

Georgia State University

ScholarWorks @ Georgia State University

ECON Publications

Department of Economics

2001

Can Indonesia Decentralise Successfully? Plans, Problems and Prospects

James Alm

Tulane University of Louisiana, jalm@tulane.edu

Robert H. Aten

Roy W. Bahl

Georgia State University, rbahl@gsu.edu

Follow this and additional works at: https://scholarworks.gsu.edu/econ_facpub



Part of the [Economics Commons](#)

Recommended Citation

Alm, James, Robert H. Aten, and Roy Bahl. 2001. "Can Indonesia Decentralise Successfully? Plans, Problems and Prospects." *Bulletin of Indonesian Economic Studies* 37 (1): 83–102. <https://doi.org/10.1080/000749101300046537>

This Article is brought to you for free and open access by the Department of Economics at ScholarWorks @ Georgia State University. It has been accepted for inclusion in ECON Publications by an authorized administrator of ScholarWorks @ Georgia State University. For more information, please contact scholarworks@gsu.edu.

CAN INDONESIA DECENTRALISE SUCCESSFULLY? PLANS, PROBLEMS AND PROSPECTS

James Alm

Andrew Young School of Policy Studies, Georgia State University, Atlanta

Robert H. Aten

United States Agency for International Development, Jakarta

Roy Bahl*

Andrew Young School of Policy Studies, Georgia State University, Atlanta

Indonesia is engaged in an unprecedented social and economic experiment. Responsibility for much government expenditure is being decentralised, largely to local (district) rather than to provincial governments. If this process is successful, the world's most centralised large country could become one of its most decentralised. This paper considers the issues arising as preparations for decentralisation are finalised, and as the socialisation of its plans and practices is considered by the central government, the People's Representative Council, the decentralised units of government, and the public. These issues were identified partly through interviews with local government officials. They include policy and administrative matters yet to be resolved, such as local budgeting, financial management and auditing practices, personnel decentralisation, local taxation, borrowing by local governments, and the match between revenues and expenditures. A major theme is the importance of a continuing national and local discussion on the goals and processes of decentralisation.

For nearly 50 years, Indonesia has been a multitiered unitary state, with provinces as the second tier below the centre, and local (district) governments as the third tier.¹ The centralization of authority in Jakarta was long justified as a way of maintaining national unity in a nation now of over 200 million people, spread across about 14,000 islands and 2 million square kilometres; it was also in part a reaction to efforts by the former Dutch colonial power to impose federalism in a last bid to control the newly independent Indonesia. Now, however, the government is undertaking a major program of decentralisation. In May 1999, two laws on various aspects of decentralisation were passed: Law No. 22/ 1999 on Regional Government (UU PD) and Law No. 25/1999 on the Fiscal Balance between the Central Government and the Regions (UU PKPD).

Their implementation is far advanced, and these laws and their implementing regulations promise to transform intergovernmental fiscal relations in Indonesia.

In many respects, Indonesia's intergovernmental system to date makes it an international outlier: it has many of the characteristics of countries that typically choose decentralisation as an economic framework, but until now it has opted to remain a highly centralised state. While their findings are far from definitive, empirical studies on the determinants of fiscal decentralisation tend to show that decentralisation is greater in countries that have larger populations and land areas, more diverse populations, and higher levels of economic development (Bahl and Nath 1986).² On these grounds, Indonesia is a good candidate for fiscal decentralisation, and should in fact exhibit much more decentralisation than has occurred to date. The main feature of Indonesia that, in the experience of other countries, typically argues for greater centralisation is civil unrest: countries at war, close to war, or fearing internal military strife tend to be more centralised. This is an argument made by some for Indonesia's long history of centralised government. Turmoil in such provinces as Aceh and Irian Jaya, and in the former province of East Timor, has often been used to justify continued centralisation of authority.

The government is now embarked upon a major program of fiscal decentralisation. Our purpose in this paper is to examine this program. We base our analysis largely on a series of interviews with officials at all levels of government, conducted over the period since the decentralisation laws were passed; we have also had extensive discussions on these issues with individuals in the private sector, in academia and in international agencies. A strong political imperative for decentralisation is already in place, supported by clear views on the part of the government. Implementation of the new program has already begun. There is no way of stopping this process, and indeed we believe that it should not be stopped.

In the next section, we outline the major features of the program. We then discuss the general process that is leading the reform program. Next we focus upon specific problems in the implementation of the reforms, problems that could compromise the achievement of their objectives. We then present specific suggestions for improving the process, and offer conclusions.

THE NATURE OF INDONESIA'S DECENTRALISATION

It may be useful at the start to clarify some of our terms (Bird and Vaillancourt 1998). 'Decentralisation' is used here to denote the transfer of significant degrees of authority and responsibility for governmental expenditures and revenues from the central government to lower levels of government. In contrast, 'deconcentration' occurs when central government functions are dispersed to central government offices located in provinces, cities or other local areas, but these functions remain the responsibility of the central government.

Until the passage of the recent reforms, the practice in Indonesia has been largely one of deconcentration, not decentralisation. In the highly centralised multitiered unitary state that has existed since the 1950s, with provinces and then local governments as the tiers under the central government, many government functions have been performed by deconcentrated central government agencies in provinces and districts (Shah and Qureshi 1994; Booth 1996;

Aten 1999). Laws No. 22/1999 and 25/1999, when fully implemented, will change this organisation in several fundamental ways. *First*, Law No. 22/1999 on Regional Government (UU PD) eliminates the hierarchical relationship between the provincial and the district governments. The district governments – called *kota* (municipality) and *kabupaten* (district or regency) – will become fully autonomous, so that their heads (respectively, the mayor or *walikota* and the district head or *bupati*) will no longer report to the governor of the province. Instead, the district heads will be responsible to the locally elected assembly (Dewan Perwakilan Rakyat Daerah, or DPRD). In contrast, the provinces will retain a hierarchical relationship with the central government.

Second, with some limited exceptions, Law No. 22/1999 also makes all deconcentrated central government ministry offices at the province and the district level the responsibility of the respective subnational governments; the exceptions are those for defence and security, foreign policy, monetary and fiscal policy, and judicial and religious affairs. In the current system, the central government and its ministries have deconcentrated departments called *kantor wilayah* (*kanwil*) at the provincial level; in some cases, the *kanwil* has a sub-branch at the district (or subdistrict) level called a *kantor departemen* (*kandep*). The province has its own Regional Planning Agency (Bappeda) and various autonomous ‘decentralised’ departments (or *dinas*) under its own control, generally dealing with own revenues (*dinas pendapatan daerah*, or *dipenda*), and with education and culture, health, public works, traffic management, agriculture, livestock, fisheries, forestry, plantations, industry, social welfare, labour, and tourism, all of which have central government counterparts in the deconcentrated *kanwil*; the province may also have branch offices (called *cabang dinas*) at the district level, although this is apparently not common. Like provinces, districts have an autonomous decentralised department in charge of own revenues (again, called a *dipenda*), and they generally have departments (*dinas*) for services like health and public works, although the range of these departments depends upon the size and location of the district. In the new system, the deconcentrated central government departments at the provincial level will become the responsibility of the province, and those at the district level will be turned over to the district. This change promises a major reorganisation in the way public services are delivered in Indonesia.

Third, Law No. 25/1999 on the Fiscal Balance between the Central Government and the Regions alters the transfers received by local governments from the central government. The routine transfer that was largely used to pay the salaries of local civil servants (the Subsidi Daerah Otonom, or SDO) has been eliminated; also eliminated are general development transfers known as block Instruksi Presiden, or block Inpres. These two transfers have been combined into a general allocation fund whose total amount is specified as at least 25% of central government domestic revenues and whose distribution among local governments is determined by formulae designed by the central government (McLeod 2000: 36–7). Law No. 25/1999 also introduces revenue sharing for provincial and district governments, assigning each level of government its share of revenues from taxes on land and buildings, the transfer of land and buildings, forestry, mining, fisheries, oil, and gas. Other local government sources of revenue (e.g. own source revenues, fees and charges, profits from government enterprises, borrowing) are largely unchanged, as are revenues from specific Inpres grants used to finance development projects in areas such as primary schools, health facilities, water supply, and roads; this feature of the decentralisation is discussed in more detail later.³ Borrowing is to be permitted from within Indonesia, although this practice is viewed with some concern by international agencies.

The two decentralisation laws are beginning to transform intergovernmental relations in Indonesia. In particular, and together with the 1999 elections held at the province and district levels, the laws and the related implementation process have the potential to increase significantly the accountability of local government officials. It is this accountability that offers the major advantage of decentralisation: moving government closer to the people (Oates 1972, 1999). Because of Indonesia's democracy reforms, the leaders of the local governments – the governor at the provincial level, the *bupati* at the *kabupaten*, and the *walikota* at the *kota* – are now being chosen by the respective elected legislatures (although not directly by the voters), rather than appointed from above. As a result, their responsibility will be directed downward to the elected legislature and not upward to the central government. The assignment of significant new expenditure responsibilities to provincial and especially to *kota/ kabupaten* governments has the potential to achieve the efficiency gains that come when a government's decisions are more responsive to the wishes of its citizens, so that public services are provided in amounts that correspond more closely to the preferences of the individuals in those jurisdictions, rather than at uniform national levels. Other potential gains include greater revenue mobilisation because citizens may be more willing to pay local taxes to provide local public services and because local governments may be more familiar with, and so better able to tax, local tax bases.

Of course, there are many government functions that need to be performed by the central government, especially those related to macroeconomic stabilisation and income distribution, including the equalisation of fiscal capacities across local jurisdictions; national defence and foreign policy are also duties best retained by the central government. There are also natural regional functions (e.g. universities, large hospitals, trunk roads). However, many other functions are appropriately assigned to governments that are closer to the people: primary and secondary education, health clinics, local and regional roads, local police, water and sewerage systems, and the like. There may well be a national role in the establishment of standards for these services, in order to ensure minimum provision requirements and, perhaps, to facilitate national integration (e.g. the use of a common language, *bahasa Indonesia*). However, there is no necessity to prescribe all details at the national level, since local officials can readily deal with many matters more efficiently, quickly, and responsively.

There are therefore many functions of government that should be carried out at the provincial or the district level, rather than at the central level. In most cases, it is precisely these functions that are being assigned to provincial and district governments. The decentralisation laws and their implementing regulations are meant to carry out a proper sorting of the assignment of expenditure responsibilities. If successful, they have the potential eventually to generate significant gains for the people of Indonesia.

THE PROCESS AND GOALS OF DECENTRALISATION

The government has taken a politically expedient path in developing its decentralisation policy. The first step in most successful decentralisations is the establishment of an official general framework within which the broad goals of the reforms are articulated and agreed upon. This step was insufficiently carried out in Indonesia. Instead, the government moved directly to drafting decentralisation laws and the implementing regulations that go with these laws.

One must be sympathetic with the strategy of moving quickly to the implementation of decentralisation, and indeed it seems impossible – and, we believe, undesirable – that a process already under way should be stopped in its tracks. Despite the political necessity for the strategy, however, this kind of shortcut raises several questions. Is the government clear about what it wants to achieve through decentralisation? Is there widespread support within the government, the People’s Representative Council (DPR), and the society as a whole for these objectives? Is the decentralisation strategy that is moving forward a well thought-out plan, or is it more of an idea in its infancy, with many unanswered questions about its structure? Can the decentralisation that began in January 2001 be sustained?

As noted, the first step in successful decentralisations is a clear statement of the objectives of the reforms. However, there is little evidence of any such statement. Discussions with various government officials indicate that the policy has been under discussion for two decades, mainly in the Ministry of Home Affairs, with an original policy paper and a (1974) law written and enacted in the 1970s. However, officials reported that the policy paper was not widely disseminated, and the law was typically evaded. Also, there has been little advance preparation for the decentralisation. Admittedly, a District Autonomy Pilot Program (DAPP) was established in 1994/95, in which a number of local governments were given greater responsibilities. As part of this program, there has been some effort to evaluate the ability of local government officials to handle these responsibilities, with the general conclusion that local governments are largely unprepared for any new tasks. Further, we can identify only one common issue that is being addressed by the decentralisation program: the need to move government decision making on expenditures and perhaps taxes to the provincial and the district level. It is not yet clear that this means ‘closer to voters,’ and it is also not clear that central government ministries will resist the temptation to impose regulations, mandates and minimum standards on local government service delivery, all of which would reduce local autonomy. It is certainly clear that the reforms so far do not extend any new significant revenue raising powers to local governments. A plan, even if incomplete, is a necessary starting point for any successful reform. There is no single best structure for fiscal decentralisation. There are many options, and the appropriate strategy for a country depends on what that country is trying to accomplish. When there is not a clearly articulated decentralisation policy, and one that commands widespread support and consensus, then there is no road map for designing all features of the program – the laws, the regulations, the transition, the implementation, or the evaluation.

Consider the following kinds of issues. First, the laws and regulations defining expenditure assignment and revenue powers have been written in a relatively uncoordinated way by two different groups within government. Without a policy design to guide this drafting, and despite substantial analytical work already carried out during 2000, it is almost guaranteed that there will be a fiscal mismatch, setting the stage for a ‘soft budget constraint’ for local governments.

Second, the design and implementation of intergovernmental transfers were not guided by clearly stated government objectives concerning equalisation of fiscal capacities across local governments, the desired level of expenditure control by line ministries, local government revenue mobilisation, and the like. The political disagreements that arise as a result are beginning to emerge.

Third, without a clearly stated set of objectives and priorities for the decentralisation program, it has been difficult to draft the implementing regulations for the various components of the

program. Although these central government regulations are now largely in place, there is as yet little familiarity with, or understanding or acceptance of, these regulations by those outside the central government. Without clear objectives and priorities, it will be particularly difficult to achieve full acceptance. Fourth, similarly, the absence of a clear statement of objectives and priorities will make it impossible to evaluate the success of the program's various components or to put in place an evaluation effort.

Fifth, the decentralisation program will grow and develop as the country changes in the coming years, and a strategy for adjusting the structure of the decentralisation policy to keep up with this economic development will be essential. This fine-tuning must be guided by a clearly articulated set of objectives and priorities.

These *general* considerations point to a number of *specific* issues that need to be addressed for the decentralisation now under way in Indonesia to have some prospect of success. These specific issues are discussed next.

ISSUES IN IMPLEMENTATION OF THE REFORMS⁴

Revenue Raising Powers for Local Governments

It is apparent that the two laws and the more detailed implementing regulations provide mainly for expenditure, not revenue, decentralisation. Despite the enactment of revenue sharing for natural resource revenues, the laws do not give local governments any meaningful new locally controlled tax instruments or borrowing authorities independent of the national government. This means that no provision has been made for local governments to raise significant own source revenues and that the central government is considering no major new taxes for local governments. An amendment to the local tax law was enacted at about the time the decentralisation laws went into effect, but the amendment does not provide any clearcut additional tax discretion to local governments and also does not assign them any new broad-based taxes. At the present time, the implementing regulations have not all been approved, in part because it is not yet clear whether local governments will receive significant new revenue-raising powers.

This omission is a major limitation of the new laws. In order to establish a link between costs incurred and services demanded by citizens, local governments must have the ability to make some real choices in their use of tax instruments (at least at the margin). It is this linkage that is crucial: it makes the citizens aware that there is a connection between the taxes that they pay and the services that they receive (provided there is transparency), and it establishes accountability on the part of local government officials. If all expenditures are financed by intergovernmental transfers, then voters will not feel the pain associated with better services, as they would if the local government had some rate setting powers. This does not require that the local government control *all* of its revenues, only *enough* to change at the margin the revenues it collects and so the services it provides. However, even this modest amount of local control is not present in the decentralisation reforms. Under the new laws, voters may only learn to spend: they will realise that they have discretion over spending decisions, but that they do not have to worry about revenue decisions because the central government is effectively

responsible for local revenues. This unfortunate outcome has occurred in other large decentralised nations (e.g. Russia) that chose to decentralise expenditure responsibilities but not the corresponding revenue responsibilities. Of critical importance to greater local control of revenues is the necessity for strong local accountability generated from communities and the private sector. Democracy is a key part of this process. In the absence of such accountability, it is difficult quickly to resolve the tax decentralisation issue, particularly for those many decentralised government units with the most limited capacity.

Revenue–Expenditure Balance

There may well be a mismatch between the revenues and the expenditure responsibilities that are assigned to local governments. On the revenue side, local governments receive both 25% of domestic revenues in the form of inter- governmental transfers and a share of natural resource revenues. On the expenditure side, there has been a decentralisation of responsibility for a broad range of expenditure functions. There has been too little analysis of the required expenditure budget for sub- national governments implied by this assignment of functions, and no realistic public debate about the adequacy of the transfers.

For example, in 1999/2000 the 25% allocation is projected to equal Rp 35.6 trillion (25% of Rp 142.2 trillion), which is roughly double the projected regional routine expenditures of Rp 19.5 trillion; also, revenue sharing is estimated at about Rp 6–7 trillion, so that total local government transfers (aside from the specific allocations) are estimated at approximately Rp 43 trillion. However, it is not known whether this amount is greater than, equal to, or less than the target level of expenditure, either at the aggregate or at the disaggregate level.

In addition, there is much uncertainty at the local government level about the revenue–expenditure balance. Some local officials we interviewed consider that there will be no problem in paying the salaries of any new civil servants, in part because they mistakenly believe that the SDO will continue, but there could be a problem in funding other routine expenditures because some new departments will be created that do not currently exist, and funds must be found for these departments, especially for maintenance, transport, utilities, stationery, and the like. Some district officials also believe that their revenues will be lower under the new system. Others, at both the province and the district levels, estimate that revenues will increase substantially with the transfer of the deconcentrated central government agencies and their budgets.

Prior to the reforms, many local officials indicated that they simply did not know what would happen to their budgets in the new system, in large part because many have no knowledge of the central government’s formulae for grant distribution (McLeod 2000: 33–4, 36–7). Similar uncertainty was also present among some central government officials. Anecdotal evidence suggests that this uncertainty continued during the initial period after the reforms were enacted. Many local governments still did not have a budget one month into the fiscal year, and there was a general puzzlement about how grants were being distributed. Our judgment is that the degree of uncertainty is still a good deal higher than it should be as implementation proceeds.

Local Government Capacity to Deliver Services

A major issue is whether the provincial and local governments can absorb these new expenditure responsibilities and with them the 'back office' functions that have hitherto been centralised, including personnel management, data processing, procurement, contracting, and the like, thereby providing the full range of services that will become their responsibility in the new system. There is also a question about whether district governments should absorb functions that are inherently regional in nature, such as universities, large hospitals, and trunk roads.

This general issue raises a number of specific questions. Is the quality of the human capital in the provincial and district governments capable of delivering the services to be transferred, or is the idea simply to absorb the heretofore central government employees? How will management be handled? Will former central employees be brought into the provincial and local service, and placed directly under local government managers? Will the managerial personnel from the central government be transferred in? Are there some purely physical limits to the absorption of these functions by subnational governments? For example, are the provincial and local computer systems adequate for the increased record keeping tasks implied? What new budget formats and accountability systems will be required when these new functions are absorbed into the decentralised system? What provisions have been made, or need to be made? Will a new legal framework and a new reporting system need to be established to govern subnational budget decisions, personnel management, and the like? Will these governments be able to deal with the compliance costs involved? The Ministry of Home Affairs has made efforts to address these issues, but the results are by no means clear as yet.

One view often expressed by local officials is that they will have little difficulty in providing these services, in part because many of the relevant functions have already been shifted to local governments. In North Sulawesi, for example, 20 programs funded by specific Inpres allocations have been channelled directly to district governments by the provincial Bappeda since 1994, including programs for roads, health, drinking water, primary schools, agriculture, and marketplace development. Other officials similarly claim that 'it is easy to turn over an agency to a district.'

Another expressed view is that the magnitude of these tasks will be much greater in the new system, so that their complete absorption by local governments will take some time, and the lead time will vary greatly across regions. For example, one local government secretary estimates that the extra burden of these functions could be as much as Rp 15 billion in a district budget of Rp 111 billion; another estimates that the district civil service would roughly double in size under the reforms, growing from 12,000 to 24,000 employees; and in another district, the personnel officers say that the number of district *dinas* would increase from 11 to 21 (adding new offices in fisheries, livestock, mining, forestry, land institutes, industry, manpower, education and culture, cooperatives, and trade), with more than a doubling of the number of district civil servants. In the province of North Sulawesi, there are currently 35,000 employees in deconcentrated agencies throughout the province (compared with 45,800 provincial civil servants) and, with decentralisation, most of the 35,000 deconcentrated agency employees will become provincial or district civil servants. Officials in professional and highly specialised deconcentrated agencies such as education and manpower worry that they often need extensive central government assistance on matters in which the local governments have little expertise or interest. Meanwhile, a separate process of governmental expansion is taking

place at the provincial level: parliament has approved the creation of three new provinces, and several more are under consideration.

Some officials estimate that only 10–20% of the districts can absorb all of their new duties quickly. A Bappenas rating indicates that only three provinces meet appropriate standards at present, especially in terms of the quality of the civil service. Some local government officials are already preparing for the changes. However, many local government officials are following the Indonesian tradition of waiting for central government assistance. It should not be assumed that service delivery under the old centralised regime was effective. In very many cases it was not. While there is likely to be a messy transition for all the reasons discussed, prospects are quite reasonable for eventual improved service delivery as a result of these changes.

Civil Service Issues

The civil service implications of decentralisation could be daunting, and it is not clear how far the planning has gone on this set of issues. Questions about seniority, compensation, pensions, fringe benefits, and work rules have been raised consistently by central government employees who expect to be absorbed into the subnational government service. More than anything else, civil servants are concerned about these issues. There has been a delay in addressing them simply because they are so difficult.

Discussions held prior to the reforms indicated that most central government civil servants preferred to stay at the centre, rather than be transferred to the province or the district. However, the decentralisation will eventually require massive personnel transfers to local governments, perhaps as many as two million central government civil servants. The alternative is to replicate central capacity at the decentralised level at very substantial expense. A mix of both options is likely to be chosen.

In the initial months of the reforms, public employees have been kept in their previous positions, and their compensation rates have not been altered. Payments to subnational government employees have been made as before. However, with large numbers of central government employees likely to be transferred to district governments during the first quarter of 2001, there is a great deal of uncertainty about how civil service reform and decentralisation will be coordinated.

Civil servants at all levels have exhibited anxiety about their job status. Surprisingly, some (though clearly not all) officials are unconcerned about salaries, believing (incorrectly) that the central government will continue to pay their salaries via the SDO. Officials more often expressed anxiety about guarantees (or lack thereof) of continued employment in certain positions, especially supervisory ones in departments that will be created or moved to district control. They noted that job rankings could be an issue. For example, one district secretary has a current ranking of 2B; under the new system, he believes that the duties of his position will require a higher ranking of 1B (the same as that of a provincial-level secretary), so he may not actually be 'qualified' for his position in the new system. More generally, with changes in the rankings required by the reforms, there may not be sufficient numbers of qualified civil

servants for the various positions. Central government civil servants in deconcentrated agencies are also worried about career advancement in local governments, especially since they typically view themselves as ‘specialists’ whose skills may not be appreciated or understood in a local civil service; indeed, a district counterpart agency does not always exist for the deconcentrated agencies, so that regulations need to be written. Answers to questions of seniority (e.g. who will be the head of a deconcentrated department merged with a district counterpart agency?), promotion (e.g. who will decide it?) and transfer (e.g. will transfers be mandated?) in the new system are very unclear at present. It appears that these issues will be determined by district (not central) government personnel and their evaluations, and the district may not apply the same standards as are currently applied by the central government.

Accountability of Elected Local Officials

There is a widespread belief that local accountability will be improved by the electoral process. Voters now have some say in determining the composition of local councils, and local officials often claim as a result that ‘expectations are high.’ The new procedures for selection of the local head should also improve accountability. Under the old system, the district head was selected with the heavy involvement of the central government, so that the responsibility of the incumbent was directed mainly upward, to the central government. In contrast, under the new system the responsibility of the district head is to the elected council, which will elect the head without the approval of the central government. Finally, there is now local approval of budgets, and this should lead to increased accountability. Many facets of the reform therefore move government closer to the people. However, there are also some ‘grey’ areas, where the new reforms may not lead to so much accountability to voters. Several local officials noted that the absence of any proposal for significant expansion of local revenue raising powers represented a limitation on local autonomy. In the regulations, authority is provided to local government to raise additional revenues, so long as there is no conflict with national revenue sources. Central government ministries may well impose a range of regulations, mandates, and minimum standards on the now decentralised agencies, features that could severely limit local autonomy and therefore local accountability to voters. Intergovernmental transfers may well eventually become conditional, which will limit local government discretion. The electoral process is not direct; that is, the responsibility (and the loyalty) of the elected official remains directly to the party rather than to the voters, and the party can select – and remove – candidates on its authority. Finally, it may take some time before the accountability implied by free elections actually occurs.

In fact, local officials have mixed views on the changes in accountability. Many believe that the new laws significantly increase their autonomy, and so their accountability to their constituents. They point especially to local approval of budgets and local discretion on spending levels and composition. Central government officials generally endorse this view also, fearing that the central government may well lose overall budgetary control, but acknowledging that this is the price of decentralisation.

However, many local officials also believe that they have always had substantial autonomy. In particular, the current formulation of the provincial development budget is a ‘bottom-up’ procedure over which local officials exert substantial influence, and many

local officials do not believe that the decentralisation will enhance (or lessen) this autonomy; the main change under the new laws is that final approval for the budget comes from the provincial assembly, rather than from the central government. On balance, these officials believe that they will have 'more room to manoeuvre' and less intervention from above, but that these changes will be minor.

Finally, there are some officials who believe that local autonomy will be largely unaffected by the new laws. There is a possibility that central government ministries will resist the transfer of their line ministries to provincial and district governments via regulations and mandates, tendencies that are already apparent, because the ministries will otherwise lose much influence, resources, salaries, and the like with any transfer. These local officials also maintain that local autonomy will suffer from a lack of own local revenues; in the words of one district secretary, there will be 'decentralisation in management,' but there will be 'no decentralisation in finance.'

Central Government Assistance and Leadership

Somewhat paradoxically, successful fiscal decentralisation requires a strong central government to lead the process. Given that the Indonesian system will start with more than 370 provincial and district local governments – a number that is still rising – an important issue is whether the central government has the capacity to provide the oversight, guidance, and leadership necessary. These issues are a particular problem in the face of continuing distrust of central government motives and actions in several provinces.

There are a number of areas where such central leadership is crucial. First, it is necessary for the central government to carry out analytical fiscal work to evaluate and monitor the system on a continuous basis. This involves identifying tax effort performance, tracking local budgets, evaluating any proposed alternative fiscal reforms, and so on.

Second, the central government must maintain the intergovernmental transfer system. This will involve a number of activities, such as updating the information to which grant formulae are applied and evaluating the fiscal equalisation features of the grant system. In addition, if there are conditional grants, a compliance monitoring system needs to be in place.

Third, and related to the transfer system, a finance commission is often created to oversee and advise on intergovernmental fiscal relations, and this is provided for in Indonesia's decentralisation laws. This body would necessarily have to possess a strong analytic capability, some modelling capacity, and an ability to make the system transparent. A finance commission could stand between the central and local governments, thereby becoming the honest broker of intergovernmental fiscal relations. It could also resolve disputes between ministries about fund allocations, thereby depoliticising intergovernmental fiscal decisions. The central government will play a major role in organising and supporting this unit. A start in this direction has been made through a nascent body established in the Ministry of Home Affairs, but decisions by the central government mean that neither the new body nor its secretariat, concerned with financial issues and headed by the finance minister, as yet has the autonomy and the analytical capacity of an independent commission. The Ministry of Finance is actively working on improving its

own analytical capacity.

Fourth, with provincial and district governments eventually able to borrow (with central government approval), the central government will need to develop a regulatory framework that can monitor compliance (e.g. disclosure, purpose of borrowing, eligibility, and borrowing limits). The decentralisation laws distinguish between domestic and offshore borrowing, and the regulatory framework that is established will also need to make this distinction.

Fifth, the central government will need a fiscal information system to monitor the progress of decentralisation and to serve as the database for the research that will be necessary to continue to fine-tune the system. Many large countries with significant intergovernmental fiscal programs have moved to develop a fiscal information system (e.g. Brazil, India, the US, Canada, Australia). It is our understanding that a management information system along these lines is being designed in the Ministry of Finance. However, substantial data issues remain. Moreover, there does not yet appear to be a strong commitment by the government to ensuring that the data from its system are made available to academic analysts, including those serving the NGO community and local governments.

Sixth, if the central government imposes the condition of a hard budget constraint on subnational governments, it will be charged with determining whether the latter are in compliance. It must also lay down the rules for audit. Seventh, to the extent that the central government imposes regulations, mandates, and minimum standards (and it certainly will, because all countries in the world do this), there must be a system to monitor compliance with these requirements. Examples include compensation rates for employees, environmental regulations, adherence to standards for schoolteachers, and expenditure of minimum required amounts. A process of setting minimum service standards is under way, involving the Ministry of Home Affairs and the line ministries, and some ministries have already completed it.

Eighth, the central government may take the lead in providing technical assistance and training to local governments. The more technical the training, the more likely is the central government to lead the training and technical assistance.

Ninth, in any intergovernmental fiscal system there will be disputes between the central and local government, among local governments, and even between ministries. Among the possible sources of contention are the specific data used in the distribution of transfers by formulae, compliance with grant conditionality, and unclear expenditure assignments. The resolution of such disputes will require central government involvement. Again, an independent finance commission can assist in this task.

Tenth, if the central government adopts options such as a financial control board to deal with bankruptcy of local governments, or if it intervenes in order to act as guarantor, say, by providing collateral for local borrowing, central control and monitoring will be required, as will sanctions and remedies for defaulting local governments.

All of these considerations point to the necessity for fiscal decentralisation to be accompanied by a strengthening of the central government's ability to lead and manage the process. A necessary condition for successful decentralisation is to have a strong central

government intergovernmental fiscal relations unit in place. This in turn raises some important questions: where in government will such a unit be placed, how will its information system be supported, and how will it be staffed?

A Hard Budget Constraint for Local Governments

It is not clear that provision has been made for the imposition of a hard budget constraint on subnational governments. Two conditions are necessary. First, there must be a reasonable balance between expenditure responsibilities assigned and revenue instruments available. Second, local governments must have some meaningful and significant ability to set tax rates so that they can tax their constituents to cover any shortfall. As of now, the balance between expenditure assignment and revenues has not been worked out, and there is only limited provision for local taxing power. Another issue is local government borrowing. Currently, provincial and district governments can borrow for capital projects with central government approval, and the loans often come from regional banks. (Central government approval is required for foreign borrowing.) These banks are largely conduits for money from the centre, are run by local bureaucrats for the benefit of the local government, and have recently been recapitalised. Given these considerations, there is a real concern in the central government that local borrowing will grow out of control, despite the central approval necessary for such borrowing specified in the two decentralisation laws. In fact, some local officials stated that they believed local loans would be assumed by the central government in the event that the local government was unable to service them. This is a view that is undoubtedly mistaken but which, if widely held, would also eliminate a hard budget constraint at the local level, creating a severe 'moral hazard' problem for local officials.

The Decentralisation Laws and Their Implementing Regulations

At the time of this writing, the new laws and their implementing regulations have largely been approved. In a real sense, the implementing regulations are defining the structure of decentralisation in Indonesia. Many of the regulations were issued in the final days before decentralisation became effective.

A number of important issues have been specified – but not clearly or finally – in these implementing regulations: the exact assignment of expenditure responsibility (especially at the provincial level), local tax authority, local user charge authority, borrowing powers, civil service regulations, and the structure of the grants system. There is much to be done in fine-tuning the regulations and possibly in revising the laws to improve clarity and transparency.

A Transition Plan

Any fiscal decentralisation program needs a carefully thought-out transition plan. A major issue is the speed with which the program can be implemented, even if it is carefully planned to take account of all the issues discussed above. By some estimates, at most 20% of all local

governments are ready to absorb their significant new responsibilities. Even if these governments can assume the responsibilities presently laid out, how will the remaining 80% be treated? Will they be brought slowly into the system, with more limited powers until they prove their ability to take on new responsibilities? What will be the criteria for graduation to the next class of local government? What training will their civil servants be given to assist them in fulfilling their new responsibilities? These questions must be answered in a transition plan.

MOVING FORWARD WITH DECENTRALISATION

This discussion has highlighted a number of potential problems in the decentralisation process. There are several actions that the government can and should take at this time, to help the process move forward and to improve its chances for success.

Help Establish the Intellectual, Practical, and Technical Foundations As emphasised above, the development of a strategy and of an agreed set of objectives is crucial. Until this is in place, the program cannot move successfully ahead with a consistent set of laws and implementing regulations.

Perform the Basic Research on the ‘Numbers’ and the Plan

As part of establishing the foundations, there is much basic quantitative economic research that must be carried out before there is a decentralisation plan ready for implementation. There are at least four areas where this work might be focused.

First, the government must re-assess the *revenue–expenditure balance*. The plans for the decentralisation of revenues via the intergovernmental transfer system, the proposed assignment of expenditures, and the proposals for local taxation and user charge autonomy need to be coordinated. In some cases, the basic structures need to be re-thought. It is necessary to estimate the cost implications of the expenditure assignment under consideration, and to cost out the central mandates that are likely to be imposed. Following these calculations, revenue needs can be estimated, and the feasibility of the 25% transfer of domestic revenues and likelihood of a hard budget constraint can be considered. To do this work, a simulation model needs to be developed and estimated. From this, the central government could begin the hard work of making choices as regards the proper ‘vertical split’ in revenues between different levels of government.

Second, before the government can make decisions about the proper ‘horizontal split’ of revenues among local governments, it must have hard data on the budgetary implications of different formulae for the distribution of *intergovernmental transfers* among local governments. Armed with such a quantitative analysis, the government can begin making decisions about the proper structure of the intergovernmental transfer system, including the role of conditionality in grant design. If significant, this should perhaps be generally agreed upon at a reasonably high and centralised level. Under this approach, debate about conditions would occur

before they are put into place. Also, agencies would use their rule-making authority to impose conditions on central government grants only by clearing them through a central decision authority, where proposed regulatory changes must be published before going into effect, and where review and comment procedures are open to local governments and other interested parties.

Third, the government needs to decide how much it wants to emphasise *revenue mobilisation* and how much it wants to emphasise *revenue equalisation*. There are many pieces to this puzzle, including the grant formulae, conditionality, borrowing versus grants, expenditure assignment, mandates, and local taxing and user charge powers. A thorough quantitative analysis of the options and of their implications needs to be carried out.

Fourth, a major flaw in decentralisation programs around the world is that there is little analysis of the degree to which a program is meeting the objectives set for it. Does the program equalise resources across local governments? Does it stimulate revenue mobilisation? Does it lead to changes in public expenditure mixes? Are hard budget constraints effective? Do higher income localities borrow more? Are budgeting practices improved? The government needs to set up a modelling and information system that can be the basis for a rigorous *quantitative evaluation system*. Some technical work is being carried out by the government on these matters, but there is as yet little public acceptance of this work, in part because the studies are largely not yet in the public domain. It is very important to public acceptance that these processes be far more open and transparent than the government has thus far been willing to permit. Other issues will arise as these initial studies are completed.

Consider the Bottom-up Issues Associated with the Transition

There are many implementation issues associated with the transition to a decentralised system in a country as large and as complex as Indonesia. At present, there does not seem to be a comprehensive strategic plan upon which agreement has been reached to guide fiscal decentralisation over the next several years. On the one hand, it seems clear that not all local governments are able to absorb the new responsibilities because of their very different management capabilities. On the other hand, it is easy for government officials to hide behind this problem and create a self-fulfilling prophecy that leads to the conclusion that 'local governments are not able to manage their own affairs.'

The right answer is probably that there needs to be a transition in which some local governments participate fully in the new decentralised system from the outset, while others are classified as not yet ready for decentralised authority. In this designation, it is necessary to establish a clear and detailed set of criteria for promotion from one level to the other. In this regard, a series of case studies would be especially helpful in determining exactly what is necessary to implement a decentralisation program, in terms of budgets, management, civil service, absorption of new employees, back office function arrangements, training needs, and so on. These case studies could then establish the criteria for selecting those local governments that would go first into the program, and could also provide the criteria for deciding when a local government would be qualified to move to the next stage. Publicly, the government is asserting that all jurisdictions will go forward together, but privately it appears more realistic,

even though no criteria for assessment of readiness are publicly available, if they exist at all.

Finalise the Implementing Regulations

The government has now drafted the implementing regulations, which spell out some of the details that will allow interpretation of the law. They include such matters as exact expenditure assignments, revenue powers and limits, budget constraints, mandates, and borrowing authority. However, what the government has accomplished in this area is subject to reconsideration by the DPR. Because a full public debate on these regulations has not yet taken place, some local jurisdictions may feel free to try to go their own way.

Develop a Transition Plan

An urgent need is for the government to develop a transition plan that establishes the intellectual, practical, and technical foundations for decentralisation. A major stumbling block to successful decentralisation in most developing and transition countries is the implementation. Sometimes all the pieces are not in place, sometimes the speed of implementation is too fast or too slow, and very often the central government has no strong ability to monitor or evaluate the process. In Indonesia, one favourable sign is that all the pieces for the process are already being discussed, and much detailed work has been completed.

Create a Capacity for the Future Decentralisation is a policy that will evolve over time, and it will change as well as deepen. This outcome seems almost certain in Indonesia. While there is a great need to worry about implementation over the next 24 months, there is also a need to think about the future and to prepare Indonesians to lead it.

In this regard, the government should undertake a number of activities. It should organise a training program in economics and public administration, focused on and built around the specific subject area needs of decentralisation (e.g. public finance, budgeting, financial administration, local government).

The government should support the development of faculty and curriculum in these areas at several Indonesian universities. In time, the technical assistance expertise and the sources of professional staff should be in the local universities, but there is much work to do in first developing local expertise in these areas. In addition, such training in the universities would benefit those who will be elected leaders in the future.

The government should also support the continued development of training academies for short-term certificate courses in policy and public administration, and assist these academies in upgrading their curriculum in areas most closely related to decentralisation. While those capacities are in place in the central government in a very limited sense, even there they need strengthening.

It is important to develop an information system of fiscal and economic data on a regional

basis, which will serve as a research source as well as a monitoring and tracking source for evaluating local government performance. This information system would constitute a kind of 'census of local government finances.

Finally, the government should establish an independent commission on intergovernmental fiscal relations. This commission would play the role of objective broker in analysis of questions related to intergovernmental finance, and could also play a role in performance evaluation and the fine-tuning of the fiscal system that must take place in the future. The Ministry of Home Affairs is probably too tainted in the view of local governments to be the sole repository of this key group, because of the perception on the part of local governments that it has been the source of years of authoritarian decision making. At a minimum, the commission should report directly to the parliament and to the president's office.

Assign New Revenue Authority to Local Governments

We noted above that the new decentralisation laws provide for expenditure, but not for revenue, decentralisation, because there are only limited plans for delegating new taxing sources to local governments. The absence of significant revenue authority at the local government level severs the linkage between the taxes that citizens pay and the services that they receive, and thereby weakens the accountability of local government officials. To remedy this limitation, a partial decentralisation of Indonesia's tax revenue sources is necessary.⁵

It has been argued that such revenue decentralisation might undercut the ability of the central government to repay its foreign debts, or otherwise compromise its ability to conduct macroeconomic policy (Tanzi 1996). More broadly, decentralisation of revenue authority may reduce the central government's ability to mobilise the revenues needed to support the general goal of economic development. However, a nation absorbed in questions of regional stability and preoccupied with ongoing political debates about such matters is also not very likely to meet the necessary preconditions for rapid economic growth that make feasible the repayment of foreign debt, the maintenance of macroeconomic stability, or the pursuit of economic growth. Thus, the government and its international lenders should consider seriously the importance of encouraging a sound and rapid solution to Indonesia's fiscal decentralisation issues. Successful progress towards resolving the country's regional problems might help keep its attention better focused on the critical economic stabilisation issues that require prudent macroeconomic policies.

To this end, the government should deliver significant control over own source revenues to all provinces, including the energy-rich regions. The specific revenue sources suitable to be considered for partial provincial control are the corporate income tax, the individual income tax, the land and business tax, and taxes on the operation of motor vehicles. Provincial and district parliaments should be allowed to set the rates of these taxes, within limits established by the central government. However, the tax base should remain under the central government's control, and tax administration should continue to be an entirely central government function. The technical and administrative problems arising from permitting changes in the base of these taxes, while preserving central administrative control, are too difficult to resolve right now. Changes in the base of these taxes should only be permitted at a later date, after

some tax administration responsibilities are decentralised to provinces.⁶

More precisely, the central government would implement a policy that would reduce some central government taxes and transfers but at the same time would give provincial governments both the incentive and the ability to replace these lost resources with additional tax revenues of their own. This policy would have several components. First, the central government would reduce the level of general budget support it provides to provinces, while maintaining the payment of funds to each province that it currently provides for fiscal capacity equalisation. Second, the central government would reduce the taxes it now collects for all purposes in each province by an amount that approximates its reduction of general budget support. (The amounts obtained for fiscal equalisation grants would continue to be collected by the central government, as would the revenues required to carry out national government functions.) Third, the central government would authorise the national tax department to collect taxes for provincial governments and, at the same time, provinces would be allowed to enact provincial statutes to impose taxes at rates of their choosing, but on the same nationally developed tax bases of the land and business tax and the individual and corporate income taxes. The taxes would be collected for them and disbursed directly to them by the Ministry of Finance. Again, in this way the central government would give provincial governments both the incentive and the ability to increase the amounts of own source provincial revenues.⁷

If adopted, these proposals would provide substantial additional fiscal discretion to provincial and local government decision makers to make public tax and spending choices more freely than at present, subject to the constraints imposed by accountability to local voters. They would also reduce the pressure on the central government to act in areas beyond providing finance, setting standards, monitoring behaviour, carrying out research and evaluation, leading innovation processes, and nudging provinces and local governments to better behaviour.

CONCLUSIONS

Implementing the two new decentralisation laws will be a monumental task. To our knowledge, no nation has ever undertaken economic decentralisation on the scale that would result from the laws already in place, much less the additional economic transformations that we have suggested. However, the existence of a democratic government suggests some promise of an ability to address these matters.

There are no real alternatives to decentralisation. The pursuit of it may well be the only means of keeping Indonesia intact. Some decentralisation is necessary to retain as part of the nation the resource-rich provinces that are now arguing noisily for more local control. With sensible policies, Indonesia may well be able to prevent its political disintegration, as well as to generate the gains that decentralisation can yield.

NOTES

* We are grateful to two anonymous referees for helpful comments, to Bert Hofman of the World Bank for valuable discussions, and to seminar participants at Gadjah Mada University, Georgia State University, and Universitas Sam Ratulangi. The views expressed here are ours, and do not necessarily reflect those of Georgia State University, USAID, the World Bank, or the Indonesian government.

1 The fourth tier, the village level, is not discussed in this paper.

2 The reasons are several. First, it is difficult and costly to govern effectively from the centre when the population and land area are very large, in part because of the manpower costs of bureaucratic administration, the time required to approve local decisions, and the problems of communication (e.g. Russia has 11 time zones); larger countries are also likely to have greater variations among regions in climate, geography, and economic base, so that centrally mandated uniformity in the provision of government services is likely to be quite inefficient. For these reasons, many of the world's largest countries, such as the United States, Canada, Australia, Germany, Russia, Nigeria, India, Brazil, and Argentina, have adopted decentralised forms of governance and finance. Second, regional diversity in ethnic, religious, and cultural backgrounds, isolation from the governing centres, and distinctive economic bases may be better accommodated in terms of preferences for services by decentralised governance, and a potentially divided country may be held together by providing a degree of regional autonomy to potential breakaway regions. Third, greater economic development may allow greater decentralisation because of more accountable electoral systems, more stable fiscal and monetary systems, better infrastructure, or more equal regional distributions of income and wealth. See Bahl and Nath (1986) and Bahl and Linn (1992) for further discussion.

3 Provincial taxes consist mainly of taxes on motor vehicles, on the transfer of motor vehicles, and on motor vehicle fuel. District taxes include the hotel and restaurant tax, the entertainment tax, the advertising tax, the street lighting tax, the mineral tax, and the water use tax. Under the plan, the major provincial taxes are being transferred to district level. Changes made to the Indonesian constitution in the middle of 2000 allow for the profits of state-owned enterprises located in decentralised regions to be shared with those regions; in addition, 20% of the individual income tax will be shared by the national government with the regions. As most income taxes from employed persons are collected in the corporate income tax, this latter change is not as significant a concession as might be thought.

4 Much of this discussion is based upon the guidelines and considerations set out by Bird (1993) and Bahl (1999). See also Shah and Qureshi (1994) and Bird and Vaillancourt (1998).

5 See McLure (1983) and, more recently, Bird (1999) for discussions of the principles of subnational revenue assignment. Aten (1999) examines these principles in the specific context of Indonesia. McLeod (2000: 33–7) provides a useful summary of the formulae already spelled out in law.

6 The individual income tax consists of a tax paid by individuals on their income and the tax payments made by corporations on the income of their employees, in lieu of such individual tax payments; both taxes are imposed at progressive rates on a tax base with relatively few exemptions. The corporate income tax is imposed on the accounting profits of corporations, where the tax base is determined by province. In general, both taxes are likely to be more

efficiently collected by the central government than by local governments; the proceeds from each district can then be distributed to the relevant local government. The land and business tax is essentially a tax on the real value of property, now administered by the central government but more appropriately assigned to local governments. The other main candidate for local assignment is the value added tax (VAT). In Indonesia, the VAT is a destination-based tax, formally administered via the invoice method, although there are practical exemptions for administrative reasons under which retailers and others may pay a small percentage of total sales value rather than calculating value added. This tax is not usually a good candidate for decentralisation, owing largely to administrative considerations.

- 7 Note that this set of policies applies to provincial, not to district, governments, while in most cases the new decentralisation laws transfer powers and responsibilities to the district rather than to the provincial level. As noted by McLeod (2000: 34), there is in fact a lack of clarity in the decentralisation laws in their many references to subnational governments and the new responsibilities of these governments.

REFERENCES

- Aten, Robert H. (1999), 'Why Increased Local Democratic Decision-making Would Aid Indonesian Economic Development', in *Sustaining Economic Growth in Indonesia: A Framework for the Twenty-First Century*, Redecon, Jakarta.
- Bahl, Roy (1999), 'Implementation Rules for Fiscal Decentralization', in *Proceedings of the International Seminar on Land Policy and Economic Development*, International Centre for Land Policy Studies and Training, Taiwan.
- Bahl, Roy, and Johannes Linn (1992), *Urban Public Finance in Developing Countries*, Oxford University Press, Oxford.
- Bahl, Roy, and Shyam Nath (1986), 'Public Expenditure Decentralization in Developing Countries', *Environment and Planning C: Government and Policy* 4 (4): 405–18
- Bird, Richard M. (1993), 'Threading the Fiscal Labyrinth: Some Issues in Fiscal Decentralization', *National Tax Journal* 46 (2): 207–27.
- Bird, Richard M. (1999), 'Rethinking Subnational Taxes: A New Look at Tax Assignment', IMF Staff Working Paper, WP/99/165, International Monetary Fund, Washington DC.
- Bird, Richard M., and Francois Vaillancourt (eds) (1998), *Fiscal Decentralization in Developing Countries*, Cambridge University Press, Cambridge.
- Booth, Anne (1996), 'Intergovernmental Fiscal Relations and Fiscal Policy in Indonesia: The National Impact of Equity and Inequity in the Provinces', in Christine Fletcher (ed.), *Equity and Development Across Nations: Political and Fiscal Realities*, St Martin's Press, New York NY.
- McLeod, Ross H. (2000), 'Survey of Recent Developments', *Bulletin of Indonesian Economic Studies* 36 (2): 5–40.

McLure, Charles E. (ed.) (1983), *Tax Assignment in Federal Countries*, Centre for Research on Federal Financial Relations, Australian National University, Canberra.

Oates, Wallace (1972), *The Economic Theory of Federalism*, Harcourt, Brace Jovanovich, Engelwood Cliffs NJ.

Oates, Wallace. (1999) 'An Essay on Fiscal Federalism' *The Journal of Economic Literature* 37 (3): 1,120–49.

Shah, Anwar, and Zia Qureshi (1994), *Intergovernmental Fiscal Relations in Indonesia*, World Bank Discussion Paper 239, The World Bank, Washington DC.

Tanzi, Vito (1996), 'Fiscal Federalism and Decentralization: A Review of Some Efficiency and Macroeconomic Aspects', in Michael Bruno and Boris Pleskovic (eds), *Annual World Bank Conference on Development Economics*, The World Bank, Washington DC.