

***The Making of the Big Bang and its Aftermath***  
***A Political Economy Perspective***

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*Abstract*

Indonesia's 2001 decentralization was a "Big Bang," indeed. Much of the apparatus of government was transferred to the regions in the course of the year, the regional share in government spending jumped steeply, and a completely new intergovernmental fiscal system was put in place. Surprisingly little went wrong in the logistics of this radical, hastily prepared move born amidst the political turmoil in the aftermath of the New Order government. But now that the dust is settling on the first year of decentralization, several key issues have 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.

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<sup>1</sup> The findings, interpretations and conclusions expressed in this paper 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 paper 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, 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 paper. We thank Fitria Fitriani for excellent research assistance.

## 1. The Making of the Big Bang

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 regions in all but a few tasks that are explicitly assigned to the center—including defense, justice, police and planning. 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. 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 measures in population or geographical size. In addition to spending, much of the apparatus of government was put under the control of the regions. Over 2 million civil servants, or almost 2/3 of the central government workforce, was transferred to the regions. Now, out of a civil service of 3.9 million, some 2.8 million are classified as regional. And 239 provincial-level offices of the central government, 3933 local-level offices,<sup>2</sup> more than 16,000 service facilities—schools, hospitals, health centers-- were transferred rock stock and barrel to the regional governments throughout Indonesia.

***Decentralization and Diversity:*** Decentralization makes sense for a country as diverse as Indonesia. Spread out over 5,000 kilometers and over 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 barely have one-tenth of Jakarta's per capita income. And whereas barely 10 percent of the students in Sambang, East Java make it into senior high school, 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. 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—the classic arguments to makes 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 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.

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<sup>2</sup> This report uses "local government" and "local level" to indicate the second level regions, or Kabupatens (districts) and Kotamadjah's (cities). "Regions" refers to provinces, districts and cities together.

***A brief history of decentralization:*** The 2001 Big Bang was hardly Indonesia's first attempt to decentralize. Starting back in colonial times, there have been numerous attempts to do so, but none became a success. 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.<sup>3</sup> After the proclamation of independence, Indonesia's first law—Law 1/1945—dealt with regional autonomy,<sup>4</sup> which was also specified in article 18 of the 1945 constitution that established the Republic of Indonesia as a unitary state. Meanwhile, the Dutch started to set up several Indonesian republics on the islands outside Java, and all united under the Dutch crown. This was largely a political move against the Republik Indonesia as a means to argue that 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 of 1957 tried to revitalize regional autonomy, but these attempts were aborted after the outbreak of regional unrests on Sumatra, Sulawesi, and in West Java. Presidential Decision No. 6 of 1959 brought back the 1945 constitution, and effectively abolished the 1957 autonomy law. [Law 18/1965] It was not until Law 5/1974 that the issue of regional autonomy was raised again. This law whose implementing regulations started to dribble in only in 1992, 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. An experimental implementation in 26 districts took off in 1996, which was fraught with difficulties—not least because resources and facilities were not handed over together with the tasks. The experiment was taken over 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 22 and 25 of May 1999

***The Politics of the Big Bang:*** The failure of the earlier attempts to decentralize, combined with the extraordinary political circumstances in 1998 became 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 resource-rich regions felt against the central government who had "stolen their natural resources." Suharto's successor President Habibie, who had no intention of remaining just an interim president, nor one presiding over a disintegrating Indonesia, was seeking actively the support of the regions and 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 Home Affairs, charged with drafting the administrative law.

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<sup>3</sup> J.J. De Jong: *Het Koninkrijk der Nederlanden in the Tweede Wereldoorlog*, (The Kingdom of the Netherlands in the second World War), Volume 11a, pp.

<sup>4</sup> Indonesians usually use the term regional autonomy rather than decentralization. This report uses the terms interchangeably, except in sections where the difference matters.

Those that produced the early drafts were simply good bureaucrats that wanted to implement the presidential orders. But they were later joined by strong political proponents for decentralization, including Ryaas Rasyed, who was later to become the State Minister for Regional Autonomy.<sup>5</sup> Increasingly, regional autonomy was considered to be, and presented as the natural complement to the emerging democracy at the central level. Yet, the drafting of the law remained largely a bureaucratic one, with little feedback from the politicians, and even less consultations with the regions. By the time the first drafts saw the light in end-1999, the basic structure for a radical decentralization was set.<sup>6</sup>

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 22/1999 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 MOF, at the advice of IMF and World Bank, had removed the specific assignment of revenues to the regions,<sup>7</sup> Parliament brought these right back in. For central government, the choice was now to either break the law, or to devolve as much expenditures as possible to minimize the impact on the central government deficit.

The provinces survived by chance. The President's intend was to decentralize rapidly and radically to local governments, but to eliminate the provinces. These had been the center of the regional unrests 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.

By the time the decentralization laws saw their first draft, new election laws had been finished which 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 head of region without a government, it was decided to put the provinces back in, albeit with a limited role.

**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 inter-ministerial implementation team (“Tim Keppres 157”) but this never really functioned—not least

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<sup>5</sup> Although Ryaas Rasyed (and his expert staff Andi Malarengeng) became the figurehead for decentralization, it was Mr. Oentarto, expert staff in Home Affairs that drafted the first version of the administrative decentralization law. The drafting team was subsequently led by Rappioeddin (director...). In fact, at some point there were two versions of the administrative law—but Rappioeddin's version largely prevailed.

<sup>6</sup> The World Bank commented on the draft laws in December 1999, together with the IMF. The two main concern that were raised were (i) that expenditure assignments were extremely vague; and (ii) that revenue assignments were very specific. Taken together, it was felt, the laws provided significant risk for macroeconomic stability and service delivery.

<sup>7</sup> World Bank and IMF feared that, because there was hardly any clarity on how much expenditures were to be decentralized together with the authorities, the Government risked large deficits and macroeconomic instability by putting in specific revenue assignments in the laws.

because of the significant rivalry between the constituting agencies, especially MOHA and MOF. It 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 were 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, passed in the fall 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 Government 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, Central Government banned regions from new borrowing in 2001, except through the center. Although Law 25 allowed the regions to borrow, and Government Regulation 108 provided affordability limits to borrowing by individual regions, this would not have assured that aggregate regional borrowing was in line with macroeconomic requirements. In the 2001 budget, the Government 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 the provincial level. Finally, Central Government decided to continue to pay the formerly central civil servants for a transitional period of 5 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 Government had to apply an emergency break to save central finances from getting out of control as a result of decentralization. The emergency break applied was to disburse the transfers to the region as per budgeted amount, not as per actual revenues as Law 25/99 and Pp 104/99 prescribed. This little observed measure saved the center more than Rp. 10 Trillion. The reason for squeezing the regions in this way was that the central government had underestimated the new budget dynamics that resulted from decentralization. Whereas

before decentralization a rise in the oil price and a depreciation worked out positively for the central budget, after decentralization it worked out negatively. The reason 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.<sup>8</sup> Fortunately for the center, hardly any of the regions noticed.

*One year after:* One year into Indonesia's decentralization, it is fair to say that the program started off much better than many—including the World Bank—expected. There were no mayor disruptions of services, civil servants got paid by and large, and with the exception of some teachers striking for the pay-out of the retroactive wage increases, little of the feared unrest substantiated. And although a significant part of the regulatory framework is still outstanding, regional governments did by and large muddle through, and service delivery units did what they used to do before decentralization—good or bad. And many regions have already started to pursue the possibility for experimentation that decentralization offers. For example, several local governments have 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 is far from perfect. In some of the core areas of decentralization, the hasty preparation shows, and those not necessarily in favor of decentralization are all too willing to exploit the confusion to their own advantage. Some central agencies have even managed to hold on to powers that by law should have already been devolved to the regions. And some of the anecdotes on egregious local taxes, corruption in the DPRD's, or fish in need of an ID card have caused a backlash against decentralization itself. But despite the debate on possible revision of the law, the second and third amendment 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 will deal with some of the administrative and fiscal issues to which this paper now turns.

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<sup>8</sup> See World Bank (2001) *The Imperative for Reform*, Brief to the meeting of the CGI in Jakarta, November.

## 2. Issues in Administrative Decentralization

Law 22 of 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 national defense, international relations, justice, police, monetary, development planning, religion, and finance. The districts 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 coordination, and backstopping districts and cities that cannot yet perform their functions—which may be an opening for an expanded provincial role. Law 22 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 (PP25/2000) 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 the national level, DPRD and head of regions are supposed to be partners of the regional government (Art.16) after the collegial model as it exists for instance in the Netherlands. The 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 into 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.

### Whose function is it anyway?

More than one year into decentralization, much unclarity remains on what exactly has been decentralized. Law 22 does not define local government functions directly, but only 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 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.<sup>9</sup> 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.

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<sup>9</sup> Gabe Ferazzi, (2002): *Obligatory Functions and Minimum Standards: A Preliminary Review of the Indonesian approach* GTZ SfDM, Report No/2002-2, March.

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 obvious<sup>10</sup>) 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.<sup>11</sup> 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 which exempts their authorities from decentralization as Law 22/99 calls for. And the adjustment of sectoral laws to align them with regional autonomy, as is called for in Law 22/99 Art. 133. Finally, the revised Art.18 of the constitution now calls for central functions to be regulated by Law, and the question is whether that law is Law 22/99, 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 state of play not only undermines accountability of the regional government, but also hampers judgment on the vertical distribution of fiscal resources (see below). The confusion has not stopped central government to embark on an effort to have the regions “recognize” their functions in a positive list that is to be cleared by Presidential Decree.<sup>12</sup> 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 9 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 capacity. Standards thus agreed could then become the basis for monitoring and supervision, and possibly sanction. In all likelihood, these standards will vary widely per region, given Indonesia’s wide diversity in capacity. Meanwhile, a process to align sectoral laws with Law 22/99 could start, and the revisions could further specify the functions, and service standards, and which of those standards are to be considered as binding and sanctionable under PP20/2001 Art.16. Those sanctionable standards are likely to be few.

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<sup>10</sup> Conversation with Bernd May.

<sup>11</sup> 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.

<sup>12</sup> 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.



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

Law 22/99 assigns most responsibility to the local government level. The provincial level only has coordinating functions, a role in issues that surpass district boundaries, or they can perform local government functions for those unable to perform the functions. The Province has a potential role in performing task on behalf of the districts, but little initiative has been undertaken to exploit this possibility under the law.<sup>13</sup> The fact that the law explicitly states that there is no hierarchical relation between the province and the local governments did not help the province in gathering the local governments 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.

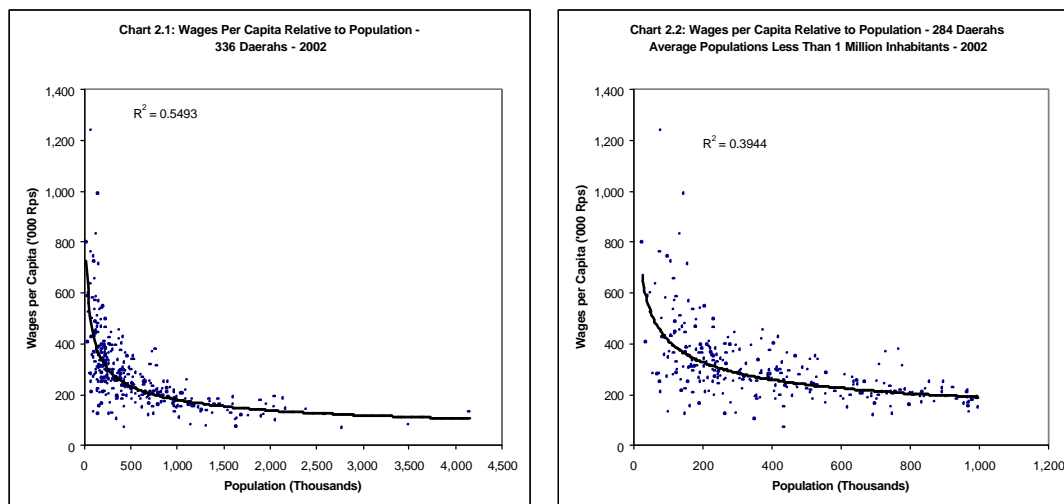
Scale economies are also at risk because of the size of local governments. This is likely to get worse in the near future due to the apparently unstoppable tendency to create new regions—both provinces and local governments. The number of local governments since Law 22 passed has increased from less than 300 to 348 in 2002, with over 20 new ones expected for 2003, and the number of provinces 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 less than 800,000 inhabitants (Gorontalo) to over 35 million (East Java), and local governments from 24,000 to 4.1 million. 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 to become a province, as it then no longer need to share the revenues with surrounding districts, 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 off. And 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). The districts with less than 100,000 people have about twice the wage bill per capita that those districts 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 prima facie the suggested scale economies would argue for consolidation of regions rather than the creation of new ones.

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<sup>13</sup> One exception familiar to the authors are the two Provincial Health Projects financed by the World Bank. These projects create province-level cooperative structures among the local governments to develop and implement province-wide health policies.

**Figure 1: Diseconomies of Scale**



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

## 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 the local level is still out, and<sup>14</sup> several concerns about the prospects of decentralization/devolution in developing countries.<sup>15</sup> 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 New Order regime in 1999 and the subsequent “Big Bang” decentralization of 2001 promised to fundamentally change the locus of responsibility *and* 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 highest internationally levels of corruption. This has proven corrosive to both public service delivery and the private-sector environment.<sup>16</sup>

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. Local political elites in executive and

<sup>14</sup> Save for a brief federalist constitution in the wake of independence from Holland in 1949, Indonesia’s prevailing constitution of 1945 is that of a unitary state.

<sup>15</sup> See for example Crook and Sverrisson (1999) or Azfar et al. (2000;2001).

<sup>16</sup> See for example O.B. Server (1996) and Partnership for Governance Reform (2001)

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, or 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”*).<sup>17</sup> This problem is accentuated by the belief on 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 the 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 undermines accountability as well, but these are likely to become clearer over time. But other, more fundamental causes seem 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. And finally, absence of formal accountability mechanisms such as external audit of regional governments also undermines accountability.

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<sup>17</sup> In December 2001, the Head of the DPR’s budget commission, Benny Pasaribu, created a stir when he claimed that 40 percent of the General Block Allocation Grant (DAU), implicitly arguing that more control and oversight from the center was needed (Jakarta Post 2001a). Arguably capacities differ widely by islands. On islands like Java-Bali capacities can generally be argued to be sufficient, which the situation more difficult in Local Governments in some of the Outer Islands.

### 3. Issues in the Intergovernmental Fiscal System

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

Law 25 of 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 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 aimed 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 re-greening to the construction of public markets.<sup>18</sup>

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 1:DAU Dominates). Well over 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, *sumber daya alam*), and a special allocation grant channel (DAK, *dana alokasi khusus*). Local governments have limited own revenues (PAD, *pendapatan asli daerah*), which constitutes less than 7 percent of total revenues. Starting 2002, the center is also making additional special autonomy transfer arrangements with two provinces.

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<sup>18</sup> See Annex Table XXX for detail, and Silver, Christopher, Iwan J. Azis, and Larry Schroeder. 2001. Intergovernmental Transfers and Decentralization in Indonesia. *Bulletin for Indonesian Economic Studies* 37 (3):345-62

Table 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
Shared Taxes	20.3	21.2 <sup>(**)</sup>	24.6
Special Autonomy	-	-	1.3
Special Allocation Fund (Reforestation)	0.9	0.7	0.8
Total Transfers	<u>87.7</u>	<u>85.4</u>	<u>97.8</u>
Regional Own Revenues (PAD)	7.0	7.0	7.6

*Source* : FY 2001 budget as per Law 35/2001; adjustments are based on the preliminary outcome as per 1<sup>st</sup> December 2001. FY 2002 is based on Parliament's approved budget as per 23<sup>rd</sup> 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

*(\*\*)* 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.

*Dana Alokasi Umum.* The *Dana Alokasi Umum* (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.<sup>19</sup> For 2001 and 2002 this minimum allocation has been maintained by Government and Parliament. However, although the law and the regulations suggest that the 25 percent is the share of *actual* revenues after revenue sharing, for FY2001 the *budgeted* amount was disbursed. In all, this cost the region some Rp. 9 Trillion in revenues, or 15 percent of the total DAU for that year.<sup>20</sup>

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 over provinces and local governments seems to have been based on thorough analysis of expenditure needs. The provincial and local government allocations are determined by 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 Government 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 Government introduced a "hold harmless" element in the formula related to past SDO and INPRES grants.

<sup>19</sup> Law 25 is not specific on whether the 25 percent is before or after revenue sharing. PP104 has taken this interpretation, which has apparently been accepted by Parliament and the regions.

<sup>20</sup> Revenues in the approved budget for 2001 were Rp.263T and revenue sharing Rp. 20 T, which yields a DAU of Rp. 60T. Actual revenues as per preliminary outcome data suggests revenues of Rp. 299T. Assuming the same amount of revenue sharing, this would result in a DAU of Rp. 69T

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. But “hold harmless” obtained a new meaning: Parliament objected against the proposed distribution of the DAU, because the richer regions stood to lose compared to the 2001 distribution.<sup>21</sup>

The formula part of the allocation relies on the notion of expenditure needs and own fiscal capacity. 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 differently from 2002, in part due to practical reasons, 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 they were included, but natural resource revenue shares only for 75 percent. As indicators for expenditure need the formula includes (i) population; (ii) poverty rate; (iii) land area; and (iv) 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 25/99. 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.* 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. 6T. in 2001, some Rp. 3 T was disbursed. The first tranche of Rp. 1.1 T. 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 which felt that “Jakarta” took their resources, and they did not get anything in return. True or not, with the implementation of Law 25/1999, they now get a significant share of those revenues (see Table 2: Revenue shares). In addition, the personal income tax was included for sharing through Law 17 of 2000.<sup>22</sup> For each of these shared taxes, the province gets a minor part, whereas the bulk of revenues goes to the local governments.

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<sup>21</sup> This Parliamentary involvement in the distribution seems against Law 25/1999 which specifies that the Regional Autonomy Advisory Council proposes the distribution of the DAU to the President, who approves it by Presidential decree.

<sup>22</sup> The sharing of the 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 17/2000 describes the sharing. However, the article is unclear whether the sharing of the personal income tax is based on the residence principle or the place of work.

**Table 2: Revenue Sharing**

(Shares of revenues to central, provincial and regional government)

<i>Item</i>	<i>Central Government</i>	<i>Provincial Government</i>	<i>Originating Local Government</i>	<i>Other Local Governments in the same province</i>	<i>All Local Governments in Indonesia (Equal Share)</i>
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 <sup>a</sup>	16.2	64.8	--	10
Land Transfer Fee		16	64	--	20
Personal Income Tax	80	8	12	--	--

<sup>a</sup>The Government's share in the Property Tax is supposed to cover administrative costs.

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

*Own Revenues.* Law 34/2000 greatly expands the scope for local government revenues. The law amended law 18 of 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 high costs to the taxpayer and the economy. Law 18/1999 therefore restricted regional taxes to a closed list, and made any additional taxes conditional upon approval of the Ministry of Finance.

Law 34 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 (Box), but supervising them has turned out to be problematic—not least because the law has tight deadlines for central government to meet if it wants to cancel a local tax. An added complication is the way supervision is structured: Law 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 regional government's creativity in taxation, and although the damage still remains limited, 84 out of the more than 1,000 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?**

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: (i) do the regions receive enough resources to cover the expenditures needed for the tasks they are expected to perform? (ii) do the regions receive an amount compatible with what government as a whole can afford? and (iii) do the regions receive enough to cover the spending obligations they inherited from the central government in the course of decentralization.

Method (i), sometimes labeled the *costed minimum standards* approach, has practical and theoretical issues. For starters, as was argued previously, Law 22/1999 does not clearly define the functions of the regional governments, as the functions are defined negatively: local government does everything that the center and the provinces does not do. And for the obligatory functions of local government, which are defined in the law, it does not clearly define what part of the function local government performs, not 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. Moreover, determining what the functions cost *at present* may not be very telling for what the functions *should* cost if efficiently delivered. But apart from all these practical objections, there is a more fundamental objection against this method: unless carefully managed, minimum standards are but a wish list of spending developed independently of what government as a whole can afford.

Method (ii) the *affordability approach* faces several issues as well. The method requires the Indonesian government to make choices for the nation as a whole as to what it wants to spend its scarce resources on. If the priorities so determined are tasks of regional government, then more resources would need to be devolved—be it through grants, revenue sharing, or devolution of more tax bases to regional governments.<sup>23</sup> 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 which does not allow a link between policy goals and spending.

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 or [1 percent] of GDP in spending which could be further devolved to the regions, together with a corresponding increase in revenues. Note

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<sup>23</sup> 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; get a larger share.



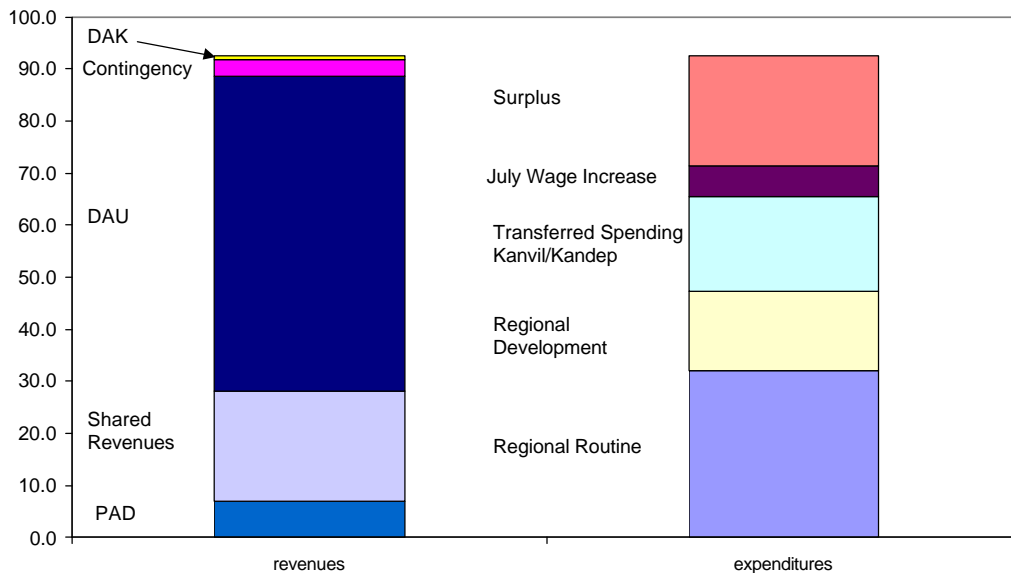
that implementation of these projects is already largely done at the sub-national level. However, since the financing is done from the central budget, there is no local scrutiny over the spending. On the recurrent budget, the wage bill probably offers further scope for savings, as not all civil servants that ought to have been decentralized actually were. Moreover, the Government 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. And finally, the government is determined to increase the tax ratio 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, several areas of central government's own responsibility that have been chronically underfunded, most notably Operations and Maintenance. Second, the central government is aiming for a zero budget deficit by fiscal year 04, and achieving this goal is likely to absorb much of the savings and additional revenues mobilize. And third, local governments may not be ready to absorb additional spending at this time, as they have just almost doubled their levels of spending, and their local planning, budgeting and financial management systems may already be stretched, and accountability at the local level is still weak.

(iii) Do the devolved resources cover the devolved responsibilities? On 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 correcting the region's own development spending for inflation. In total, the regions

**Figure 2: More than Enough on Aggregate**

(Regional Revenues, Expenditures, and Transferred Expenditures, Rp. Tr.)



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.

received “surplus” revenues of some Rp.21 Tr. in 2001, or 1.5 percentage point of GDP (Figure 3.\_\_: More than enough).<sup>24</sup>

One could, therefore, argue that decentralization “cost” the center this very same amount: if Government could have perfectly targeted the devolved resources, it could have transferred Rp. 21 Trillion less than it actually did. Lewis (2001, p.330) estimates an even higher surplus of Rp.27.5, but this was before the wage increase and the subsequent disbursement of the contingency fund. Lewis also estimates separately the surpluses of the provincial level and the local level. His judgment is that whereas at the provincial level the extra revenues more or less just cover the extra expenditures, local governments received most of the surplus. This findings jives also 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 Tr. in FY2000 to a planned Rp. 26 Tr. in FY2001 (Table 3: Consolidated Development Spending).

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 percent of GDP did not lead to a n overall decline: for both 2000 and 2001, this was budgeted to be about 5.1 percent of GDP.

Thus, the regions as a whole do not seem strapped for funds. The increase in development spending in the regions also suggests that there is more than sufficient funds 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,” therefore seems to be a red herring. In fact, on aggregate, wages make up little over 50 percent of regional spending (Table 4: Summary Regional Expenditures). Moreover, it is a misconception that only development spending can be considered as service delivery: as the civil service numbers in chapter 2 suggest, some 70 percent of the wage bill is paid to teachers and health workers, civil servants that provide direct services to the people.

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<sup>24</sup> One caveat here is the assumption that all development projects implemented by the Kanvils and Kandepts continue to be financed from the central budget. This seems to have been the case but the center is now trying to find ways do devolve this financing responsibility.

**Table 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

Notes: 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). 2002 regional development expenditures assume as per Table 2 that regions spend 28.9 percent of total revenues (central + PAD) as per Table \_\_\_\_ on development.

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 sufficiently large to cover some minimum standard of services in the regions.

### How equal 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 FY2001 the richest local government had more than *fifty* times as much revenues per capita as the poorest one (Table A.2). The poorest region has only 20 percent of the per capita revenues as the average. And 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

**Table 4: Summary Regional Expenditure Estimates (2001)**

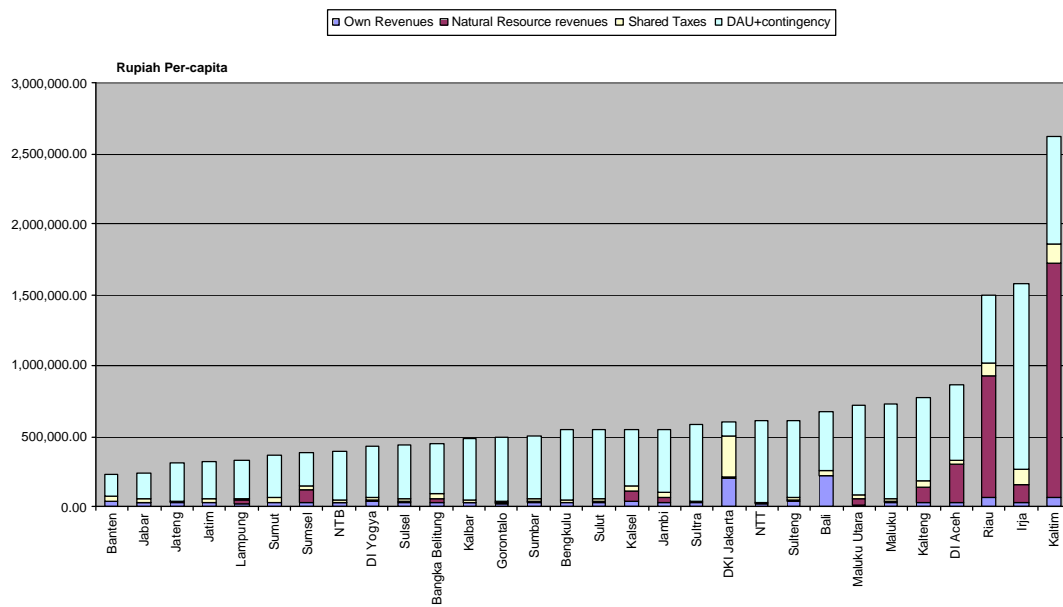
	Local governments (Rp. Tr.)	Provinces (Rp. Tr.)	Local governments (%)	Provinces (%)	Total (Rp. Tr.)
Total Revenues	74.098	18.190	100.0%	100.0%	92.288
Wages	40.55	6.90	54.7%	37.9%	51.4%
Other Routine Development	15.52	2.76	20.9%	15.2%	19.8%
	18.03	8.53	24.3%	46.9%	28.8%

Source: MOF SIKD, authors' estimates

in Indonesia.<sup>25</sup> But even if one aggregates revenues at the provincial level, the variation in revenue capacity remains large: the richest province has about ten times as much revenues per capita as the poorest one, and the poorest one has 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, and in Germany, any state falling below 95 percent of average gets subsidized. In Russia, the variation in the [56] oblasts is more in line with that of Indonesia: the richest of the 89 regions has revenues per capita some 40 times higher than the poorest, which is still considerably less than that among Indonesian local governments, although larger than among the provinces.<sup>26</sup> In Brazil, the richest state has 2.3 times the revenues per capita of the poorest state.<sup>27</sup> In China, expenditures per capita in the richest province was some 17 times that of the poorest one, but excluding the city provinces of Shanghai, Beijing, and Tianjin, the disparity fell to 5.5 to 1.<sup>28</sup>

**Figure 3: Some are more equal than others**

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



Source: *SIKD*, authors' calculation. Note: the numbers for consolidated province are aggregates of the local level and the provincial level within the same province

<sup>25</sup> This point was made by Richard Bird in a comment at the Bali conference on Decentralization in East Asia, January 10-11 2002.

<sup>26</sup> Martinez-Vazquesz, Jorge and Jameson Boex (1998): Fiscal Decentralization in the Russian Federation: Main Trends and Issues. Report prepared for the World Bank/EDI, December.

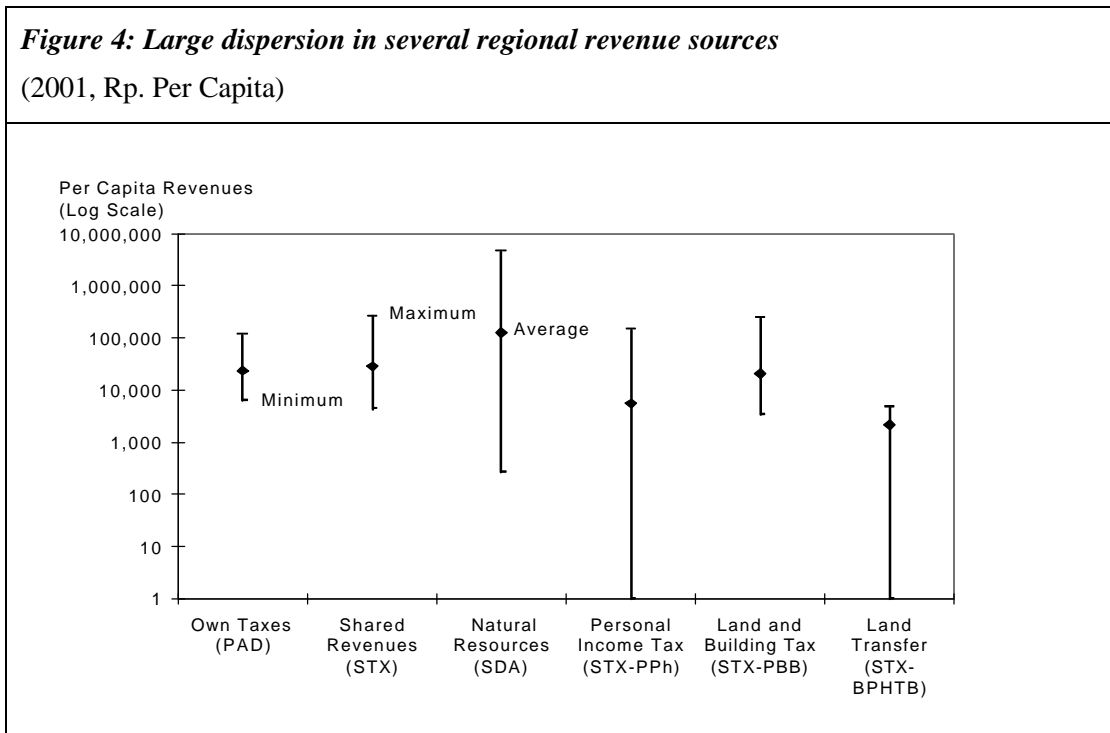
<sup>27</sup> Issues in Brazilian Federalism, *Draft World Bank Report*, May 8, 2001

<sup>28</sup> World Bank, 2001 *China: Provincial Expenditures Review*, Report No. 22591-CHA, November, Washington DC.

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

**Disparities in own fiscal capacity.**

Own fiscal capacity among the regions varies widely. Much of the variation is due to revenues from natural resource sharing. The few regions that do receive substantial amount, but not all. 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.

**Equalizing properties of the DAU<sup>29</sup>**

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 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 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—which was later interpreted as cost differences. There are

<sup>29</sup> For more detail on this issue see Lewis (2001) and Hofman, Kajatmiko, and Kaiser (2002)

several reasons for this, but the key one was that the allocation of the DAU was restricted by the need to give regions enough finance to pay for the devolved government apparatus, and the resulting “hold harmless” clause was misinterpreted.

*The hold harmless clause.* 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 that the bulk of the money, the DAU, would land somewhere else, and thereby risking that civil servants went unpaid and services break down, it was decided that the DAU allocation should hold regions harmless compared to what they received before in SDO and INPRES and what they had to spend extra on the devolved government apparatus. This became known as the “base amount,” equal to 130 percent of SDO and 110 percent of INPRES of (annualized) FY2000 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 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.

The “hold harmless” took on a different meaning in 2002. MOF had proposed a more equalizing DAU allocation for 2002—among others by now 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 25/99 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 as DAU as in 2001.

The bottom line of all this is that the DAU allocations are less equalizing than one would expect based on the Law. Regression analysis in Hofman, Kajatmiko, Kaiser (partially reproduced in Annex 3) 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 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.

<b>Table 5 : Cumulative Variation in Revenue Per Capita FY2001</b>			
	Coefficient of Variation	Standard Deviation of Logarithms	Gini Coefficient
<b>PC Cumulative</b>			
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
<i>Source Notes: Results are for 336 local governments, using DAU 2001 simulation data received from Ministry of Finance.</i>			

### **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 Matias Barenstein 2001), and fiscal dependence should therefore be a concern for Indonesia.

Law 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 34/2000 allows for regions to issue their own tax regulations, as long as they abide by certain (sound) principles. This is far more liberal than Law 18/1997 which only allowed a limited number of taxes specified in the law, with high hurdles on additional taxes. At the same time, Law 34/2000 did not devolve a tax most suited for regional governments: the land and real estate tax.<sup>30</sup> Arguably the approach of Law 18/1997 may be better, even though it did perhaps not encompass an appropriate tax base for the regions. “Nuisance” or “predatory” taxation 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 to this problem. But 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 be less desirable

<sup>30</sup> The thinking in the ministry of Finance on this has already shifted in the direction of devolving this tax.

from an equalization of fiscal capacity perspective (e.g., natural-resources or property/service based taxes which will disproportionately benefit urban areas).<sup>31</sup>

### **Directions for Reforms**

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 to enable them to provide similar quality services at similar local tax rates throughout Indonesia.

Improving the intergovernmental fiscal system in this direction requires, among others:

- 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 the property taxes, and could include a local surcharge in the 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.

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<sup>31</sup> Zhuravskaya (2000) argues that the intergovernmental fiscal system prevailing in the Russian federation in the nineties 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 incentives to increase the local tax base and will over-regulate local business.



### Annex 1: Summary Local Government Measures (2001)

	Units	Mean	Min	Max	Variation	Gini Coef.
<b>Expenditure Needs Indicators</b>						
Population		581,000	24,000	4,147,000	0.953	-
Area	km <sup>2</sup>	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	68,830	1,239,510	0.510	0.255
		207,780	-	-	-	
PC HH Exp	Rp.*	1,923,704	970,773	5,465,882	0.335	-
		1,938,202				
<b>Fiscal Capacity Indicators</b>						
PC RGDP	Rp.*	4,901,200	856,500	147,676,700	2.116	0.461
		4,068,320	-	-	-	
PC Own Taxes (PAD)	Rp.*	22,415	302	855,251	2.245	0.518
		18,640	-	-	-	
PC Shared Taxes (STX)	Rp.*	28,480	4,340	265,360	1.308	0.508
		18,800	-	-	-	
PC Personal Income Tax (STX-PPh)	Rp.*	5,600	0	146,570	2.20	0.611
		4,120				
PC Land and Building Tax (STX-PBB)	Rps*	20,870	3,360	243,020	1.45	0.516
		12,520	-	-		
PC Land Transfer (STX-BPHTB)	Rp.*	2,000	0	4,820	2.41	0.783
		2,170	-	-	-	
PC Natural Resources (SDA)	Rp.*	128,640	270	4,609,570	3.35	0.878
		47,720	-	-	-	
PC Total Revenue (PAD+STX+SDA+DAU+Contingency)	Rp.*	638,944	133,837	7,034,325	1.132	0.427
		371,550				
PC Gross LG 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 LG figures followed by national averages. Data is same as used for 2002 DAU final simulations, and refers 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 is from BPS 1999. Own revenues (PAD) are annualized figures from FY 2000. Total revenues include own taxes (PAD), shared revenues (SDA+STX), DAU2001 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

## Annex 2: Summary Provincial Measures (2001)

	Units	Mean	Min	Max	Variation	Gini Coef.
<b>Expenditure Needs Indicators</b>						
Population		6,784,000	778,000	35,501,000	1.398	-
Area	km <sup>2</sup>	64,569	662	414,040	1.266	-
Poverty Gap	index	6	1	25	0.667	-
Construction Costs	index	135	116	212	0.138	-
PC Wage Bill	Rp.*	46,930	4,260	176,950	0.721	0.343
		32,450	-	-	-	-
PC HH Exp	Rp.*	1,995,386	1,244,601	3,733,311	0.268	-
		1,938,202	-	-	-	-
<b>Fiscal Capacity Indicators</b>						
PC RGDP	Rp.*	4,556,350	1,429,580	23,465,080	0.864	0.311
		3,900,720	-	-	-	-
PC Own Taxes (PAD)	Rp.*	22,890	1,740	201,900	1.663	0.497
		21,320	-	-	-	-
PC Shared Revenues (STX)	Rp.*	17,420	3,070	289,010	2.974	0.680
		18,020	-	-	-	-
<i>PC Personal Income Tax (STX-PPh)</i>	<i>Rp.*</i>	<i>8,730</i>	<i>840</i>	<i>172,570</i>	<i>3.56</i>	<i>0.678</i>
		9,700	-	-	-	-
<i>PC Land and Building Tax (STX-PBB)</i>	<i>Rp.*</i>	<i>6,560</i>	<i>1,570</i>	<i>67,370</i>	<i>1.85</i>	<i>0.550</i>
		5,780	-	-	-	-
<i>PC Land Transfer (STX-BPHTB)</i>	<i>Rp.*</i>	<i>2,130</i>	<i>10</i>	<i>49,070</i>	<i>4.17</i>	<i>0.868</i>
		2,540	-	-	-	-
PC Natural Resources (SDA)	Rp.*	24,720	0	376,830	2.99	0.851
		12,600	-	-	-	-
PC Total Revenue (PAD+STX+SDA+DAU+Contingency)	Rps*	133,760	36,270	594,460	1.030	0.426
		86,960	-	-	-	-
PC Gross Provincial Borrowing Capacity	Rps	100,320	27,200	445,850	1.030	0.715
Total Gross Provincial Borrowing Capacity	total Rps billion	491.64	73.38	3,738.37	-	-

**Sources:** \*= Average of LG figures followed by national averages. Data is 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 is from BPS 1999. Own taxes (PAD) are FY 2000, annualized, although refers 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.

### Annex 3: Correlation of DAU 2001 and 2002 allocation with various variables

Dependent Independent	DAU PC* (2001)	DAU PC (2001)	DAU PC^ (2002)	DAU PC (2002)
	(Ia)	(Ib)	(IIa)	(IIc)
FISKPC	0.065 (4.59)	0.080 (5.47)	0.615 (13.48)	0.5992 (19.52)
POP*CST	-0.531 (-28.29)	-0.519 (-26.99)	-0.188 (-5.60)	-0.0454 (-1.96)
AREA*CST	0.048 (3.45)	0.046 (3.27)	-0.027 (-2.55)	-0.0279 (-4.04)
POV*CST	0.149 (6.35)	0.163 (6.80)	0.047 (2.77)	.01315 (1.57)
PC Wage Bill				0.4076 (21.59)
City/Kota	0.069 (1.17)	0.049 (0.81)	-0.096 (-2.41)	-1.1125 (-4.41)
Constant	3.105 (10.61)	2.900 (9.65)	1.720 (6.73)	-4.599 (-13.31)
R <sup>2</sup>	0.808	0.802	0.921	0.967
N	336	336	336	336

**Source :** Hofman, Kajatmiko, Kaiser, 2002

Notes:

All variables are in logarithmic form except dummy (city/Kota). t-stat are reported in brackets. FISKPC refers to own calculation per capita of sum of OSR<sup>est</sup>+ STX + SDA, where OSR<sup>est</sup> is estimates as per the DAU simulations. Population, area, and poverty gap as per DAU 2002 simulations. PC Wage bill are based on Ministry of Finance Estimates for September 2001 used in DAU 2002 simulation. Note that 2001 DAU simulation appears to have used head count poverty index.

These and other regressions are implemented in procs\_dau table A9.

(I) DAU 2001\* Excludes additional contingency payments

(II) ^Adjusted DAU 2002 (without Contingency Fund but has been adjusted by DAU 2001+CF, and ready to distribute). Note that \* as the result of logarithm natural of the variables, some observations disappear (ln 0 = unspecified).

(III) DAU 2002s are for 348 regions. They do not have FISKPC, and the CST of 12 new kotas come from their original source kabupaten