Conference on Fiscal Decentralization

Indonesia: Managing Decentralization

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I. CONTEXT

The Governance and Fiscal Balance Laws,[1] enacted by the Indonesian Parliament in May 1999 aim to decentralize both political and economic power away from the central government after decades of highly centralized and autocratic rule. The new legislation recognizes political reality—Indonesians across the country want greater involvement in the management of their day to day affairs. In particular, the natural resource rich regions want a larger share of the resource pie—which was seen as being preempted and often misused by the elite in Jakarta. Thus the political pressures for decentralization reflect in part the reaction to the demise of an authoritarian regime.

The pressure for decentralization in many parts of the world often is driven by the need for improved service delivery (Dillinger 1994). However, in Indonesia, distinct ethnic and geographic factors have exacerbated the frustration with central domination, and the demand for decentralization is associated more with control over resources and political and legal autonomy than with a perceived need to improve local service delivery.

The conflicting agendas have had a visible hand in defining the implementation of the decentralization program. From the outset, Parliament modified the draft legislation to accommodate demands from producing regions for a share of onshore oil and gas revenues. In addition, the legislation established a floor of 25 percent of domestic revenues (including all oil and gas revenues) for transfers to regions through a General Allocation Fund aimed at supplementing local revenues and equalizing regional needs and revenue capacities. The appeasement of regional interests (especially relating to oil and gas-rich districts) created an inconsistency in the approach. Furthermore, while Law 22/99 remained vague on functions to be transferred and the process to be adopted, Law 25/99 assured financing for sub-national administrations without linking this to delivery of services. This dichotomy increases the risks from decentralization in that financing has been assured before the effective devolution of responsibilities—which may have to continue to be borne by the center.

Decentralization, nevertheless, offers considerable opportunities for better governance. In principle, decentralization could improve the local provision of public goods, tailored to local preferences and local responsibility. Combined with more efficient taxation and spending, this should bring greater prosperity to all regions. To actually realize these benefits, however, international experience suggests that decentralization must be properly sequenced and phased. Ill-sequenced reforms can threaten service delivery and result in "capture by local interests", thereby threatening good governance. Moreover, unless implemented to be fiscally neutral, decentralization could jeopardize Indonesia's hard-earned stabilization by substantially increasing deficits of general government.

[1] Laws 22/1999 and 25/1999, respectively.

There are many different ways to manage the decentralization process. Political realities and the conflicting perspectives on decentralization generally shape the outcome, as is the case in Indonesia. Yet international experience often provides a guide as to appropriate sequencing. This is often the only guide to relevant options since the effects of decisions taken with respect to decentralization may only be fully felt with a relatively long lag. Also the resulting structures may make the overall economy less able to cope with external shocks. The hierarchical relationships that characterize Indonesian society may help offset some of the inherent problems (see Hofstede, 1991). However, it may not be appropriate to rely on such traditional response mechanisms, since it is a moot question as to whether past behavior remains a guide to future responses in a completely different political environment, with conflicting interests and incentives. On a technical level, there is broad agreement among officials in Indonesia that the sequencing of decentralization measures is of critical importance. However, in practice, decision makers have found it expedient to focus on pressing political issues—particularly the pressures for sharing of revenues—without explicit attention to sequencing of decentralization measures.

This paper focuses on the key issues that need to be addressed in order to achieve the desired decentralization in a systematic manner, and thus secure the benefits without endangering either macroeconomic stabilization or Indonesia's territorial integrity.

II. INSTITUTIONAL SETTING

Under Suharto's "new order" regime that governed Indonesia from 1965 through 1999, the country had a very centralized government, albeit with a veneer of decentralization. Law 5/1974 provided the framework for decentralization, but there was little implementation or effective devolution of authority to lower levels of government. Formally, there were three main levels of government consisting of: the central government, 27 provinces and 333 districts. In practice, the center dominated all levels. Indonesia was more a model of deconcentration than of decentralization, with central government exercising significant control over the appointment of local officials and uses of funds by these officials (Shah, 1999).

After decades of highly centralized diktat, the movement toward multiparty elections, particularly at central and district levels, should lay the foundations for greater accountability in government operations and improved efficiency in the delivery of public services.[2] Although the political reforms are important in setting the stage, the sequencing and design

[2]Lower levels of government are known as regions. Provinces are allocated few decentralized responsibilities, and serve as a coordinating layer, but without authority over the tertiary tier, and as agents for the central government for "deconcentrated" central functions. The third tier is composed of districts (also known as regency regions) and municipalities, and will be the main decentralized level of government, with elected regents and mayors. Since provinces are to function also as agents of the center, the appointment of provincial governors requires Presidential approval.

of the devolution of administrative responsibilities and financial arrangements will be critical in ensuring macroeconomic stability and integrity of the Indonesian State.

The Government of President Habibie, which oversaw the enactment of Laws 22/99 and 25/99, was responding to pressures for more autonomy while aware of the fault lines that provincial boundaries might offer to separatists. This explains why the legislation focuses on the decentralization to the district level. [3] This arrangement also suits bureaucrats in Jakarta since the central government is likely to have more influence over relatively weak districts compared with strong provinces. Moreover, the current approach provides the Central Government a natural role to arbitrate between districts and provinces. However, the negative experience with Law 5/1974 led Parliament to impose a tight deadline for implementation (by June 2001)[4] and specified minimum revenues to be transferred.
This mechanism is also seen as a way to diffuse separatist tendencies in the natural resource producing regions. At the same time, to minimize the risk of provincial boundaries serving as fault lines for separatism, the legislation limits the role of provinces to co-ordination and devolves authority and particularly revenues directly to districts.

Law 22/99 assigns all government expenditure functions to districts except for finance, foreign affairs, defense, religion, and state administration.[5] Under Law 22/99, the provinces have no hierarchical authority over districts, and perform largely coordinating tasks. Also, in the transition period, provinces may undertake those tasks that specific districts may not be in a position to perform. Article 11 of Law 22/99 spells out the functions that the district *must* perform—and which cannot be handed back to the province—include education, health care, and local infrastructure.

The election of President Wahid reinforced the dynamics by bringing to the core of Government a stronger commitment for more meaningful decentralization. As a token of his support, the President appointed a State Minister of Regional Autonomy to his new Cabinet.

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[4] In response to pressure from the regions, the present government decided to decentralize the provision and financing of government goods and services in January 2001.

[5] The law mandates exclusive authority for the Central Government over "the fields of international policies, defense and security, judicature, monetary and fiscal, religion, national planning, and macronational development control, financial balance fund, state administration and state economic institutional systems, human resources development, natural resources utilization as well as strategic high technology, conservation, and national standardization."

Despite the backing of the President, progress on implementation was stalled by disagreement on either a “big bang” decentralization to districts (as provided by Laws 22/99 and 25/99), sequenced decentralization to districts, or initial decentralization to the provinces. After some discussion that might have led to a modification of the legislation, leading to decentralization to provinces, the opposition from key players within the Government led to consensus in favor of implementing Laws 22/99 and 25/99 and devolving responsibilities to districts without modification. The differences on strategy and sequencing were matched by rival claims to lead the process. The Ministry of Home Affairs, designated in the Law, was unwilling to yield to the newly created Ministry of Regional Autonomy. As a result of these discussions, the key implementing regulation for Law 22/99 was only signed by the President on May 6, 2000, detailing the remaining functions of central and provincial governments (PP25/00). The functions to be decentralized to districts are thus defined by default.

The President appointed a Coordinating Team (CT) to implement Laws 22/99 and 25/99. The CT was to coordinate the drafting of regulations for implementation on January 1, 2001. A Regional Autonomy Advisory Council (RAAC) is to advise the President on decentralization, while generating consensus among central, provincial, and district authorities. In April 2000, Kepres 49/2000 appointed the Minister of Home Affairs to chair the Regional Autonomy Advisory Council (RAAC) and Kepres 52/2000 the State Minister for Regional Autonomy to chair the CT. The Minister of Finance was vice chairman of both. The RAAC includes the Minister of Regional Autonomy and regional representatives (6 by the Associations of Local Governments and 2 by regional assemblies). The RAAC is serviced by the Ministry of Home Affairs (Head of Secretariat) and has two secretariats headed by senior civil servants: a Fiscal Balance Secretariat led by the Ministry of Finance and a Regional Autonomy Secretariat by the Ministry of Home Affairs.

Following the appointment of his second government in August 2000, the President merged the Ministry of Regional Autonomy into the Ministry of Home Affairs (renamed Ministry of Home Affairs and Regional Autonomy)[6]. This reduces divergences over policy and simplifies co-ordination by firmly establishing the leadership of the Ministry of Home Affairs. Some of the risks are also probably attenuated, given the hierarchical relationship that has existed for many years between the Ministry and the regional governments. This should allow the Central Government to “guide” the local governments during a transitional phase.

In view of the political imperatives, the line of least political resistance remains the implementation of Laws 22/99 and 25/99, imperfections and all. This is why the Ministry has been reluctant to exploit the opportunity provided by the August 2000 session of the

[6] The Coordinating Team was rolled over into a Core Ministerial Group chaired by the Minister of Home Affairs and Regional Autonomy. The Ministry also took over the Chairmanship of the Technical Working Groups (chaired by appropriate technical Ministries) reporting to the CT.

MPR (People's Consultative Assembly—the highest legislative body of Indonesia) which issued decree IV/MPR/2000 allowing a phased implementation of decentralization[7].

III. Issues

Given the political imperatives, the challenge for Indonesia is to draw on the international experience to maximize the benefits and minimize the risks. Litvack, Ahmad and Bird (1998) argue that **design flaws are responsible for failures of decentralization.** Hommes (1995) argues that local governments overspend when they have relative budget autonomy, but do not have to raise taxes to support their spending. Moreover there can be little accountability if local administrations do not have the ability to modify tax rates: they cannot finance additional expenditures from taxation at the margin that impinges on their own residents (Brosio, 1997). The Indonesian case is one where local governments did not have control over rate structures for a major source of revenue, including the property tax. This suggests the importance of reviewing Law 18/97 on local finances to grant regions bounded control over property tax rates and to explore other local tax bases (e.g., a piggyback on the income tax).

Other challenges include: provisions to safeguard public services by building local capacity and pooling skilled technical staff; managing the transition with fiscal neutrality; and establishing an effective budget and public expenditure management system. To achieve these objectives the following three principles should underlie implementing regulations and procedures:

Function should follow capacity; revenue should follow functions; and decentralization should be deficit neutral, i.e., resources transferred from central to district and provincial governments should match the expenditure transferred. If districts fail to deliver assigned services, the central government may need to step in, at a cost to the budget, to avoid service disruptions. This may happen if, for example, districts take responsibility for control of tuberculosis but lack trained staff to follow up with patients. Such improperly sequenced decentralization may lead to a reversal of the decentralization process (Shah, 1999).

If revenue precedes rather than follows functions, local governments will have surplus resources while the central government budget will pay for expenditure functions that should have been decentralized. This could happen if districts receive more revenue and transfers than the cost of additional services, for example, if they fail to pay for secondary schools. In

[7] While the decree sets deadlines for implementation to begin in January 2001, it also explicitly states that regions which are not able to implement full autonomy should do so in stages in accordance with their capabilities.

Colombia, fiscal imbalances partly arose because the central government continued to spend in areas of competence of lower levels of government (Hommes, 1995). This was largely due to the local administrations refusing to take responsibility for teachers and health service workers—who also resisted coming under district control—however the Constitution mandated a level of transfers to the district level.[8] Such cases would breach the principle of deficit neutrality.

Deficit neutrality would suffer with an expansion of spending financed by subnational borrowing based on guaranteed revenue shares or transfers, as has occurred in several countries in Latin America (Ter-Minassian, 1997). To avoid these pitfalls, there have to be sufficient prudential or legal safeguards, especially where capital markets are not sufficiently developed to provide appropriate signals or a disciplining role. Moreover, the Ministry of Finance has to be sufficiently strong. (Von Hagen, 1992). Fortunately, the Indonesian legislation allows this by assigning the finance minister the Chairmanship of the Fiscal Balance Secretariat and it is up to the regulations to further bolster his position to exert fiscal discipline.

IV. The Risks

Macroeconomic imbalances

The main fiscal risk arises from the absence of a clear link between revenue and the cost of the functions being decentralized. The absence of this link could exacerbate macroeconomic instability. The fiscal risks can be assessed based on preliminary estimates that show regional governments will receive approximately 1.3 percent of GDP as shared revenues and a minimum of about 4.0 percent of GDP as GAF transfers—an increase of 1.7 percent of GDP relative to the discretionary transfers (3.6 percent of GDP) in FY2000 (Table 1).

A mismatch between transferred revenues and expenditure functions devolved to regional governments can have serious fiscal implications. For decentralization to be fiscally neutral, the transfer of expenditure responsibilities to regional governments should amount to at least 1.7 percent of GDP. Preliminary estimates suggest that the provinces would need to take on activities equivalent to about 0.3 percent of GDP, whereas the districts would need devolved functions amounting to 1.4 percent of GDP[9].

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[8] Indeed, transfers continue to be made to districts and regions directly or indirectly controlled by guerrillas.

[9] Also see the Annex of Ahmad, Hofman and Mansoor (2000) for a comprehensive assessment of the fiscal implications of Laws 22/99 and 25/99.

Table 1. Indonesia: Impact of the changes in revenue assignment and transfers
(percentage of GDP)

	FY2000	FY2001	Change FY2001-FY2000
Total transfers to regional governments	3.6	5.3	1.7
Shared revenues	…	1.3	…
Discretionary	3.6	…	…
Current	1.9	…	…
Capital	1.7	…	…
Mandatory minimum GAF	…	4.0	…
Contingency	…	0.4	…
Memorandum items:			
Total current expenditure	18.2	15.5	-2.7
Central government	16.3	12.9	-3.4
Local governments	1.9	2.6	0.7
Total personnel	5.1	5.4	0.3
Central government	3.3	2.8	-0.5
Local governments	1.9	2.6	0.7
Total development expenditure	4.2	5.1	0.9
Central government	2.5	2.4	-0.1
Local governments	1.7	2.7	1.0
Oil price (US$/bbl)	*27.0*	*22.0*	
Nominal GDP (Rp trillion)	965.4	1,424.7	
Real GDP growth (in percent)	4.5	5.0	

Source: based on Budget estimates.

In the medium term, once all the functions assigned by Law 22/99 have been decentralized, the transfers would be insufficient to cover costs for virtually all public services (estimated at about 6 to 9 percent of GDP). However, during the transition, particularly in 2001, it may not be possible to decentralize enough staff and development expenditure to absorb the resources being transferred. This is particularly true for the twenty or so districts which benefit from the arrangements for sharing of natural resource based revenue (see below). In these districts, the local authorities may be under irresistible pressures for new, possibly unproductive, spending.

Even after the transition period, a mismatch between the additional transfers and the functions in particular districts or regions could jeopardize continued public services in the majority of districts that do not benefit from the natural resource sharing arrangements and possibly also the transfers as well as some resource rich but sensitive regions.

Expenditure assignments and service delivery

In the Suharto era, Indonesia relied extensively on “deconcentrated” expenditure functions—i.e., most public services provided at the local level at the behest of the center, usually with staff paid for directly by the center. Financing came through a plethora of special purpose grants. [10] Local administrations had little in the way of own-source revenues, and even the property tax was administered by the center and shared with local administrations. The new legislation focuses on devolving expenditures to districts, but is not sufficiently explicit in this regard.

The Governance law 22/99 requires that virtually all functions be transferred to districts in 2001. It contains the only references to the ***devolution of expenditure responsibilities***. These are defined in very general terms, assigning most functions to the regency/district level—including “public works, health, education and culture, agriculture, communications, industry and trade, capital investment, environment, land, cooperative and manpower affairs (Governance Law, Article 11).” There is a recognition in the Ministry of Home Affairs and in other government departments that this very broad allocation of responsibilities does not carry much operational significance, and that a more detailed specification, taking into account administrative capabilities, needs to be developed. The Governance Law accepts that some districts may not be able to perform all the assigned responsibilities—and that these may be reallocated to other districts or to provinces, and associated resources would follow. Since funding for decentralized functions is to be made mainly through a general allocation, and increased reliance on own-source revenues, including user charges, it may be difficult to extract the relevant funds for the reassigned function. Consideration should be given to contracting out services that cannot be provided by a district-level government.

Another issue, insufficiently developed in the present legislation, is the role of the central government in determining policy objectives, such as minimum standards for education, health or the safety net, and the implications these policies may have for financing issues (where these policies affect sectors allocated to lower levels).

Given that in the past most of these public services were performed through “deconcentrated” delivery, a minimum requirement for effective continuation of these services into the “decentralized” era would entail that the deconcentrated staff previously employed by the center needs to be reassigned to district or provincial administrations—depending on the level of administration assigned the relevant functions. However, there have been difficulties in attempting to “unload” centrally paid staff onto local administrations.

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[10] See Anwar Shah et al., 1994, *Intergovernmental fiscal relations in Indonesia: Issues and Reform Options,* World Bank Discussion Paper 239.

The main difficulty has been transferring staff to district administrations. First, staff show resistance to permanent assignment to district level jurisdictions, with which they may have little in the way of ties. Second, there has also reportedly been resistance to take on the previously deconcentrated staff by the recipient regions, partly because these staff tended to represent Jakarta.. However, replacing the entire staff providing current central or deconcentrated functions may not be feasible in the short-to-medium term. In the present context of high unemployment, it may not be easy for these staff to find employment in the private sector, thus the center may have to continue to foot their wage bill. Recent pay increases that have erased pay differentials of the public sector with the private sector, make government employment very attractive. To compound the problem, most civil servants outside Jakarta are in provincial capitals and may resist being relocated to districts with even fewer amenities. Moreover, it is unlikely that the replacement staff hired in the districts would have the requisite skills to ensure effective and continued service delivery.

In the short run, appropriate sequencing would suggest that the functions, together with the requisite staff, be devolved to the districts and provinces, and that the transfers be sufficient to cover these costs. In the medium term, the devolution of functions provides an opportunity to evaluate improvements in the efficiency of existing public programs, reorienting them more toward the poor, and improving their delivery including through greater private sector participation. This should then become the foundation for more efficient service delivery. This sequencing to changing employment patterns is contentious because local governments see decentralization as a means of creating jobs for locals.

Reflecting the absence of adequate attention, expenditure assignments were approached through a negative list approach. Government Regulation 25/00 issued in early May 2000 specified the functions to be performed by the center and by provinces and left, by default, anything not specified to the districts. It is only in September 2000 that some attention was paid to precisely what services each district would be expected to take over. Even now, no proper costing of services to be taken over has been carried out and this is unlikely to occur before decentralization is implemented on January 1, 2001.

One consequence of this lack of attention to continuation of service delivery is that the Central Government is likely to face a large bill for social expenditure on *subsidies, social safety nets, and poverty alleviation programs*, that under Law 22/99 are the responsibility of the districts. To address this problem, the National Planning Board (BAPPENAS) would need to formulate proposals to transfer these functions to the districts. This should include transitional arrangements, to be endorsed by the RAAC, to make districts pay at least a share of the cost of these programs through their General Allocation Fund allocation. In parallel, line ministries should cost functions to be transferred.

Drawing on the input, the RAAC should put in place transitional arrangements to guarantee the smooth transfer of personnel, physical assets, development expenditures, and social safety net/poverty alleviation programs. The MOF should present the RAAC and Parliament with an early assessment of the fiscal imbalances associated with the adopted GAF.[11] The RAAC should consider redesigning the formula and replacing it with one that limits the fiscal imbalances. However, it is unclear if any of these steps can be completed prior to implementation in January 1, 2001 nor whether the political process would accommodate required change.

Indeed, the political process that has driven decentralization makes it difficult, at least initially, for Indonesia to seize the potential welfare gains from improved service delivery more attuned to local needs. Instead, this lack of planning of expenditure assignments raises risks to service delivery.

In response to the approaching deadline, the authorities have belatedly requested districts to provide a self-assessment of their capacity to deliver services. To manage the transition, they are also, informally, relying on their powers of moral suasion, particularly the influence of the Ministry of Home Affairs and Regional Autonomy. Thus, a process that should have been driven by local consultations may in the end require strong central direction to enable a smooth transfer of services.

Arrangements for Financial Management

In the centralized model of the Suharto era, there was little need to develop a capacity for local financial management. Since most of the financing was through special purpose grants administered by centrally appointed officials, there was little attention paid to information on actual current spending—this was generally put together by the Ministry of Home Affairs and made available to the Ministry of Finance with a substantial lag, usually up to two years for expenditures at the district level. The current system is overly centralized, lacks transparency and the flow of information is not timely nor suited to provide early warning signals when corrective action might be warranted.

These issues have been even more neglected than expenditure assignments. As a result, the central authorities may be unable to monitor outlays, assess the needs of districts and track the use of transfers. The absence of appropriate budget information systems adds to the risks of a breakdown in service delivery.

To address this gap in preparations for decentralization, the Central Government should coordinate reform to minimize risks of a breakdown in budget management. Given the short time before implementation, districts may need to adopt interim arrangements resting on existing Central Government systems.

[11] On September 28, 2000 the RAAC chose the formula for allocating the GAF, but data are not yet available to assess the size of the fiscal gap. Currently, a working group in the MOF is in the process of refining the formula, and a final decision on the GAF individual allocation will be made in November.

Unfortunately, even the expenditure management system at the center is weak, with numerous extrabudgetary funds and poor cash management, accentuating a lack of transparency that has led to numerous avenues for the misuse of resources. The center is at present attempting to strengthen its treasury functions and the functioning of a treasury single account. Once the central treasury is fully functional, its could provide services also to district level administrations that may lack the resources to establish independent treasury and payment systems of their own.

The lack of transparency in public expenditure management at the center threatens to complicate the revenue-sharing arrangements, and there is evidently considerable scope for disagreement. Reform needs to focus on monitoring and control to minimize possibilities of mismanagement or graft and to provide early warning of potential disruption in public service delivery.

The center will also need to establish standard budgeting, auditing, and reporting procedures for all local budgets and mechanisms to monitor the sharing of natural resources revenue and transfers.[12] Central Government should require sub-national governments to adopt its mechanisms for enhancing transparency and accountability.

For effective monitoring of special purpose transfers, the center would need to establish the performance it is expecting from local governments for each devolved function. To complement action at the sub-national level, central government will need to reform its budgeting and financial management interface with sub-national governments and modify its monitoring of sub-national governments including minimum reporting standards. It will be important also to develop mechanisms to smooth out fluctuations in revenue, given the relative weight of sharing of natural resource revenues, another neglected area that also increases risks of service disruption.

The fact that there are no safeguards against excessive sub-national borrowing is particularly worrying, especially given the contingent liabilities facing the center and the overall level of general government debt at the present time.

To help monitor fiscal decentralization during the execution of the budget, regulations should be issued to link the release of revenue sharing and General Allocation Fund allocations to the submission of reports on district/provincial budget execution, and to sanction districts and provinces that fail to submit timely, accurate, and comprehensive fiscal reports. In addition, the BAPPENAS should put in place a system to monitor development and social spending at the district level.

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[12] The General Allocation Fund (GAF) and Special Allocations.

Subnational taxes and charges[13]

Provincial and local taxes and charges are principally regulated by Law m 18 of 1997 (Law on Regional Government Taxes and Charges) which came into effect during 1998, which rationalized local taxes and eliminated a number of nonproductive taxes and charges. Under the law, the following three taxes are assigned to provincial governments: motor vehicles transfer tax; motor vehicles registration tax; and fuel tax. The rates for these taxes are set by the central government, within ranges specified in the law. The motor vehicle transfer tax, the largest source of provincial tax revenue, is levied at the time of resale of a motor vehicle. Currently, the first sale is taxed at 10 percent of the value, while subsequent sales are taxed at 1 percent of the value. The motor vehicle tax is an annual tax on the value of the vehicle. The current tax rate is 1.5 percent. For both taxes, the determination of value is done by the MOHA periodically and made available to provincial governments who then collect the tax. The fuel tax is a new provincial levy at 5 percent shared with district governments.

District governments are authorized under the Law to levy a number of small taxes: hotel and restaurant tax; entertainment tax; advertisement tax; street lighting tax; base mineral extraction tax; and water tax. Districts have some flexibility in choosing rates for these taxes within specified maxima, but changes must be approved by the MOHA after consultation with the MOF.[14]

Although districts receive most of the revenues from the land and property tax, they have no control over the rate structure and it is like a shared-source of revenue administered by the center. The complicated sharing arrangements for the land and property tax are designed to introduce “equalization” elements into the tax. However, this equalization function would become redundant when there is a much larger general allocation transfer (far exceeding the combined revenues from the land and property tax) that is also to be distributed on the basis of “equalization” principles.

The Fiscal Balance Law 25/1999 also introduced revenue sharing for oil and gas. For onshore oil, 15 percent of non-tax revenues are to be distributed to subnational governments, of which 3 percent to the producing province, 6 percent to the producing district and 6 percent to be shared by non-producing districts in the producing province. For on-shore gas, 30 percent of the non-tax revenues is to be shared, of which 6 percent to the producing province, 12 percent to the producing district and 12 percent to the non-producing districts in the producing province. This formulation is relatively opaque, further complicated by the inclusion of off-shore oil within 12 miles. Also, the non-producing provinces may need to be

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[13] This section is largely based on Ahmad and Krelove (2000).

[14] In addition, Article 2 of the law allows local and provincial governments to introduce new taxes by local regulation, subject to approval by the MOHA, provided they meet a number of criteria.

compensated by an "equalization" transfer system that reduces the inter-regional disparities created by the oil and gas sharing formula.

This arrangement is opaque, subjects the local producing governments to the full variance in international oil and gas prices, and may be implemented before the expenditure devolution is effective, thereby providing revenues to some districts that they may not be able to use effectively. In the absence of effective safeguards and monitoring mechanisms, the possibilities for misuse of resources are magnified.

It is not a priori evident that the sharing of resources with a producing region will in itself satisfy the aspirations of separatists—since by definition they would do better if the resource were fully assigned to the region. Thus, for the center and the producing regions it may be difficult to establish the politically acceptable level of resource-sharing, particularly of oil and gas revenues, and there is plenty of scope for building up further resentments. National unity would thus have to rest on other factors, such as the services that the center could provide with greater efficiency, national defense and identity.

In addition to adding to "unsatisfied aspirations", the sharing of oil and gas could:

- actually widen regional disparities (see below);
- prove difficult to administer, particularly at district level, as volatile oil prices lead to a divergence between budgets and realized revenues;
- in some cases may provide more revenues to non-producing districts in a province than producing districts;[15] and
- complicate the functioning of a grants system.

V. The Decentralization Legislation Laws 22 and 25—An Evaluation [16]

Macroeconomic Context

Ahmad, Hofman and Mansoor (2000) provide an illustrative scenario of the macroeconomic effects of the proposed decentralization of public finances to the regional level. Many of the calculations are based on assumptions rather than stated policies, and the results should

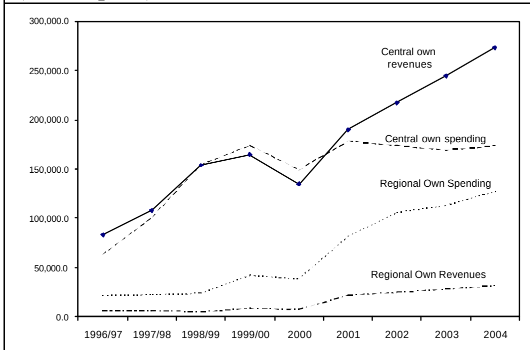
[15] This would depend on the number of non-producing districts receiving transfers relative to the number of producing districts in a province.

[16] This section draws on Ahmad, Hofman and Mansoor (2000).

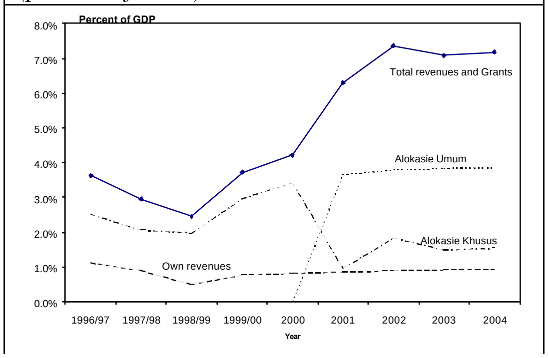
therefore be interpreted with great care. For simplification, regional government is treated as one level.

The regional share of general government spending will eventually more than double to over 40 percent with full implementation (Fig.1). Some 60 percent of the development budget will be managed at subnational levels. Under the framework, the districts will manage most of the Government's services, including health, education, and infrastructure. Regional tax revenues, however, will rise only slightly, and the difference be made up by grants from central to regional governments. The largest component is the General Grant (*Alokasie Umum*) which will consist of least 25 percent of domestic revenues (Fig. 2).

Figure 1: Impact of Decentralization
(Bn. Rupiah)



A. Figure 2: Regional Revenues
(percent of GDP)



The general grant and regional own resources will have to cover some of the development expenditures devolved to the regions. Overall, regional development spending will rise to some 4 percent, whereas specific grants from central government are unlikely to be higher than 2 percent of GDP. The general grant of some 3.8 percent of GDP will cover personnel spending (2.5 percent) but then leaves only 1.3 percent of GDP as a contribution to development spending. Thus some 0.7 percent of GDP will have to be covered by own revenue sources, and borrowing. For regions with oil, gas, or forestry, this is undoubtedly easier to than for those without natural resources.

For now, the assumption in the projections is *no* local borrowing. The implicit assumption here is that international borrowing is done by the center, and passed on to the province as a specific grant. This is not a realistic assumption, but it is likely that—if the regions can borrow from abroad—their special grants would be reduced. Any domestic borrowing is not taken into account in the projections. Own revenues may increase in the future (e.g., by devolving control over the rate structure of the land and building tax) but this is likely to be offset by a cut in special grants.

Vertical fiscal imbalances

Using data from the state budget and estimated provincial and district budgets for 1999/2000, three scenarios are undertaken:

(1) "*Current policy*," as implied by the 1999/2000 central and subnational budgets;

(2) "New policy under existing expenditure assignment," which shows the additional budgetary deficit or surplus that would be generated by the implementation of the Governance Law at each level of the government, if the existing division of expenditure responsibilities is unchanged; and

(3) "*New policy under reassignment of expenditure responsibilities*," which shows the extent to which central government expenditure responsibilities have to be devolved to local levels, if each level of the government is to maintain its current level of fiscal deficit.

The simulation results (see Table 2) suggest the following:

- The rules for oil and gas revenue sharing and general allocation **will significantly increase the central government deficit** (or require a sharp reduction in central government expenditure).[17]

- Under the current expenditure assignments and budget estimates for 1999/2000, the implementation of the new legislation will lead to an increase in the central government deficit of about 1.2 percent of GDP, as a result of the oil and gas revenue sharing (about Rp 2 trillion for subnational governments) and a sharp increase in general allocation (about Rp 12 trillion). [18] Alternatively, if the central government is to maintain the budgeted level of deficit, it has to transfer expenditure responsibilities of about Rp. 14 trillion to lower level governments in 1999/2000 terms.

[17] Note that the government's medium-term fiscal objective is to restore budgetary balance.

[18] Note that the amounts to be transferred are a function of the oil price, which has risen from $10.5 per barrel (assumed in the 1999/2000 budget estimate) to over $30 per barrel by mid- 2000. A US$1 per barrel increase results in a 0.1 percent of GDP increase in revenue net of oil subsidies, most of which is transferred to the local governments.

Table 2. Impact of the Fiscal Balance Law on 1999/2000 data (in billions of rupiah)

		New Policy	
	Current Policy l/	Current expenditure assignment 2/	Reassignment of expenditure responsibilities 3/
Central government			
Domestic revenue	142,204	142,204	14,204
Expenditure and transfer	219,604	231,518	217,694
Expenditure	190,337	190,337	176,513
Transfers	29,267	41,181	41,181
General allocation	23,637	35,551	35,551
Special allocation	5,630	5,630	5,630
Oil and gas sharing	0	1,910	1,910
Deficit	77,400	91,224	77,400
Provinces (excl. Jakarta)			
Revenue and transfer	9,068	9,283	9,283
Own and shared revenue	3,661	3,661	3,661
Oil and gas revenue	0	382	382
Transfers	5,408	5,240	5,240
General allocation	3,687	3,520	3,520
Special allocation	1,721	1,721	1,721
Expenditure	9,068	9,068	9,283
Deficit	0	(215)	0
Districts and lower (excl. Jakarta)			
Revenue and transfer	29,205	42,695	42,695
Own and shared revenue	5,700	5,700	5,700
Oil and gas revenue	0	1,528	1,528
Transfers	23,505	35,467	35,467
General allocation	19,714	31,676	31,676
Special allocation	3,791	3,791	3,791
Expenditure	29,205	29,205	42,695
Deficit	0	(13,490)	0
		(In percent)	
Memorandum items:			
General allocation as percent of domestic revenue	16.6	25.0	25.0
Provincial general allocation as percent of total general allocation	15.6	9.9	9.9
District general allocation as percent of total general allocation	83.4	89.1	89.1
General allocation to Jakarta as			1.0
percent of total general allocation	1.0	1.0	
		(In billions of rupiah)	
General allocation to Jakarta	236	356	356
Special allocation to Jakarta	118	118	118

Sources:Ahmad, Hofman and Mansoor, 2000.

1/ Provincial and district level data for “current policy” are estimates based on 1998/99 budget data and previous years’ budget outcomes, and do not necessarily match the 1999/2000 budgets
2/ Under existing expenditure assignment, deficit is treated as residual.
3/ Under reassignment of expenditure responsibilities, expenditure at each level of government is adjusted to maintain the budgeted level of deficit.

- The revenue sharing and general allocation rules will lead to a **drastic increase in fiscal transfers to district** level governments. Under the current expenditure assignment, this implies a budget surplus at the district level of about Rp 13.5 trillion, as a result of the sharing of oil and gas revenue by districts (about Rp 1.5 trillion) and the sharp increase in general allocation to districts (about Rp 12 trillion). If the higher level governments are to maintain the deficit levels in the current budget, district governments will have to take over expenditure responsibilities of about Rp 13.5 trillion, a nearly 50 percent increase from the current level.

- If the specific purpose grants under the Regional Development Funds are included in the definition of general allocation (25 percent of domestic revenue), the magnitude of the change in vertical imbalance implied by the Law can be reduced by about Rp 5.5 trillion. In other words, the required transfer of expenditure responsibilities under Scenario 3 will be about Rp 8 billion, rather than Rp 13.5 trillion.

Existing horizontal imbalances

Indonesian local governments' capacities to raise revenue from their own sources and revenue-sharing arrangements vary significantly. In 1996/97, per capita own-source revenue and shared revenue in East Kalimantan (including provincial and district levels) was 5.4 times that in Nusa Tenggara Barat. If Jakarta is included in this comparison, the ratio of maximum to minimum level of per capita own-source and shared revenue among provinces would reach 27.

Local expenditure needs also differ vastly across provinces and districts. For example, at the provincial level, life expectancy ranged from 55 years in East Nusa Tenggara to 70 years in Jakarta in 1997; poor quality roads as a proportion of the total length of provincial roads ranged from 24 percent in Sulawesi Selatan to 70 percent in Kalimantan Barat in 1997.[19] It is expected that even larger variations in expenditure needs exist across districts and municipalities.

The current intergovernmental transfer mechanisms, including the Regional Development Funds and Routine Expenditure Funds for decentralized staff salaries (SDOs), contain some elements that are designed to equalize revenue capacities and compensate for differences in expenditure needs across regions. However, the **transfer system is highly segmented**, with many subprograms distributed on a range of different, and sometimes conflicting criteria, resulting in a very weak equalization effect on local governments' abilities to provide public services, and may even be **disequalizing** when measured by revenue capacity.

Using provincial data, simple regressions show that the per capita transfer to provinces in 1997/98 was positively related to per capita own-source and shared revenues (Chart 1), and had no statistically significant relationship with per capita GDP.[20] A similar analysis using district level data for 1996/97 suggests that per capita transfers to districts were significantly and positively correlated with per capital own source and shared revenues and had no relation with per capita GDP.

The Fiscal Balance Law and horizontal (dis)equalization

The sharing of oil and gas revenue, as required by the Fiscal Balance Law, would further disequalize regional revenue capacities, as the sources of oil and gas revenue concentrate in a small number of provinces and districts. According to the Law, three percent of onshore oil revenue will be distributed to provincial governments based on production origin, six percent will be distributed to the producing districts, and the other six percent will be distributed to non-producing districts in the producing province. Similarly, six percent of onshore gas revenue will be distributed to provincial governments based on production origin, 12 percent will be distributed to the producing districts, and the other 12 percent will be distributed to non-producing districts in the producing province.[21] Based on very conservative assumptions of oil and gas prices, it is estimated that, if the Law were implemented for the 1999/2000 budget, about Rp 2 trillion would be distributed to local governments as a result of the oil and gas revenue sharing, and three provinces (Riau, East Kalimantan, and Di Aceh) would receive about 82 percent of the total local share. For Riau and Di Aceh, the provincial governments' oil and gas receipts would amount to 70-80 percent of their existing revenue capacities. In the meantime, 21 provinces would receive zero or near zero oil and gas revenue (see Table 3).

[20]Per capita GDP is sometimes used as a proxy of revenue capacity, or a partial indicator for social and development expenditure need.

[21]The Law, however, does not specify the method for distributing the 6 percent oil revenue and 12 percent gas revenue to non-producing districts.

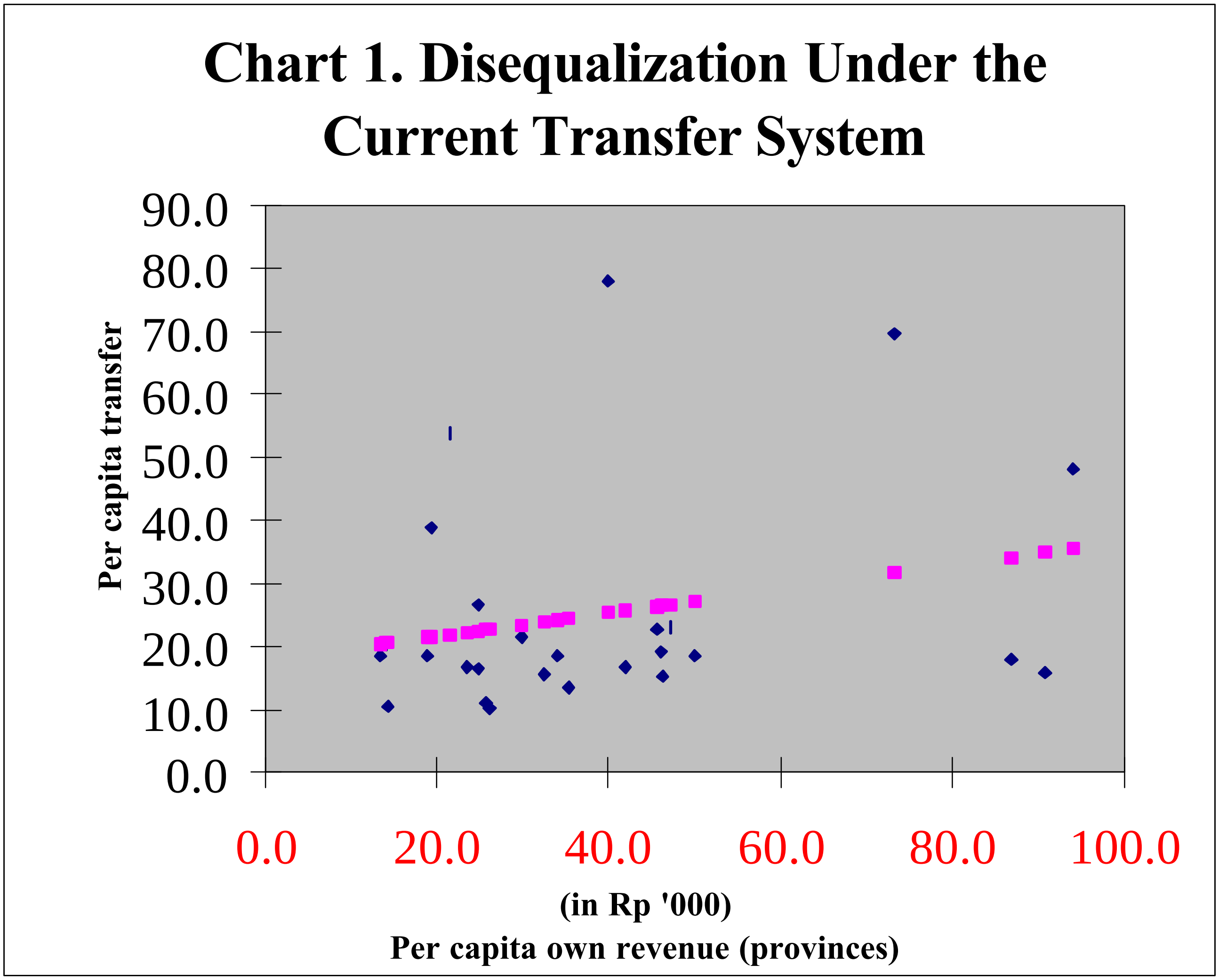


Chart 1. Disequalization Under the Current Transfer System
Per capita transfer
90.0
80.0
70.0
60.0
50.0
40.0
30.0
20.0
10.0
0.0
0.0
20.0
40.0
60.0
80.0
100.0
(in Rp '000)
Per capita own revenue (provinces)

Table 3. Revenue Capacities of Provincial Governments, 1999/2000

(In thousands of rupiah)

	Per Capita Existing Revenue Capacity	Per Capita Oil and Gas Revenue	Per Capita Total Revenue Capacity
Dista Aceh	18.99	16.60	35.59
Sumatera Utara	22.66	0.11	22.77
Sumatera Barat	18.65	0.00	18.65
Riau	53.71	40.58	94.29
Jambi	21.57	1.54	23.10
Sumatera Selatan	20.29	2.88	23.16
Bengkulu	18.56	0.00	18.56
Lampung	10.38	0.00	10.38
Jawa Barat	16.83	0.67	17.50
Jawa Tengah	13.31	0.00	13.31
DI. Yogyakarta	22.99	0.00	22.99
Jawa Timur	18.40	0.36	18.77
Kalimantan Barat	16.57	0.00	16.57
Kalimantan Tengah	48.10	0.00	48.10
Kalimantan Selatan	26.69	0.00	26.69
Kalimantan Timur	78.01	39.49	117.49
Sulawesi Utara	15.50	0.00	15.50
Sulawesi Tengah	18.03	0.00	18.03
Sulawesi Selatan	18.52	0.03	18.55
Sulawesi Tenggara	15.39	0.00	15.39
Bali	38.97	0.00	38.97
Nusa Tenggara Barat	11.08	0.00	11.08
Nusa Tenggara Timur	10.28	0.00	10.28
Maluku	16.77	0.06	16.83
Irian Jaya	69.60	1.99	71.59
Mean	25.2	4.0	29.2
Standard deviation	17.8	11.1	26.3
Coefficient of variation	0.70	2.77	0.90

Sources: Ahmad, Hofman and Mansoor, 2000.

Note: Jakarta is excluded from the above table as available statistics do not distinguish between its provincial and district functions.

To assess the extent to which the sharing of oil and gas revenue would exacerbate the distribution of revenue capacities, we calculated the coefficient of variations of per capita provincial revenue (including from own sources and shared sources) before and after the oil and gas revenue sharing. Preliminary results show that the coefficient of variations across 26 provinces (excluding Jakarta) would increase from 70 percent to 90 percent due to the oil and gas revenue sharing. In other words, the average deviation of per capita revenue capacity from the national mean would rise by nearly 30 percent (see Table 3).

The Law requires that an equalization transfer program—the general allocation—be set up to offset, at least partially, the existing and newly created revenue disparity. As the formula for the general allocation has not been determined, it is difficult to measure its impact on regional equality.

Despite the obvious need for an equalization transfer, care has to be taken to ensure that the initial allocation of funds does not vary too greatly from the distribution of public service expenditures—to prevent a major disruption in the delivery of such services.

General conclusions that emerge from the above analyses are that:

- **The magnitude of expenditure devolution required by the Law would be overwhelming,** especially considering the very limited administrative capacities at the district level.

- **To achieve the legally mandated degree of decentralization will surely take much longer than one year.**

- Implementing the proposed oil and gas revenue sharing and a full 25 percent of domestic services for general allocation in the next budget ahead of expenditure devolution, is likely to **lead to a substantially larger fiscal deficit at the central level**, as lower level governments are not ready to absorb fully their mandated responsibilities.

- **If this process is not managed with prudence and skills, it could pose a threat to macroeconomic stability.** Oil and gas shares and moves toward a larger share of domestic revenues for the general allocation should be gradually phased in over a period of time.

- **With weak management and uncertain political accountability at the local level, there is potential for "capture of funds" by interest groups.**

Concluding remarks

It is understandable that there has been a focus on control over and access to natural resource revenues in the first stages of the decentralization and political liberalization processes. However, the discussion now should focus on service delivery and fiscal equalization as the “cement” to keep the nation together.

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