

**CAN INDONESIA DECENTRALIZE SUCCESSFULLY?
PLANS, PROBLEMS, AND PROSPECTS***

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Abstract

Indonesia is now 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 to the more common provincial government level. As implementation gets underway, from being the most centralized large country in the world, Indonesia is likely to become one of the most decentralized. As with any such effort, there are numerous problems and unresolved matters. This paper addresses the major issues that are arising as the Government of Indonesia implements decentralization. We consider the issues that are confronting the central government and its ministries, the People's Consultative Assembly, the decentralized units of government, and the public at large. Principal concerns raised in the paper include the major concerns regarding policy and administrative matters yet to be resolved, such as local budgeting, financial management, personnel decentralization, local taxation, the role of borrowing by local governments, and the match between revenues and expenditures. Indonesian decentralization is being carried out in an environment of substantial distrust of the Government, its plans, and its likely actions by many Indonesians, particularly off Java. . 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 hopefully resolution. A major conclusion of the paper is the critical importance of a continuing discussion process about Indonesian decentralization (national and local, public and private, expatriate and Indonesian, etc) designed to reach agreement on its detailed goals and processes. This situation suggests one major remaining step is the need to develop carefully, comprehensively, and publicly the information and analyses that will permit resolution of remaining issues: a strategic framework.

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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 Government of Indonesia.

For nearly fifty years, Indonesia has been a multi-tiered unitary state, with provinces as the second tier below the central government and local 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 of over 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 has embarked on a major program of governmental decentralization. In May 1999, two laws on various aspects of decentralization were signed into law, 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 of these laws, which commenced on 1 January 2001, is transforming intergovernmental fiscal relations in Indonesia.

Until now, Indonesia's intergovernmental system has made it an international outlier: it has many of the characteristics of a country that typically pursues 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.² 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.

Our purpose in this paper is to examine Indonesia's fiscal decentralization. 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. A strong political imperative for decentralization is already in place supported by clear statements that decentralization should proceed on the part of the Government. Implementation of this new program has already begun. The authors believe the process should go forward.

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

It may be useful at the start to clarify some of our terms. “Decentralization” 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 nonetheless remain the responsibility of the central government (Bird and Vaillancourt, 1999). Until the passage of the recent reforms, the practice in Indonesia has been largely one of deconcentration, not 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 and with many governmental functions performed by deconcentrated central government agencies in provinces and districts (Shah and Qureshi, 1994; Booth, 1996; Aten, 1999). The full implementation of Laws No. 22/1999 and 25/1999 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* – have become more autonomous, so that the heads of these district governments no longer report to the governor of the province. Instead, the district heads are responsible to the locally elected assembly (*Dewan Perwakilan Rakyat Daerah*, or *DPRD*). In contrast, the provinces 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 level the responsibility of the respective local government; the exceptions are for defence and security, foreign policies, monetary and fiscal policies, judiciary affairs, and religious affairs. In the previous system, the central government and its ministries had deconcentrated departments called a *kepala kantor wilayah*, or *kanwil*, at the provincial level; in some cases, the *kanwil* had a sub-branch at the district (or subdistrict) level called a *kantor departemen*, or *kandep*. The province had 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 also had branch offices (called *cabang dinas*) at the district level, although this was apparently not that common. Like provinces, districts had an autonomous decentralized department in charge of own revenues (again, called a *dipenda*), and they generally had departments (or *dinas*) for services like health and public works, although the range of these departments depends upon size and location of the district. Now, the deconcentrated central government departments at the provincial level are the responsibility of the province, and those at the district level are being turned over to the district. When complete, this change promises a major reorganization in the way in which public services are to 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 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 percent of central government domestic revenues and whose distribution among local governments is made by a formula (McLeod, 2000). 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) 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.³ Borrowing is to be permitted from within Indonesia, although the IMF is still quite uncomfortable with this outcome.

The two decentralization laws are transforming 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 (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 mayor 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 is more directed downwardly to the elected legislature and then upwardly 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. There are also natural regional functions, e.g., universities and trunk roads. 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. However, there is no necessity to prescribe all details of service provision at the national level, since local officials can readily deal with many of them more efficiently, quickly, and responsively.

The decentralization laws and regulations are meant to carry out a proper sorting of the

assignment of expenditure responsibilities. The ongoing process of implementation of the two decentralization laws has the potential and eventual likelihood to generate significant gains for the people of Indonesia.

II. The Process and Goals of Decentralization

The pace of decentralization reform has followed the political rhythms of the evolving political process in Indonesia. 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 was insufficiently carried out in Indonesia. Instead, in response to the political rhythms, the Government moved directly to drafting decentralization laws, and the implementing regulations that go with these laws.

The strategy of moving quickly to the implementation of decentralization has yielded several weaknesses, and indeed it seems impossible - and undesirable - that a process already underway will be stopped in its tracks. However, this "shortcut" -- however necessary for political reasons -- raises questions. Is the Government itself clear on what it wants to achieve with the decentralization? Is there widespread support within the Government, the Parliament, opinion leaders, and the society as a whole for these objectives? This paper is about how best the Indonesian decentralization that began implementation in January 2001 can be sustained in the face of substantial remaining obstacles.

As noted, the first step in successful decentralizations is a clear statement of the objectives of the reforms. Discussions with various government officials indicate that decentralization 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 report 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 and more recently by the international donor community, there have been efforts 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 current 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." There is also little clarity about another standard issue -- how much central government ministries will resist the decentralization effort by seeking to impose additional regulations, mandates, and minimum standards on local government service delivery, all of which would reduce local autonomy. These discussions can be expected to go on for decades. It is certainly also as yet unclear whether that the additional tax discretion provided in recent law to decentralized governments will extend significant new revenue raising powers to those governments.

A "plan" even if incomplete 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 kinds of issues. First, the laws and regulations defining expenditure assignment and revenue powers appear to have been written by two different groups within government. Without a policy design to guide this drafting, 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 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.

Third, because there was not a sustained national policy discussion leading to a national consensus on a clearly stated set of objectives and priorities for the decentralization program, it was 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, understanding, or acceptance of these regulations by those outside the Government. The experience of other nations suggests, for example, that Finance Ministries elsewhere often find such lack of clarity convenient, as they are regularly caught between the demands of the international community for assured repayment of national debt, and the need to provide significant tax discretion to local governments. And without the agreed objectives and priorities, it will be particularly difficult to obtain full acceptance.

Fourth, 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.

Fifth, 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.

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 Reforms⁴

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. A recent law (No. 34 of 2000) provides unclear additional tax discretion to local governments. This amendment makes no assignment of a broad-based tax to local government. The result is that it is not clear that

adequate provisions have been made for local governments to raise significant own-source revenues. No major new taxes for local governments are currently under consideration by the Government. At the time of this writing, the implementing regulations had not been approved, since 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 (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 nations (e.g., Russia) that chose to decentralize expenditure responsibilities without decentralizing corresponding revenue responsibilities. To the extent that there are eventual improvements due to improved (more efficient) local service delivery, the pain to voters will be reduced.

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 decentralization issue, particularly for those many decentralized units governments with the most limited capacity.

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, local governments receive 25 percent of domestic revenues in the form of intergovernmental transfers, and a share of natural resource revenues. On the expenditure side, there has been a decentralization of responsibility for a broad range of functions. There has been too little analysis of the required expenditure budget for subnational governments implied by this assignment of functions, and no realistic public debate about of 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.

Prior to the reform, 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 formulae for grant distribution. Similar uncertainty was present among some central government officials. . Anecdotal evidence suggests that this uncertainty continued during the initial period after the reform was enacted and went into effect. 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. From the central perspective, these limitations reflect lack of understanding by local governments, as they believe the amounts had been communicated successfully.

Local Government Capacity to Deliver Services. A major issue is whether local governments can absorb these new expenditure responsibilities. The broad issue here is whether 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. There is also a question about whether district governments should absorb functions that are inherently regional in nature, i.e., universities, large hospitals, trunk roads, etc.

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 government 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.

Another 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".

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, with several more proposals under consideration.

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 but the Indonesian tradition of waiting for the central government to act is inhibiting.

It should not be assumed that service delivery under the old centralized regime was effective. In many, many cases it was not. While there is likely to be a messy transition for all the reasons that have been discussed, prospects are quite reasonable for eventual improved service delivery as a result of these changes.

Civil Service Issues. The civil service implications of decentralization 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 in part because they are so difficult.

Discussions held prior to the reforms indicated that central government civil servants preferred 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 2 million central government civil servants will move from one payroll to another. The alternative is to replicate central capacity at the decentralized level at very substantial expense. Some of both are likely to be chosen.

In the initial months of the reform, public employees were kept in their previous positions and their compensation rates were not altered. Payments to subnational government employees were made as before, and then deducted for the DAU entitlement for the appropriate local government. Approximately 2 million employees will be transferred to the district governments during the first quarter of 2001. There is a great deal of uncertainty about how civil service reform and decentralization will be coordinated.

Civil servants have exhibited anxiety about their job status. 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 district (not central) government personnel, and, again, the district may not apply the same standards as currently.

Accountability of Elected Local Officials. There is a widespread belief that local accountability has been improved by the electoral process. Voters now have some say in the determination of the composition of the local councils, and local officials claim as a result 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 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 gray areas, where decentralization may not lead to as much accountability to voters. As noted earlier, there is no clear proposal sharing the tax base of a major national tax with local governments, a point raised by several local officials as 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. The experience in other nations suggests that 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. Despite the Constituent Assembly's involvement in the current process, it seems possible that the Parliament will move to require some conditionality. 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. 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 local officials also believe that they have always had substantial autonomy. In particular, the 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 comes from the provincial assembly, rather than from the central government. On balance, some officials believe that they will have "more room to maneuver" and "less intervention from above", but that their increased flexibility 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 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 how the central government will mobilize to provide the necessary oversight, guidance, and leadership. These issues are particularly a problem for the management of decentralization in the face of the continuing distrust of the 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 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, a finance commission is often created to oversee and advise intergovernmental fiscal relations, as is provided for in the decentralization laws in Indonesia. 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 body established in the Ministry of Home Affairs, but decisions by the central government mean that neither the new body nor its component secretariat concerned with financial issues headed by the Finance Minister as yet have the autonomy and the analytical capacity of an independent commission. The Finance Ministry is actively working on improving its analytical capacity.

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). The decentralization 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 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, including the reliability of existing and future data. Moreover, there does not yet appear to be a substantial commitment by the government to ensure that the data from its system is made available to academic analysts, including those serving the NGO and local governments.

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 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. There is an ongoing process of setting minimum service standards involving the Ministry of Home Affairs and Regional Autonomy and the line ministries, and some ministries have already completed initial versions of this process. However, these issues will certainly be a continuing topic of discussion.

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 distribution of transfers by formulae, compliance with grant conditionality, unclear expenditure assignments, and the like. 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, or if the government intervenes in order to act as guarantor by, say, 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 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 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, as noted above, there is only limited provision for local taxing power.

Another issue here is local government borrowing. Currently, provincial and district governments can borrow for capital projects and these loans often come from regional banks. Central government approval is required for foreign borrowing. 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 and among certain foreign donors that local borrowing will grow out of control. 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. This is a view 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 and the implementing regulations have largely been approved. In a real sense, the implementing regulations are defining the structure of decentralization in Indonesia. Many of these implementing regulations were issued in the final days before decentralization 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, 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 revising the laws to improve clarity and transparency.

A Transition Plan. Any fiscal decentralization program 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 as currently 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 Government 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 an overall decentralization strategy can be finalized. 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 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. 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 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.

Second, before the Government can make final 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 then begin making its decisions about the proper structure of the intergovernmental transfer system, including the role of conditionalities in grant design. These conditionalities, if significant, should perhaps be generally agreed upon at a reasonably high and centralized level. Under this approach, debate about conditionalities would take place before they are put into place. Also, 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.

Third, 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 formulae, 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.

Fourth, 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 Government 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 Government on these matters, but there is as yet little public "buy-in" to this work, in part because the policy analyses are largely not yet in the public domain. It is very important to the "buy-in" 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 decentralized system in a country as large and as complicated as Indonesia. At present, there does not seem to be a comprehensive strategic plan on which agreement has been reached to guide fiscal decentralization over the next several years. On the one hand, it seems clear that many local governments in Indonesia are not yet 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 Government is asserting that all jurisdictions will go forward together, but privately it appears that the Government is being more realistic, even though any criteria are not publicly available, if they exist at all.

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. These regulations include such things as exact expenditure assignments, revenue powers and limits, budget constraints, mandates, borrowing authority, and the like. What the Government has accomplished in this area is subject to reconsideration by the Parliament. 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 of the Government 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. In Indonesia, one favorable sign is that all the pieces for such a process are already on the table, and much detailed work has been completed.

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 Government should undertake a number of activities. It should 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). 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 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 decentralization. While those capacities are theoretically 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 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 commission at least should report directly to the Parliament and to the President's office.

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 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 decentralization of Indonesia's tax revenue sources is necessary.⁵

Of course, it has been argued that such decentralization might partially 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, decentralization of revenue authority may reduce the ability of the central government 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 Government 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 Government should deliver significant control over own-source revenues at the provincial levels to all provinces. The specific revenue sources considered for partial provincial and local government control are the corporate income tax, the individual income tax, and, especially, and the land and business tax. Provincial and district parliaments should be allowed to establish the tax rates of these taxes, within limits established by the Government. However, the tax base could remain under the control of the central government, and tax administration could continue to be an entirely central government function. 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. Local control of the base of these taxes should only be permitted at a later date, after some tax administration responsibilities are decentralized to provinces.⁶

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.

V. Conclusions

Implementing the 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. However, the existence of a democratic government suggests promise of an ability to address these matters.

Still, nothing changes the core economic and technical logic that underpins the importance of the ongoing decentralization. The pursuit of decentralization may well be 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 much 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

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

² 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.

³ 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 middle of year 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.

⁴ 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).

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. See Ross McLeod (2000) for 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 calculated by province. In general, both taxes are likely to be more efficiently collected by the central government than by local governments; the local surtax can then be distributed to the relevant local government. The land and business tax is essentially a property tax

on the real value of the property, now administered by the central government but more typically assigned to local governments. The other main possible 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 usually a good candidate for decentralization, due largely to administrative considerations.