

# International Studies Program

Working Paper 00-10  
December 2000

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# International Studies Program

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# **CAN INDONESIA DECENTRALIZE?**

## **PLANS, PROBLEMS, AND PROSPECTS\***

*James Alm, Robert H. Aten, and Roy Bahl*

### **Abstract**

*Indonesia is engaged in an unprecedented major social and economic experiment in which much authority and responsibility for its governmental expenditures are being decentralized from the national government, largely to the local government level rather than the provincial government level. From being the most centralized large country in the world, Indonesia is likely to become one of the most decentralized if this process is successful. This paper addresses the major issues that are arising as the Government of Indonesia (GOI) efforts to prepare for decentralization are being finalized and the process of socialization of these GOI ideas and practices are considered by decentralized units of government, the Parliament and the Indonesian Constituent Assembly, and the public at large. These issues have been chosen in part on the basis of detailed results of interviews carried out with local government officials as they consider the decentralization matters fast approaching them. Principal concerns raised in the paper include the policy and administrative matters yet to be resolved, such as local budgeting, financial management, and auditing practices under decentralization, personnel decentralization, the role of borrowing by local governments, and the match between revenues and expenditures. A major theme of the paper is the importance of inaugurating and upgrading a continuing national and local discussion process to reach agreement on the goals and processes of decentralization. Although there are certain aspects of the Indonesian experience that present significant problems for the decentralization, most of the key issues are on the table for discussion and perhaps resolution.*

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\* Georgia State University, United States Agency for International Development, and Georgia State University. This work was partially funded by U.S.A.I.D. We are grateful to Bert Hofman of the World Bank for helpful discussions, as well as to participants at seminars 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, U.S.A.I.D., the World Bank, or the Government of Indonesia

For nearly fifty years, Indonesia's constitutional arrangements have established it as a multi-tier unitary state, with provinces as the second tier below the central government and local governments as the third tier.<sup>1</sup> The centralization of authority in Jakarta was long justified as a way of maintaining national unity in a nation of nearly 200 million people, spread across 14,000 islands and 2 million square kilometers; it was also in part a counterreaction to efforts by a previous colonial power, the Dutch, to assert the importance of federalism as a last dying effort to control the newly independent Indonesia. Now, however, the Government of Indonesia (GOI) is committed to a major program of governmental decentralization. In May 1999, the GOI passed two laws on various aspects of decentralization, Law No. 22/1999 on Regional Government (UU PD) and Law No. 25/1999 on the Fiscal Balance between the Central Government and the Regions (UU PKPD). The implementation process for these laws is far advanced, and the laws and the implementing regulations promise to transform intergovernmental fiscal relations in Indonesia.

In many respects, Indonesia's current intergovernmental system makes it an international outlier: it has many of the characteristics of a country that typically chooses decentralization as an economic policy, but until now it has chosen to remain a highly centralized state. Empirical studies on the determinants of fiscal decentralization point to a number of characteristics of countries that have adopted decentralized political and fiscal structures (Bahl and Nath, 1986). These studies are far from definitive, but they tend to show that decentralization is greater in countries that have larger populations and land areas, more diverse populations, and higher levels of economic development.<sup>2</sup> On these grounds, Indonesia is a good candidate for fiscal decentralization, and should in fact exhibit much more decentralization than has occurred to date. The main feature of Indonesia that, in the experience of other countries, typically argues for greater centralization is civil unrest; that is, countries at war, close to war, or fearing internal military strife tend to be more centralized. This is an argument made by some for Indonesia's long history of governmental centralization. Turmoil in such provinces as Aceh, Irian Jaya, and East Timor has often been used to justify continued centralization of authority; indeed, East Timor has achieved independence after a 1999 referendum, although border problems remain between it and Indonesia that have created serious problems for Indonesia in its international relations.

However, the GOI is embarked upon a major program of fiscal decentralization. Our purpose in this paper is to examine this program. We base our analysis largely on a series of interviews with government officials, at all levels of government, that we have conducted over the period since the decentralization laws have been passed; we have also had extensive discussions on these issues with individuals in the private sector, in academia, and in international agencies.

In the next section, we outline the major features of this program. We then discuss in section II the general process that is leading the reform program. In the following section, we focus upon specific problems related to the implementation of the reforms, problems that could easily compromise the ability of the reforms to achieve their objectives. In section IV we present a number of specific suggestions for ways in which the process could be improved. We conclude in section V.

### **I. The Nature of the Indonesia Decentralization**

Since the 1950s, Indonesia has been a highly centralized but multi-tier unitary state, with provinces and then local governments as the tiers under the central government.<sup>3</sup> Laws No. 22/1999 and 25/1999, if implemented as enacted, will change this organization of governments, 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/kabupaten* - will become fully autonomous, so that the heads of these district governments (the *walikota/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 ministries at the province and the district the responsibility of the respective local government.<sup>4</sup> (The exceptions are for defence and security, foreign policies, monetary and fiscal policies, judiciary affairs, and religious affairs.) This change promises a major reorganization in the way in which public services will be delivered in Indonesia.

*Third*, Law No. 25/1999 on the Fiscal Balance between the Central Government and the Regions (UU PKPD) alters the transfers received by local governments from the central government. The current routine transfer that is largely used to pay the salaries of local civil servants (the *Subsidy Daerah Otonom, or SDO*) will be eliminated; also eliminated will be general development transfers known as block *Instruksi Presiden*, or block *Inpres*. These two transfers are instead combined into a general allocation fund whose total amount is specified as at least 25 percent of central government domestic revenues and whose distribution among local governments are to be determined by formula. 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 revenues (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 decentralization is discussed in more detail later.<sup>5</sup>

When fully implemented, the two decentralization laws will transform intergovernmental relations in Indonesia. In particular, and together with the 1999 elections held at the province and district levels, the laws and related implementation process have the potential to increase significantly the accountability of local government officials. It is through this accountability that the major advantage of decentralization is obtained: moving government closer to the people.<sup>6</sup> 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 mayor at the kota - are now being chosen by the respective elected council (although not directly by the voters), rather than appointed from above, so that their responsibility will be more directed downward to the elected council 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 governmental decisions are more responsive to the wishes of its citizens, so that public services are provided in amounts that correspond more closely to the preferences of the individuals in those jurisdictions, rather than at uniform national levels. Other potential gains include greater revenue mobilization because citizens may be more willing to pay local taxes to provide local public services and because local governments may be more familiar with, and so better able to tax, local tax bases.

Of course, there are many governmental functions that need to be performed by the central government, especially those related to macroeconomic stabilization and income distribution, including the equalization of fiscal capacities across local jurisdictions; national defense and foreign policy are also duties best retained by the central government. However, many other government 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., bahasa Indonesia). However, there is no necessity to prescribe all details at the national level, since local officials can readily deal with many details 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. As a result, a strong case can be made that the two decentralization laws and their implementing regulations have the potential to generate significant gains for the people of Indonesia.

However, despite these potential benefits, the new decentralization laws and the implementing regulations also exhibit some crucial limitations. First, the laws are not accompanied by any well-articulated goals that their implementation is intended to achieve; indeed, the entire process by which the decentralization has proceeded seems ill-defined. Second, the laws themselves also lack many specific details that their implementation will require and that are being addressed in the implementation process. These two aspects pose significant potential problems, for reasons discussed in detail in the next sections.

## **II. The Process and Goals of Decentralization**

The Government of Indonesia has taken a politically expedient path in the development of its decentralization policy. The first step in most successful decentralizations is the development of an official general framework within which the broad goals of the reforms are articulated and agreed upon. This step seems to have been skipped in Indonesia. Instead, the GOI has moved directly to drafting decentralization laws, and is now well along in thinking about the details of the implementing regulations that go with these laws. At present, there seems to be little intention to go back to the question of policy design.

One must be sympathetic with the strategy of "getting on with it", and indeed it seems impossible - and undesirable - that a process already underway will be stopped in its tracks. However, this kind of shortcut raises several questions. Is the Government clear on what it wants to achieve with the decentralization? Is there widespread support within the GOI, the Parliament, and the society as a whole for these objectives? Is the decentralization 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?

As noted, the first step in successful decentralizations 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 current 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 widely evaded. Also, there has been little advance preparation for the decentralization. It is the case that a pilot program (the "District Autonomy Pilot Program", or DAPP) was established in 1994/1995, in which a number of local governments were given more 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 decentralization 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 yet clear that central government ministries will resist the effort 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 the local governments.

A "plan" is not simply an afterthought, but is a necessary starting point for any successful reform. There is no single best structure for fiscal decentralization. There are many versions, and the appropriate strategy for a country depends on what the country is trying to accomplish. When there is not a clearly articulated decentralization 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 issues:

- The laws and regulations defining expenditure assignment and revenue powers are being written in an uncoordinated way by two different groups within government. Without a policy design to guide this drafting, and despite substantial analytical work already carried out through the fall of 2000, it is almost guaranteed that there will be a fiscal mismatch, setting the stage for a "soft budget constraint" for local governments.
- The design of intergovernmental transfers is not being guided by clearly stated government objectives concerning equalization, the desired level of expenditure

control by line ministries, local government revenue mobilization, and the like. The political disagreements that arise as a result are starting to show.

- Without a clearly stated set of objectives and priorities for the decentralization program, it will be 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 acceptance of these regulations by those outside the GOI.
- Similarly, the absence of a clear statement of objectives and priorities will make it impossible to evaluate the success for the various components of the program or to put in place an evaluation effort.
- Indonesia's decentralization program will grow and develop as the country changes in the coming years, and a strategy for adjusting the structure of the decentralization 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.

Piecemeal reforms usually achieve some goals, but they are also often plagued by many problems.

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

### **III. Issues in the Implementation of the Reforms**<sup>7</sup>

To take the next steps in a fiscal decentralization program, the Government of Indonesia will need to address a number of important issues. In the subsections below, we outline these issues, and provide some anecdotal supporting evidence.

Revenue-raising Powers for Local Governments. It is apparent that the two laws and the more detailed implementing regulations provide mainly for expenditure, but not revenue, decentralization. Despite the enactment of revenue sharing for natural resource revenues, the laws do not give local governments any new, meaningful, and locally controlled tax instruments or borrowing authorities independent of the national government. This means that no provisions have been made for local governments to raise significant own-source revenues, that no plans have been examined to devolve significant new taxing sources to local governments, and that no major new taxes for local governments are currently under consideration by the GOI.

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 (at least if there is transparency), and it establishes accountability on the part of the local government officials. If all expenditures are financed by intergovernmental transfers, then the 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 government control **all** of its revenues, only **enough** to change on 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 decentralization reforms. Under the current Indonesian decentralization laws, voters may only learn to spend; that is, voters will realize that they have discretion over spending decisions, but they will recognize 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 decentralized nations (e.g., Brazil) that chose to decentralize expenditure responsibilities without decentralizing corresponding revenue responsibilities.

In this regard, it is interesting that many local officials stated that they would like to take complete control of the land and buildings tax. We understand that this was considered by the central government on several occasions before being abandoned.

Revenue-Expenditure Balance. There may well be a mismatch between the revenues that are assigned to local governments and the expenditure responsibilities that are assigned to them. On the revenue side, the idea is to guarantee a transfer to local governments of 25 percent of domestic revenues, plus a share of natural resource revenues, in the form of intergovernmental transfers. On the expenditure side, the goal seems to be the decentralization of responsibility for a broad range of expenditure functions. There has been little analysis of the expenditure budget for subnational governments implied by this assignment of functions, particularly studies undertaken by those governments, and no realistic public debate about the adequacy of the 25 percent revenue transfer.

For example, in 1999/2000 the 25 percent allocation is projected to equal Rp. 35.6 trillion, or 25 percent 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 expenditures, either at the aggregate or at the disaggregate level.

In addition, there is much uncertainty about the revenue-expenditure balance at the local government level. Some local officials whom we interviewed believe 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, transportation, utilities, electricity, papers, water, phones, 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 turnover of the deconcentrated central government agencies and their budgets.<sup>8</sup>

Regardless, however, the local officials always indicated that they simply do not know what will happen to their budgets in the new system, in large part because many have no knowledge of the still

unresolved formulae for grant distribution. Similar uncertainty is present among central government officials

Local Government Capacity to Deliver Services. A major issue is whether the provincial and local governments can absorb these new expenditure responsibilities. The broad issue here is whether provincial and district governments can absorb the "back office" functions that are now centralized, including personnel management, data processing, procurement, contracting, and the like, and thereby provide the full range of services that will become their responsibility in the new system.

One view often expressed by local officials is that they will have little difficulty in providing these services, in part because many of these functions have already been largely shifted to local governments. In North Sulawesi, for example, 20 programs funded by specific *Inpres* allocations have been channeled directly to district governments by the provincial *Bappeda* since 1994, including programs for road, 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".

However, another expressed view is that the funds necessary to provide these support services may not be forthcoming, even if the local skills needed to provide the services are present. For example, the district of Minahasa participated in the District Autonomy Pilot Program, during which the transfer of 9 (deconcentrated) departments with 500 employees to the district occurred (manpower, manufacturing, trade, social, cooperatives, mining, health, rural development, and registration). According to officials there, the results of the pilot were threefold: there was no problem in absorbing the employees, there was no problem in providing most of the basic services of the departments, but there were financial problems because only funds for routine expenditures (salaries) were transferred to the district and no funds for development expenditures were transferred. The Secretary of the district believes that this last problem could also arise in the decentralization, if sufficient funds (aside from salary support) are not provided; if salary support is also not provided - and there are very mixed views on the likelihood of this - then additional problems will be created. The national budget difficulties make these issues extremely topical.

A related concern often expressed is that magnitude of these tasks will be much greater in the new system, so that complete absorption will take some time and will vary greatly by local government. For example, one local government Secretary estimates that the extra burden of these functions could be as much as Rp. 15 billion relative to a district budget of Rp. 111.0 billion; another local Secretary estimates that the district civil service would roughly double in size with the reforms, from 12,000 employees 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 ones in fishing, livestock, mining, forestry, land institutes, industry, manpower, education and culture, cooperatives, and trade), with more than a doubling of district civil servants. In the province of North Sulawesi, there are currently 35,000 employees in deconcentrated agencies throughout the province (relative to 45,800 provincial civil servants), and, with decentralization, most of the 35,000 employees in the deconcentrated agencies would become provincial or district civil servants. Also, officials in

professional and highly specialized deconcentrated agencies (e.g., education, manpower) worry that they often get extensive central government assistance on matters for which the local governments have little expertise or interest. A process for governmental expansion is also taking place at the provincial level, as Parliament has approved the existence of three new provinces that have come into existence, with several more potentially in process.

Overall, some officials estimate that only 10 to 20 percent of the districts can absorb all of their new duties quickly. A *Bappenas* rating indicates that only 3 of the 27 provinces meet appropriate standards at present, especially in the quality of the civil service. Some local government officials are already preparing for the changes. For example, in North Sulawesi, civil servants have been encouraged to improve their educational levels. However, this appears to be the exception. Instead, most local government officials are waiting for central government assistance.

This general issue raises a number of specific questions:

- Is the quality of the human capital in the provincial and district governments up to the task of delivering the services to be transferred, or is the idea simply to absorb the heretofore central employees?
- How will management be handled? Will former central employees be brought into the provincial and local service, 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, is the provincial and local computer system up to the increased record keeping tasks implied? What new budget formats and accountability systems will be required when these new functions are absorbed into the decentralized 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 the budget decisions, personnel management, and the like of subnational governments? Will these governments be able to deal with the compliance costs involved?

Efforts have been made to address these issues by the Ministry of Home Affairs, but the results are by no means clear as yet.

Civil Service Issues. The civil service implications could be daunting, and it is not clear how far the planning has gone on this set of issues. Issues of seniority, compensation, pensions, fringe benefits, and work rules have been raised consistently by central government employees who anticipate being absorbed into the subnational government service. More than anything else, civil servants are concerned about these issues. Addressing these issues has been delayed simply because

they are so difficult.

Our discussions indicated that most central government civil servants prefer to stay at the center, rather than be transferred to the province or the district. However, the decentralization will eventually require massive transfers to local governments, according to one estimate, of perhaps as many as one-third of the 1.5 million central government civil servants. The alternative is to replicate central capacity at the decentralized level at very substantial expense. Some of both are likely to be chosen.

Civil servants at all levels are largely in the dark, something that has created much anxiety for them. Surprisingly, some (though clearly not all) officials are unconcerned about salaries, believing that the central government will continue to pay their salaries via the *SDO*. Officials more often expressed anxiety about guarantees (or lack thereof) for 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 his position will require a higher ranking of 1B (the same as a provincial-level Secretary), so he may not actually be "qualified" for his position in the new system. More generally, with new required rankings, 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. Issues like seniority (e.g., who will be the head of a deconcentrated department merged with a district counterpart agency?), promotion (e.g., who will decide promotion?), and transfer (e.g., will transfers be mandated?) in the new system are very hazy at present. It appears that these issues will be determined by the district (not the central) government personnel people and their evaluations, and, again, the district may not apply the same standards as currently.

In the face of these issues, some officials believe that central and local government employees will be placed on the same track in a new system in order to maintain the "unity" of the civil service, as well as to allow the mobility of civil servants across provinces and districts; in their view, a unified system will require that the salaries continue to be paid by the central government. However, officials admit that this is largely speculation at this point, and they are awaiting the issuance of regulations.

Accountability of Elected Local Officials. There is a widespread belief that local accountability will be improved by the electoral process. Voters will now have some say in the determination of the composition of the local councils, and local officials often claim that "expectations are high". The new procedures for the selection of the local head should also improve accountability. Under the old system, the local head was selected with the heavy involvement of the

central government, so that the responsibility of the local head was directed mainly upward, to the central government. In contrast, under the new system the responsibility of the local head is downward, to the elected council that will elect the head without approval of the central government. Finally, there will be 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 gray areas, where the new reform may not lead to as much accountability to voters. As noted earlier, there is no proposal for significant expansion of local revenue raising powers, a point raised by several local officials as a limitation on local autonomy. Central government ministries may well impose a range of regulations, mandates, and minimum standards on the deconcentrated 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. It seems possible that the Parliament will move to require some conditionality. The electoral process is not direct; that is, the responsibility 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. 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 that this is the price of decentralization.

However, many also believe that they already have substantial autonomy in the current system. In particular, the current formulation of the provincial development budget is a bottom-up procedure over which local officials exert substantial influence, and local officials do not believe that the decentralization will enhance (or lessen) this autonomy; the main change with the new laws is that final approval for the budget will come from the provincial assembly, rather than from the central government. On balance, these officials believe that they will have "more room to maneuver" 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 strong 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 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 "decentralization in management" but there will be "no decentralization in finance".

Central Government Assistance and Leadership. Somewhat paradoxically, successful fiscal decentralization requires a strong central government to lead the process. Given that the Indonesian system will have more than 370 provincial and district local governments and still rising, an important issue is whether the central government has the ability to provide the oversight, guidance,

and leadership necessary.

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 to 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, like updating the basic formula information and evaluating the equalization features of the grant system. In addition, if there are conditional grants, there needs to be a compliance monitoring system in place.

*Third*, and related to the transfer system, one possibility is that the Indonesian government could create a finance commission to oversee and advise intergovernmental fiscal relations. This body would necessarily have to possess a strong analytic capability, some modeling capabilities, 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 in terms of fund allocations, thereby de-politicizing intergovernmental fiscal decisions. The central government will play a major role in organizing and supporting this unit. A start in this direction has been made through a nascent independent body established in the Ministry of Home Affairs, but it does not yet appear as if it will have the autonomy and the analytical capacity of an independent commission.

*Fourth*, with the ability of provincial and district governments eventually to borrow (with the approval of the central government), the central government will need to develop a regulatory framework that can monitor the compliance that goes with this (e.g., disclosure, purpose of borrowing, eligibility, limits).

*Fifth*, the central government will need a fiscal information system to monitor the progress of decentralization and to serve as the database for research 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, U.S., Canada, Australia). It is our understanding that a management information system along these lines is currently being designed in the Ministry of Finance. However, substantial data issues remain.

*Sixth*, the central government, if it imposes the condition of a hard budget constraint on subnational governments, will be charged with determining whether local governments are in compliance. Central governments also must lay down the rules for audit.

*Seventh*, to the extent the central government imposes regulations, mandates, and minimum standards (and it almost certainly will because all countries in the world do this), there must be a

system to monitor compliance with these requirements. Examples include everything from compensation rates for employees, to environmental regulations, to the adherence with standards for schoolteachers, to the expenditure of minimum amounts.

*Eighth*, the central government may take the leadership 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 formula distribution, compliance with grant conditionality, unclear expenditure assignments, and the like. The resolution of such disputes will require central government involvement. Again, a finance commission can assist in this task.

*Tenth*, if the central government adopts options such as a financial control board to deal with bankruptcy, or if the government intercepts to act as 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 that fiscal decentralization calls for a strengthening of the central government's ability to lead and manage the process. A necessary condition for successful decentralization 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, the local government must have some access to tax rate setting 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, as noted above, there is no provision for significant local taxing power.

Another issue here is local government borrowing. Currently, provincial and district governments can borrow for capital projects, with central government approval, and these loans often come from regional banks. These banks are largely conduits for money from the center, are run by local bureaucrats for the benefit of the local government, and have just been recapitalized. Given these considerations, there is a real concern at the central government that local borrowing will grow out of control, despite the approval necessary for any such borrowing as specified in the two decentralization laws. In fact, some local officials stated that they believed that local loans would be assumed by the central government in the event that the local government was unable to service the loan, something that is undoubtedly mistaken but, if widely held, something that would also eliminate a hard budget constraint at the local level by creating a severe "moral hazard" problem for local officials.

The Decentralization Laws and their Implementing Regulations. At the time of this writing, the new laws are stated in very general terms, and the implementing regulations have largely been approved. In a real sense, the implementing regulations are defining the structure of decentralization in Indonesia.

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. Local officials do not seem overly concerned about the absence of clarity or finality in these regulations at this stage of the decentralization. However, a constant refrain was that they simply did not know what would happen in virtually all areas of the reforms.

A Transition Plan. A fiscal decentralization program in a country so important as Indonesia needs a carefully thought-out transition plan. A major issue is the speed with which a decentralization program can be implemented, even if the plan is carefully thought out to cover all of the issues described above. By some estimates, at most 20 percent of all local governments are ready to absorb their significant new responsibilities. Even if these governments can assume the responsibilities presently laid out, there are concerns about the treatment of the remaining 80 percent of the governments. Will they be brought slowly into the system, with more limited powers until they prove their ability to take on the new responsibilities? What will be the criteria for graduation to the next class of municipality? What training will their civil servants be provided to assist them in their new responsibilities? These questions must be answered in a transition plan.

#### **IV. Moving Forward with the Decentralization**

This discussion has highlighted a number of potential problems in the decentralization process. However, there are a number of actions that the GOI can and should be 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 emphasized above, the development of a strategy and of an agreed-upon 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 decentralization plan ready for implementation. There are at least four areas where this work might be focused:

- Revenue/expenditure Balance. The plans for the decentralization 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. It is necessary to estimate the cost implications of the expenditure assignment under consideration, and to cost out the central mandates that will likely be imposed. Following these calculations, the revenue needs can be estimated, and the feasibility of the 25 percent transfer of domestic revenues and the 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 Indonesian government could begin the hard work of making choices as regards the proper "vertical split" between different levels of government.

- Intergovernmental Transfers. 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 among local governments. Armed with such a quantitative analysis, the GOI can then begin making its decisions about the proper structure of the intergovernmental transfer system, including the role of conditionalities in grant design.<sup>9</sup>
- Equalization versus Revenue Mobilization. The government ultimately needs to decide how much it wants to emphasize revenue mobilization and how much it wants to emphasize equalization. There are many pieces to this puzzle: the grant formula, conditionality, borrowing versus grants, expenditure assignment, mandates, local taxing and user charge powers, etc. A thorough quantitative analysis of the options and of their implications needs to be carried out.
- Evaluation. A major flaw in decentralization programs around the world is that there is little analysis of the degree to which the existing program is meeting the objectives set for it. Does the program equalize across local governments? Does it stimulate revenue mobilization? Does it lead to different public expenditure mixes? Are hard budget constraints effective? Do higher income places borrow more? Are budgeting practices improved? The GOI needs to set up a modeling and information system that could be the basis for a rigorous quantitative evaluation system.

Some technical work is being carried out by the GOI on these matters, but there is as yet little public "buy-in" to this work, in part because the studies are largely not yet in the public domain. 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 decentralized system in a country as large and as complicated as Indonesia. At present, there does not seem to be a detailed implementation plan. On the one hand, it seems clear that all local governments in Indonesia are not able to absorb their new responsibilities because of their very different management capabilities. On the other hand, it is quite easy to hide behind this issue 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 decentralization under the new system, while other local governments are classified as not yet ready for decentralized authority. In this designation, it is necessary to establish, in some detail, a clear 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 would be necessary to implement a decentralization program (e.g., budgets, management, civil service, absorption of new employees, back office function arrangements, training needs, etc.). These case studies could then establish the criteria for selecting those who 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 step. Publicly, the GOI is asserting that all jurisdictions will go forward together, but it appears that the GOI is being more realistic, even though any criteria are not publicly available, if they exist at all.

Finish the Implementing Regulations. The GOI has now drafted the implementing regulations, which spell out some of the details that will allow interpretation of the law. These regulations include such things as exact expenditure assignments, revenue powers and limits, budget constraints, mandates, borrowing authority, and the like. What has been accomplished by the GOI in this area is subject to reconsideration by the Parliament because its active participation in drafting the regulations was not obtained.

Develop a Transition Plan. An urgent need of the GOI is to develop a transition plan that establishes the intellectual, practical, and technical foundations for decentralization. A major stumbling block to successful decentralization 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 good ability to monitor or evaluate the process.

Create a Capacity for the Future. Decentralization 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 GOI should undertake a number of activities:

- Organize a training program in economics and public administration, focused on and built around the specific subject area needs of decentralization (e.g., public finance, budgeting, financial administration, local government).
- Support the development of faculty and curriculum in these areas at several of the Indonesian universities. In time, the technical assistance expertise and the sources of professional staff should be 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.

- 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 decentralization.
- 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".
- Establish an independent commission on intergovernmental fiscal relations. This commission would play the role of objective broker of analysis of questions related to intergovernmental finance, and could also play a role in the 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 by local governments that it has been the source of years of authoritarian decision making.

Assign New Revenue Authority to Local Governments. As noted above, the new decentralization laws provide for expenditure, but not for revenue, decentralization, because there are no 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 decentralization of Indonesians tax revenue sources is necessary.<sup>10</sup>

Of course, it has been argued that such decentralization might partially undercut the ability of the GOI to repay its foreign debts, or otherwise compromise its ability to conduct macroeconomic policy (Tanzi, 1996). More broadly, decentralization of revenue authority may reduce the ability of the GOI to mobilize 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 debts, the maintenance of macroeconomic stability, or the pursuit of economic growth. Thus, the GOI and its international lenders should consider seriously whether it is important to encourage a sound and rapid solution to Indonesia's fiscal decentralization issues. Successful progress towards a solution to Indonesia's regional issues might help keep its attention more successfully focused on the critical economic stabilization issues that require prudent macroeconomic policies.

To this end, the GOI should deliver significant control over own-source revenues at the provincial levels to all provinces, including the energy-rich provinces. The specific revenue sources considered for partial provincial control are the corporate income tax, the individual income tax, and, especially, the land and business tax.<sup>11</sup> Provincial parliaments should be allowed to establish the tax

rates of these taxes, within limits established by the GOI; however, the tax base would remain under the control of the central government, and tax administration will continue to be an entirely central government function.<sup>12</sup> These provincially determined tax rates would then be applied uniformly within each province for each of these taxes. The proceeds of the income taxes would be provided on an origin basis to the appropriate provincial government, to be utilized at that level and/or provided to local governments by the province; the land and business tax proceeds could be distributed both to the appropriate province and its local governments. These additional tax revenues will partially substitute for funds the central government now provides to local governments out of central government own-source revenues, revenues that are generated from several of those same tax sources. Of course, the provinces could elect to impose these taxes at lower rates than at present.<sup>13</sup>

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. These proposals would also reduce the pressure on the central government to act in areas beyond providing finance, setting standards, monitoring behavior, carrying out research and evaluation, leading innovation processes, and nudging provinces and local governments to better behavior.<sup>14</sup>

## **V. Conclusions**

Implementing the two new decentralization laws will be a monumental task. To our knowledge, no nation has ever undertaken the scale of economic decentralization that would result from the laws already in place, much less the additional economic transformations that we have suggested. It is not clear whether there is sufficient political will in Indonesia to carry out these structural changes. However, the existence of a new government suggests some promise of an ability to address these matters.

Still, it appears that there are no real alternatives to the proposed decentralization. The pursuit of decentralization seems the only real policy capable of keeping Indonesia intact. Some decentralization 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 decentralization can yield.

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### **Endnotes**

<sup>1</sup> The fourth tier, the village level, is not discussed in this paper.

<sup>2</sup> The rationales for these conclusions are several. First, it is difficult and costly to govern effectively from the center when the population and land area are very large, in part because of the manpower costs of bureaucratic red tape, the time required to approve local decisions, and the problems of communications (e.g., Russia has 11 time zones); larger countries are also likely to have larger 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 have adopted decentralized forms of governance and finance, such as the United States, Canada, Australia, Germany, Russia, Nigeria, India, Brazil, and Argentina. Second, defining "diversity" in terms of variations in ethnic, religious, and cultural backgrounds, isolation from the governing centers, and distinctive economic bases, then decentralized governance may be better able to accommodate regional differences in preferences for services and/or to hold a potentially divided country together by providing appeasement via some degree of regional autonomy to potential breakaway regions. Third, greater economic development may lead to greater decentralization 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.

<sup>3</sup> For detailed discussions of intergovernmental issues in Indonesia prior to the enactment of the recent laws, see Shah and Qureshi (1994), Booth (1996), and Aten (1999).

<sup>4</sup> In the current system, the central government and its ministries have "deconcentrated" departments called a *kepala kantor wilayah*, or *kanwil*, at the provincial level; in some cases, the *kanwil* has a sub-branch at the district (or subdistrict) level called a *kantor departemen*, or *kandep*. The province has its own planning agency (*Bappeda*) and various autonomous "decentralized" departments (or *dinas*) under its own control at the provincial level, generally consisting of departments for own revenues (called a *dinas pendapatan daerah*, or *dipenda*), as well as *dinas* for education and culture, health, public works, traffic management, agriculture, livestock, fishery, forestry, plantations, industry, social welfare, labor, and tourism, all of which have central government counterparts in the deconcentrated *kanwils*; the province may also have branch offices (called *cabang dinas*) at the district level, although this is apparently not that common. Like provinces, districts have an autonomous "decentralized" department in charge of own revenues (again, called a *dipenda*), and

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they generally have departments (or *dinas*) for services like health and public works, although the range of these departments depends upon 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.

<sup>5</sup> Provincial taxes consist mainly of a tax 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 summer of 2000 include the potential that the profits of state-owned enterprises located in decentralized regions will be shared with those regions; in addition, 20 percent of the individual income tax will be shared by the national government. As most income tax for employed persons is collected under the corporate income tax, this latter change is not as significant a concession as might be thought.

<sup>6</sup> See Oates (1972, 1999) for detailed analyses of the potential efficiency gains from decentralization, often discussed under the heading of the “decentralization theorem”.

<sup>7</sup> Much of this discussion is based upon the guidelines and considerations discussed by Bird (1993) and Bahl (1999). See also Shah and Qureshi (1994) and Bird and Vaillancourt (1998).

<sup>8</sup> For example, in North Sulawesi revenues and expenditures are Rp. 155.1 billion in the 1999/2000, and officials estimate that revenues will increase to Rp. 1,413.9 billion in 2000/2001, given their estimates of their share of the general allocation fund, of specific grants, of revenue sharing, and of salaries and development budgets of deconcentrated agencies. Of course, there will also be greater expenditure responsibilities, and the department estimates that expenditures will increase from Rp. 155.1 billion in 1999/2000 to Rp. 1,119.1 billion in the next year. On balance, then, the estimates are that revenues will exceed expenditures by Rp. 294.8 billion.

<sup>9</sup> These conditionalities, if significant, should perhaps be generally agreed upon at a reasonably high level, such as the Parliament and/or the GOI. This approach would insure that debate about conditionalities would take place before they are put into place. One possible step is to centralize the process of considering conditionalities. Under this approach, agencies would use their rule-making authority to impose conditionalities on central government grants only by clearing those conditionalities 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.

<sup>10</sup> See McLure (1983) and, more recently, Bird (1999) for discussions of the principles of subnational revenue assignment.

<sup>11</sup> 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

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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 calculated by province. The land and business tax is essentially a property tax on the real value of the property. 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 percent of total sales value rather than calculating value added. This tax is not a good candidate for decentralization, due largely to administrative considerations.

<sup>12</sup> The overwhelming technical and administrative problems of permitting changes in the tax base of these taxes, while preserving central administrative control, are too difficult to resolve right now. Changes in the tax base of these taxes should only be permitted at a later date, after some tax administration responsibilities are decentralized to provinces.

<sup>13</sup> More precisely, the GOI will initially reduce the rate of budget support it provides to provinces, while maintaining the payment of funds to each province that it currently provides for fiscal capacity equalization. The central government will also reduce the taxes it now collects for all purposes in each province by an amount that approximates the total budget support it currently provides to each province. The amounts obtained for fiscal equalization grants would continue to be collected by the central government, as would the revenues required to carry out national government functions. The central government would also authorize the national tax department to collect taxes for provincial governments. At the same time, provinces would be required 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 Indonesian Ministry of Finance.

<sup>14</sup> For a more detailed discussion of this strategy, see Aten (1999).