Decentralization and Intergovernmental Fiscal Reform Course
Case Study: Decentralizing Indonesia

Discussion Problem #1: Decentralization Framework

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 22 of 1999 gives broad autonomy to the local governments in all but a few tasks that are explicitly assigned to the center: defense, justice, police, planning and religion. There is no explicit list of what expenditure responsibilities local governments must carry out, i.e., it is a “residual approach”. Based on the functions to be assigned to the center, we can estimate that over time, this assignment of expenditure responsibility is likely to lead to a sub national government expenditure share of more than 40 percent of total government spending.

In addition to spending, much of the apparatus of government has been put under the control of the local governments. Over 2 million civil servants, almost two-thirds of the government workforce have been transferred to the regions. Of the 239 provincial-level offices of the central government, 3933 local-level offices, more than 16000 service facilities (schools, hospitals, health care) were transferred to the local governments. The former provincial governments were not given an explicit assignment list for expenditure functions. The provincial level has only coordinating functions, and can provide functions on behalf of local level governments.

[Note: Prior to decentralization, the government was organized into 30 regions and about 300 local level governments. Local governments range in size from 24,000 to 4 million. The previous system was very highly centralized, and local governments had relatively little autonomy.]

Local elections have taken place, under a party system. There are no direct elections of local government officials.

At the same time that Law 22 was being drafted to focus on expenditure responsibility, Law 25 on revenue authority was being drafted. Different ministries led the two drafting teams, and there was relatively little coordination. The new revenue system guarantees local governments an amount equivalent to 25 percent of total central government budgetary revenue collections.

Law 25 did not give local governments any significant independent taxing powers. Subsequently, Law 37 did give local governments an ability to gain some independent revenue raising powers. Local governments could submit proposal to the Ministry of Home Affairs for local taxes. The restrictions were essentially that these could not be broad based taxes, and they should not tax mobile factors. If these proposals were not denied in 60 days, the local government could proceed to levy this tax.

Questions:

1. What are the advantages and disadvantages of the “big bang” approach as taken in Indonesia? As an outside commentator, what questions would you raise?

2. How would you have taken on the issue of expenditure assignment? Is there an alternative approach to the “residual approach” that might work better?
Discussion Problem #2: Intergovernmental Transfers

Before the reform, provincial and local governments received intergovernmental transfers. These were composed of two types. The first were conditional grants for infrastructure projects. These were allocated for specific purposes by formula and on an ad hoc basis. The second was a cost reimbursement grant for the compensation of local government employees that served at the local level. Both of these transfers were abolished in 2001.

The new system allocates 25 percent of budgetary revenues of the central government to the local government sector, as an unconditional grant (the “DAU”). The DAU is allocated 90 percent to local governments, and 10 percent to provinces. The distribution is by formula, which includes population, poverty rate, land area, and the construction price index to indicate regional variations in costs. Population and land areas receive higher weights.

The grant was introduced with a “hold harmless” provision where no individual local government could receive less under the new system than it did under the previous system.

In addition, a share of natural resource taxes is now allocated to subnational governments. This also is an unconditional grant. The conditional grant program (the “DAK”) is very small but there is interest in strengthening it.

Questions: Is the new system an “improvement” over the old? Does it impose any significant risks for the government? Does it appear to be sustainable? How might its effectiveness be monitored? How might World Bank operations (especially sectoral programs) be affected by this transfer system?
**Table 1: DAU Dominates**

Regional Revenues 2001 and 2002 (Rp. Trillion)

<table>
<thead>
<tr>
<th></th>
<th>FY 2001</th>
<th>FY 2001-adjusted</th>
<th>FY 2002</th>
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<tbody>
<tr>
<td>DAU</td>
<td>60.5</td>
<td>60.5</td>
<td>69.1</td>
</tr>
<tr>
<td>DAU Contingency</td>
<td>6.0</td>
<td>3.1</td>
<td>2</td>
</tr>
<tr>
<td>Shared Taxes</td>
<td>20.3</td>
<td>21.2(***</td>
<td>24.6</td>
</tr>
<tr>
<td>Special Autonomy</td>
<td>-</td>
<td>-</td>
<td>1.3</td>
</tr>
<tr>
<td>Special Allocation Fund (Reforestation)</td>
<td>0.9</td>
<td>0.7</td>
<td>0.8</td>
</tr>
<tr>
<td>Total Transfers</td>
<td>87.7</td>
<td>85.4</td>
<td>97.8</td>
</tr>
<tr>
<td>Regional Own Revenues (PAD)</td>
<td>7.0</td>
<td>7.0</td>
<td>7.6</td>
</tr>
</tbody>
</table>

Source: FY 2001 budget as per Law 35/2001; adjustments are based on the preliminary outcome as per 1st December 2001. FY 2002 is based on Parliament’s approved budget as per 23rd 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). (***Although national summary budgets reflected a higher value that the original budget, the regions appear only to have actually received the budgeted amounts in 2001.)
Figure 1: Some are more equal than others

(Per capita revenues after DAU, 2001, consolidated province, Rp.).

Source: Hofman, Katjatmoko and Kaiser (2002). Note: the numbers for consolidated province are aggregates of the local level and the provincial level government within the same province.
Discussion Problem #3: Feasibility Assessment of Tempe Timur Sub-National Operation

Background

In recent months, the Government of Indonesia has met a number of important milestones in its reform, allowing the World Bank to consider higher lending levels in the context of its present CAS. Mounting concerns about low levels of investment in social and physical infrastructure have led to a request for Bank assistance.

The Country Director has just met with a delegation of officials from the Province of Tempe Timur, headed by the Governor. The Governor has requested a team from the Bank visit the province as soon as possible to assess opportunities for assistance. The Governor articulated a series of development challenges for the regions, and stressed that public investments have been neglected in the province even prior to krismon. The provincial government is keen to address these issues under the recent regional autonomy.

You have been appointed as part of a task team to identify the possibility of a USD 100 million Provincial Assistance Loan (PAL) for activities in Tempe Timur. The Government hopes that this could be the first stepping stone for enhanced donor assistance at the sub-national level, and the Country Director is interested in developing subnational modes of engagement that can be replicated throughout Indonesia.

Tempe Timor has a population of over 35 million and accounts for about 16 percent of Indonesia’s population. The province covers almost 40 districts, which differ greatly in their geographic, demographic and economic conditions. The urban areas of the north are relatively developed and are important centers of manufacturing, including both heavy industry and export-oriented sectors in textile, foods, and footwear and trade. The highland regions are predominantly agricultural, whereas the province’s southern belt remains remote and shows high concentrations of poverty.

The request from Tempe Timur is of great interest as it allows an opportunity to pilot the Bank’s draft sub-national strategy in a province with a substantial population living below the poverty line. The CD has requested a presentation by a WB task team in the next 24 hours to assess the feasibility of the proposed PAL.

You will be expected to make a 15 minute presentation to the Country Director on the feasibility and propose a potential design for the PAL. Your team will outline the key design features for the PAL, assess stakeholder support, and define the analyses that will be needed to prepare the project.

Questions:

1. What policy issues must be resolved for the Bank to engage subnationally? How could they be addressed within the PAL dialogue/operation?
2. Who are the key counterparts and stakeholders? Who appear to be champions for reform? Who might hinder the reform process?

3. What analytical work would be needed to prepare the PAL?

4. What are the key reform areas that will be addressed in the PAL?

The Setting

The province of Tempe Timur is keen on Bank investment, particularly in infrastructure development, and capacity building for local government staff. Several other donors are active in the province including GTZ and USAID, who are both supporting a number of “good governance” initiatives. The Japanese Government, through JBIC, is financing power transmission and ports development and is considering several large infrastructure projects in the province.

The Governor, Bapak Edi Wiranto, was recently elected to the post in a campaign widely covered in the national press for “money politics” and vote buying of DPR members. The Governor -- a former academic and Head of the regional University (University Merdeka) -- comes from an aristocratic Javanese family. His younger brother, Bambang Suryono, owns a large kretex company (Surya Kretek) which is the second largest tax-payer in the country and the largest private sector employer in the province. Several members of the family are members of the provincial legislature (DPRD), including his wife Siti Nurbaya, a charismatic local pop-singer, who also hosts a weekly phone-in talk-show on radio mega musik—the local radio station. The campaign, and Pak Wiranto’s public pronouncements about disciplining “corrupt” bupati and walikotas has led to some mounting tensions between the provincial authorities and the local governments. The Governor, however, has been backed by elements of the Ministry of Home Affairs, who feel that many local governments are not ensuring adequate levels of service delivery.

The province of Tempe Timur has a population of 30 million and a GDP per capita of $500 in 2001. Its annual growth rate was 5%, well above the national average of 3.4%. However, there are significant differences in the relative performance across local governments, and increasing concerns about the growing development gap within the province.

The province is also rich in natural resources with the recent development of an off-shore gas field. Much of the current economic growth was “fueled” by the development of the off-shore gas fields. The province is characterized by its large rural population (20 million), 50% of whom earn less than $2 a day, the current poverty line. Many of the rural poor seasonally migrate to the provincial capital and district cities to work as casual laborers, becak pullers and those with some secondary education find employment in the local garment and shoe industry.

The Jakarta Post reported that each DPR member was given Rp 500 million and a Mercedes
Poverty Issues

Susenas data indicate some 7 million people live close or below the poverty line, mainly in the southern kabupatens. Kabupaten indicators for maternal mortality and school drop-out rates for children under 16 are well above the national average. Literacy rates are relatively high in the northern industrial region, but far below average in the poorer south. The high levels of poverty in the rural areas are also leading to some social conflict particularly between the kabupatens relating to resource allocation of provincial revenues.

Sectoral Issues- Health and Education

The HD team has recently completed an assessment of health and education issues in the province. Following a recent textbook scandal, sectoral projects in education were recently suspended. The team has been exploring ways by which increased community participation and accountability of resources can be guaranteed by moving away from project platforms involving the central ministry.

Budget Information

Results from the regional expenditure review mission recently carried out by the Bank show an overall provincial budget of 18 trillion (about USD 2 billion), if the provinces and the local governments are combined.

<table>
<thead>
<tr>
<th></th>
<th>Population (million)</th>
<th>PC Revenues (million)</th>
<th>DAU (trillion)</th>
<th>Own Revenues (PAD)</th>
<th>Shared Revenues</th>
<th>Civil Servants (% Wage Bill as Total)</th>
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<tbody>
<tr>
<td>Province</td>
<td>35.1</td>
<td>0.56</td>
<td>0.5</td>
<td></td>
<td></td>
<td>42.2</td>
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<td>Kabupaten Bonanza</td>
<td>0.3</td>
<td>5</td>
<td>1</td>
<td>0.2</td>
<td>1</td>
<td>45</td>
</tr>
<tr>
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<td>0.7</td>
<td>0.1</td>
<td>0.1</td>
<td>0.1</td>
<td>82</td>
</tr>
<tr>
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<td>0.2</td>
<td>0.1</td>
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<td>1.5</td>
<td>0.17</td>
<td></td>
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<tr>
<td>Kota Metrópolis</td>
<td>4</td>
<td>2.0</td>
<td>10</td>
<td>2</td>
<td>1</td>
<td>75</td>
</tr>
<tr>
<td>Others</td>
<td>29</td>
<td>1.4</td>
<td>50</td>
<td>5</td>
<td>10</td>
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A recent mission visited four kabupatens and one kota in the province. All local governments expressed a strong interest in receiving assistance from the World Bank. Expressed needs and ability to demonstrate future revenue flows differed significantly across the province and local governments.
The Province was quite eager to engage with the WB, arguing that many sectors had been neglected in the wake of Law 22/1999 on decentralization. Officials felt that the Province needed to have a stronger role in ensuring the future development of the province, especially its ability to meet the Millennium Development Goals.

Kabupaten Bonanza, which has recently benefited from oil revenue sharing, was eager to borrow for new road infrastructure. Most of the other kabupatens were eager to receive funds from the World Bank, although the mission detected mixed reactions on borrowing from the executive and DPRD, both of which would need to approve sub-national operations. Kabupaten Miskin expressed a strong interest in social projects.

The majority of APBD—80 percent-- pays for recurrent costs with little left over for development. Kabupaten Bonanza is spending a lot of money on large scale infrastructure, including several shopping malls and a four-star hotel which are owned by the city government.

The Civil Service

Decentralization has left the Province with significant imbalance in its civil service. With its current authorities, the Governor has argued that perhaps 20% of the Province’s 50,000 workforce are perhaps redundant. Meanwhile other kabupatens are suffering from significant shortages of staff. The Civil Service—10,000 staff, mainly echelon 4 and 5. Governor and Bupatis have recruited some external administrators on short-term contracts and are looking at down-sizing staff through administrative procedures. Kota Metropolis has taken a proactive approach to civil service reform.

Civil Society

The Province has an active and fractious civil society, represented by labor unions, NGOs, the press, academics and several anti-corruption groups. Labor unions, include a union for the city’s becak drivers who are actively campaigning for special becak lanes, less harassment from the police, and transparency in the “permitting” system. Several city-NGO forums (Forkot-Tahu) have a large membership and are pushing for reforms in city budgeting and planning, and improved accountability. Several anti-corruption groups including “Yayasan bersih pemerintahan” and a local chapter of Indonesia Corruption Watch have documented a number of corruption cases within local government. One of the most prominent is the recent case of the head of Dinas PU propinsi getting a USD 2 million kick-back on the JBIC ports development contract, from a local contractor Bpk S, also a member of the provincial DPR. The case was highlighted in the national and local press, and resulted in the transfer of the head to Kabupaten Toge as Kepala Dinas Pendidikan. Professors Bodoh and Pintar (from University Merdeka) are conducting research on good governance and are piloting “citizen score cards” for basic service provision in Kabupaten Toge. The results of the score card will be published in the provincial newspaper.

Press and Media

The local press is active. Each kabupaten has a local paper, owned by the local government and mainly used for public relations and to publish procurement notices. The most popular paper is “Suara Masyarakat,” a daily newspaper published in Tahu. The paper has
published numerous stories relating to decentralization, interviews with Bupatis and DPR members, and a weekly complaints page for concerned citizens. The newspaper is owned by Agus Prabowo, a Jakarta based businessman, originally from the area, who has aspirations of running for Governor. The independent journalists network “Aji” is also active in the Province, and has a grant from the Ford Foundation to monitor and write stories on good and bad governance in the province. Several radio stations, including mega musik, have weekly talk shows, and several Bupatis –including Mega and Rais –are regular participants on the show. The City also has a web-site (Tahu-online), mainly for foreign and local investors; its content focuses mainly on services and infrastructure provided by the city.

**Local Business Environment**

The city has an active Chamber of Commerce, mainly dominated by Surya Kretek which pays for the Association’s secretariat. The kabupatens have many contractor’s associations (Apkasi, Apkindo) for local contractors. Two of the kabupatens only allow contractors registered with the association to bid for contracts financed by the APBD. The informal sector (becak drivers, small business) are not represented by any of the associations, but are represented through NGO lobby groups in the Forum-Kota. A recent survey carried out by the University shows that establishing a new business in the Province requires 20 different permits from several organizations and can take anywhere between 6-9 months.

**Political Parties and Election Cycle**

The provincial DPR has 30 members. The majority (25) are PDI-P and the remainder are Golkar, Islamic Freedom party and crescent party. The compositions are somewhat similar in the five Kabupatens, although with higher representation of Golkar and Islamic parties. Smaller religious parties (crescent party, Islamic freedom party) are fairly active in Miskin and Matra Matra. The election for governor will be held in 2004, while bupati elections will occur in different years.

Several of the DPR members, including the head of the provincial DPR, Bambang S., have actively supported consultation sessions with civil society and are keen on supporting a participatory budgeting process. Many of these ideas come from the long-term GTZ program on good governance with the provincial government. Bambang S. also has aspirations for a national-level profile and is actively lobbying for a cabinet position in the next government. His arch rival is the Bupati of Pempek Bpk Rais, who is active in national politics through the crescent party, and has been known to influence DPR members through payments during the annual accountability speech of the Governor. Bpk Rais has made it publicly known that he would like to be the next Governor of the Province, and is keen to have grants for provincial infrastructure. Bitter debates have taken place in the province regarding whether Bank loans and investments should be approved by the provincial DPR or regional DPRDs. Some have even argued that such a program should be delayed until bupatis are elected directly. Relations between the province and the Kabupatens are thus fairly strained, with little or no coordination between the two.
<table>
<thead>
<tr>
<th>DPRs</th>
<th>PDI-P</th>
<th>Crescent</th>
<th>Islamic</th>
<th>Golkar</th>
</tr>
</thead>
<tbody>
<tr>
<td>Province Tempe Timur</td>
<td>25</td>
<td>2</td>
<td>2</td>
<td>1</td>
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<tr>
<td>Kabupaten Bonanza</td>
<td>4</td>
<td>3</td>
<td>3</td>
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<td>Kabupaten Suharti</td>
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<tr>
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<td>2</td>
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<tr>
<td>Kota Metropolis</td>
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<td>8</td>
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<tr>
<td>Others</td>
<td>8</td>
<td>2</td>
<td>4</td>
<td>6</td>
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</tbody>
</table>

Central Government

The Ministries of Finance and Home Affairs are piloting improved financial management and budget reporting systems with the five districts. The Sekgen of Home Affairs is also distantly related to the Governor of the Province and has been pushing for donors to work in the Province. As noted above, the Ministry of Finance supports onlending for local infrastructure. Kempraswil supports a national infrastructure rehabilitation program, whereas the Ministry of Education supports investments in local schools. Bappenas asserts that it should be responsible for vetting proposed projects to assure that they meet national priorities.

Results from the Governance Survey

The Governance Partnership contracted University Merdeka to prepare a governance perception survey of key stakeholders in the province and kabupatens. The results of the survey are attached and were initially deemed quite controversial. However the Governor and three Bupatis Bpk Rais, Habibie and Mega are quite keen to follow up on the results and improve the performance of their departments through benchmarking performance.

Current Reforms

The Province and the kabupatens are relatively reform-minded and have over the past two years instituted a series of reform initiatives. These include:

- One-stop permitting for business and for people to get key documents such as KTP and land certificates
- Publication of the provincial budget in the newspapers, only Toge and Manisan have published their budgets, with the Bupati of Pempek holding out
- Establishment of e-government kiosks for simple bidding documents at the provincial HQ
- Monthly Q and A session with the Bupatis on radio musik
- Perda on freedom of information at the provincial and kabupaten level
- Recent perda on anti-corruption
The Bank’s Program in Tempe Timur

Performance of the Bank’s portfolio in the Province has been mixed. The urban development project with the City of Tahu was investigated by INTIU and over USD 2 million in contracts were cancelled based on mark-ups by local contractors and collusion. However the national poverty program, KDP III has been performing extremely well with the local kabupatens allocating their own resources for block grants using KDP facilitators. A number of KDP groups have also used funds to improve schools and health facilities.