

# FISCAL DECENTRALIZATION IN INDONESIA: CURRENT STATUS AND FUTURE CHALLENGES<sup>1</sup>

By

Maman Suhendra and Hidayat Amir<sup>2</sup>

*Using 214 out of 440 data set in 2004, it is found that most of local governments in Indonesia showed poor performance in generating local own revenues. The methods used here are the Quadrant and Index Methods. Some reasons can explain this poor situation. Beside the weak local taxation power, the dominant role of central government in revenue-generating has led to the poor performance. Furthermore, the Indonesian decentralization is in process toward the more ideal form. Nonetheless, it is widely-known that the “big-bang” decentralization approach has changed Indonesia as one of the most centralized countries into one of the more decentralized ones without any significant interruption.*

*Key Words: decentralization, local own revenue, general allocation grant (DAU)*

---

<sup>1</sup> Published at Jurnal Keuangan Publik, Ministry of Finance RI, September 2006

<sup>2</sup> Maman Suhendra ([maman.suhendra@iei.com](mailto:maman.suhendra@iei.com)) is staff for the Fiscal Policy Office, Ministry of Finance. Maman graduated from KDI School of Public Policy and Management South Korea in August 2006. Hidayat Amir ([hidayat.amir@iei.or.id](mailto:hidayat.amir@iei.or.id)) is researcher for the Fiscal Policy Office, Ministry of Finance. Hidayat got his master degree in Economics Science from University of Indonesia in 2004.

## **I. INTRODUCTION**

### **I.1 Background**

Decentralization has been implemented in Indonesia since January 1, 2001. Upon a radical and rapid decentralization program, regional autonomy is transforming one of the most centralized countries in the world into one of the more decentralized ones. The transition to a significantly more decentralized mode of governance was smooth. Many indications showed the well-going transition process. Firstly, local governments assumed responsibility for their new functions as scheduled. Secondly, the central government has continuously increased the pool of resources transferred to sub-national governments, both in relative and absolute terms. Third, in 2004 the second round of democratic elections, at both national and sub-national levels took place without any major interruptions and local governments are now headed by democratically elected mayors. Finally, at the same time, the most significant risks associated with decentralization were minimized. However, there exist some crucial issues that come into consideration such as the weak local taxing power, the controversial intergovernmental transfers, and the low local accountability for service delivery.

### **I.2 Objectives of the study**

The objectives of this study are to examine the recent fiscal decentralization process in Indonesia and to identify the problems arisen by the decentralization program. Several recommendations will be suggested as policy alternatives for the government, both national and sub-national level. More specifically, this study aims:

1. To provide a brief description of the fiscal decentralization process in Indonesia since the beginning up to the recent.
2. To assess the current fiscal decentralization status in Indonesia.
3. To understand the local government (district-level) financial ability.
4. To figure out some issues and problem in the fiscal decentralization program.
5. To give several recommendations on the problems arisen in the fiscal decentralization program.

### **I.3 Methodology**

Methods used to examine the study's objectives are both descriptive qualitative and quantitative methods, in that all information and data collected are critically examined and described in order to achieve the research questions. Type of data collected is secondary data. The secondary data is collected from institutions and agencies including Ministry of Finance, National Development Planning Agency, and Indonesian Central Board of Statistics at provincial and regency/municipality levels. The purpose of collecting secondary data is to provide a description of the fiscal decentralization trends and progress since 2001. Other related information and secondary data are also collected from many sources.

## **II. THEORITICAL CONCEPT**

### **II.1 Decentralization: Pros and Cons**

Decentralization allows individuals a variety of bundles to choose among, as well as

two means of expressing preferences: voting within a jurisdiction and migrating between jurisdictions (Rubinfeld 1994). The advantages of decentralization correspond to the advantages of the competitive market system; to the extent that there is competition, it can be expected that decentralization outcomes will be economically efficient because sub-national governments are better positioned than central government to deliver public services as a result of information advantage. Therefore, decentralization has been promoted not only to accommodate cultural diversity but also to enhance democracy, mollify separatist tendencies, help restrain a central government from excessive concentration of power, foster economic development, improve government efficiency and facilitate modernization. These powerful arguments help explain why decentralization has become so popular in recent decades.

Some, however, have advanced counterarguments that challenge some of the promising conclusions or, at least, outline conditions in which decentralization could be less attractive policy (Tanzi 1995). Tanzi (2000), Prod'homme (1995), and Alesia and Perotti (1995) warned that sub-national governments may overspend in anticipation of receiving additional resources from general purpose grant. Geographically dispersed interests also present the danger that some sub-national governments to the central government could collude to extract more resources from general purpose grant allocation. Thus, they point towards efficiency and equity considerations whereby decentralization could lead to problems of macroeconomic management.

Based on the above controversy arguments, although decentralization may be rather simplistically defined as opposite of centralization, in reality, the concept is far more complex, not least because in the real world perfect decision autonomy and hence pure decentralization do not exist (Leonard 1982). Decentralization, then, must be understood as a process, rather than as a final goal or objective that can be fully attained in a set period of time. Instead of being something that can be accomplished, it must be regarded as a series of measures that are followed in an attempt to eliminate or at least to reduce over concentration.

## **II.2 Economic Rationale of Decentralization**

The fundamental theorem of welfare economics – Adam Smith’s “invisible hand” – implies that in the absence of market failure, the economy will be Pareto efficient. Individuals, acting in their own self-interest, will make decisions that lead to Pareto efficiency. Competition among producers leads them to supply the goods that individuals want at the lowest possible cost. An analogous argument can be made for the provision of local public goods and services by state and local governments as distinct from federal government. It is argued competition among communities will supply and produce goods and services in an efficient manner. The theory of fiscal federalism suggests that decentralization improves public service delivery because of greater allocative efficiency (matching public goods to local preferences), as well as improved productive efficiency (in part because of greater accountability, less bureaucracy, and better knowledge of local costs) and better cost recovery (greater willingness of citizens to pay fees and taxes for improved public services). Furthermore, the allocative efficiency analysis (Oates 1972) holds that local governments will likely be better able to match public goods to local preferences

than will higher-level governments. Another strand of the argument is that decentralization is thought to increase the likelihood that governments respond to the demand of the local citizens by promoting competition among sub-national governments (Tiebout 1956). Tiebout's model suggests that competition among communities is not only healthy, but necessary to attain Pareto optimality.

### **II.3 Fiscal Decentralization Requires Significant Local Government Taxing Powers**

Fiscal decentralization should be viewed as a comprehensive system. The system covers both necessary and desirable conditions. The necessary conditions include: 1) elected local council; 2) locally appointed chief officers; 3) significant local government discretion to raise revenue; 4) significant local government expenditure responsibilities; 5) budget autonomy and 6) a hard budget constraint transparency. In addition, the desirable conditions comprise: 1) freedom from excessive central expenditure mandates, 2) unconditional transfers from higher-level governments and 3) borrowing powers. Voters will hold their elected officials more accountable if local public services are financed to a significant extent from locally imposed taxes, as opposed to the case where financing is primarily by central government transfers. To do so, the tax must be visible to local voters, large enough to impose a noticeable burden, and the burden must not be easily imported to residents outside the jurisdiction. Moreover, to capture the benefits of fiscal decentralization, it is suggested that there must be significant local autonomy given not only on the taxing side but also on the expenditure side. If local governments do not have the power to set tax rates, then their officials cannot be held fully accountable by voters for the quality of public services delivered. In addition, it is also necessary for local councils and chief officers to be elected. Otherwise, they will not be accountable to the local voting population, and the efficiency gains of decentralization will be lost (Bahl 1999).

## **III. THE REVIEW OF FISCAL DECENTRALIZATION IN INDONESIA**

### **III.1 Long Way toward Decentralization**

Indonesia is a nation of huge territorial area. It has not only enormously diverse ethnic and cultural groups but also different resources endowments from one region to another. As a consequence, the economic development levels differ considerably. Given the vastness of, and diversity in, the country, the need for decentralizing government function has long been recognized, although with a varying intensity. There existed fluctuation between decentralization and centralization in the political thinking and sentiment.

In 1970s, there was a more serious effort to promote regional development and to decentralize as a means of doing so. Following the MPR State Guidelines and the second 5-Year Development Plan for 1973-1978, Law 5 of 1974 on Regional Autonomy was passed. However, the effort was brought to an end. The law was never followed up by any government regulation for implementing it, in spite of the fact that the next third 5-Year Plan also gave pertinent emphasis to regional development.

Under Law 5 of 1974, the central government was the most powerful

institution, and the country became highly centralized since the Minister of Home Affairs (as the central government's representative) controlled all regional affairs and activities. Furthermore, at the regional level, governors had great stature as the heads of territorial units and enjoyed higher positions than the heads of district government. As the only executive branch manager in every region, the governors had the authority to control, manage, lead, supervise, as well as coordinate subordinates in their region.

Law 22 of 1999 on Local Government Administration and Law 25 of 1999 on Central and Local Fiscal Balance have changed the inter-governmental relationship. These two laws are used as the legal basis for the decentralization process in Indonesia by establishing a stronger role for district-level governments (regencies and municipalities) as opposed to province-level governments (Brodjonegoro and Asanuma 2000). Since Law 22 of 1999 was enacted, Indonesia has changed drastically from a highly centralized government to a very heavily decentralized system (Usui and Alisjahbana 2003).

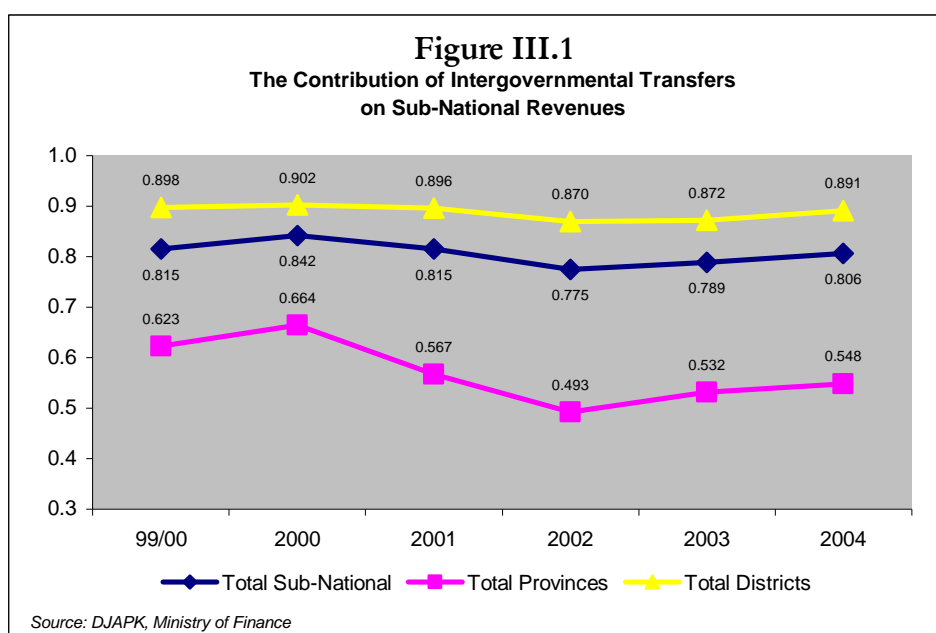
The recent revised Law 22 of 1999 (Law 32 of 2004) and Law 25 of 1999 (Law 33 of 2004) are noticeably a promising step to make the Indonesian decentralization work and to navigate the decentralization process into a right direction. There are several important spirits toward this direction. The main spirits of revised Law 22 of 1999 are to promote local democracy and local good governance that are consistent with the issues at national level. On the other hand, the revised Law 25 of 1999 encourages the idea of fiscal sustainability and more equalized intergovernmental transfers.

### **III.2 Fiscal Decentralization: Objectives and Recent Status**

In Indonesia, the implementation of the fiscal decentralization program are intended to: (1) increase national allocation and regional government efficiency; (2) meet regional aspirations, improve overall fiscal structure, and mobilize regional and therefore national revenues; (3) enhance accountability, increase transparency, and expand constituent participation in decision-making at the regional level; (4) lessen fiscal disparities among regional governments, assure the delivery of basic public services to citizens across the country and promotion of government efficiency objectives; and (5) improve social welfare of Indonesians.

Law 22 of 1999 eliminated the hierarchical relationship between provincial and district governments. According to this Law, district governments have total administrative authority except for five sectors: 1) defense and security, 2) monetary and fiscal policy, 3) diplomacy, 4) religion, and 5) judiciary. The regency/municipality governments, so-called Kabupaten and Kota, have more authority to govern their own districts. As government has three important functions, i.e., stabilization, distribution and allocation, the central government will take responsibility for the first two functions, while regional governments (provinces and districts) will implement the third function. In addition, because of decentralization, provincial governments are not as powerful as before, while local governments (regencies and municipalities) play a more important role in planning and development due to their proximity to the local populace.

Even though decentralization has continued since 2001, and local governments have the higher priority, most of their funding sources are still dependent on the central government. As depicted by Figure III.1, the transfers from the central government, which consist of shared revenue, general allocation fund (DAU) and special allocation fund (DAK), are the major sources of funding for local governments. The figure shows that the districts are more relied on the intergovernmental transfers than the provinces. On average, the districts relied almost 90 percent on the intergovernmental transfers to fund their expenditures. On the other hand, the provinces relied only about 55 percent on average on the transfers.



Furthermore, the dependency on the central government has increased since the start of decentralization. It can be seen from Table III.1 that the national spending for the sub-national levels increased during the five years implementation of the decentralization era.

**Table III.1**  
**Sub-National Spending in the State Budget**  
**FY 2000 to 2005**

Fiscal Year	Sub-National Spending (Rp trillion)	GDP (Rp trillion)	% of GDP	National Revenues (Rp trillion)	% of National Revenues	National Spending (Rp trillion)	% of National Spending
2000	32.9	997.0	3.30	205.6	16.00	220.8	14.90
2001	82.4	1615.7	5.10	305.2	27.00	355.2	23.20
2002	94.5	1688.0	5.60	302.0	31.30	343.8	27.50
2003	116.9	1948.0	6.00	336.2	34.77	377.5	30.96
2004	119.0	2017.6	5.90	349.9	34.02	373.4	31.88
2005	129.9	2201.7	5.90	378.2	34.35	392.8	33.07

Source: DJAPK, Ministry of Finance

The current local revenue framework specifically defines four principle revenue categories (1) Regional Own Revenues, consisting of tax and non-tax

revenues; (2) the intergovernmental transfers, consisting of the shared taxes and revenues, the general allocation grant (DAU) and the special allocation grant (DAK); (3) loans and other forms of local borrowing; and (4) other local revenues. Among these revenue instruments, the DAU still remain the main source of local government revenues. The current system relies primarily on general allocation fund (DAU) over which local governments have full discretion.

The main trust of the recent Indonesian decentralization policy was still on the devolution of expenditure responsibilities. On the other side, the tax assignments remain largely unchanged by the decentralization policy. All significant tax bases, including value added tax (VAT), personal and corporate income taxes remain under the control of the central government.

### III.3 Regional Own Revenue (PAD)

Local taxing power could be reflected in the regional own revenue since its main sources are local tax and user-charge. Ideally in the era of decentralization, the revenue from this source must be increasing over time. However, some empirical evidences showed that the regional own revenues from local governments in Indonesia were still very small compared to the total local revenues.

**Table III.2**  
**The District Own Revenue Contribution from Total Revenues**  
**Before and After Decentralization Era**

Region	Before Desentralization (%)			After Desentralization (%)		
	98/99	99/00	<i>Average</i>	2001	2002	<i>Average</i>
Java	14.2	12	13.1	8	13.2	10.6
Non Java	8.5	8.2	8.4	6	7	6.5
Java plus Non Java	10.6	9.8	10.2	6.7	9.4	8.1

Source: Bapekki, Ministry of Finance

In the beginning period of decentralization, the average regional own revenue contribution was decreasing. Overall, the contribution before decentralization was 10,2 from total revenue while after decentralization was 8.1 percent. It means that there happened a 2.1 percent decrease in the own revenue contribution. In other words, the fiscal ability to fund expenditures decreased in the beginning period of decentralization. However, in the decentralization era, the nominal amount of own revenue increased significantly compared to periods before the decentralization era. The average own revenue before decentralization was Rp 7.9 billion. This amount changed to Rp 21.5 billion in the decentralization era (170.2 percent increase). Before decentralization, the own revenue growth was only 7.7 percent, while in the decentralization era was 68.3 percent. This fact shows us that the local governments have done significant efforts to find out the revenue sources seriously.

It is important to note that the non Java region showed lower efforts than Java region. This is because the economic activities in Java are much bigger than non Java. In addition, Java has adequate infrastructures and human resources to support such activities.

**Table III.3**  
**Average District Own Revenue before and after Decentralization**

Region	Before Decentralization				After Decentralization				Average Growth (%)
	98/99	99/00	Growth (%)	Average	2001	2002	Growth (%)	Average	
	Java	11,452	14,048	22.7	12,750	24,001	50,138	108.9	
Non Java	5,791	5,830	0.7	5,810	12,797	17,499	36.7	15,148	160.7
Java + Non Java	7,691	8,285	7.7	7,988	16,088	27,077	68.3	21,583	170.2

Source: Bapekki, Ministry of Finance

As the main source of regional own revenue, the growth of local tax and user-charge were positively affected by the decentralization policy. Before decentralization, the local tax growth was 31.4 percent and the user-charge was -11.6 percent. In the decentralization era, the growth changed to 87.8 percent and 24.5 percent, respectively.

**Table III.4**  
**District Own Revenue Components before and after Decentralization**

Region	Before Decentralization			After Decentralization		
	98/99	99/00	Growth (%)	2001	2002	Growth (%)
	<b>Java</b>					
Local Tax	4,083	5,777	41.5	9,204	26,463	187.5
User-Charges	5,347	6,372	19.2	10,270	12,752	24.2
Profit from Local Owned Enterprises	319	390	22.2	519	1,154	122.4
Others	1,703	1,509	-11.4	4,008	9,769	143.7
<b>Non Java</b>						
Local Tax	2,802	3,594	28.2	6,395	8,199	28.2
User-Charges	2,232	1,419	-36.4	3,093	3,871	25.1
Profit from Local Owned Enterprises	119	160	34.2	260	487	87.5
Others	637	657	3.1	3,049	4,941	62.1
<b>Java + Non Java</b>						
Local Tax	3,232	4,246	31.4	7,221	13,559	87.8
User-Charges	3,278	2,899	-11.6	5,202	6,477	24.5
Profit from Local Owned Enterprises	186	229	22.8	336	683	103.3
Others	995	912	-8.4	3,330	6,358	90.9

Source: Bapekki, Ministry of Finance

Sub-national taxation is regulated by Law 34 of 2000 on regional taxes. There are four provincial taxes, 1) motor vehicle tax, 2) motor vehicle transfer tax, 3) fuel excise tax, and 4) ground water extraction and use tax. Moreover, there are seven kinds of taxes for local government, 1) hotel tax, 2) restaurant tax, 3) street lighting tax, 4) advertisement tax, 5) entertainment tax, 6) mining tax for class c minerals and 7) parking tax. The tax bases here are determined by central government. For each of these taxes, there is rate cap within which sub-national governments can set their

rates.

**Table III.5**  
Sub-National Taxes

Type of Tax	Level	Tax Base	Cap
Motor Vehicle Tax	Provincial	Based on Vehicle Value (annual)	5%
Motor Vehicle Transfer Tax	Provincial	Based on Vehicle Re-Sale Price (annual)	10%
Fuel Excise Tax	Provincial	Based on Fuel Consumption (Retail Price excl. VAT)	5%
Water Excise Tax	Provincial	Based on Water Consumption	20%
Hotel Tax	Local	Based on Turn Over	10%
Restaurant Tax	Local	Based on Turn Over	10%
Entertainment Tax	Local	Based on Turn Over (Admission Price)	35%
Advertisement Tax	Local	Based on Advertisement Rent	25%
Street Lighting	Local	Based on Electricity Consumption (Retail Price excl. VAT)	10%
Mining of C-Class Minerals	Local	Based on Market Value of Extracted Minerals	20%
Parking Tax	Local	Based on Parking Fees	20%

Source: Law 34 of 2000, (Worldbank 2003), PWC (2005)

### III.3.1 Recent Performance of District-Level Own Revenue

To understand the recent regional own revenue performance for the district-level governments, a research was conducted. Considering the data availability and consistency, this research used 214 out of 440 local governments' data in FY 2004. This amount is relatively adequate to represent all districts in Indonesia since it covers all provinces in Indonesia.

**Table III.6**  
More than 100% Growth in District Own Revenue

No.	Regency/Municipal	Province	Own Revenue Growth (%)*
1	Kab. Aceh Tamiang	NAD	437.70
2	Kab. Penajam Paser Utara	Kaltim	367.55
3	Kab. Aceh Barat Daya	NAD	334.00
4	Kab. Paniai	Papua	310.12
5	Kab. Fak-Fak	Papua	261.39
6	Kab. Lombok Tengah	NTB	221.99
7	Kota Ambon	Maluku	167.73
8	Kab. Banyuasin	Sumsel	136.72
9	Kota Tanjung Pinang	Riau	129.56
10	Kab. Nagan Raya	NAD	128.15
11	Kab. Rokan Hulu	Riau	121.66
12	Kota Tebing Tinggi	Sumut	118.24
13	Kab. Bekasi	Jabar	117.48
14	Kab. Banggai	Sulteng	105.14

\*the growth of own-source revenue year  $i$  from year  $i-1$

The focus of the research is to portrait the performance of local own revenue collection for FY 2004, the fourth implementation year of decentralization. This research is important because in the future, ideally, the local governments should not very much rely on the intergovernmental transfers to support the spending as happened up to the recent. The local governments should seek the way to optimize the revenues from own-sources. This effort should be done because the

intergovernmental transfers are more fluctuated than the local own revenues (Bappenas 2003). The intergovernmental transfers could be difference from time to time due to the existing policy or the other factors. Therefore, it is quite important to increase the role of the local own revenue on the local spending to guarantee the fiscal sustainability of the localities. Similar research for provincial-level governments has been conducted by National Development Planning Agency (Bappenas) in 2003. At that time, it was found that in FY 2002 most of the provinces had poor performance in generating the regional own revenues.

In 2004, the average own revenue growth was 25.24 percent. It means that, on average the local government could increase the own revenue growth to slightly more than a quarter from the previous fiscal year (FY 2003). Unfortunately, from 214 local governments, 50 local governments had negative growth. Another interesting finding is that non-Java local governments could lead the own revenues growth. This means that they performed well-efforts to identify their own revenues then executed well-organize management to capture the sources. The following table shows the fact.

The table depicts that of the leading in-growth local governments (i.e. those could reach more than 100% growth), there was only one district in Java, i.e. Kabupaten Bekasi (Province West Java), could reach such level. The rest are non-Java local governments. However, it should be noted that the high growth of own revenue does not always mean the high share to the local spending. It is found that in 2004, the leading - in growth governments were different from the leading - in share governments. On average, the own revenue supported about 8.17 percent of the total spending. Kabupaten Badung, located in Province Bali, accounted more than 60 percent. On the other hand, Kabupaten Penajam Paser Utara accounted only about 1 percent. It means that this regency depended very much on the other revenue sources other than its local own revenue to support the total spending.

**Table III.7**  
**The Big 14 in Share on Total Spending**

No.	Regency/Municipal	Province	Share to Spending 2004 (%) <sup>*</sup>
1	Kab. Badung	Bali	60.44
2	Kota Cilegon	Banten	35.52
3	Kab. Bekasi	Jabar	33.96
4	Kota Denpasar	Bali	26.06
5	Kota Medan	Sumut	25.68
6	Kota Semarang	Jateng	23.56
7	Kota Yogyakarta	Yogya	21.58
8	Kota Bandung	Jabar	21.02
9	Kota Tangerang	Banten	19.60
10	Kab. Sidoarjo	Jatim	19.45
11	Kota Kupang	NTT	18.49
12	Kab. Bogor	Jabar	17.20
13	Kab. Tangerang	Banten	17.16
14	Kab. Fak-Fak	Papua	16.97

*\*the ratio between the own-source revenue and the total spending*

In order to get the local financial ability status more precisely, the Quadrant

and Index method will be used. In doing so, some measures will be determined first. Elasticity (E), share (S) and growth (G) are chosen to represent the local financial ability (Bappenas 2003). *Elasticity* is the ratio between the own revenue growth and the gross domestic regional product (GDRP) growth. *Share* is the ratio between the own revenue and total spending. Finally, *growth* is the growth of own revenue year i from year i-1.

### III.3.1.1 Quadrant Method

This method will show the financial ability map. The map will be divided into 4 quadrants. Each quadrant will explain better the financial condition of each local government in terms of share (S) and growth (G). To obtain the map, first of all, the share (S) and the growth (G) for each local government are calculated using the following formula.

$$S = \frac{PAD}{totspending} \times 100\% \quad (1)$$

$$G = \frac{PAD_i - PAD_{i-1}}{PAD_i} \times 100\% \quad (2)$$

Where:

*S* = share of local own revenue on total spending (in percent)

*PAD* = local own revenue

*totspending* = total spending for the respective fiscal year

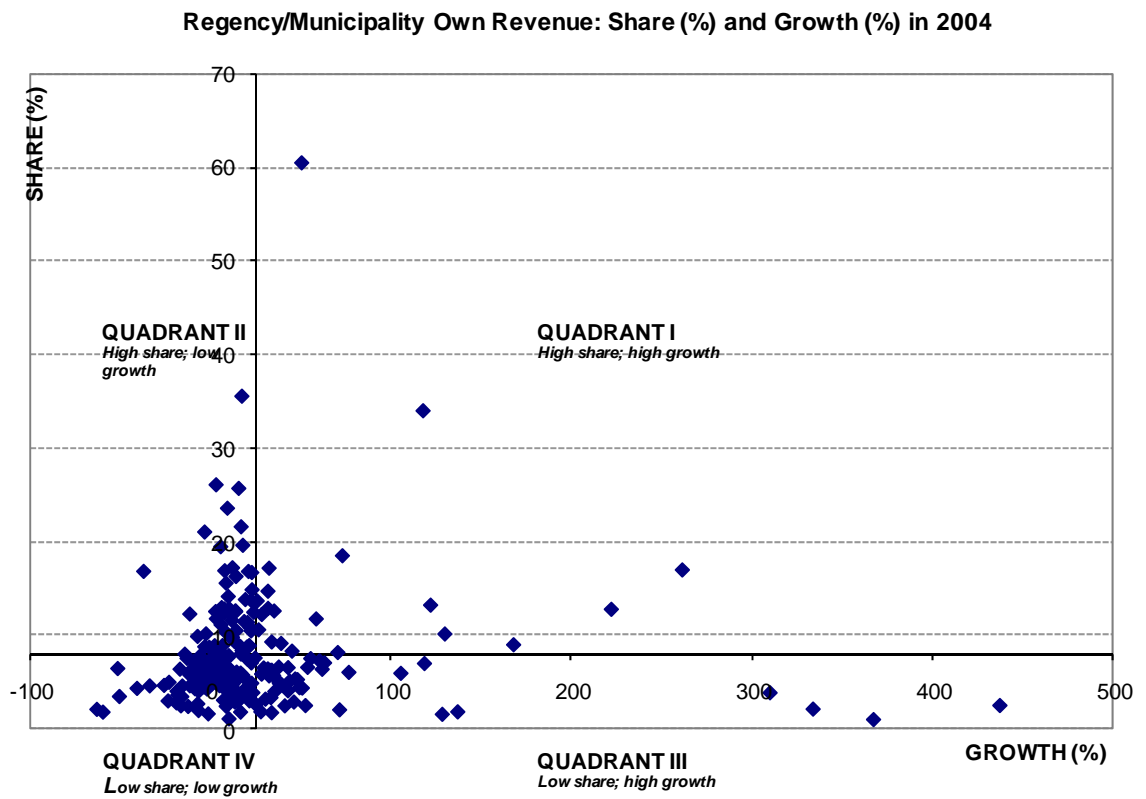
*G* = local own revenue growth (in percent)

*PAD<sub>i</sub>* = PAD year i

*PAD<sub>i-1</sub>* = PAD year i-1

After obtaining the share and growth for each local government, an average share and growth were determined. Based on this average point, the quadrant for each local government could be determined. From the 214 local governments observed, it is found that almost 50 percent were still in the Quadrant IV. Meanwhile, only around 9 percent were in the Quadrant I. Slightly over 25 percent were in the Quadrant II. Finally, around 20 percent were in the Quadrant III (See Figure III.2 for the brief).

**Figure III.2**  
**The Map of Local Governments Financial Ability-Quadrant Method**  
**(Average Point: Growth = 25.24; Share = 8.17)**



The following table gives the explanation for each quadrant.

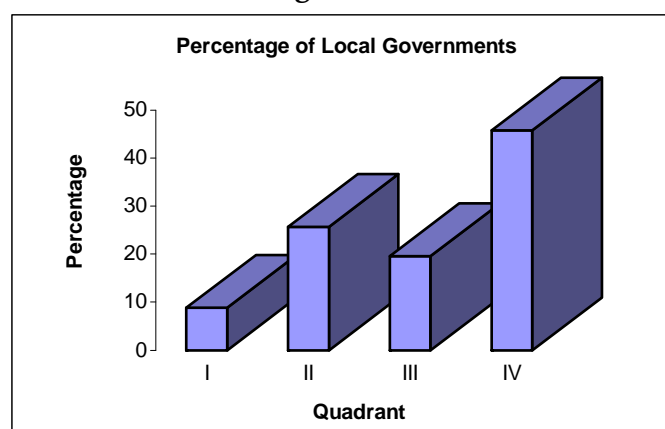
**Table III.8**  
**Quadrant Descriptions**

Quadrant	Description
I	This is an ideal condition. Own revenue has a significant share in the total spending. In addition, the local government also has the ability to improve local potency. This condition is showed by the high share and growth.
II	This condition is not ideal yet. The relative high share of own revenue has chance to decrease due to the low growth of own revenue. Here, the share of own revenue to total spending is high, but the own revenue growth is low.
III	This condition is also not ideal yet, but the local government has ability to improve the local potency so that own revenue has chance to have larger share in total spending. Here, the share of own revenue is low but the growth is high.
IV	This is the worst condition. The own revenue has not had significant share in total spending. Also, local government has not had ability to improve the local potency. Both the share and growth of own revenue are low.

Source: National Development Planning Agency (2003)

From 214 local governments observed, 8.88% local governments had high share and growth, 25.70% high share but low growth, 19.63% low share but high growth, and 45.79% low share and growth (See Figure III.3).

Figure III.3



Of 19 local governments in the Quadrant I, there were 7 local governments come from the Eastern Part of Indonesia. It indicates that the fiscal decentralization had stimulated those regions to increase their ability to support their own-spending. It is well-known that years before the enactment of the fiscal decentralization, most of the eastern part of Indonesia showed poor performance in generating their own revenue due to the highly centralization policy. In addition, Table III.9 informs that the Java local governments' domination had been decreased. It is indeed a good signal of equalization as one of the basic fiscal decentralization purposes. However, most of the local governments were still in the Quadrant IV. Both their share and growth of own revenue were still low. The local governments in the Eastern part of Indonesia accounted almost 46 percent while the Western part accounted almost 54 percent.

Table III.9

List of Districts in Quadrant I (With Share and Growth Criterion are HIGH)

No.	Regency/Municipality	Province	Remarks	No.	Regency/Municipality	Province	Remarks
1	Kab. Badung	Bali	Western Part	11	Kota Ambon	Maluku	Eastern Part
2	Kab. Bekasi	Jabar	Western Part	12	Kota Banjarmasin	Kalsel	Eastern Part
3	Kab. Fak-Fak	Papua	Eastern Part	13	Kota Blitar	Jatim	Western Part
4	Kab. Lombok Tengah	NTB	Eastern Part	14	Kota Depok	Jabar	Western Part
5	Kab. Lombok Timur	NTB	Eastern Part	15	Kota Gorontalo	Gorontalo	Eastern Part
6	Kab. Pasuruan	Jatim	Western Part	16	Kota Jambi	Jambi	Western Part
7	Kab. Pati	Jateng	Western Part	17	Kota Kupang	NTT	Eastern Part
8	Kab. Rokan Hulu	Riau	Western Part	18	Kota Pangkal Pinang	Babel	Western Part
9	Kab. Tabanan	Bali	Western Part	19	Kota Tanjung Pinang	Riau	Western Part
10	Kab. Tangerang	Banten	Western Part				

### III.3.1.2 Index Method

The next method used to determine the financial ability among regions is the Index Method. Beside the two measures (share (S) and growth (G)) used in the previous method, elasticity (E) is added in this method. The following formula is used to calculate the elasticity.

$$E = \frac{\frac{PAD_i - PAD_{i-1}}{PAD_i}}{\frac{GDRP_i - GDRP_{i-1}}{GDRP_i}} \quad (3)$$

Where:

- $E$  = the ratio between PAD growth and GDRP growth
- $GDRP_i$  = gross domestic regional product year i
- $GDRP_{i-1}$  = gross domestic regional product year i-1

After calculating the measures, each measure is transformed to the index number using the following formula.

$$IndexX = \frac{X - X_{min}}{X_{max} - X_{min}} \quad (4)$$

Finally the following formula is used to get the Index of Financial Ability (IFA).

$$IFA = \frac{X_G + X_E + X_S}{3} \quad (5)$$

Where:

- $X_G$  = Growth Index
- $X_E$  = Elasticity Index
- $X_S$  = Share Index

**Table III.10**  
**The Big 10 Districts with  $E \geq 1$**

No.	Regency/Municipal	Province	Elasticity
1	Kab. Aceh Tamiang	NAD	35.64
2	Kab. Aceh Barat Daya	NAD	31.67
3	Kab. Fak-Fak	Papua	28.75
4	Kab. Penajam Paser Utara	Kaltim	23.89
5	Kab. Lombok Tengah	NTB	20.92
6	Kota Ambon	Maluku	16.73
7	Kab. Paniai	Papua	16.48
8	Kab. Bekasi	Jabar	14.69
9	Kota Kupang	NTT	12.44
10	Kab. Nagan Raya	NAD	11.03

From the elasticity analysis, it is found that almost 120 local governments had elasticity  $E \geq 1$ . It means that any change in the GDRP is sensitive over the change (i.e. increasing) in own revenue. However, there were 25 local governments that had  $E \geq 1$  with negative sign. This means that any change in the RGDP is sensitive over the change (i.e. decreasing) in own revenue. Finally, the rest local governments had  $E < 1$  which means the change in RGDP is not sensitive over the change in own revenue.

Comparing to the Quadrant Method, the Index Method accommodates more measure than the Quadrant Method since it accommodates the elasticity ( $E$ ) of own revenue growth over the gross domestic regional product (GDRP) growth. The big ten local governments that had high IFA are as follow.

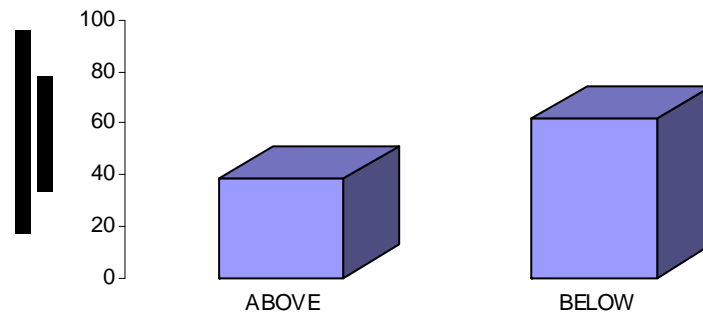
**Table III.11**  
**The Big 10 High IFA Districts**

No.	Regency/Municipal	Province	IFA
1	Kab. Aceh Tamiang	NAD	0.68
2	Kab. Fak-Fak	Papua	0.58
3	Kab. Aceh Barat Daya	NAD	0.57
4	Kab. Penajam Paser Utara	Kaltim	0.53
5	Kab. Badung	Bali	0.50
6	Kab. Lombok Tengah	NTB	0.47
7	Kab. Bekasi	Jabar	0.47
8	Kab. Paniai	Papua	0.44
9	Kota Ambon	Maluku	0.38
10	Kota Kupang	NTT	0.34

Consistent with the previous method, the Index Method shows that most of the local governments (68%) still had below-the average IFA. Even after considering the elasticity of GDRP growth over the PAD growth, the financial ability of most local governments was relatively low.

**Figure III.4**

**THE LOCAL GOVERNMENT PERCENTAGE OF ABOVE AND BELOW THE AVERAGE IFA**



### III.4 Intergovernmental Transfers

The system of intergovernmental transfers in Indonesia comprises three basic types of transfer schemes, i.e. revenue sharing, a general allocation grant (Dana Alokasi Umum – DAU), and grants for special allocation (Dana Alokasi Khusus – DAK). The following table describes the main objectives of intergovernmental transfers system in Indonesia.

Shared revenue, DAU and DAK can be used to stimulate revenue mobilization. DAK is also used to address some local matters. On the other hand, DAU is used to equalize regional development fiscal capacities. Finally, both shared revenue and DAU can be used to address vertical imbalances between government levels.

**Table III.12**  
**The Main Objectives of Intergovernmental Transfers**

Intergovernmental Transfers' Objectives	Instruments
1 Address vertical fiscal imbalances between government levels	shared revenue, DAU
2 Equalize regional government fiscal capacities to deliver services	DAU
3 Encourage regional expenditure on national development priorities	DAK
4 Promote the attainment of minimum infrastructure standards	DAK
5 Compensate for benefit/cost spillovers in priority areas	DAK
6 Stimulate regional commitment	DAK
7 Stimulate revenue mobilization	shared revenue, DAU, DAK

Source: Sidik (2003)

From FY 2001 to FY 2005, intergovernmental transfers had steadily increased. General Allocation Grant took the highest contribution in the transfers. It accounted slightly over 70 percent for the recent fiscal year. On the other hand, the shared revenue took the second high in the transfer. It was a little over 25 percent in the FY 2005. Finally, the Special Allocation Fund took only less than 5 percent of the transfers.

**Table III.13**  
**SPENDING FOR SUB-NATIONAL GOVERNMENTS FY 2001 TO 2005**

Item	State Budget				
	(Rp trillion)				
	2001	2002	2003	2004	2005
<b>Intergovernmental Transfers</b>	<b>81.48</b>	<b>94.53</b>	<b>109.93</b>	<b>112.19</b>	<b>124.31</b>
<b>Revenue Sharing</b>	<b>20.26</b>	<b>24.60</b>	<b>29.93</b>	<b>26.93</b>	<b>31.22</b>
Tax	8.55	11.95	15.83	16.42	19.50
Personal Income Tax	3.10	4.07	5.47	6.04	6.40
Property Tax (PBB)	4.27	5.67	8.52	7.71	9.80
Property Title Transfer Tax (BPHTB)	1.18	2.21	1.85	2.67	3.20
Natural Resources	11.71	12.66	14.09	10.51	11.80
Oil	5.90	5.79	6.23	3.84	4.70
Gas	3.84	4.78	5.67	4.66	4.60
Mining	0.74	1.07	1.19	1.30	1.60
Forestry	1.00	0.79	0.57	0.23	0.30
Fishery	0.23	0.23	0.43	0.48	0.60
<b>General Allocation Grant (DAU)</b>	<b>60.52</b>	<b>69.11</b>	<b>76.98</b>	<b>82.13</b>	<b>88.77</b>
<b>Specific Allocation Grant (DAK)</b>	<b>0.70</b>	<b>0.82</b>	<b>3.02</b>	<b>3.13</b>	<b>4.32</b>
Special Autonomy Fund and Adjustment	-	3.77	9.39	6.86	7.24
Special Autonomy Fund	-	1.38	1.54	1.64	1.78
Adjustment Fund	-	2.38	7.85	5.21	5.47

Source: DJAPK, Ministry of Finance

### III.5 Local Government Borrowing

Concerns about macro-economic instability have led Indonesian government to regulate access of regional governments to capital markets carefully. Both Law 25 of 1999 and its revision, Law 33 of 2004, allow for regional borrowing from both domestic and international sources and to issue denominated municipal bonds on domestic capital markets. In addition, regional governments may also guarantee

third party debt. However, at the same time the related government regulation on regional borrowing sets tight limits for debt-revenue ratios. The total debt is limited to 75 percent of revenues minus necessary expenditures<sup>3</sup>. On the other hand, service is limited to 35 percent of revenues minus necessary expenditures. Moreover, the short term borrowing (less than one year maturity) is limited to 1/6 of current spending and can only be used for cash flow management. Long term borrowing (more than one year maturity) can only be used for capital expenditures in projects with cost recovery potential. Any long and medium term borrowing of local governments requires approval by both the local representative council (DPRD) and by the central government (via Ministry of Finance). The regulation also gives the central government the right to intercept the transfer of DAU grants in the event that sub-national governments fail to serve their service obligations (Government Regulation 107 of 2000).

#### **IV. MANAGING BETTER FISCAL DECENTRALIZATION**

More than five years have passed since major local government reforms were first implemented in the beginning of FY 2001. Regional autonomy has transformed Indonesia, as one of the most centralized countries in the world, into one of the more decentralized ones. Nevertheless, there is always a room for improvement in a number of areas that can further enhance the positive effects of decentralization in the Indonesian context.

##### **IV.1 Strengthening Local Taxing Power**

Although both provincial and local governments have more variety on collecting taxes, it is quite clear that more significant taxes such as income tax, value added tax, land and property tax are all under control of the central government. In general, the local taxing power in Indonesia considered weak due to the absence of one of these major taxes at the local level, even through the piggy-backed system. The current fiscal decentralization system, through Law 33 of 2004, still emphasizes on the tax revenue sharing of property tax, land transfer tax, and personal income tax. While the local governments receive certain part of the respective tax revenue, they do not have authority in setting tax rate and tax base. As a result, the local governments have little room to provide incentive for local investors.

Having the fact that most districts are still low both in term of own revenue share and own revenue growth and classified below the average IFA Index, it is worth to address such issue in a more balanced approach. Ideally, the decentralization of expenditure responsibilities should be accompanied gradually with enhanced taxing power at local levels. Nonetheless, the current approach devolves expenditure authority more seriously than tax authority. Moreover, the approach also supports a strong role of the central government on the revenue side.

The following option offers how decentralization should be done better. While the decentralization of expenditures allows for some of the gains from decentralization, such as lower cost of production, informational advantages and matching of services with local demand, substantial benefits of fiscal

---

<sup>3</sup> This condition is now directly included in Law 33 of 2004.

decentralization require the devolution of the power to tax. The existing reliance on unconditional transfers (general allocation grants-DAU) to finance local government operations creates incentives that potentially undermine accountability of sub-national governments.<sup>4</sup> Therefore, making local tax bases broader has a number of potential benefits. If service delivery is more closely linked to local tax payments, citizens face greater incentives to monitor government performance and demand accountability from local governments. At the same time, it can further enhance interjurisdictional competition and people choosing low tax – low spending jurisdictions over high tax – high spending jurisdictions could create powerful incentives to increase spending efficiency. If Indonesia wants to benefit from these effects greater, the local taxation autonomy is indeed a necessary institutional prerequisite.

#### IV.2 Shared Revenue: Providing Trade-Off for Asymmetric Decentralization

Despite the spirit and commitment to make decentralization of Indonesia a success, the central government is doing some policies that might not look like in the support decentralization itself but actually to protect the unity of Indonesia. In 2002, along with the internal problems in the province of Aceh and Papua and the trauma of losing the East Timor province, the government decided to issue special autonomy laws for both provinces that not only gave special local political treatments, but also special intergovernmental transfer treatment, especially natural resources revenue sharing.

Unlike other oil and gas producing regions, those two provinces will receive 70% of government revenue share in oil and gas as contrary to others that will only receive 15% or 30%. In addition to the special natural resources revenue sharing scheme, the Papua province receives their special allocation fund with of 2% of total DAU. That fund has to be allocated for basic public services such as education, health, and infrastructure.

**Table IV.1**  
**The Proportion of Revenue Sharing for Aceh & Papua**

No.	Revenue Type	Special Autonomy Laws (%)	
		Aceh	Papua
1	Oil	70	70
2	Gas	70	70
3	Landrent	80	80
4	Royalty	80	80
5	Fishery	80	80
6	Forestry Right to Operate Levy (IHPH)	80	80
7	Forestry Resources Commission (PSDH)	80	80
8	Reforestation Fund	40	40

Source: DJAPK, Ministry of Finance

The decision to apply asymmetric decentralization might be questionable

<sup>4</sup> See Rodden (2002) for some theoretical considerations and across country analysis. In FY 2005, it is found that the DAU accounted more than 80% of the districts' revenue.

from economic policy point of view. The political point of view might be more dominant here. As expected, the asymmetric decentralization generated similar aspiration in other resources rich, but not troubled, regions such as Riau and East Kalimantan. Those two provinces were trying to have similar treatment but the central government was determined that special autonomy laws will only be applied for Aceh and Papua, and not to be replicated in other provinces.

Complaints from Riau and East Kalimantan might have been accommodated through the additional 0.5% oil and gas revenue sharing in Law 33 of 2004. Yet, the more crucial problem is still unsolved. This is the issue about the transfer disbursement. During the three years period (2001 to 2003) the resources rich regions always had hard time in managing their cash flow since the central government always disbursed the oil and gas revenue sharing very late in a fiscal year. The first disbursement might not happen until the end of first semester and the following disbursement might continue as well toward the end of fiscal year.

This is certainly difficult for those regions that have major percentage of revenue coming from that resources revenue transfer. As a result, they ended up with relatively large surplus at the end of fiscal year and implicitly, they effectively utilized their excessive funding a year later. Other effects were delay of payment to contractors and suppliers working with local government or the short term local borrowing to bridge the financing of local projects or programs.

The central government prefers to do this disbursement scheme due to uncertainty in both price and volume of oil and gas in the revenue side of the budget. However, this cautious move will certainly result in the delay of disbursement since the volume prediction and hence, the revenue prediction will take some time. To deal with this problem, a better disbursement management must be made by the central, while the local must run well budget management to ensure better cash flow management to overcome such problem.

### **IV.3 DAU: Addressing the Inequalities**

The Indonesian large horizontal imbalances in fiscal resources need to be addressed ensuring that in particular poor local governments have adequate resources to fund their newly acquired expenditure functions. The currently available fiscal instruments, in particular the DAU grant, which is used to pursue partly conflicting purposes (wage costs and horizontal equalization), may not be able to satisfy regional equity objectives. While compensating vertical fiscal gaps, the DAU is associated with positive but unclear equalization outcomes. This is because the desirable level of equality, or conversely the level of acceptable inequality is still essentially a political question.

A fiscal equalization system must utilize an explicit standard of equalization that is used to determine total pool as well as allocation across jurisdictions. However, the DAU does not embody an explicit standard of equalization. Its total pool is arbitrarily determined. Moreover, its formula combines multiple factors that also work arbitrarily at across purposes. That is why the equity of the final impact therefore remains uncertain.

Nevertheless, identifying a politically sustainable way of reforming the fiscal

systems naturally involve tradeoffs. In particular, the combination of measures that increase local tax autonomy and strengthen the revenue base of fiscally strong regions with a more equalizing DAU system might be a politically suitable trade off.

The role of the DAU formula from 2001 to 2004 had steadily increased both for provincial and district level. However, the role was not significant yet relatively. There were still many things came into consideration in determining the amount of DAU for each government level. Beside non-formula factors, the *bold-harmless*<sup>5</sup> provision must be considered too. All these affected the inequalities. Nevertheless, this situation can not be avoided due to some reasons. First is the economic reason. It is actually not an easy task to have variables that can measure the precise needs of each local government. What could be done is only how to develop better approach to have such measure. The other one is the political reason. As a matter of fact, this reason often became more important than the others in the DAU allocation.

The DAU distribution formula has the objective of ensuring that additional financing of local governments compensates fiscal capacity deficiencies without rewarding grantmanship. Recent refinements on such as elimination of equal per municipality component support this objective by eliminating incentives for local governments to split up to receive additional assistance. Nevertheless, there are several limitations of this formula. First, while expenditure need factors used are defensible, their weights are quite arbitrary and indefensible. Second, rationale for the inclusion of the wage factor is not clear. It has the potential of creating a perverse incentive for padding up civil service payrolls resulting in higher local wage bills. Finally and most importantly, the formula lacks an explicit standard of equalization and its allocation is not guided by this standard. As a result, while DAU allocations are expected to vary positively with fiscal need and inversely with fiscal capacity, there would not be any clarity in the degree of equalization achieved by this formula.

The ideal fiscal decentralization will divide clearly the responsibilities of central and localities. With this clarity, theoretically, the expenditures of each level of government could be calculated based on the Standard of Spending Assessment (SSA). However, the national calculation guidance for this standard has not been made yet. Therefore, current decentralization has not had valid calculation. For this reason, the allocation of intergovernmental transfers is done without the accurate calculation. Finally, all the transfers, especially general allocation grant (DAU), the most important transfer, is allocated based on variables which are assumed could represent the local fiscal needs.

The establishment of such standard may be left until after actual experience of several years has been accumulated. In the meantime, the government should use the currently existing standard for the purposes of planning, programming and budgeting. More importantly, efforts should be made to construct the mechanisms for monitoring and evaluation of local governments' performance in public service

---

<sup>5</sup> The fund receipt in the current fiscal year should be at least the same as or more than last year.

provisions, and the mechanism for the central government's assistance or interventions in cases of egregiously poor performances on the part of local governments (e.g. through the use of DAK). This approach would not only obviate time and efforts for working out the standard now, but also serve the spirit of local autonomy better.

#### **IV.4 Addressing Better DAK Management**

Considering the spirit of decentralization, there are two brief comments on DAK in order. First, despite significant increases in recent years the DAK expenditures remain relatively limited compared to the regular sectoral development expenditures of the central governments (DIP). In the medium term, DIP should be migrated into DAK. Whether this is a suitable option will depend to a significant degree on the willingness of sector departments to shift resources from DIP to the DAK, over which they have considerably less control. Increasing DAK funds that are regionally and functionally targeted could provide an important instrument to establish common minimum service standards and to address disparities in expenditure needs across Indonesia. In comparison to DIP funds that are not part of the local budgets (APBD), DAK funds are more transparent and can be used as complementary to local spending. The second point refers to the distribution of the DAK. With the notable exception of the DAK to finance government infrastructure that was allocated to finance government infrastructure in newly established governments, the DAK grants are widely dispersed across large numbers of receiving districts. In FY 2005, for example, 333 local governments received education DAK. Allegedly, the allocation process of the DAK funds remain vulnerable to political interference, by regional governments, sectoral departments and budgeting commissions of the parliament (DPR). In effect, the DAK grants seem to be used to cross-subsidize capital expenditures rather than as transfers specifically targeted to districts with serious infrastructure deficiencies. To sum up, beside to maintain the DAK transparency, it is also important to implement DAK management better.

#### **IV.5 Local Accountability for Service Delivery**

Analyzing the impacts of fiscal decentralization to the quality of local public service is complicated since measuring the appropriate indicators that can clarify those impacts is not an easy task. In Indonesian context, the reforms have emphasized a gap filling approach to fiscal transfers that stress local autonomy with little concern for local accountability for service delivery (Eckardt and Shah, 2006).

To assess the quality of local public services, the focus should be on the indicators such as poverty rate and human development index (HDI). During the first three years of fiscal decentralization, those two indicators apparently showed improving figures. HDI in most regions, for example, was higher in 2002 compared to 1999. The poverty rate in most regions also showed significant decline in the same period. These promising figures might imply that the quality of basic public services during the decentralization era better fit local needs and well-targeted. However, that good performance might be more contributed by national program than local government programs. The poverty reduction program is more well-

known as the national program that is cross-sectoral and cross-regional. Moreover, Indonesia has not clarified the health roles and responsibilities of central and lower governments after three years of decentralization. Nor has the country moved to emphasize core public health functions, or seen marked improvements in specific areas such as infectious disease control, pharmaceuticals, and human resources. Also in the education sector, despite on average, districts governments in Indonesia do have more resources at their disposal than in the past, and allocation formula stipulates that poorer districts should receive larger transfers but the central government still expects districts to mobilize more of their own resources to supplement the transfers.

The local accountability for service delivery can be achieved by instituting out-put oriented national minimum standards grants for merit good such as education, health, and roads. These grants could be allocated to local jurisdictions on the basis of simple service population, such as school age population for education grants, and onward distributed to local public and private providers based upon objective indicators of clients served (e.g. school enrollment). Then the continuation of grant in future years would depend upon meeting or improving on baseline service standards monitored directly by citizen-customers. Indonesia in the pre-reform was a pioneer in instituting simple and objective performance oriented grants for education, health, and roads. This is why it would be useful to reintroduce similar transfers again.

#### **IV.6 Issues and Problems of Fiscal Decentralization**

A crucial thing that might still be missing from the recent revised decentralization law process is the law integration spirit that has caused, to some extent, difficult coordination between Ministry of Home Affairs (MOHA) and Ministry of Finance (MOF). Coordination is certainly a key word in Indonesian decentralization process. Therefore, the process still needs a lot of improvement not only among government ministries but also between central and local governments. In the spirit of coordination, the sectoral laws, should, in turn, be adjusted to decentralized environment.

The next difficult issue is the revised laws implementation. As known, the original laws of 22 of 1999 and 25 of 1999 still had a lot of unfinished homeworks. Many necessary government regulations did not exist or have not been finished yet. The incoming of revised laws could help in certain cases but potentially, they could create more complication by having to make the new regulations or adjusting the old ones. The political will of both central and local governments will be a basic requirement to succeed in this tiring and exhausting step. Strong political will then has to be accompanied by competent human resources and managerial capacity, especially at local level. Another implementation problem that needs to be revolved is the administrative duplication or competition between central government (through line ministries) and local government. The better government regulations could be a good start toward the realization of “money follows functions” principle that implicitly demonstrates the consistency between the decentralization laws. At the same time, more political will from central government will be really needed to adjust first the sectoral laws with revised Law 22 of 1999 and 25 of 1999, and then

to reduce the power of line ministries in relation with local governments. Line ministries should promote the gradual transfer from deconcentration activities (also known as DIP activities) into decentralization activities. The empowerment of specific allocation fund (DAK) will be a good solution for that.

Aside from potential political and administrative decentralization problems, there will be some fiscal decentralization problems to be watched for. First is the proposed implementation of no hold-harmless DAU provision in the beginning 2008. The central governments should anticipate the possible resistance of those local governments since there will be some zero DAU local governments. It is better if the central government beginning the socialization of the process earlier before 2008 and preparing better disbursement mechanism of natural resources revenue sharing to ensure better cash flow management of the resources rich local governments that could be the ones with zero DAU. Second, the relatively weak local taxing power substantiated by the failure of shifting the land and property tax authority to the local governments. This could imply to various different effects. One of them is no existence of the “tax price” to local residents where they have less incentive to hold the local governments accountable in delivering basic public services. Another is no existence of appropriate local fiscal incentives that potentially discourage the local governments in pursuing the GDRP growth, and instead, focusing on APBD growth. Third is the possible implementation of local borrowing and local bond issuing in the near future following more detailed explanation in the revised Law 25 of 1999. Since the needs for local borrowing, especially to build and maintain the deteriorating infrastructures, could be unavoidable, the central government has issued some safety guards in the revised Law 25 of 1999 through hard budget constraint concept and limitation of cumulative central and local borrowings. The commitments from both central and local governments in maintaining the principle will be very crucial in avoiding Indonesia to be the “second Brazil” (Brodjonegoro 2006).

## V. CONCLUSION AND RECOMMENDATION

### V.1. Conclusion

The previous entire analysis leads to conclusion that fiscal decentralization in Indonesia is still in the process toward the more ideal form. After five years of decentralization, both national and international communities praised the big-bang approach of Indonesian decentralization as a success. However, in spite of the success, there are some important issues come into consideration.

*First*, the Indonesian local taxing power is still weak. The current approach devolves expenditure authority more seriously than tax authority and supports a strong role of the national government on the revenue side. This leads to the condition of local governments’ high reliance on transfers from the central. Moreover, there is also no adequate incentive for the local governments to upgrade their capacity in generating more local revenues since most of important taxes are managed by the central. As a result, the empirical evidence shows that in FY 2004 the performance of local own revenue was very poor in term of share and growth.

*Second*, the hold-harmless provision, in fact, has worsened the equalization

objective of the general allocation fund (DAU). The inclusion of this provision in the DAU allocation could not be avoided due to political reason. As a result, the role of the DAU formula was relatively not significant. Although this provision will be eliminated in the beginning FY 2008, but the elimination is still linked to the existence of basic allocation.

*Third*, although the Indonesian reforms have emphasized a gap filling approach to fiscal transfers that stress local autonomy but there is still only little concern for local accountability for service delivery. There is need to have a more balanced approach which further strengthens autonomy while creating incentives for accountable local governance.

*The last* but also an important issue is the weak coordination among the levels of government. This issue even has not been addressed totally by the newly revised local autonomy and fiscal decentralization although its importance in the success implementation of the local governments reform.

## V.2. Recommendation

Addressing the previous issues, there are some recommendations come into consideration.

*First*, if Indonesia is to benefit from the fiscal decentralization effects greater, sub-national taxation autonomy is indeed a necessary institutional prerequisite. The assignment of some significant tax bases, like property tax or a piggybacked income tax, to finance marginal public good provision has the potential to increase efficiency and accountability in local government operations. Only by choosing to pay higher or lower taxes at the margin can residents of sub-national jurisdictions choose the level of public services they want.

*Second*, to retain the equalization objective, the hold-harmless provision should be gradually eliminated. At the same time the role of the DAU Formula (i.e. Fiscal Gap Formula) should be gradually increased. In order to attain the equalization objective better, the existence of non-formula components in the future DAU allocation should be limited since they are biased to the equalization.

*Third*, dealing with the accountability matters, the local accountability for service delivery can be achieved by instituting out-put oriented national minimum standards grants for merit good such as education, health, and roads.

*Finally*, it should be understood that the success of fiscal decentralization cannot be achieved without proper coordination among the government levels. Indonesia needs a lot of improvement both among government ministries and between central and local governments. In doing so, the sectoral laws, in the spirit of coordination, should be adjusted to decentralized environment.

## VI. BIBLIOGRAPHY

Agency for Economic and Finance Research, and International Cooperation, 2005, *“Evaluation on the Implementation of Law 34 of 2000 on Local Tax and Charge”*, Research Report, Jakarta.

- Bahl, Roy, W., 1999, *Implementation Rules for Fiscal Decentralization*, Published of the World Bank, New York.
- Brodjonegoro, Bambang (2006), *The Indonesian Decentralization after Law Revision: Toward a Better Future?*, International Conference on Responsive and Accountable Local Governance, Hotel Nikko, Jakarta, 21-22 February 2006.
- Central Statistics Agency (2005), *Gross Regional Domestic Product Regencies/Municipalities in Indonesia*, BPS-Statistics Indonesia, Jakarta.
- Eckardt, Sebastian and Anwar Shah (2006), *Local Government Organization and Finance in Indonesia*, International Conference on Responsive and Accountable Local Governance, Hotel Nikko, Jakarta, 21-22 February 2006.
- Ferrazi, Gabriel (2005), *Obligatory Functions and Minimum Service Standards for Indonesian Regional Government: Searching for A Model*, Journal of Public Administration and Development 25, p. 227-238.
- Fisher, Ronald C. (1987), *State and Local Public Finance*, Scott, Foresman and Company, Michigan.
- Hamid, Edy Suandi (2005), *Alternative Formula for General Allocation Grant (DAU)*, UII Press, Yogyakarta.
- Kwon, Osung (2001), *The Effect of Fiscal Decentralization on Public Spending: the Korean Case*, Paper Prepared for Presentation at 13<sup>th</sup> Annual Conference on Public Budgeting and Financial Management, January 2002, Washington DC.
- Mahi, B. Raksaka (2004), *Four Years Review of Fiscal Decentralization in Indonesia*, Paper Presented at Annual Economic Seminar, December 2004, Jakarta.
- National Development Planning Agency (2003), *Provinces Financial Ability Map in the Era of Autonomy*, Directorate of Regional Autonomy Development, National Development Planning Agency, Jakarta.
- Rodden, J. (2002), *The Dilemma of Fiscal Federalism: Grants and Fiscal Performance around the World*, American Journal of Political Science 46 (3), p. 670-687.
- Sidik, Machfud (2003), *Fiscal Decentralization: A Long Way Process, Caveat, Challenge, and Its Smooth Path*, A Paper for Magister Ekonomi Pembangunan (MEP), University of Gajah Mada, Yogyakarta.
- Sidik, Machfud and others (2002), *General Allocation Grant (DAU): Concept, Constraint and Prospect in the Era of Autonomy*, Penerbit Kompas, Jakarta.
- Subkhan (2004), *The Optimal Size of Local Government and Fiscal Decentralization in Indonesia*, Jurnal Keuangan Publik 2 (1), p. 69-87.
- Stiglitz, Joseph, E. (2000), *Economic of Public Sector*, Third Edition, W.W. Norton & Company, New York.
- The World Bank (2005), *East Asia Decentralizes: Making Local Government Work*, The World Bank, Washington DC.
- Tiebout, Charles (1956), *A Pure Theory of Public Expenditures*, Journal of Political

Economy LXIV (Oct., 1956), p. 416-424.

Usui, Norio and Armida Alisjahbana (2003), "*Local Development Planning and Budgeting in Decentralized Indonesia: Key Issues*", A Paper for Tokyo Symposium, Indonesian-Japanese Joint Study on Indonesia's Joint Study.