenditures, and a transitional arrangement under which the center continued to administer the payroll of transferred civil servants for the first five months of 2001.

The evidence of the first two years of implementation showed that the DAU allocation largely met the expenditure needs of regional government. It is also widely recognized that the DAU formula has flaws, especially in its elements that attempt to measure and to incorporate in the formula the fiscal gap between expenditure needs and fiscal capacity. With two years of experience and learning about the impact of the DAU, there is now broad agreement that the formula needs improvement. For example, a recent analysis of allocation of the DAU showed that its equalization potential has been limited by the 'balancing factor,' which accounts for about 80 percent of the DAU allocation, as well as by a 'hold harmless' provision, which specifies that no region will receive a smaller transfer than last year. These features make the allocation far less equalizing than its formula would otherwise imply.

The DAU mechanism should be more equalizing, more predictable, and more transparent across regions. The government's strong commitment to local autonomy implies a greater degree of equalization. This is a laudable objective, but other economic and political aspects are to be considered within the discussion of fiscal sustainability in the future. These include whether the distribution of the DAU should be based on actual collections or budget; whether (and when) local governments should be allowed to borrow directly; and how long the 'transition' period of the 'balancing factor' and the 'hold harmless' provision should be continued.⁶

The lack of clarity regarding objectives means that fiscal decentralization is overburdened by expectations, and its ability to achieve these objectives is impeded. The general prescription to bear in mind is that any single instrument should be designed to meet only one policy objective, which in this case would be equalization. Different instruments should be used to meet other decentralization objectives.

THE CHALLENGE FOR FISCAL SUSTAINABILITY

In FY 2001 and in early 2002, the fiscal decentralization process was well managed, and the widespread fear of destruction of public services did not materialize. The budget deficit for 2001 was lower than the one budgeted.

With the passage of the FY 2002 budget in November of that year, the government was committed to taking a number of politically difficult actions. From the budget point of view, financing of the fiscal deficit should be relatively secure. A major task is now to ensure that further decentralization is fiscally neutral. Any additional revenue allocation to sub-national governments will have to be followed by decentralization of corresponding expenditure responsibilities.

Challenges in conducting fiscal decentralization remain. A clear consensus has yet to emerge on the relative roles of the province, the district, and the center. As a result, key issues relating to regions' regulatory and taxation powers, the feasibility of local borrowing powers, management and ownership of natural resources and infrastructure, and the setting of national standards have yet to be resolved. An especially important issue relates to extending local taxation powers: how regions can increase the revenue mobilization from their own source revenues. A significant increase in local own source revenue can help the central government in managing its budget, since the intergovernmental transfer of funds is still a large part of the budget. Allowing regions to make foreign borrowing could also be an alternative, but central government must be clear on the mechanisms that would control such borrowing. Problems also remain in the intergovernmental fiscal system. Slow progress has been made in strengthening government oversight of regional regulations that may be in conflict with the national interest. Finally, an adequate financial reporting system is not yet in place, and accountability mechanisms have not kept pace with the expanded layers of government.

Accomplishing all of these tasks will be hard for the government, and not all of what must be done is within its control. Given the challenges that it faces, so far the government has been able to communicate well with Parliament, the regions, and the people at large, to begin to implement neutral fiscal decentralization policies that are necessary to maintain fiscal sustainability. At this time, the government needs to continue delivering on its promises. If it succeeds in FY 2002 and is able to formulate a tight budget for FY 2003, then fiscal sustainability over the longer run is within reach.

NOTES

1. This views expressed here are my own and do not necessarily represent the view of the Ministry of Finance.
2. The government did not make two key sales that had been scheduled for 2001: the sale by IBRA of BCA scheduled for the end of December and the exercise of the put option on Semen Gresik that had already been delayed until late 2001. While the BCA deal was only delayed and completed in the first quarter of 2002, the Semen Gresik sale was scuttled by protests from local governments. The failure to sell Semen Gresik is quite troubling as it suggests that the government may find it difficult to sell any significant state-owned company

without consent from the region in which the company is located. This provides yet another angle for the importance of decentralization sustainability in Indonesia.

3. While interest payments are expenditure items, principal payments are financing items and they will be discussed later.
4. The regions were estimated to be spending another 1 percent of GDP on developing funding out of their own funds, but the regions would have been spending this pre-crisis as well.
5. The decentralization of civil servants is a part of expenditure decentralization, but in the early decentralization, the salaries of these civil servants will still be paid by central government. Hence, revenue decentralization is still not matched by expenditure decentralization.
6. The government has to set a clear time span on when the economic crisis will be resolved and it must also clearly state its thoughts on any plans to postpone or change some of the decentralization reforms, plans that can be accepted by the regions.

PART V

Lessons from International Experience and the Current State of Decentralization

14. Implementing decentralized local government: a treacherous road with potholes, detours and road closures

Anwar Shah and Theresa Thompson¹

INTRODUCTION

During the past two decades, a silent revolution in public sector governance has swept across the globe.² This revolution aims to move decision-making for local public services closer to the people. The interest in this new paradigm of public governance has further been heightened by the information revolution and globalization of economic activity which tend to weaken central government at the expense of supranational regimes and local governments.

The countries embracing and adapting to this silent revolution had diverse motives and followed even more diverse approaches. This chapter attempts to present a stylized view of the motivations, approaches and processes used to strengthen localization. In doing so, it attempts to draw lessons of some general interest on the process and substance of decentralization, in part how they apply to Indonesia.

The chapter is organized as follows. The first section introduces the reader to basic concepts in decentralization. The second section is concerned with the motivations for decentralization. The third section presents a worldwide overview of decentralization efforts. The fourth section is concerned with the processes of decentralization and examines sequencing issues. The fifth section deals with sustainability and local capture issues, and the sixth section draws lessons for the future of decentralization in Indonesia.

DECENTRALIZATION: SOME BASIC CONCEPTS

A review of basic concepts commonly used in the decentralization literature is presented here so as to facilitate communications in subsequent sections.

- *Subsidiarity principle* states that public service responsibilities must be exercised by the lowest level of government unless a convincing case can be made for higher level assignment.
- *A unitary country* has a single or multitiered government in which effective control of government functions rests with the central government.
- *A federal form of government* has a multilayered structure with decision making shared by all levels of government.
- In a *confederal system of government*, central government serves as the agent of member units, usually without independent taxing and spending powers. The European Union is an important example of a confederal form of government. Switzerland has a confederal constitution but is considered a federal country in practice.
- *Devolution* means empowering people politically.
- *Localization* means decentralization of decision making to local level. It is pursued through political, administrative and fiscal decentralization.
- *Political or democratic decentralization* implies directly elected local governments, thereby making elected officials accountable to citizens.
- *Administrative decentralization* empowers these governments to hire and fire local staff (thereby making local officials accountable to elected officials) without any reference to higher level governments.
- *Fiscal decentralization* ensures that all elected officials weigh carefully the joys of spending some one else's money as well as the pains associated with raising revenues from the electorate and facing the possibility of being voted out of office.
- *Administrative deconcentration*, where decision-making is shifted to regional and local offices of the central government, would not be consistent with administrative decentralization.
- Similarly *administrative delegation* where local governments undertake activities on behalf of the higher level governments falls short of administrative decentralization.

(See Tables A14.1–A14.3 in Appendix 14.1.)

WHY COUNTRIES ARE DECENTRALIZING? NOT ALWAYS FOR THE RIGHT BALANCE

The reason for rethinking fiscal arrangements are manifold and the importance of each factor is country specific. Table 14.1 presents prime motivations in recent decentralization moves. The table shows that the quest for the right

Table 14.1 *Motivations for decentralization*

Motivation	Countries and/or regions
Political and economic transformation	Central and Eastern Europe, Russia
Political crisis due to ethnic conflict	Bosnia and Herzegovina, Ethiopia, Yugoslavia, Nigeria, Sri Lanka, South Africa, Philippines
Political crisis due to regional conflicts	Indonesia, Madagascar, Mali, Senegal, Uganda, Mexico, Philippines
Enhancing participation	Argentina, Brazil, Bolivia, Colombia, India, Pakistan, Philippines
Interest in EU accession	Czech Republic, Slovakia, Hungary, Poland
Political maneuvering	Peru, Pakistan
Fiscal crisis	Russia, Indonesia, Pakistan
Improving service delivery	Chile, Uganda, Côte d'Ivoire
To centralize	China, Turkey, European Union
Shifting deficits downwards	Eastern and Central Europe, Russia
Shifting responsibility for unpopular adjustment programs	Africa
Prevent return to autocracy	Latin America
Preservation of communist rule	China
Globalization and information revolution	Most countries

balance (i.e. appropriate division of powers among different levels of government) is not always the primary reason for implementing decentralization. Instead various political and economic events have often triggered such an interest.

Table 14.1 shows that on the domestic front political considerations have been the major catalyst in initiating a process of decentralization. These considerations had broader goals of political and economic transformation

and aspirations for European Union membership in former centrally planned economies. In most other countries, the agenda for reform was driven by ethnic and regional conflicts and fiscal crisis. Interestingly enough, in some countries such as Indonesia and Pakistan, decentralization processes which had been stuck in the mud for a long time were given a big boost by political and fiscal crises. In Peru and Pakistan, recent decentralization moves had their origins in attempts by regimes in power to sideline or weaken potential opposition.

While the political process of decentralization is important, it is an issue that has not yet been explored in the literature as highlighted by the following quotes.

What is efficient – or even optimal – from an economic viewpoint might not always be sustainable politically. I believe one of the greatest challenges ahead of us as formal scholars of federalism is to synthesize the two branches of the literature, to consider how policy efficiency and political feasibility are related ... Questions of when to decentralize, how, and to whom – questions regularly raised by the policy literature – might not be best answered by examining policy efficiency, but instead ought to be informed by work on political feasibility. (Bednar, 2000)

How do inter-governmental politics, party structures, political career patterns, clientelistic networks, and interest group pressures shape the causes and consequences of decentralization? Answers to this question would not only shed new light on the conditions under which decentralization may be expected to yield its theorized benefits, but also help to advance ongoing but increasingly sterile debates about the quality of democracy in the region [Latin America]. (Remmer and Wibbels, 2000)

Political scientists see federalism as a way to promote political stability in fractured societies (see Rose-Ackerman, 2000). This seems to have been part of the reason for decentralization in Uganda where there is a geographical divide among ethnic groups. There is some evidence to show that the decision to decentralize may have more to do with short-term political considerations of politicians rather than being based on the perceived benefits of decentralization in the long run. Eaton (2001) suggests the following possible political motivations for decentralization:

1. Decentralization might be a voluntary choice of politicians – it can increase political stability and economic growth in a way that compensates politicians for any loss of power they may experience in the short run (see also Manor, 1999).
2. Decentralization may result from political pressures exerted by sub-national politicians. If sub-national politicians can influence the political careers of their representatives in the national assembly, these legislators

may be coerced into supporting decentralization (according to Willis et al., 1999). In Brazil, the return to democracy in the 1980s set the stage for fiscal decentralization when governors regained political influence.

3. Decentralization may reflect short-term gains for politicians, since politicians usually discount future gains heavily. When government is divided, the party in control of the legislature may promote decentralization as a way to constrain the executive branch. Experiences of Argentina and the Philippines suggest that political struggles over the control of revenues and expenditures may have less to do with substantive debates over development strategy than with short-term and highly dynamic political calculations.

External influences through globalization and the information revolution are also having profound influences on the division of powers within nations. The information revolution has weakened the ability of governments to control information flows. With globalization, it is increasingly becoming apparent that nation states are too small to tackle large things in life and too large to address small things. More simply nation states are fast losing control of some of their areas of traditional control and regulation, such as regulation of external trade, telecommunications, and financial transactions. National governments are experiencing diminished control in their ability to control the flow of goods and services, ideas and cultural products. These difficulties are paving the way for the emergence of specialized institutions of global governance such as the World Trade Organization, Global Environmental Facility with many more to follow, especially institutions to regulate information technology, satellite communications, and international financial transactions. Even development finance institutions are assuming an increasingly powerful role in macroeconomic management. Thus nation states would be confederalizing in the coming years and relinquishing responsibilities in these areas to supranational institutions. This trend, however, contributes to a democracy deficit as citizens do not have the possibility of direct input in vital decision making by supranational institutions. The European Union's policies and principles regarding subsidiarity, fiscal harmonization and stabilization checks are also having demonstrable effects on developing and transition economies' (DTEs) policies.

WHAT ARE THEY DECENTRALIZING AND FOR WHAT PURPOSES?

Moving decision-making closer to people requires that citizens have voice and exit options for local governance (political decentralization). In addition, local

governments they elect should be allowed home rule in fiscal, regulatory and administrative matters (fiscal and administrative decentralization). All these elements must be in place to ensure effective decision making at local level. It is interesting to note that very few developing countries have adopted such a comprehensive approach to decentralization of decision-making. To take stock of the progress of decentralization worldwide, for a selected group of countries representing different regional grouping, we take a comparative look at key aspects of political, fiscal and administrative decentralization. From country experiences, we develop a stylized view of regional progress on decentralization (see Tables 14.2 to 14.4 later in the chapter).

The focus of this chapter, by design, is on decentralization to municipal local governments (such as municipalities, cities, and districts). This is because such a focus enables us to get a comparative perspective as to the extent to which decision making has been shifted to people. This focus implies relative neglect of decentralization to the intermediate levels of government, as for example in Argentina and Mexico where local governments are simply hand-maidens of the provinces/states and intermediate level governments have a large role in social services provision.

Political decentralization

This represents the area of most intensive political interest and reform. Following the lead of Latin America, other regions have also carried out reforms in support of political decentralization. Among the countries selected for this study, the legal status of local government is recognized in most constitutions. Furthermore, local councils and their heads are typically elected through popular vote. The degree of popular participation and contestability of local government elections nevertheless remains low. For example, very few countries have provisions for popular recall of local officials. In addition provisions for the disbandment of local councils by higher level governments have been enacted in most of these countries.

Overall, during the last two decades, there have been major gains in political decentralization worldwide, with South America and Eastern Europe having completed their agenda for reform in this area. Other regions have also shown progress, but progress has been quite slow in Central America and non-existent in the Middle East and North African regions (see Table 14.2, following).

Administrative Decentralization

Effective administrative decentralization requires lack of any *ex ante* controls by the central authorities over the decision to hire, fire and set terms of

employment of local staff. To improve tax collection or the delivery of local public services, local government should have the freedom to contract their own taxing and spending responsibilities. Furthermore, local governments should have the authority to pass by-laws in their spheres of responsibility without having to obtain prior clearance from higher level government.

In practice however, local governments in a large majority of countries do not have the authority to hire and fire senior local staff. Eastern European countries represent an important exception in this regard. The freedom to contract their own responsibilities is typically available but this option in some cases (e.g. in the Philippines) is constrained to the expenditure side only. Regulatory authority for municipal services is usually available to local governments in most countries, although in Indonesia local government regulations have to be approved by central government. Overall, there has been significant progress in administrative decentralization in developing countries in recent years (see Table 14.3, following). Such progress has been much slower in the area of local government autonomy for their own civil service. In Pakistan, lack of such autonomy is considered the Achilles' heel of devolution as the provincially transferred civil servants have no personal stake in the success of the devolution. In Indonesia, central government sets the minimum salaries for civil servants of sub-national governments.

Fiscal Decentralization

Fiscal decentralization has three important components: (1) revenue autonomy and adequacy; (2) expenditure autonomy and; (3) borrowing privileges. The progress in these areas is reviewed in the following paragraphs (see also Table 14.4, following).³ Note that due to data limitations, the figures in these sections refer to sub-national levels (intermediate and local governments combined) rather than just local governments alone.

Revenue autonomy and adequacy

The theoretical literature on fiscal federalism suggests that decentralization of taxing powers may not fully match the decentralization of expenditure and regulatory functions. This is largely because taxes on mobile bases and multi-stage sales taxes are better assigned to national government in the interest of tax harmonization. However, in developing and transition economies (DTEs), centralization of taxing responsibilities is much more pronounced than would be based on economic considerations. In some countries such as Mexico and Pakistan, the national government raises more than 90 percent of consolidated public sector revenues. Revenue systems in developing and transition economies are typically characterized by a large and dominant central government role and a heavy reliance on indirect taxes such VAT, excises, taxes

on external trade and fuel taxes. Sub-national sales taxes are permitted in a number of countries including Brazil, India, Russia and Krygyz Republic. Sub-national level VAT is popular only in Brazil (see Shah, 1988, 1994, 2001 for practical difficulties with a sub-national VAT) but several Indian states have introduced multi-stage sales taxes.

Local governments have very limited access to own source revenues such as property taxes and user charges, and even for these limited tax bases they typically have autonomy only with respect to rate setting within limits. Even property related taxes, which are seen as good sources of local revenue since the base is immobile, are under central control in some countries. In China and Indonesia, central government levies taxes on land, property and housing, and in India state governments levy urban property tax and taxes on property transactions. In Brazil rural property tax is in the federal domain, in Nigeria state governments tax non-agricultural land and in Pakistan provincial governments are empowered to tax agricultural land. Private sector participation in collecting taxes and user fees on behalf of local governments is practiced in some countries. For example, tax farming whereby rights for revenue collection are auctioned, is practiced by local governments in Pakistan for collecting taxes and user fees. Currently, the proceeds of the land and buildings tax (*Pajak Bumi dan Bangunan* or PBB) and the land and buildings transfer tax (*Bea Perolahan Hak atas Tanah dan Bangunan* or BPHTB) in Indonesia are collected by central government and shared with local governments, thereby denying local governments autonomy in this regard.

Sub-national own revenues constitute about 7.9 percent of GDP in transition economies (11 percent in Moldova, 10 percent in Belarus and 0.01 percent in Croatia) and 5.5 percent of GDP in developing countries (8 percent in Argentina, less than 1 percent in Bahrain and Mauritius and 0.1 percent in Dominican Republic) in 1999. In transition economies, on average sub-national governments raise 18.4 percent of public sector revenues (52 percent in China, and 3 percent in Albania) and in developing countries they raise slightly less – about 16.6 percent (39 percent in Argentina and India and 0.8 percent in Dominican Republic) in 1997. During the past two decades, transition economies have shown a decline in these revenues as tax collection was centralized, whereas in developing countries, there has been a modest increase due to small degree of tax decentralization. Sub-national revenues financed 55 percent of sub-national operating expenditures in transition economies (71 percent in Lithuania and 70 percent in Moldova, and 2 percent in Albania) and 40 percent of the same in developing countries (78 percent in Argentina, 63 percent in Costa Rica and 7 percent in Peru and South Africa) in 1999. The rest of the financing comes from shared taxes, transfers and borrowing. Overall tax decentralization remains an unfinished agenda for DTEs.

This discussion implicitly assumes that assignment of taxes entails control over tax base, tax rates and collection authority. This need not be the case, and higher level governments may instead in the interest of harmonization and minimizing collection and compliance costs, allow lower level governments to either levy a supplementary rate on their own base (tax base sharing) or agree to share the proceeds from specific taxes in a pre-determined way (shared taxes). Under such arrangements, tax base determination usually rests with the higher level government, with lower levels of government levying supplementary rates on the same base. Tax collection is by one level of government, generally central government in market economies and local government in transition economies, with proceeds shared downwards or upwards depending on revenue yields. Only a handful of developing and transition economies have adopted tax base sharing. Sub-national surcharge on personal income tax is permitted in Brazil and Croatia. Russia allows a surcharge on corporate income tax. Provincial governments in Pakistan allow local governments to have a supplementary rate on property transfer taxes. While the practice of tax base sharing is uncommon, sharing the proceeds of various taxes on a tax by tax basis is frequently practiced in DTEs. Shared taxes are more akin to transfers than autonomous local government revenue since local governments have no say over either the base or rate of the tax. In transition economies in 1999, 49.3 percent of sub-national government revenues were obtained from shared taxes (see World Bank, 2001). In developing countries, the role of shared taxes in financing sub-national governments is of lesser significance as general revenue sharing is widely practiced.

While giving local authorities some tax authority in principle should increase accountability of local officials to the electorate, giving local governments too much leeway can also present problems, especially when central government reserves for itself all of the productive taxes. For instance, one local council in Tanzania set up 60 'nuisance' taxes and fees that serve little more than to make the system non-transparent. Nuisance taxes have also been implemented in some parts of Indonesia, but central government is trying to limit this distortionary trend by canceling such local government regulations implementing them.

Expenditure responsibility and autonomy

Expenditure assignments in DTEs have undergone significant changes in the past two decades. In transition economies such changes reflected a new role for the public sector in support of a market economy. As a consequence sub-national expenditures contracted as a percent of GDP among the transition countries from about 17.2 percent in 1980 to 10.8 percent in 1999. Sub-national expenditures in transition economies as a proportion of total public sector expenditures experienced an even sharper decline during the same

period, from 44.9 percent to 22.3 percent. In developing countries, on the other hand, there has been a gradual, generally piecemeal yet persistent decentralization of expenditure responsibilities. Sub-national expenditures in developing countries rose from 3 percent of GDP in 1980 to 6.1 percent of GDP in 1997. Sub-national expenditures increased from 12.7 percent of total public sector expenditures in 1980 to about 19.6 percent of the total in 1998. The sub-national government role in education and health spending shows divergent trends in transition economies and developing countries. In transition economies, sub-national educational expenditures as a percent of public sector education expenditures declined from 71 percent in 1981 to 55 percent in 2000. In developing countries, on the other hand, such expenditures rose from 21 percent of total public sector education expenditures in 1980 to 40 percent in 2000. In health, the role of sub-national governments in total public sector health expenditures in transition economies declined from about 92 percent in 1977 to 39.2 percent in 2000. In developing countries, the same role expanded from about 22 percent of total education expenditures to 57 percent in 1999. These trends, however, hide the wide variations in such ratios across countries. On the high side, China (56 percent), India (46 percent) and Argentina (40 percent) are noteworthy for the relative importance of sub-national expenditures in total public expenditures. Moldova (18 percent) and South Africa (18 percent) have the highest percentage of these expenditures with respect to their GDP. Slovak Republic (8 percent), and the Dominican Republic (2.6 percent) are noted for the lowest share of sub-national expenditures in total public sector expenditures in transition and developing countries respectively. As a percentage of GDP, Croatia (0.01 percent), Dominican Republic (0.4 percent), Costa Rica and Bahrain (less than 1 percent of GDP) are noteworthy.

Many central governments play a larger direct role in service provision than the theory would recommend. For example, in India, South Africa and Mexico, central government accounts for more than two-thirds of total expenditures. Even in countries where the de-jure assignment of expenditures agrees with theoretical principles, practices can differ. Brazil and Pakistan are the cases in point. In Brazil, central government has found it difficult to withdraw from some purely local functions such as public markets, local schools, and local bridges more than a decade after the adoption of the 1988 constitution. In Pakistan, central and provincial governments have a prominent role in local functions. In Mexico, the dominance of central government results from both the direct assignment of functions to federal level and the supposed inability of lower governments to assume delegated responsibilities. In China, Russia and other transition economies, state enterprises continue to have a role in local government functions. Their redistributive role associated with consumer and producer subsidies,

especially in the housing market, is large and threatens the fiscal health of local governments.

Quite a large number of central governments are involved in local functions. Out of a sample of 33 countries for which details on the assignment of local functions are available, primary education is the sole responsibility of the center in 12 countries and in an additional nine countries central government is involved in this service along with local governments (see Table 14.2 for details on central government involvement in local functions).

In areas of shared responsibility such as education, health and social services, policies of various levels of government are typically uncoordinated. While social services expenditures tend to be less important in developing countries than industrial countries, the role of local government in these functions is more important in the latter. These are also the functions that are in some countries mandated by the constitution to be provided universally and free. In transition economies central governments have often attempted to shift social expenditures downwards to regional and local governments without providing additional finances. In Bolivia and Venezuela as well, increased sub-national expenditure responsibilities were not matched by equivalent increases in revenue. These largely unfunded mandates have therefore been seen as attempts by national governments to shift deficits downwards, so creating disharmony and conflicts among governments at different levels. Division of expenditure responsibilities within nations have been further complicated by the role of external donors. In their attempt to create islands of integrity associated with the use of their funds, donors have often supported the creation of parallel structures of decision making which bypass local government institutions.

Finally, expenditure autonomy (percentage of own expenditure under effective control of sub-national governments), is on average higher (74 percent on average but 96 percent in Croatia, and 7 percent in Albania) in transition economies than developing countries (58 percent on average but 95 percent for Dominican Republic and 23 percent for South Africa).

Fiscal transfers: a mixed grab bag

Intergovernmental transfers are the dominant source of revenues for sub-national governments in most DTEs. In 1999, they constituted on average 24 percent of total revenues for transition economies (93 percent in Albania and 4 percent in Croatia) and 42 percent (81 percent in South Africa, 75 percent in Peru and 7 percent in China) of the same (in 1997) for developing countries. This ratio ranges from 4 percent to 95 percent for individual countries. The transfers constituted 75–95 percent of sub-national revenues in Indonesia, Nigeria, Mexico, Pakistan and South Africa. The design of these transfers is of critical importance for the efficiency and equity of local service

Table 14.2 Central involvement in local functions remains extensive

Service	Number of countries				Sample size
	Purely central function	Central government involvement (other)	Purely local function		
Social services					
Public service					
Primary and preschool education	12	9	12	33	
Secondary education	13	8	10	31	
Public health	9	14	8	31	
Hospitals	11	12	4	27	
Transportation					
Urban highways	7	5	17	29	
Urban transportation	6	4	12	22	
Utility services					
Drinking water and sewerage	8	16	6	30	
Waste collection	0	2	27	29	
Electric power supply	8	13	4	25	
Other services					
Fire protection	0	5	4	9	
Public order and safety	1	1	0	2	
Police	14	10	5	29	

Source: Authors' calculations based on data from World Bank Decentralization website.

provision, autonomy, and fiscal health of sub-national governments (see Shah, 1994, 1998a for general principles and better practices in grant design). For enhancing accountability it is desirable to match revenue means (the ability to raise revenues from own sources) as closely as possible to expenditure needs at all levels of government. However, higher level governments must be allowed greater access to revenues than needed to fulfill their own direct service responsibilities so that they are able to use their spending power through fiscal transfers to fulfill national and regional efficiency and equity objectives. We can identify six broad objectives for national fiscal transfers, each of which suggests a specific design of such transfers (see also Table 14.3). In the following, we examine adherence to these principles in practice in DTEs.

Table 14.3 Ensuring consistency of grant design to achieve grantor's objectives

<i>Objective</i>	<i>Grant design</i>	<i>Better practices</i>	<i>Practices to avoid</i>
Fiscal gap	Reassign, tax base sharing	Canada	Deficit grants, tax by tax sharing
Regional disparities	Fiscal capacity equalization	Australia, Canada, Germany, ECA region	General revenue sharing
Setting national minimum standard	Block transfers, conditions on service standards	Ex-Indonesia roads and education, Chile education	Conditions on spending
Benefit spillovers	Matching grant	S. Africa teaching hospitals transfer	
Influencing local priorities	Open-ended matching	Canada social assistance	Ad hoc grants
Stabilization	Capital with upkeep requirement	Political and policy risk guarantee	Stabilization without upkeep

i. Deficit grants to bridge fiscal gaps are still commonplace. The theory suggests tax decentralization or tax base sharing as preferred alternatives to deal with fiscal gaps. In DTEs on the contrary, general revenue sharing or tax by tax sharing are typically used to deal with fiscal gaps. A number of countries including China, India, Malaysia, Pakistan and South Africa have

in the past tried deficit grants to fill fiscal gaps at sub-national levels with unwelcome results in terms of mushrooming of sub-national deficits. These grants are still in vogue in Bosnia and Herzegovina and the Republic of Srpska, China, Georgia, Hungary, Moldova, Serbia and Montenegro and South Africa. In Bulgaria, even though there is a formula for transferring resources, the system is undermined because of unplanned, end of the year transfers to cover deficits.

ii. Fiscal equalization transfers to correct fiscal inequities and fiscal inefficiencies arising from differentials in regional fiscal capacities have been adopted in a number of Eastern European countries but remain largely untried in developing countries. Most transition economies have equalization components in their grant programs to sub-national governments. Latvia, Lithuania, Poland, Romania, Russia and Ukraine have adopted transfer formulae that explicitly incorporate either fiscal capacity and/or expenditure need equalization concerns. In developing countries, programs using an explicit standard of equalization are untried, although equalization objectives are implicitly attempted in the general revenue sharing mechanisms used in Argentina, Brazil, Colombia, India, Nigeria, Mexico, Pakistan and South Africa. These mechanisms typically combine diverse and conflicting objectives into the same formula and fall significantly short on individual objectives. Because the formulae lack explicit equalization standards, they fail to address regional equity objectives satisfactorily.

iii. Open-ended matching grants with the matching rate determined by benefit to compensate for benefit spillovers are not practiced. Although benefit–cost spillover is a serious factor in a number of countries, such transfers have not been implemented in developing countries with the single exception of South Africa. South Africa provides a closed-ended matching grant to teaching hospitals based on an estimate of benefit spillovers associated with the enrollment of non-local students and use of hospital facilities by non-residents.

iv. Conditional non-matching transfers to set national minimum standards to preserve internal common market and attain national equity objectives, are rarely used. Conditional non-matching transfers to ensure national minimum standards are rarely used in DTEs. Central government transfers to provincial and local governments in Indonesia until 1999, central per capita transfers for education in Chile, Colombia and South Africa, and the capitation grant to Malaysian states come close to the concept of such a transfer.

v. *Matching transfers to influence local priorities in areas of high national but low local priority are practiced in a handful of countries.* India, Malaysia, and Pakistan use conditional closed-ended matching programs. Pakistan in the late 1990s got into serious difficulty by offering open-ended matching transfers for provincial tax effort. Central government had to abandon this program in midstream as it could not meet its obligations under the program.

vi. *Capital grants to create macroeconomic stability in depressed regions are commonplace.* Capital grants are pervasive in DTEs and most countries have complex processes for initiation and approval of submissions for financing capital projects. These processes are greatly susceptible to lobbying, political pressures and grantmanship and favor projects that give central government greater visibility. The projects typically lack citizen and stakeholder participation and often fail due to lack of proper local ownership, interest and oversight. The requirement for matching funds helps in monitoring and evaluation of projects and in building local ownership.

vii. *Formula-based transfers to municipal local governments are in vogue in Eastern Europe and Latin America but are less commonly practiced in other regions.* General purpose transfers to local governments require special considerations as these governments vary in population, size, area served and the type of services offered (for example urban versus rural). In view of this, it would be advisable to classify local governments by population size, municipality type, and urban/rural distinction and have a separate formula for each class of municipalities. Some common useful components in these formulae are: equality per municipality component, equality per capita component, service area component and fiscal capacity component. The grant funds should vary directly with service area but inversely with fiscal capacity. Even in countries that have instituted such formula based transfers, further design improvements are possible to incorporate the considerations listed.

Borrowing privileges

In developing countries, undeveloped markets for long-term credit and weak municipal creditworthiness limit municipal access to credit. Nevertheless, the predominant central government policy emphasis is on central controls and consequently less attention has been paid to assistance for borrowing. Argentina, Bolivia, Brazil, Chile and Colombia have cooperative controls on domestic borrowing and administrative controls on foreign borrowing. Ethiopia, India, Indonesia, Korea, Mexico and Peru have administrative controls on domestic borrowing. India, Indonesia, Korea and Peru also have administrative controls on foreign borrowing. Foreign borrowing is prohibited in Thailand, Pakistan, Armenia, Czech Republic, Kazakhstan, Kyrgyz Republic, Lithua-

nia, Poland, Russia and Slovenia. Domestic borrowing is prohibited in Ethiopia, Mexico, Thailand (see World Bank, 2000, 2001). Almost all DTEs with the exception of South Africa and Hungary do not have a regulatory framework for declaring local government bankruptcy. In a few countries credit market assistance is available through specialized institutions and central guarantees to jump-start municipal access to credit. The menu of choices available to local governments for financing capital projects is quite limited and available alternatives are not conducive to developing a sustainable institutional environment for such finance. This is because macroeconomic instability and a lack of fiscal discipline and appropriate regulatory regimes have impeded the development of financial and capital markets. In addition, revenue capacity at local level is limited due to tax centralization. A first transitory step to provide limited credit market access to local governments may be to establish municipal finance corporations run on commercial principles and to encourage the development of municipal rating agencies to assist in such borrowing. Tax decentralization is also important to establish private sector confidence in lending to local governments and sharing in the risks and rewards of such lending.

HOW DO WE GET THERE? REVISITING MAJOR CONTROVERSIES ON THE PROCESS OF DECENTRALIZATION

Most of the decentralization literature (see Shah, 1988, 1994 for surveys of this literature) deals with normative issues regarding the assignment of responsibilities among different levels of government and the design of fiscal transfers. The *process* of decentralization has not received the attention it deserves as the best laid plans can go awry due to implementation difficulties. In this section, we revisit major issues and controversies regarding preferred approaches to obtaining a successful outcome. Key approaches examined are big push versus small steps; bottom up versus top down; and uniform versus asymmetric. In addressing these approaches, the role of inadequate capacity as a constraint to development is also examined.

‘Big Bang’ versus Gradualism

The literature on federalism calls for a holistic approach to division of powers within nations. This entails an integrated approach to decentralization so that major decisions on political, administrative and fiscal decentralization are adopted as a single package. (Note that crystallization of such an approach may entail a long drawn out process of democratic consultations and consen-

sus building at the grassroots levels.) Such a package of reforms when implemented in a single initiative and implemented over a relatively short period of time would constitute a 'Big Bang' approach to decentralization. A 'Big Bang' approach has two defining characteristics: (1) it is holistic (comprehensive); and (2) it is implemented at lightning speed. Such an approach has a number of meritorious elements. The holistic approach ensures that all pieces of the puzzle fit together, hence the desired balance in autonomy and accountability is achieved while providing incentives for cost efficiency. This balance might not be achieved under piece-meal reform. For example, if expenditure decentralization is not accompanied by revenue decentralization, the decentralization plan may fail to fully take into account local governments' fiscal capacity and fiscal needs, the availability of good sources of local revenue, the trade-off between equity and efficiency, and the inefficiencies caused by high vertical imbalances (lack of incentive for revenue effort and reduced accountability). If political decentralization occurs without fiscal decentralization, people may quickly become disenchanted with decentralization in general because there are no tangible benefits from the reform. Rarely is there some unique moment in the political history of a nation that permits such systemic reforms to be feasible. Lightning speed represents the best use of this window of opportunity. This is because all such reforms create winners and losers, and it is generally central government, which stands to lose power from decentralization, that must implement it. Decentralization reforms empower people and local politicians at the expense of national politicians and bureaucrats. If the reforms are planned to take place over a longer period of time, the latter may be given an opportunity to organize, and they are likely to build coalitions to circumvent reforms. In contrast to the 'Big Bang' approach, gradualism calls for a sequenced approach to implementing in small steps quite possibly a comprehensive agenda of reform. A gradual approach to decentralization might work if there is likely to be a strong political commitment to reform in the foreseeable future and it is unlikely that groups adversely affected could get organized to block reform. A gradual approach is sometimes advocated on the grounds that local governments have inadequate capacities to handle newly assigned responsibilities (see Brodjonegoro and Asanuma, 2000 for Indonesia) as in Indonesia, Pakistan, Uganda and Vietnam, or citizen participation in local government is weak due to a lack of interest and/or lack of education as in Bangladesh. Gradualism is also advocated when decentralization, if done incorrectly, could cause serious problems. Advocates for gradualism might say this is the case, for example, if local participation is weak and local government is captured by elite, or if service delivery and/or revenue collection break down because the capacity of local government is weak. Lack of capacity at local level is often offered as a reason why decentralization should proceed slowly. But technical capacity can be contracted at

first, and eventually be home-grown. What is essential is for the decentralization process to start and to allow accountability mechanisms to take effect.

Are There Any True ‘Big Bang’ Reformers?

The word ‘bang’ is defined in the Merriam-Webster dictionary as ‘a loud percussive or explosive noise.’ While ‘Big Bang’ reforms are defined in this chapter as comprehensive decentralization reforms that occur over a short time, rapid but incomplete decentralization reforms in some countries such as Indonesia, Pakistan and Uganda may qualify as ‘Big Bang’ approaches in the Merriam-Webster sense since these did cause ‘explosive’ noises. These indeed are major reform efforts but do not qualify to be termed ‘Big Bang’ based on the definition adopted here as they lack some important dimensions. For instance, in all three countries, administrative decentralization has not happened and fiscal decentralization, especially tax decentralization, has been woefully inadequate.

Bottom Up versus Top Down

A bottom-up process of decentralization entails resident-voters getting organized in Tiebout type communities and declaring home rule for local public services and asking higher level governments to be supportive of these efforts. This has been the dominant mode of decentralization in North America and Northern Europe. A top-down process of decentralization, on the other hand, represents a blueprint drawn up by national governments to shift some of their responsibilities downwards. This has been the dominant process of decentralization followed in Southern Europe and all developing and transition countries. A top-down process is fraught with major difficulties. National government motivations as highlighted in the second section, have often less to do with improving efficiency, equity and accountability of local governance but more to do with shortrun political and bureaucratic imperatives (see Table 14.1). In view of these motivations, the decentralization initiatives are usually piece-meal and incomplete and result in either inadequate reform or even deform as various elements of this change work at cross purposes and defy success in improving public sector performance.

Uniform versus Asymmetric Decentralization

Uniform decentralization implies that the legal status of a constituent unit is the sole criterion used for assigning responsibilities. For example while there may be differential assignment of responsibilities between the categories of cities, town and villages, there will not be any such differentiation within

each category (i.e. all cities will be treated equally, etc.) Uniform decentralization is desirable when various jurisdictions are relatively homogeneous with respect to their fiscal capacities and there is no particular asymmetry of political or ethnic grouping that calls for special recognition. Asymmetric decentralization, on the other hand, means that constituent jurisdictions are allowed differentiated responsibilities due to political, fiscal or technical capacity considerations (see Shah, 1994 for a framework for asymmetric decentralization of local urban public services). Asymmetric decentralization at regional level is practiced in a few countries such as Belgium, Canada, India, Spain, Malaysia (see Watts, 1999), and now Indonesia. Asymmetric decentralization at local level is more prevalent in practice (*de facto*) although such policies may not have been specifically prescribed in law (*de jure*). In any case asymmetric decentralization makes capacity constraint as a hindrance to decentralization largely a non-issue.

WILL DECENTRALIZATION BE SUSTAINED?

Decentralization initiatives are likely to be sustained if they have been implemented after reaching a broad societal consensus. Sustainability potential is much higher for reforms stemming from grassroots support. If, on the other hand, decentralization is motivated by short-term goals, it increases the likelihood that the process will be reversed later on. Also, since decentralization in most countries is a top-down affair rather than the result of grassroots pressure from below, the interests that benefit from decentralization are rarely organized enough to defend it against reversals. Another reason for backtracking on decentralization is the struggle that politicians have with bureaucrats over its implementation. This struggle has taken place in scores of countries, including Bangladesh, India, Kenya, Pakistan, Sudan, Sri Lanka, Morocco and Tanzania. This, as noted earlier, may have implications for the debate on the pace of decentralization. 'Big Bang' decentralization might reduce the resistance that the bureaucracy can effectively mount because they do not have time to regroup and fight the changing conditions as they would be able to do with gradual change. Thus the pace of decentralization may affect the probability that reforms will be sustained.

Decentralization initiatives during their process of implementation may create dysfunctionalities. This may increase the likelihood that reforms are reversed. Developing countries' experiences show that ill-conceived and poorly executed 'decentralization' programs can undermine economic reform policies, exacerbate regional inequalities, empower local traditional elites, foster clientelism, and undermine the delivery of public services. (see Remmer and Wibbels, 2000). Eaton (2001) notes that in Argentina, President Menem

partially reversed the previous decentralization of revenue to bring provincial governors into his fold. In the Philippines, national legislators were averse to decentralization as it lessened their political power and influence. In Pakistan, both the major political parties have distanced themselves from recent decentralization initiatives, for they see these as attempts by military regime to weaken their political base.

Local Capture

Another important issue to consider is that of capture of local government by elites. When civic participation in local government is low, there is a greater risk that interest groups and local elites may capture them and direct resources towards their own priorities rather than towards improving the provision of local public goods and poverty alleviation. This is a particularly serious problem for rural areas in countries where there are large inequalities in land ownership (e.g. rural Sindh province of Pakistan). High civic participation and contestability in local elections are particularly important in the DTE context since the ability to 'vote with one's feet' is limited. However, the degree of local participation is likely to be endogenous in urban areas; as local governments take on larger roles in expenditure and taxing decisions, then the degree of participation in local government affairs should rise commensurately as the stakes increase for participation at local level. In rural areas, without serious land reforms, the outlook remains pessimistic for countries with concentrated land ownership.

A similar concern that election reforms in Latin America have attempted to address is the influence of national politics on local elections. When national and sub-national elections coincide, there is a greater probability that national politics will influence results of local elections, reducing the accountability of local officials. In Colombia, the Dominican Republic, Ecuador and Venezuela, sub-national elections do not coincide with national elections. In addition, in some DTEs, local elections can only be contested on a non-party basis.

LESSONS FOR THE FUTURE OF DECENTRALIZATION IN INDONESIA

Indonesia with the passage of Laws No. 22/1999 and No. 25/1999 took large steps towards political decentralization and expenditure decentralization to municipal local governments. All municipal local services and health, education and culture, public works, agricultural development, communications, environment, land management, capital investment, labor, cooperatives,

and management of manufacturing and trading activities were devolved to districts, cities, towns and villages. The major functions that have remained with central government are justice, defense, police, monetary policy, development planning, and finance. All other functions are reserved for local governments. The provinces have only been given a minor, coordinating role. While expenditures were devolved, Indonesia, following external advice, did not go forward with the assignment of taxes to local levels. There was a major change in the orientation of fiscal transfers. The new transfers were to be formula based and unconditional. Provinces rich in oil and gas resources are given a larger share of revenues from these natural resources. To create capacity commensurate with new local responsibilities, over two million central staff were transferred from the center to local governments.⁴ The program was implemented at a great speed and completed in less than two years. As a result of these changes, local government expenditures rose from 17 percent in 2000 to 28 percent in 2001. The World Bank was impressed with the speed of implementation and dubbed this program the 'Big Bang' (see World Bank, forthcoming).

The program of decentralization implemented by Indonesia is commendable on a number of counts. It chose to decentralize responsibilities from the center to local governments, in the process by-passing the provinces. This move is thoughtful given the fragile nature of the Indonesian union and a potential threat to this union if the provinces become too powerful (see Shah, 1998b for an analysis of this issue). It also sought to enhance political participation and strengthen home rule for local services. It provides resources to match responsibilities in an unconditional manner to promote greater flexibility and autonomy of decision making at local level. It tried to redress long-standing grievances of resource rich provinces by giving them greater access to resource revenues collected by the center from their provinces. It also introduced a formula based equalization program (see Box 14.1). Indonesian local governments now have the possibility to match local services with local preferences. The program involved big and bold steps executed with lightning speed. The World Bank characterization of the program as the 'big bang' is correct in the Meriam-Webster Dictionary sense of being explosive in nature. The program, however, could not be characterized as such using the definition of 'Big Bang' presented in this chapter because it has important links missing, making it difficult for different pieces of the puzzle to fit together.

Missing Links in the Indonesian Decentralization Program

Important pieces of the puzzle missing from the Indonesian decentralization program implemented so far are as follows.

BOX 14.1 THE NEW FISCAL EQUALIZATION PROGRAM IN INDONESIA (DANA ALOKASI UMUM, OR DAU)

This program was first introduced in 2001 and has the following elements:

Total pool Some 25% of total national revenues (not including shared taxes) are reserved for transfers to provinces and kabupaten/kota in shares of 10% and 90% respectively. The same formula is used for kabupaten as kota, and it is only slightly modified for the provinces. Both the provincial and kabupaten/kota DAUs are further broken down into three components: lump sum, balancing factor (to maintain 'hold harmless'), and the formula amount. For the provinces, the shares of each component are 20% lump sum, 50% formula and 30% balancing factor. For the kabupaten/kota, the shares are 10% lump sum, 40% formula and 50% balancing factor.

Lump sum Of the provinces' share of the DAU (which is 10% of the total DAU) 20% is distributed as equal lump sum amounts to each province (by dividing the total lump sum allocation by the number of provinces). Kabupaten/kota receive 10% of the total kabupaten/kota share of the DAU (which is 90% of total DAU) as a lump sum distributed in equal amounts to each kabupaten and kotamadya.

The formula amount In 2002, a formula was used to distribute 50% of the provincial DAU and 40% of the kabupaten/kota DAU. The formula amount allocated to each local government depends on that local government's share in the countrywide local government fiscal gap (sum of all local government fiscal gaps). The fiscal gap is the difference between expenditure needs and fiscal capacity. The *expenditure needs* for each jurisdiction are approximated by multiplying a weighted index of four variables (population, area, cost differences and poverty) with the average of all jurisdictions' expenditures. In 2001 equal weights were applied, but by 2002 higher weights were applied to population and cost. *Fiscal capacity* is approximated by adding an estimate of own source revenues to actual shared revenues (shared taxes and a share of natural resource revenue). *Own source revenue*

is the predicted value based on a regression of own source revenue on the services component of regional GDP. The major *shared taxes* include property tax, land transfer fees, and income tax (the latter is apportioned according to place of work rather than residence.) One should note that the extra funds that Papua and Aceh receive from natural resources is not taken into account in the calculation of their fiscal capacity, and the shared natural resource revenues given to all local governments only receive a weight of 75% in the fiscal capacity formula.

Balancing factor The final 30% of the provincial DAU and 50% of the kabupaten/kota DAU is distributed as the balancing factor. Each local government's share of the amount allocated to the balancing factor is determined by that government's share of the total government wage bill. It is intended to function as a 'hold harmless' measure, ensuring that no local government receives less than the previous year's transfer payment. This component is due to be phased out of the DAU eventually.

Bottom-up accountability

The program is solely focused on enhancing local autonomy with almost complete neglect of bottom-up accountability issues. The Indonesian program implemented so far has failed to address accountability of local governments to resident citizens. This is for several reasons.

First, lack of any tax decentralization means that local government would have the pleasure of spending money raised by someone else without experiencing the pain associated with raising taxes. This is likely to create incentives for fiscal mismanagement while enlarging the size of public spending. Over-centralization of taxing responsibility has been a major concern in the past (see Shah et al., 1994 and Shah, 1998b) as sub-national taxes were previously only a small proportion of total government revenues (4 percent for municipal governments in 1997/98). This concern was not overcome in the recent program. Only 15 percent of kotamadya and 5 percent of kabupaten funds are derived from own source revenue. Local governments are permitted to create new taxes, but they do not have control over good tax bases. Consequently, some distortionary new local taxes have been created. The justification advanced for inaction on tax assignment was grounded in a concern, forcefully put forward by international development finance institutions, that such an assignment would put a strain on central government finances which were already under great stress. Such an argument to the extent that it holds water, suggests that a major program of decentralization is better undertaken when

the country does not face any political or economic turbulence. If, however, the government has already embarked on such a course, then it must ensure that finance follows function. There is some empirical evidence to support this view as well. Recent studies demonstrate that concurrent decentralization of tax and expenditure responsibilities actually reduce the size of the public sector (see Ehdaie, 1994). Tax decentralization is a major issue that remains on the agenda in Indonesia. Government accountability to the people will be incomplete until the politicians making the decisions about expenditures are the same ones who have to justify tax rates to the populace. Good sources of revenue at local level include property taxes, property transfer taxes, frontage charges, fuel taxes, environmental charges, hotel and entertainment taxes, tax base sharing for personal income tax and user charges and fees.

Since most of the financing for local governments is now in the form of unconditional transfers from the center, this further weakens bottom-up accountability as funds flow like manna from heaven.⁵ Such finance de-links local governments from their resident voters and as a result the responsiveness of local governments to citizen voters and concerns for cost-efficiency are no longer assured. Such financing is also shown empirically to lead to a commensurate increase in the size of local public spending (Ehdaie, 1994) due to the 'fly-paper effect' but without any observable increase in the quality, quantity and responsiveness of public services.

In the absence of administrative decentralization, moral hazard and bureaucratic incentives to re-centralize have not been overcome. Industrial country experiences suggest that citizen voice and exit and local autonomy go hand in hand for the success of decentralization policies. In Indonesia, local government regulations are subject to review by central government, which still sets the minimum salaries for civil servants of sub-national governments.

Expenditure assignment is an issue where confusion remains. In some respects local government responsibilities derive from a 'residual list' – certain powers (monetary policy, etc.) are reserved for central government, and all other unspecified powers are the domain of local governments. On the other hand, a positive list of responsibilities (listed previously) is derived from Law No. 22/1999. The law is unclear about which responsibilities are mandatory for local government to take on, and which ones may be shared (because of capacity or cross-jurisdictional externalities). The result of the unclear demarcation of responsibilities is weakened accountability, as people are unsure which level of government is responsible for what. Asymmetric decentralization (of expenditures, revenues, responsibilities) may be appropriate in Indonesia due to the diversity of the country. Some provinces may have the desire and capability to carry out more functions than others. However, a framework is needed to avoid confusion about the separation between

central and local government responsibilities and to maintain clear lines of accountability.

There remain some aspects of the political/electoral system that may compromise accountability. As under the old system, the new election laws have not corrected the over-representation of some electoral districts. In addition, local chief executives are not directly elected, and there is no mechanism for popular recall. Finally, the new amendments to the constitution do not make clear that local governments' democratic structures are protected from central government interference or dismissal.

Coordination of the decentralization process by central government has been lacking in some respects. Some local governments, awaiting regulations from central government that were never delivered, have proceeded with decentralization even without the guidelines. The result has been local government actions that conflict with central government laws.

Accountability for results

Ironically, Indonesia threw the baby out with the bath water by abandoning one of the better designed performance-oriented fiscal transfers programs (*Instruksi Presiden*, or INPRES education, health and road transfers) which helped it achieve national minimum service standards across the country. The primary school grant, initiated in 1973/74 provided funds to local governments based on the number of children aged 7–12. An additional capital grant was provided to achieve uniform minimum standards of access to education across the country. The health grant implemented in 1974/75 provided local governments with funds based on a formula including medicine needs and requirements for health centers (1 per 30,000 population) but left decisions on execution to local governments. Likewise, the district/town road improvement grant allocated funds from 1979/80 to local governments based on such factors as road length, condition, density, and cost. Indonesia would be well advised to reconsider such grants to establish national minimum standards. These grants can also be used to provide incentives for competitive service delivery by public and private sectors as shown in Box 14.2.⁶

It is interesting to note that a number of local governments have recently adopted the criterion of financing schools based on school enrollments as opposed to the centrally suggested criterion of an equal fixed amount per school (see Hofman and Kaiser, 2002, p. 6). Recognizing the importance of such transfers, the government of Indonesia in June 2002 announced plans for the introduction of DAK transfers for basic education, basic health services, and basic infrastructure in the 2003 budget. The design of such transfers has yet to be worked out.

BOX 14.2 AN EXAMPLE OF A PERFORMANCE-ORIENTED GRANT: EDUCATION GRANT TO SET MINIMUM STANDARDS WHILE ENCOURAGING COMPETITION AND INNOVATION

Allocation basis among local governments school age population.

Distribution to providers equal per pupil at both government and private schools.

Conditions universal access to primary and secondary education regardless of parents' income; improvements in achievement scores; no condition on the use of grant funds.

Penalties for non-compliance with standards public censure, reduction of grant funds.

Incentives for cost efficiency retention of savings.

Source: Shah (1998b).

Fiscal Equalization

Fiscal equalization is an important goal of the new fiscal transfer system, and to this end, an equalization program, the so-called *Dana Alokasi Umum* (DAU), has been proposed. Under the new system, the equalization transfer is to be determined by a formula that calculates the fiscal gap between the expenditure needs of a local government (based on population, area, costs, and poverty) and its fiscal capacity (based on estimates of own and shared revenues) (see Box 14.1 for details).

The new equalization program has several meritorious elements. It provides significant resources to local governments in a transparent and somewhat equitable manner. It embodies a well thought out transition for the implementation of such a program through a 'hold harmless' provision (guaranteeing no less than the previous year's level of transfer payment) during 2001 and 2002. This provision could provide a smooth transition to the phasing in of the new system over the next three to five years. However, the program as currently implemented has a number of design flaws. First the total pool of resources is arbitrarily set and is not determined by application of the equalization formula. This arbitrary determination may be contributing to a negative fiscal balance for the central government after the transfers are accounted for. Fiscal capacity determination is based on revenue collections as opposed to

the more desirable alternative of taking into account revenue bases. Expenditure need determination uses an adjustment of local expenditures by an index that uses arbitrary weights for population, area, poverty gap and cost factors. The balancing factor is the most indefensible element of the new equalization program as it is based on personnel expenditures. A simplified application of the 'hold harmless' provision based on the total amount of transfers received in the pre-reform year to serve as the minimum grant would have served as a simpler and more justifiable alternative. The program also uses the same formula for different categories of local governments and as a result may be contributing to fiscal inequity across different types of local governments. A provision of Government Regulation PP No. 84/2001 requiring quarterly reports on the use of DAU funds negates the autonomy objectives of this formula-based equalization program. Overall the program does not use an explicit standard of equalization and as a result its accomplishments cannot be assessed against a common yardstick. A simpler fiscal capacity equalization program using a national average standard, separately for each type of local government (kota, kabupaten and the provinces) would have been more desirable. In short, the current equalization program requires a re-examination to make its design consistent with its objectives.

Bureaucratic Culture and Incentives

In Indonesia in the past, centralization of responsibility and concentration of controls in bureaucracy created a culture of rent seeking and command and control with little concern for citizens' preferences and needs. Particularly in Indonesia, power has been firmly in the hands of the bureaucracy since the 1970s.

In Indonesia operational capacity of the bureaucracy for local governance is deficient. This deficiency, however, can be overcome in the short run by borrowing such capacities from national governments, other local governments, the private sector, and civil society. In the long run, training of staff and creating an enabling environment for competitive service delivery through partnership with the private sector and civil society can augment operational capacity. A matter of greater concern in Indonesia is that the available capacity is not geared towards serving the citizen voters. A similar rent seeking bureaucratic culture prevailed in industrial countries not long ago. Over the years, however, industrial countries have shown a remarkable change in the performance of their public sectors. It is interesting to note that this change was brought about not through a system of hierarchical controls, as continue to be the focus in Indonesia but more through strengthened accountability to citizens at large.

Overall the emphasis of these systems of accountability has been to bring about a change in both the bureaucratic culture and the incentives public

employees face. This is done by steering attention away from internal bureaucratic processes and input controls and towards accountability for results. While various countries have followed diverse policies to achieve this transformation, the underlying framework driving these reforms is uniform and firmly grounded in the results-oriented management and evaluation framework (ROME). Under ROME, a results based chain provides a yardstick for measuring public sector performance.

Results-oriented management and evaluation (ROME) chain:

Program/project → inputs → activities → outputs → reach (stakeholders positively or adversely affected) → outcome (purpose) → impact (goal) → citizen feedback and evaluations → program design → program/project

Most ROME-related approaches have the following common elements: (1) government as a purchaser but necessarily as a provider of public services; (2) incentives for competitive service delivery; (3) contracts/work programs based on pre-specified output and performance targets and budgetary allocations; (4) managerial flexibility but accountability for results; (5) subsidiarity principle; (6) incentives for cost efficiency; and (7) citizen charter, bottom-up accountability.

ROME provides a coherent framework for strategic planning and management based on learning and accountability in a decentralized environment. This framework calls for competitive wages and task specialization and lack of formal tenures for public personnel. Public providers are given the freedom to succeed or fail and public employees hold their jobs so long as they are able to fulfill the terms of their contracts. Persistent failures initiate the exit process. Responsiveness to citizenship and accountability for results are the cornerstone of this approach (see Box 14.3). A recent empirical study by Gurgur and Shah (1999) supports this view as it shows that political and bureaucratic culture and centralization of authority represent the most significant determinants of corruption in a sample of 30 countries. In view of this evidence, the ROME framework offers great potential in Indonesia to improve public sector governance by nurturing responsive and accountable governance. Administrative decentralization is a pre-requisite for implementation of ROME. Administrative decentralization as discussed earlier requires lack of any ex ante controls over the decision by local governments to hire, fire and set terms of employment of local staff. To improve tax collection or the delivery of local public services, local governments should have the freedom to contract their own taxing and spending responsibilities. Furthermore, local governments should have the authority to pass by-laws in their spheres of responsibility without having to obtain prior clearance from the higher level government. Local governments in Indonesia do not as yet in practice have the authority to hire and fire senior

BOX 14.3 MAKING THE DOG WAG ITS TAIL: ACCOUNTABILITY FOR RESULTS

<i>Old system</i>	<i>versus</i>	<i>'Accountability for results'</i>
Rigid rules		Managerial flexibility
Input controls		Results matter
Top-down accountability		Bottom-up accountability
Low wages and high perks		Competitive wages but little else
Life-long and rotating appointments		Stay with-it culture but exit with persistent failures
Intolerance for risk/ innovation		Freedom to fail/succeed

Source: Shah (1999).

local staff. The lack of such autonomy is considered the Achilles' heel of the devolution as the centrally transferred civil servants have no personal stake in the success of the devolution.

CONCLUDING REMARKS

In conclusion, while the Indonesian decentralization program is to be commended for its achievements over a short period of time, its long-term success is not assured as the program has failed to recognize and provide incentives for local governments to be accountable and responsive to their residents. Critical missing links in this regard identified in this chapter include: (1) tax decentralization; (2) performance-oriented transfers to set national minimum standards; (3) equalization to a standard; (4) administrative decentralization; and (5) results-oriented management and evaluation. Unless urgent action is taken to overcome these missing links, the bold Indonesian experiment may not bring the expected results in public sector performance in delivering quality local public services as demanded by its citizens.

NOTES

1. This chapter is the revised version of the paper presented at the conference 'Can Decentralization Help Rebuild Indonesia?' sponsored by the Andrew Young School of Policy

- Studies, Georgia State University, Atlanta, Georgia, May 1–3, 2002. The authors are grateful to Jorge Martinez for suggesting this topic and to Matthew Andrews for comments. The views expressed are those of the authors only and should not be attributed to the World Bank.
2. This silent revolution has led to the break-up of existing countries and moves towards democratization and confederal or federal forms of governance. The total number of countries rose from 140 in 1975 to 192 in 2001 and of these 25 percent were democracies in 1975 compared to 60 percent in 2001. In 2001, there were 24 federal countries with 25.4 percent of the world population and another 20 decentralized unitary countries with some federal features having 35 percent of world population (see also Watts, 1999). The World Bank had programs in support of decentralization in 74 countries during 1986–2001.
 3. While the focus of this chapter is on decentralization to the local level of government, the lack of available statistics on local government finance has resulted in our resort to the use of sub-national expenditures and revenues from the Government Finance Statistics database (IMF) in this section.
 4. Law 22 stipulates that sub-national governments have the ability to hire, fire, and train civil servants.
 5. The DAU is supposed to be formula based, but in 2002, 60 percent of transfers were allocated by lump sum and the ‘hold harmless’ which provided that sub-national governments should receive no less in transfers than the previous year. The Dana Khusus (DAK), a system of conditional grants, has not yet been implemented. Reports for the Consultative Group on Indonesia (June 2002) suggest that there will be conditional grants for education, basic health, and infrastructure in the 2003 budget, but their design was not available at the time of writing this chapter.
 6. Note that the new system of transfers is supposed to include the DAK, a conditional transfer. However, its implementation has been limited to reforestation activities

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APPENDIX 14.1 DECENTRALIZATION TABLES

Tables A14.1, A14.2 and A14.3 give detailed information for the countries discussed in this chapter on political decentralization, administrative decentralization and fiscal decentralization respectively.

Table A14.1 *Political decentralization*

	Constitutional safeguard against arbitrary dismissal of local govt	Popular election of local council members	Popular election of heads of local councils	Degree of popular participation in local elections	Provisions for popular recall of local officials	Contestability in local elections	Security of existence for local government	Overall political decentralization
<i>Africa</i>								
Burkina Faso	no	yes						
Mozambique	no	yes		low	?	low	?	low
Nigeria	yes	yes	no?	low				
Senegal	yes	yes		low?				
South Africa	yes	yes	no	high	yes	high	yes	high
Uganda	yes	yes	yes	?	yes	?	?	
<i>East Asia/Pacific</i>								
China	no	no	no	low	no	low	no	low
Indonesia	unclear	yes	no	medium	no	low	no	medium
Philippines	yes	yes	yes	high	yes	medium	no	medium

E. Europe/C. Asia

Albania	yes	yes	yes	low	?	low	no	high
Bosnia and Herz.	yes	yes	yes	high	?	high	no	high
Czech Rep.	yes	yes	yes	high	?	high	no	high
Georgia	yes	yes	no	low	?	low	yes	low
Hungary	yes	yes	yes	low	?	low	yes	low
Kazakhstan	no	yes	no	low	?	low	yes	medium
Moldova	yes	yes	yes	low	?	low	yes	medium
Montenegro	yes	yes	yes	low	?	low	no	medium
Poland	yes	yes	yes	medium	yes	medium	yes	high
Russia	yes	yes	yes	low	?	medium/high?	yes	medium
Serbia	yes	yes	yes	low	?	low	no	medium
Latin America								
Argentina	?	yes	yes	medium	yes	high	no	medium
Brazil	yes	yes	yes	medium	yes	high	yes	high
Mexico	no	yes	yes	medium	yes	high	no	medium

Mid. East/N. Africa

Egypt	no	yes	no	medium		low	low	medium
Jordan	yes	yes	yes	medium		low/medium	medium	medium
Morocco	yes	yes	no	medium		high		

S. Asia

Bangladesh	yes	yes	yes	medium	yes	high	no	medium
India	yes	yes	no	medium	yes	yes	yes	high
Pakistan	No	yes	no	medium	yes	yes	no	medium

Table A14.2 Administrative decentralization

	Freedom to hire/fire/set terms of employment of local govt employees	Freedom to contract out own responsibilities	Administrative authority (by-laws)	regulatory approval	Overall administrative decentralization
<i>Africa</i>					
Burkina Faso		yes (waste)			
Mozambique					
Nigeria	no	no	yes		low
Senegal			yes?		
South Africa	no	yes	yes		medium
Uganda	no	yes	yes		low
<i>East Asia and Pacific</i>					
China	no	yes		no	low
Indonesia	De jure, yes; de facto, no	De jure, yes; de facto, no		Central govt approval required	low
Philippines	no	no		yes	low
<i>Eastern Europe and Central Asia</i>					
Albania	yes	yes		yes	high
Bosnia and Herz.	yes	yes		yes	high
Czech Rep.	yes	yes		yes	high

Georgia	yes	yes	yes	high
Hungary				
Kazakhstan	yes?	no	no	low
Moldova	yes	yes	yes	high
Montenegro				
Poland	yes	yes	yes	high
Russia	no	yes	?	low
Serbia	yes	yes	yes	high
<i>Latin America</i>				
Argentina				
Brazil	yes	yes	yes	high
Mexico	no	yes	yes	low
<i>Middle East/ N. Africa</i>				
Egypt	no		yes	
Jordan				
Morocco				
<i>South Asia</i>				
Bangladesh	no	yes	yes	low
India	no	yes	yes	low
Pakistan	no	yes	yes	low

Table A14.3 *Fiscal decentralization*

	Rate and base setting for local revenues	Majority of transfers are formula-based and unconditional	Revenues more or less match responsibility	Own revenues finance majority of expenditures	Responsibility and control over all municipal services	Responsibility and control over health, education, welfare
<i>Africa</i>						
Burkina Faso			no	yes	yes	no
Mozambique				yes?	yes	no
Nigeria	no	no	no	no	some	no
Senegal			no	no	yes	yes
South Africa	yes	yes	no	yes	yes	no
Uganda	yes	yes	no	yes	yes	no
<i>E. Asia/Pacific</i>						
China	no	yes	yes	no	yes	yes
Indonesia	no	yes	varies by municipality	no	yes	yes
Philippines	no	yes	no	no	yes	health and welfare
<i>E. Eur./C. Asia</i>						
Albania	rate only	yes	no?	no	yes	yes
Bosnia and Herz.	no	no	no?	no	yes	yes
Czech Rep.	no	yes	no?	no	yes	yes
Georgia	rate	yes	no?	no	yes	yes
Hungary	some	no	no	no	yes	yes
Kazakhstan	no	no	no?	no	yes	yes
Moldova	no	no	no?	no	yes	yes
Montenegro	rate?	yes?	no?	no	yes	yes
Poland	no	yes	yes	yes	yes	yes
Russia	no	yes	no	no	yes	yes
Serbia	rate only	yes	no	no	yes	yes
<i>L. America</i>						
Argentina	yes	yes	yes	yes	yes	no
Brazil	yes	yes	yes	yes	yes	yes
Mexico	no	yes	yes	no	no	no
<i>Mid East/N Africa</i>						
Egypt	no	no	no	no	no	no
Jordan	no	no	no	no	yes	no
Morocco	no	interpret data?		no	yes	
<i>South Asia</i>						
Bangladesh	no	yes	yes	yes	yes	no
India	no	yes	yes	yes	yes	no
Pakistan	no	yes	yes	yes	yes	no

Autonomy for planning	Autonomy for procurement	Ability to borrow from domestic banks/higher levels of govt	Ability to issue domestic bonds	Ability to borrow from foreign banks	Ability to issue foreign bonds	Overall fiscal decentralization
no						
shared	no	no	no	no	no	low
yes	yes	yes	no	no	no	medium
yes	?	yes	no	no	no	medium
no	no	no	no	no	no	low
shared	no	yes	yes	yes, through central govt	no	medium
no	no	yes	yes			low
yes	no	yes	yes	yes	yes	medium
yes	no	y/n	y/n	no	no	
yes	no	yes	yes	yes	yes	
yes	no	no	no	no	no	
yes	no	yes	yes	yes	no	modest
yes	no	no	no	no	no	low
yes	no	?	?	?	?	
yes	yes	yes	yes	yes	yes	high
no	no	no	no	no	no	modest
yes	no	yes	yes	yes	yes	
no	?	yes	yes	yes	yes	medium
yes	yes	yes	yes	yes	yes	high
no	no	yes	yes	no	no	low
limited		yes				low
		yes	yes			low
yes		yes – from govt				medium
no	no	yes	yes	no	no	medium
no	no	yes	yes	no	no	medium
no	no	yes	yes	no	no	medium

15. The current state of decentralization reform in Indonesia: a postscript¹

Jorge Martinez-Vazquez and Jameson Boex

The chapters in this volume were papers written for a conference that was held in Atlanta in May 2002. In the fast changing environment of decentralization reform in Indonesia a period of even a year is a long time, given the speed at which policy changes have been introduced in that country in the recent past. This postscript provides an update of the state of decentralization reform in Indonesia, in particular emphasizing the main obstacles to progress and suggesting the main priority areas for continued reform. For convenience we organize the review around the main functional 'building blocks' of intergovernmental relations, covering political, administrative, and purely fiscal decentralization issues.

THE POLITICAL STANCE OF THE COUNTRY'S LEADERSHIP

A formidable obstacle to continued progress in the decentralization process in Indonesia would appear to be the lack of overall vision and weak commitment to the decentralization agenda by the country's top leadership. The experience with decentralization reform around the world shows the critical role that needs to be played by high-level 'champions' for decentralization reform. Unfortunately in Indonesia, support and guidance from the President, the Minister of Finance, and the Minister of Home Affairs has been lagging over the last year. Without this vision and commitment, it is not surprising that progress on the reform agenda has slowed down considerably. The national elections coming up during the first half of 2004, and the potential resulting changes in the political line-up at national level, will provide an important indicator for the future direction – and speed – of decentralization reforms in Indonesia.

Two areas in particular will require political direction from the top. The first is whether Indonesia will continue to move in the direction of asymmetric decentralization (e.g. special statutes for Aceh and West Papua) or whether

the government will seek to address provincial peculiarities and demands within a general common framework. The second issue is whether – and how – to recognize the role of the sub-national government associations in the design and implementation of decentralization policy.

THE ELECTORAL/REPRESENTATIONAL DIMENSIONS OF DECENTRALIZATION

The absence of direct elections of local executives may reduce accountability of government officials, but more immediately it has caused problems in the relationship between bupati and mayors with their local councils or legislatures (the DPR-D). Another aspect of the electoral systems that is reducing political accountability at sub-national level is the election of local councils by proportional representation according to closed party lists, as opposed to direct elections by districts. These rules continue to provide too much power to national party chiefs (for example, Law No. 31/2002 states that political parties can recall members of the local parliaments) and too little to local residents. For these reasons, there is a generalized feeling in the country that the members of the DPR-Ds owe more allegiance to provincial and even to national political party bosses than to their local constituencies. These issues call for a serious review of the current electoral laws.

CIVIL SOCIETY PARTICIPATION IN DECENTRALIZATION

On a related issue, government policy continues to be ambiguous with regard to the role of civil society and its de facto participation in decision-making in a decentralized system of government. There is little doubt that civil society's capacity to make itself seen and heard remains weak, and progress in this respect has been patchy and lacking institutional roots. Nevertheless, there is clearly a role to be played by civil society, and this role is not yet generally recognized in the legislative or regulatory framework for decentralization.

THE STRUCTURE AND SCOPE OF THE GOVERNMENT SECTOR AND INTERGOVERNMENTAL RELATIONS

Several problems have emerged over the recent past in the structure of inter-governmental relations. First, there continues to be further fragmentation of sub-national governments, with the creation of new local and provincial

governments. This fragmentation has been largely derided in most quarters, and has been interpreted as the result of simple fiscal incentives (e.g. the lump-sum component in the DAU transfer). However, the government has not taken a clear stand on whether further fragmentation is desirable. The basic question that needs to be considered is whether there are any significant advantages in representation and accountability gained that offset the possible disadvantages in lost economies of scale or duplication of fixed overhead costs. If the answer is no, then formal standards for the creation of new local governments must be tightened.

Second, the role of the provinces in the new decentralized era remains confused. Should they be largely independent decentralized units of government or simply deconcentrated units of central government? Law No. 22/1999 and other pieces of legislation framing decentralization reform in Indonesia significantly enhanced the role of local governments (e.g. kabupatens and kotas), at the same time that they minimized the role of the intermediate level of government (e.g. provinces). In addition, No. Law 22/1999 eliminated any hierarchical role the provinces may have had over the kabupatens and kotas. Even so, provincial governors appear to have been delegated power from central government to 'supervise and to facilitate' the functions of the kabupatens and kotas, as outlined in Government Regulation (PP) No. 20/2001.

Third, a related issue is whether the functions of the provinces should be re-evaluated to provide them with more expenditure responsibilities, especially those that exhibit significant economies of scale and those in which benefit areas extend beyond those of most kabupatens and kotas. The fundamental reason for which the framers of Indonesia's decentralization had to emphasize the role of local governments and considerably dampen the role of the provinces was to contain centrifugal separatist forces in some of the provinces. However, now that Aceh and West Papua have their own special statutes and East Timor is independent, it may be the right time to leave the old political considerations aside and reconsider the role of the provincial governments in a decentralized Indonesia.

Fourth, another important and unresolved issue in the vertical structure of government is whether there should be a formal role given to the sub-districts (e.g. the Desa) in the delivery of public services. Even though Law No. 22/1999 only recognizes three levels of government, it would appear that de facto some kabupatens delegate functions to the sub-districts and provide them with regular sources of revenue. Traditionally, villages have played an important role in the delivery of certain public services in Indonesia. Some international technical assistance (for example, the UNDP Partnership for Governance Reform in Indonesia) has provided energetic support for 'village decentralization.' Although three levels of government are just adequate in

some areas, in others a more efficient provision of services may be generated by adding a fourth level, especially in rural areas where some kabupatens are large in size and in population. Some large countries have more than three levels of government, with separate budgets. For example, China has five levels, and Russia has just recently re-introduced a fourth level, the village or settlement level. In the United States, the vertical arrangements in some states also allow for a fourth level of government.

One last question is the unresolved scope of local governments in private sector activities. This is not so much a question about the entrepreneurial activities of local governments and their unfair competition with private enterprises, but more about the possible over-regulation of business activities at local level. Businesses and investors continue to complain about local governments being excessively intrusive and bureaucratic.

THE ADMINISTRATION AND DELIVERY OF SERVICES

At the beginning of the decentralization, many observers were skeptical of the ability of local governments to absorb their new responsibilities. Indeed, many believed that the delivery of a lot of basic services would deteriorate, perhaps to the point of collapse. It is one of the achievements of the Indonesian decentralization that these fears have been largely unrealized.

Nevertheless, concerns about local government capacity to administer and deliver services are real. It has become increasingly clear that the most formidable obstacle to the improvement of local administration and service delivery is the reform (or rather the absence) of a local government civil service. The fundamental issue is whether local governments that do not have control over their own staff (e.g. hiring, firing, wage setting) can effectively deliver local public services. In addition, local governments may seem to have little incentive to invest in improving the skills of officials, because under current rules the officials can move on to other jobs outside the jurisdiction. The current laws (Law No. 22/1999 on decentralization and Law No. 41/2001 on the civil service) make conflicting pronouncements about the nature of a sub-national civil service. In practice, central government has so far not committed itself to the development of a sub-national civil service. Those opposed to the development of such a civil service have argued that a national service for all kinds of local government employees is part of the critical glue that will hold the country together, ensuring that people from different regions work together.

Another issue is how to proceed with civil service reform. One has to be skeptical about the chances for successful introduction of a local government civil service in the absence of a strong push for decentralization from the

country's leadership, especially when it is the central agency for manpower, MENPAN, that is leading the effort in Indonesia. Local civil service reform led by MENPAN could be considered akin to putting the fox in charge of the chickens.

The delivery of basic services has been hampered by unresolved conflicts between sectoral laws (on education, on health, and so on) and decentralization laws. Lack of clarity over the authority of local governments versus central government ministries is contributing to confusion over ownership and ultimate responsibility for the delivery of services. This is exemplified by the ongoing search, at times quite confusing, regarding the specification of national minimum standards (NMS) for the provision of local services. The delivery of basic services also continues to be hampered by poor management practices at local level and by the lack of qualified trained personnel.

FUNCTIONAL AND EXPENDITURE ASSIGNMENTS

The approach to expenditure assignment in Law No. 22/1999 was to provide a broad listing of expenditure responsibility for local governments and an exclusive list of sectors for central government. This approach has created significant uncertainty together with some mistakes as to how local government functions were defined. The implementing regulations for Law No. 22/1999 (or PP 25 and its elucidations) have attempted to clarify several issues, but, in some ways, have further worsened the situation. What is still absent in Indonesia is a clear and comprehensive assignment of functional responsibilities at the three levels of government and a clear assignment of attributes within each functional responsibility for regulation, finance, implementation, and capital expenditures. The greatest risk of failure – an inefficient level of provision, a low quality of service provision, and so on – lies within the 'shared responsibilities'.

An attempt is currently under way, led by the Ministry of Home Affairs (MOHA) and broadly supported by the donor community, to address the lack of clarity on expenditure responsibilities in Law No. 22/1999 (as well as in supporting regulations such as PP 25 and its elucidations). The basic approach involves a review of obligatory functions and national minimum standards for public services (SPMs). In addition to the MOHA, a variety of other stakeholders are involved in the 'model building exercise' that is intended to guide the formulation of SPMs and to clarify expenditure responsibilities, including the Ministry of Finance (MOF), line ministries, and selected local governments. However, it is doubtful that regulatory reforms and the introduction of minimum service standards alone will be adequate to correct the confusion on expenditure assignments. The root cause

of this arises from improper wording of key clauses in Law No. 22/1999, which should properly be addressed through legislative reform of the law itself.

As noted, the administration and delivery of local services are further hampered by conflicts between sectoral laws and decentralization laws. Of course, confusion in the assignment of expenditure responsibilities also emanates from the lack of harmonization between the current legislation on decentralization and sectoral laws. For example, the laws on education and health still need to be revised to make them relevant in a decentralization era.

In practice, it is not possible to legislate for every single issue that eventually needs to be taken into account for a complete and smoothly functioning assignment of expenditure responsibilities. The relevant question is whether Indonesia should imitate the international practice of employing institutions and mechanisms of cooperation and dialog among different levels of government and among agencies at the same level of government to address the possibility of incomplete assignments and to fill in the gaps that may exist in the legislation. The court system, the independent third branch of government, can also be used to clarify different opposing interpretations of the laws concerning functional responsibilities. Indonesia currently lacks adequate mechanisms for coordination among central government agencies as well as institutions for dialog and coordination between different government levels.

ASSIGNMENT OF REVENUE SOURCES

The initial decentralization laws largely provided for expenditure decentralization, not revenue decentralization, because they did not give local governments any meaningful new locally controlled tax or borrowing instruments independent of central government. Subsequent legislation, especially Law No. 34/2000, has partially remedied this, but there still remains the lack of commitment by central government to provide local government with a meaningful degree of revenue autonomy. All initiatives that have been pursued over the past year within the Ministry of Finance to provide local governments with some degree of revenue discretion, including property tax and a piggyback personal income tax, appear to be dead at this time. This outcome has been explained as resulting from internal opposition within the Ministry of Finance itself, especially from the Director General of Tax. The opposition has at times been interpreted in a narrow sense as protecting turf. For example, DG Tax could lose the 9 percent of the property tax revenues earmarked to it in the law in compensation for collecting this tax for local governments. The lack of support for increased tax autonomy could also be at higher levels in the administration. For example, a proposal for keeping the

administration of property tax at central level but letting local governments set tax rates within some margins was not supported by the administration either. The government of Indonesia appears to be adamantly opposed to granting tax autonomy to sub-national governments, perhaps because of the belief that autonomy can lead to macroeconomic destabilization. However, this belief is mistaken. Two sets of activities may be helpful in demonstrating this: holding a high level conference on the advantages and disadvantages of subnational tax autonomy in Indonesia, and/or finding the means to 'socialize' international research findings that tax autonomy has been on average associated with greater macroeconomic stability.

It has also become apparent that the framework for tax autonomy created by Law No. 34/2000 remains inadequate. This law provides no significant tax instrument to local governments, and many of the nuisance taxes adopted by local governments have become counterproductive. The new taxes introduced by local government are supposed to meet certain (some say impossible) criteria (e.g. a new tax cannot distort economic decisions); in addition, new taxes are supposed to be approved by the MOHA. Despite this supervision process by the MOHA, many nuisance taxes continue to be introduced, and there is a widespread feeling that many local governments have abused their power to introduce new taxes and fees. The question is whether the 'open list' approach to local tax powers in Law No. 34/2000 should be repealed and replaced with a 'prescribed list' approach.

INTERGOVERNMENTAL FISCAL TRANSFERS

Two issues have become dominant in the area of transfers. First, the equalization grant (DAU) is not sufficiently equalizing, largely because the current formula is not applied. If the formula was applied, the DAU would be much more equalizing than it currently is. However, the bulk of the DAU funds are now distributed according to the 'balancing factor,' with other criteria including public employees and a constant lump-sum amount. Importantly, over the past year the focus has continued to be on 'holding local governments harmless,' thereby protecting them from any decrease in DAU funds that they would receive if the formula was actually in force. The unwillingness of the national parliament (DPR) to allow full implementation of the DAU as designed is a major political issue. Furthermore, as long as the DAU is used to provide guaranteed funding for civil service salaries, there is a major incentive problem. On the technical side of the DAU, there continue to be complaints about the quantification of expenditure needs and the lack of a bridge between Law No. 22/1999 on expenditure assignments and Law No. 25/1999 on revenue assignments and transfers. There are no obvious answers to these

problems. One possibility to consider is whether minimum requirements for expenditure responsibilities can be used to compute expenditure needs.

Second, the system of conditional capital transfers (DAK) remains basically undeveloped, and the DAK still lacks meaningful funding levels in the national budget. The transformation of line ministries' discretionary funds into conditional grants within the DAK system could represent a win-win policy choice for all, except the narrow interests of the line ministries themselves. However, the right types of grant vehicles still need to be developed to implement an expanded DAK program. In this regard, a Presidential Decree has recently been issued to begin implementing the DAK, and technical procedures are being prepared by the Ministry of Finance and the responsible sector ministries.

LOCAL GOVERNMENT BORROWING AND INFRASTRUCTURE DEVELOPMENT

There is much evidence that many local governments have borrowing capacity. However, current central government regulations impose very restrictive rules on borrowing, largely because of concerns about the macroeconomic consequences of uncontrolled local borrowing. Over the past year, the policy focus has shifted to on-lending issues, with an emphasis on projects with sufficient cost-recovery possibilities. For projects with low or non-existent possibilities for cost recovery, the policy direction is to rely on either grants from foreign donors or new categorical grants issued by central government (Ministerial Decree No. 35/2003). Less attention is being given to setting up conditions for a market for local government credit, where creditworthy jurisdictions can borrow and credit rating mechanisms are in place. There continues to be a need to legislate general principles for local government borrowing, including the conditions that borrowing should be allowed to finance capital investment and that explicit levels should be established for overall debt limits and debt service financial requirements on the budget. In the absence of such basic ground rules, the concern is that local government borrowing could easily become irresponsible. Responsible borrowing by local governments will also require training in debt management and capacity for capital planning and project evaluation. The Ministry of Finance – in collaboration with BAPENAS and the line ministries – is currently working to complete the regulatory and administrative framework on local government borrowing. Substantial progress has been made on defining the structure of mechanisms that would enable local governments to engage in on-lending (as well as to receive on-granted resources) from international financial institutions. In order to overcome the current moratorium on local borrowing imposed by the MOF (as required by IMF criteria), local governments

would have to comply with numerous conditions; for instance, they would have to be current on debt repayment, and new projects would have to be approved not only by the local executive, but also by the local legislature. Despite these preparations, currently there is only very limited reliance by local governments on private sector borrowing.

LOCAL GOVERNMENT PLANNING, BUDGETING, AND FISCAL MANAGEMENT

Budgeting and fiscal management at local level has largely continued to be a neglected area. However, in 2003 the MOHA introduced Regulation 29, which prescribes performance-based budgets for all local governments in Indonesia. Moving the budget process from being input-oriented to more of an outcome orientation is desirable. However, questions are being raised about the timing and the practicality of a massive adoption of performance budgeting at local level, given that local governments are poorly administered and lack capacity building options.

Also, there is still confusion at all levels of government on the responsibilities for planning development budgets. Law No. 17/2003 gives the MOF authority over recurrent and capital budgets. However, in practice BAPENAS continues to exercise influence with discretionary capital funds, in particular the DIPS of line ministries, which represent over 30 trillion rupees in 2003 in comparison to the overall funding for the DAK in the neighborhood of 2 trillion rupees. There is still confusion also about the roles that BAPEDAS and provincial governments are to play in local government planning.

The overall budget process is likely to come out reinforced as a result of internal reforms of the MOF, with the reorganization of the general directorates involved with the budget process and an emphasis on the differences between budget preparation and analysis, and budget execution and control. A clearer separation between budget preparation and execution and control would prove beneficial also at sub-national level. Important questions remain about the adequacy of external audit at all levels of government, but especially at local level.

CONCLUSIONS: THE WAY FORWARD

The process of decentralization in Indonesia still faces significant challenges. With so many issues remaining to be addressed, it is important for the government to try to prioritize areas for further reform. Here is our view of the main priorities for immediate action.

- Establish a clear ‘blueprint’ for – and commitment to – the decentralization policy for the next 3–5 years emanating from the highest level in the GOI, perhaps through the appointment of a Presidential Commission charged with evaluating what has happened so far in decentralization and with putting together an overall strategic framework for the next 3–5 years.
- Determine the minimum set of electoral reforms at sub-national level needed to increase political accountability.
- Provide formal roles for local government associations and civil society in the institutional and regulatory frameworks of decentralization.
- Establish an explicit policy on local government fragmentation (e.g. advantages in representation and accountability versus disadvantages in lost economies of scale or duplication of fixed overhead costs).
- Begin reforms for a sub-national civil service that is accountable to the relevant sub-national government.
- Consider alternative approaches to minimum standards for public services, in order to ensure that these SPMs are affordable within regular budget allocations.
- Produce a clear and comprehensive assignment of functional responsibilities at the three levels of government, and introduce institutions for central–local government dialog and coordination.
- Determine the appropriate ways in which the village level of government should be incorporated with the current center–provincial–district system of intergovernmental relations.
- Ensure the necessary harmonization between decentralization laws and sectoral laws.
- Provide local government with meaningful revenue autonomy, including the assignment of significant sources of locally controlled taxes and the establishment of a viable market-oriented framework for local government borrowing.
- Recognize that the medium- and long-term solution to Indonesia’s vast needs for local infrastructure lies in the development of a healthy and disciplined local credit market.
- Implement fully the formula distribution of funds in the DAU, including an improvement in the measurement of expenditure needs in the DAU formula.
- Develop – and fund – a system of conditional grants under the DAK umbrella.

There is little question that much has been achieved in the implementation of decentralization reforms in Indonesia since the decentralization laws were passed in 1999. Significant expenditure decentralization has occurred as local

governments have been given substantive control over the spending of a large amount of public resources. Central government has transferred control over a large share of physical facilities and – at least notionally – personnel to local government level. All of this has been accomplished in a short period of time without the public sector collapsing, as many doomsayers had prognosticated at the time Laws No. 22/1999 and No. 25/1999 were passed.

Despite the advances in recent years, there is a clear slowing of progress in the decentralization reform agenda. As noted, there are several key obstacles to the remaining reforms, obstacles that must be addressed if the momentum is to be re-established. Although it may seem to some that the decentralization reforms have stalled and that a stalemate has arisen, none of these challenges is insurmountable. The glass of decentralization in Indonesia is half full.

NOTE

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