Fiscal Decentralization in Indonesia a Decade after Big Bang

Editor:
Ministry of Finance, Republic of Indonesia, Directorate General of Fiscal Balance
Fiscal Decentralization in Indonesia
a Decade after Big Bang

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Preface

The Directorate General of Fiscal Balance of the Ministry of Finance of Indonesia in September 2011 convened an important international conference on fiscal decentralization in Indonesia a decade after big bang. As Director General of the Directorate General of Fiscal Balance I was very pleased to convene the conference and also to now introduce this book that has been prepared covering the more important papers and discussions that arose from the conference. We hope the book will serve as an important reminder of our progress in the first decade after big bang and also as a signpost for the challenges that lie ahead in the next decade.

This publication is based on papers presented to an international conference on fiscal decentralization held in Jakarta Indonesia in September 2011. The conference was convened by the Indonesian Ministry of Finance, Directorate General of Fiscal Balance with sponsorship support provided by the Asian Development Bank (ADB), the World Bank / Decentralization Support Facility (DSF), Australian Aid (AusAid); and German Gesellschaft für Internationale Zusammenarbeit (GIZ). The conference was titled Fiscal Decentralization in Indonesia a Decade after Big Bang. Its sub title was Indonesian and International Perspectives on Best Practice for Fiscal Decentralization and its Impact on Economic Development and Social Welfare. The book is organized under three core themes pervading fiscal decentralization in Indonesia and many other parts of the world today. Firstly, challenges in getting the political economy of decentralization right. Secondly, designing and implementing effective systems of intergovernmental financing; and finally, optimizing the delivery of public infrastructure and services at sub-national levels and supporting broader growth and development.
Many people contributed to the international conference and preparation of this publication and their support is gratefully acknowledged here.

My own Directorate General of Fiscal Balance in the Indonesian Ministry of Finance organized and ran the conference. Members of the Organizing Committee were myself as Director General; Professor Heru Subiyantoro, Secretary; Dr. Ahmad Yani, Head of Division of Planning and Organization; and Erny Murniasih, Head of Sub Division of Planning.

Authors of the main papers to this publication are separately acknowledged and profiled on page v. In addition the following provided services as speakers, panelists and breakout group discussants during the conference: Dr. Etisham Ahmad; Dr. Rabin Hattari; Dr. Agung Pambudhi; Dr. Eko Luky Wuryanto; Dr. Elan Satriawan; Dr. Machfud Sidik; Professor Heru Subiyantoro; Dr. Roy V. Salomo; Professor Chandra Fajri Ananda; Dr. H. E. Edi Siswadi; Professor Abdul Halim; Dr. Max Pohon; Professor Wihana Kirana; Dr. M. Najib; Dr. Adler Haymans Manurung; Dr. Nao Badu; Drs Budi Sitepu; Dr. Budhi Santoso; Ir. Adijanto; Tim Auracher; and Dr. Hefrizal Handra.

From the Development Partners (DPs) organizational and management support for the conference and publication was provided as follows. For the Asian Development Bank by: Rabin Hattari; James Lamont; Mohammad Handry Imansyah; and Jessey Hutapea. From the Decentralization Support Facility (DSF) by: Daan Pattinasarany and Rayi Renggani. From German Gesellschaft fur Internationale Zusammenarbeit (GIZ) by: Tim Auracher; Joerg-Werner Haas; and Paulita Septarini Sedia. From AusAID by: Petrarca Karetji; Leonardo Simanjuntak; and Lila Sari.

We particularly thank those participants that came from many countries within and beyond the region, adding important international dimensions to the papers and discussions. The participants expressed a strong desire to maintain close contacts and to convene similar conferences in the future to review important developments in the field of fiscal decentralization. The Directorate General of Fiscal Balance in the Ministry of Finance in Indonesia will be active in pursuing further international dialogue over time so as to
ensure Indonesia’s policies and approaches to fiscal decentralization remain best practice.

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Ani Lamont, a freelance editorial consultant led editorial and layout work in preparation of the book.
Abbreviations

ANC African National Congress
APBD Sub-National Government Budgets
APBN Central Government Budget
APL Productive Agglomerations System
ASEAN Association of South-East Asian Nations
BLAs Black Local Authorities
BPGA Borrowing Powers of Provincial Government’s Act (South Africa)
BPHTB Property Title Transfer Tax
BPMKS Education Subsidy
BVPIs Best Value Performance Indicators
CAR Regional Autonomous Corporation (Colombia)
CBDs Central Business Districts
CCSC The Social Security (Costa Rica) Fund
CDD Community Driven Development
CG Central Government
CPA Comprehensive Performance Assessment
DAU General Purpose Grant
DAK Conditional Grant
DBH Shared Revenues (Indonesia)
DDFs District Development Funds
DID Regional Incentives Grants
DORA Division of Revenue Act (South Africa)
DPOD Indonesian Body Advising President on Decentralization
DP Development Partner
DPR Indonesian House of Representatives
DPRD Regional House of Representatives (Indonesia)
DR Regional Directories
ECLAC  UN Economic Commission for Latin America and the Caribbean
FFC  The Financial and Fiscal Commission (South Africa)
GDP  Gross Domestic Product
GDS2  Second Governance and Decentralization Survey
GR  Government Regulation
GRDP  Gross Regional Domestic Product
HDI  Human Development Index
IDR  Indonesian Rupiah
IGRFA  Intergovernmental Fiscal Relations Act
ILPES  UN Economic Commission for Latin America and the Caribbean
District in Indonesia
Kota  City in Indonesia
KPP  Kantor Pelayanan Pajak/ Regional Tax Office Services
LDFs  Local Development Funds
LG  Local Government
LGA  Local Government Act
LGTA  Local Government Transition Act (South Africa)
MDG  Millenium Development Goals
MFMA  Municipal Finance Management Act
MLG  Ministry of Local Government
MOHA  Ministry of Home Affairs
MSS  Minimum Service Standards
MTEF  Medium Term Expenditure Framework
NGIP  National General Income Participation
NHI  National Health Insurance Scheme
NJOP  Property Sales Value
NPOP  Nilai Pasar Objek Pajak/ Property Market Value
OECD  Organisation for Co-operation and Development
PAD  Local Own Source Income
PBF  Performance Based Financing
PBG  Performance Based Grant
PBB  Property Tax on Urban and Rural Property
PFM  Public Financial Management
PFMA  Public Finance Management Act
<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Description</th>
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<tr>
<td>PG</td>
<td>Provincial Government</td>
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<tr>
<td>PISA</td>
<td>Program for International Student Assessment</td>
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<td>PKMS</td>
<td>Health Subsidy</td>
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<td>PMAS</td>
<td>Performance Management Systems</td>
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<td>PMES</td>
<td>Performance Measurement Systems</td>
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<td>PMIT</td>
<td>Performance Improvement Models and Tools</td>
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<td>PNPM</td>
<td>National Program for Community Empowerment</td>
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<tr>
<td>RBF</td>
<td>Results-Based Financing</td>
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<td>RDAs</td>
<td>Regional Development Agencies</td>
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<tr>
<td>RG</td>
<td>Regional Government</td>
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<tr>
<td>SALGA</td>
<td>South African Local Government Association</td>
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<td>SARS</td>
<td>South African Revenue Service</td>
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<td>SDO</td>
<td>Regional Autonomy Grant</td>
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<tr>
<td>SEBRAE</td>
<td>The Brazilian Service of Support for Micro and Small Enterprises</td>
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<td>SFG</td>
<td>School Facilities Grant</td>
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<td>SGP</td>
<td>Service Goods Provisions</td>
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<tr>
<td>SISMIOP</td>
<td>Property Tax Administration Management System</td>
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<td>SISTEP</td>
<td>Sistem Tempat Pembayaran / Payment Point Collection System</td>
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<tr>
<td>SNG</td>
<td>Sub-national Government</td>
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<tr>
<td>SOEs</td>
<td>State Owner Enterprises</td>
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<tr>
<td>SWApS</td>
<td>Sector Wide Approaches</td>
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<tr>
<td>TIMSS</td>
<td>Third International Mathematics Science Study</td>
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<tr>
<td>TSS</td>
<td>Revenue Sharing Agreement (China)</td>
</tr>
<tr>
<td>UDIcS</td>
<td>Urban Development and Investment Companies</td>
</tr>
<tr>
<td>UNCDF</td>
<td>United Nations Capital Development Fund</td>
</tr>
<tr>
<td>UPE</td>
<td>Universal Primary Education Grant</td>
</tr>
<tr>
<td>VAT</td>
<td>Value Added Tax</td>
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<tr>
<td>WLAs</td>
<td>White Local Authorities (South Africa)</td>
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SECTION A
Overview
Fiscal Decentralization in Indonesia a Decade after Big Bang
1 Overview

James Lamont, Muhammad Handry Imansyah, and Erny Murniasih

1.1. Background

This book is based on papers presented to an international conference on fiscal decentralization held in Jakarta Indonesia in September 2011. The conference was convened by the Indonesian Ministry of Finance with sponsorship support provided by the Asian Development Bank (ADB), the World Bank/Decentralization Support Facility (DSF), Australian Aid (AusAid); and German Gesellschaft fur Internationale Zusammenarbeit (GIZ). The conference was titled Fiscal Decentralization in Indonesia a Decade after Big Bang. Its sub title was Indonesian and International Perspectives on Best Practice for Fiscal Decentralization and its Impact on Economic Development and Social Welfare.

The chapters of this book are organized under three core themes pervading fiscal decentralization in Indonesia and many other parts of the world today. Firstly, challenges in getting the political economy of decentralization right. Secondly, designing and implementing effective systems of intergovernmental financing; and finally, optimizing the delivery of public infrastructure and services at sub-national levels and supporting broader growth and development. As evidenced by the conference papers and discussions the three themes of politics, systems and outcomes are all very closely intertwined.
Ten years have now passed since Indonesia pursued momentous decentralization reforms at around the time of the new millennium. The current Government, particularly through the Ministry of Finance, thought that a decade on would be a good time to take stock of the journey to date, and even more importantly to review the adequacy of policy settings for the still challenging period ahead. All of the three core themes of the book have considerable relevance for Indonesia’s current circumstances and its future development path.

Indonesia’s decentralization reforms grew out of nothing short of a political revolution. Many of the big policy issues in decentralization today retain political dimensions. These include continuing expressions of regional aspirations, managing demands for regional government fragmentation, coping with competing party influences centrally and locally; and also intensely political competitiveness within different arms of the central and sub-national bureaucracies.

The design of Indonesia’s intergovernmental financial system a decade ago involved intense political and technical debate and ultimately compromises. Not many closely involved with the reforms at the time got exactly what they wanted. Nevertheless, with a few relatively modest changes along the way, the initial intergovernmental financing system designed has prevailed. As indicated by some of the papers in this book, the initial debate over design continues almost unabated today. Some want to pursue radical reforms to the system while others, probably in the majority, are for more modest refinements at the edges of existing core approaches.

With the third main theme Indonesia like many others is increasingly turning to critical questions of how to improve the delivery of services and infrastructure at sub-national levels and how approaches to decentralization can support broader growth and development. While the decade of decentralization has been consistent with a decade of strong economic growth for Indonesia, including weathering the international, American and European crises better than most countries, very few at any level, including within the sub-national Governments (SNGs), are yet comfortable with the contribution of decentralization to the delivery of infrastructure, services and better local living standards. As set out in the following chapters there are many issues to
address if performance is to be improved, not the least of which relate
to the assignment of clearer responsibilities and accountabilities and
appropriate revenue sources to the three different tiers of Government.

The view of many at the conference was that Indonesia’s first
decade of decentralization has been broadly successful, though there is
much unfinished work for the next decade. There is no question or talk
of turning back. Decentralization is here to stay and the challenge
ahead is to make it work better.

In planning the conference the Ministry of Finance wanted to
review a decade’s performance not only in relation to domestic
developments, but also in relation to broader international practical
experience and academic knowledge. Thus the conference and the papers
involved an important mix of academics and practitioners from Indonesia
and around the world. From a comparative country perspective important
country papers were contributed from South Africa, China and from a
number of countries in Latin America. Papers were also contributed by
five internationally renowned academics, all of whom have close
knowledge of the Indonesian experience over the past decade, along
with capacities to place Indonesia in an international context. Finally,
the conference itself benefited greatly from the presence and
contributions of many participants from the far flung regions of
Indonesia and from fourteen other countries (China, Chile, Cambodia,
Mongolia, Bangladesh, Papua New Guinea, Australia, USA, Germany,
South Africa, Benin, Singapore, and Thailand). Around three hundred
persons participated in the conference which ran for two days.

In terms of layout the remaining sections of this introductory
chapter provide a brief summary of the main papers presented along
with an overview of the main issues arising from the breakout and
broader plenary discussions held. The main papers to the conference
are presented one by one under the three broad themes outlined above.
Reflecting the importance the Government attached to the conference
keynote addresses were made by each of the Ministers of Finance;
National Development Planning (Bappenas); and Home Affairs. These
Ministerial addresses are also included at the front of the book as a
form of a preface to the main papers.
1.2. Keynote Ministerial Addresses

Taken together three very senior Ministers in the Indonesian Government presented a consistent and hopeful story. Firstly, that decentralization still lies at the heart of the reform model for Indonesia and is central to its policies for economic and social development. Secondly, that real progress has been made in the past decade—considering declining contributions of the oil and gas sectors, the rapid economic growth that has been experienced for a decade now has been sectorally and regionally broadly based, contributing to broadly based improvements in living standards. Thirdly, that significant constraints and challenges still remain, with scope for major further improvement still over the next decade. Finally, that there is no complacency amongst senior Indonesian leaders, with a willingness to make further fiscal decentralization reforms as needed in the period ahead, with important further changes now well advanced on the drawing board.

The Minister of Finance of Indonesia, Agus Martowardjo provided the opening address and welcome. He focused on the theme of how best to implement fiscal decentralization in Indonesia so as to contribute to growth and regional living standards. He covered achievements and problems to date and ongoing challenges for the future. The most important achievement has been the increasing involvement of local communities in political and economic decision making in their communities with growing employment and declining poverty levels. Local communities have better knowledge of local needs and can better deliver local infrastructure and services (health and education services have improved). Other important achievements have included: (i) finalization of a clear and detailed regulatory regime; (ii) provision of adequate financing for regional governments, with significant expenditure discretions given to them (using the money follows functions approach); (iii) recent revisions to the sub-national tax and charges law (including phased devolution of the property and property transfer taxes); and (iv) fiscal decentralization policies that have been supportive of macro-economic policies, including during challenging financial times.

Ongoing problems and challenges that are being addressed by Government policy reforms in the context of revisions to Law 33 of
Section A: Overview

2004 and the Grand Design on Fiscal Decentralization include: (i) improving clarity in the assignment of functions between regions; (ii) strengthening budgeting and public financial management, including improved transparency and audit standards; (iii) improving resource allocation by sub-national governments, particularly reducing administrative expenditures and raising capital and development expenditures; (iv) delinking wage expenditures from calculation of the general purpose allocation fund (DAU) making it a full fiscal gap approach; (v) refining the variables and weightings in the DAU formula to better reflect fiscal capacities and needs; (vi) strengthening criteria for the establishment of new regions and removing DAU incentives to fragmentation; (vi) use of central sanctions and incentives to improve resource allocation by the sub-national Governments; and (vii) reforming the specific allocation grant (DAK) to focus on poorer regions in priority sectors like health and education. Beyond these significant reforms the Government and Ministry of Finance are open to further sensible reforms to improve fiscal decentralization outcomes over time.

The Minister of National Development Planning (Bappenas), Professor Armida S. Alisjahbana indicated that decentralization is at the heart of political and economic reform (reformasi) and to achieving inclusive economic and social development of the regions. A decade after major reform is a good time to reflect on progress. While further research is needed as to outcomes the current assessment as to increasing roles of the Regional Governments is broadly positive. Decentralization has been consistent with a decade of strong economic growth and development, including satisfactorily maneuvering through major global economic downturns. Inequality is improving between Provinces. Gross Regional Domestic Product (GRDP) differences between provinces are narrowing as are differences in service delivery in areas such as school participation and health facilities. However, trends do not seem to be so clear cut as between districts and cities where some widening of inequality may have occurred in some cases. Important challenges and issues for the future include: (i) building capacities of staff and systems in the Regional Governments for planning and budgeting; (ii) balancing
local autonomy with wishes to achieve national minimum standards in key services; (iii) deciding how big (or small) Central Government should be: (iv) fine tuning allocations in the inter-governmental financing system; (v) sensibly devolving further revenue raising powers to the regions so incentivizing local development; and (vi) achieving better connectivity between major regions while recognizing the autonomy of regional governments.

The Minister of Home Affairs, Gamawan Fauzi commenced by indicating the centrality of decentralization to political reform which commenced over a decade ago and which has been focused around decentralizing political powers and resources. Budgets of regional governments, which are now highly discretionary, have grown from minimal levels of Rp 38 trillion in 2000 to Rp 477 trillion in 2011, in the process significantly stimulating local economies. The bulk of Regional Government (RG) funding still comes from central transfers so there is a need to further enhance local revenue raising capacities. Important fiscal decentralization challenges and policy areas to address in the future include: (i) improving the quality of RG expenditures, particularly by reducing personnel and administrative expenditures in part to be engineered through provision of incentives and sanctions for good and bad financial management behavior; (ii) improvements in public financial management (PFM) systems to provide more orientation to performance based management and also to provide for accrual accounting, to better allow costing and monitoring of services; (iii) by more clearly defining functional assignments with better synchronized allocations of central and local expenditures; (iv) short term policy is currently focused on freezing regional government employees but in the longer term policy seeks to expand the usage of minimum service standards (MSS) for managing and monitoring priority national functions; and (v) by expanding own source revenue mandates of the regional governments.
1.3. Theme 1 – Getting the Political Economy of Decentralization Right

1.3.1. The Political Economy Challenges and Successes in Indonesia

Professor Djohermansyah Djohan’s paper addressed political economy challenges and successes in Indonesia. Given the geographic and cultural diversity of Indonesia, issues of centralized versus deconcentrated and/or decentralized management have been at the core of political debate since independence. Recent decentralization policies have pursued two objectives, namely introduction of local democracy and the attainment of improved social welfare and living standards.

One important political dimension has been the movement to open and fair elections, including direct election of regional heads since 2004/2005 replacing indirect elections by local parliaments. People have embraced elections which empower local people, enhance accountability and build pressures for improved service delivery. Nevertheless, there have been problems in running many local elections and improvements to both legal instruments and administrative procedures are being pursued through development of a new Law to be devoted solely to local elections.

More broadly speaking in terms of the political economy, the Government’s strategy for the successful implementation of decentralization contains seven core components as follows: (i) providing clarity in the assignment of functions based on criteria of externality, accountability; and efficiency; (ii) facilitating appropriate (not necessarily uniform) regional government structures; (iii) ensuring flexible civil service management arrangements; (iv) effective financial management systems and controls; (v) balanced local representation (between the local elected Head and the local parliament; (vi) facilitating improved public service delivery and poverty reduction as key end goals; and (vii) putting in place effective systems for control and monitoring.

Important political economy issues and constraints include: (i) discussions over the role of Provincial Governors with intentions to strengthen their roles as part of Law 32 of 2004 reforms; (ii) emergence
of excessive hierarchical constraints; (iii) concentration of benefits in a small number of strong Regional Governments; (iv) poor PFM systems and ineffective funds utilization; (v) synergies of regional autonomy are not taken up, indicating a need for better cooperation between levels of Government; (vi) ongoing legal conflicts between regions, especially over land, forestry and mining suggesting a need for synchronized local legal systems; (vii) a need to remove obstacles to developing a good business and investment climate, including appropriate deregulation; (viii) high cost and sometimes flawed elections; (ix) excessive proliferation of Regional Governments; and (x) the need to further develop weak capacities in the Regional Governments, including institutional strengthening.

Matters discussed included: (i) Central Governments should not be too paternalistic—local governments (including poor ones) should stand on their own with more emphasis on accountability to citizens; (ii) varying views are held on asymmetric approaches for Indonesia—some favored it though others thought this would be a disaster leading to more isolated and rebellious areas; (iii) corruption still exists but this is not necessarily caused by decentralization—broader reforms need to address corruption; (iv) there are excessive numbers of civil servants and difficulties in rationalizing them—the 2009 Civil Service Law is not being implemented with no implementing regulations as yet; (v) institutional fragmentation and bureaucratic politics is still a major concern. MOF, MOHA; and Bappenas need better-coordinated efforts and DPOD has not succeeded; and (vi) money politics and corruption are big problems especially in local elections.

1.3.2. Assignment of Functions between Government Levels in Latin America

Luis Riffó Perez outlined the results of a major UN Economic Commission for Latin America and the Caribbean (ILPES) study on functional assignments in Latin America covering Brazil, Chile, Colombia, Costa Rica and Mexico in: (i) primary health services; (ii) pre-school/basic/secondary education; (iii) waste disposal; (iv) civil security; and (v) economic development promotion. Varying assignments of responsibilities have occurred in different sectors and countries though
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in most cases still under broad policy and regulatory leadership of Central Governments. Significant roles have been found for intermediate and local level governments in most of the countries studied, especially for education, primary health; and waste disposal. The functions of civil security and promotion of economic development have not seen uniform moves to decentralization though some initiatives have recorded successes. The research draws together eight broader conclusions as briefly summarized below.

Firstly, decentralization processes vary widely between countries. There is variable (but generally reluctant) willingness to assign functions and resources to sub-national levels.

Secondly, decentralization has made at least partial progress over the decade. Important factors supporting progress have been: (i) development of local political parties and leaders; (ii) support of central leadership; (iii) the importance of local elections; (iv) growing voice of local citizens; (v) municipal growth; and (vi) promotion of decentralization by key institutions and experts.

Thirdly, A common framework for reassignment has not emerged because: (i) widely differing circumstances and capacities; (ii) some services have been decentralised too quickly; (iii) management across different municipalities has shown some successes; (iv) there are benefits to asymmetric approaches; (v) it is agreed the national level should focus on policy; the intermediate level on territorial management of policy and programs; and the local level on the direct management of service delivery; and (vi) well synchronized national—intermediate and local networks in planning and financing have not yet emerged.

Fourthly, examples of good practice have emerged and could be replicated. Factors influencing good practice include: (i) local leadership, skills and political support; (ii) community support to medium term activities; (iii) availability of adequate long term financing; and (iv) the linking of cross municipal agreements on activities to national policy priorities. Replications of good practice require good research and planning. Good practice should be largely locally driven.

Fifthly, achieving consistent quality remains a problem for primary education and basic health. Constraints include: (i) low access to local finance; (ii) varying local capacities; (iii) local ownership and leadership
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by managers and professionals is important but often lacking; (iv) lack of clarity as to local responsibilities and resources; and (v) lack of monitoring and evaluation. Intermediate levels can be important in facilitating training of key personnel.

Sixthly, solid waste collection and disposal faces challenges of coverage and quality. Most countries have defined national policies and localized service delivery. Regional systems are being introduced along with new technologies. Financing is a major constraint and better coordinated management systems that incorporate broader public health issues would be useful. Community awareness programs fostering a culture of cleaning up can be useful.

Seventh, crime is a major problem in all countries and local community involvement demonstrates some successes over national militaristic approaches. Better research on crime is needed at local levels. A single police force under a single command is found to be superior to national, intermediate and local forces. There is a need to link police reforms to related services (judiciary, prisons etc.). Neighborhood organizations integrated with a respected police force can be important for success.

Regional economic development is important for decentralization. Often policies to support private sector development are not well defined and are poorly implemented across regions. Support agents are usually central with only partial deconcentrated presence in the regions and low sub-national government involvement. There have been some successes with public-private partnerships though usually working through groupings of municipalities or at intermediate levels. Activities planned by groupings of municipalities show promise. Research and applied technology initiatives can be important. Development of entrepreneurship has been important in many of the more successful local governments and institutions.

The discussion suggested some similarities exist in devolving functions in Indonesia and elsewhere and Asia and the Latin American countries studied. It was felt that the approach of cross country research studies was a useful one and that this might be replicated in a number of Asian countries, perhaps under ASEAN leadership. Regular research is important not only between countries, but within countries over time
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as while clarity in expenditure assignments is important they should not be seen as permanent but rather as subject to change as technologies and circumstances change.

1.3.3. Managing Pressures for Fragmentation in Indonesia

Professor Jorge Martinez-Vazquez provided a paper on SNG fragmentation (pemekaran) in Indonesia, which asked the fundamental questions of whether there is a need for concern? Concerns over fragmentation are common internationally and a key matter of policy debate in Indonesia, with a freeze on new units having been in place for some time pending finalization of new policies. Under Soeharto there was very little growth of new SNG units which were based around centralized rule. This situation changed very rapidly from the early 2000s, with major demands for new units. Numbers of Local Governments (LGs) grew from 304 to 510, while Provinces grew from 27 to 33. Growth has been regionally focused with heavy growth of RGs in Papua, Maluku and Sumatera and to a lesser extent in Sulawesi and Kalimantan, with very little growth of RGs in Java, Bali and Nusa Tenggara.

Determinants of fragmentation are complex. The geographic specific nature of much fragmentation suggests perverse fiscal incentives or the extraction of local rentals by elites alone cannot explain trends. Earlier (2005) studies had pointed to (other things being constant) the importance of: (i) sparsely populated regions; (ii) large land areas; (iii) large populations; and (iv) more heterogeneous populations. Some influences were also attributed to fiscal incentives and political motivations. More recent (2010) work by the author found the main determinants to be: (i) large populations or land area; and (ii) fiscal incentives, especially through DAU and DAK transfers and non resource shared revenues. Of low significance were GRDP per capita, relative poverty, separatism in Aceh and Papua; and areas of ethnic conflict.

Both the 2000 and the subsequent 2007 Government Regulations (GRs) involved complex processing requirements (under the 2007 instrument 11 factors and 35 indicators had to be reported on and assessed). In many cases the complex procedures have been by passed by going straight to the National Parliament (DPR) which independently
prepared Laws which required approval of the President—often with processing of the various criteria by officials ignored.

The concept of optimal size for decentralized governments has two dimensions: (i) responsiveness to citizens (allocative efficiency), usually implying benefits of smallness; and (ii) cost minimization (economies of scale). The evidence on economies of scale suggests many services can be produced efficiently with relatively low population levels (e.g. police, general education) though economies of scale can be important for some services (e.g. water supply, public transport). In Indonesia average sizes of LGs are still very high—488,000 for all LGs and 214,000 for newly created pemekaran LGs. Thus Indonesia’s LGs on average are large enough to be cost efficient (some may be too large with diseconomies of scale). Nevertheless, some LGs are much smaller than the average (e.g. below 20,000) and are of efficiency concern. Also LGs are assigned most functional responsibilities in Indonesia, some of which would be better assigned to the Provincial level, especially those with large externalities. Poor administrative capacities in many LGs and scope for capture by local elites are also causes for concern.

The impact of pemekaran on LG performance is difficult to measure with studies to date throwing up both positive and negative results, without clear conclusions. Some studies have recorded positive benefits in newly formed regions with regard to: infant mortality rates; basic education, water supply; and sanitation systems.

Some commentators may have become too negative over pemekaran, seeing all pemekaran as bad. Nevertheless, back door processing approaches through the DPR need to be stopped. The DPR itself needs to formulate a Law on processing requirements that largely leaves itself out of the approval processes. Trying to define a precise optimal number of local governments is elusive and not worth pursuing. There needs to be appropriate regulations for processing new applications and these need to be strictly complied with. Perverse incentives in the transfer mechanisms and shared revenues need to be removed. While most LGs are large enough to be efficient a small number are probably too small and this needs to be watched closely. The processing arrangements need to be shortened and simplified into four basic criteria:
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(i) minimum population levels; (ii) representation and accountability; (iii) financial and fiscal capacity and sustainability; and (iv) administrative capacity. Other secondary criteria might be considered such as territorial continuity and security and border issues. Furthermore, there might be introduction of: (i) incentives for amalgamation; (ii) assignment of further cross district responsibilities to Provinces; (iii) enhancement of cooperation between LGs; (iv) the use of special service districts (e.g. for water and transport); and (v) pursuit of privatization of some services.

The discussion suggested that the balanced views presented have become more mainstream than when first launched a couple of years earlier, when the general perception was that virtually all forms of pemekaran were politically driven and inherently bad. Democracy has an administrative cost but the benefits of local governance can far outweigh these costs. Indonesia was not a better place under Soeharto simply because it had lower costs of local democracy and administration. Empowering people in matters important for their daily lives (e.g. trash collection, child care services etc.) can make important differences. Papers by Government officials elsewhere in this publication (including by the Minister of Finance) recognize the need to get in place a new workable set of regulations for the processing of applications for establishment of new regions.

1.4. Theme 2 – Effective Systems of Intergovernmental Financing

1.4.1. Experiences and Lessons From Indonesia

Bapak Marwanto Harjowiryono provided a paper on experiences and lessons learned from Indonesia. Prior to the reform era governance was heavily centralized with strong political and security control through the Minister of Home Affairs and appointed provincial Governors. Post reform district and city heads were given far more prominence and powers, with the provinces provided diminished roles in coordination, without significant hierarchical powers. Around one third of total government resources were placed in the hands of SNGs more than doubling previous levels. This level has since risen to around 40%
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indicating that Indonesia is a highly decentralized country. Own source revenues of SNGs have remained low (around 7% to 8% of total SNG revenues). Most early reform occurred on the expenditure side.

Inter-governmental fiscal transfers policy aimed to follow the principle of money follows functions, which created challenges both in the articulation of functions and the design of appropriate financing arrangements. Transfers were designed to provide for vertical and horizontal balance and to address situations of inter-jurisdiction spillovers. Prior to 1999 most transfers were conditional (Inpres) but today most are non-conditional through the DAU and shared revenues. The general allocation grant (the DAU) uses the notion of fiscal gaps which represent the difference between fiscal capacities and fiscal needs. The aim is to reduce gaps over time so lessening fiscal inequalities. However, equalizing all outlays may discourage local revenue raising efforts and also work against local expenditure restraint. The specific allocation grant (DAK) focuses on physical capital investments in selected SNGs and nationally important sectors. A contribution of 10% is required from SNGs. General, specific and technical criteria apply. Some revenue sharing (DBH) is assigned by source and others by formula. Expenditure choices are solely at the discretion of the SNGs. An additional 2% of the DAU pool goes to the three special autonomy Provinces.

SNG own revenues until recently remained somewhat limited having grown modestly from 17.3% of total Regional Government revenues in 1999/2000 to 18.9% in 2011. The new Law 28 of 2009 on SN Taxes and Charges made important changes including movement from an open to a fixed list approach (partly to address proliferation of local nuisance taxes) and providing for devolution of the property transfer tax (by 2011) and the rural and urban property taxes (to be phased in by 2014). Initial indications are that most Regional Governments have commenced to collect the transfer tax in 2011 and that strong growth in collections is being experienced. One city (Surabaya) has moved to collect its own property taxes in 2011 and a further twenty three have indicated intention to commence from 2012. Nine regional governments are to be given particular central support to implement the proposed tax with the hope they can be used as a model for others to learn from.
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After a decade of reform further refinements are still needed. Future policy reforms under close consideration are: (i) the basic (staffing) allocation of the DAU makes no contribution to horizontal balance and gives incentives to excessive staffing levels and will be removed; (ii) use of actual local revenues in the DAU formula (rather than potential revenues) acts as a disincentive to own revenue collections —this problem will be corrected (iii) shared revenues are sometimes delayed awaiting calculation of revenue data—this will be addressed (iv) the DAK warrants increases in size so that national priorities can be targeted—furthermore targeting needs to be improved, in part through use of MSS; (v) proliferation of SNGs needs to be addressed including removal of perverse incentives embedded in transfers and tighter processing conditionality on the establishment of new regions; (vi) on the revenue side implementing Law 28 of 2009 is the immediate focus particularly the closed list approaches and devolving the transfer and property taxes; (vii) policy aims to improve the quality of local spending, especially excessive spending on wages and administration — the short term response has been a freeze on both central and SNG staff recruitment —other options are being considered including setting limits (to be achieved over time) on the ratio of personnel to total or alternatively a minimum required capital ratio.

The discussion suggested many were in agreement with the policy initiatives under consideration, though a small number were in favor of more dramatic reform to the core transfer components. Some suggested a case for considering the introduction of Provincial based DAUs (similar to the Chinese approach), giving provinces a greater role in resource allocation. One commentator suggested a framework for considering future reforms based around three fundamental questions that need to be answered, namely: (i) local discretion versus central direction—if more direction is required then introduce more specific purpose and performance based transfers—though this lessens downwards accountability; (ii) symmetric versus asymmetric approaches —to what extent are different approaches and outcomes acceptable; and (iii) service delivery versus economic development and growth—this is partly a question of improving cross district infrastructure perhaps at the expense of social services. A number of presenters to the
conference had alternative views on reforms to the inter-governmental financing system which are addressed more directly in the chapters herein.

1.4.2. Reforming the Intergovernmental Financing System in South Africa

Kenneth Brown commenced by presenting a detailed history of inter-governmental financing reforms in the context of the transition from heavily centralized apartheid to decentralised democracy. Important historical reform steps included: (i) the interim and final constitutions of 1993 and 1996 with both involving political compromises; (ii) major inter-governmental reforms occurred from 1997/98 with transfer of provincial debts to the Central Government and introduction of provincial and municipal equitable lump sum grants; (iii) provinces were given very limited own revenue raising powers (currently only about 4% of their total revenues); (iv) under a Municipal Demarcation Board the numbers of municipalities were cut dramatically from 843 in 1995/96 to 284 in 2000 (6 metropolitan; 232 local and 46 districts); (v) a strong legal base for financial and democratic management in SNGs was put in place from 1998 onwards; (vi) special infrastructure grants were provided, especially for previously deprived areas; and (vii) management capacities remain a major challenge especially in weaker rural municipalities. For Brown at the end of the day the processes in forming the intergovernmental system were more political than economic, with many elements of the new system based on political compromise.

The system that has emerged gives most revenue raising powers to the Central Government with limited revenues at provincial levels. Total expenditure levels for particular levels of Government are determined politically (on advice of the Financial and Fiscal Commission) in the context of the annual budget and are also contained in the MTEF forward estimates. Horizontal distributions to sub national levels are determined by formulae (separately for provinces/municipalities and for local governments). Each of the formulae has different components and weights, commonly including population, GDP, access to basic services and institutional operating costs. Formulae,
weights and data are published annually. Provinces receive a general equitable share and a number of sector specific and operational conditional grants. Municipalities on average collect 75% of their own revenues (urban municipalities also get a share of the fuel levy) though with wide variations (the poorest 75% of municipalities receive 75% of resources through national transfers). Transfers to municipalities are similarly structured to the provinces but conditional grant funding is focused on infrastructure backlogs and emerging infrastructure needs. Eleven core lessons from the South African experience are set out as follows.

First, a strong constitutional/legislative approach to functions and finance has benefits and costs. Legalism prevents short term political populism but changes can be slow in coming.

Second, simplicity is central to an efficient transfer system allowing SNGs to plan and manage budgets with some certainty, though a drawback is that local accountability is low.

Third, sound financial management needs to be promoted through legislation. The Public Finance Management Act (PFMA) is backed by strong controls by a National Treasury. However, new requirements are not well complied with so capacity building is critical.

Fourth, rapidly growing revenues under leadership of the South African Revenue Service have helped to finance the reforms, including rapidly growing SNG personnel and infrastructure.

Fifth, ambiguity over assigned responsibilities allows flexibility but can also create confusion. The equitable share formulae are not well linked to performance. Implementation of concurrent programs with SNGs is often weak (e.g. health, education and housing).

Sixth, hard budget constraints are important do not have to be a fiscal rule. New systems from 1998 require SNGs to live within their means, though this is budget policy and not rules driven.

Seventh, hard budget constraints are needed to address problems of central wage bargaining. Wages are centrally set but provinces have flexibility in managing their personnel resources.

Eighth, fully control sub-national borrowing or remove moral hazard opportunities. Provincial borrowing is only feasible by borrowing from the Central Government. Municipal borrowing is more flexible with
access to capital markets, though they have not much utilized borrowing.

Ninth, institutionalize benchmarking to improve compliance, oversight and knowledge sharing. National Treasury has introduced benchmarks which it applies to reviews of draft provincial and municipal/local budgets (conditional grants, new policy initiatives). Results are shared with all SNGs and can be an important tool for improving the quality of sub-national budgets.

Tenth, use functional groupings for budgeting purposes. National Departments are grouped by functions so as to identify budget efficiencies and savings across a group of like Departments.

Eleventh, a critical lesson is to properly sequence institutional capacity building. Initially capacities to implement reforms do not exist. Building them is difficult and complex, especially given widely differing circumstances between SNGs. Building a base of administrative competence before pushing too many reforms may have had advantages. National Treasury is now driving much of the capacity building effort. An earlier start would have helped.

An important conclusion is that reform has essentially been about politics. To address local preferences requires strong leadership, policy, administrative and financial management capacities. These do not emerge in response to fiscal incentives embedded in the assignment of revenues or functions. They are created purposively through continuity, commitment and strong capable leadership. This is the most important lesson from South Africa.

Discussion focused mainly around participants obtaining a better understanding of the South African system with a number of commentators suggesting that Indonesia and Asia have much to learn, particularly with regard to structuring of the transfers system and experiences with capacity building efforts.

**1.4.3. Strengthening the Revenue Side**

Professor Roy Kelly commenced by indicating a key requisite for decentralization success is the adequacy of revenues assigned to fund expenditure responsibilities of SNGs. While inter-governmental transfers and shared taxes typically dominate, local own revenues also have a critical role in enhancing local autonomy, governance, accountability,
ownership and responsibility. Enhancing local revenue generation is an important though sometimes politically challenging policy objective. At local levels the links between improved revenue collections and improvements in services provided to the community need to be highlighted.

Theory and practice indicate most tax bases are better levied and administered centrally. SNGs should focus on bases with low mobility and where there are clear benefit linkages to local services. Local revenues can be divided according to the level of local autonomy. Low local autonomy sees the Central Government controlling policy and administration. Limited local autonomy may involve some sharing of policy and administration. Full local autonomy generally applies to both policy and administration. Discretionary revenues should be sufficient to allow SNGs to influence the efficiency and accountability of expenditure choices. Decentralization objectives suggest benefits in moving towards more locally autonomous (and accountable) forms of revenue raising. Such movement can occur through dramatic reforms shifting policy and administration all at once or through more sequential mixes of each; either asymmetrically between SNGs or gradually over time for all. Many countries (including Indonesia) are moving from open to closed lists of taxes. These can improve accountability and lessen local nuisance taxes. Defining the list becomes important if reasonable revenue capacities are to be provided.

In Indonesia Law 28 of 2009 provided for a reversion to a closed list. Provincial taxes now relate to: motor vehicle registration; motor vehicle transfers, motor vehicle fuel, surface water tax, and cigarette tax. Local level taxes now relate to: hotels, restaurants, entertainment, advertisements, street lighting, parking, category C minerals, water, bird nests, urban and rural land and building; and land and building transfers. Taxes assigned do have something of an urban bias but it is difficult to totally avoid this in Indonesia. Generally the closed lists are well formulated.

Law 28 of 2009 took bold steps in providing for property tax devolution (building on administration and collection systems reforms at the centre from 1985). Districts and cities can now determine (within limits) property tax rates, valuation exemptions and tax relief measures.
and have full responsibility for administration. The property transfer tax is to be devolved by 2011 while the property tax is to be phased in by 2014. While most policy reform issues seem settled, issues of how to build capacity in LGs to support the reforms remain. As systems for property tax collection had been built up over some time in the DG of Taxation in the Ministry of Finance part of the capacity development challenge is how to take existing systems and make them operational and effective under the new devolved arrangements.

Initial indications are that devolution of the property transfer tax from 2011 is being successfully implemented. This is a simpler proposition than devolution of the rural and urban property taxes which are more complex. Revenue potentials and administrative capacities vary widely between the 490 LGs in Indonesia. Three distinct clusters of LGs have been identified: (i) highly urbanized (30 LGs); (ii) medium urbanized (100 LGs); and (iii) less urbanized (360 LGs). Cluster three LGs are expected to face the most challenges. Asymmetric approaches to the different clusters are proposed. Clusters one and two are likely to pursue a full local administration model while cluster three is likely to pursue a joint (central and local) administration model. Maintenance and improvement of property records and systems is a very important indirect consideration under the new arrangements as this is critical, for example in documenting customary land rights (Hak Girik). Transfer of other administrative functions, computerized collection systems and so on will be major challenges for some in cluster two and most in cluster three so comprehensive programs of capacity building support under initial joint administration models will be needed.

The new closed list, particularly devolution of the property transfer and property taxes should allow rapid growth in own source revenues over time. Mastering administrative and collection challenges will be important, requiring well thought out asymmetric approaches. Full political, administrative and technical support will need to be provided to the SNGs, especially those in most need.

Discussion was generally supportive of recent reforms to a closed list including devolution of the property transfer and property taxes. Some felt that there should be provision of a better framework of incentives to encourage the regions to raise more revenues, including
attention to possible perverse incentives within the DAU to minimize revenue collections with suggestions this could be addressed by moving back to the approach of calculating revenue potentials rather than using actual revenues in the DAU formula. There was broad agreement that devolution will challenge the capacities of many SNGs and that long term programs of support will be needed.

1.5. Theme 3 – Optimizing the Delivery of Public Infrastructure and Services

1.5.1. Case Study One—Service Delivery in Surakarta City, Indonesia

The Mayor of Surakarta City provided a case study of his city with focus on local policies to improve infrastructure and services. He commenced by noting that political euphoria with the arrival of democracy needed to be tempered with crisis in the daily lives and living circumstances of the people. Important city priorities have been to target the needs of the poor, especially in health, education and business development and to improve local spaces and infrastructure. Strong growth in local revenues has been promoted through the strengthening of user charges and disciplined collection approaches and has also been supported by strong national and local economic growth. Nine key initiatives have been taken as follows:

Firstly, development of a strong city vision and mission. The vision centres on improving people’s welfare and the cultural identity of the city. Important areas of the mission include: (i) strong local economy; (ii) strong ethics and cultural values; (iii) strong city character and recognizable brand name; (iv) a city providing excellent health and education services; (v) employment promotion; (vi) conducive environment for investment; and (vii) improvements to and good maintenance of city infrastructure.

Second, developing policies for street vendors, including market place revitalization. Previously almost 6,000 vendors were creating traffic problems, pollution and a worsening of slum areas. Following consultations a pilot project involving almost 1,000 vendors was introduced through new open space planning for vendors. This experiment was later expanded to other areas and vendors.
Third, improvements to slums and low cost housing—including renovation and relocation—and greening of urban areas. Fourth and closely related were improvements to community sanitation, including renovations and extensions to public toilets.

Fifth, new focus was given to improvement and development of transport hubs—air, road and rail—which were linked to growth in trade, commerce, education, health services; and tourism.

Sixth, Surakarta was strongly promoted as a cultural city for domestic and international tourism as well as to promote citizen pride. The city's strong cultural heritage has helped to foster strong feelings of cultural identity and has boosted the investment climate and business development. Initiatives have included opening of parks and city spaces; and car free days in major streets.

Seventh, health and education subsidies were introduced for the poor with introduction of silver, gold and platinum subsidy cards (highest subsidies go to the very poorest families). The city is promoted as a hub for good health and education services.

Eighth, business and trade development are strongly promoted. This has included support to vocational schools, a technology park, one stop licensing and other facilities and a strong emphasis on building the environment for business development.

Ninth there has been a strong focus on promoting social improvements. There has been very close monitoring of trends in the Human Development Index which has been improving.

1.5.2. Case Study Two—Service Delivery in Gorontalo Province, Indonesia

The Head of the Provincial Planning Office commenced by indicating Gorontalo had been split off from North Sulawesi Province in 2001. It is a relatively small province with six districts/cities. It has developed an innovative development strategy which aims to improve citizen welfare (material and spiritual), particularly by pursuing poverty reduction, through effective utilization of all resources in the context of global development.

The province's vision is for Gorontalo to be an innovative province which aims to promote a community that is independent, productive
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and religious. It’s vision is pursued through a four point development agenda: (i) business oriented approach to governance focusing on results based performance aiming to raise confidence; (ii) human resources development, to make personnel more business oriented and religious; (iii) to promote a village based people’s economy based on specialty local sectors; and (iv) the promotion of efficient technologies.

Three priority programs are pursued: (i) human resource development, particularly entrepreneurship; (ii) agricultural development (especially corn); and (iii) fisheries development.

Bureaucratic reform is pursued based on strong political and bureaucratic leadership and a performance orientation. This includes financial management reform and personnel reform.

Development networking and cooperation at regional, national and international levels is pursued. This includes working with universities and sister provinces and districts across Indonesia and abroad (5 countries). The province also works closely with seven international Development Partners (DPs).

Other strategies include: (i) reducing the ratio of provincial personnel expenditures below 40%; (ii) price support stabilization schemes in corn and fisheries; (iii) focus on sub-districts with low HDIs; (iv) expenditure analysis reviews; (v) targeting of MDGs in the budget strategy; and (vi) development of an infrastructure master plan 2010.

Development performance of the province has been strong: (i) annual growth from 2002 to 2010 has ranged from 6.5% to 7.6% (above national averages); (ii) there have been reductions in the poverty rate from 32.1% in 2002 to 18.8% in 2011; (iii) steady improvement in the HDI from 64.1 in 2002 to 69.8 in 2009; (iv) decreases in open unemployment from 9.3% in 2002 to 5.2% in 2010—as of 2009 Gorontalo was ranked 13th out of 34 provinces; (v) infrastructure conditions are improving— in 2010 access to reasonable sanitation had grown to 45.7% (MDG target of 75%)—urban water supply reached 67.5% (MDG target of 85%)—over 164 kilometers of local roads and 5,000 new low cost houses had been constructed.

The Head of Planning in the Province concluded by providing some reform policy recommendations for the special allocation specific
grant scheme (the DAK) as follows: (i) do not give perverse rewards (of more DAK) to those SNGs with high ratios of personnel expenditures. Gorontalo has low access to DAK because of its policies of low ratios of personnel expenditures; (ii) increase allocations to the DAK fund by further cutting deconcentration expenditures; (iii) provide additional DAK to those regions with high poverty and low HDIs; (iv) reward those devoting more resources to development expenditures with less emphasis on, e.g. good administration and audit reports; and (v) infrastructure plans should guide the development of infrastructure spending in the regions.

1.5.3. Central Financing of Sub-National Governments in Indonesia

Dr. Anwar Shah commenced by providing a detailed description of the main components of the system of central financing of SNG expenditures in Indonesia. He then reviewed two components of the system in more detail, namely the general allocation grant (the DAU) and the specific purpose grant (the DAK). Eight concerns are raised regarding the current DAU formulation as follows: (i) cities and rural jurisdictions of different sizes and characteristics are all treated together; (ii) the use of the coefficient of variation approach (Williamson Index) in determining the standard for equalization is complex and subject to manipulation and irregular results in relation to Shah’s own preferred equalization standard of “reasonably comparable levels of public services at reasonably comparable levels of tax burdens across all jurisdictions”; (iii) an unsatisfactory approach to fiscal capacities with different revenues given arbitrary weights, while DAK transfers are excluded; (iv) local tax effort is discouraged through the use of actual revenues as opposed to potential revenues; (v) there is undermining of agreements with special autonomous regions due to additional resource rental shares being offset by lower DAU allocations; (vi) there are perverse incentives to employ excess personnel, with low personnel management flexibility due to the basic (wages) allocation component; (vii) some indicators of fiscal need are inappropriate, particularly Gross Regional Domestic Product (GRDP); producer price indexes, and the HDI; and (viii) there are perverse incentives that encourage proliferation of new SNGs.

Rather than fine tune the DAU fiscal gap approach Shah proposes
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a rather different system. The criteria for new design are: (i) clustering of liked sizes/classes of SNGs; (ii) five year fixed period formulae and weights; (iii) ceilings and floors to provide stability; (iv) national averages by size and class as the equalization standard to replace the Williamson Index; (v) gap filling by size and class of local government; (vi) fiscal capacity measurement based on potential revenues plus 100% of tax sharing and other revenues and 50% of shared resource revenues; and (vii) the fiscal need measure should discontinue use of basic (wages) allocation and other criteria, instead using a needs measurement based on indicator measures for each service category. Three alternative approaches to reformulating the DAU were proposed as follows.

Alternative one involves a new form of gap filling based on 10 clusters: (i) one cluster for all provinces; (ii) 5 types of cities based on population size; and (iii) 4 types of districts based on area sizes. Under this approach fiscal capacity is based on potential revenues (using non resource GRDP adjusted for national average effective tax rates as the proxy). All tax sharing and other central transfers would be counted but only 50% of potential resource revenues are counted. Fiscal need would be based on around 10 (COFOG defined) functions (administration, health, education etc), comprising most SNG expenditures over a prior 5 year period. Some twelve indicators of need are arbitrarily determined for each function and include (alternatively across all proposed functions): population, area, school population, numbers unemployed, number of public houses, number of tenants in public houses, kilometers of roads, area of agriculture, area of forestry, property values, numbers in poverty; and numbers of residences with piped water and sewerage.

Alternative two involves movement from gap filling to an alternative fiscal equalization approach. Calculation of fiscal capacity and needs still occurs as per alternative one. However, surpluses or deficiencies of per capita fiscal capacities and needs with reference to a standard of equalization would be calculated. Those in net deficiency situations would receive equalization payments from the centre. An explicit standard of equalization would determine the pool and distributions.

Alternative 3 involves the proposed approach to fiscal equalization
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in alternative two supplemented by output based operating grants for priority services and capital grants/loans to overcome infrastructure deficiencies. Here expenditure needs compensation occurs through output based operating transfers for priority services where allocation is based on the share of the service population, with no conditionality on expenditure, but conditions on service performance (MSS). Failure to meet MSS would mean denied access. In Shah’s view this simplifies determination of the grant pool and allocations and enhances accountability to local residents.

Shah also reviews the special allocation fund, the DAK arguing that capital grants can only be effective if they embody a central planning view with a need to map the entire country to identify regional deficiencies in relation to national minimum standards in basic infrastructure for priority services. There are deficiencies with current DAK formula approaches, e.g. poor indicators of fiscal capacity favoring small jurisdictions and a lack of sector prioritization. The required matching contribution is appropriate but should be scaled according to clear criteria, and wealthier SNGs should be encouraged to go to the capital markets. The current approach of automatic rather than application based financing is appropriate as it keeps politics at bay and overcomes grantsmanship, but it needs more of a central planning view and not complex arbitrary criteria. The planning view would prioritize the infrastructure needed in the context of MSS and would be set out in the national five year plan.

In summary the author’s preferred position is for: (i) more tax sharing and tax devolution; (ii) output based per capita operating grants based on MSS for key services using allocation criteria based on service population areas; (iii) fiscal capacity equalization grants to enable all regions to provide reasonably comparable levels of public services at reasonably comparable tax burdens; (iv) well planned capital grants to fiscally weak SNGs to address infrastructure deficiencies in achieving MSS in priority sectors; and (v) help for access to capital markets for richer SNGs.

Discussion suggested that many favor reforms to the DAU, though not many had yet considered major reforms of the nature proposed. Aspects of the current reform agenda as indicated in papers from the
Minister of Finance and the Director General of Fiscal Balance in MOF (e.g. returning to revenue potentials in the capacities formula; removing the basic wages allocation from the needs formula; and fine tuning other needs criteria) are broadly consistent with the Shah proposals. Some questioned whether the Williamson Index is really so complex or inappropriate and whether movement from a single formula with five variables to ten or more formulae with a dozen or so variables would really meet the interests of simplicity proposed. Technical weaknesses with the SNG, COFOG functional data as a basis for determining any new scheme were questioned as was the merit of basing weights on functional expenditures in the previous five years, given policy concern as to past inappropriate patterns of expenditure composition and given that related PFM reform is based on policy change rather than incrementalism. Dr Shah’s proposals for DAK reform were more widely understood and accepted and are in line with reforms to the DAK currently under consideration within Government, though some questioned the capacity of central planners to contribute to investment decisions on what are local functional responsibilities; and some doubted that there will be rapid progress in development and implementation of MSS given limited progress in the past decade.

1.5.4. Incentives for Better Local Service Delivery

Blane Lewis and Paul Smoke provided a paper on incentives for better local service delivery, reviewing international experience and potential relevance for Indonesia. They commenced by questioning the role of national incentives in decentralized systems and whether central involvement beyond design of effective national systems is appropriate. SNG behavior is supposed to be driven by local elections. However, many see the need for gradual crafting of national goals and local autonomy. Most Central Governments try to influence SNG behavior. Local capacities and accountabilities need to be worked at. Reform is long term with both systemic and behavioral changes needed over time some of which warrants central involvement, including use of incentives to SNGs, to help achieve national objectives.

There are limited incentives in Indonesia at present, some intended and some not. Some are positive and some perverse. The approach has
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been ad hoc and uneven partly due to poor bureaucratic design, implementation and monitoring of performance. Revenue incentives include: (i) 3.5% of property taxes collected centrally are sent to those SNGs exceeding budget targets; and (ii) the DAU fiscal capacity formula initially provided for own revenues to be estimated on a potential (not actual) basis, so aiming to incentivize SNG tax effort—this practice has now ceased but may not have had much influence. Expenditure incentives include: (i) earmarking of 0.5% of oil and gas revenues for education expenditure (not well enforced or monitored); (ii) the basic allocation which accounts for around 50% of the DAU acts as a disincentive to rationalize the national civil service; (iii) the conditional DAK grant may crowd out capital spending from own sources; and additionally sector and regional targeting of the DAK has increasingly weakened, and (iv) experience with withholding of DAU transfers (for SNGs not meeting budget preparation guidelines) seem to have positively influenced SNG compliance.

There are three broad approaches to designing SNG incentives: (i) performance measurement systems, comparing performance over time or against norms; (ii) performance management systems, aiming to improve management through incentives for performance, including performance based grants (PBGs); and (iii) performance improvement models and tools, understanding the steps and processes involved in designing improved service delivery.

A five part framework for considering SNG incentives is proposed as follows: (i) broad target purposes for incentives, e.g. systems reforms; (ii) potential specific objectives e.g. inputs, outputs or outcomes; (iii) a large number of key design issues to be aware of; (iv) overview of issues in measuring performance, e.g. measures and data; and (v) defining institutional responsibilities for performance incentives systems. Selected international experience is then provided. Getting systems, monitoring and compliance approaches in place has proved very difficult for most countries. Three main approaches have been used internationally as follows:

Firstly, sectoral conditional grants and performance systems – e.g. specific targeting of school facilities in Uganda; health financing facilities in Rwanda; In some pilots quantities of services have improved but
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qualities have not. Some schemes are targeted to quantity and quality—these can be complex e.g. in health, but where successful can get good results. There may be inequities in favoring incentive recipients which are stronger to the detriment of weak units;

Secondly, broader PBG systems, mainly targeting process improvements, e.g. in PFM, planning etc. SNGs have to meet basic minimum eligibility conditions and then can receive performance based bonuses, which the SNGs usually have the discretion to spend, though they may be targeted at particular forms of infrastructure. In some cases sector service targets are included (usually quantity rather than quality). Wide advertising of the scheme and generation of a competitive culture between SNGs can be helpful. The size of grants must be meaningful to incentivize people. Once basic processes are established continuation of incentives may not be relevant with need for movement to more sector specific service delivery type incentives.

Thirdly, comprehensive (usually complex) performance assessment systems cover a wide range of processes and outcomes, with incentives for improvement on a broad range of fronts. The United Kingdom Comprehensive Performance Assessment is the best known case. It rates all local governments on six services—education, housing, social care, environment, libraries and leisure and the use of resources and finance. It is a combined ratings and incentives scheme. It gives heavy emphasis to service quality along with measures of efficiency (resources/financing) and a process based institutional health indicator.

Finally, possible new incentives for Indonesia are explored. Complex schemes such as the British CPA do not seem feasible. It seems late in the decentralization process to be pursuing the process oriented PBGs schemes, though a number of SNGs may not have mastered required processes so perhaps PBGs could be targeted at them. There is broader concern with the quality of services. The most likely next stage for Indonesian reforms is sectoral performance incentives through use of conditional transfers. The DAK is one likely instrument here. Furthermore, a case could be made for incentivizing better fiscal management in a number of areas, including: (i) reserves accumulation; (ii) debt financing; (iii) balance between recurrent and capital expenditures; (iv) enhancing own source revenues; and (v) generation
of local business and growth. Aspects of the DAU formula mechanism also need broader debate and review so as to remove perverse incentives and perhaps link it to more positive incentives. Better coordination of incentive schemes across the main bureaucratic arms will be important in Indonesia. Finally many SNGs operate inefficiently, so there are risks for rewarding inefficient behavior, though it is difficult to clearly identify the inefficient and impose sanctions on them. Despite the challenges further research and experimentation with incentives is warranted.

Discussion suggested broadly based concerns with performance of Indonesian SNGs (and in other countries) and thus considerable interest with exploring incentive based schemes. One question was whether to completely redesign the existing system (containing limited incentives) or adjust at the edges? Some indicated a need to better define SNG performance which is an important prerequisite for designing incentives. Furthermore, it is difficult to design incentives if the assignment of functions is not clear and appropriate. There is also a need for louder citizens’ voices to demand accountability and performance, thus citizens need to be the focus of incentives/sanctions. A further question is whether the aim is to reward better performing regions irrespective of equity—there may be tradeoffs between growth and equity. Finally one commentator noted that the paper had not addressed the Governments new regional incentives pilot scheme (DID) and that this initiative warrants close review over time.

1.5.5. Financing Regional Infrastructure and Growth in China

Professor Baoyun Qiao provided a paper on China’s approach to stimulating regional infrastructure development and growth, from the perspective of debt financing of capital expenditure. The analytical framework adopted assumes the risk in SNG borrowing is influenced by the country’s fiscal strength, as determined by intergovernmental financing arrangements and financial market constraints determined by the current status of financial markets. Expenditure responsibilities under the Budget Law are heavily decentralised but SNG revenues collect significantly less than the expenditures incurred. While there are many general purpose and specific purpose transfers mechanisms,
the amounts transferred are not highly significant, thus leaving debt financing as a key instrument of SNG deficit financing in China. Officials are incentivized to maximize growth in the regions, including infrastructure growth, so financing of growth emerges as a critical challenge. SNG debt has helped to fuel growth and development. However, it also generates financial risks.

Levels of risk need to be contained and not eliminated. There are costs (e.g. foregone growth) to excessively risk averse approaches. Risk depends on hardness of budget constraints and financial market constraints. Hardening budget constraints requires strengthening of the whole inter-governmental financing system, not just debt controls. Similarly financial markets need broad strengthening not only in relation to SNG debt. The essence of the optimal risk approach is to minimize risks in SNG borrowing at a given level of cost, particularly losses to economic growth. The solution is dynamic as costs, benefits and systems used change over time. For most developing countries both budget and market constraints are weak and both need significant strengthening to control risk.

On the demand side (soft budget constraints) the factors contributing to weakness include: (i) blurry government enterprise relations, including guarantees by SNGs to State enterprises; (ii) weakly designed inter-governmental financing system (imbalances between expenditure and revenue assignments and poorly designed transfer mechanisms) all lead to excessive debt, partly in expectation of Central Government bail outs in the event of crisis—all are competing for growth in line with central directives and incentives and anticipate that the centre will eventually finance them; (iii) slack budgetary management—lack of transparency means lack of monitoring and control—excess expenditures on personnel and administration are common; (iv) not much voting with hands or feet; SNG officials are appointed by higher levels and mainly accountable to them; people do not have free movement between locations; (v) high expectations are placed on growth, and the view that future growth will continue to provide revenues to fund current debt; (vi) rapid urbanization has led to massive demands for new infrastructure; (vii) wealth effects—land is 100% State owned and has been heavily used as SNG security for borrowing, particularly from
state banks; and (viii) the aggressive fiscal policy from 2008, with shared central and regional responsibilities for expanding infrastructure development;

On the supply side (market constraints) factors contributing to weakness are: (i) weak financial governance is common, including weak information on borrowers’ capacities. Incentives for banks are to grow not to be prudent. There is greater tolerance for risk with SNGs in expectation they will be bailed out if needed. There is strong influence of SNGs in personnel and decision making of the State owned banks. Finally, interest rate controls are insensitive to risks of different credit lines; and (ii) high savings rates and excessive liquidity in financial markets—with growing gaps between savings and loan levels—meaning competition to attract borrowers, with SNGs perceived as good borrowers.

A further strengthening of both budget and market constraints would reduce risks of SNG borrowing substantially. On the demand side both administrative and rules based controls are options. Administrative controls may be best in the short run (greater compliance, easier to vary for widely differing SNG circumstances) but in the longer run strong rules based approaches are appropriate. On the supply side rules based approaches are preferred (e.g. capital risk weighting of loans to SNGs could be linked to international ratings of creditworthiness of SNGs) because of significant costs in micro managing financial institutions via administrative controls.

The discussion indicated considerable interest within Indonesia at China’s successes (albeit with risks) in stimulating significant infrastructure development and broader economic growth through use of the SNGs as major agents for public investment. The highly risk averse approaches to SNG debt financing taken in Indonesia are matched here by the very slow pace in infrastructure development. The tradeoffs between risks and growth contained in the paper provide interesting food for thought for Indonesia and other countries where such choices exist.
SECTION B
Ministerial Keynote Addresses
Implementing Fiscal Decentralization in Indonesia

Agus D.W. Martowardjo, the Minister for Finance

This paper addresses the theme of, ‘The Implementation of Fiscal Decentralization in Indonesia: Achievements, Problems and Challenges’. I hope that my paper will be able to stimulate constructive inputs on the current implementation of fiscal decentralization in Indonesia.

Fiscal decentralization reform has been an important instrument for supporting the finance functions that have been delegated to sub-national governments. Hence, sub-national governments are able to improve the efficiency and effectiveness of governance, public services and infrastructure. Such improvements aim to encourage regional economic development, thus providing opportunities for the improved welfare of all people.

Having started the regional autonomy in 2011, the path towards fiscal decentralization in Indonesia has thrown up many challenges, as we seek to meet high expectations. Fiscal decentralization reforms go hand in hand with reforms to political and administrative decentralization arrangements; which has involved delegating important responsibilities to sub-national governments.

Efforts have been made to accelerate improved public welfare, by providing more scope for local communities to be involved in development processes. Governance and service provision by the regions has become more effective and efficient because of the better knowledge
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of local people’s needs. In addition, public decision-making processes have become more democratic as local parliaments have become more involved in the planning and supervision of local budgets.

The implementation of decentralization reforms has been guided by the development of a modern and consistent legal framework aimed at supporting good governance. Important legal reforms have included the issuance of fundamental new laws in 2004, relating to the administration and financing of decentralization, along with a related 2009 law on the strengthening of local taxing powers.

A key principle of our fiscal decentralization reforms has been that money should follow function—where sub-national governments must be given adequate sources of funding to exercise the authorities that have been delegated to them. The main instruments applied in Indonesia have been the designated taxing powers to sub-national governments and the intergovernmental fiscal transfers.

We are aware that, as a result of the limited authority of taxing powers at the sub-national government level—which is similar in other countries—there has been solid growth in own source revenues. The aggregate of own source revenues peaked at about Rp 71.8 trillion, or 17.9% of the total sub-national government revenues by 2010. However, it is worth noting that improvements have been made simultaneously—we recently stipulated a new Law on Regional Taxation and User Charge (Law Number 28 (2009)). The new law intends to strengthen local taxing powers, namely by expanding local tax bases.

Having said that, the role of intergovernmental fiscal transfers (as the instrument used to fund the assigned functions delegated to sub-national governments) has been a major issue. The intergovernmental fiscal transfers consist of Balancing Funds, Special Autonomy Funds, and Adjustment Funds. The amount of the transfer has continued to increase sharply over time, and by 2011, amounted to Rp 412.5 trillion, or 5.7% of GDP. The money that has been transferred through this mechanism is directly transferred to each LG budget.

In addition to that, the CG also allocates funding, to finance programs and activities in the regions devoted to Deconcentration and Co-Administration Funds. The state ministries or government institutions have continued to fund important regional programs, such as the
National Program for Community Empowerment; the School Operational Assistance Program, as well as national subsidies programs. The amount of all broadly defined funding to the regions in 2011 reached a very significant level of 61.2% of the total state budget expenditures.

Given the significant amount of funding provided to sub-national governments, and considering the multiplier effects, it is worth noting that sub-national governments should also play an important role in improving regional and local development, as well as raising public welfare.

Nonetheless, the results of fiscal decentralization are not always encouraging. Yes, there is some progress, but it is not yet maximal. We have made achievements: major improvements to services and living standards in regional communities; support to macroeconomic improvement—including higher economic growth and improved GDP per capita; lower unemployment; and reduced poverty levels.

Decentralization has contributed to improvements in services delivered in important sectors, such as education and health. The CG’s Special Allocation Fund (DAK), has helped with the building and renovation of schools in every region, which has helped to increase enrollment rates, which are now quite high. As for the health sector, there have also been significant increases in budget. However, improvements in the coverage and distribution of services has been limited, especially considering the improved macroeconomic performance from 2004–2010, with the average annual rate of economic growth (GDP) recorded at 5.7%.

Let me now turn to some of the challenges we face in the pursuit of our fiscal decentralization goals. One issue is the division of functions between levels of government. We are aware that functional responsibilities have not yet been implemented consistently. Thus, challenges persist in achieving quality in expenditure. Furthermore, challenges persist in the area of strengthening public financial management, including the need for further transparency and accountability in public financial management.

Inconsistencies in the implementation of functional assignments have encouraged inefficiency in budget allocation. There are still some local affairs that are funded by the line ministries. Conversely, some
functions that are funded locally should belong to the CG.

Problems persist as a result of poor local budgeting and expenditure management. Personnel expenditure dominates as a share of regional expenditures, representing some 45% of local expenditures in 2010. The high share of personnel costs erodes funding available for capital expenditure. This means sub-optimal results for service delivery and infrastructure. Of course personnel expenditures are influenced by the legitimate and growing needs for teachers and medical personnel. However, there are also increasing numbers of administrative civil servants, who are often less productive.

Weak financial management is also a major challenge. For the time being, some regions are still receiving ‘disclaimers’ and ‘adverse’ opinions on their Regional Financial Reports. Delays in setting budgets—often triggered by the long decision-making processes undertaken by local parliaments—have been represented as one of the major problems. Shortages of human resource skills and breaches in regulations on the procurement of goods and services are also another of many concerns.

My brief coverage of the various issues that affect the successful implementation of fiscal decentralization has indicated that important challenges still lie ahead. We need to find appropriate solutions to address these challenges, so that the objectives of fiscal decentralization can be met, in order to speed up improvements to public welfare.

One of the issues we will need to account for in the future is the need to improve the efficiency of local budgets. One of the future policies that will be considered is to ensure there is no direct link between the needs of personnel expenditure and the general allocation fund (DAU). Rather, it will only be based on the formula defined as the fiscal gap. In addition, improvements on the variables of fiscal needs in the DAU formula will be pursued, by having a better proxy to reflect local needs.

Regional proliferation has also been an important policy issue. Proliferation of regions has resulted in reduced funding for individual LGs to finance their responsibilities. Budget demands to fund central administrative offices in the regions have also grown sharply. To address this problem, we are reconsidering the criteria used to form new regions. Consideration of financial capabilities—particularly the potential for
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regional revenue raising and capacities for achieving results—should receive greater weighting in decisions about new regions. New regions should not simply expect an automatic financing from the DAU.

Various initiatives to improve the quality of local spending are currently being considered by the government, either through direct fiscal instruments or through incentives and sanctions. Some sub-national governments are not yet sufficiently efficient in the management of budgets and employees. In the short term, this has been addressed by a moratorium on new employment. However, in the future, the CG is considering policies to cap wage expenditure, and/or to prescribe minimum levels of capital expenditure.

Policies affecting patterns of local spending can improve the quality of services. We are also considering earmarking funds to target better results—for example reforestation funds and some oil and gas funds—and the use of special allocation funds. Some revenue sharing from oil and gas is directed to elementary education. The DAK will be redirected to help areas that have limited fiscal capacity to provide basic services in education, health, roads, bridges, drinking water, irrigation and drainage.

The government is also considering further developing its systems of rewards and punishment. This will also require developing adequate systems to monitor and evaluate the results of decentralization. We must then assess progress in the implementation of regional autonomy periodically. The results of these assessments will be used to refine incentives or sanctions, with the aim of improving overall results.

In order to address the types of challenges I have outlined, the government has embarked on efforts to improve existing policies and legislation. Planned reforms include, firstly, finalization of the Grand Design for Fiscal Decentralization; secondly, preparing revisions to the fiscal decentralization Law; and finally, revisions to the Regional Governance Law—which will be finalized in the near future.
Decentralization has been core to our Reformasi, underpinning all dimensions of domestic governance. It is the Government of Indonesia’s main policy instrument for supporting and accelerating regional development, as well as the other core commitments promised as a part of the Reformasi such as democratization and improved governance.

The transfer of some government responsibilities, tasks and functions to Regional and Local Governments (LGs) is intended to improve the welfare of our people, in line with our national objectives, as stipulated in the Constitution.

It has been seven years since the implementation of Law 32 of 2004—the prevailing law pertaining to decentralization—and it is time for us to reflect upon what has been achieved. Are people better off? Are local economies flourishing? Have incomes per head risen after a decade? Are people receiving better services from different levels of government? And there are many more questions we need to ask.

Unfortunately, we do not yet have comprehensive research that could indicate what impact decentralization has had on rates of development. However, if we take as an indicator the increased role that RGs and LGs have started to play, then we can say that we are on the right track in terms of what we are trying to achieve. An inclusive approach to development has not only been important as a general
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objective, but has increased the ownership that RGs, LGs, and all people, have over our national development processes.

With regard to fiscal decentralization, a growing part of the Government’s budget has been transferred to the Regional and Local Governments. In 1999 this share represented 13.7%. Before implementation of Law 32 of 2004 on decentralization, the budget transferred to RGs and LGs increased to an average of 28.4% of the total budget over the 2000–2004 period. From 2005–2009 the proportion of transferred funds has increased further to 33%.

Despite the financial crisis in the late 1990s, our economy recovered fairly quickly. By 2001, when the law on decentralization was implemented, growth had returned to 3.5%. In 2004 our economy was growing at 5%, and reached 6.3% in 2007. In 2008 when another crisis hit us, we were afraid of what impact it might have on our economy and growth but we were back on track by 2010, and we have managed to sustain our momentum of increasing growth, accelerating expansion and improving economic development. While growth is affected by a number of factors, it is safe to say that decentralization has been a major contributing factor.

To analyze the quality of development, more information is needed to look at whether the welfare gap between provinces is decreasing as the national GDP increases. Only in some years, have some provinces had negative growth when all others were growing positively. The gap of GRDP among provinces is narrowing. So is the gap among provinces of some non-economic indicators like school participation rates, health, and some other MDG indicators. In spite of that improvement, there was a tendency towards wider gaps in welfare within provinces: gaps among kabupaten/kota are, in some cases, becoming wider. From our experience we might say that it is really important to increase willingness and to build the capacity of regional and LGs to take advantage of decentralization policy.

We have encountered many obstacles and challenges in implementing decentralization. That is not surprising, since we took a Big Bang approach to meeting commitments to democracy, decentralization and to improving governance at the same time.

I must admit that we Indonesians sometimes try to do too many
things in too short a period of time. To add to that, we should not
forget that we started our regional autonomy and decentralization process
during a difficult time, when the economic impact of the East Asian
financial crisis (*krismon* as we called it) was at its most severe.

Through our experiences of trying to implement the 1999, and
later 2004, legislation on decentralization, we have learned and sought
to improve the process of decentralization. Much has been done in
recent years to revise our policies, to overcome the difficulties we have
encountered. We have revised two important laws relating to decen-
tralization, as well as several government and ministerial regulations
and other implementing legal documents.

In order to improve the process of decentralization, we have worked
closely with panels of experts, academics, outstanding people, local
leaders and community organizations. We have also worked together
with our international partners of development. I will not name them
one by one, as that may take too long—a testament to the number of
constructive relationships we have managed to develop.

I am sure that this international conference will act as a fine
example of this partnership and cooperation. The timing has come
perfectly, as we take on the process of self-reflection to evaluate the
successes of the past decade.

At this time, let me list a few of the issues that I believe we will
need to think about into the future:

- How can we balance the wish to delegate responsibility for
  local services to LGs, but ensure that there are minimum
  standards of access to, and quality of services?
- What will be the most appropriate role for the Central
  Government? And how big should the Central Government
  be?
- How do we fine-tune the allocation of finance from the center
  to the provinces and districts, to try to improve the distribution
  of income and access to services at the same time as providing
  incentives for all levels of government to promote economic
development?
- Can we strengthen the incentives for promoting local economic
development and raising more revenue at the local level, by
decentralizing more taxation powers? Can that be managed without potential damage to national priorities and nationwide income distribution?

- What is the best approach to take, to improve the capacity for planning at the provincial and district levels? And what can we do to achieve more consistency among the many plans made by various levels of government?
- As we move to implement an ambitious strategy to improve connectivity among regions of Indonesia, how can we ensure that all levels of government will facilitate implementation without infringing upon their autonomy?

I know that many countries have tried to find an appropriate balance on all of these matters and it is never easy to do so. We know that there is plenty of room for improvement. Through review and dialogue we hope we can re-examine our achievements and disappointments so far with decentralization in Indonesia and also learn from the experiences of other countries.
We are now celebrating 10 years of fiscal decentralization in Indonesia. This conference has brought together the world’s experts on decentralization to offer their views and experiences from different countries, thereby providing participants with the unique opportunity to gain a true overview of decentralization policies as a whole and as they have been applied to Indonesia.

In Indonesia, fiscal decentralization has not been approached as a stand-alone measure; it has formed but one part of a political reform agenda that began 13 years ago. This reform agenda has been marked by drastic changes to governmental organization, as we moved from a centralized to a decentralized system, to allow for the regions to take on greater authority. As a consequence, regions have been provided with more funding support, including more funds transfers and an increase in discretionary powers to develop their own sources of revenue.

Data has shown that LG budgets have risen sharply over the past 10 years since the implementation of fiscal decentralization policies. In 2000, the total budget for LGs across Indonesia was approximately Rp 38 trillion. This soared to an all time high in 2011, to Rp 477 trillion. This increase in local revenue was coupled with greater powers for LGs, to use their own discretion to spend their budgets in accordance with local needs and priorities. We anticipate that this expenditure will
provide fiscal stimulus for the local economy and improve levels of public welfare—an essential point of providing regional autonomy.

These increases in local revenue are inseparable from fund transfer allocations from state to local treasuries, via the balance funds. On average, government transfers make up more than 73% of local revenue per year, while locally generated revenue provides less than 21% of contributions—and as little as 13% in certain years. The remaining percentage is derived from other legitimate sources of local revenue.

Substantial funds transfers from the CG to LGs should be followed by fiscal balances—strengthening local taxes and fees—to maintain local taxing powers and fulfill requirements of local accountability. Once again, efforts to strengthen local fiscal measures should be oriented to local development expenditure that is of a sustainable nature.

To provide measurable and relatively objective indicators of the success of local budgeting measures, Minimum Services Standards (MSS) should be adopted, to ensure the effective delivery of public services. It is for this reason that I look forward to this conference, as an opportunity to hear success stories from around the world and from various parts of Indonesia, about better fiscal management, including the use of analytical tools to improve local revenue and expenditure management. These examples, I am sure, will benefit all participants in their efforts to formulate and implement decentralization policies in the future.

While revenue regulation—particularly with regard to transfer and local taxing power—is relatively sufficient, expenditure in LG budgets is highly variable at the local level. In the aggregate, the expenditure composition of LG government budgets for 2000–2010 consisted of personnel expenditure of between 35% and 45%; activity expenditure of between 35% and 56% (including capital and goods expenditure); and the rest for other indirect expenditures, such as grants and social aid. The figures from the regions show that, 294 districts and cities set aside 50% of their budget for personnel expenditure, while other regions allocated up to 75% of their budget for personnel expenditure.

There has been an increasing tendency for the composition of local expenditure to be dominated by allocations for personnel expenditure. The government must take corrective measures to address
this, including placing a stay on personnel recruitment for the next 14 months. Such a measure would suit the bureaucratic reform agenda we are working towards, which aims to ensure all regions achieve an ideal composition of local civil servants and to ensure expenditure is more oriented towards the delivery of basic services (as specified in the MSS).

The government is currently working on revising laws related to regional autonomy, in order to refine aspects of local financial management. Reviews are continually being conducted on the regulations for local finance, these include: regulations on local expenditure for social aid; MSS; extended incentives and punishments for local financial management; the application of accrual-based Governmental Accounting Standards; and methods for implementing accountability practices—including improving the quality of the inspection agency responsible for assessing local financial reports. It is hoped that, over the coming years, these measures will help to promote improvements in local financial management.
SECTION C
Getting the Political Economy of Decentralization Right
5

Political Challenges and Successes in Indonesia

Professor Dr. Djohermansyah Djohan

5.1. Introduction

The founding fathers of modern Indonesia made a strong decision when they implemented regional autonomy and decentralization policies, as a way of managing the diversity within the Republic of Indonesia. Consisting of 17,500 islands, numerous tribes, customs and religions, it would be almost impossible for a country like Indonesia to be managed through a centralized system. The legal basis for Indonesia’s decentralization policies date back to the Proclamation of Independence in 1945, and article 18 within the Constitution, which provided for greater regulation through the Local Government Act (LGA). Various LGAs have contributed to the decentralization process over that time: Law Number 1 (1945) concerning the status of the National Committee of the Regions; Law Number 22 (1948) on the Fundamentals of Local Government; Law Number 1 (1957) concerning the principles of regional government; Law number 18 (1965) on the fundamentals of local government; Law Number 5 (1974) on the principles of regional administration and finally; Law Number 22 (1999) on regional government administration—which was further enhanced through the enactment of Law Number 32 (2004).

The LGA is a cornerstone for policies on regional autonomy in
Indonesia, and has been continually updated in accordance with the development needs of the nation. In various LGAs, the definition of regional autonomy is essentially right, autonomous regions are granted the rights, authorities and obligations associated with organizing and managing their own affairs, in accordance with the interests of local communities and legislation. Thus, regional autonomy, in principle, is the granting of autonomy to the people of a region, to govern themselves. There are two main objectives to decentralization: the promotion of democracy and the enhancement of welfare objectives. Local government democracy is positioned as an instrument of political education at the local level. It is hoped this will also contribute to national levels of political education and accelerate the efforts of civil society. Welfare provided at the LG level is aimed at providing public services for local people effectively, efficiently and economically. This is exemplified in the explanation of Law Number 32 (2004) on regional government Administration, which states the goal of decentralization, as a push to improve people's welfare, public services and regional competitiveness.

In 1999, Indonesia applied a wide-range decentralization system, which has significantly altered relationships among citizens, regions and the CG. The system shifted responsibility to LGs to manage their own accountability, transparency, decision-making, financial management and service delivery.

Indonesia’s decentralization policy has reformed the governance system in Indonesia fundamentally, through the implementation of laws such as: Law Number 22 (1999) on regional governance and Law Number 25 (1999) on fiscal balance between regional and central governments. Since then, these laws have been replaced by Law Number 32 (2004) and Law Number 33 (2004), which provide clearer and more detailed regulations for the implementation of decentralization and regional autonomy. These laws underline the continued commitment in Indonesia, to promoting regional autonomy as a means to enhance service delivery, increase the welfare of the people and ensure the political, economic and social stability of the nation. The government has undertaken necessary efforts to facilitate the smooth implementation of these laws.
5.2. Decentralization for Democracy

One of the major breakthroughs brought about through the introduction of Law Number 32 (2004), was the mandate to have directly elected regional heads. This was considered an important initial step towards consolidating the country’s democratic system; though the government has recognized the need for better implementation plans for future elections.

In line with the spirit of decentralization, direct elections for regional heads have been held since 2005. These local elections improve upon the previous system, which relied on indirect (representative) democracy. Under the previous system, the regional head and deputy regional head were elected by the parliament. Though this approach still represented the choices of the voters who elected their government, now, voters at a community level are entitled to vote directly, in accordance with their own conscience as they choose the head of their region.

The decision to hold elections was a strategic step, aimed at broadening, deepening and improving the quality of democracy in Indonesia. It also aligns with decentralization’s aims to promote autonomy, in that it allows local communities to determine their own destiny and recognizes the aspirations and initiatives that occur at this level. When viewed within the framework of decentralization as a tool for democratization, the importance of elections cannot be underestimated.

In addition to these arguments, the election of regional heads fosters a sense of accountability, while further promoting the need to provide quality services. Elections create political stability and effective government. Further to this, open elections create new opportunities for improving the quality of national leadership, as potential national leaders emerge from the regional level. This falls in line with the overall goals of decentralization and regional autonomy, by promoting new training opportunities and possibilities for national leadership.

The opportunity to vote for the regional head was enthusiastically welcomed by people. This enthusiasm is indicative of a wider hope and expectation developing in the community that general elections will continue to be held in a democratic, safe and orderly manner.

Through the experience gained in implementing elections across
various regions, it has been realized that the election arrangements outlined in Law Number 32 are limited in terms of the systems and technical rules in place. It is through these reflections on the law’s limitations though, that the government has further cemented its commitment to improving elections, and will strive to improve the various aspects of election organization in the future.

To do this, it would be necessary to create a separate law, in addition to Law Number 32, to further regulate elections. This would improve the accuracy of election results and lead to citizens being engaged in a higher-order form of democracy. The preparation of a draft law on the election of regional heads has become one of the cornerstones of the government’s national legislation program for 2011, so we hope to see the next general election arranged under new and improved legislation.

5.3. Decentralization for Prosperity

The Government has drafted a grand strategy for the implementation of decentralization, as a means of consolidating Indonesia’s challenging system. The strategy addresses seven key areas: government functions; the management of civil servants; local financial administration; local representation; public service delivery systems; and implementing effective control and monitoring systems. Building on from this grand strategy, more detailed action plans are yet to be developed in conjunction with key stakeholders. For now though, I shall extrapolate on the functions within the grand plan.

5.4. Government Functions

To achieve regional autonomy it has been necessary to implement a division of government affairs, to work between the central, provincial and local district government levels. The establishment of a division of government affairs was based on the premise that there are a variety of government functions that remain wholly within the authority of the CG to ensure the survival of the nation as a whole. These areas include: foreign policy, defense, security, monetary decisions, judicial and religious matters.

Equally, there are matters which are considered to be under the
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authority of LGs. These areas fall into two categories: mandatory government functions, and functions which are considered to be adopted by a LG in reaction to the specific nature of their communities’ needs and abilities. Mandatory government functions include the provision of basic services such as: basic education, health, subsistence minimums and basic environmental infrastructure. Other LG initiatives are seen to be adopted as a matter of choice, but are dedicated to improving the distinct assets of a particular area.

In some areas, there are matters of government affairs, which must be handled jointly by the CG and LG. For matters which are handled jointly in this manner, the CG maintains authority, while particular functions are passed onto the provincial, district or city level.

The proportions of influence held by the various tiers of government when working jointly must be carefully considered. The grand plan contains a draft of criteria to be considered in these situations, that stresses the need for externality, accountability and efficiency while promoting harmonious relationships between the levels of government management.

5.5. Government Structures

Within local government, the regional head is assisted by the regional administrative apparatus, which in general consists of members of staff who assist with policy formation and coordination. Regional heads are further assisted in their tasks of preparing and implementing regional-specific policies, by local technical institutes—which contain within their offices, regional affairs executives.

The nature of government functions that need to be addressed, requires that regional bodies be structured as an organization. This does not mean, however, that separate organizations should be formed in order to manage government affairs.

The scale of regional organizations should consider at the least: the financial capacity of an area; the needs of the region; the scope of duties required to meet identified targets; the space available for working areas; and the geographical and population factors that are specific to that area. In this way, it can be seen that regional organizations across the board will not be uniform, but will be configured to suit their respective areas.
5.6. Engaging Civil Servants

Civil servants hold an important position within the national system unifies the nation. In line with decentralization governance policies, there is scope for local civil services to take a greater role in the employment of staff. The systems and procedures outlining the hiring of regional personnel are covered within the legislation and include appropriate guidelines on planning, appointments, placement, education and training, remuneration, dismissal, retirement, and the rights and obligations of those working within the national civil service.

5.7. Local Financial Administration

For LGs to effectively implement government services, sufficient sources of revenue are required. Law Number 33 addresses this issue, indicating the need for finances between the CG and LGs to be balanced, in accordance with the degree of authority and control held by the various tiers. Each area of control granted to the local LG will have financial resources attached and provide a source of local finances.

Local areas are further given the right to obtain financial resources through the collection and utilization of taxes and levies; funds raised from local resources; the effective funds management of regional finances; and through other sources of legitimate income and financing. These arrangements are essentially an example of the government applying the principle that, ‘money follows function’.

5.8. Local Representation

LGs and the parliament work as a partnership on this matter, with both being given equal authority. The nature of this relationship is reflected in policies on regional regulations. It is considered necessary, as part of the move to regional autonomy, to encourage strong working relationships between the two institutions, that takes into account the differences in their respective functions, while working in a mutually supportive manner.

5.9. Public Service Delivery System

The end goal for LGs should be to provide a wide availability of
the goods and services that are required by the community. LGs should provide goods of local benefit, such as roads, bridges, irrigation, school buildings, markets and hospitals. The LG should also produce services that help regulate public order. For instance, they should manage the issuing of birth certificates, ID cards, building permits and licenses required to facilitate peace and order within society. The important point to consider is how can public services be provided in a way, which helps local communities to prosper? The principles of minimum service standards, excellent delivery (that services are delivered at a cheaper, better and faster rate), and accountability are all to become major public service issues in the future.

5.10. Effective Monitoring and Control Systems

Supervision is undertaken by the government, in relation to appropriate ways of conducting government affairs and in accordance with local regulations and rules. There are a range of processes and activities involved, intended at ensuring that LGs are acting in accordance with plans for the nation as a whole, and with relevant legislation.

The government is aware of complaints that have been made, by national and foreign businesses, that LG regulations have placed an unfair burden on them, which restricts local economic activity. Some of these regulations, particularly certain local taxes and levies, have had a serious impact on the business and investment climate in regions. The CG will continue to monitor this problem, aware that it poses risks to economic development at a regional and national level.

How to provide effective guidance for and supervision of LGs, without limiting the authority of LGs, will be an ongoing challenge for the decentralization system. Law Number 75 (2005) on supervision of LGs provides guidelines on the rules and procedures associated with this kind of monitoring. The most important aspect to this law, are the mechanisms put in place for supervising local regulation systems, to ensure they comply with higher tiers of laws and regulations.

Ongoing efforts are being made to ensure these mechanisms are being implemented in a consistent manner. This includes developing clear guidelines on how to deal with inappropriate local regulations.
Inappropriate regulations are defined as: regulations which may have negative impacts on local economic development, or Indonesia’s investment climate; that endanger the sustainable management of natural resources and the environment; or that threaten levels of social and political stability.

In order to provide more effective guidance and supervision for LGs, we intend to strengthen the role of the governor within the regions, so that they may act as a representative of the CG. Within such a framework of guidance and monitoring systems, the government maintains the ability to cancel a regional regulation, if it is deemed to be contrary to the public interest, or a higher point of legislation.

Since the implementation of Law Number 22 (1999), some 205 new LGs have been created (covering 7 provinces, 164 regencies and 34 cities). There are currently 524 LG areas operating across 33 provinces, 398 regencies and 93 cities. The establishment of so many new LG areas has been seen as necessary, to meet the demand from local communities that government operates at a closer level to the people. At the same time however, this large-scale approach to developing autonomous regions has not always resulted in local governance that is effective and efficient. To control future moves around establishing new regions, the government has implemented a grand plan for regional establishment (Deastarda), which provides estimations on the ideal number of autonomous regions to be achieved at the provincial and district level by 2025.

The grand design for regional establishment was developed with the aim of accelerating national integration and economic development, and improving the quality of public services available to communities throughout Indonesia. For this purpose, a suitable design can be built on a framework which considers three dimensions, namely: (i) the geographic area; (ii) demography; and; (iii) systems (e.g. defense and security, social and political, economics, finance, public administration; and Government management). Based on such a framework, the design of regional spatial arrangements consists of four main policy elements. Firstly, the preparation for formation of new autonomous regions. Secondly, incorporation and refinement of autonomous regions. Thirdly, setting up autonomous regions that have certain special characteristics.
Finally, determination of the estimated maximum number of autonomous provinces, districts and cities until 2025.

The Government’s agenda prioritizes poverty reduction and directs efforts towards projects and programs that support this focus. The government realizes that decentralization has fundamentally changed the governance system in Indonesia and placed greater responsibility on the provinces and districts to provide public services. The alleviation of poverty therefore requires a strong commitment from decision-makers at the local level, and efforts to engage local stakeholders in the formulation and implementation of poverty reduction programs.

Mandates on the obligatory functions of LG and minimum service standards will continue to contribute to efforts to alleviate poverty. Regions will be provided with the guidance necessary to make basic services, like health, education and infrastructure more accessible and affordable for the people. Regional planning and budgets will come to reflect the goals of poverty reduction and minimum service standards, as well as the objectives of the Millennium Development Goals (MDGs).

The introduction of minimum service standards is expected to increase levels of transparency, improve planning standards and help clarify the roles of different tiers of government. In this way it is hoped that the introduction of minimum service standards will help guard the rights of communities to gain access to basic services. In practice, service provision measures must ensure peoples’ access to basic services, in accordance with the stipulations made by the CG. Therefore, service-planning measures offer a simple, concrete, measurable and accountable set of principles to consider when developing local plans and budgets.

5.11. Implementation Problems

The efforts made to implement decentralization and regional autonomy policies, have not been without fault. Some of the problems encountered in implementation have included:

- Unexpected hierarchical relationships have developed (indicating the system has not worked well);
- Decentralization moves continue to be concentrated in areas with a high degree of local government capacity;
- Budgetary funds have not been managed in an accountable...
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and efficient manner;
- Support for exploiting the potential synergies of regional autonomy is not optimal;
- Legal conflicts continue between various regions over legislation differences on forestry, mining and land matters;
- There continue to be obstacles to creating a conducive investment climate. Bureaucratic issues, high-cost economies and local regulations continue to be problematic;
- In some areas, elections have been implemented at too high cost; and
- There has been an explosion in proposals suggesting the formation of new autonomous regions. In 2010, 181 proposals were received suggesting new areas for autonomy.

5.12. Conclusions and Recommendations

There are several actions that could be taken to overcome these implementation problems:
- Synchronize the legal systems at the local level;
- Increase cooperation between the central, provincial and district/city levels;
- Build capacity at the local government level;
- Promote regional expansion by improving the design of regional structuring plans for 2010-2025;
- Implement administrative reform to overhaul the bureaucracy. This would help create a positive investment climate and eliminate the problems of a high-cost economy; and
- Revitalize the seven basic elements of regional governance: government functions; government structures; civil service management; local financial administration; local representation; public service delivery systems; and the implementation of effective management and monitoring systems.
6
Assigning Functions in Latin America

Luis Riffo Perez

6.1. Introduction

This article is a summary of the project document ‘Decentralization of essential services: the cases of Brazil, Chile, Colombia, Costa Rica and México in health services, education, waste disposal, security and promotion’, a comparative research of decentralized services between five countries done by the UN Economic Commission for Latin America and the Caribbean (ILPES) within the framework of the GIZ agreement on decentralization and good governance.

The hypothesis for this research establishes that the supply, coverage and quality of essential public services could be improved by decentralization, and proposes a case study for the last decade.

Regarding methodology, this document briefly provides some useful concepts to analyze the decentralization process for essential public services in Brazil, Chile, Colombia, Costa Rica and Mexico. The sample chosen accounts for the variety of sub-national situations in the region; the differences in federal and unitary institutional systems; differences in decentralization practices; the variety of political, social and economic problems; territorial dimensions and local realities; and a great number of essential services public administration practices.

Eight hypotheses are given to account for the specific characteristics in the decentralization process and to provide recommendations for
national, regional and local governments and communities.

It is important to notice that the results of this research are based on a thorough bibliographic analysis, 52 interviews with key informants and 207 online surveys with Latin American experts on the subject. In the original document this is provided in 5 country chapters, a chapter for the survey results and a chapter for fiscal decentralization indicators on health and education in Chile.¹

6.2. A Summary of Approaches to Decentralization in Latin America

Decentralization in Latin America is integrated by a highly complex set of processes, considering the array of centralistic, federation schemes, unitary states and various intermediate approaches that characterize the region. Because of this diversity, there is always a certain level of distrust towards decentralization. This distrust has been heightened by external crises, resource difficulties and problems with providing quality social services.

The decentralized institutional scale is variable. We observe that the national level is followed by states, regions, provinces, departments, municipalities and neighborhood institutions. For each level, specific or shared institutional roles can be expressed; specific institutional development can be observed; social cohesion and development processes will be encouraged and different forms of participation and citizen prominence will take place. The public authority election system will account for the ‘relative autonomy’ of each entity and, in all of the cases there are different territorial institutional structures. Practically every country in Latin America and the Caribbean is unique, with different historical evolutions. These issues of territorial identity sometimes play an essential role.

Decentralization processes should be analyzed in four dimensions: institutional, development, equity and participation. These complementary approaches are presented in Figure 6.1, which tries to

explain these very complex processes, while accounting for the different dynamics and foreseeable effects of the different approaches taken in each nation.

6.3. The Methodology

Considering the dimensions of decentralization and the various essential services that could be supplied regionally or locally, it seems adequate to consider a limited but representative sample. The election of essential services is based on the following methodological considerations:

- That the sample is sufficiently varied in order to consider services with different degrees of effective decentralization; and that the sample accounts for the different territorial scales in the region, with regards to policy, characteristics, direct administration and relation to users and citizens;
- That the sample allows the study to provide explanation of different forms of inter-territorial coordination in each of the
considered cases, given that the quality of such coordination is the essence of the service supply optimization for citizens;
• That the sample is wide enough to express different resource administration schemes for the supply of services, also recognizing this dimension as the key to defining public policy and different degrees of fiscal decentralization.

Based on these considerations, five essential services are defined, which allow for an understanding of the problems faced in various countries and their choice of decentralization schemes.

**Primary health**

Primary health services are considered broadly, encompassing health care services, prevention and health control mechanisms. These services are located in medical and emergency centers and different establishments distributed in rural and urban areas. These services are eminently local. Located near the demands of the population they house an important number of specialized and auxiliary staff, equipment and infrastructure.

**Education**

The provision of education services at pre-basic, basic and secondary levels constitute the basic services usually guaranteed by the government. Education is covered by a wide group of provisions. Countries have and continue to make efforts to improve coverage, and are beginning to make efforts to improve quality too. The provision is carried out at a local or regional level, traditionally by public establishments directed and sometimes administrated by the CG. In the last decade, because of the territorial elements that impact education services, and the need to adapt to local realities, execution and supervision has been emphasized at a local and regional level.

**Collection and treatment of waste**

These services constitute an important environmental and sanitary necessity. Recognizing the diversity in wastes and the different institutional and technological realities in the countries, collection, disposal and treatment phases are administrated and executed at a sub-
national level. Latin American cities express different realities, but usually, service quality is low, there are structural deficiencies and small budgets for local operations. It is a service that is essential to maintaining the general sanitary conditions of the population, especially for the poorest of the population.

Public safety

There is an urgent necessity for civil security services in Latin American communities, which are widely demanded by the population. According to recent studies, delinquency is the main concern for citizens, even before employment rates. The provision of surveillance, prevention, delinquency control and connected matters are mainly in the hands of specialized police services. While its operation is mainly local, supplied directly to the population, its territorial management may vary in federal or unitarian countries. This is a highly complex service that is subject to citizen scrutiny, and transparency and corruption observations. Police service effectiveness, is related to the service network that oversees delinquency control (comprising of the judicial system, organizations for prevention, detention centers, rehab centers, etc.).

Productive promotion

Services destined to strengthen the regional and local productive system are essential for achieving the goals of second-dimension decentralization, to facilitate growth, equity, sustainability and improvements in territorial communities. These consist of a wide range of services that are usually dispersed through public agencies and provide productive promotion, technical assistance and access to credit and human resource training. These services, that require a territorial adaptation when not defined in situ, are sources of public-private collaboration and should show a more precise configuration at a sub-national level because they are strategic for productive development, venture and inter-sector productive network strengthening.

6.4. Essential Service Situations in the Selected Countries

6.4.1. Brazil

Over the last decade, Brazil has steadily increased public investment
for, and exceeded the average increase, for annual budgets provided to social infrastructure, education, health, waste disposal, pensions and productive promotion. This expresses the social priority given by central, state and local governments. In this way, a society based on guaranteed rights, with universal access to social provisions, and governmental responsibility over those services has been developing. This relies not only on constitutional and legal guarantees, but on public actions to sustain it.

**Primary health**

Since 1993, state governments have assumed responsibility for the management and supervision of health services, delegating global or partial responsibilities to the municipal government. The municipalities have become more prominent since the late 90s, although coverage, local responsibilities and quality is heterogeneous. Since 2002, with the creation of ‘health welfare regions,’ joint actions between municipalities have been encouraged, with good results for effectiveness and use of available resources. These interactions allow for the buying of inputs and medicines and specialized services; and make the most of approximately 60% of the national health budget that is transferred to states and municipalities. Since 2006, a junction of programming and planning instruments has established goals and public health compromises that define national actions and responsibilities.

**Education**

These services are organized under decentralized schemes, with the main responsibilities devolved to the states (between 70% and 90% of the basic and secondary education enrollment). Municipalities take on a secondary role, taking greater responsibility for pre-basic education (assuming up to two thirds of the enrollments). Nevertheless, great differences in quality and coverage are observed between territories, with more problems being noted in the northeastern region of the country.

Regarding educational planning, the Education Union established an Education Plan for 2000–2010 that shows the way decennial plans are to develop at the federal, state and municipal level. In every state a fund for teachers and education staff is constituted, and if a deficit is present the union contributes to compensate it.
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Collection and treatment of waste

In the last decade, significant advances have been made in the collection, classification and recycling of domestic wastes, in regards to: technology; material recovery; costs, fees and payments; and in the quality of the services in different states and localities.

Some main institutional accomplishments include: the implementation of Law 11445 (2007), which modified laws, regulations and procedures; and the development of the 2010 National Policy for Solid Wastes, has provided detailed information on the environmental and economic benefits of recycling, regulated the final destination of wastes, limits the areas for waste disposal and burning, and promotes recycling and sustainable use of landfills.

Public safety

Organized crime, drug-trafficking and general delinquency are the main national, regional and local problems, and constitute a barrier to stability, growth and the struggle against poverty.

One of the main actions to reinvigorate civil security is the National Public Security Plan. Implemented during Fernando Cardoso’s presidency, it is dependent on the Ministry for Justice. Experts have emphasized the value of prevention programs, complementary state social programs and cooperation between institutions.

Productive promotion

Brazil has implemented a productive agglomerations system, with the objective of generating more cooperation between the agents of each agglomeration, and establishing dynamic competitive advantages based on learning and innovation. This initiative has been led by the Industrial Development Ministry and the Brazilian Service of Support for Micro and Small Enterprises (SEBRAE). ECLAC further collaborates on specific projects, provides training and operates as an observer for small and medium-sized enterprises, among other activities.

Initial results are still modest, according to the experts, because of negative impacts stemming from the wider economy—the international crisis has created difficulties for expansive economic investment on
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infrastructure. It is the states, regions and territories that have the highest rates of poverty and resource shortages that lack sufficient means to generate social benefits, enterprise capacity and employment.

6.4.2. Chile

Over the last decade, systematic efforts have been made to achieve development in an equitable way, which has led to the establishment of an extended group of ‘guaranteed rights’. In a decade of expansive public investment, the growth in essential services increased the mean global growth—this led to: the implementation of various programs like the supportive basic pensions; the propagation of pre-basic education; increased attention being paid to newborns and infants (seen in Chile, Crece and Contigo); and the implementation of the Chile Solidario Program. Within this context, the territorial dimension of the programs is expressed through a major management compromise undertaken by regional governments and municipalities.

For more than 20 years, programs and social projects have been submitted to a social profitability qualification, supplied by the national System of Investments from the Ministry of Planning. On the whole, they have been evaluated after the fact by the Treasury Department (Budget Directory). Adjustments were then made to programs, while the capacity of adapting usually has recognized in decentralization a preferred management mode.

Primary health

The competency transfer was passed to the municipalities in the 80s, in a move that employed the same logic used for basic and secondary education. After questioning the moves towards primary health municipalization in the 90s, the model was reasserted. It encourages high degrees of local responsibility along with collaboration between intermediate-level health services. The local experience has been uneven in terms of financial, professional and human resources, as well as in municipal leadership capacity. This suggests that a generalized model of competence transference to local levels is not recommendable, because of weaknesses in management, financing and
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...treatment; a low level of coordination with health establishments; and the ongoing need to improve human resources. Decentralization has been seen to have had positive impacts on prevention rates in the health services.

**Education**

The decentralization of education services has consisted mainly of giving municipalities a management role over services, as delegated by the ministry. The majority of experts consulted agreed that this process had been traumatic for teachers and the municipalities. Decentralization led to the transference of a ‘problem,’ without a solution and further weakened the Ministry of Education’s control over regulation matters. Municipal management emphasized the differences between areas, in terms of capacity, infrastructure and teachers.

The most significant advances have been made in extending coverage, to assure 12 years of education and greater access to pre-basic level schooling. There continue to be unresolved matters around quality; strengthening of the intermediate level; and social integration—matters over which a wide debate has arisen, leading to the modification of various laws, including the Organic Education Law, the Education Quality and Equity Law; and proposals for an education reform plan to be in place by 2020.

**Collection and treatment of waste**

These services are a responsibility of municipalities but are nevertheless outsourced to private enterprises. The environmental quality of landfill projects and the final disposal of wastes are the responsibility of the intermediate level (in some cases between municipalities). The central level maintains control over regulations, where both the Ministry of Health and Ministry of Environment play a role in decision-making.

With regards to management results, the last decade has seen major technological advances made in the collection and treatment of solid wastes. Some examples include: the use of containers for collection; the optimization of collection routes; and increased competition among sub-contractors to encourage better performance. Problems have been detected with fares and charging mechanisms, with a high percentage...
of users being tax-exempt. This is why there is presently a structural deficit for waste collection in poor municipalities.

Public safety

Civil security has been a major priority over the last 10 years. This has led to the formulation of various government plans and the strengthening of initiatives like the Comuna Segura and Barrio Seguro programs.

Based on what we have learned through municipal surveillance, Institutional Police have been reinforced, leading to the installation of the Carabineros de Chile and the Policía de Investigaciones. This action has been favored by civil participants involved with initiatives like Plan Cuadrante; and by municipal police forces who have welcomed the opportunity to be provided with increased information, back-up logistics and improved lighting and equipment. Attention has been focused on issues of delinquency and drug trafficking (where efforts have been doubled) while other emblematic subjects like domestic violence have made fewer advances.

Productive promotion

These services are associated with public activities and organizations that promote productive strengthening—the Productive Promotion Corporation, the Technical Cooperation Service and themed organisations, like the Agriculture and Livestock Development Institute, National Mining Enterprise and Tourism National Service are the most relevant institutions.

Over the last decade promotion measures, private ventures, technical assistance, access to credit and state guarantees have been strengthened. The Regional Development Agencies (RDAs) are constituted to articulate the private and public agendas, but the main focus remains on sector policy action. Experts who were consulted as a part of our research, agreed that, local and regional economic development remains an unresolved matter, with regards to the decentralization of productive promotion, regional productive resources and sub-national cooperation.

The service is associated to the territorial real-state tax and about 75% of the lands are tax-exempt, in consequence, a high number of people don’t pay for the service.
6.4.3. Colombia

Since the 80s there has been a widening of the competencies and funds delegated downwards and a number of legal reforms designed to improve management. Important legislative reforms have included the implementation of: Law 715 (2001) which established the general participation system; Law 01 (2001); Law 04 (2007) that modified the transference system.

Bonet concludes that Colombian decentralization accentuated differences between departments and did not generate greater efficiency in the provision of public goods at a sub-national level. He ascribes such results to institutional design failures in the transference system; the lack of incentives at a local level to collect taxes; and a lack of institutional capacity at a local level.

Primary health

The introduction of Law 10 (1990) delegated the responsibility to provide health services to departments and municipalities. Since the 1993 reforms, the departments have been the ones to direct The Sectional Health System, using central government resources (fiscal allocation) and eventually their own resources. In terms of transfers, Law 60 gives departments, districts and municipalities health service personnel and property. However, the transference of such responsibilities to the departments and municipalities requires good organization and high technical capacity.

Different difficulties have postponed the implementation of planned changes and prevented the goal set in 1993, to achieve total coverage within seven years. The most obvious difficulties include: the delays to legislation on the minimal health package; the slow dissemination of public information about hospital quality—which only began in 2006; the economic crisis of late 90s; low institutional capacity among municipalities and health promotion entities; the inflexibility of health service staff; and difficulties associated with transferring resources to

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non-accredited municipalities. This is heightened by the fact that the system continued to finance non-insured workers according to historical criteria from the previous reform, which so introduced an external element to the subsidy’s originally conceived intentions.

**Education**

Law 60 points out that management of the educational system is a joint responsibility for departments, municipalities and certified districts. These entities must manage the services; carry out investments and assess educational establishments. In financial terms the Fiscal Allocation and the National General Income Participation establish a concrete resource transference mechanism for education, even when departments and municipalities can co-finance the service in their territory.

A key reform was the implementation of Law 715, on municipalities certification, which granted automatic certification to municipalities with more than 100,000 inhabitants (4% of the country) to manage education. The accreditation of new municipalities falls on the departments, which have to assess: the existence of a Municipal Development Plan (in accordance with the National Education Plan); the permanent staff (in accordance with central level standards); the organization of educational centers (in accordance with the law); and the institutional capacity of the municipalities to manage their own establishments. Non-accredited municipalities play a marginal role in education, which includes the resource allocation of Service Goods Provisions, staff reallocation between establishments and the generation of information required by the central and departmental government. Currently, only 48 municipalities have been certified and 12 municipalities are in the accreditation process.

**Collection and treatment of waste**

Environmental management in Colombia is decentralized to the

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4Health promotion entities are a type of user insurance that buys the health services provided to the population. These institutions receive contributions from finance sources (contributions from formal workers) and a per capita contribution for every poor person, from the municipalities (or the department) based on CG transfers. The user may choose between health providers that will be signed up by the health promotion entity.
Regional Autonomous Corporation (CAR) and the Environmental National Fund, which control the management and protection of the environment. These entities were created by the Ministry of Environment, Housing and Territorial Development. CAR is independent from the ministry and local authorities, and has authority over financial and management decisions. Districts with more that 1,000 inhabitants have an Urban Environment Corporation, with the same attributions as CAR.

National competencies involve defining sector policy, which includes the National Policy for the Management of Solid Wastes; establishing economic incentives to achieve the national plan; and carrying out training and technical assistance. At the local level, the 1.713 decree of 2002, assigns solid waste management responsibility to municipalities and districts, as well as the obligation to formulate and implement solid wastes integral management plans.

Another specific aspect of the environmental institution is the creation of the Department of Public Housing Services as a technical organisation that is independent from the Ministry of Economic Development. This department carries out functions related to local services control, inspection and monitoring.

Public safety

Constitutionally the National Police maintain interior security and utilize departments and police stations, but there is an overlap between the roles of the National Police and the Armed Forces. This overlap is a result of the multiple security problems that have arisen from guerrilla warfare, which military forces have been involved in. The undefined nature of these institution’s functions, was purposely established this way by the Andrés Pastrana management (1998–2002) and Alvaro Uribe management (2002–2010) with the idea to strengthen the public security forces, by increasing their staff, professionalization of the troops and internal organization improvement. In addition, the functional dependency of the Police to the Ministry of Defense increases this overlap. Looking at the policy results, experts recognize that there have been improvements in management; however, more efforts are required on decentralization and to improve relationships within the community.
**Productive promotion**

According to Law 715, the departments are the promoters of economic and social development in their territory; coordinating with municipalities on policies of industrial and development enterprise, matters of planning, financing national projects and promotion of private activities. This mandate is expressed in development plans for each sub-national level.

Law 1.014 (2006) establishes a national network for venture, comprised of different public and private organizations related to the matter. It is presided over by the Ministry of Commerce Industry and Tourism, with a territorial expression on Regional Venture Networks. The ministry rules the general guidelines in matters of promotion, coordinating with institutions like the National Fund for Guaranties, the SENA, Colciencias, Proexport, Bancoldex and Finagro, among others, and with an integral support system for micro, small and medium enterprises.

It is an interesting aspect of Colombian institutions and its venture culture, that promotion actions are introduced at the school level, to stimulate young people to create business initiatives. The resources for such activities come from the central, departmental, district or municipal level.

**6.4.4. Costa Rica**

Costa Rica is a centralized country, which has de-concentrated its functions mainly to the provincial level. Over the last decade, the municipal level has gained a certain level of independence, favored by transferences from the central level based on geography and poverty criteria. An important milestone was the implementation of the General Law of Transferences from the Executive Power to Municipalities (2010) which mandated that the central level transfer 10% of the Republic’s income to municipalities; and that all state functions not explicitly allocated to the central level be decentralized— with the exception of health and education. This Law allocates a period of seven years, to delegate the competencies and their resources until the 10% is reached.
Primary health

The national primary health policy, regulation and planning is defined by the Ministry of Public Health. There are seven institutions involved in the sector, both from the central and non-central level—even though some functions can be delegated to other institutions. Among these are the Ministry of Health and the Aqueduct and Sewer Institute. From the Ministry of Planning there are also: the Health Investigation Institute; the Alcoholism and Drug Dependence Institute and the Costa Rican Investigation and Training on Nutrition and Health Institute.

From a financial perspective, The Social Security Costa Rican Fund (CCSC) maintains and manages the social security systems that independently finance public health; drawing their resources from worker, employer and state contributions. A parallel task focused on labor accidents and diseases, is carried out by the National Insurance Institute. According to regulations covering the CCSC Fund, attention is to be focused on managing health budgets and providing primary health services to the population. With all of these regional organizations present, the municipality does not have to control these tasks.

Education

Basic and secondary education in Costa Rica is managed centrally, by the Ministry of Public Education and by the Superior Education Council—which is presided over by the Minister of Public Education. It consists of 27 Regional Directories (DR) in different provinces and zones. The DRs maintain technical and management departments and at the same time are subdivided into minor territorial units called ‘school circuits’ (groups of educational institutions dependent on the Ministry). Each circuit is presided over by an advisor, who is the chief of the educational services in their jurisdiction.

The strength of the municipal level in regards to educational matters, has been progressively weakening since late 19th Century, with the Common Education Law (1886) leaving the role of immediate inspection of schools to the Education Municipal Board—of which there is one in each education district. Finally, it is important to note that article two of the Municipal Code grants this administrative level the role of
promoting education at a local level, managing scholarships and allocating resources (when available) to the public schools.

**Collection and treatment of waste**

Two institutions are involved with solid waste management, the Ministry of Health and the municipalities. An old dispute between the Ministry of Health and Environment and the Ministry of Energy and Telecommunications, was recently settled by the National Legislative Assembly, which approved the Law for the Integral Management of Solid Wastes (Law 8.839). Institutions that participate in the support system for solid waste management include: the Industrial Chamber of Costa Rica, which supports the formation of enterprises for recycling; and the Municipal Promotion Institute, that by law is in charge of technical assistance to the municipality. The latter also finances municipal investment incentives that involve waste collection equipment.

**Public safety**

Current modes for the organization police are covered in article 12 of the Constitution, which removed the army’s role. Since then, the only state institution in charge of defense and national security is the Public Force. The main police branch focuses on prevention. It is constituted of the Public Force, which is independent of the Ministry; is divided into 10 regional directories; works in a de-concentrated way; and operates in different divisions. The immigration police depend on the Ministry of Public Security. Police forces continue to be dependant on the judicial system through the Police Investigation Organization; while the Ministries of Justice, Public Works and Treasury possess specific police forces.

The Municipal Police are also involved in security, though they serve limited functions within the community—such as securing the safety of parks, protecting municipal buildings, controlling street commerce and monitoring gambling and liquor sales. There exists 14 corps in the whole country. On the other hand, it is part of the Municipal

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5 These are: frontier police, coastguard service, community and commerce security, drug control, legal support, special units, airports and information analysis and treatment.
Police’s role to promote community participation, to complement central level activities. This has led to the implementation of programs like the Community Safety and the Proximity Police. The former has tried to involve local communities, through the creation of Citizens Safety Committees, while the latter is typically more de-concentrated because it coordinates actions to prevent—not just stop—crimes at a local level.

**Productive promotion**

MIDEPLAN oversee the long-term plans to develop the nation’s productivity, in spite of the fact that there is no national investment system. The creation of six development planning regions in 1970—to which two more were subsequently added—was aimed at generating a space where local needs could be debated at National Development Councils. Despite the fact that such attempts at debate were suppressed in the early 90s, Sectoral-Technics Committees survived for a while, though now there is only the Agricultural Technical Committee. Even though the sectoral ministries have regional responsibilities, the bulk of decisions are still made at the central level.

In terms of development financing, Law 8,634 (2008) created a ‘Bank for Development,’ with the objective to finance projects that promoted “social mobility for those groups identified by the Law”. Within the sphere of improving performance in the productive sector, there also exists a National Institute for Learning—an autonomous institution for training people in 12 specific areas designed to strengthen productive labor.

Finally, MIDEPLAN is today in a phase of recovery with regards to its national system of public investment. However, there is still little indication of the specific systems of approval MIDEPLAN may adopt with regards to investment projects; or how the regional dimension may be recovered as a space for coordination and de-concentrated planning.

**6.4.5. Mexico**

Over the last decade there have been a group of socio-economic phenomena, partly related by the international crisis and other economic
difficulties that have severely compromised productive growth, leading to an increase in unemployment and an expansion of the informal labor sector. This has limited the ability of social programs to maintain quality and extend, due to the increase in people on basic incomes and benefits programs. Also, some of the Ministry of Social Development traditional roles have diminished in importance, significance and coverage—though the Oportunidades program still operates, to directly alleviate rural poverty.

Simultaneously, there has been a strengthening of heterogeneous, representative and political democracy in Mexican society, which has expressed itself through the development of a multiparty system and through shifts in national political dynamics which have seen greater emphasis placed on states and local elected authorities. In terms of social investment, it is significant that state incomes have practically tripled over the past 10, thus reducing the discretion in transfer assignments. So there exists more balance, based on the increased political power of the sub-national level to provide support to state management—even though there are central budgeting limitations.

**Primary health**

The Ministry of Health has been in the process of implementing decentralization since 1983, across 14 states of the Union. In 1996, a National Agreement for Health Services Decentralization was signed by all the states, stipulating a transfer of responsibility to the states for: delivering primary health services and preventive medicine to the whole population; providing a universal service; and to progressively transfer sanitary control to municipalities. The central level maintains exclusive control over regulatory and legal activities, as well as financing activities through transfers.

In operative terms, for several years, the federal health establishment (at ministry level) has coexisted with state-operated establishments that have been provided transfers. This has added to the complexity of the system, which was already subject to challenges of coverage and quality.

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6 Mexican States depend in a high proportion from federal transfers (about 82%). The same states determine the final destiny of their spending in an estimated figure of less than 40%.
This fragmentation makes coexistence and complementation difficult; and favors the efficiency of benefits as a whole. For these reasons, it will be a challenge to solve the differentiation of quality in benefits—a problem which has been further exacerbated by low levels of investment in health.\footnote{Between 1997 and 2007, an average state oriented 88% to current spending and only a 12% to investment, even though there are considerable variations among states.}

\textit{Education}

The Law on General Education Law (1993)—last reformed in 2006—made explicit that educational services at nursery school, primary and secondary levels, should be delivered on a federal basis, in conjunction with several institutions outlined in the Constitution (these include: educational authorities of Federation, federative entities and municipalities, through the Ministry of Public Education, the executive of each State and the educational authority of each municipality). There are definitions outlining the scope of exclusive competencies for each level and concurrent competences. Additionally, there is a mechanism of collaborative agreements between entities to coordinate unified educational activities. Also, by means of a reform in January 2005, it was established that the general amount that the Union, federal and municipal entities assign to spend on public education and education services could be no less than 8\% of GDP, including 1\% oriented to scientific and technological research.

Certain decentralized modalities have been progressing in Mexico. The division of functions between the CG and the states have been constructed on a framework of ‘new federalism’, which centralizes power (the former focused on plans, regulations and norms) and decentralizes management (states manage the system). In operative terms, educational federalization shows highly diverse results. A study of six Mexican states (Chihuahua, Estado de México, Durango, Veracruz, Puebla; and Oaxaca), shows that advances in decentralization are quite heterogeneous, and always limited to central directives, with great influence on teachers unions and with poor results for efficiency and educational quality. Social participation, even though a legal disposition, has a low practical expression.
Collection and treatment of waste

Municipalities are constitutionally responsible for waste collection and disposal. In practice, waste collection is done by municipal companies, or (as is usually the case) by private contracted services—this can relate to companies contracted to supply machinery, transport and places, and different franchises.

A different situation occurs in the treatment and final disposal of waste, which generally goes to dumps specifically arranged for this purpose, where techniques have been developed for accumulation. Many times, due to minimum productive scales, these dumps receive waste from several municipalities within a particular territory; implying that these places are subject to inter-municipality competence. Regional operations may also exist when treatment and disposal projects employ the use of landfills; and in contexts of high and constant demand. These circumstances justify a regional scale more than a municipal scale, incorporating direct and indirect responsibilities from state governments.

Detailed research conducted by Flamand and Rodríguez from el Colegio de México, identify good practices associated with service, concluding that best practice in this complex arena, is associated with actualized and coherent legal instruments; specialized and experienced human resources; financial resources from federal programs; and active and effective civic participation.

Public safety

One of the main problems for Mexican society is security, which is a result of the drug cartels, criminal organizations and institutional violence that has affected many within the federal authorities—including municipal mayors, police members and citizens in general. Within this context, the Senate Municipal Development Commission recently denounced the fact that drug dealers control 195 mayoralities and hold strong influence in another 1,536—this constitutes 71% of the total municipalities in the country. Weak arms-control laws, an increase in private security systems, a slow and highly complex judicial system and slow advances in jail and rehabilitation programs, complete this difficult panorama.
Section C: Getting the Political Economy of Decentralization Right

This context of violence, insufficient police and judicial action and civic distrust transform this issue into a state question, which threatens institutions, affects society and the economy. Nevertheless, a few exceptional indications show an increase in areas denouncing such violence; and an increase in local situations that are helping to implement structures of trust between the community and police. Documenting these practices should be prioritized as a source of a social pedagogy. However, the decentralization of police services oriented towards an increase in civic safety, faces several challenges, such as how to define the parameters of a state policy on civic safety and the unification of police commands among others.

**Productive promotion**

Government action on productive promotion has traditionally focused on providing credit and technological assistance to small and medium enterprises, favoring associated productive agglomerations, inclusive social development, organized expansion of public infrastructure—energy, roads and communications, and strategic orientations of development (which includes territorial dimensions as a key issue).

The actors that play a key role in this include: the Ministry of Finance and Public Credit which manages territorial productive policies; SEDESOL, which controls the promotion of modalities of local productive development and the general coordination of micro-regions; the Ministry of Economy, which provides training, technological innovation and business promotion—with an emphasis on small and medium business; the Ministry of Environment and Natural Resources, which is involved in environmental planning for local productive development; and Ministry of Communications and Transports, which provides support for infrastructure programs, favoring a detailed view of territories.\(^8\) All the institutions previously mentioned have an effective territorial view, even though inter-institutional

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\(^8\) Where there are integrated zones, municipalities and communities from different States of the country characterized by their high levels of productive and social backwardness. In those cases it is established public programs of interventions with an integral sense and there is an increase in synergies with the private sector.
or inter-ministry coordination has been difficult to achieve. At the level of states, of regions inside them, and within ‘special territories’ there should be a strategic emphasis on optimizing available instruments.

6.5. Conclusions and Recommendations

6.5.1. Generalizations are Difficult

Current research confirms that decentralization processes have particular results, depending on the country, so it is difficult to obtain general conclusions for the countries studied. This singularity highlights the conditions that explain the most important advances towards local development, institutional and fiscal management and social empowerment.

Among other explanations the following stand out:

• The existence of an institutional mechanism functional to decentralization, favoring competence delegations and confidence toward sub-national entities. This is fostered when those functions are not only delegated, but also when they are earned through accreditation of competencies and resources. The associated risk is that these processes, in some cases, could be linked with populist or superficial demands, or with political opportunism;

• When there is a historical trajectory of decentralization that, in some limited way, could show significant success. These examples are the best pedagogy for a deepening of decentralization;

• In those circumstances, which show a social regional or local force, social capital is key to the complex processes. These strengths are institutional, cultural, autonomous and educative;

• Over the last decade, with recessive or expansive economic cycles, the dynamics of anti-cyclical investments and public policies have favored territorial diversification of growth or adjust;

• Political electoral events have increasingly evaluated regional and municipal representatives. This is especially true in cases
Section C: Getting the Political Economy of Decentralization Right

where elections have generated a substantial debate and legitimized regional and local leaderships that acquire national dimensions;

• In the development of exceptional national programs oriented towards poverty reduction, social inclusion or special support to small and medium enterprises. These pro-equity programs have important decentralized effects.

6.5.2. Decentralization Has Made Progress

For different reasons it has been possible to establish that decentralization processes have shown partial levels of progress. This was the opinion of most of the key experts consulted. Among the factors that explain this relative progress, we find the following:

• The emergence of a relevant regional or local political dynamic, through the development of political parties, that constitute spaces recognized by citizenship;

• A strong presidential commitment—whose figure is quite relevant in the region—that is expressed through various programs, policies and actions, that are sub-nationally differentiated;

• The importance of regional and local elections in the political calendar that could act as some sort of primary elections for national elections;

• A stronger and systematic citizenship claim for local solutions. This is more evident in conditions of natural disaster or long-term crisis in certain territories;

• The emergence of a municipal movement, even in conditions of high centralism, that could recognize and legitimize new local leaderships;

• The persistent influence of decentralization from international organizations; international experiences and experts; and from regional and local leaders.

6.5.3. Scales for Essential Services Management are Variable

Most of the experts consulted could not agree upon ‘general
frameworks,’ for the decentralization of essential services. These general frameworks should move towards specific and gradual situations, to permit feedback over the long-term.

This opinion is based on the followings points:

• The low effectiveness of ‘total and unique’ frameworks. Normally, regional and local institution conditions are so variable that a generalized approach is inadequate;

• In some cases, decentralization of essential services has been implemented too fast, without a relevant debate that could lead to more gradual progress or alternative modalities. Or, in some cases, implemented without an analysis of essential previous requirements and with no specific consideration of its impact on the general development of the country and on general fiscal balances;

• Increasingly, there is conviction about the inter-municipal scale as the more adequate scale to manage essential services. There is not only a question of market size, but also of efficient management systems for specialized human resources; and the effective possibility to generate synergies over the territorial system. This scale supposes strong and long-term agreements among authorities, which gives stability to decentralization;

• The idea of conditioned decentralization is increasingly being considered. This implies that previous requirements have been fulfilled, that each sub-national entity must receive respective competencies to be transferred; and evaluated by the national/sectoral institutions in charge. Also there should be a reverse regime for the services transferred. All of these should contribute to ensuring the quality of services and consolidating a system of regulated transfers;

• Despite specificities in competencies and attributions of the analyzed cases, in all of them, the national level should be that which issues central policy guidelines; the medium level that which concentrates on territorial disaggregation of policy and programs, and eventually assumes direct management of services when necessary; the local level keeps for itself the direct management, with the previously mentioned orientation of inter-municipal management;
The efficacy of decentralization is based on the existence of a national-regional-local network, or a system with complementary roles in planning, programs, direct management and ex-post-evaluations of delivery. The vitality of decentralization not only rests on the execution of services, but also on its financing professional human resources, the supply market, the quality achieved and the synergies with other complementary services in respective territories.

6.5.4. Examples of Best Practice

Examples of best practice could be seen in all of the countries studied—either in comparative costs, service quality, positive participation of organized community, or the effective improvement in quality of life for users.

Among the associated factors—even though they are more exceptions than norms were:

- The quality of the directive and professional team in charge of service management, in terms of: leadership, professionalism, commitment to the community, continuity of actions and political support of the authority—which implies adequate doses of autonomy for management;
- The participation of organized community is a condition for success when it is permanent, committed to long and medium-term goals for services; and when it moves away from activities that are merely defensive;
- When financing for the delivery of services is adequate, safe and timely; when it covers direct and indirect costs; and is available for improvements, infrastructures and future investments. Moreover, when financing of investment is transferred based on competitive terms based on an efficient management;
- When institutional agreements between municipalities, or public services involved, are well-linked with the national level of policy and finance. This encourages efficiency in the delivery of services; and favors synchronization and national recognition;
- On occasion, these examples could be replicated, although it
would not be a simple process, because of several circumstances and conditions which support successful experiences. There is a need for a serious and detailed review of experiences, in order to identify which parts could be replicated and which don’t work;

• It is fundamental that good practice stands on its own and not be the result of external interventions—like support from NGOs, or special central state support (like a direct political and finance support)—or, of a unique situation. The good experience requires stability and normality.

6.5.5. Optimizing Quality in Education and Health

The essential services analyzed, have shown good performance in coverage, though there are still social groups living in poverty conditions; and populations that live in remote areas with severe deficits. This situation is beginning to contrast with the problems being shown, with regards to the quality of service delivery—particularly in primary health and in basic and intermediate educational services.

Among the recurring issues that describe or explain these complexities, we found the following:

• There exists a growing demand for a better quality of services. This is especially so in social and geographical areas where there coexist quite different educational standards. Legitimate social aspirations are related to quality as well as access. Today, quality has been improved in health-service delivery, which has been associated with new technologies and specialized attentions; however, this has occurred with unequal access;

• Issues of financing have been solved in a very limited way; and sub national entities supplying these services have found themselves limited by structural budget deficits. Transfers usually contain only minimum-costs associated with payroll and regular administrative operations. Initiatives of shared financing with families sharpened the gaps between services with or without private contribution. The challenge for decentralization is related to the need to improve financial
mechanisms;

• Special programs designed to improve quality and productivity; support infrastructure and equipment; or provide incentives for teachers and doctors, have shown inadequacies. Sometimes, the uniformity of institutional systems prevents the adoption of quality incentives. In others, to efficiently take advantage of new information technologies requires a minimum general context that doesn’t exist;

• In some cases, important improvements in quality are associated with relatively stable directors, well conducted professional teams, collective work and strong commitment to professional responsibilities. A greater autonomy of schools and clinical centers would be desirable, to create favorable conditions for the diffusion of these kinds of experiences, joined by enough institutional support and financing;

• Many of the set backs for these services are related to the absence of a structured system, which local benefits depend upon. Such a system should include better specifications of competencies by levels; an appropriate system of derivations; and control and monitoring mechanisms to ensure quality; and

• It is important to ensure that there is preferential access to specialization programs for directors and professionals, that work for local entities. When specialized training is offered at local levels there will be more efficient incentives. These programs are successful if they are implemented with regional financing and surveillance.

6.5.6. Optimizing Quality and Coverage of Waste Management

Solid waste collection and disposal, from a theoretical point of view, are a group of services with clear territorial hierarchies. In practice, this service still has severe problems of coverage and informal operations that operate outside basic sanitary and environmental rules.

Among the issues to consider are the following:

• The necessity of a basic waste collection and disposal service. The impacts of not having one are clearly visible in health
conditions and quality of life for the population. Most of the analyzed countries have defined national policies that look to formalize this activity and to search for a territorial hierarchy for its operation;

- Steady efforts are being made to improve the service and to design medium and long-term programs that incorporate new technologies to improve the design of regional-integrated systems of home waste disposal;

- International experiences and those of the analyzed countries, show important improvements in terms of waste classification, recycling, and recovery—even in productive modes of associated collectors and other interesting practices. Nevertheless, basic operation conditions should be in place before starting these innovations;

- Financing is an important restriction, especially for the establishment of regional systems. The disposition of families to pay for the service is relatively low when delivery is erratic, and when the municipality must take care of it. So there is a need for steady public policies, with adequate financing and innovation; and methodologies for charging that could create incentives for payment;

- The environmental and health considerations inherent to these complex activities mean the debate should include other issues, like industrial or dangerous waste; waterways; ecological risk zones; illegal waste disposal; and wastewater treatment. A coordinated management system could produce important synergies; and

- It is possible to incorporate citizen participation in some of these activities. Educational programs have had some success, especially when the goal was to build a culture of cleaning-up. Also, it is possible to recover an associative culture among local collectors, which has important environmental and income benefits.

6.5.7. Urgent Action Needed on Public Safety

For the countries included in this study, there is a clear relationship
between feelings of civic unsafety and global issues like drug trafficking, corruption and organized crime. Civic unsafety corrupts civic coexistence; and experiences of prevention and confrontation are in most part local exceptions.

However it is possible to make reference to some specific issues:

• National security is different, although related to civic safety. This distinction is important because, for locals, daily safety is an important factor for community organization and building trust in police. The militarization of police should be replaced by a citizenship approach, within a new framework of civic safety;

• It is essential to keep an accurate level of information and research on crime operations, to track the ways in which crime evolves. There are several situations where criminals have been more changeable in their tactics than police; or where there have been considerable suspicions of police corruption and associations with criminals. An increase in police trust will be linked to more scientific and timely information;

• Specialists consulted agree that it is necessary to unite police under a unique institution, or at least under a unique command, with clear policies and with a sense of state. The coexistence of national, regional, municipal and specialized networks of police (apart from judicial) often introduce complexities and competitive dynamics that do not contribute to citizenship safety;

• Management at the municipal, inter-municipal or regional level of police services depends on several factors. The debate over municipal police is held openly, with many experts seeing more risks than virtues in decentralization (depending on local civil authority). Experts agree upon decentralization with a more de-concentrated character, with local management depending on a unified police entity;

• It is necessary to link the issue of civic safety with the activities of directly related institutions, like the judicial system, public defense, penalization, and the prison system—recognized in
the region as being severely limited in its capacity to support reintegration—the educational system and prevention programs—particularly with respect to drug trafficking and other crimes with high social impacts; and

* When neighborhood organization is strong and respected, and supported by an honest and efficient police force that is when there could be successes. It is quite relevant to systematize these experiences.

**6.5.8. Addressing Regional Economic Development**

Specialists agree it is necessary to generate local economic development in order to sustain long-term decentralization processes - including essential services management. Important improvements have been made, especially when the efforts have been put on productive clusters, as the foundations for endogenous dynamics of sustainable development. Difficulties are particularly faced over issues of encouraging greater investment and new public-private relationships; and encouraging competitive strengths.

Among the aspects to consider are the following:

* The search for local or regional economic development supposes that there is an efficient group of public policies that have considered the availability of: steady and long-term resources for training; credits and guarantees; innovation and applied research; and support to associated entrepreneurs. All the previous aspects suppose stable guidelines that permit efficient joint actions with the private sector;

* Although this territorial scale of development could be evident from the point of view of potentials and resources, regional and local institutions for productive promotion and innovation usually suffer serious problems. They are very centralized; normally based on agents of territory; and there are low levels of commitment from regional and LG entities that suffer from low levels of empowerment;

* The experiences of public-private association are varied in the analyzed countries. Important achievements have been made in the field of roads and infrastructure, but association for
local development management is still insufficient. Some regional cases stand out because of the creation of development corporation or equivalents entities;

- Productive associations—whether clusters or not—constitute an improvement in those countries of bigger size and which are federations. They always have risks, but if they are established with agreement from the private sector they could produce favorable results. Local and regional development is increasingly based on productive activities related to natural resources;

- Research and applied technology is established as a fundamental requirement to sustained efforts for local development. Research centers and private producers associations, among others, are essential for the deployment of efforts that normally faced difficulties because of weak research institutional frameworks; and

- There should be simple frameworks for business management, so entrepreneurialism is not limited by a rigid and un-innovative institutional framework. This attitude in favor of entrepreneurialism is at the base of success obtained in local development in some cases in our sample of countries.
Managing Pressures for Fragmentation

Professor Jorge Martinez-Vazquez

7.1. Introduction

Many of the already decentralized countries and others that are undergoing decentralization around the world, face the challenge of what would appear to be excessive fragmentation of their sub-national governments—with too many units that are too small to be able to deliver services efficiently. The lower production efficiency is associated with the loss of economies of scale. On the other hand, it is also generally recognized that there are advantages to smaller sub-national governments, from the perspective of allocation efficiency. Smaller sub-national governments may be more responsive and accountable to residents.

Since the Big-Bang decentralization reforms in 2001, Indonesia has seen a significant increase in the number of sub-national governments, especially those at the local level. Because decentralization is a fairly new phenomenon in Indonesia and because the process of creating of new LGs (kabupaten and kota) and provinces has been quite rapid in just several years, there is a lot of confusion surrounding the process. There are many questions about the nature (causes and

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9 Economies of scale are present when the unit cost of the service delivered decreases with the size of the sub-national government, or, that is, with the level of the services produced.
motivations), consequences and effects, and therefore the overall desirability of this process.

There has been, and continues to be, important concerns in Indonesia as to how the ‘process’ (pemekaran or proliferation) has taken place. Even though there have been regulations, the generalized feeling is that past and current legislation/regulations lack a ‘grand strategy’. It needs to be further considered, how much LG fragmentation is optimal for Indonesia? On top of that, the existing regulations have not always been complied with. In addition, there continues to be concern about the ‘perverse incentives’ for increased proliferation, including how the transfer system and revenue sharing have been designed.

Because of the ongoing suspicions and confusion regarding the pemekaran process, a freeze on any new LG proliferation has been in effect for several years. The main goals of this paper are to shed light on these issues by looking at both the evidence in Indonesia and how it compares to other country practices around the world, and suggest some potential avenues for reform.

7.2. Defining the Problem

Since the decentralization process started in earnest at the turn of the new century there have been significant increases in the number of LGs. These changes in recent times contrast markedly with what had happened historically. Under the Soeharto regime, the formation of new LGs—either of provinces or kabupaten/kota—was very selective, fitting a centralized regime politically, administratively and fiscally.10

The fall of the Soeharto regime and the advent of a relatively much weaker CG in 1998, led to the strengthening of separatist movements in a number of provinces. The separatist movements were strongest in regions that are rich in natural resources such as Aceh, Papua, and Riau. An important response of the new government to this difficult situation was to decentralize and provide substantially more autonomy to the regions to run their own affairs. The new policy took

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10 The will to maintain the status quo was evidenced by the fact that Law Number 5 (1974) that had been issued to regulate regional government was never followed by an implementing government regulation.
shape in Law Number 22 (1999) regarding regional government and regional autonomy and Law Number 25 (1999) regarding fiscal decentralization. The content of these laws provided considerable autonomy and powers to LGs (districts and cities) and less to Provincial Governments (PGs). To a large extent the new laws de-linked any hierarchical relationship between the provinces and the LGs. This was largely seen as a strategic maneuver to deflate separatist intentions throughout the country; and to facilitate more powerful LGs and much weaker provinces. It was only later in 2002, when things had settled some more that the restive provinces of Aceh and Papua got special laws recognizing their special status to provide for asymmetric measures in revenue sharing from natural resources and other areas.

After Laws 22 and 25 took effect, the central authorities issued Government Regulation Number 29 (2000), which dealt with the formation, merging and liquidation of new LGs.

In this context, several significant points were at play:
- There was in 1999, a vertical structure of sub-national governments in Indonesia that had been forged under colonial and later dictatorial and highly centralized rule, so there could not be any presumption that this inherited structure could be the right one for a significantly decentralized system of government;
- With the advent of the new decentralization legal system there was a huge rush to create new LGs and also a number of new PGs; and
- The processes and motives involved in the creation of new governments were in part suspect, as further discussed below.

On the first issue, there has been no explicit examination that we know of, as to whether or not the existing number of kabupaten/kota and provinces was the right one, or whether the distribution of these government units across the country was the desired one. However, from the avalanche of criticisms that the pemekaran process received, it would seem that the assumption was that the number of provinces and kabupaten/kota existing in 1999 may not have been far from the right number. However, this assumption has not been based on any objective scientific analysis.
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On the second issue, the numbers do not lie: there has been a large increase in the number of jurisdictions since 1999. The current total number of kabupaten/kota is over 510. The base number of kabupaten/kota before 1999 was 304, so there has been a 67% increase in the number of LGs. The number of provinces is currently 33, from a base number of 27—an increase of 18% (Table 7.1).

<table>
<thead>
<tr>
<th>Period</th>
<th>Provinces</th>
<th>Districts/Cities</th>
</tr>
</thead>
<tbody>
<tr>
<td>1950-1955</td>
<td>6</td>
<td>99</td>
</tr>
<tr>
<td>1956-1960</td>
<td>16</td>
<td>145</td>
</tr>
<tr>
<td>1961-1965</td>
<td>3</td>
<td>16</td>
</tr>
<tr>
<td>1966-1970</td>
<td>1</td>
<td>11</td>
</tr>
<tr>
<td>1971-1998</td>
<td>1</td>
<td>33</td>
</tr>
<tr>
<td>1999-2008</td>
<td>7</td>
<td>206</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>33</strong></td>
<td><strong>510</strong></td>
</tr>
</tbody>
</table>

Source: Imansyah and Martinez-Vazquez (2010)

An important feature of the growth in the number of LGs is that it has been very unevenly distributed across Indonesia. Figure 7.1 shows the relative importance of the pemekaran process for LGs by island. Significant increases in the number of LGs have taken place in Papua, Maluku, and Sumatera. In contrast, there has been practically no change on the islands of Java, Bali and Nusa Tenggara. The islands of Sulawesi and Kalimantan are somewhere in the middle. The extremely uneven pattern of increases in the number of LGs highlights the need to examine the presence of region-specific causes for pemekaran, as opposed to, or in addition to, causes or explanations for pemekaran that may apply generally to all islands or regions of the country.

On the third issue, the processes and motives for the creation of new governments were indeed suspect. Though the conditions required for the creation of new LGs in Government Regulation 129 (2000) were thought by many to be lax, in fact, the process frequently followed for pemekaran was a political route that sat outside of the Government
Regulation 129 (2000), by obtaining direct approval by the Parliament (DPR). This shortcut was frequently used by the local elites seeking pemekaran, by directly appealing to the DPR or Parliament to issue a law authorizing the creation of the new government. This political avenue frequently ignored the technical and administrative process and requirements in Government Regulation 129 and produced results too quickly. As can be seen from Table 7.2 the expedited political process

Table 7.2. Number of SNGs Created through Regular and Expedited Processes, 1999–2008

<table>
<thead>
<tr>
<th>Province</th>
<th>District</th>
<th>City</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Government</td>
<td>DPR</td>
</tr>
<tr>
<td>1999</td>
<td>2</td>
<td>-</td>
</tr>
<tr>
<td>2000</td>
<td>-</td>
<td>3</td>
</tr>
<tr>
<td>2001</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>2002</td>
<td>-</td>
<td>1</td>
</tr>
<tr>
<td>2003</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>2004</td>
<td>-</td>
<td>1</td>
</tr>
<tr>
<td>2005</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>2006</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>2007</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>2008</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Total</td>
<td>2</td>
<td>5</td>
</tr>
</tbody>
</table>

Source: MOHA, 2009
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through the DPR dominated the creation of new sub-national governments, especially after the first few years of the decentralization reforms in 2001 and 2002, and especially in 2007 and 2008.

7.3. Determinants of Proliferation

The main objective for creating new LGs should be to improve welfare, by getting government closer to the people and increasing accountability in the provision of public services. Suspicion remains however, that the true reasons for pemekaran may have been something else, including such things as taking better advantage of fiscal transfers (such as the incentives provided by the DAU or the DAK grants) or political rents for local elites from having their own LG. A statistical analysis of the process of pemekaran may be helpful in identifying some of the more valid, as well as the less valid causes. However, we need to be aware from the start that, while some of the possible causes of pemekaran are easily quantified, for example differences in population or geographical area, some other potential causes, for example political motivations and rent seeking by local officials, are much more difficult or even impossible to quantify.

As we have seen above, a significant fact is that most of the district/city proliferation has taken place in just a few geographical areas (islands) of the country. This is significant because if pemekaran were a phenomenon that responds mostly to (perverse) incentives such as taking advantage of the DAU transfers, or capitalizing on local political rents, since these incentives are quite evenly distributed in all areas of the country, then we should expect a more even geographical distribution of pemekaran impact across Indonesia. This leads us to give more consideration to other factors or causes. For example, parts of Sumatera such as Aceh, plus Papua and the Maluku islands had a much more marked history of political repression and military intervention during the Soeharto regime. Also the presence of natural resources, especially gas and oil, is quite unevenly distributed across the Indonesian islands. There are other factors that traditionally are considered in the public finance literature to be important determinants of the number of LGs—such as population and land area—which may differ significantly across provinces and islands in the country and
thus contribute to explanations of the differences in the pemekaran processes we have observed since 1999.

But most likely, the causes and reasons behind the pemekaran phenomenon are not simple but are rather multiple and complex. Sorting out and identifying the relative importance of possible causes is hard because many of these factors are likely to be interrelated. Our intention is to report on the results of regression analysis in Imansyah and Martinez-Vazquez (2010) conducted with the objective of identifying the separate roles of various factors.11

Several previous studies, in particular those by Fitrani, Hofman, and Kaiser (2005)12 and Qibthiyyah (2008)13 have also investigated the question of the determinants of pemekaran but focusing on the variables that may increase the probability that any given local government will undergo pemekaran. These two studies tend to agree on several major determinants of the pemekaran process. First, sparsely populated regions—those with larger land areas and larger populations—as well as those with more heterogeneous populations, are more likely to undergo pemekaran. These are findings that assume ‘other things are constant’. These are important findings stating that the process of new LG creation in Indonesia would seem to respond to the same economic fundamentals that are predicted by public finance theory and is observed in other countries around the world. Second, both studies also identify a role, perhaps weaker in statistical terms, for fiscal incentives, such as those provided by transfers. Third, the political drive behind pemekaran may be there but it is not as noticeable as economic fundamentals of land area and population or even the fiscal spoils or incentives.

In Imansyah and Martinez-Vazquez (2010) the analysis differs from the previous studies in that: (i) it looks at a more extended period up to 2006, thus adding three more years of observations to the previous

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studies; and (ii) it adopts a different methodological approach to those used in the previous studies. While the two previous studies looked at the determinants of the probability that pemekaran would take place in any given jurisdiction, Imansyah and Martinez-Vazquez (2010) attempt to explain the increase in the number of LGs in the original provinces and the growth rate in these numbers. The analysis focuses on the 25 original provinces (number of provinces before decentralization, excluding DKI Jakarta) over the years 1999–2006; this approach is needed to have a uniform unit of observation for the statistical analysis.

For the determinants or explanatory variables to be considered Imansyah and Martinez-Vazquez (2010) use—with some changes—the same variables used in the previous studies and also introduce several additional explanatory variables. As in the hypothesis for ‘administrative dispersion’ used by Fitrani et al. and Qibthiyyah, it is also expected that larger populations and/or land areas of the local jurisdictions will positively affect the pemekaran process. Income per capita (GDRP per capita) is also introduced to control for the impact of income differences on the demand for political representation, and the share of the population living in poverty, to control also for any desire for fragmentation based on fiscal redistribution. As in the two previous studies, Imansyah and Martinez-Vazquez also include some measure of the impact of ethnic and religious heterogeneity and measure it with a dummy variable capturing the presence of ‘ethnic or religious conflict’. We also include several measures of fiscal incentives to pemekaran including: the amounts of the DAU and the DAK per capita; revenue sharing in natural resources per capita; revenue sharing in other sources per capita; and finally wage expenditures per capita as a measure of potential patronage and political rent seeking. These variables control for the general fiscal incentives in the intergovernmental finance system.

It is also arguable that areas that have a history of violent separatist movements may have had pent-up demands for more representation.

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and autonomy and therefore may have had a greater tendency to get involved in pemekaran. Thus, Imansyah and Martinez-Vazquez construct a dummy variable for previous separatist struggles taking a value of one for Aceh and Papua, and zero otherwise; note that areas where separatism aspiration exists or has existed at a political/administrative level, such as Riau, are still assigned a value of zero. Finally, as the number of provinces also has increased during the decentralization period, it is important to understand that the increase in the number of LGs may not be due merely to the fact that some provinces now contain more LGs, but also due to the fact that there now exist more provinces with the splitting of the original or mother provinces and that these new provinces may favor the creation of new LGs. The results in Imansyah and Martinez-Vazquez (2010) are reproduced in Table 7.3.

These are the main findings. As was the case for the previous studies that focused on the probability of pemekaran covering a shorter

Table 7.3. Determinants of No. of LGs and their Rate of Growth by Original Province (from 1999)

<table>
<thead>
<tr>
<th>Variables</th>
<th>Municipals growth</th>
<th>Municipals growth</th>
<th>Municipals growth</th>
<th>growth</th>
<th>growth</th>
<th>growth</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dummy separatism</td>
<td>1.157</td>
<td>1.067</td>
<td>1.726</td>
<td>-0.0578</td>
<td>0.00913</td>
<td>-0.0396</td>
</tr>
<tr>
<td></td>
<td>(0.556)</td>
<td>(0.501)</td>
<td>(0.864)</td>
<td>(-0.610)</td>
<td>(0.105)</td>
<td>(-0.414)</td>
</tr>
<tr>
<td>Dummy ethnic conflict</td>
<td>-2.432***</td>
<td>-2.654***</td>
<td>-2.587***</td>
<td>-0.1</td>
<td>-0.0546</td>
<td>-0.0655</td>
</tr>
<tr>
<td></td>
<td>(-2.463)</td>
<td>(-2.636)</td>
<td>(-2.631)</td>
<td>(-0.869)</td>
<td>(-0.474)</td>
<td>(-0.566)</td>
</tr>
<tr>
<td>Constant</td>
<td>7.124***</td>
<td>7.991***</td>
<td>9.913***</td>
<td>0.232***</td>
<td>0.226***</td>
<td>0.218**</td>
</tr>
<tr>
<td>Observations</td>
<td>175</td>
<td>175</td>
<td>175</td>
<td>175</td>
<td>175</td>
<td>175</td>
</tr>
<tr>
<td>Number of provinces</td>
<td>25</td>
<td>25</td>
<td>25</td>
<td>25</td>
<td>25</td>
<td>25</td>
</tr>
</tbody>
</table>

Source: Authors’ calculations

Notes: t-statistics are in parentheses; *** significant at 99%, ** significant at 95%, * significant at 90%.
(+) these are different specifications explaining the same dependent variable, the number of LGs.
(++) these are different specifications explaining the same dependent variable, growth rate in no. of LGs.
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period of time (up to 2003 as opposed to 2006 with our data) we also find that, as expected, ‘administrative dispersion’ as measured by larger populations, or larger land area plays a significant role in the number of LGs created. These findings, together with those in the previous studies, seem to be quite robust. As predicted by simple public finance theoretical principles, the equilibrium number of LGs is affected by size and density fundamentals.

But we also find evidence that fiscal incentives have played a role. Interestingly, the sizes of intergovernmental transfers with lump sum components (especially DAU but also DAK) seem to encourage pemekaran. The logic is that the DAU and DAK provide incentives as the new municipalities will receive lump-sum transfers (at no cost to other municipalities). On the other hand, higher shares from natural resources in the province do not lead to higher numbers of LGs. Perhaps, as concluded by Fitrani et al. (2005), whatever pemekaran was to happen to secure higher shares of natural resources already happened before the significant decentralization process in 1999; indeed many resource-rich areas already had experienced pemekaran before decentralization got under way (e.g. Kepulauan Riau split from Riau province, and Bangka Belitung split from Sumatera Selatan).

Other fiscal variables also seemed to stimulate pemekaran during the period. These included revenue sharing in all other taxes per capita and higher wage expenditures per capita. On the other hand, there is no more demand for new LGs originating in higher GRDP per capita; and the presence of relative poverty does not have a statistically significant effect either. Controlling for all other variables, surprisingly from a raw data perspective, the dummy variable for separatism (Aceh and Papua) is not statistically significant. Finally we find that the dummy variable for ethnic conflict takes a negative and statistically significant sign, which contradicts the findings in the previous studies.

We must be reminded that the interpretation of the each of the estimated coefficients is “holding other things constant.” So, for example, Java with a large population did not experience a high incidence of pemekaran; but, as we have already explained above, there are other counterbalancing factors beyond populations that help explain why Java, on the whole, experienced a lower incidence of pemekaran.

This is so despite the fact that for much of the period studied the lump sum wage transfers were not in place.
7.4. Legislation Versus Actual Practice

The proliferation in the number of regional governments, including provinces and kabupaten/kota can be dated to the issuance of Law 22 (1999) and its Government Regulation (GR) 129 (2000), which relaxed conditions to form new regional governments. This change in regulatory regime was driven by the aspirations of many local people and communities to form their own LGs. These feelings were fueled by geography and history. Regions that are far from the centre of government activities have often felt left behind in economic development and in many other respects as well.

However, the proliferation of new regional governments that ensued, raised serious concerns and thus in 2004, the government together with the DPR passed a new Law for the Administration of Local Government, Law 32 (2004). The effect of the new law was to effectively stop the process of pemekaran, at least until a new government regulation based on Law 32 was issued. In GR 129, to form a province it was required to have a minimum of only three kabupaten/kota. Meanwhile, to form a kabupaten/kota only three kecamatan were required (the administrative unit below). These lax rules allowed for a massive proliferation of LGs from 1999–2004. The requirements in the new GR 78 (2007) to form new regional governments are somewhat more stringent. For example, to form a new province, a province is required to have at least five kabupaten/kota. Meanwhile, to form a new kabupaten/kota, a kabupaten is required to have at least five kecamatan and a kota four kecamatan. In addition, another requirement is that the new autonomous region can only be split after 10 years for a province, and after seven years for a kabupaten/kota.

Of course, with the stricter requirements based on the Law 32 (2004) and GR 78 (2007), it was expected that the formation of LGs would be more selective than in the past. As opposed to ‘minimum conditions,’ the procedures indicated in Law 22 (1999) with its GR 129 (2000) and the procedure indicated in Law 32 (2004) with its GR 78 (2007) to form new provinces and kabupaten/kota were not significantly different from each other. In late 2007, the Government issued GR 78 (2007) under Law 32 (2004), seeking to manage the formation, amalgamation and elimination of LGs. Overall,
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this GR is more comprehensive and more detailed than the GR 129 (2000).

The assessment criteria to create new LGs based on GR 129 (2000) and GR 78 (2007) are different in nature. In the GR 78 (2007), the criteria are divided into three sets of requirements covering administrative, technical and physical requirements. The administrative requirements include: a letter of approval from the grassroots community, the regional parliament (DPRD) approvals from provinces and kabupaten/kota, approval from the head of the districts (bupati) and mayors, the approval of the governor, and a submission to the CG. The technical requirements cover the issues of economic capacity, regional potential, social and cultural issues, social and political issues, total area of the region, national defense issues, security, financial capacity, community welfare level, and span of control of the LG administration. The physical requirements cover the scope of the area (the minimum number of lower-level units), the location of the proposed capital city, and government facilities and infrastructure.

All those requirements add up to 11 factors. These factors are population, economic capacity, regional potential, financial capacity, social culture, social politic, total area, defense, security, community welfare level and span of control. These factors, in turn, are subdivided into 35 indicators—a number that is slightly lower than that in GR 129 (2000). However, the real implementation worth of GR 78 (2007) is still in question, as the number of indicators still appear to be too many and the calculation/scoring system too problematic. In addition, GR 78 (2007) is relatively new, which makes it premature to evaluate its performance.

In reality, the process of pemekaran approval has followed different routes from those determined in the legal norms. First, some recently established kabupaten were processed without using GR 78 (2007). The main reason would appear to be that the process had been started before the issuance of GR 78 (2007) and then it continued to be completed by the DPR under GR 129 (2000) provisions. Second, and much more important, a number of new LGs have been formed, based on own initiative of the DPR without exactly following the procedures stated in the government regulations for this purpose.
The main reason for these additional avenues for the creation of new LGs is that new creations at the end of the day require a DPR law, and under legislative powers the DPR has the right to take the initiative to make laws as stated in Law 22 (2003). The procedures typically followed for the creation of new LGs under DPR have been as follows: grassroots aspirants looking for the creation of a new LG go directly to the DPR; after that, at its own will, the DPR submits the proposal to the President. However, all the required documentation (as in the regulated process) needs to be included in the submission proposal to the President. If the President does not respond within 60 days to the DPR, the proposed law of pemekaran of a region will become a Law and thus take effect without the President’s signature.

Law 22 (2003) makes this alternative route for pemekaran, as already mentioned above, possible. Law 22 (2003) addresses the structures and functions of the Nation’s High Level Institutions and it specifically states that the DPR and the DPD have the right to propose pemekaran. In particular, articles 42 and 48 state that the DPD can propose pemekaran of a region but that the DPD needs to pass the initiative through to the DPR as the ultimate legislator. Note also that the DPD needs to be included into the discussion of pemekaran of any region whether the proposals come from the Government or the DPR. But again, it must be noted that the criteria and requirements to form a new local government (Province/Kabupaten/Kota) via the initiative of the DPD or DPR are the same as the criteria and requirements in the process through the Government/Ministry of Home Affairs (MOHA). All required documents as listed in GR 78 (2007) should be included when the DPR or DPD receives the submission. The main problem seems to be a political one. In recent times, the government has not had the required parliamentary majority to reject the DPR initiative law even when the technical requirements are not met at their minimal threshold.

7.5. International Perspectives on Optimal Size and Number of LGs

The question of what is the optimal size and number of local administrations arises both in centralized (albeit de-concentrated) systems and in decentralized systems. However, the term ‘optimal size’ takes
significantly different meanings in the two systems.\textsuperscript{17}

In the case of a centralized government with de-concentrated units (local administrations) for the delivery of local public services, the exclusive focus needs to be on minimizing the costs of production and taking advantage of any existing economies of scale and, if pertinent, also avoiding any diseconomies of too large a scale. The meaning of ‘optimal size’ in this case can be naturally associated with the concept of production or cost efficiency as they are faced, for example, by plant managers in the production of industrial private goods. In contrast to the case of de-concentrated local administrations, the decentralized LGs have autonomy through their elected representative officers to make their own decisions about the level and composition of local public services; and quite likely also to have autonomy to raise their own revenues. While the decisions for de-concentrated local administrations are made elsewhere by CG agencies, for decentralized governments it becomes very important that local officials make the right decisions about the level and mix of local public services. This decision has to satisfy constituents’ demands for public goods, and preferably produced with the least cost possible. Thus the concept of ‘optimal size’ for decentralized governments has two dimensions: (i) responsiveness to the needs and preferences of local residents—which is called in the theory of public finance, ‘allocative efficiency’, and (ii) cost minimization—or ‘production’ efficiency—in the delivery of public services.

But as production efficiency in general, tends to improve with size or scale, responsiveness or allocative efficiency tends to deteriorate with size or scale. Any one individual is more likely to feel heard and represented in a small group than in a very large group. The essence of this tradeoff between the greater efficiency of smaller governments that can better match local preferences and desires of local residents in their expenditure allocation and economies of scale in production with lower costs associated with larger governments was first stated in the work of Wallace Oates (1972).

\textsuperscript{17} The two questions of optimal size of local governments and the optimal number of them are one and the same for a fixed level of population. Therefore, focusing on optimal size also addresses the question of the optimal number.
Where does the existing theory leave us in terms of determining the optimal size of LGs? Although a simplified theoretical framework may allow us to visualize the meaning of ‘optimal LG size’, in reality it will be quite difficult to identify in the case of a decentralized country. If existing public finance theory cannot help us to pinpoint the optimal LG size, the question is whether we can turn to the international experience to provide policy guidance on the matter.

The international experience shows considerable variation in the average size of LGs around the world. A striking feature of this experience is a high degree of fragmentation or small average population size of LGs in many countries. For example, the average population size of LGs in countries such as Austria, France, Germany, Hungary, Italy, Russia, Spain, Switzerland, Thailand and Ukraine is under 10,000 residents. Thus, the problem of a high degree of fragmentation seems to be quite common to developed countries—many of which are highly decentralized—in western and central Europe.

With all this varied international experience, the important question is what are the costs in terms of forgone efficiency that countries with high levels of LG fragmentation are confronting? A natural way to answer this question is to identify the existence of economies of scale in the production and delivery of basic services and by quantifying the minimum population sizes that are required for those economies of scale to kick in.

The empirical literature on the existence and extent of economies of scale in the production and delivery of public services is quite large. Although the studies differ in the type of methodology used and the time period examined, and their results are generally mixed, two clear patterns appear to emerge from the empirical findings reviewed. First, there is a wide array of local public services (police services, firefighting, public housing, social services, and general education, etc.) for which there appears to be no evidence of economies or only weak evidence at quite small scales of operation, as measured by the population size of the jurisdictions. Second, there are, however, a small number of local services (water services, disposal facilities or brown fields, some forms of public transportation) requiring some heavy development of infrastructure for which there is solid evidence of the
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The presence of economies of scale, after some significant size of the servicing jurisdiction is reached.

Where does the existent empirical evidence leave us? Is smallness of size in LGs a big problem? Depending on the assignments of expenditure responsibilities, the existence of relatively small LGs—say 10,000 or even 5,000 residents—may not pose additional costs to the delivery of services. But for some other services (water, transport, and brown fields) economies of scale are present. One way to address these economies of scale is to require that all LGs have a minimum size that is large enough to take advantage of those economies of scale. However, it is rather apparent, given the information we have, that other solutions are also feasible and politically they may be more expedient. One such solution is to assign the expenditure responsibilities for those public services that exhibit economies of scale to the intermediate level of government, such as the province or region, which is much more likely to have that minimum required size. Other possibilities include privatization of some services or the formation of associations of LGs.

Where does all this leave us with respects to pemekaran in Indonesia? What is very important in the Indonesian case is that even though there is some fragmentation of LGs through the pemekaran process, the average population size of all Indonesian LGs in 2004, was 488,000 people and the average size for the newly created LGs through pemekaran also in 2004 was 214,000 people. With this average size, most Indonesian LGs would appear to have a sufficiently large scale to take advantage of the economies of scale that have been identified in the empirical literature. Actually, it could be argued that, being that large, one could expect some diseconomies of scale to set in place for the few services where this has been observed in other countries. This, we think, is an important finding. From the perspective of the international experience and what is known from the most serious scientific research, the pemekaran process should not pose serious threats to the overall efficiency of Indonesia’s decentralized system of government. However, this does not mean that the pemekaran process does not represent a threat in the case of some kabupaten/kota in the present or in the future, to the effectiveness and efficiency of the system of decentralized governance in Indonesia. In the first place,
some LGs in Indonesia are relatively small, although not to the scale observed in, for example, many western European countries. For example, a few kabupaten in Papua and Irian Jaya Barat have populations under 20,000. In the second place, the assignment of expenditure responsibilities to LGs in Indonesia is much more extensive than is the case in many other countries because the decentralization laws so far have assigned very few uniquely independent responsibilities to the provincial governments—especially those with larger externalities and likely to be subject to economies of scale. If the assignments of expenditure responsibilities in Indonesia are reformed to provide the PGs with more meaningful competencies, the preferable population size of scale for kabupaten/kota would be significantly reduced. Third, there are permanent, albeit unmeasured threats arising from the lack of administrative capacity and the potential political capture by local elites. Unfortunately, currently there is not enough information available to identify whether these considerations should be given any weight in Indonesia, but there is a presumption that both issues, lack of administrative capacity and local elite capture, are more likely with smaller sized LGs.

7.6. Impacts of Proliferation on Performance

Decentralization reforms and the increase in the number of LGs in Indonesia to some extent, was expected to accelerate regional development in many regions of the country that had been left behind by the economic and regional policies of the Soeharto regime—this was especially true for regions located in more remote places. The general aspirations for decentralization reforms—also shared by the proponents and defenders of pemekaran—have been to improve the quality of public services, by bringing government closer to the people. Thus an important question is whether these promises and hopes were realized through the process of pemekaran, or whether this process actually led to a worsening of local development opportunities and quality and access to public services.

These are difficult questions to answer because they involve complex measurement issues (in Indonesia but also everywhere else, including developed decentralized economies); because there are a
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relatively limited number of years so far to evaluate performance; and because the data are not of the best quality and are reported with a significant lag.

The pemekaran process has spawned an increasingly large number of studies on its impact (positive or negative) on the quality of service delivery and on a number of performance indicators. An easy way to divide the findings is between those that we can classify as ‘negative’ or ‘positive’. Among those with negative outcomes are the 2006 Second Governance and Decentralization Survey (GDS2) that contains one-shot data on residents’ opinions about service quality in their jurisdictions. Regarding services provided by public clinics (Puskesmas) paired original and new LGs performed less well than other LGs in the GDS2 sample.

There are also several research pieces on the impact of regional autonomy and decentralization on the business climate. This research was conducted through a collaboration between SMERU, Partnership for Economic Growth and USAID and was published in Usman et. al.18 In general it was found LGs tried to add new regulations to create local revenues, but it was not necessarily worse in those undergoing pemekaran. Similar results are reported by Lewis.19 In a more recent paper Kuncoro has argued that the decentralization process in Indonesia also had a significant negative impact on levels of corruption.20 In a case study by Bappenas/UNDP (2007/2008) it was generally found that the performance on ‘regional finance’ of the new LGs was lower than that of the original LG region (daerah induk). Also in a simulation study, Oosterman (2007) concluded that the losses in foregone public investment at the sub-national level arising from pemekaran could be quite large.21

On the positive side, the GDS2 found, new districts created under pemekaran were somewhat more likely to provide information to their residents on village (desa) programs vis-à-vis other LGs in the sample. In the area of primary education services, the GDS2 found that LGs that had experienced pemekaran had schools in better conditions and with lower student-teacher ratios. Also, as reported by Oosterman (2007), using data from SUSENAS from 2001 to 2005, the number of local residents with access to piped water increased by twice as much in LGs undergoing pemekaran than in the rest.\textsuperscript{22} The number of residents with access to sanitation increased four times faster in local jurisdictions undergoing pemekaran vis-à-vis the rest, although these numbers were small (8% and 2%, respectively).

Increases in development expenditures between 2001 and 2005 were also faster for pemekaran districts (139%) compared to the rest of the districts (103%). Also, as reported by Oosterman pemekaran districts appear to have used their development expenditures during this period of 2001–2005 much more productively that the rest of the districts. Quoting Oosterman, (page 59), “an increase of IDR 1 billion in development expenditure resulted in an increase of 70,000 persons with access to piped water or improved sanitation. In contrast, an increase of IDR 1 billion in development expenditure in other districts only provided an additional 52,000 persons with access to piped water and about 24,000 persons with access to improved sanitation.”\textsuperscript{23} The case study by Bappenas/UNDP also found that in the educational sector, the growth in the number of teachers in elementary schools was higher for the newly created governments than was the case for either the original (daerah induk) LGs or those in the control group. Finally, a recent study by the Research Agency of the Ministry of Home Affairs on pemekaran found that many of these new LGs have been successful in developing local institutions effectively, although capacity to manage local natural resources remains low and disputes over assets between the new and original local governments still abound.\textsuperscript{24}

\textsuperscript{22} See footnote 21.
\textsuperscript{23} See footnote 21.
\textsuperscript{24} R.E. Jaweng. 2007. \textit{Menimbang Regulasi Baru Pemekaran Daerah}. \url{http://www.sinaharapan.co.id/berita/0802/27/opu01.html}.
Quite likely the most careful analysis to date on the potential impact of pemekaran on public service delivery performance in Indonesia is the study conducted by Qibthiyyah. Using dynamic data panel estimation techniques, she also found negative and positive outcomes from pemekaran. In particular, infant mortality rates were significantly lower for the LGs experiencing pemekaran, with the effect being more significant for the newly created LGs. In the case of education outcomes, the results show that pemekaran reduces the dropout rates in the case of the new kabupaten; but the originating kabupaten experienced higher dropout rates. In the case of test scores and graduation rates, both new and originating kabupaten tend to experience a worsening of outcomes after pemekaran. The Qibthiyyah study was extended by Imansyah and Martinez-Vazquez (2010) to more recent years and found very similar results. Infant mortality was found to be significantly lower for the new kabupaten for all years after proliferation. The results also showed that dropout rates were lower for newly established kabupaten beyond the second year after proliferation. However, pemekaran did not have a positive impact on test scores and graduation rate. The overall results in Imansyah and Martinez-Vazquez is that pemekaran has had mixed effects on the performance indicators for the health and education sectors. In general, we observe that pemekaran had a negative effect on health outcomes but a quite robust positive for education outcomes.

Where do we stand? Taking into account all the limitations on methodologies, available data, and long enough time periods, the past available empirical evidence on the impact of pemekaran on LG performance for public service delivery is mixed. Although some negative aspects and problems are present, there are some other positive factors, such as the fast response of pemekaran districts to improve some basic public services and infrastructure, which give us pause to come up with a general conclusion. In truth, the evidence is still developing and clearly more work is needed to understand what is really happening. However, the evidence available so far provides the basis for a cautious note on the speed and extent of further pemekaran. We should also say that other evaluations of pemekaran in the national press and commentators have been less than scientific and should be discounted. For example, pemekaran has often been dubbed to be a failure because
it has not eliminated poverty in places like North Maluku or because those LGs still continue to be dependent on CG transfers. These are unfair or misplaced assessments since there are no a priori reasons to expect that a different form of vertical government structure should have an impact on pervasive economic problems such as the presence of poverty levels and lack of economic development.

7.7. Conclusions and Recommendations

In this paper we have made an effort to understand many of the complexities of the pemekaran process and its advantages and disadvantages without taking an a priori stand on the issue. Our reading of most past studies and evaluations of pemekaran is that they have been too focused on the negative side or disadvantages of pemekaran possibly ignoring some potentially important advantages. Perhaps because of these views but also because of seeing a process taking place that it could not control—approvals through the DPR route—the Government of Indonesia’s position over the past several years became unduly negative toward pemekaran. Ironically, the extended moratorium of the past several years on any new pemekaran may have pushed those communities with legitimate reasons for pemekaran to seek expedited solutions, by appealing to DPR members. But, at the same time, the wide opening of this undesirable avenue for pemekaran decisions through the DPR may have also given an opportunity to those without legitimate reasons, such as local political elites, to push through political bargaining—and some say even bribes—for pemekaran that perhaps should have never taken place.

The Government of Indonesia’s efforts to come up with the right policy towards pemekaran may have been hampered in the past by their approach taking too close a focus on finding an exact optimal solution—the belief that a solution to the pemekaran issue lied in the determination of an exact ‘optimal size’ of sub-national governments and consequently an ‘optimal number’ of sub-national governments for the whole of Indonesia. However, as we have attempted to explain in this paper, coming up with an exact optimal number of jurisdictions is an elusive, and probably illusory, target. The unproved working hypothesis from the government side, and in some previous technical
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reports on this issue, has been that this optimal number of sub-national governments is smaller than the actual number of sub-national governments at present in Indonesia and that, therefore, all pemekaran or most of it would have negative consequences and should be stopped.

An important message of this paper is that unless we are willing to settle for one single criterion for pemekaran decisions, such as population size, a fixed ideal number will not be the right policy to follow. For example if we accept the international empirical evidence that most economies of scale are reached at a population size of 100,000 residents, then given that the average population size of all kabupaten/kota in Indonesia is 500,000, the ‘ideal’ number would be about 2,500 kabupaten/kota in Indonesia, or approximately five times the number that now is in place. But, of course, we do not believe that this would be the right approach. Instead, the government policy toward pemekaran should be based on seeing that the right process, as stated in the law, is followed and that the core criteria as also stated in the law are met in each case.

The approach followed in this paper has been to take a fresh look at the issue of pemekaran by reviewing and producing new evidence on the causes and impact of the process on public service delivery and then coming up with policy recommendations that were not prejudged a priori. The outcome in terms of the conclusions and recommendations for many in Indonesia may sound heterodox, but we believe it is well supported by the analyses reported in this paper. The paper first looked at the nature of the pemekaran process, its possible causes and determinants, and its impact on local public service delivery outcomes. This analysis allowed us to better understand the nature and outcomes of pemekaran. Although there are multiple causes behind pemekaran, there is robust evidence that this process in Indonesia responds to the same basic determinants that have worked in other places and are predicted in basic public finance theory: pemekaran is more likely to take place where, considering other things equal, there are large populations and larger land areas. That in a way is reassuring: on average, it appears there are good positive reasons behind pemekaran in Indonesia. However, we also find that pemekaran has been quite responsive to perverse negative incentives coming from the structuring
of the transfer system (DAU and DAK) and revenue sharing from natural resources. These issues need to be addressed and, in particular, the government needs to reform DAU and DAK to get rid of any remaining incentives to the fragmentation of LG units. Regarding the impact of pemekaran, this paper reports on the existent evidence on whether the LGs that have undergone pemekaran have suffered in public service performance vis-à-vis the originating LGs. We find that the evidence is mixed; in some cases performance has improved (as in the case of education) while in others it has deteriorated (as in the case of health).

In asking the question of what would be the right policy for Indonesia concerning pemekaran, this paper first looked at what public finance theory and international practice have to offer in terms of determining the size and number of LGs based, among other things, on the available empirical evidence for economies of scale in the delivery of local public services. What we find is that the degree of sub-national government fragmentation in Indonesia is much less than in many other countries, but more importantly, that the average size of kabupaten/kota in Indonesia is large enough to take advantage of any possible economies of scale found in the empirical literature on public finance. This does not mean that there are not problems in Indonesia, there are because a few LGs may be already too small and because the process of fragmentation cannot continue unabated.

The main recommendations for creating the basis of a ‘grand strategy’ for the reform of the pemekaran process in Indonesia can be summarized by two propositions. First, the DPR needs to follow regular procedures for pemekaran. Achieving this goal will require incorporating the approved process and requirements for pemekaran into a law approved by the DPR, as opposed to having them in a government regulation as is now the case. Although this will not be easy to accomplish, it is the most realistic solution; otherwise it will not be possible to just simply eliminate the role of DPR as legislator in the pemekaran process. Having the process and requirements in a law will help guarantee that the requirements for technical and administrative aspects for pemekaran are applied consistently and that no short cut is used for the process. However, we must not overlook the fact that
many laws are, de facto, ignored in Indonesia and that no law can take effect until there is a corresponding government regulation to that law.

Second, the criteria for pemekaran now in GR 78 (2007) will need to be rationalized and simplified by incorporating four basic core criteria regarding: (i) minimum population scale; (ii) representation and accountability; (iii) financial and fiscal capacity and sustainability; and (iv) administrative capacity. Other criteria may be added, such as territorial continuity and security and border considerations, but these additions should be minimal.

The formulation of a ‘grand strategy’ for pemekaran should also consider the development of other instruments that have proved successful in the international experience for dealing with the problem of fragmentation at the sub-national level, including the introduction of incentives to encourage the voluntary amalgamation of LGs; the redesign of expenditure assignments by developing the role of PGs for those services with significant economies of scale and externalities across LGs; the promotion of different forms of cooperation among LGs in the provision of local public service; the creation of special service districts (for example for water or transportation); and the privatization of some services.
SECTION D
Providing for Effective Systems of Intergovernmental Financing
Fiscal Decentralization in Indonesia a Decade after Big Bang
8
Development of Indonesia’s Intergovernmental Financing System

Dr. Marwanto Harjowiryono

8.1. Introduction

Indonesia is an archipelago country in Southeast Asia comprising of 17,508 islands, with the fourth largest population in the world—around 238 million people. Indonesia as a nation consists of more than 300 ethnic groups with their own local languages and cultures. This diversity has significantly influenced the government system in Indonesia, which has evolved as a unitary country, comprised of 33 provinces and 491 districts (regency/kabupaten and municipal/city/kota). Indonesia also has the largest economy in Southeast Asia, with an expected GDP of about US$ 850 billion in 2011.

The Indonesian economy from the early 1970s to the mid 1990s showed relatively good performance, with continuous high economic growth of more than 6% (GDP) annually on average. However, the Asian financial crisis in 1997 disrupted this economic development and the GDP of Indonesia showed an enormous decline of 13.1% in 1998. The crisis has drastically increased the number of poor and unemployed people.25 This situation caused unrest and chaos among the people.

President Soeharto, who was in power for 32 years, was forced to step down in May 1998 and was replaced by Vice President Habibie. During the short period of President Habibie from May 1998 to July 1999, he introduced radical changes to the Indonesian administration system to promote democratization and decentralization. At that time, democratization and decentralization were the most important issues, as many provinces had, for years, expressed dissatisfaction with political, social, and economic centralization. In extreme cases, several provinces which had a long history of armed conflict and access to rich natural resources, such as Aceh, Papua and East Timor, demanded independence.

Under President Habibie, two laws were enacted in 1999, as a legal basis for decentralization. They were implemented in 2001 under the next President, Aburrahman Wahid. These were Law Number 22 (1999) concerning sub-national Administration and Law Number 25 (1999) concerning Fiscal Relations between Central and Sub-national Governments. Under Law Number 22 many of the responsibilities and authorities of the CG were devolved to provincial and district governments (kabupaten or regency and kota or municipality).

In line with this, Law Number 25 (1999) intended to promote this process by giving sub-national governments more financial resources through intergovernmental fiscal transfers, i.e. revenue sharing with the CG and general and specific allocation grants. Both of the laws were amended in 2004; Law Number 22 was replaced by Law Number 32 (2004), and Law Number 25 by Law Number 33 (2004).

These laws replaced Law No. 5 (1974) on Local Administration—enacted during the Soeharto era—which centralized governance. The 1999 laws changed the intergovernmental relationship between central and sub-national governments and enhanced competences, especially of district governments (regencies and municipalities). Before the changes in 2001, sub-national governments were strongly subordinated to the CG. The Ministry of Home Affairs had the power to control most activities of sub-national governments. Furthermore, governors of provinces were

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27 See footnote 25.
considered to be superior to heads of district governments (mayor or Walikota and head of regency or Bupati). As the only executive branch manager in each region, governors had the authority to control, manage, lead, supervise, as well as coordinate subordinates in their region. After 2001, governors lost these competences and merely became the coordinators of heads of district governments in their regions.

One of the most remarkable changes was the transfer of many administrative powers from central to sub-national governments. Sub-national governments were now responsible for important functions like education, health, infrastructure, environment, investment, farming, forestry etc. Competences of the CG were restricted to foreign affairs, defense and safety, fiscal and monetary, judicial, and religious affairs—that is, the strict minimum of competences which need to remain at national level to run a state.

One of the most impressive changes after 2001 can be found in the significant change of the fiscal relations between central and sub-national governments. Sidik explains that one third of the net national revenue was transferred to the sub-national governments and their share in overall government spending was almost doubled. It is very interesting to compare fiscal decentralization in Indonesia, with that in other developed and developing countries. Table 8.1 shows the revenue and the expenditure shares of SNGs in total national revenue and expenditure.

Before 2001, the share of sub-national to total national revenue (about 5.4% on average) was very low compared to other countries. After the implementation of decentralization though, the share increased to 7.1% on average; this level is below other developing countries, and far below the transition and OECD countries. Though sub-national governments could generate more by themselves, its share was still low. Therefore, they were highly dependant on revenue transfers from the CG.

On the expenditure side, the sub-national government’s share significantly changed after decentralization. In 2000, the share of sub-national government expenditure was 16.2%. It increased, though, dramatically to 27.3% in 2001. In the following years, the share steadily increased to reach around 40% in 2007–2011. The decline in 2005 and

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2006 was caused by the worldwide rise in oil price, which forced the CG to increase oil subsidies. The average share of sub-national government expenditure after decentralization is 36.2%—slightly higher than the OECD countries and more than double compared to developing countries. In short, Indonesia has decentralized, especially on the expenditure side, but is still centralized on the revenue side.

This paper will describe fiscal decentralization in Indonesia and is structured as follows: a chapter on intergovernmental fiscal transfer policy, followed by a chapter on sub-national government revenues; the next chapter deals with sub-national government proliferation, continued by a chapter on some experiences of fiscal decentralization and prospective solution; and finally a conclusion.
8.2. Intergovernmental Fiscal Transfers Policy

Indonesia experienced what has been referred to as ‘Big Bang’ decentralization in the early 2000s, after the enactment of Law 22 and Law 25; and further revised by Law 32 and Law 33 in 2004. These laws have explicitly stated the division of responsibilities between central and sub-national governments; and outlined policies on how the CG will finance those devolved responsibilities to sub-national governments.

The new laws state that fiscal decentralization consists of three principles: devolution, de-concentration, and co-administration. The concept being introduced by the new laws is devolution. Sub-national governments are able to exercise fiscal autonomy on a set of functions assigned to them. On the other hand, CG creates fiscal transfers in order to co-finance those assigned functions—this is known as finance follows function. This policy of substantial devolution of roles and responsibilities to LGs has been the basis of the so called ‘Big Bang’ decentralization in Indonesia.

Decentralization is expected to increase responsibility for delivery of public services and achievement of Millennium Development Goals by sub-national and LGs. However, devolving responsibilities for service delivery to lower tiers of government risks being counter-productive if it is not followed by financial decentralization to support those responsibilities, usually called the ‘finance follows function’ principle. This provides a challenge for a country to design not only an effective decentralized structure but also an effective apportionment of resources and powers between different tiers of sub-national government. Furthermore, it is important to ensure that the amount of money delivered can have a significant effect on LG performance to meet the objectives of decentralization.

Decentralization of responsibilities and service delivery to sub-national governments will be counter-productive in the absence of financial reorganization to fund those functions. Literature on public finance advocates the finance follows function principle to show that fiscal decentralization takes place in a devolved system. “Fiscal decentralization requires devolution of decision making power in order to be meaningful, while devolution of decision making power requires fiscal decentralization in order to be meaningful” (Devas, 2008). The substance of finance follows
Fiscal decentralization consists of some key elements. One of them is the existence of a well-designed intergovernmental fiscal transfer system. Transfers are needed where vertical and horizontal imbalances persist and when there is problem of inter-jurisdiction spillover effect, or externalities. Transfers can be in the form of unconditional and or conditional grants, depending on the purpose. The principle is that transfers should be sufficient enough to ensure that sub-national governments can afford to implement functions that are decentralized to them; and should lead to a reduction in inequality between sub-national governments.

8.3. Current Practice on Intergovernmental Fiscal Relations

The types of intergovernmental fiscal transfers, established under law Number 33 (2004), consist of General Allocation Grant (DAU), Specific Allocation Grant (DAK), and Revenue Sharing of some taxes and natural resources.

8.3.1. General Allocation Grant (DAU)

In developing and transitional countries, there are wide disparities among sub-national governments’ fiscal capacities. One way to overcome this problem is by creating a formula calculating each sub-national government’s fiscal capacity. The fiscal capacity is then compared to the fiscal need of sub-national governments. Fiscal transfers are then calculated to close or narrow the fiscal gap. Fiscal gap is the key concept in this respect, since every region has different fiscal needs. Fiscal gap is calculated in order to have a figure that can show how big the gap is between fiscal needs and fiscal capacity of each sub-national government. Therefore, equalization of horizontal imbalances is not done with the aim of evenly distributing fiscal transfers among regions but to evenly distribute fiscal capacity to fulfill each of the region’s needs. However, equalizing actual outlays would discourage both local revenue raising effort and local expenditure restraint, since under this system, those with the highest expenditures and the lowest taxes get the largest transfers.

DAU is a general-purpose grant issued from the CG budget (APBN)
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to all sub-national government budgets (APBD). It is also used as an equalizing grant to reduce horizontal imbalances. Allocation is based on a set of formulae. The basic formula consists of the following elements: a ‘basic allocation’—which is the amount of a LG employee’s salary—and the fiscal gap calculation.

The fiscal gap itself is calculated by subtracting expenditure needs from fiscal capacity. The calculation of fiscal need is based on the following components: population, surface area, cost price index, human development index, and the gross regional domestic products (GRDP) per capita index. Meanwhile, the fiscal capacity of LGs consists of their own source and shared revenues.

The condition that must be met by sub-national governments is that they submit their APBD within a certain timeframe. Failure to comply with this requirement would result in delaying DAU transfers. This requirement is meant to encourage sub-national governments to establish their budget before the beginning of next fiscal year, so that the time used to absorb the funds is more optimal. This requirement intends to improve the degree of sub-national budget realization, based on the analysis that one of the reasons for low budget realizations is insufficient time to implement the projects or activities.

8.3.2. Specific Allocation Grant (DAK)

The DAK scheme is a specific purpose grant allocated from the APBN to certain sub-national governments and certain sector programs. The main purpose is to finance physical capital investment and limited-period financing of operational and maintenance needs, in accordance with national priorities. Sub-national governments are also required to provide matching funds of at least 10% from the total DAK allocated in each sector.

The criteria for DAK are divided into general, special, and technical criteria. General criteria should consider the financial capacity of sub-national governments, while special criteria emphasize the specific characteristics of sub-national areas. Technical criteria are more specific, with implementation guidelines established by line ministries.

As the National Government sets clear conditions for the implementation of DAK funds, sub-national governments have limited
scope to use the funds. However, the ‘bottom up’ principle applies during the process of DAK allocation. In this process sub-national governments may propose programs and activities that are in line with the national priorities.

8.3.3. Revenue Sharing (DBH)

Revenue sharing describes a system in which some national revenue sources are shared with sub-national governments in order to reduce vertical imbalances. The objective of this is to address the existing gap between own revenue raising powers and expenditure responsibilities given to sub-national governments. Increasing responsibilities for sub-national governments to perform specific functions would create an obligation for them to provide an adequate budget. The CG’s may solve this problem through greater local revenue-raising powers or by providing fiscal transfers, including transfers from shared revenues.

The revenue sharing transfer scheme is allocated based on the prediction of next year’s revenue, but transfers are based on the actual revenue received. It uses a mix of two approaches for its calculation, which are ‘by origin’ and ‘by formula’. Most of the shared revenues in Indonesia are transferred as a block grant, allowing sub-national governments to use their own discretion on the use of the funds.

8.3.4. Tax Revenue Sharing

Some major taxes in Indonesia, such as income tax (both personal and corporate), VAT, property tax, and excise, are still centrally collected and administered. Previously, only personal income tax, property title transfer tax, and property tax were shared with LGs. Since 2009, a new revenue sharing scheme from excise has also been included. Furthermore, the property title transfer tax and property tax for rural and municipal properties were devolved to district governments in 2010; property tax will be devolved gradually until 2014.

The proportion for each type of tax comes with different percentages for revenue sharing. The biggest share of a single revenue source for

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Sub-national governments is on property tax. Sub-national governments receive 90% of its actual revenue. The amount of 90% is divided into: 16.2% for provinces, 64.8% for originating districts, and 9% as a collection fee for central and sub-national government agencies. The remaining 10% was originally supposed to remain at the central level; however, the centre reallocates this amount to sub-national governments: 6.5% is allocated equally among all sub-national governments, while 3.5% is used as an incentive for sub-national governments, whose actual property tax received is higher than the budgeted amount.

Before 2011, the second largest amount in terms of percentages was from property title transfer tax which gave sub-national governments 80%, of which 16% went to provinces and 64% to district governments, based on revenue origin. However, property title transfer tax has been entirely devolved to districts according to law Number 28. Hence, the second largest amount is now from personal income tax, 20% of which goes to originating sub-national governments, of which a province receives 8%—the originating district receives 8.4%, and the remaining 3.6% are distributed equally to all other sub-national governments within the same province.

8.3.5. Natural Resources Revenue Sharing

Shared revenues from natural resources are derived from forestry, fishery, general mining, oil and gas. Sharing of revenues from geothermal energy has recently been added. The transfer scheme of this kind of revenue sharing in Indonesia is quite unique because the CG assigned earmarked funds within the transfers. The earmarked fund is the re-forestation fund—which amounts to 40% of re-forestation revenue for originating sub-national governments—and an additional 0.5% from oil and gas revenue that is earmarked to finance basic education in sub-national governments.

Furthermore, the proportion of revenue sharing from forestry and general mining are 80% for local governments. If it is production revenue, the 80% comprises of 16% for province, 32% for originating districts, and the remaining 32% are distributed equally to other districts within the same province. Meanwhile, if it is only the exploitation permit fee, the 80% comprises of 16% for the province and 64% for originating districts. Regarding oil and gas, LGs receive smaller percentages of
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Shared revenue from oil given to LGs is 15% (3% for provinces, 6% for originating districts and 6% distributed equally for other districts within the same province); while from gas it is 30% (6% for provinces, 12% for originating districts, and 12% distributed equally to other districts within the same province). These percentages do not include the additional earmarked fund mentioned above.

Despite a lower percentage, the amount of revenue sharing from oil and gas, in terms of the overall amount of money received by sub-national governments, is the highest among all shared revenues from natural resources. Moreover, revenue sharing from oil and gas is based on special arrangements. Sub-national governments in the province of Aceh, Papua, and West Papua are given additional revenue sharing percentage of 55% for oil and 40% for gas. These additional percentages are transferred on behalf of their special autonomy status.

8.3.6. Special Autonomy Funds and Other Transfers

The Special Autonomy Fund is transferred to only three provinces, Aceh, Papua, and West Papua. It is given under law Number 11 (2006) and law Number 21 (2001) which was later revised by law Number 35 (2008). The laws stated that 2% of the national DAU ceiling is to be transferred to provinces with special autonomy status. This fund is mainly to support additional infrastructure funding in those provinces. Furthermore, other type of transfers to all sub-national governments may exist occasionally depending on the National State Budget policy, which differs every year.

The historical data on the intergovernmental transfer (revenue sharing, DAU and DAK) in Indonesia from 1995/1996 to 2008 can be seen in figure 8.1. The data before 2001 for DAU was subsidized by the regional autonomy grant (Subsidi Daerah Otonom or SDO); meanwhile DAK was subsidized for regional development through a Presidential Instruction grant (Instruksi Presiden or Inpres grant).

Based on the figures, intergovernmental transfers in Indonesia have significantly increased every year, especially after 2001 when fiscal decentralization was implemented. The biggest portion comes from the DAU, while the DAK is the lowest and not significant compared others. Revenue sharing has increased significantly during the era of fiscal
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Decentralization, since provinces with rich natural resources get a higher proportion of natural resources revenue, such as oil and gas. Besides that, most of the provinces in Java get higher revenue from tax sharing because economic activities are concentrated on Java. Prior to fiscal decentralization, the biggest portion of intergovernmental transfers came from the DAK predecessor ‘Inpres’. However, DAK is a conditional grant, so that the transfer was earmarked. In contrast, after fiscal decentralization in 2001 the share of DAK drastically shrank and the proportion coming from the unconditional DAU grant replaced the one from DAK as the biggest in intergovernmental transfers in Indonesia.

8.4. Local Government Revenue

Local government revenue mainly consists of intergovernmental transfers (balance fund) and LG own source revenue. Sub-national governments have their own revenue stemming from local taxes, local charges, revenue from regional assets and other revenues. If necessary, they can issue government bonds, too. The components of local taxes for provincial and district government differ; provincial governments are
authorized to collect lucrative local taxes like fuel tax, vehicle registration tax, vehicle ownership transfer tax, and underground water tax. District governments can, in contrast, collect only seven kinds of less lucrative local taxes: i.e. hotel tax, restaurant tax, entertainment tax, advertisement tax, street light tax, parking tax and quarrying tax.

Table 8.2 shows the components of LG revenues before and after decentralization. We find that over 70% of their revenue comes from transfers from CG, so that the role of local own revenue are still insignificant. While the SDO and the Inpres grant—which made the largest part of the transfer before the decentralization—are conditional grants, the DAU—the largest part of the transfer after the decentralization—is unconditional. The conditional grant since decentralization, the DAK, took, in contrast, only a marginal portion. In addition, other revenues in 2011 increased, stemming from the special autonomy fund and adjustment fund.

There are different revenue capacities between provincial and district governments. Compared to district governments, PGs get more revenues based on own sources; they can collect lucrative local taxes. Until now, significant taxes like value added tax, income tax and property tax used to be under the control of the CG. However, property tax is about to be devolved to LGs, by 2014. The CG decides the maximum tax rate and tax base of local taxes and, as a consequence, LGs have little room to

<table>
<thead>
<tr>
<th>Item</th>
<th>1999/2000 (billion Rupiahs)</th>
<th>2011 (billion Rupiahs)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Revenues</td>
<td>40,912 100%</td>
<td>479,098 100%</td>
</tr>
<tr>
<td>SNG own source revenue</td>
<td>7,069 17.3%</td>
<td>90,383 18.9%</td>
</tr>
<tr>
<td>Local Taxes</td>
<td>5,044 12.3%</td>
<td>63,640 13.3%</td>
</tr>
<tr>
<td>Local Charges</td>
<td>1,215 3.0%</td>
<td>7,935 1.7%</td>
</tr>
<tr>
<td>Separated Asset Revenue</td>
<td>176 0.4%</td>
<td>435 0.9%</td>
</tr>
<tr>
<td>Other Own Source Revenues</td>
<td>633 1.5%</td>
<td>14,465 3.0%</td>
</tr>
<tr>
<td>Balance Fund Transfers</td>
<td>31,113 76.0%</td>
<td>327,361 68.3%</td>
</tr>
<tr>
<td>Revenue Sharing</td>
<td>5,437 13.3%</td>
<td>76,358 15.9%</td>
</tr>
<tr>
<td>SDO/DAU</td>
<td>16,525 40.4%</td>
<td>225,717 47.1%</td>
</tr>
<tr>
<td>Inpres/DAK</td>
<td>8,945 21.9%</td>
<td>25,287 5.3%</td>
</tr>
<tr>
<td>Other Revenues</td>
<td>206 0.5%</td>
<td>61,344 12.8%</td>
</tr>
</tbody>
</table>

Source: Ministry of Finance
increase their tax revenues. Despite the recent changes regarding property taxes it can be said that fiscal decentralization on the revenue side is not yet as far advanced as it is on the expenditure side.

If fiscal decentralization is to be a reality, LGs must control their own sources of revenue in order to finance their expenditures sufficiently. LGs that lack independent sources of revenue can never truly enjoy fiscal autonomy. They may be, and probably are, very dependent on the intergovernmental fiscal transfer from the CG. The question then, is which revenue sources can and should be assigned to sub-national levels of government, and how these assignments are to be effected?

In 2001, LG’s own source revenues contributed to only 5% of their total budget, becoming 7% in 2009. Since 2009, Indonesia has used a closed-list system and each level of government has their determined taxes, so that each tax cannot be imposed twice. In order to empower local taxes, the CG can enlarge the object of local taxes and user charges; increase the maximum rate; and give discretion of rate determination to sub-national governments. Preventive and corrective control mechanisms are conducted by the CG as a regulatory function to ensure that the local taxes are in line with the higher existing regulation.

In 2009, the CG promulgated the law of sub-national taxes and charges, better known as the Law Number 28, which marked a very strategic and fundamental change in fiscal decentralization. This law has the following objectives: to grant maximum autonomy to sub-national governments; to give more authority over taxation; to improve the accountability of service delivery and LG administration; and to improve certainty for businesses.

Fundamental changes according to this law are the shift from an open-list (Law Number 34/2000) to a closed-list system of taxes and charges, as well as the devolution of property taxes (PBB/BPHTB) to the regencies/municipalities. Under the open-list system, LGs had the authority to create new taxes. There were too many local taxes, impacting negatively on the business climate. Based on international experiences, most of the developed countries delegate property tax matters to sub-national governments.

Property tax is the most common source of revenues for LGs. It is an ideal tax for LGs, since property is a relatively immobile base (land is
completely immobile). Property tax can produce a stable source of income, is quite an efficient tax, and can enhance local accountability and transparency between citizens and the government. This devolution policy is a big change considering that Indonesia is a large country with big differences in population density, geographic area and economic conditions among regions. Based on the law, which starts on 1 January 2011, BPHTB becomes a regency/municipal tax, while property tax on urban and rural property (PBB) shall come into effect by 1 January 2014. Upon devolving PBB/BPHTB to become regency/municipal taxes, expectably the regency/municipal governments will be able to optimize their revenue collection and spend them for the maximum interest and welfare of their people.

To implement these taxes, district governments have to prepare local regulations; Standard Operation Procedures (SOP); and database systems that can assist in the training of human resources and institutions involved with property tax.

By August 2011, the first year of the BPHTB implementation, 410 regencies/municipalities are prepared to collect their own BPHTB (83.3%), 79 regencies/municipalities are preparing their local regulations (16.1%) while three regencies have not prepared anything yet. Several LGs also reported that they have already exceeded their BPHTB target for the year.

Although PBB will only become a local tax on 1 January 2014, Surabaya has started to collect PBB this year, while 23 regencies/municipalities confirmed to collect PBB in 2012. There are 9 regencies/municipalities which will become pilot regions in PBB devolution so that other local governments could learn from their experiences.

However, there could be some challenges to implementing PBB and BPHTB devolution for some LGs, especially for those that are not well prepared. Relatively poor regions will lose a part of their revenues because they will not have access anymore to shared revenues from BPHTB and PBB.

8.5. Local Government Proliferation

The euphoria generated by regional autonomy in Indonesia has had various effects on society and government. One of them is an increase in
demands to create new sub-national governments by separating existing ones. One of decentralization’s goals is to bring public services closer to the people, especially in remote areas and thereby to increase social welfare. The separating process is regulated in Government Regulation Number 78 (2007) which reformed the original Government Regulation Number 129 (2000). According to this regulation, demand for separation should start from the will of the society. Since the first year of local autonomy (2001) until 2010, 158 new sub-national governments have been created through separation of old ones (see Table 8.3).

Table 8.3. Numbers of New Regions Established, 2001–2010

<table>
<thead>
<tr>
<th>YEAR</th>
<th>New Regions</th>
<th>Provinces</th>
<th>Districts / Cities</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>2001</td>
<td></td>
<td>12</td>
<td></td>
<td>12</td>
</tr>
<tr>
<td>2002</td>
<td></td>
<td>37</td>
<td></td>
<td>37</td>
</tr>
<tr>
<td>2003</td>
<td>1</td>
<td>49</td>
<td></td>
<td>50</td>
</tr>
<tr>
<td>2004</td>
<td>1</td>
<td></td>
<td></td>
<td>1</td>
</tr>
<tr>
<td>2005</td>
<td>1</td>
<td></td>
<td></td>
<td>1</td>
</tr>
<tr>
<td>2006</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2007</td>
<td></td>
<td>25</td>
<td></td>
<td>25</td>
</tr>
<tr>
<td>2008</td>
<td></td>
<td>30</td>
<td></td>
<td>30</td>
</tr>
<tr>
<td>2009</td>
<td></td>
<td>2</td>
<td></td>
<td>2</td>
</tr>
<tr>
<td>2010</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>3</td>
<td>155</td>
<td></td>
<td>158</td>
</tr>
</tbody>
</table>

Source: Ministry of Finance

Separations might provide more benefits to new regions, such as (i) increasing services for the community; (ii) encouraging sustainable natural resource management; (iii) increasing community participation and ownership; (iv) improving efficiency and effectiveness in natural resource management; (v) improving maintenance of environmental sustainability; (vi) increasing regional productivity, value added, and competitiveness; and (vii) improving social welfare.31

The desired effects of separations are contrary to the conclusions drawn by several studies on the matter. Economic activity in new regions

has not improved the welfare of their societies, even five years after separation. Based on that, Susilo Bambang Yudhoyono, President of the Republic of Indonesia, exposed this problem in a Special Plenary Session of the Regional Representative Council of the Republic of Indonesia on August 23, 2006. He said that his government should rearrange the concept of separations of SNGs.

The current regulatory framework gives financial advantages (grants) to newly established sub-national governments, from its predecessor and the PG (in case a district split into two or more), where the new region is located. The effect is that new sub-national governments get highly dependent on external subsidies from the beginning. This also violates Paragraph 4 and 5 in Government Regulation Number 129 (2000) and also Paragraph 6 phrase 1 in Government Regulation Number 78 (2007), which stipulates that the capability of the economy, regional potential, and fiscal capabilities are technical requirements that must be fulfilled to qualify for separation. If those requirements are fulfilled, a new region would be able to run government activities and to sustain development programs without being completely dependent on external subsidies.

Furthermore, newly established regions also receive from the first year onwards, grants from the CG, such as the balancing fund. Law Number 32 (2004) permits new regions to issue a sort of ‘mini budget,’ because in the first year a new region has no executive leader or legislative board yet. However, this option has not produced any reasonable results. Only in the second year after separation can the new sub-national government be fully established. Still, it is normal that planning documents will not be developed by the second year and received grants will be managed on an ad-hoc basis.

Separations also affect the share of DAU allocations among SNGs. The DAU, as part of the balancing fund mechanism, is the most reliable fund for sub-national governments. The existence of new regions, and the remaining part of the predecessors, affects DAU allocation. New regions absorb more funds from DAU allocation than other sub-national governments in the second year after separation, as seen in Table 8.4.

Beyond DAU, the separation also impacts on DAK, on deconcentrated agencies, public services, and transfers of civil servants. As the amount of DAK, especially in government infrastructure, increases every year, the financial burden on central budget increases consequently. Another problem is the transfer of civil servants into new regions. In many cases, civil servants do not want to be transferred to new regions for various reasons. This leads to the recruitment of new civil servants within the new region and hence to an overall increase in the amount of civil servants, as opposed to CG policy.

Furthermore, it is necessary to effectively monitor progress in new regions, to verify whether the main purpose of separations, i.e. improving the welfare of society, has been achieved or not. Monitoring aims to disclose all the information related to the appropriateness of separation. If evaluation of monitoring data shows that within a certain timeframe set goals have not been achieved, i.e. prosperity has not increased, or other criteria are not met, the CG can decide to merge concerned subnational governments back to their original status. Government Regulation No. 129 (2000) as amended by Government Regulation No. 78 (2007) allows for it, as was the case in some counties in the United States.33

Table 8.4. Absorption of DAU Increases by New Regions and Remaining Predecessors (billion Rupiah)

<table>
<thead>
<tr>
<th>Year</th>
<th>DAU For Districts / Cities</th>
<th>Budget Escalation</th>
<th>Absorption by New and Remaining SNGs Total</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>2003</td>
<td>69,280.2</td>
<td>7,077.5</td>
<td>556.4</td>
<td>7.9%</td>
</tr>
<tr>
<td>2004</td>
<td>73,917.9</td>
<td>4,637.6</td>
<td>1,168.9</td>
<td>25.2%</td>
</tr>
<tr>
<td>2005</td>
<td>79,889.0</td>
<td>5,971.2</td>
<td>985.7</td>
<td>16.5%</td>
</tr>
<tr>
<td>2006</td>
<td>131,097.8</td>
<td>51,208.7</td>
<td>5,829.4</td>
<td>11.4%</td>
</tr>
<tr>
<td>2009</td>
<td>167,772.7</td>
<td>6,216.3</td>
<td>2,570.2</td>
<td>41.4%</td>
</tr>
<tr>
<td>2010</td>
<td>173,241.3</td>
<td>5,468.6</td>
<td>4,533.3</td>
<td>82.9%</td>
</tr>
<tr>
<td>2011</td>
<td>202,979.5</td>
<td>33,042.5</td>
<td>3,608.9</td>
<td>10.9%</td>
</tr>
</tbody>
</table>

Source: Ministry of Finance

8.6. Finding Solutions

This year marks the 10-year anniversary of the implementation of, so-called, ‘Big Bang’ decentralization in Indonesia. Despite the many achievements that have been made, there are also many problems, from which lessons can be learned. Policies have improved compared to the pre-decentralization era; however, there is still space to refine Indonesia’s fiscal decentralization—such as the overlap between some sector-specific regulations within the regulatory framework for local autonomy. In this regard, the ‘Grand Design’ of fiscal decentralization, prepared by the Ministry of Finance, identifies drawbacks of policies in place as well as identifies effective policies.

8.6.1. Reforming the Intergovernmental Fiscal Transfer System

It is necessary to reform the current intergovernmental transfer system to make sure that vertical and horizontal imbalances can further be decreased. One thing to be considered is the role of the DAU in reducing fiscal imbalances among sub-national governments. It needs to be improved by re-designing its formula. The DAU formula currently consists of two components: basic allocation and fiscal gap. The former component has nearly no impact on horizontal equalization. In addition, it has provided an incentive to recruit excessive numbers of civil servants at the sub-national level and thus, to lessen the quality of local spending—marked by exorbitant salary expenditure—in many LGs. If the DAU formula were constructed only on the basis of the latter component, it could help to improve horizontal equalization.

Furthermore, it is necessary to respond to current disincentives in the DAU formula, concerning sub-national governments’ efforts to increase their local own revenue. In calculating the fiscal gap, the formula uses the actual local own revenue as a component of fiscal capacity. Therefore, increasing local own revenue decreases the fiscal gap and finally results in lower DAU allocations for a sub-national government. This could be achieved by enhancing incentive-based instruments in the fiscal transfer system.

The revenue sharing component, as a tool to close the vertical imbalance, needs some refinements, especially related to timing and channeling. Some difficulties have arisen from the current revenue sharing
system, which is calculated based on actual revenue, especially at the end of the year. Sometimes this results in shared revenues being transferred after the respective fiscal year has ended. For this problem, CG will revise the current system, so LGs can receive their revenue in a timely manner.

Regarding the DAK, its role is to fund expenditures on projects that further national priorities at the sub-national level. Despite its role, this type of intergovernmental transfer, which was first introduced in 2003, is a relatively small proportion of the total intergovernmental transfers. To support the development of specific sectors, there is a need to increase the proportion of DAK. As DAK is an earmarked grant, it is best suited to support the achievement of minimum standards in specific public services at the sub-national level such as education, health, and infrastructure (road, irrigation, draining, water supply).

Another reason for revising the intergovernmental transfer system is that it has provided incentives for regional proliferation, as newly created regions will receive their balancing funds on the first year of its existence. A feasible policy would be to allocate balancing funds after a few years of the formation, or to set tighter criteria on creating new LGs. As mentioned before, the number of new regions created after the law on decentralization had been stipulated, is 158 regions, including three new provinces. A study has been carried out to see the effect of this proliferation, by examining the increase of DAU between provinces with new regions and without new regions.

The finding is that provinces with new regions have received a significant increase in DAU over the last 10 years, while those with no

<table>
<thead>
<tr>
<th>Province</th>
<th>Total DAU of Districts / Cities (billion Rp)</th>
<th>Number of Districts / Cities</th>
<th>Total DAU of Districts / Cities (billion Rp)</th>
<th>Number of Districts / Cities</th>
<th>Increase in DAU, 2001 – 2011 (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bengkulu</td>
<td>527.15</td>
<td>4</td>
<td>3,044.16</td>
<td>10</td>
<td>477%</td>
</tr>
<tr>
<td>Kalimantan</td>
<td>861.09</td>
<td>6</td>
<td>5,536.94</td>
<td>14</td>
<td>528%</td>
</tr>
<tr>
<td>Jawa Tengah</td>
<td>7,216.48</td>
<td>35</td>
<td>20,286.07</td>
<td>35</td>
<td>181%</td>
</tr>
<tr>
<td>Yogyakarta</td>
<td>857.32</td>
<td>5</td>
<td>2,710.42</td>
<td>5</td>
<td>216%</td>
</tr>
</tbody>
</table>

Source: Ministry of Finance
proliferated regions only showed small increases over the last decade (see Table 8.5). For example, Province Bengkulu, with 6 new regions, has shown a significant increase in total DAU allocated, reaching 477%. By comparison, Province Yogyakarta, with no new regions has only shown a 216% increase in DAU allocated to all LGs within it. The new intergovernmental transfer system should remove such incentives.

8.6.2. Developing Efficient and Effective Local Revenue Systems

Reforming the system also includes developing an efficient and effective sub-national revenue system, to support LGs in implementing their expenditure assignments. The new local revenue system, as stipulated in Law 28 (2009) has drastically reduced the number of taxes and charges levied by LGs. Under the previous law, there were thousands of new taxes and charges that LGs had created. This situation caused high administrative costs for investments and had a negative impact on local and national economic development. With regard to strengthening the sub-national revenue system, the CG will tightly monitor and evaluate the devolution process of property taxes, although there are still a couple of years for LGs to prepare for directly collecting the newly devolved tax.

8.6.3. Optimizing Quality of Local Spending

The quality of sub-national spending is worrying. Spending for public services and goods is subordinate to spending for employee salaries. The excessive shares of salary spending can be seen in the 2011 aggregate sub-national budgets. Salaries and expenditures for benefits constitute 44.5% of annual budgets of all sub-national governments, including provinces. The average salary and benefits spending for all districts (kabupaten/kota) reaches 51%. However, in some regions, the salary expenditure reaches more than 70%. The graph in Figure 8.2 displays the 20 LGs with the lowest and highest salary spending. The 10 LGs with the highest proportion of salary and benefits expenditure are mostly located in Java. The 10 LGs spending the lowest share on salaries and benefits are mostly newly created LGs. This can be explained by the fact that newly created regions mostly do not share civil servants with the
original region, as they normally don’t want to move to the new region’s capital. Hence, new regions need to recruit from scratch, while the remaining regions have a disproportionally high amount of civil servants left.

The increasing share of expenditures for employees caused decreasing shares of spending on development and public service provision overtime. Although the CG has decided to impose a moratorium on the recruitment of central and sub-national level civil servants, this is only a short-term solution. Thus, long-term solutions need to be found. One way to solve the issue might be to set a maximum proportion of employee expenditures compared to total expenditure. This solution, however, needs time to take place, as some sub-national governments, which have an employee expenditure ratio exceeding the allowed rate need to make adjustments, for instance applying negative/zero growth rate for total number of employees, or a ‘golden handshake’ approach to reducing employee numbers.

Another way to deal with this issue is to set the minimum requirement for capital expenditure. This will guarantee that LGs satisfy, even though partially, their needs for development spending; as well as indirectly limit

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**Figure 8.2. Ratios of Salary to Total Spending, for Selected Districts and Cities, 2010**

Source: Ministry of Finance
their spending on salaries and benefits. However, such policies need to be developed wisely and with detail, as capital expenditures can vary among LGs for exogenous reasons.

8.7. Conclusions and Recommendations

Fiscal decentralization in Indonesia has been in place for 10 years and some achievements have been acknowledged; however, there is still space for refinement to Indonesia’s fiscal decentralization policy. The refinement should be aligned with the ‘Grand Design’ of Fiscal Decentralization prepared by the Ministry of Finance.

To make sure that the vertical and horizontal imbalances can be further decreased, the current intergovernmental transfer system should be revised. Reforming the formula for DAU is essential, to eliminate the basic allocation, which has provided an incentive recruitment excessive numbers of civil servant at sub-national levels.

The revenue sharing component, as a tool to close the vertical imbalance, needs some refinements, especially related to the timeliness of funds channeling. Finally, to support the development of minimum standards in basic public services at the sub-national level, there is a need to increase the proportion of the DAK grant.

Reform will also need to include the development of a more efficient and effective local revenue system, to support LGs in implementing their expenditure assignments.

The quality of local spending has been a concern because of excessive spending on employees’ salaries and benefits compared to spending for public services and goods. The probable solution for this concern would be to set a maximum proportion of employee expenditure, or a minimum proportion for capital expenditure compared to total expenditure.
9

Reforming South Africa’s Intergovernmental Financing System

Kenneth Brown

9.1. Introduction

Following the transition from apartheid rule—where only the minority white population could exercise democratic rights—to a full democracy, South Africa went through a process of fiscal decentralization to create the current unitary arrangement, with high levels of expenditure decentralization. However, the process of decentralization in South Africa has been unlike most other countries. The newly democratic state had to simultaneously consolidate a fragmented government, created by the apartheid state, and devolve certain functions.

The current intergovernmental system in South Africa has its roots in the negotiation process that led to the interim Constitution of South Africa. Key political leaders in the then unbanned, African National Congress (ANC) and the National Party began formal constitutional negotiations in December 1991. A stop start process, marred by escalating violence and threats of breakaway groups followed. The violence and desire of key political leaders to avoid violence spurred political parties to compromise and reach agreements that ensured the process was taken forward. The National Party proposed a two-stage reform process, which the ANC initially opposed but amid threats of
further violence, the ANC agreed to a two-stage reform process. It was under these circumstances that the interim Constitution was drafted, which is where the seeds of the current intergovernmental system were planted.

The South Africa of 2011 is a constitutional democracy, the terms of which are captured in the 1996 Constitution. The government of South Africa consists of three spheres of government: national government, nine provinces and 278 municipalities. The Parliament of South Africa consists of the National Assembly and the National Council of Provinces. The former represents the people of the country and the latter represents the provinces. Provinces are mainly responsible for implementing national legislation and each province has an elected provincial legislature. There are three categories of municipalities; and the legislative and executive authority of a municipality is vested in municipal councils. The majority of provincial revenue comes through national transfers, whereas the majority of LG revenues come through own revenues for user fees and property rates.

Under apartheid the South African government recognized four independent states and six self-governing states. The intention of the white government was that the black population would be relegated to homelands. The homelands collected some general sales tax and income taxes and the South African government collected similar taxes in these territories on their behalf and transferred these to the homelands. Homelands could also borrow, backed by the state guaranteed Development Bank of South Africa. These arrangements ensured these homelands were largely dependent on the South African government. Most whites lived in White Local Authorities (WLAs) in one of the four provinces. Provinces collected a few service charges but were reliant on the national government for over 80% of their budgets. The national government raised its revenue through personal income tax, sales tax, trade tariffs and excise duties. The WLAs collected property rates and service fees. Blacks that lived close to the job opportunities in urban centers lived in Black Local Authorities (BLAs) which could collect rates and charge service fees, but the residents boycotted these payments. Regional Service Councils collected a regional service levy from businesses, which was used to invest in infrastructure in the BLAs.
The transition to the current intergovernmental system involved taking this fragmented set of structures of homelands, provinces and local authorities into a consolidated intergovernmental system consisting of national government, nine provinces and a local sphere of government, initially recognized in the Interim Constitution of 1993. The revenue sources of the homelands were taken over by the national government and minor changes were made to the revenue assignments of provinces. LGs went through a transitional period and then a re-demarcation process, which was completed with the LG elections in December 2000 and gave rise to the current LG system.

In the 1998/99 Budget, government implemented a new set of intergovernmental transfer mechanisms - the structure of which has largely remained unchanged. Provinces receive a provincial equitable share and a number of conditional grants. The equitable share is an unconditional transfer and each province’s share is calculated by means of an objective formula. Conditional grants provide funding for national priorities and are currently used to fund priorities across most sectors for infrastructure and operational purposes. On average, provinces receive 96% of their revenue from national transfers. Transfers to municipalities are structured in a similar way, although their conditional grant funding is biased towards addressing infrastructure backlogs and emerging needs for municipal infrastructure. In aggregate, municipalities collect 75% of their own revenues; however this figure masks significant variations as the poorest 70% of municipalities receive 75% of their budgets through national transfers.

The transition described above was one of consolidating a fragmented set of institutions into an intergovernmental system; assigning functions and broad revenue assignments through the Constitution; and then designing fiscal transfer mechanisms to address fiscal imbalances. There was little devolution of revenue assignments but rather a proliferation of fiscal instruments to address fiscal imbalances.

This paper is divided into two main sections. The first describes the intergovernmental system during apartheid, the transition through to democracy and how the intergovernmental fiscal system evolved during this time. Considerable attention is given to the constitutional
negotiations and details of the two Constitutions as the intergovernmental fiscal framework is embedded in the final, 1996 Constitution. The second part of the paper provides more detail on some of the key lessons that can be extracted from the South African experience. A short conclusion is provided which also covers key principles underpinning the system.

9.2. From Apartheid to Unified State

9.2.1. Fragmentation Under Apartheid

Prior to the democratic elections of 1994, South Africa’s fiscal system was determined by the spatial segregation of races. 87% of South Africa’s land area was preserved for whites, who made up less than 15% of the population. Most whites lived in urban areas located in one of four provinces in nominally democratically run communities, governed by the WLAs. The provinces were dependent on central transfers and acted as delegated administrations on behalf of the national executive. WLAs provided a full array of public services that were on par with services delivered in developed nations. WLAs were assigned revenue assignments typical of LG and services in these areas were funded primarily from user fees and property taxes. The WLAs could raise capital funds directly from the capital markets and even receive central guarantees for their borrowings.

Officially, blacks were relegated to one of 10 ‘homelands’, in areas with limited productive potential and distanced away from the white cities. It was enforced through the use of ‘pass laws’. However, in reality there was always a large black population in urban areas. The homelands were given different levels of political and economic autonomy, but as they were artificial regions, they enjoyed neither. There were four ‘independent’ states and six ‘self-governing’ territories. Although these territories collected their own income tax and sales taxes, they were financially dependent on fiscal transfers from the CG. Access to capital markets required central guarantees through the Development Bank of Southern Africa.

As the economic opportunities and businesses were concentrated in the cities, non-white settlements were created near the cities. These townships were established significant distances from the peri-urban...
areas of the whites. As land ownership and business rights were not recognized, townships had little revenue raising potential. Regional Service Councils collected revenues from businesses and allocated these to black areas. Separate BLAs were set up in urban areas to be run by nominally democratic, but racially exclusive structures. The BLAs were also entirely dependent on the national government for revenue. Even though the BLAs had legal authority to levy taxes and fees, blacks had restricted rights to property and businesses and could not raise significant revenues. There was much resistance in the form of organized boycotts, the non-payment of services and civic movements that brought about the unbanning of the ANC.

By the time of the transition in 1994, there were many systems of government and administration: (i) three separate administrations covering whites, Indians and coloreds; (ii) four provincial administrations; (iii) four ‘independent states’; and (iv) six ‘self-governing’ territories. The provinces were administrative arms of the House of Assembly while other systems each had, on paper at least, a political executive, an administration of public servants and a legislative assembly. In addition there were white and black local authorities and Regional Service Councils. The highly centralized structure of intergovernmental relations was essential to maintaining and controlling the apartheid system.

9.2.2. Compromise Politics and Constitutional Negotiation

The existing South African Intergovernmental System was established in the interim Constitution of 1993, including a Bill of Rights and the division of South Africa into nine provinces. It also established the structure of national, provincial, and local spheres of government and principles governing interaction between spheres. A two-step approach (Interim and then Final Constitution) was one of many compromises made during the negotiations of the early 1990s. It remained in force until 4 February 1997, when the current, 1996, Constitution of South Africa came into force.

Negotiating the interim Constitution was a process of compromise politics and delicately balancing the wish of the ANC for a strong CG with the wishes of the minorities for strong sub-national governments.
In many ways it was more important than the drafting of the final Constitution. The independent judiciary was tasked with ensuring that the new Constitution complied with a set of 34 principles. This was something that factions within the minorities used to their benefit. An irony was that the National Party (which governed during apartheid) argued strongly for federalism whereas during their time of rule they did everything in their power to maintain a strong CG.

9.2.3. From Fragmentation to Unified System

Under apartheid the major sources of revenue were assigned to the CG, which was collected nationally. This revenue included income taxes, value added tax, custom duties, import surcharges, excise duties, the fuel levy and other small taxes. Income taxes and VAT included collections on behalf of the TBVC states and self-governing territories. Revenue was also diverted to the TBVC states from collections by Customs and Excise in terms of the Custom Unions Agreements. Allocations were also made to these areas from the fuel levy and ordinary levy collections. The former territories also collected their income taxes, VAT and other revenues, which were not reflected on the national budget. The former Own Affairs Administrations and Provincial Administrations collected own-revenue from user charges and fees. In 1990/91 the CG accounted for 71% of total government spending and collected over 80% of all tax revenues.

The Government departments that consisted of only a national department (e.g. Foreign Affairs) submitted a budget to the Department of State Expenditure for approval. In the case of departments that had provincial counterparts (e.g. health, education and social development), functions committees coordinated budget proposals and distributed allocations for the function to national and the former self-governing territories, TBVC states, Own Affairs Administrations and Provincial Administrations. Transfer payments were also made to other levels of government such as local authorities and extra-budgetary institutions and funds.

In the absence of legislation for the financing of provinces, the budget process that applied for national government was extended to include function committees, the Budget Committee of the Department
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of State Expenditure (which is now the Treasury Committee), the Technical Committee on Finance, the Budget Council and ‘the intergovernmental forum’ to determine the transfers to provinces in the 1996/97 budget. According to the 1996 Budget Review, recommendations made by function committees on the division between provinces of guideline amounts for agriculture, education, health, nature conservation, roads and welfare were an important input in the process. The function committees generally sought to balance the goal of distributing resources equitably between provinces with the need to maintain continuity in services. The adjustments had to be phased in over a realistic time frame.

In 1997/98 (the first budget under the 1996 Constitution), in order to level the playing field in provinces, the cost of financing provincial debt was taken up by the National Government. This was the first year that provinces received their equitable share as a lump sum and could choose how to allocate across provincial programs, which allowed them to establish their own priorities and rendered the function committees obsolete. Provincial departments no longer competed for funds within a function across provinces, but rather between functions within a province. Provincial treasuries were now required to take on a provincial coordination, monitoring and expenditure control function.

Transfers to provinces were determined by government on the basis of recommendations made by the Budget Council (Minister of Finance and the provincial equivalents), after considering recommendations of the Financial and Fiscal Commission (FFC)—an independent organization established in both constitutions, that is required to make impartial recommendations to government on fiscal matters. Provinces continued to receive earmarked grants for LGs, including support for 293 towns (former TBVC and self-governing territories).

In 1998/99 the provincial equitable share was distributed to provinces using the provincial equitable share formula for the first time. Government relied on recommendations provided by the FFC in finalizing the formula. Given the inequities in the distribution of expenditure across provinces caused by different levels of service provided to different races the formula distributed resources in widely
different proportions to how resources were previously distributed. It was agreed that the shares created by the formula would be phased in over five years. In June 1998, the LG equitable share was also distributed to municipalities directly for the first time through the use of the formula. That was the first vertical division of revenue as we know it now. It took 18 months to complete, compared to the 10 months now required by the Intergovernmental Fiscal Relations Act.

The Intergovernmental Fiscal Relations Act (IGRFA), Act No 97 (1997), established a process for considering intergovernmental budget issues. It requires that the budget process begins with the FFC making recommendations on the Division of Revenue 10 months before the start of the financial year. The Minister of Finance is then required to consult with the provinces, LG and the FFC concerning these proposals. The Act establishes the Budget Council and Budget Forum (the members of budget forum, plus organized LGs) to facilitate consultation with provinces and LGs, respectively. The Budget Council meets a few times a year and the Budget Forum meets annually. These forums discuss a wide range of fiscal, budgetary, legislative and financial matters.

The Minister is required to table a Division of Revenue Bill at the time of the Budget, specifying the allocations to each sphere and the conditions that may apply to any of these allocations. In addition, the Division of Revenue Bill is to be accompanied by a memorandum that explains any assumptions and formulae used in arriving at the allocations, as well as how they incorporate constitutional requirements and the FFC’s recommendations.

In six years a fragmented system was brought together into an interlinked fiscal system that has not changed significantly since.

9.3. The Equitable Division of Revenue

Chapter 13 of the 1996 Constitution deals with transfers from national government to provinces and municipalities. The Constitution requires that an Act of Parliament provide for the ‘equitable division of revenues among the national, provincial and local spheres of government’. The Division of Revenue Act (DORA) must also provide for the determination of each province’s equitable share of the provincial
share of nationally raised revenue. The Constitution lists the following factors that must be considered when the division of revenue is determined:

- the national interest;
- provision for national debt servicing and other national obligations;
- the needs and interests of the national government, determined by objective criteria;
- ensuring provinces and municipalities can provide basic services and perform the functions allocated to them;
- the fiscal capacity and efficiency of the provinces and municipalities;
- developmental and other needs of provinces, LG and municipalities;
- economic disparities within and among the provinces;
- obligations of the provinces and municipalities in terms of national legislation;
- the desirability of stable and predictable allocations of revenue shares; and
- the need for flexibility in responding to emergencies or other temporary needs, and other factors based on similar objective criteria.

These factors are stated neutrally, which allows government to interpret them either punitively or developmentally. For instance “the fiscal capacity and efficiency of the provinces and municipalities,” can be interpreted that fiscal capacity and efficiency should be rewarded or that additional resources should flow to areas where there is inefficiency and/or a lack of fiscal capacity.

The Constitution promoted “all universally accepted fundamental human rights”. The interim Constitution used phrases such as “every person shall have the right to basic education,” and made no reference to available resources; whereas the 1996 Constitution requires the state to progressively realize rights so that everyone has “the right to access,” rights within reasonably available resources. This commits government to increase access to services within available resources.
The Constitution allows the quantum of fiscal resources each sphere of government receives during the vertical division of revenue, to be a political judgment and the wording means that this judgment cannot be challenged. The equitable share to provinces and municipalities must enable the progressive realization of rights. However, the National Government is not required to ensure the equitable share is ‘adequate’ enough to cover the basket of services provinces and municipalities provide. This is a critical feature of the vertical division of revenue.

However, it is not the same with the horizontal division. Since the provincial equitable share formula was first used in 1998/1999, it was explained in detail in the explanatory memorandum to the Division of Revenue Bill, which is tabled with the national budget. The LG equitable share formula has been explained in the explanatory memorandum since 1999/2000.

Both formulae are based on objective criteria and use official statistics, general household surveys, mid-year population estimates and regional GDP estimates. The provincial equitable share formula is updated with enrollment at public ordinary schools each year. The LG formula uses data from the 2001 Census about population sizes and access to basic services. This formula has a number of components, two of which are the basic services component and the institutional component and their purposes are to assist municipalities provide basic services and cover administrative running costs.

Poor municipalities receive additional LG equitable shares compared to non-poor communities. In addition they receive a range of conditional grants. Shortly after the transition, the National Government decided to support capital expenditure required for the delivery of basic services and to require municipalities to largely cover recurrent expenditure from their own revenue sources. The LG equitable share is intended to assist municipalities cover the operational costs of services to the poor.

Herein lie valuable lessons for other countries. Neither formula is perfect, but both serve their purpose, of being blunt instruments that calculate an unconditional transfer that provinces and municipalities have discretion to prioritize. By publishing the formula and the data sources each year, the formula and the allocations they produce cannot be manipulated. While the quantum of the equitable shares going to
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PGs and LGs may be a political judgment, the individual allocation to each province and municipality is a technical process determined, and protected by, a formula.

9.3.1. Constitutional Shifts: Impacts on Provinces

Perhaps the most significant compromise in the structure of the intergovernmental system in the 1997 Constitution was the establishment of nine provinces. The ANC would have preferred to centralize power without the existence of provinces, but this was a key bargaining tool of the opposition, as provinces gave the opposition possible control over some areas of the country. After the first democratic elections in 1994, seven of the nine provinces were controlled by the ANC.

Changes to provincial powers between the interim and final Constitution illustrate how provincial powers were curtailed and also demonstrate how compromise politics continued to influence how powers were structured. The interim Constitution allowed provinces to write their own legislation. The 1996 Constitution allows a premier of a province to exercise its executive authority by, amongst others, implementing all national legislation, within the functional areas provinces are responsible for and have been assigned to a province. Provinces can also implement their own legislation but the default competence of provinces switched from making their own legislation to implementing national legislation. In addition, the 1996 Constitution gave provinces executive authority, only to the extent that the province has the “administrative capacity to assume effective responsibility”. In practice the administrative capacity has been assumed, but this clause significantly reduces the powers of provinces.

Schedule 6 of the Interim Constitution listed “legislative competences”. In the 1996 Constitution these functions were made “concurrent national and provincial legislative competences,” in Schedule 4 but with a short list of “exclusive provincial competences,” in Schedule 5. New functions are included in Schedule 5 and some of these were clearly added as part of a trade-off to prevent resistance to the new Constitution. However, only functions with little political meaning are included in Schedule 5, such as community libraries, abattoirs and liquor licenses.
Both Constitutions list a similar set of factors as to when national legislation can prevail over provincial legislation. In the interim Constitution these factors applied to all provincial functions. In the final Constitution a different set of factors apply to concurrent functions than functions over which provinces have exclusive legislative competency. It is relatively easy for national government to intervene in the affairs of a province if it does not perform a concurrent function effectively, but a lot more difficult if a province does not perform a function for which it has exclusive legislative competence. In the case of exclusive competences, national government can only intervene if it is necessary to maintain national security, national unity or essential norms and standards and to prevent action from a province that may prejudice another province or the country as a whole.

The interim Constitution entitled provinces to an equitable share of revenue collected nationally—which was to consist of a percentage of income tax; VAT or other sales tax; and the fuel levy—each of which would be fixed by an Act of Parliament. The equitable share would also consist of transfer duties collected nationally on property and other conditional or unconditional allocations from national revenue. In both Constitutions, provinces can raise other sources of revenue as regulated by national legislation. However, whereas the interim Constitution required the provincial equitable share to be a fixed share of certain revenues, the 1996 Constitution does not provide a similar mechanism. This change means provinces cannot make claims on specific amounts of national revenue. The 1996 Constitution requires that each provinces’ share of the provincial equitable share must be determined in an Act of Parliament and requires that each province receives an ‘equitable’ share of the provincial share.

9.4. Provincial Revenue Assignments

The interim Constitution granted provinces exclusive legislative competencies to impose taxes on casinos, gambling, wagering, lotteries and betting and allowed them to raise other sources of revenue. The 1999 Budget Review summarized key recommendations of a special revenue commission (the Katz Commission) on assigning revenue raising powers for provinces—the most critical of which was: “economic
disparities between provinces could be reinforced by expanded revenue-raising powers. There is a trade-off for provinces between additional revenues raised through a surcharge and the loss of revenue from a smaller provincial equitable share. Given the redistributive nature of the formula, poorer provinces are likely to be disadvantaged.” The majority of expenditure performed by provinces is on education, health and social welfare. Given the public benefit and ‘merit good’ nature of these goods there are logical reasons for funding them through a redistributive funding mechanism. This reasoning is still relevant in 2011.

In 2011/2012 provinces raise the majority of their revenue through car license fees and casino taxes, the latter of which was assigned in the interim Constitution. No province is yet to raise any other source of revenue and own-revenues in 2011 account for about 4% of total provincial revenue. During the transition only minor changes were made to the revenue assignments of provinces. If the TBVC and self-governing states can be counted as part of the middle sphere of the apartheid government, the middle sphere lost revenue assignments during the transition, as the fragmented system of racially-defined administrations were integrated into a single non-racial system of government. From a political economy perspective, the lack of revenue assignments limits provincial powers and enables national government to ensure that centrally agreed upon policies are funded.

9.5. Unified Local Governments and the Demarcation Process

Like the other spheres of government, municipal government in South Africa worked differently for different racial groups under apartheid. The Local Government Transition Act, LGTA, 209 (1993) (LGTA) was introduced to provide for a pre-interim phase (1993 to 1995/96) during which temporary councils would be appointed to govern until the elections and interim measures that would be in place during the restructuring of LG (after the 1995/1996 elections).

The LGTA required nine demarcation boards to be set up to establish the boundaries for the LG elections in 1995/96. White municipalities were enlarged to include black areas and municipalities were governed by elected councilors and non-elected representatives. The 1995/96 elections resulted in the establishment of 843 municipalities
and the election of the following structures: (i) transitional metropolitan councils with substructures in metropolitan areas; (ii) transitional local councils for urban areas; and (iii) district councils for rural areas accompanied by a network of transitional representative councils and rural local councils.

The 1996 Constitution required that legislation must establish criteria and procedures for demarcating municipal boundaries. These were described in the Municipal Demarcation Act, Act 27 (1998), which established the Municipal Demarcation Board and required that the board must determine or re-determine the municipal boundaries as well as the factors that must be taken into account during demarcation. The Municipal Demarcation Act was assented to on 24 June 1998, and the Demarcation Board was tasked with finalizing the re-demarcation process before the LG elections, which were held on 5 December 2000. The board issued and refined general frameworks describing the factors that would determine nodal points and boundaries for Category A (metropolitan) and C (district) and separately for Category B (local) municipalities. It also published the boundaries for municipalities and received consultation on these boundaries a number of times.

The Board emphasized that great care was taken to match each municipality against the following principles:

- There is geographical contiguity (each municipality must become a single entity with its own capacity, identity and civic purpose);
- There is greater scope for the development of capacity (scope for developing their own administrative capacity);
- There is greater sharing of resources (weaker areas should be paired with stronger areas);
- Municipalities are more manageable in size; and
- There is greater financial, administrative and social functionality (travel patterns, patterns of social interaction and economic interdependencies must be considered—in the case of metros, the metropolitan character of the economy and spatial urban coherence were also considered).

During the re-demarcation process the Demarcation Board had to handle a number of objections to proposed boundaries and still managed
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to reduce the number of municipalities from 843 to 284 (6 Category A, 232 Category B and 46 Category C) in just over a year and a half. Some simplistic ratios, like the number of people per municipality, had to be applied to ensure the principles were applied consistently and while the consultation process ensured that a wide range of factors were considered, there was no explicit requirement for social and political cohesion to be considered.

The Municipal elections of 5 December 2000 brought the interim LG arrangements to an end and the demarcation process to put in place a democratic LG system, which was effectively a new LG system.

The Demarcation Board made the following observation: “No matter how the boundaries were re-drawn as the large parts of the country had never had any form of local government, the end result of the demarcation process would have many municipalities still without access to human and other municipal resources.” Thus the demarcations created a number of transitional challenges. Municipalities had to incur moving costs related to consolidation, integration, staff rationalization and redeployment; asset and liability alignment; and the alignment of agreements, contracts, bank accounts, investments, insurance, and IT systems integration. To support municipalities through this transition, government introduced a number of LG grants to meet these challenges.

The new municipal demarcations for the first time introduced wall-to-wall municipalities, so that every household in the country was part of a municipality and was, in theory at least, entitled to expect to receive the same municipal services. This was a major change for households outside of towns and cities and particularly for rural households in the former homeland areas, as they had not been connected to any municipal services during the apartheid years. Typically, municipal boundaries had ended at the edge of towns; now, in the poorest parts of the county municipal boundaries were extended to include hundreds of thousands of households that had no connections to running water, electricity or often roads. In addition, most of these households still lived on land that was governed by traditional systems of ownership, which had been institutionalized by the colonial regime in the late 1800s as vesting ownership with traditional leaders. This
makes it difficult for these municipalities to levy property rates and limits their ability to optimize this revenue source. Households are also typically too poor to pay for services even if these can be extended to them. Thus the new system created enormous service delivery obligations for weak municipalities, leaving them largely dependent on central transfers.

9.6. Establishing Local Governments

The 1998 White Paper on Local Government initiated an extensive process of change to enhance municipal accountability, improve developmental impact, streamline systems and improve the delivery of services. It set in place a process for establishing a comprehensive legislative framework for LGs. Act 117 (1998) The Municipal Structures Act, provided for the establishment of municipalities including the categories and types of municipality; criteria for determining the categories of municipalities; the division of functions and powers between categories of municipality, amongst others. Act 32 (2000) The Municipal Systems Act, provides for “the core principles, mechanisms and processes that are necessary to enable municipalities to move progressively towards the social and economic upliftment of local communities”.

Act 56 (2003) the Municipal Finance Management Act (MFMA) provides for the “secure sound and sustainable management of the financial affairs of municipalities and other institutions in the local sphere of government; to establish treasury norms and standards for the local sphere of government; and to provide for matters connected therewith.” Act 6 (2004) The Municipal Property Rates Act, regulates the power of municipality to impose property rates. The final piece of legislation specific to LGs is the Municipal Fiscal Powers and Functions Act, Act 12 (2007), which regulates how municipalities may impose surcharges and provides for the authorization of taxes, levies and duties that municipalities may impose. The Constitution allows municipalities to impose rates on property and surcharges on fees for services provided for or on behalf of the municipality, but does not allow municipalities to impose income tax, VAT, general sales taxes or customs duties.

The above legislation creates a comprehensive framework for the
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governance of municipalities. The Systems Act, Structures Act and Property Rates Act are the responsibility of the minister responsible for LG, with the Minister of Finance responsible for the remaining legislation. Within this comprehensive framework there is no explicit duplication, but there are many inter-linkages. For instance the Systems Act governs credit control policy and issues related to billing systems in municipalities. Whereas the MFMA governs how the revenue collected as a result of these policies and through billing systems should be reported. Therefore the policies of both departments need to be aligned to ensure that credit control practices and billing systems lead to the sustainable financial management, which also requires coordination between the two ministries, which sometimes causes delays in decision making.

On the ground, municipal infrastructure was far superior in white neighborhoods than in other areas. A process began to significantly increase capital spending on providing water, sanitation and electricity infrastructure to deprived communities. Municipalities received infrastructure grants to enable them to address backlogs that were capital in nature and the LG equitable share was intended to cover operational costs where the population was too poor to pay for these services.

Local Government in 2011 faces many challenges. There continues to be major urbanization to the large cities, which are the economic hubs of the country and account for a large share of the country’s GDP and population. However, there are also large concentrations of very poor people in the cities who live in informal settlements with varying access to basic and other services. Despite these challenges, these cities are generally financially viable; however the management capacity in the cities varies considerably. On the other side of the scale are the poor rural municipalities with limited options to raise own revenues. Many of these municipalities are poorly managed and failing to serve the needs of their people. Government is progressively introducing a differentiated approach to funding LG, which recognizes that cities must be supported as engines of economic growth and that the focus on the poorest municipalities should be about functional institutions rather than financially viable institutions.

There are a range of important lessons to be learnt from LG in
South Africa, but perhaps the most important is that effective systems and strong institutions are critical foundations on top of which a well designed transfer system may be able to achieve policy objectives (necessary, but not necessarily sufficient). However, well-designed transfer mechanisms are unlikely to cause strong institutions to emerge. In the absence of strong institutions elite capture easily happens.

9.7. Lessons Learned

9.7.1. Functional and Fiscal Processes in Legislation: Pros and Cons

Important structures and processes are embedded in the Constitution and supporting legislation to an extent, which is unusual by international standards. This has positives and negatives. On the positive side, it ensures that change is not done arbitrarily or due to populist pressure. The equitable shares are also protected from political meddling and also exclude any need for political decision making over the share any individual province or municipality should receive from a national transfer. Thus the allocation process is transparent and efficient. On the negative side, legalities slow the natural evolution of the system as changes require legislative changes. The legislation does not stop the evolution of the system, it simply slows it down: provinces can raise other sources of revenue if approved in national legislation; functions can be devolved to municipalities if approved in national legislation and so on.

However, for any of these processes to happen a fairly laborious process must be followed, requiring administrative and sector capacities. Attempts to introduce substantive changes will often be challenged. Currently there is widespread agreement that the housing function should be decentralized to municipalities with the capacity to perform the housing function. Housing is assigned to provinces in the Constitution, but the housing legislation makes provision for the full function to be devolved to municipalities. Despite numerous attempts by national government to get provinces to devolve the function they have not done so, most likely because doing so will require them to give up some of their powers. In the 2011 budget, in an attempt to fast track this process, national government transferred a portion of the housing grant directly to metropolitan municipalities instead of
provinces, despite the obstinacy of provinces.

In 2011, debates rage about how to fund rural and urban municipalities. There is no single agreed upon definitions of ‘urban’ and ‘rural’ or applicable criteria. Government recognizes that a differential approach to urban and rural municipalities is required; however this approach is ad-hoc and lacks a clear framework. The embedding of certain entitlements in the constitution means that the LG equitable share formula can only use a weighting that is seen as appropriate and beyond challenge. For instance, the provincial equitable share formula has an ‘institutional,’ component that is shared equally across provinces and addresses above average unit costs that may exist when providing services in rural areas. It also has a revenue sharing component to compensate provinces for costs related to having a large economy. Therefore in the absence of an agreed definition for ‘rural’ and ‘urban’, the government has addressed the differential needs indirectly.

9.7.2. Simplicity Builds Efficiency

Provinces receive an unconditional transfer through the provincial equitable share and different types of conditional grants. The structure is mirrored with municipalities, except that metropolitan municipalities receive a share of the fuel levy in addition to their equitable share and conditional grants. National Treasury consults with national departments and provinces when finalizing the payment schedules for these transfers, which are agreed to for one year at a time. Therefore, provinces know their incoming cash flow for 95% of their budgets at the beginning of the year and can plan their expenditure accordingly. The simplicity (and bluntness) of transfers, supported by the nature of the payment system, creates a potentially very efficient system. Provinces can plan and allocate budgets with fair certainty and flexibility. Thus there are advantages to simplifying the transfer system as much as possible but it also requires those implementing policy to at least adopt a systems approach to their overall planning.

Unfortunately most provinces and national departments have not made the shift to the new paradigm of managing resources from a systems perspective and thereby achieving the impacts envisaged in the
legislative framework. Rather, provinces seem to be stuck half way and want the discretion to allocate, but also ask national government to give and ring-fence sufficient resources for certain functions. The transfer system creates inherently weak accountability mechanisms at the provincial level and this allows political leaders to use their discretion to allocate resources to pet projects that are not core provincial functions, as well as letting administrations make excessive and unnecessary personnel appointments and then claim the reason why backlogs are not addressed is because they are underfunded.

9.7.3. Legislation Promotes Financial Management

The Public Finance Management Act (PFMA) came into effect on 1 April 2000. It governs the financial management and reporting requirements of government, and significantly reformed budgeting and financial management. The key objectives of the Act can be summarized as: (i) modernize the system of financial management in the public sector; (ii) enable public sector managers to manage, but at the same time be held more accountable; (iii) ensure the timely provision of quality information; and (iv) eliminate the waste and corruption in the use of public assets. The PFMA conferred substantive powers and responsibilities on a new National Treasury in line with the Constitution providing transparency and expenditure control in all spheres of government and also enforcing compliance with these measures. The PFMA established provincial treasuries and requires these bodies to enforce the Act in their provinces.

The PFMA details budget reporting requirements of provinces and also enables the national treasury to prescribe budget and reporting formats with standardized chart of accounts that are aligned with IMF, GFS standards. The PFMA enables National Treasury to analyze and investigate budgets/financial management and in year reporting requirements provide for early warnings of over expenditure. Had the PFMA been implemented in 1996 the expenditure crises of 1997/98 would most probably not have happened.

The PFMA as well as the MFMA impose reporting requirements at all levels of government, that are critical for the production of budget information that can be used to monitor and evaluate expenditure.
The political leaders in many provinces changed after the 2009 national and provincial elections and the lack of institutionalization of the PFMA is being exposed through continuing financial management problems in many provinces. Initially this was manifested in over expenditure on most items, across most departments. In the most recent expenditure information for the 2010/11 budget year it manifested in over expenditure on salaries and under expenditure on everything that is required to actually deliver services.

Governments going through a process of decentralization will increase the likelihood of success by ensuring that they have in place legislation that achieves many of the basic requirements of the PFMA and MFMA, especially with respect to budget preparation and expenditure reporting. However, key lessons are emerging about the importance of building sufficient organizational capacity to implement the legislation. It is the capability of the people using the systems and extent to which systems are embedded in organizational processes that determine the quality and usefulness of the information they produce. Institutionalizing the systems also ensures there is continuity in processes following changes in leadership.

9.7.4. Growing Tax Revenues is Essential

During the transition, function committees went about the task of allocating funds equitably in a variety of ways, but generally sought to balance the goal of distributing resources equitably between provinces, with the need to maintain continuity in services and phase in adjustments over a realistic time frame. South Africa’s ability to increase tax revenues following the transition to democracy is every bit as astounding and miraculous as the political transition.

Two key features of the reform of the tax system are worth noting. Firstly, government commissioned the Katz commission, which during the 90s made a number of recommendations and proposals on new taxes and revenue assignments. Secondly, the South African Revenue Services (SARS) was established by legislation to collect revenue and ensure compliance with tax law. It is an administratively autonomous organ of state. South Africa’s tax regime is set collectively by the National Treasury and SARS.
The 1997 budget review reported revenue collections of R145.8 billion, which was about 24% of GDP. By 2005/2006 revenue collections had grown to R495 billion and in the most recent budget review, revenue collections for 2010/2011 were R755 billion. The fiscal breathing space created by rapid growth in revenue was critical for plugging gaps that arose during the transition and to ensure a fragmented system could be consolidated into a unified system. Certain expenses like provincial debt and the cost of personnel increases could have derailed the system. Increased revenues meant government could afford to continue providing services where they existed and also address issues of redress, which was politically important.

The same Minister of Finance served from 1996 to 2009 and the same Commissioner of SARS served in the position from 1999 to 2009. Both these men are recognized as remarkable leaders and the stability and continuity they brought to the finance Ministry contributed significantly to the successes achieved. National Treasury and SARS are recognized, by a highly critical local and international media, as well run and effective organizations.

9.7.5. Ambiguity: Fostering Responsiveness, or Creating Confusion?

The provincial equitable share formula is loosely linked to the performance of provinces. The combination of components and the weights thereof are linked to the functions of provinces. However, performance is only really rewarded, or punished, financially if there is migration in or out of a province. National Government makes additional resources available for provinces to use to address specific priorities in a specific sector. If the resources are made available through conditional grants, the conditions pertaining to the use of the money will be clear. If the additions are made to the provincial equitable share, which is often the case for concurrent functions, each province will be advised as to how much they received for the specific priority and are expected to allocate the monies in their budgets accordingly, even though they supposedly have discretion over how to allocate it.

The Constitution creates a comprehensive framework around the roles and responsibilities for concurrent functions. This comprehensive framework allows each sector to develop and adapt legislation and
supporting mechanisms that correspond to the specific needs of their sector. The sector can choose how to combine expenditure and other input norms with performance standards as best suits the nature of their policies and function. Sectors with strong national departments are able to use the Constitution, and their own legislation, to ensure close alignment between national policies and provincial programs by prescribing and enforcing relevant norms.

The sectors that do not enact their own legislation and/or do not develop the capacity to support and oversee provinces create ambiguity and confusion over roles and responsibilities within their function. In these cases provinces are able to play budget games and pass the buck back to the national department, claiming lack of funding, unclear mandates and a lack of own revenues. Even if the national department made a budget bid and ensured additional resources were added to the provincial equitable share, there is little the relevant national department could do in the absence of their own policy framework with clear norms and standards to hold provinces accountable. This gives rise to tensions between the spheres of government, especially in the health and education sectors.

Many government role players, at all levels of government, attribute service delivery problems to concurrency. In addition, tensions prevail between national departments and provinces over levels of funding for nationally determined priorities and concurrency and the Constitution are often blamed. The problems are not created by the system, but by the application of its rules.

The narrative also does not consider that (i) Section 125 of the Constitution only entitles provinces to the executive authority to the extent that they have the administrative capacity to assume effective responsibility; and (ii) section 156 of the Constitution requires national government to assign any function currently assigned to provinces to a municipality if the function would be administered most effectively locally and the municipality has the capacity to administer the function. The constitution therefore requires that the principle of subsidiarity be applied regardless of where the function is assigned in the Constitution. However, some functions—housing is a case in point—have been assigned inappropriately to provinces. The National
Government is implementing measures to assign this function to municipalities where the capacity to administer the function exists.

In response to many of the tensions discussed, national government has tended to centralize functions. In 2005, the social assistance function was transferred from provinces to national government. Provinces provided very different products and the expenditure was beginning to crowd out provincial budgets. Fortunately at that time, revenue collections were growing and government therefore had the fiscal space to transfer this function between the spheres without it being overly disruptive.

In 2011, the National Department of Health released a green paper (the first official discussion document on a policy) on a proposed National Health Insurance Scheme (NHI). This green paper proposes that provinces will have to accredit their hospitals and compete for NHI funds with any other accredited hospital. If it is implemented in this form, provinces will have to rescind in aggregate 28% of their total budgets and reclaim these funds by competing for it. If provinces do not improve the current poor state of the public health system and private sector competitors enter the market, they will not reclaim much of this money. The debates on the NHI have barely started, however the NHI clearly removes provincial control over the function.

In the 2011 budget, government introduced the first in-kind infrastructure conditional grant for education. It is envisaged that national government will deliver a portion of the provincial education infrastructure portfolio on behalf of the provinces. Mid-year through the 2011 budget the National Department of Health would like to introduce a similar arrangement for the 2012 budget.

The tendency in the above examples is to re-centralize provincial functions in response to capacity weaknesses. These steps, as well decentralizing housing to local authorities, will erode the power of provinces, as every change discussed above will result in the reduction of transfers to provinces and—in the absence of own sources of revenue—a proportional reduction in their potential influence.

Once the NHI is implemented and the housing function is devolved, the only major functions provinces will be left with are education, social welfare services, agriculture and provincial roads. This will be a
motley collection of functions that do not fit together in any way that would allow provinces to address socio-economic priorities in a systematic way and is likely to bring further to light the relevance of this sphere of government.

9.7.6. Hard Budget Constraints do not have to be a Fiscal Rule

An important change that happened after the transition was the decision of national government (the Ministry of Finance) to end soft budget constraints and impose hard budget constraints. During apartheid the provinces and homelands had no real budget constraints. The debts of provinces were guaranteed by the CG. Subsidies and transfers to the BLAs, homelands and other sub-national structures were determined at the end of the year on an ad-hoc basis and based on historical expenditure. If they had over spent, the over expenditure would be funded through deficit grants. If provinces over spent they could borrow more. This created incentives to be profligate, but also kept the homelands, BLAs and provinces dependent on the center and therefore enabled the government to maintain apartheid structures. However, it also allowed central budget deficits to reach 8% of GDP in 1992.

Provinces initially were not properly geared for a decentralized system. In addition, there was considerable uncertainty arising from the implementation of the new Constitution, the shifting of functions between spheres and the evolution of the intergovernmental financial system in general. In 1997/1998 the CG had to intervene in two provinces and provide conditional grants, which the provinces were required to repay. The 1998 Budget Review reported that provinces expected a bailout due to previous experiences, but by then the “nature of the intergovernmental system had changed, demanding that each province live within its budget.”34Provinces were forced to undertake some difficult restructuring of their finances to control their expenditure. In 1998/1999, a year later, provinces had a combined surplus of R500 million, which is a remarkable turnaround.

These events marked a key change in intergovernmental fiscal relations. The decision to enforce hard budget constraints was in part, a reaction to the fear caused by the crises of 1997/1998. Enforcing

budget constraints was a decision of national government. They were supported by expenditure controls and an emphasis on fiscal discipline. But this is not an inherent feature of fiscal decentralization and there is no law in South Africa that requires hard budget constraints, it is simply a principle that is stringently imposed by national government. The same budget constraints are imposed on municipalities, which must return unspent conditional grants to the national government and cover any over expenditures from own revenues or borrowings.

9.7.7. **Hard Budget Constraints to Address Central Wage Bargaining**

High costs of personnel were an important transition issue for provinces, with salaries of all employees having to be made equitably, thus crowding out expenditure on service delivery, which in some cases undermined the quality of services offered, especially in education. Wage agreements in the public sector have become one of the most disruptive budget events on the annual calendar. Currently, the National Government negotiates with the labor unions on a yearly basis to reach wage settlements. Provinces do not participate in the bargaining process, but once the agreements have been reached, are obliged to pay the salary increases agreed to in the bargaining council. If wage settlements result in an above budgeted (inflation) levels, the National Government will provide additional resources to cover this cost. The additions over the medium-term expenditure framework are distributed through the provincial equitable share formula, which is not based on personnel levels in the provinces. As a result of these arrangements, the cost of the wage agreements may not be fully covered and in the provinces with larger than average staff complements the shortfall is likely to be substantial.

Provinces can choose how to manage their staff complements and should do so according to their needs and available resources. They can therefore control the scale of this substantive expenditure item over the long run; however in the short term it is not possible to simply remove staff from institutions because of budget pressures. Nor can they increase revenue collections to cover these costs. Provinces are able to, and do use the cost of wage agreements as an excuse for underfunding government priorities and service delivery.
A similar political economy tension exists in LG. Trade unions bargain with the South African Local Government Association (SALGA) on municipal salaries. However, as municipalities are expected to raise substantive own revenue they are more able to cover additional salary costs by adjusting rates and fees. Fortunately for government, the LG equitable share formula does not have a component that deals with salary costs, otherwise municipalities would use that as a means to argue that national government must assist municipalities to provide for the cost of salary increases.

For most of the 2000s up to the crisis of 2008, additions to budget baselines have allowed for real growth in provincial budgets and this has created inefficiencies and allowed provinces to spend on a range of non-core items and non-core programs. Since 2008/2009 the public sector wage agreements have led to above inflation increases and national government has not covered the cost of all of these salary increases as this was not affordable. Provinces have had to reprioritize their budgets and cut non-core expenditure to ensure both core services and the salary increases could be funded.

9.7.8. Sub-National Borrowing Powers

Under apartheid, the loans of provinces, municipalities and homelands were guaranteed by the CG and national government took over the debts of provinces and homelands in 1996. This arrangement meant a dependency on the CG. Act 48 (1996) the Borrowing Powers of Provincial Government’s Act (BPPGA), regulates local borrowing. Section 66 of the PFMA does not allow provinces to raise loans unless approved through the BPPGA. Provinces may raise bridging finance as long as it is repaid within the financial year and the Act governs how other provincial loans will be approved. As provinces do not have sufficient own-sources of revenue to repay loans there is an agreement between national government and provinces that they won’t access capital markets, but rather approach national government for loan requirements. The National Government is under no obligation to guarantee the debt of provinces, but may, if approved by the Loans Coordinating Council under the BPPGA.

Municipal debt is now governed under the MFMA, which came
into effect in 2004. The only real restriction placed on municipalities is that all debt must be denominated in Rand and that municipalities may not pledge capital assets that are deemed essential to the provision of basic services. Besides these restrictions, municipalities are able to participate in the capital market the same way private companies may. To access capital, municipalities must be creditworthy and the private sector will price their debt accordingly. This should facilitate financial accountability in municipalities. In practice, municipalities do not make the most of the debt markets.

9.7.9. Practical Lessons in Institutionalized Benchmarks

Following the financial crises in provinces in 1997/1998, National Treasury instituted ‘Provincial Benchmarks’. Provinces are required to have their draft budgets reviewed in the context of benchmarks by National Treasury and to undergo an interrogation from a team of budget analysts. Each province receives a report on the benchmark exercise and a copy of this report is handed directly to the Provincial Minister for Finance. The key lessons of the benchmarks are shared with all provinces at the first Technical Committee for Finance of the year. The benchmarks also allow National Treasury to ensure that additions earmarked for specific policy priorities find their way into the correct provincial budgets. The process has been replicated at the LG level since 2010.

The reviews have opened the eyes of officials in National Treasury to the practices of municipalities and the gap between the municipal interpretation of budget allocations and conditional grants objectives and national government’s intended interpretation. The response from the municipalities has been positive and there is a clear willingness to implement the advice given to them, but the impact of the lessons will probably take one or two budget cycles before they become visible. These exercises therefore strengthen provincial and municipal budget processes, as well as the credibility of their budgets, and provide insight to National Treasury that can be used to ensure oversight is effective and leads to improved policy making.
9.7.10. Practical Lessons in Functional Budgeting

Government established a process of budgeting over a Medium Term Expenditure Framework (MTEF) at the end of the 1990s. This involves agreeing to the budget for the next financial year and provisional allocations for the budget over the subsequent two years. The provisional allocations are known as the baseline. Once the MTEF baseline is established, the budget process each year focuses on how additions to baselines are allocated in the budget. This was enabled by a growing economy and strengthened tax collections.

Up until 2008/2009, when the economic crisis hit, the only real discussions during budget preparation were about what additions to baseline were required. The baseline itself was not really scrutinized. The economic crisis of 2008 and the above wage agreements have forced government to reconsider this approach and now look at the baselines.

In preparing the 2011 budget, national government introduced a new approach to preparing the budget. Instead of the budget bids of departments being presented to Medium Term Expenditure Committees, departments were grouped into functional groups along with similar departments. Each department’s baseline was scrutinized and possible savings were identified that could be reprioritized by the function group to priorities within the function. Only in later stages of the budget process were ‘additions’ added.

There is much learning required before the new approach will become fully effective and it is difficult to get departments to volunteer savings that will be given to other departments in their functional group. It is also difficult to reconcile the function groups with varying needs at provinces and municipalities and sub-national discretion to determine budget priorities. But the new approach is forcing a re-think about the way in which government goes about its business. It also forces officials involved in the budget process to pay more attention to the priorities of national government.

9.7.11. Practical Lessons in Sequencing Institutional Capacity Building

Arguments in favor of decentralization assume that the sub-national
administrative capacities can be efficient and responsive. It also assumes benevolent political and administrative leaders will follow standard processes to arrive at decisions that are informed by credible and reliable information. The theory does not consider that sub-national governments’ functions are assigned to political units and not economic clubs. Not all politically elected leaders and their appointed bureaucrats are benevolent. The capacity to produce and use information cannot be assumed. Performance is a function of a host of cultural factors.

Sub-national governments can only match policies to local needs and allocate resources more efficiently than their central counterparts if they are given the responsibility to make the necessary decisions. However, when the decentralization process begins the necessary organizational and administrative capacity to do this effectively will not yet exist. It also takes time to understand the local environment, the national policies and how to match these policies to local needs. Therefore, at the start of decentralization processes, governments are caught in a catch twenty-two, between devolving functions to gain the benefits; and risking poor implementation and associated wastage until the capacity is built.

Building institutional capacity is a complex process and subject to the interplay of a host of factors that are effectively impossible to quantify. Measures of organizational efficiency and effectiveness in the private sector are less complex, but in the public sector, measures of efficiency run the risk of creating perverse incentives, as they create an inward and short term focus that is detrimental to the long term objectives of government. In 2011, South Africa does not have indicators of administrative capacity that can reliably indicate the effectiveness of government departments.

In the South African experience, the provinces were formed by merging a fragmented set of very different administrations; the LG re-demarcation process pulled together municipalities of varying types and required the consolidation of different administrations that used different financial systems. The burden the transition placed on administrations varied across the country. In the former white established areas the administrations largely existed but even there the paradigm
shift took some time to achieve. In the former homelands where the administrations did not exist there was no institutional foundation on which to build. In 2011, this asymmetric distribution of administrative capacity is still evident.

At the provincial level a whole new paradigm to planning and budgeting was introduced, now aligning budgets with government priorities and departmental strategic plans. A completely new process of decisions making was required. The paradigm shift to the new PFM processes was further complicated by requiring administrations—both provincial and local—to provide services in poor areas and achieve new developmental priorities on top of onerous redress targets. So in addition to new processes, government units had to deal with a new policy landscape.

At the time of the transition the political pressure for new policies and processes was inescapable, however in hindsight, government would have benefited from a significant period of stabilization that focused on administrative capacity building and institutionalizing the necessary systems in a way that was somehow immune to political meddling. The political reality was that this was impossible. Although there are municipalities and provinces that function relatively well, in 2011 there are still wide ranging institutional weaknesses in South Africa. National Treasury is responding by driving a process of building capacity in provincial and national departments. National Treasury is also working with the provincial treasuries to support them to build their own capacity and is in the early phases of a very comprehensive and substantive process of building budgeting, financial management and revenue management capacity in municipalities. The capacity that would have been built by investing more in institutionalizing systems and building capacity in provincial treasuries in the early 2000s would have spilt over into other provincial departments and municipalities and many, admittedly not all, of the current service delivery failures would have been avoided.

The lesson for comparable countries is to ensure that following decentralization, building administrative capacity and institutionalizing administrative systems at the sub-national level is ranked as at least one of the first order priorities.
9.8. Conclusion and Recommendations

This paper is not intended to be an academic article and was written with the intention to share useful lessons in responding to the questions: (i) what is the political economy rationale behind decentralizing a country?; and (ii) what drives a country to decentralize (or to federate)?

In the South African context the answer to the two questions is that South Africa’s decentralized structure of intergovernmental relations is a product of compromise politics. That is a key lesson for proponents of decentralization: it is a political process, not an economic one.

In South Africa, the theoretical benefits of decentralization have been achieved where there is the political will to create the benefits. The benefits exist at the provincial level where there are strong and visionary leaders who are able to impose their will on the provincial administrations they lead. At the LG level the benefits of decentralization have been yielded where there is the administrative capacity and political will to use that capacity to collect revenue and provide services.

Good governance can be described as efficiently implementing national policies in a way that matches local preferences. At the bare minimum, strong administrative, financial management and policy interpretation capacities are required. These do not emerge in response to fiscal and financial incentives that may be embedded in the assignments of revenues and functions. They are created purposefully through continuity, commitment and strong and capable leadership. This is perhaps the most important lesson that can be learnt from South Africa.
10
Strengthening the Revenue Side

Professor Roy Kelly

10.1. Introduction

Countries everywhere are undertaking reforms to enhance economic and social development. Reforms are aimed at facilitating economic growth and employment generation through the private sector, complemented by public sector reforms to improve governance and public service delivery. The various public sector management reforms have focused on reengineering, privatizing, and decentralizing the government in an attempt to improve the efficiency and accountability of delivering public services.

The ongoing decentralization reforms are focused on: improving public service delivery efficiency and accountability; promoting a more equitable distribution of services and resources across each country; and on enhancing more accountable and responsive governance. By bringing key public expenditure decisions closer to the people, governments are attempting to empower communities to more actively participate in the prioritization, implementation and monitoring of government expenditures, so as to encourage more efficient, accountable and transparent public resource management related to the design and delivery of public services.

These various decentralization reforms involve a combination of political, administrative and fiscal components. Political accountability
mechanisms, along with administrative institutional capacities and clearly defined fiscal responsibilities and resources are essential for success. On the political side, LGs must have mechanisms for being responsive to their local residents. On the administrative side, LGs must have capacity to plan, budget, deliver and account for government services. On the fiscal side, LGs must have clear expenditure responsibilities and revenue options, including appropriate, locally owned revenues; and access to intergovernmental transfers; as well as clarity on sub-national borrowing options. These political, administrative and fiscal components need to be designed, implemented and integrated to provide the framework for the implementation of successful, sustainable decentralization reforms.

Successful fiscal decentralization hinges on effectively integrating the four pillars of fiscal decentralization; namely, the allocation of functions across various government levels, the allocation of revenue responsibilities and the design of the intergovernmental transfer system and an appropriate sub-national borrowing policy. There is general agreement among decentralization experts that ideally ‘finance should follow function,’ implying that governments must clarify the expenditure responsibilities for each level of government before determining the financing structure and mixture of revenues and intergovernmental grants and the ability to borrow. Additionally, these various reform components must be sequenced and appropriately tailored to the country—specific context, to maximize the chances for successful achievement of the reform objectives.

A key requisite for decentralization success is the adequacy of revenue resources to fund the expenditure responsibilities allocated

35 Local Governments refer to all levels of sub-national governments such as provinces, states, districts, cities, towns, communes, and villages. As required, this chapter will refer to specific levels of local government in terms of revenue responsibilities for policy and administration.


to LGs. These revenue resources typically come from a combination of user charges, local taxes, shared taxes and intergovernmental transfers. The exact mix of the financing structure and amounts needed varies by country and time, depending on the nature and the extent of the expenditure responsibilities assigned to each level of government.39

Decentralization finance in most countries is heavily dominated by intergovernmental transfers and shared taxes. LGs in most developing countries tend to rely on 60–80% of these CG revenue transfers, while local own revenues—which can include both user charges and local taxes—tend to be quite small.40 Striking the appropriate balance and structure of central transfers and local revenues is a major challenge for these decentralization reforms.

Intergovernmental transfers/shared taxes and local own revenues each play important, yet distinct, roles in fiscal decentralization. Intergovernmental transfers/shared taxes are structured to address vertical and horizontal fiscal imbalance within countries. In addition to strong political objectives, intergovernmental transfers and shared taxes can be designed to assist in balancing vertical funding needs between the CG and LGs; to achieve horizontal equity among LGs of various expenditure needs and fiscal capacity; to improve the delivery of national priority merit goods; and to compensate for inter-jurisdictional spillovers, among others.41

Local own revenues, although often small, are equally critical to support decentralization reforms by enhancing local autonomy, governance accountability, ownership and responsibility, while providing an

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important source of additional funding (at the margin) for local budgets. Ultimately, it is the combination of CG revenues, along with local revenues, which provide the resource envelope needed to fund LG services. Although CG transfers and shared taxes dominate, governments everywhere recognize the importance of local own revenues to ensure decentralization, governance, autonomy and accountability objectives. Governments are therefore exploring options to implement appropriate local revenue policy and administrative reforms to enhance local revenue mobilization.

Constraints and obstacles to greater local revenue mobilization are numerous. These constraints and obstacles emerge from political, institutional and administrative problems from within both the CG and LGs. Therefore, reform measures must necessarily incorporate a comprehensive approach, which addresses the political and institutional environments of both the CG and LGs.

Reform measures must ensure that CGs assign LGs adequate and productive local revenue instruments, and give the necessary discretion, along with accountability constraints, to influence the tax policy and revenue administration (at the margin). Reforms must be structured to reduce excessive CG direct and indirect interference. They must also be structured so as to overcome any CG administrative apathy towards creating a proper balance between appropriate CG intervention, and CG support of LGs needed to encourage local revenue mobilization. For example, intergovernmental transfer and shared taxes must be structured to minimize disincentives for mobilizing local revenues, while the CG must be constrained from intervening with ad hoc policy changes and/or administrative regulations which can dramatically discourage LG revenue mobilization.

Reform measures must also be undertaken to create an enabling environment to empower LGs to effectively enhance local governance and improve local public service delivery. Strengthened local political legitimacy and credibility will better enable LGs to work with their residents to mobilize additional local revenues needed for identified local expenditure priorities. In addition, various political and institutional reforms must be undertaken to build up local administrative capacity and to mobilize the local political will needed to effectively levy, collect
and enforce against non-compliance. It is the successful combination of these various central and local reforms, which will provide the framework for improved local revenue mobilization.

This chapter focuses on these local own revenues, with particular attention on the property tax as the primary source of potential and sustainable LG revenues. The chapter is divided into five sections. Following the introduction, section 2 outlines the theory and practice of revenue allocation across government levels and examines various ways of structuring revenues to support local autonomy and fiscal decentralization. Section 3 focuses on the Indonesian reform experience in structuring its local own revenue system. Section 4 examines the property tax devolution process in Indonesia under Law Number 28 (2009). Section 5 concludes with recommendations for the way forward.

10.2. Theory and Practice of Revenue Allocation

Theory and international practice argue that most tax bases are better levied and administered at the CG level. In general, lower level governments should raise revenues from those revenue bases with lower mobility and those with clear benefit linkages to local services. However, most other taxes should be allocated to the CG. Countries therefore allocate international trade taxes, VAT, the personal and corporate income taxes, and typically natural resource taxes to the CG level. LGs at the provincial or state levels usually are allocated taxes such as motor vehicle taxes, and sometimes retail sales taxes and personal income taxes, while lower level LGs are usually allocated property taxes and other less mobile tax bases. Excises are often given to all levels of government, with those at the LG applied to tax bases with

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43 International experience does vary considerably—with the federal countries often granting corporate income and individual income taxes to provincial/state levels (e.g., US and Canada). In the US, some LGs also impose an individual income tax (often a payroll tax) (e.g., New York, Philadelphia). Scandinavian countries allow LGs to apply individual income taxes. Most developing countries keep the income taxes at the central government level, but may allow for piggy backing (levying a surcharge).
relatively low mobility and with less ability for tax exporting (e.g., hotel rooms, entertainment, restaurants, etc.). In addition, theory and practice encourage all levels of government to apply user charges as appropriate.

Taxes can be structured to give various levels of autonomy and/or control depending on which government level is given the authority to define and choose the base, the tax rates and administer the taxes. As Table 10.1 indicates, local revenues can be divided into those which give no local autonomy; those which provide limited local autonomy; and those which provide local autonomy.

<table>
<thead>
<tr>
<th>Level of Autonomy</th>
<th>Tax Policy / Administration Characteristics</th>
</tr>
</thead>
<tbody>
<tr>
<td>No Autonomy</td>
<td>Tax sharing / revenue sharing, with central administration</td>
</tr>
<tr>
<td>Limited Autonomy</td>
<td>Tax sharing, with joint administration</td>
</tr>
<tr>
<td></td>
<td>Central Government sets tax rate of “local revenues,” but with some local level administration responsibilities</td>
</tr>
<tr>
<td>Autonomy</td>
<td>Local taxes/revenues where LG sets tax rate, but often within centrally permissible ranges</td>
</tr>
<tr>
<td></td>
<td>Local taxes/ revenues where LG determines tax base</td>
</tr>
<tr>
<td></td>
<td>LG responsible for revenue administration with/without joint administration</td>
</tr>
<tr>
<td></td>
<td>Tax Surcharge with / without joint administration</td>
</tr>
</tbody>
</table>

Let us consider these three levels of local autonomy/local control as they relate to the allocation and structure of revenues:

10.2.1. No Local Autonomy

This can occur when the CG controls the revenue policy and administration, with no policy discretion and administration role given to LGs. This occurs under a system of shared taxes or general revenue sharing where the CG will allocate a portion of a central level tax to LGs or under a system of general revenue sharing where the CG may allocate a portion of a central level revenue pool to LG. Shared taxes
are those which are levied by the CG, which also controls the policy (base and rate) and administration.

LGs are given a share of the tax revenues, sometimes even up to 100%. Under shared taxes, LGs have no direct influence/control and/or accountability over the tax revenues received, over the tax base, tax rates, and/or administration. The property tax in Chile is an example where the CG sets the tax rate, tax base and administers the tax as a shared tax, with revenues given to LGs based partially on derivation and partially on formula. LGs do not participate in the policy or administration, but only receive the revenues.

10.2.2. Limited Local Autonomy

This can occur when the CG may delegate some administrative functions to the LG. Thus, through participation in administration, LGs may be given sufficient autonomy/control, albeit often very limited, to affect the level of revenues received—even under a shared tax system. Limited autonomy also occurs when the CG sets the tax rate for ‘local revenues’, thus taking away LG discretion to influence the tax rate while still allowing LG power to administer the tax.

In both these cases, the LG is given some limited local autonomy by being empowered with the potential to influence the level of revenues through active or inactive participation in some key administrative functions. The Property Tax in Indonesia, prior to Law Number 28 (2009), was such an example where the CG set the tax rate, tax base and relied on a system of limited joint administration, with revenues given to LGs based on derivation and formula. LGs did participate, albeit in a very limited way, in the administration of the property tax, and thus potentially had some (limited) influence on the revenues generated. LGs in Indonesia were given partial responsibility for delivering tax bills and providing taxpayer services and information on tax payment. LGs also were involved somewhat during the field data fiscal cadastre updating process.

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A system of “shared taxes” is sometimes referred to as “financial decentralization”, a system which decentralizes revenues, in contrast to a system of “fiscal decentralization”, a system which decentralizes the responsibility and authority to LGs to levy taxes on defined tax bases either solely or jointly with the CG.
10.2.3. Local Autonomy

This can occur when a LG is given the ability and discretion to directly influence the amount of revenue collected through having a degree of discretionary control over tax rates and/or the tax base and/or revenue administration. Having some control of the tax policy and administration increases local autonomy but also enhances LG accountability for the taxes levied on its residents. This said, however, it is possible for LGs to have a great deal of autonomy even while maintaining a nationally mandated tax base and outsourcing either part or all of the tax administration. The critical issue is that the tax revenues accrue to the LG and that the LG can affect the tax revenue amount at the margin by changing the tax rate. LGs must be accountable and responsible for officially ‘levying’ the tax and affecting the amount of the tax levied and collected, not just for ‘receiving’ revenues from a tax.

Many property taxes operate as local taxes where the LG has some control of the tax rates (often within limits) and the tax base (often with options to provide limited exemptions) as well as responsibility for at least some of the administration functions (e.g. North America, South Asia, Philippines, Indonesia after Law 28). Other property taxes operate as local taxes with the tax rate fixed in national law, but with administration under the LG (e.g. Latin America and many transitional countries).

Given the importance of local autonomy, discretion and accountability to the achievement of the decentralization objectives, it is important to consider options as to how a country can strategically shift from a centrally-controlled revenue structure to a more locally-
controlled revenue structure. What are the strategic options for a country to devolve revenue powers in order to promote and support greater local autonomy and fiscal decentralization? Let us explore those options.

There is common agreement that fiscal decentralization requires the assignment of appropriate revenue instruments to LGs—the exact mixture of which varies across countries—but which typically includes a combination of user charges, property taxes and location-specific, benefit-related taxes, along with selected excises, personal income taxes, payroll taxes, general sales taxes and business taxes. These revenues need to be adequate, with sufficient discretion and autonomy given to LGs to influence the amount of collected revenue at the margin. Agreement on the definition of adequacy and level of needed discretion may not be clear in the literature, but suffice to say that the discretionary revenues should be sufficient enough to allow flexibility at the margin for LGs to influence the efficiency and accountability of expenditure choices. Regardless of the magnitude needed, this implies a necessary shift from revenues with no local autonomy to revenues with a higher degree of local autonomy and control.

There can be a progression of revenue allocation and revenue structures, which can increasingly support decentralization, as countries move from a system of complete central control to one of increasingly greater local control. Increased local autonomy and discretion, with accountability, can emerge as countries shift from pure central taxes—where all tax policy and administration is under CG control—to variations of tax sharing with joint administration, local surcharges and/or local own revenues.

As indicated in Figure 10.1 countries can move to reduce central

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49These local own revenues are a necessary but not sufficient condition for successful decentralization. The imperative is that local governments must be able to control the mobilization of these local revenues “at the margin”. That is, local governments must be able to mobilize the discretionary dollar to have the power to affect the amount of collected revenues in order to reach the accountability and efficiency objectives of decentralization. Local governments must be given the discretion to raise additional revenues, but also must be fully accountable to the local residents for the levying of these local revenues, how these revenues are mobilized and how these and all local resources are spent.
government control and increase LG autonomy and control. Each incremental movement provides LGs with increased responsibility and discretion within nationally-set bounds to influence the amount of revenues collected. These various stages, however, are not necessarily sequential, meaning that a country can move directly to devolve an existing central tax to become a local revenue, without the need to progress incrementally first to a shared tax, to a local surcharge stage and then ultimately to a local own revenue, respectively. In other cases, if shifting from a tax sharing regime to a local tax regime may be considered too radical, a country may opt for moving to a tax sharing regime with joint administration or to a local surcharge option with joint administration, as appropriate.

In the case of the property tax in Indonesia under Law Number 28 (2009), the Government took the option to shift the rural and urban property tax from being a shared tax with joint administration, directly to a local own tax with full local administration, while keeping the
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property tax on estates, forestry and mining remaining as central shared taxes. The Law devolved the property tax uniformly to all LGs structured as a local own revenue with administration responsibility, where LGs are allowed the option to delegate/outsore most administrative functions to third parties, as appropriate.

In some countries, the property tax is structured slightly differently, even in cases where the property tax is devolved to LGs as a local tax. In these cases, LGs are given tax rate discretion (perhaps within limits) and often some discretion on granting exemptions on the tax base; but the administration is structured as a joint administration model. This joint administration model delegates in law and government regulations certain administrative functions to various levels of government in order to take advantage of economies of scale, capacity, and equity concerns, among others.

Theory and international practice suggests that property tax administration should not necessarily be assigned completely to the CG or LG levels, but, as with all public sector functions, the administrative functions need to be ‘unbundled’, identifying specific sub-administrative functions which can be assigned and structured based on such principles as economies of scale, economies of scope, taxpayer proximity, government accountability and responsiveness, and as well as government preference. The ultimate assignment of these administrative functions should be based on a careful analysis of cost and benefits, considering options across levels of government and/or across public and private sector alternatives, always cognizant of overall efficiency and equity criteria. In Australia, New Zealand, Malaysia, and Jamaica, for example, many of the property valuation functions are given to the central or state government level, while all other property tax administration functions are given to the LGs. In fact, a majority of countries use some degree of joint administration for the fiscal cadastre functions while relying on local administration for the treasury functions.50

In some countries an asymmetric approach may be needed, allowing

some LGs to administer the property tax under a local administration model and others to administer the property tax under a joint administration model. This may be the option in Indonesia so as to allow LGs to take advantage of economies of scale and capacity constraints, especially in those less-urbanized, rural LGs, which have less revenue potential and less local capacity to fully administer the property tax. This option will be further discussed in a later section of this paper.

Countries typically enable LGs access to local own revenues through either an ‘open list’ or a ‘closed list’ system. Under an open list system, LGs are allowed to levy revenues not specifically reserved for other levels of government within general limits and restrictions. As intended, this open list approach provides wide discretion to LGs, empowering them to introduce new local tax structures and freely raise their own revenues with few limitations. Under a closed list system, LGs are only allowed to levy taxes and charges on those tax bases listed as assigned to LGs, restricting LGs from levying taxes and charges on other revenue bases. Under a closed and open list system, countries can provide some limited flexibility to propose alternative taxes and charges, which must be approved by the central government on an exception basis.

Unfortunately the ‘open’ list approach, in providing a high degree of local discretion, often does so without a sufficient level of accountability and control, thus providing strong incentives for the introduction of nuisance taxes and/or highly distortionary taxes, which can adversely affect equity and economic growth.\textsuperscript{51} To avoid these incentives, many countries are moving towards adopting a ‘closed list’ of allowable local revenues from which a LG can choose. For example, in 2003, Tanzania introduced amendments to the Local Government Finances Act of 1982 to switch to a closed list approach; while Indonesia in 2009 replaced Law Number 34 (2000) with Law Number 28 (2009) to reintroduce a closed list approach.

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To ensure successful achievement of decentralization objectives under the ‘closed list’ approach, countries must ensure the inclusion of sufficient revenue instruments on the limited ‘closed list’, with sufficient LG discretion, which can have potential for generating stable and buoyant local revenues (e.g., property taxation, appropriate local excises and business taxes). This was done in Indonesia, which reintroduced the ‘closed’ list approach under Law Number 28 (2009), this time including local access to the rural and urban property tax and to the property transfer tax.

Indonesia had traditionally followed a ‘closed list’ approach, including Law Number 18 (1997) which was passed just prior to the 2001 Decentralization Reforms. However, Law Number 18 did not include the property tax as a LG revenue option. Following the Big Bang decentralization reforms, the Government introduced Law Number 34 (2000), which shifted from a closed list to an open list approach to provide increased discretion to LGs in support of decentralization. Under this open list approach, however, LGs were still not allowed access to property taxes as these taxes already existed as CG shared taxes. As will be explained, the open list approach led to a proliferation of nuisance and highly distortionary taxes—as LGs creatively sought ways to improve their local revenues. In reaction to the problems resulting from Law Number 34 (2000), the government shifted back to a closed list approach, but this time devolved the rural and urban property tax (Pajak Bumi dan Bangunan/PBB) and the property transfer tax (Bea Perolehan Hak atas Tanah dan Bangunan/BPHTB), giving LGs access for the first time to potential revenues from property taxation.

Once specified, under either an open or closed list approach, the local revenue instruments made available and/or utilized must be designed and implemented to mobilize revenues in an efficient and equitable manner while cognizant of administrative feasibility and political acceptability. Although the theory on tax design and
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implementation is applicable to all countries, the fine art of reform is in knowing how to creatively adapt the theory to the local situation to ensure an appropriate design and strategy to facilitate the adoption, implementation and sustainability of the revenue reform process. This is the essence and challenge for the success of all major reforms.

Within the context of this theory and practice of revenue assignment, let us now turn to explore in more detail and try to learn from the experience of Indonesia within the last 15 years with the allocation of revenues to LG levels, with emphasis on Law Number 28 (2009) which established a closed system of revenue assignment, that, for the first time, provided LG access to the rural and urban property tax and the property transfer tax.

10.3. Local Government Revenue Assignments in Indonesia

The Government of Indonesia has long recognized the importance of enhancing local revenues (Penerimaan Asli Daerah/PAD) to strengthen local autonomy and accountability. Prior to the decentralization reform in 2001, the government had enacted Law Number 18 (1997) to strengthen/ rationalize the LG revenue structure. Immediately following the “Big Bang” decentralization reforms, the Government passed Law Number 34 (2000) to tackle some limitations inherent in Law Number 18 (1997) and provide greater discretion to LGs. And most recently, the government passed Law Number 28 (2009) on Sub-National Taxation and Charges.

Law Number 28 (2009) replaced Law Number 34 (2000) on Sub-National Taxation and Charges, which had provided an open list approach to the assignment of local own revenues, an approach which had allowed LGs to levy new taxes/charges through local regulations, if consistent with principles mentioned in the law and not denied a separate CG review process. Although perhaps well intentioned, to support the decentralization process, this open list system under Law Number 34 (2000) led to a proliferation of local taxes, which increased the complexity of the LG tax structure, introduced unintended economic distortions on investment, location and consumption decisions, and created many nuisance taxes, where the cost of administration was
greater than the revenue generated.\textsuperscript{54}

To correct these problems, the government enacted Law Number 28 (2009) with the stated objective of further supporting the Indonesian decentralization reform by:

- Empowering sub-national governments through providing local autonomy and discretion with accountability. Tax rate limits were increased and LGs given discretion to choose local tax rates, thereby increasing local autonomy and downward accountability to local resident taxpayers;
- Enhancing potential local autonomy through providing access to more productive local taxes and charges (including property taxation), increasing tax rate limits, giving tax rate discretion policy and shifting administrative responsibility to the provincial and local levels; and
- Improving sub-national tax administration efficiency through establishing a closed list approach to defining the system of local taxes and charges. Law Number 28 (2009) simplifies local taxation and limits both PGs and LGs to only 16 taxes and 30 charges, allowing LGs to focus their administrative resources on key productive local revenues, including property taxation.\textsuperscript{55} The law provides for the provision of a collection incentive system to be determined through national regulation.

Law Number 28, through its inclusion of the property taxes, represents a major policy change in support of decentralization, giving LGs full access to the range of revenues which theory and international best practice confirm should be assigned to LGs. As Table 10.2 indicates, Law No. 28 provides PGs access to five taxes while LGs (kota and kabupaten) are given access to 11 taxes. Of particular significance are the inclusion of the property transfer tax (BPHTB) and the rural and


\textsuperscript{55} Law Number 28 (2009) limits the number of local taxes but Article 100 does allow LGs to introduce additional user charges through a MOF review/approval process.
urban land and building tax (PBB) for LGs, as these taxes had historically to date been implemented as CG shared taxes.\textsuperscript{56}

An analysis of the three revenue laws reveals some trends in provincial and local taxes as the decentralization process has been implemented. As indicated in Table 10.3 the types and number of regional taxes at the provincial level have not varied substantially over time. The province has taxed and continues to impose a combination of property-related taxes on vehicles (e.g. the annual motor vehicle tax and the transfer tax on motor vehicles ownership) and sales taxes on motor vehicle fuel and surface water. In 2009, the provinces were given access to the cigarette tax.\textsuperscript{57} At present, there are five provincial taxes, essentially two property related taxes and three sales taxes on sales/consumption which include the one tax on surface water (natural resource).

In contrast, there are many new taxes made available to the Kota and Kabupaten LGs. Beside the seven original local sales taxes (e.g. the sales tax on restaurants, hotels, entertainment, advertisements, street

\textsuperscript{56} These two property taxes (PBB and BPHTB) had previously been designed and implemented as central level “shared” taxes. The CG was responsible for the tax policy (base and rates) and for the tax administration. The property tax revenues were then shared between central, provincial and local governments. Although the rural and urban property taxes are being devolved to LGs, the property taxes on estates, forestry and mining continue to be implemented as CG shared taxes.

\textsuperscript{57} Currently, the cigarette excise is a CG shared tax, with 2\% of CG excise tax revenues on cigarettes going to regional governments, of which 0.6\% goes to provincial level based on population and 0.8\% goes to provinces where revenue is derived and 0.6 \% goes to other Kabupaten/Kota within the province. By 2014, the PG will be given a cigarette tax, which will be levied as a uniform percentage of 10\% of the existing cigarette excise revenues to be allocated by population.
lighting, parking and non-metal mineral and rock—it was a “C” category mineral previously), Law Number 28 (2009) grants LGs four new taxes, including two property taxes (rural and urban PBB and BPHTB) and two new sales taxes—one tax on ground-water, which was transferred from the PG level, and one levied on swallow nests. In total, the Kota and Kabupatens have access to 11 local taxes.

<table>
<thead>
<tr>
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</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Motor Vehicle Tax</td>
<td>Motor Vehicle Tax</td>
<td>Motor Vehicle Tax</td>
<td>The tax base continues to include sea vessels.</td>
</tr>
<tr>
<td>2</td>
<td>Motor Vehicle Transfer of Ownership Tax</td>
<td>Motor Vehicle Transfer of Ownership Tax</td>
<td>Motor Vehicle Transfer of Ownership Tax</td>
<td>The tax base continues to include sea vessels</td>
</tr>
<tr>
<td>4</td>
<td>Surface and Ground Water Tax</td>
<td>Surface and Ground Water Tax</td>
<td>Surface Water Tax</td>
<td>Surface water tax remains a provincial tax. The ground water tax was transferred to LG.</td>
</tr>
<tr>
<td>5</td>
<td>NA</td>
<td>NA</td>
<td>Cigarette Tax</td>
<td>New Provincial level tax</td>
</tr>
</tbody>
</table>

**Local (Kota / Kabupaten) Taxes**

<table>
<thead>
<tr>
<th></th>
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</thead>
<tbody>
<tr>
<td>1</td>
<td>NA</td>
<td>NA</td>
<td>Rural and Urban Property Tax (PBB P2)</td>
<td>Transferred from CG to LG</td>
</tr>
<tr>
<td>2</td>
<td>NA</td>
<td>NA</td>
<td>Property Transfer Tax (BPHTB)</td>
<td>Transferred from CG to LG</td>
</tr>
<tr>
<td>3</td>
<td>Hotel and Restaurant Tax</td>
<td>Hotel Tax</td>
<td>Hotel Tax</td>
<td>No Change</td>
</tr>
<tr>
<td>4</td>
<td>NA</td>
<td>Restaurant Tax</td>
<td>Restaurant Tax</td>
<td>No Change</td>
</tr>
<tr>
<td>5</td>
<td>Entertainment Tax</td>
<td>Entertainment Tax</td>
<td>Entertainment Tax</td>
<td>No Change</td>
</tr>
<tr>
<td>6</td>
<td>Advertisement Tax</td>
<td>Advertisement Tax</td>
<td>Advertisement Tax</td>
<td>No Change</td>
</tr>
<tr>
<td>7</td>
<td>Street Lighting Tax</td>
<td>Streets Lighting Tax</td>
<td>Street Lighting Tax</td>
<td>No Change</td>
</tr>
<tr>
<td>8</td>
<td>NA</td>
<td>Parking Tax</td>
<td>Parking Tax</td>
<td>No Change</td>
</tr>
<tr>
<td>9</td>
<td>Bahan Galian C</td>
<td>Bahan Galian C</td>
<td>Non-Metal Mineral and Rocks Tax</td>
<td>No Change</td>
</tr>
<tr>
<td>10</td>
<td>NA</td>
<td>NA</td>
<td>Ground Water Tax</td>
<td>Transferred from PG to LG</td>
</tr>
</tbody>
</table>

*Source: Kelly and Gyat, 2011*
Provincial and LG taxes are now under a closed list tax system again, which provides LGs with a fixed menu of taxes that can be adopted as provincial/local taxes, but, unlike the previous open list system, prohibits PGs and LGs from imposing any other new taxes. Instead, they are encouraged to optimize the effectiveness of the specified taxes by improving accountability, administration and procedures, as well as administratively broadening the specified tax bases.

The available taxes included in the closed list are quite urban-biased, with taxes levied largely on tax bases that tend to be located in urban areas—such as hotels, restaurants, entertainment facilities, and advertisements. The property tax also tends to support the urbanized LGs, since urban properties tend to have higher values and therefore will generate more revenues than those located in rural areas. The three exceptions, being less urban biased, may be the ground water tax, the tax on non-metal mineral and rocks and the swallow nest tax. However, the potential revenues from these three latter taxes may be quite small.

Over time, there have been a few local taxes, which have been divided into two separate laws in the hopes of improving efficiency and effectiveness in administration. For example, the underground and surface-water taxes were separated, with the surface-water tax remaining at the provincial level and the ground-water tax being shifted to the LG. At the local level, the hotel and restaurant tax was divided into a separate tax for hotels and a separate tax for restaurants.

Finally, there were some new taxes which were given to the provincial level and to the local level. The cigarette tax, previously structured as shared revenues, was given to the provincial level. At the same time, the two property taxes (PBB and BPHTB) were given from the CG to the LG and the LG was given a new tax on swallow nests.

All provincial level taxes are structured as provincial level shared taxes, where revenues are divided between the provincial level and the local level governments. For example, the motor vehicle tax is shared (30%) with the kabupaten/kota level, based on principles of equality. The proceeds from the provincial cigarette tax are shared (70%) with

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58 Mahi (2002) argues that all local taxes tend to benefit urban areas more than rural areas due to the nature of the local tax base.
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the LGs, with the further stipulation that these cigarette revenues must be earmarked at least (50%) to finance public health services and law enforcement by the competent authorities.

Until the passage of Law Number 28 (2009), the basic allocation of revenues to PGs and LGs had varied only slightly over time. By passing Law Number 28 (2009), the Indonesian Government made two major changes; first, by reintroducing the closed list approach; and second, by taking the bold decision to devolve the rural and urban property tax and the property transfer tax to become local own revenues for the Kota and Kabupaten governments. Reintroduction of the closed list approach helped to reduce the damaging effects from the excessive proliferation of nuisance and highly distorted taxes to the economy. Shifting the property taxes to LGs now gives LGs a credible, potential source of local own revenues to support local autonomy and accountability. Let us now turn to better understand this property tax devolution experience, its challenges and prospects.

10.4. Property Tax Devolution in Indonesia

With the enactment of Law Number 28 (2009), the Government of Indonesia has taken a bold decision to shift the property taxes from being CG shared taxes to becoming LG own revenues. In line with theory and international practice, this shift provides LGs with a broader base of potentially stable and buoyant LG revenues, which can further support decentralization objectives. Through the devolution of these property taxes, Law Number 28 gives the Kota and Kabupaten governments responsibility and discretion to determine property tax rates, valuation exemptions and tax relief measures; and assigns LGs the full responsibility for property tax administration. This empowers them with the potential to mobilize substantial local own revenues within the framework of improving services to the public and ensuring local autonomy.

Law Number 28 stipulated a transition period of one year for BPHTB and four years for PBB, to allow LGs sufficient time to assume responsibility for these property taxes. Thus BPHTB was shifted to LGs in 2011 and PBB is to be shifted to LGs by 2014. The law provides that the CG will no longer be able to collect these property
tax revenues after these deadlines, while LG are given the option to tax or not to tax these property tax bases, depending on revenue yield and LG policy decisions.

It is important to understand the historical context of the property tax reforms within which the current property tax devolution reform was made more easily possible. The current property tax devolution reform follows a fundamental property tax policy and administrative reform which began in 1986, with the passage of PBB (Law Number 12 (1985).\textsuperscript{59} The PBB law consolidated seven different property taxes; shifted the tax basis from a rental value to a capital value system; simplified the tax rate structure; and introduced the basis for the development of an integrated property tax administration management system.\textsuperscript{60} The property tax also continued to be structured as a CG shared tax allocating 90% of collected revenues to the LGs.

The passage of the PBB Law marked the beginning of a series of reforms, which would serve to lay a strong foundation for the current property tax devolution. Following passage of the PBB Law, the government adopted an innovative ‘Collection-Led’ property tax reform strategy, which introduced the payment point collection system (Sistem Tempat Pembayaran/SISTEP). The SISTEP system was fully implemented throughout Indonesia by 1992, enabling the banking sector to efficiently receive and properly account for tax revenues. This SISTEP system significantly simplified revenue collection; improved accountability; reduced compliance and administration costs; and provided a delinquency list for enforcement purposes. This allowed the government to enforce against noncompliance for the first time, in 1991, with an historic property seizure—the first property seizure for property tax delinquency since Indonesian independence in 1945. Tax collection efficiency rose from an average of 65% to 79% of the assessments following SISTEP’s first year of implementation. Substantial progress was made in those early years of administrative


\textsuperscript{60}PBB was structured as a shared tax allocating 10% to the CG, 9% for collection costs, 18.2% for provinces and 62.8% to the Kota and Kabupaten levels. In 1994, the CG 10% was restructured to be allocated to LGs.
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reform, through capturing property information, improving property valuations and streamlining the revenue collection systems.  

Complementing these successful collection reforms, the government introduced a computer-based property tax administration management system (Sistem Manajemen Informasi Obyek Pajak/SISMIOP) which integrated newly-developed, rationalized administrative procedures with information processing technology to comprehensively manage all aspects of the fiscal cadastre, valuation, billing, collection, enforcement, and taxpayer service. This involved introducing a unique property identification number (Nomor Objek Pajak/NOP), along with various standard operating procedures (SOPs) for property tax administration related to property information (pendataan), valuation (penilaian), assessment (penetapan), collection (penerimaan), enforcement (penagihan), appeals and dispute resolution and taxpayer service. These SOPs were linked through the computer-assisted SISMIOP computerized property tax administration system, which was essentially rolled out nationwide by 1994. By the end of 1994, the PBB property tax structure and administration was modernized as an integrated property tax administration system. These SISMIOP property tax administration system and procedures are now being used nationwide by the regional tax service offices (Kantor Pelayanan Pajak/KPP) to administer the property tax with the full set of functionalities needed for property tax administration. This SISMIOP-based property tax administration system and procedures has been in operation for over 15 years managing the various property tax administrative functions. The challenge now is to identify options to adapt the existing property tax administrative system and procedures to the LG environment, modifying the various business processes and standard operating procedures and the SISMIOP IT system as needed.

In 1994, the government introduced three policy adjustments. First, the 10% CG allocation was shifted to LGs, with 35% uniformly allocated to all LGs as an ‘equalization’ component, and 65% as

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incentive payment for a LG to achieve their mandated revenue targets. Although the property tax remained a central shared tax, the revenue sharing ratio shifted 100% of revenues going to LGs. Second, the valuation deduction increased from Rp 7 million to Rp 8 million, and switched from one based only on building value to one based on the total land and building valuation and to one applied only once for each taxpayer.63 Third, the uniform assessment ratio was changed to one differentiated by property value and sector. High value urban properties over Rp 1 billion began using a 40% assessment ratio, which effectively doubled their statutory tax rate. Subsequently in 2000, the 40% assessment ratio was also applied to all rural properties over Rp 1 billion and to all estate and forestry properties.

In 1997, the government enacted Law Number 21 on Right Acquisition over Land and Building Tax (Bea Perolehan Hak atas Tanah dan Bangunan /BPHTB), hereafter referred to as the property transfer tax. The BPHTB was also structured as a shared tax, allocating 80% of revenue to LGs.

During the ‘Big Bang’ decentralization reforms in the early 2000s, there was intense debate on how the property taxes could be restructured to support the decentralization process. The first challenge was how to creatively enable a greater LG involvement in policy and administration and how to build local administrative capacity to implement the property tax in an efficient and equitable manner. The second challenge was how to overcome the strong political and institutional inertia of the property taxes as a CG shared revenues, administratively controlled by a centralized property tax administration under the Directorate General of Taxation, Ministry of Finance. In the end, there emerged no unified agreement among the divergent stakeholders; thus property taxes remained as CG shared revenues, with only a minor change in tax policy in 2001 to grant LGs discretion to set the valuation deduction

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63 The original valuation deduction was only on buildings because the policymakers in 1985 felt that everyone who owned land should ‘participate in development’ by paying at least a token amount through the property tax. Given the uncertainty in land titles, citizens preferred to pay the property tax in order to have a property tax receipt that provided evidence of ‘indicative ownership’, especially for low value property under customary ownership (Hak Girik). The policy change in 1994 for the first time exempted low value land from the property tax.
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threshold up to a maximum of Rp 12 million.\textsuperscript{64}

Against this long historic legacy and while overcoming the political and institutional resistance to change, through the implementation of Law Number 28, the government took the extremely bold policy decision to transform the property taxes from central shared revenues to become local own revenues confirming the government’s serious commitment to support sustainable fiscal decentralization.

This decision to shift the property tax from a shared tax to a local tax should not be considered the initiation of a new property tax reform per se but rather the initiation of a decentralization empowering reform which involves transferring a previously reformed, integrated property tax and administration system from the central to the local level. The reform focus now is not to ‘re-create’ a property tax administration system, as the fundamental system reforms were completed from 1988–1994; the current reform focus is on how to relocate this comprehensive, integrated system and procedures from the CG to LGs, making any appropriate adjustments and modifications as needed. This property tax devolution reform is now focused on empowering LGs to make policy choices, adapting property tax administration systems and procedures as needed to the LG environment, developing local capacity needed to administer the property taxes and ensuring the proper set of incentives to encourage LGs to fully utilize the property tax potential to generate sustainable revenues.

With Law Number 28, the policy and legal structure for devolving the property taxes is now in place. The government reform now is focused on aspects of practical implementation—providing the overall reform guidance, technical assistance and capacity building, developing the local level legal and regulatory framework, monitoring the adoption of local regulations, facilitating local level implementation and monitoring the results. The reform support team under the Directorate

\textsuperscript{64}Granting the LG power to set the valuation deduction was essentially a token gesture in support of the decentralization process, a policy decision that could only potentially decrease property tax revenues rather than increase revenues. The real policy discretion could have been given to LG to differentially set the assessment ratio within limits which could have increased real LG autonomy and control of the property tax, essentially turning the central shared tax into a type of local surcharge system (Kelly, 2004).
General of Fiscal Balance, Ministry of Finance, is operational. Socialization seminars have been held, along with ongoing consultative meetings among the key stakeholders at the policy, technical and institutional level. Supporting CG guidelines have been issued to guide LGs in the preparation process of assuming responsibility for the PBB and BPHTB. CG guidelines have been issued to support the implementation of the PBB and BPHTB. And various interim measures have been put into place to coordinate the transfer of technical and operational systems, information, and capacity from the Directorate General of Taxation to the LGs over the transition period.

As of January 2011, the BPHTB ceased being a CG shared tax, with full responsibility transferred to LGs. As expected, the ongoing transition is faced with various experiences, challenges and success stories as the necessary LG laws and regulations are being finalized and adopted to legalize the transfer of policy and administrative responsibility. Although the experience surely varies by LG, some preliminary information from a few LGs from West Java seem to indicate that BPHTB revenue collections are exceeding planned targets as well as exceeding actual collections from the previous year. Indeed the BPHTB revenue collections in those 26 LGs have increased several times the amount of revenues collected during the same period of the preceding year. Although further analysis is needed to identify the trends and lessons from the adoption of the BPHTB, it appears that the

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66 “Pedoman Tata Cara Pemungutan Bea Perolehan Hak Atas Tanah dan Bangunan (BPHTB)” (Government of Indonesia, MOF, 2010) which included a draft Regional Regulation (PERDA), Regional Head Regulation (PERBUP/PERWAL), and technical specifications for the computers needed to run the NJOP-retrieval software for verifying the BPHTB transaction values. These BPHTB guidelines were issued to help facilitate LGs prepare their own regional regulations and appropriate administrative systems. Subsequently a similar Pedoman was prepared to be issued for the PBB, once again to support LGs in taking on the responsibility for the policy and administration of the PBB.
67 This Ministry of Finance (2011) information is only indicative and may not be representative as it comes from a small sample of 26 LGs only from West Java based on revenues collected from January to March 2010 and January to March 2011. These data indicate an average increase of about 5 times in BPHTB revenue collections. Further analysis should be undertaken to identify the nationwide trends and lessons, controlling for such factors as LG location, size, and LG type (Kota or Kabupaten).
shift of the BPHTB to become local own revenue is generating the expected results.

Although some start-up transitional challenges were anticipated, there was general consensus that the BPHTB would be relatively easy for LGs to absorb into their current administrative structure since the BPHTB is administered on a ‘self assessment’ basis. Taxpayers are required to declare the property market value (Nilai Pasar Objek Pajak/NPOP) as the tax basis and to self-assess the tax liability owed to the Government. The law allows LGs to use the property sales value (Nilai Jual Objek Pajak/NJOP) as the minimum basis for calculating the BPHTB liability, to audit the declared NPOP by the taxpayer and to adjust the market value with penalty for under or misreporting. BPHTB administration procedures in general were similar to those administrative procedures used for such local taxes as the hotel tax, the entertainment tax and the restaurant tax. The initial experience with the devolution of the BPHTB appears to be moving in the right direction.

The government naturally focused initially on supporting the BPHTB, since that tax needed to be shifted to LGs by January 2011. Law No. 28, however, provided a longer transition time—up to January 2014—for the transfer of the rural and urban property tax, recognizing that the PBB devolution would be more complicated. There are many administrative functions related to PBB processes and taxpayer services which do not currently exist at the local level. These PBB-related systems, procedures and related capacity related to property information data collection, property valuation, tax assessment and distribution of tax bills, revenue collection, enforcement, appeals, and arrears management must be transferred and adopted by the LGs.

Because of wide differences in PBB revenue potential and administrative capacity among the 490 LGs in Indonesia, the government identified the need to classify LGs into several groups/clusters in order to design an appropriate implementation strategy for devolving the PBB to LGs.68 These revenue and institutional variations suggest the

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need for an asymmetric approach and strategy to ensure the smooth implementation of the PBB devolution process. As identified in Section 2 of this paper, the effective combination of the joint administration and local administration model of local administration will facilitate the successful devolution of the property taxes in Indonesia, as further elaborated below.

What are these LG groups/clusters? As Table 10.4 indicates, the first cluster includes those few highly urbanized LGs which tend to have higher value properties occupied by higher income individuals with the ability to pay higher property taxes. These 30 most urbanized LGS account for 70% of PBB revenues. The second cluster includes the 100 medium-urbanized LGs, which are expected to have high potential for increased property tax revenues. They currently account for about 20% of the PBB revenues. The third cluster includes the 360 less-urbanized/more rural LGs which account for only 10% of PBB revenues. These third cluster LGs tend to have numerous properties with lower property values and tend to have lower income residents with a resulting lower ability to pay.

Table 10.4. Profile of LGs in Indonesia for Property Tax Devolution Strategy

<table>
<thead>
<tr>
<th>LG Group</th>
<th>No. of LGs</th>
<th>% of LGs</th>
<th>% of PBB Revenues</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cluster 1. Highly Urbanized LGs</td>
<td>30</td>
<td>6%</td>
<td>70%</td>
</tr>
<tr>
<td>Cluster 2. Medium Urbanized LGs</td>
<td>100</td>
<td>20%</td>
<td>20%</td>
</tr>
<tr>
<td>Cluster 3. Less Urbanized LGs</td>
<td>360</td>
<td>74%</td>
<td>10%</td>
</tr>
</tbody>
</table>

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Although all LGs should be able to enhance downward accountability through implementing the property taxes, it is expected that only the highly-urbanized LGs and medium-urbanized LGs will be able to achieve any significant increases in property tax revenues which can support enhanced local autonomy. The remaining highly rural, non-urbanized LGs are expected to face major challenges to mobilize substantial revenue from the property tax. However, it is anticipated that many of these LGs may still be able to significantly improve their revenue collections as LGs take ownership and responsibility for mobilizing their own local revenues for development.

In designing a property tax devolution support strategy, it is important to be cognizant of these three groups, recognizing the achievable objectives, the importance of designing cost-effective administrative systems and procedures, and the specific type of needed institutional and technical support. The strategy for the more urbanized LGs (Cluster 1 and 2) should logically focus on increasing local revenue autonomy, while enhancing downward accountability; while the strategy for the highly rural, non-urbanized LGs (Cluster 3) should logically focus more on enhancing downward accountability while trying to maximize net property tax revenues through minimizing property tax administration costs. These three distinct clusters of LGs, with very unique characteristics, argue strongly for the need to adopt an asymmetric approach to supporting property tax devolution—allowing for the application of the local administration model for Cluster 1 and 2 LGs and the joint-administration model for Cluster 3, as previously outlined in Section 2.

Although not a direct fiscal issue, all three clusters of LGs should maintain the property tax records in order to support land tenure rights and land use planning. The property tax records (including information from the SPOP and from Buku C) are critical to the preservation of the customary land rights (Hak Girik) and as supporting documentation for the issuance of legal land titles. In this regard, it will be critical for all LGs to adopt the property tax as a way of ensuring that the property information is maintained for these other social reasons.

To encourage successful adoption of the PBB by all LGs, the CG will need to be strategic in establishing a framework and set of incentives
to allow LGs to adopt and implement the PBB in a cost effective, efficient manner. Differential approaches will be needed to support each of the three distinct clusters of LGs, with unique characteristics and requirements to ensure a successful devolution of the property tax in terms of the needed central level support, regional level support, IT support and institutional and the capacity development needs within each cluster.

Not all clusters can devolve all PBB administration simultaneously, especially those in Cluster 3 and some in Cluster 2. For these the transfer of administrative functions may need to be implemented in stages, relying on a joint administration model. For Cluster 1 and some in Cluster 2, LGs should be able to adopt all the administrative functions of devolution at once, implementing the property tax under a local administration model. However, for Cluster 3 and some of Cluster 2, it would be prudent to provide a joint administration model option so as to devolve only the appropriate administrative functions, while retaining some administrative functions at the central government level to take advantage of the economies of scale and to overcome LG capacity constraints.

In January 2011, the city of Surabaya became the first LG in Indonesia to take on the responsibility to implement PBB as a local own source revenue. As expected, Surabaya, as a Cluster 1 LG, adopted the local administration model. It will now be important to monitor the implementation experience of Surabaya to identify the challenges, opportunities and lessons for subsequent implementation of the PBB in other LGs, while continuing to explore options to facilitate a joint administration model for the more rural, less urbanized LGs.

In January 2011, the BPHTB was transferred to LGs, while the transfer of the PBB is now in process up to January 2014. With the devolution of property taxes in Indonesia underway, let us now conclude by exploring the opportunities to further strengthen local revenues from the property tax in Indonesia.

10.5. Conclusion and Recommendations

Local government revenue reforms in Indonesia have rationalized
the revenue taxonomy, shifted to a ‘closed’ list system with the inclusion of property taxes for LGs, and focused on both policy and administrative reforms. The foundation which has been laid should enable LGs to dramatically increase their own source revenue mobilization, thereby increasing LG autonomy and accountability.

The recent reforms introduced under Law Number 28 (2009) open the way for LGs to dramatically improve LG own revenues. PGs and LGs now have access to a combination of property-related taxes (recurrent property taxes and property transfer taxes), selective sales taxes on consumption of goods and services and various charges. Previously the exclusion of the property tax as a local tax was the one major anomaly in the Indonesian local revenue taxonomy. With the passage of Law Number 28 (2009), the local taxation system in Indonesia is now made largely consistent with the theory and international practice of revenue assignment.

With the general policy and administration framework now in place to enhance own source revenue mobilization, all LGs must now focus on the fundamentals of revenue administration such as identifying the tax base; capturing relevant tax base information; maintaining tax registries; valuing properties; levying taxes; issuing and delivering tax bills; collecting and accounting for tax collections; auditing self-assessed tax returns; taking action against non-compliance; handling appeals and dispute resolution; and providing taxpayer service. Priority must now be placed upon improving implementation through mobilizing strong local political will, building technical and operational capacity, enhancing taxpayer service/education and improving overall revenue administration.

Theory suggests that, where possible, tax administration functions should be structured to minimize costs and take advantage of economies of scale and overcome local capacity constraints. International experience identified two general models for managing local revenue mobilization, namely, a local administration model or a joint administration model. Under a local administration model, LGs are responsible for all administrative functions but may outsource those functions to third parties as appropriate. In contrast, under the joint administration model, the LG is responsible for certain functions with the option to outsource,
while other administrative functions are assigned to a higher-level government and/or third party, in accordance with government regulations. For example, as identified in section 2, the property valuation functions in Jamaica, Australia, New Zealand, and Malaysia are assigned to the Valuer General’s Department at the central or state level for economies of scale and equity reasons.

As identified in Indonesia, there are three distinct clusters of LGs, which may need different institutional options to enable successful implementation of the property taxes. Some LGs (e.g., Cluster 1 and some Cluster 2 LGs) should be able to assume responsibility and implement all PBB administration functions under the Local Administration Model. However, due to capacity and cost effectiveness issues, many more LGs (e.g., Cluster 3 and some Cluster 2 LGs) may need to have certain PBB administrative functions administered with support from third parties.

This latter group of LGs will need a Joint Administration Model option in order to reduce fixed overhead costs and overcome capacity constraints. Initially these LGs will need support to implement valuation and property data functions, mass printing and system support. Over time, as capacity is enhanced, some of these LGs will be able to become more actively involved in the fiscal cadastre (data and valuation) field operations. But these LGs may need a joint administration model to provide property valuation assistance for many years to come.

At least for the Cluster 3 LGs, the joint administration model is critical for the successful transfer of PBB to LGs, helping reduce overall costs of administration with regards to the maintenance of the fiscal cadastre system, mass printing and overall systems support. Even today in these Cluster 3 LGs, one CG KPP is administering property taxes for several LG jurisdictions, for reasons of economies of scale. The same need for a joint administration model will continue even after the PBB is transferred to become a LG own revenue, until there is a change in the underlying revenue and cost structure and LG capacity. There seems to be a general recognition that a joint administration model is necessary, but less agreement on how such a joint administration model should best be structured, financed and
regulated so as to maximize support to LGs to implement PBB in the most efficient and cost effective manner.

Reform sequencing is also critical to ensure proper alignment of political support, development of institutional, human and system capacity, mobilization of funding for implementation, taxpayer socialization, and central and local-level monitoring. The timing of activities during the transitional period will be critical to ensure highly visible progress, strong local ownership, and efficient and equitable revenue collection. The success of the property tax devolution process cannot be measured purely in terms of increased revenues, but also by the indicators measuring LG’s level of responsive and accountable governance, as perceived by residents.

Capacity development is critical at both the CG and LG levels. Central level capacity must be enhanced to enable CG to provide the oversight, guidance and support needed to ensure successful transfer, adoption and implementation of BPHTB and PBB as viable and effective local revenues. This implies shifting the mindset of CG officials from being direct implementers to becoming enablers and facilitators. Local level capacity must also be enhanced to take on the extra policy and administrative responsibilities, mobilize local political will and build technical/operational capacity to implement the property tax in an efficient and equitable manner. Indonesia will need to find creative ways of overcoming local level capacity constraints through various combinations, such as reallocating existing human resource between central and local governments, recruiting specialists with required skills, and/or building capacity within the existing LG personnel.

The property tax devolution reform is a dynamic process, requiring careful monitoring, analysis and adjustment over time to ensure success. While the 2009-2010 preparatory stage has laid out the legal foundation for the reform process, the immediate transition phase (2011-2014) is the critical implementation stage for the BPHTB and PBB reform process. Initial reform field implementation began in January 2011, with all LGs adopting BPHTB and with Kota Surabaya assuming responsibility for the PBB. The transition stage now underway will need strong political support, ongoing technical assistance, and effective implementation to fully realize the benefits of devolving the property
taxes to local governments.

The passage of Law Number 28 (2009) demonstrated strong political commitment to empowering and strengthening LGs with increased fiscal autonomy, improved local own source revenues and greater LG accountability to the communities. The legal foundation has been laid, and implementation is underway. A collaborative and supportive reform environment will be necessary to best ensure that LGs get the sustained support needed to successfully implement the property tax laws. Sustained political will at the highest levels of CG, in support of the devolution reforms, will be vital for the success of the reform. Successful implementation of the property tax devolution in Indonesia will assist in the achievement of the decentralization objectives of improved governance accountability and improved local public services.
SECTION E
Optimizing the Delivery of Public Infrastructure and Services
Fiscal Decentralization in Indonesia a Decade after Big Bang
11
Case Study of Service Delivery in Surakarta City, Indonesia

Joko Widodo, Mayor of Surakarta City

11.1. Introduction
During the period of 2005-2010, the Mayor of Surakarta City enjoyed the euphoria of political reform in the country. Within this atmosphere, a sense of democracy flourished. But in terms of people’s daily life, there was still a sense of crisis. Developing political stability was still at a critical point that required sustained efforts to increase people’s sense of economic and social empowerment. This situation could have led to a drop in trust in government and the failure of the reform agenda’s plan to implement local autonomy. At this point in time, the main objectives were: to provide/fulfill the basic needs of poor people in terms of health and education; to develop and promote small business and economic enterprise amongst low income people; to revitalize state-owner public spaces through urban infrastructure and improved facilities, to create a better city atmosphere that promoted an image of Surakarta being a friendly place to live, work and enjoy.

In 2006, it was strategically decided that the government would first tackle the problem of street vendors. At the time, 5,817 street vendors operated across five districts, occupying public spaces, storm drains and main roads throughout Surakarta. This created traffic problems and pollution; led to the formation of slum areas; and operated
in breach of several regulations. It was regular for the mayor to receive up to 60 messages a day, from citizens wanting this situation to be addressed.

Of these 5,817 street vendors, 989 vendors operating in Monumen 45, Banjasari, were selected to become a case-study for an historic shift in urban open-space planning that was developed through intensive consultation processes with LG branches, the Non Government Organization (NGO) SOMPIS, and local Central Business Districts (CBDs). The nature of these processes, which involved multiple stakeholders, meant there was a real risk of social conflict emerging. The mayor decided to take a leadership role in the process, from its beginning to its completion.

The lessons learned from this pilot project were utilized in developing further plans to develop and improve public spaces, such as: Balekambang Park, Ngarsopuro, the areas surrounding Vastenburg Fort, Manahan Stadium and the traditional market areas. Alongside these developments in infrastructure, it was also key to improve other areas under government control, such as subsidies for health, education and cultural events.

Since 2010, the city has managed to sustain and build upon the successes gained during this initial period, and has further added to the vision by pushing towards becoming an eco-cultural city. This will mean: developing further upon the idea of Solo as a cultural city, as a means to further improve the welfare of people and the city itself. The mission is to empower and improve the people’s economy; to foster a sense of ethics and cultural value; to strengthen the city’s character; to improve and broaden the availability of health and education services; to improve access to labor work; to improve the investment climate; to improve city infrastructure and facilities; and to the promote the city as a brand.

11.2. Background and Hypotheses

The location of Surakarta, with its access to the transportation system of metropolitan Java, gives it strategic advantages. Its incorporation of the government of the Islamic Mataram Kingdom—which includes Yogyakarta—further means it is an area that receives
crowds and urban facilities. The city has been predominantly built up (over 80%) without the benefit of natural resources. All the regencies surrounding the city’s developed urban area remain at the fringe of the city boundaries.

The city’s greatest potential resource lies in its heritage. Its advantages are reached through the management of three things: products—the provision of urban facilities and services; customers—tourists, investors, traders, exhibitions and events; and brands—the city’s image as an atmospheric, social and friendly environment that is culturally unique.

11.2.1. The Economic Life of Surakarta City

As set out in Tables 11.1 and 11.2 the city’s economic structure is dominated by trade and industrial processes and the hotel and hospitality industry. These two sectors contribute almost 50% of the city’s contribution to Gross Regional Domestic Product (GRDP). In the year

<table>
<thead>
<tr>
<th>Economic Sectors</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
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<tr>
<td>Agriculture</td>
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<td>0.06</td>
<td>0.06</td>
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</tr>
<tr>
<td>Mining</td>
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<td>0.04</td>
<td>0.04</td>
<td>0.04</td>
<td>0.03</td>
</tr>
<tr>
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<td>0.10</td>
<td>0.10</td>
<td>0.09</td>
</tr>
<tr>
<td>Industrial processing</td>
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<td>25.11</td>
<td>24.34</td>
<td>23.27</td>
<td>22.17</td>
</tr>
<tr>
<td>Electricity, Gas and Water Supply</td>
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<td>2.69</td>
<td>2.69</td>
<td>2.57</td>
<td>2.63</td>
</tr>
<tr>
<td>Secondary Sectors</td>
<td>41.90</td>
<td>40.87</td>
<td>41.80</td>
<td>40.28</td>
<td>39.73</td>
</tr>
<tr>
<td>Trades, Hotel and Restaurants</td>
<td>23.82</td>
<td>24.35</td>
<td>24.78</td>
<td>25.12</td>
<td>25.25</td>
</tr>
<tr>
<td>Transport and Communication</td>
<td>11.52</td>
<td>11.78</td>
<td>11.61</td>
<td>11.20</td>
<td>11.58</td>
</tr>
<tr>
<td>Finance, Leasing, Enterprises</td>
<td>11.43</td>
<td>11.26</td>
<td>11.06</td>
<td>10.93</td>
<td>10.88</td>
</tr>
<tr>
<td>Services</td>
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<tr>
<td>Tertiary Sectors</td>
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</tr>
<tr>
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<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
</tr>
</tbody>
</table>

Source: Badan Pusat Statistik Kota Surakarta (2010).
The variety of tourist sites and hotels in Surakarta city are more attractive to tourists than those in surrounding regencies. The income ratio to the overall Local Original Income (PAD) is the biggest in the area, and it is feasible that it will continue to grow in the future. The revitalization of the traditional markets has provided opportunities for accelerating the economy of low-income people and has further contributed to PAD. The entrepreneurial spirit of people has encouraged them to help themselves and access jobs in the informal sector—an area which is able to resist economic crisis.

The integration of transportation modes—which has connected the Adisumarmo Airport; the Batik Solo Trans-Railway and the Adisucipto Airport—has facilitated a greater mobility of passengers and goods from other regions in the country, thus encouraging global economic growth.

11.2.2. The Political Life of Surakata City

Surakarta City consists of five wards/districts (kecamatan), 51 sub-districts (kelurahan), 601 (rukun warga) and 2,708 local
Section E: Optimizing the Delivery of Public Infrastructure and Services

communities (rukun tetangga). Within the greater metropolitan area, Surakarta is considered to be a hub for the hinterland regencies: Boyolali, Sukoharjo, Karanganyar, and Wonogiri, Sragen dan Klaten. Within this area there is cooperation between the regencies. Further to this, there is also cooperation between the metropolitan hub of Central Java and the Yogyakarta provinces—referred to as Jogja-Solo-Semarang. These cooperative relationships are complementary to the region’s goals to provide better and cheaper public services for people.

11.2.3. Human Services in Surakata City

- A better HDI may provide resources to accelerate the city’s development;
- Higher education facilities are available, providing better opportunities compared to surrounding areas—especially Solo Raya;
- Health services are qualified to ISO 9001:2000; there are 9 local clinics (Puskesmas) with four Puskesmas providing overnight services; and
- Surakarta is the central delivery point for services—trade, finances, education and health—for surrounding areas. This will potentially allow the city to grow at a faster rate and become a destination for people wishing to improve their quality of life.

11.3. Revenue Sources for the Surakarta City Budget

The sources for city revenue consist of:

- Own source revenues (PAD), which consist of: regional taxes; regional charges and retributions; and other sources of legal, original, local income;
- Fiscal balance transfers, which consist of: shared taxes; the general transfer (DAU); and the special allocation grant (DAK); and
- Other sources of legal local income.

The 2011 Local Revenue Budget for Surakarta city has been based on the assumptions drawn from available data on revenue sources,
such as Pendapatan Asli Daerah, Dana Perimbangan and other sources of legal, original, local income. It stands at Rp 1.003 trillion which increased by Rp 133.4 billion—an increase of 15.4%—from the 2010 figure of Rp 870.2 billion.

Local revenue in 2011 consists of: fiscal balance transfers from the CG—worth Rp 642.1 billion, or 64.0% of the overall local revenue budget; PAD—worth Rp 159.2 billion, or 15.9%; and other revenues worth Rp 202.4 billion or 20.2%.

The City Government has imposed several revenue policies, to sustain local revenue growth. These include:

• Encouraging self-help in the local budget, through improvement in collection of own source revenues;
• Improving facilities and access for tax payers;
• Enhanced enforcement of tax and non tax provisions; and
• Implementing incentives and deterrents to improve management and collection of revenues.

11.4. Summary of City Development Strategies

Important city priorities have been to target the needs of the poor, especially in health, education and business development and to improve local spaces and infrastructure. Strong growth in local revenues has been promoted through the strengthening of user charges and disciplined collection approaches and has also been supported by strong national and local economic growth. Nine key initiatives have been taken as follows:

Firstly, development of a strong city vision and mission. The vision centres on improving people’s welfare and the cultural identity of the city. Important areas of the mission include: (i) strong local economy; (ii) strong ethics and cultural values; (iii) strong city character and recognizable brand name; (iv) a city providing excellent health and education services; (v) employment promotion; (vi) conducive environment for investment; and (vii) improvements to and good maintenance of city infrastructure.

Second, developing policies for street vendors, including market place revitalization. Previously almost 6,000 vendors were creating traffic problems, pollution and a worsening of slum areas. Following
consultations a pilot project involving almost 1,000 vendors was introduced through new open space planning for vendors. This experiment was later expanded to other areas and vendors.

Third, improvements to slums and low cost housing, including renovation and relocation; and greening of urban areas. Fourth and closely related were improvements to community sanitation, including renovations and extensions to public toilets.

Fifth, new focus was given to improvement and development of transport hubs—air, road and rail—which were linked to growth in trade, commerce, education, health services; and tourism.

Sixth, Surakarta was strongly promoted as a cultural city for domestic and international tourism as well as to promote citizen pride. The cities strong cultural heritage has helped to foster strong feelings of cultural identity and has boosted the investment climate and business development. Initiatives have included opening of parks and city spaces; and car free days in major streets.

Seventh, health and education subsidies were introduced for the poor with introduction of silver, gold and platinum subsidy cards (highest subsidies go to the very poorest families). The city is promoted as a hub for good health and education services.

Eighth, business and trade development are strongly promoted. This has included support to vocational schools, a technology park, one stop licensing and other facilities and a strong emphasis on building the environment for business development.

Ninth there has been a strong focus on promoting social improvements. There has been very close monitoring of trends in the Human Development Index which has been improving.
12

Case Study of Service Delivery,
Gorontalo Province, Indonesia

Professor Dr. Winarni Monarfa, Head of the Provincial Planning Office, Gorontalo Province

12.1. Introduction

Gorontalo, the 32nd province of Indonesia, was established on February 16 2001, pursuant to Law 38 (2000). It was created out of a mother province called North Sulawesi, and has a territorial width of 12,215.44 km² (0.64% of the width of the Republic of Indonesia). Administratively, Gorontalo is divided into six districts/cities; 70 sub-districts; and 698 villages/urban districts (kelurahan) that house 1,038,585 people.

Gorontalo is aware of its limited access to natural resources that could help the region develop a competitive advantage. Gorontalo has a substantial portion of poor people (34.23% of the population); and scarce basic infrastructure, that has to be addressed with only Rp 75.62 billion (provided in the provincial budget) and Rp 73.38 billion (provided through the central budget).

12.2. Gorontalo Development Strategy

An innovative development strategy has been implemented, in an effort to compensate for the area’s limitations. This strategy is outlined below.
12.2.1. Defining a Vision

Development represents a series of efforts, constantly made, with the aim of improving public welfare. These efforts utilize available resources—natural resources, human resources and developments in science and technology—while also considering the wider challenges posed by global developments. From this perspective, the purpose of a local development policy is to address poverty and its underlying causes; to formulate local development objectives; and to help improve the material and spiritual wellbeing of local people.

Considering these points, the 2007–2012 Medium-Term Development Plan for Gorontalo Province decided upon a vision of: “Gorontalo as an innovative province,” with an overall aim to “achieve a Gorontalo community that was independent, productive and religious.” To achieve this vision, a four point agenda was developed:

- Implement a business-oriented approach to governance, that focuses on action and result-based performance, in the hopes of promoting community confidence;
- Develop available human resources to improve independence; make them more business-oriented; and religious;
- Promote a village-based people’s economy by improving the performance of specialty sectors that support the local economy; and
- Promote the development of efficient technologies that may improve public welfare.

In pursuit of a focused development program; he Gorontalo PG has decided upon three priority programs, aimed at fostering development in the area, namely:

- Human resource development: it is critical to expedite the improvement of human resources, to foster a culture of entrepreneurship, as a way of accelerating development through an area-based education model;
- Agricultural development (starting with focus on corn production). Agricultural development shall be sped-up by the implementation of a corn-based agro-political program with nine agro-political pillars; and
• Fisheries development: Development of the fishery sector and coastal areas shall be promoted through an 11-pillar fisheries system, showcased in Mina Bahari.

12.2.2. Bureaucratic Reform

Bureaucratic reform is done as needed, in response to the complex and heterogeneous demands from the community, who require their LG to improve efficiency and trim costs.

Key to the success of bureaucratic reform, is the level of political will from government, staff and managers, to support the community sector and various stakeholders; and to promote time efficiency, flexible approaches to financial sources and the implementation of information technology;

The implementation of bureaucratic reform in Gorontalo will require:
• Financial reform, including: reform of legal and governance structures; improvement of systems and procedures; developing human resources and institutions; and shifting local performance subsidies; and
• Personnel reform, including improving: personnel management; training and education approaches to human-resource development; and job tendering and performance contract procedures.

12.2.3. Developing Networks and Cooperation

To speed up local development, the Gorontalo PG continues to pursue points for cooperation at the regional, national and international level.

As of 2010, the Gorontalo PG had participated in a number of cooperative efforts, including work with 11 Indonesian universities, 13 provincial/district and city governments across Indonesia, five countries and seven different international donor agencies.

In addition to the four strategies that have been completed, numerous policies and approaches have been developed in the context of expediting the improvement of local development. These include:
Section E: Optimizing the Delivery of Public Infrastructure and Services

- A policy on provincial budget allocation, that makes direct (public) expenditure larger than personnel expenditure at a 60:40 ratio, from 2001–2010;
- Providing limited government intervention to support specialty programs—particularly in the agricultural (corn) and fisheries sectors. In a limited way, the government controls market prices for corn and fish. When corn and fish prices drop to levels below specified basic prices, the government is obligated to buy them, to prevent losses to farmers and fishermen and maintain their dedication to developing agriculture and fishing in the area;
- The preparation of a report for the UN Development Project’s Human Development Index (HDI). Since 2009, UNDP has, in cooperation with the Indonesian Agency of National Development and Planning (Bappenas), worked to identify 15 sub-districts in Gorontalo with an HDI that is lower than the provincial average. Subsequently, the Gorontalo PG was able to develop a planning model, based on the HDI, that placed focus on these 15 areas;
- The preparation of an Expenditure Analysis Document—developed in conjunction with the World Bank in 2007—to review the allocation of public expenditure from the PG’s local budget;
- The preparation of an MDG Budget Plan (2011). The MDGs are an international commitment that has been followed-up through Presidential Instruction No.3 (2010). To speed-up the achievement of the MDGs, the Gorontalo PG has developed a budget for realizing these goals; and
- The preparation of an Infrastructure Master Plan (2010) to provide LGs with input on planning for future infrastructure developments. Guidance is provided on: identifying strategic locations for infrastructure plans; mapping strategic point for infrastructure for each sub-district capital; and planning infrastructure priorities.

12.3. Development Performance

For a decade, the development strategies employed by the Gorontalo PG, have shown positive results, leading to meaningful progress in the macro economy.
12.3.1. Growth in the Economy and Gross Regional Domestic Product

Economic growth in the area has shown upward trends (see Figure 12.1)—6.5% in 2002 to 7.6% in 2010. This is higher than the national average of 6.1%. This economic growth has led to an increase in the level of income per capita in the Gorontalo community—which in 2010 reached Rp 7,720,000.

Figure 12.1. National and Gorontalo Growth, 2002–2010 (%)

Source: Gorontalo Provincial Government

12.3.2. Poverty and Human Development Index

The rate of poverty in Gorontalo has considerably decreased, from 32.1% in 2002, to 23.3% in 2010 (Figure 12.2). In 2010, it decreased by 4.4%, to 18.8%. This decrease represents the third largest drop by national standards. The percentage of poor people in Gorontalo is still below the national average and more stringent measures have been undertaken to further reduce this poverty figure. The HDI, as a measurement rod for government success, has also shown steady improvement from 2002 (64.1) to 2009 (69.8).
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**Figure 12.2. National and Gorontalo Poverty Rates, 2002–2011 (%)**

![Graph showing poverty rates](image)

Source: Gorontalo Provincial Government

**12.3.3. Open Unemployment**

The figures for open unemployment show an outstanding decrease, from 9.3% in 2002, to 5.2% in 2010 (See Figure 12.3).

**Figure 12.3. Open Unemployment in Gorontalo, 2002–2010 (%)**

![Bar graph showing open unemployment](image)

Source: Gorontalo Provincial Government
12.3.4. The Millennium Development Goals

As of 2009, Gorontalo ranked 13th nationally, in terms of progress on the MDGs (See Figure 12.4).

Figure 12.4. Attainment of MDGs, by Province, 2009 (%)

Source: Gorontalo Provincial Government

12.3.5. Infrastructure

There are various infrastructure facilities constantly being constructed by LGs, such as facilities for water supply and sanitation. In 2010, access to reasonable sanitation reached 45.7% of the 75% target set by the MDGs for 2015. Urban water supply reached 67.5% of the 85% target set. Various access roads were also constructed, to connect production centers used by the agricultural and fishing industries. Until 2010, access roads constructed and funded by the PG budget spanned 164 Kilometers. Up to 2010, construction of decent housing for the poor amounted to over 5,000 units. Further progress has been made in developing Gorontalo’s Djalaludin Airport; and in constructing various pass-roads and canals to prevent flooding. Other basic infrastructure has been developed to support the local economy and further reduce poverty rates.
12.4. Conclusions and Recommendations

For the International Conference on Fiscal Decentralization, several recommendations were provided, on how to consider allocating DAK funds. These included the following:

Adjust the criteria for allocating the DAK: According to the general criteria for the DAK, the recipient is evaluated according to the value of personnel expenditure allocation: the larger the allocation of personnel expenditure, the greater the opportunity for DAK allocation. The conditions in Gorontalo do not adhere to these principles of DAK allocation. The Gorontalo PG always allocates higher direct expenditure than indirect. As a consequence, the province has only received DAK for one sector in the last 10 years.

Increase DAK allocation (by reducing de-concentration funding): This would mean more expenditure allocation for physical (investment) activities. DAK is more oriented to physical investment activities, and de-concentration funding to non-physical activities.

Pay attention to HDI conditions: It is high time to pay attention to these conditions when allocating budgets to regions, so that LGs with a low HDI and limited fiscal capacities are given larger budget allocations.

Consider LGs allocating more funds to direct expenditure: The indicators used for DAK allocation are population, territorial width and others, but it is important to consider LGs allocating more funds to direct expenditure than indirect. These LGs should be rewarded for their pro-public and pro development policies. It is counterproductive for the national government to reward LGs from an administrative perspective (for example, rewarding LGs that get favorable audit opinions.) Rather, rewards should be given for policy that promotes pro-public and pro development budgets.

The application of territorial development is important: The notions of territorial development, as outlined in Book III of the National Medium-Term Development Plan and the KEI Master Plan, should be followed in terms of a policy of a more technical nature to guide infrastructure construction in the regions.
13
Options for Financing SNGs in Indonesia

Dr. Anwar Shah

13.1. Introduction

In Indonesia, Provincial and local government reforms continue to dominate the national policy agenda, in spite of the already extensive suite of legislative and administrative changes that have occurred since 1999, to affect the organization, function and finances of sub-national governments. Over the last decade, Indonesia has progressed a long way from its original centralized system and now ranks among the most decentralized countries in the developing world (see Figure 13.1). Indonesia quite remarkably achieved this status without experiencing any service delivery disruptions, even during the early stages of rapid transformation. Today the Government of Indonesia is reviewing all aspects of local governance to make appropriate legal and institutional adjustments, based upon the lessons learned over the past decade. An important area ripe for this re-examination and possible reform is the central financing of sub-national expenditures. The system of intergovernmental finance in vogue today represents one of the most complex systems ever implemented by any government in the world. The system primarily takes a gap-filling approach to provincial-local finance, in an objective manner, to ensure revenue adequacy and local autonomy, but without accountability to local residents for service delivery performance. This system relies on academic rigor and highly
complex procedures to provide precise justice and keep politics at bay.

Do these complex programs serve their explicitly stated objectives? This paper takes a closer look at selected major programs of central transfers provided to finance provincial-local government expenditures in Indonesia. It concludes that, super complexity leads to a lack of transparency, inequity and uncertainty in allocation. Simpler alternatives are available that have the potential to address equity objectives, while also enhancing efficiency and citizen-based accountability. Such alternatives would represent a move away from complex gap-filling and special allocation approaches, to simple output-based transfers to finance operating expenditures. These would be complemented by capital grants designed to address infrastructure deficiencies and assist with establishing fiscal capacity equalization as a residual program. Fiscal capacity equalization programs would hold explicit standards, to ensure that all local jurisdictions had adequate means to deliver reasonably comparable levels of public services at reasonably comparable levels

Figure 13.1. SNG Shares of Total National Expenditure (%)

Fiscal Decentralization in Indonesia a Decade after Big Bang

of tax burdens across the country. This paper argues that such an alternative system of intergovernmental finance would preserve autonomy, while enhancing equity, simplicity, objectivity, transparency and accountability.

13.2. An Overview of Provincial-Local Finances in Indonesia

Indonesia’s political and administrative system consists of three formal government levels, (i) the central; (ii) the provincial; and (iii) the district/urban municipalities. In addition to this, there are unincorporated villages in both urban and rural areas. Currently there are 33 provinces, 405 districts, 97 cities, 6,543 sub districts and 75,244 villages (out of which, roughly 12,000 are urban villages). Both the sub-districts and villages do not have formal LGs. The average population of a province is around 7 million people—ranging from fewer than 1 million in North Mollucu to more than 38 million in West Java. The average population under Indonesian LGs (including rural districts and urban municipalities) is about 500,000 people—a rather large number, by international standards. There is a wide diversity in provincial sizes, which range from fewer than 25,000 in sparsely populated areas like Sabang, to almost 4 million in metropolitan areas like Bandung. Some of these jurisdictions might in fact be too large, whereas others might be too small to deliver services efficiently.

Local governments differ vastly in their geographic and socioeconomic characteristics. Per capita incomes in the richest 20% of districts are more than three times higher than in the poorest 20% of districts. This uneven distribution of economic activity is reflected in the large disparities seen in living conditions. Poverty rates range from about 7% in the industrialized district of Bekasi at the fringe of Jakarta, to more than 40% in the West Sumba district in the eastern part of Indonesia. Illiteracy in the East Javanese district of Sampang is still more than 40%, though it has decreased to 12% for Indonesia as a whole. And though about 98% of people in Tanjung Jabung Barat in the province of Jambi have access to primary health care, only 22% do in Sintang in West Kalimantan. This heterogeneity potentially increases the benefits of decentralization, but it also places considerable pressure on the fiscal system to ensure minimum standards are met with regards
Section E: Optimizing the Delivery of Public Infrastructure and Services

to the quantity, quality, and access to public services, in order to allow for the convergence of living conditions across Indonesia’s LG areas.69

Indonesia retained a centralized unitary government structure until 1999. In May 1999, President Bacharuddin Jusuf Habibe supported the enactment of major legislation, that stipulated that a new division of powers be created among the different tiers of government. Through the enactment of Law 22 (1999) on regional governance, responsibility for much government expenditure was decentralized—largely to local (district) governments rather than PGs. Law 25 (1999), on fiscal balance between the CG and the regions channeled budgetary flows to the district level. Subsequently in September 2004, the parliament approved Law 32 (2004) on sub-national governance and Law 33 (2004) on fiscal decentralization, thereby reinforcing Indonesia’s efforts to create a decentralized system of governance.

Article 18 of the 1945 Constitution provides for the creation and maintenance of LGs through the enactment of a LG Act. The decentralization laws of 1999 and 2004, and associated regulations, are the basis for Indonesia’s current LG system. The Second Constitutional Amendment Act (2000), has embedded parts of the decentralization reforms—for example, the democratic elections of mayors and governors—into the Constitution, to ensure the long-term stability of the system and to provide political safeguards against arbitrary reversals.

The resources placed at the disposal of LGs have been increased through the enactment of article 7 of Law 25 (1999), which required the CG to transfer at least 25% of domestic net revenues (total domestic revenue minus revenue sharing) to sub-national levels of government. As of 2008, Law 33 (2004) has increased the sub-national share to a minimum of 26% of net domestic revenue. 10% of that amount accrues to the provincial governments and 90% to the LGs, which carry out the bulk of expenditure responsibilities.

Overall, in 2008, the CG accounted for 95% of revenue collection and 67% of direct spending. Provinces and LGs account for 5% of

revenue collection and 33% of expenditures. PGs are relatively less important than LGs and command only 8% of national expenditures. LG expenditure share (25%) in Indonesia compares favorably with most developing and industrial countries (see Figure 13.2).

**Figure 13.2. Indonesia, Expenditure, Employment and Revenue Collection Shares by Government Level**

![Pie charts showing expenditure, employment, and revenue shares by government level.](source: Ministry of Finance and Eckardt and Shah (2007))

### 13.2.1. Sub-National Expenditure Responsibilities

Indonesia’s decentralization policy shifted responsibility for all but five exclusive national functions to regional governments. According to Laws 22 and 32 the national government retained power over five functions that affect the nation: foreign relations, defense and security policy, judiciary and law enforcement, monetary and macroeconomic policies, and religious affairs. Sub-national governments are responsible for all residual functions. In addition, Law 22 spells out 11 obligatory functions for LGs (See Figure 13.3). The revised Law 32 (2004) removed the omnibus assignment of the residual functions to regional governments; stipulated 15 obligatory functions, and a number of discretionary functions.

Decentralization policies have mainly placed emphasis on the third tier of government because provinces were perceived as potential drivers of political disintegration. Compared with LGs, provinces have far more limited responsibilities—a fact that is also reflected in their much
smaller share of expenditures. The provincial level has a double role as an autonomous regional government and as the regional representative of the national government. Provinces are mainly responsible for supervisory functions and are supposed to intervene in matters that require cross-jurisdictional cooperation. Law 32 explicitly strengthens the coordinating role of provincial governments as regional representatives of the CG, a step that was based on the perception that closer central supervision and oversight were needed to make decentralization work more effectively.

In practice, the distribution of specific responsibilities is regulated by a number of sectoral laws, numerous government regulations and ministerial decrees. For most sectors, responsibilities are shared among government levels—with the national government also involved in formally decentralized sectors. A national role in most of the sectors listed may be helpful, provided that it does not reinstate central bureaucratic controls and that focus remains on providing financial and technical support and service delivery oversight. For example, equity concerns might necessitate a strong national role in financing and regulating standards of basic public services, such as education and health. At present, national development (capital) expenditures represent more than 60% of total development spending, including significant outlays in decentralized service sectors, such as health.

Table 13.1. Obligatory Functions under Laws 22 of 1999 and 32 of 2004

<table>
<thead>
<tr>
<th>Law 22/1999 Functions</th>
<th>Law 32/2004 Functions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Infrastructure (public works)</td>
<td>Development planning and control</td>
</tr>
<tr>
<td>Health</td>
<td>Planning, utilization, and supervision of zoning</td>
</tr>
<tr>
<td>Education</td>
<td>Public order and peace</td>
</tr>
<tr>
<td>Agriculture</td>
<td>Providing public means and facilities</td>
</tr>
<tr>
<td>Communication</td>
<td>Handling of health sector</td>
</tr>
<tr>
<td>Industry and trade</td>
<td>Education</td>
</tr>
<tr>
<td>Cooperatives</td>
<td>Social affairs</td>
</tr>
<tr>
<td>Land administration and zoning</td>
<td>Employment promotion</td>
</tr>
<tr>
<td>Capital investments</td>
<td>Facilitating the development of cooperatives and small and</td>
</tr>
<tr>
<td>Environment</td>
<td>medium-size businesses</td>
</tr>
<tr>
<td>Employment promotion</td>
<td>Environment</td>
</tr>
<tr>
<td></td>
<td>Agriculture</td>
</tr>
<tr>
<td></td>
<td>Demographics and civil registry</td>
</tr>
<tr>
<td></td>
<td>Administration affairs</td>
</tr>
<tr>
<td></td>
<td>Capital investment</td>
</tr>
<tr>
<td></td>
<td>Other mandatory affairs in laws and regulations</td>
</tr>
</tbody>
</table>

education, and infrastructure. This trend suggests that the implementation of decentralization is still lagging in some sectors.

Eckardt and Shah (2007) report that LGs account for roughly half of the total wage bill. With decentralization, wage costs increased significantly, as a consequence of civil servants being transferred to the jurisdiction of sub-national governments. These increased costs placed a significant burden on LG budgets. Indeed, in the aggregate, the expenditure side of LG budgets is dominated by wage costs, which account for about half of total LG expenditures. There is significant variation across LGs, with wage cost shares ranging from 10% to more than 90%, depending on the district. Local budgets in most districts are heavily skewed toward operating expenditures, leaving few funds for much-needed capital spending. Most local public services are labor intensive and significant shares of the public payroll are allocated to cover personnel expenses related to service delivery—including the salaries of teachers, doctors, and health care workers. However, the country’s largely depreciated infrastructure (for example, elementary school buildings, medical equipment) suggests that higher capital expenditures might be needed to provide high-quality services. In the long run, underinvestment in infrastructure will most certainly lead to quality reductions and efficiency losses in public service delivery.

13.2.2. Sub-National Taxing Powers

Provinces have access to motor vehicles registration and transfer taxes and fuel and water excises. They finance 43.8% of expenditures from these sources. In addition, they also receive specified shares of revenues from personal income taxes, property taxes, oil and gas taxes, and mining and forestry royalties. Tax sharing for income and resource taxes accounts for an additional 24.5% of revenues; other revenues about 10%; and the remaining fiscal gap is filled by DAU grants worth 21.1% and specific and DAK grants worth 1.8%. In 2008, 50% of provincial expenditures were financed by central transfers.

Districts have access to hotel, restaurant, entertainment, advertisement, street lighting taxes, mining taxes for class C minerals and parking charges and user fees. These sources finance only 6.5% of district expenditures. They will soon also have access to property taxes.
Section E: Optimizing the Delivery of Public Infrastructure and Services

as own source revenues. In addition to these they receive: 17% from tax sharing from the same revenue sources as the provinces; 10% as miscellaneous revenues; and 61% from general purpose and 8% from specific purpose transfers. In 2008, 90% of district and city expenditures were financed by central transfers.

13.3. Central Transfers in Indonesia: A Review

13.3.1. A Synopsis of Central Transfers

Central transfers are the most important source of revenue for sub-national governments in Indonesia. In 2010, central transfers financed 90% of sub-national governments, 54% of provincial, 86% of cities and 93% of district expenditures. Major transfers (balance grants) to finance provincial and local expenditures are set out in Table13.1.

<table>
<thead>
<tr>
<th>Transfer Type</th>
<th>Share of Total CG Transfers</th>
<th>Share of SNG Expenditures</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tax Sharing (DBH)</td>
<td>25%</td>
<td>20%</td>
</tr>
<tr>
<td>Gap Filling (DAU)</td>
<td>56%</td>
<td>46%</td>
</tr>
<tr>
<td>Specific Purpose Grants (DAK)</td>
<td>6%</td>
<td>5%</td>
</tr>
<tr>
<td>Other Specific Purpose Grants</td>
<td>13%</td>
<td>10%</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>100%</strong></td>
<td><strong>90%</strong></td>
</tr>
</tbody>
</table>

(Provinces = 54%; Cities = 86%; Districts = 93%)

Source: Ministry of Finance, Indonesia

**Tax sharing**

Central Government collects taxes on personal income, property, and renewable and non-renewable natural resources, and returns by origin a pre-defined share of the revenues to the originating jurisdiction. These transfers accounted for 25% of total central transfers in 2010 and financed 20% of sub-national expenditures.

**Vertical and horizontal fiscal gaps**

The Central Government provides a basic allocation for wages and salaries and a fiscal gap transfer (DAU) if a jurisdiction’s revenues fall short of calculated expenditure needs using macro indicators. These
transfers accounted for 56% of total central transfers and financed 46% of sub-national expenditures.

Specific purpose grants

These grants include the DAK; special autonomy grants for Aceh, Papua and Papua Barat; adjustment fund compensation; Special Incentives Grants (DID); and other grants (Hibah). DAK is intended to influence LG spending on areas of national priority. It accounts for 6% of central transfers and finances 5% of sub-national expenditures. Adjustment Fund compensation provides special ad hoc assistance for school operational assistance, allowances for certified teachers etc. Special Autonomy grants are intended to provide special and preferential support to the Aceh and Papua provinces. DID is a small grant program accounting for less than 1% of total transfers (and are granted to provinces and cities that are performing better on public financial management, tax efforts, having higher HDI relative to fiscal capacity, higher economic growth, higher reductions in poverty, unemployment and inflation). Hibah transfers are primarily financed by external assistance and are intended to finance sub-national infrastructure and social development expenditures. Specific purpose transfers in total accounted for 19% of central transfers in 2010, and financed 15% of sub-national expenditures.\(^{70}\)

13.4. Tax Sharing Arrangements in Indonesia

Indonesia has instituted an elaborate tax by tax sharing system for major sources of revenues other than custom duties and corporate income taxes. Shared taxes (other than personal income taxes, oil and gas revenues) see the majority of revenues returned, mostly by origin, to provinces and districts using pre-defined legislated shares. For forestry and mining revenues, the CG retains only 20% of revenues and the remaining 80% of revenues are distributed to provinces and LGs— with originating governments receiving a commanding share. For fisheries, the remaining 80% of royalty revenues are distributed to all

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LGs. Some 91% of property taxes are shared using mixed criteria. The CG retains only 9% of property tax revenues as the cost of collecting this tax. Only 20% of personal income taxes are shared using place of work as the criterion. In addition to sharing revenues from central revenues, LGs also receive a fixed share of revenues from four provincially collected taxes—motor vehicle tax, vehicle transfer tax, fuel excise tax and groundwater extraction and use tax.

The tax sharing system adopted by Indonesia is quite transparent and enables the Government of Indonesia to maintain a harmonized tax system with lower costs of tax administration. Nevertheless, the system suffers from a number of limitations. For most of the shared taxes, tax base sharing—with PGs and LGs opting to levy supplementary rates—might be a superior alternative to current arrangements. Tax base sharing has the potential to introduce greater accountability in the system, as LGs would have to justify tax rate imposition to local electorates. If tax base sharing is ruled out as an option then it would be better to consider using taxpayer place of residence as the criterion for allocation of personal income tax revenues. Such a criterion will lead to greater jurisdictional equity, as it will enable residential communities to recoup revenues to provide residential services. The real property tax is currently being devolved to LGs as it is truly a local tax—a tax on immobile base with LGs having better information and also as a benefit tax for local services. However, it may be advisable to devolve this tax fully to urban LGs only. In the interest of tax base harmonization and considering capacity constraints of rural LGs, central determination of tax base and tax collection may be retained while devolving responsibility for tax rate determination to rural LGs.

Sharing of resource revenues represents a difficult challenge in any multi-order governance system, whether unitary or federal. Political cohesion and environmental protection considerations require preferential access of resource revenues to producing regions. Economic and social unions require national ownership and sharing of resource wealth. A decentralized resource rent tax regime creates both fiscal inefficiencies and inequities. Fiscal inefficiency is created by mobility of labor and capital, to capture resource rents accruing to the resource rich jurisdiction. Fiscal inequity arises from citizens being treated differently
depending upon their place of residence. Of course royalties, fees, severance, production, output and property taxes related to resources and conservation charges can be suitably devolved to state and LGs to enable them to provide services for resource exploitation and environmental conservation.

Natural resources in Indonesia according to articles 18 and 33 of the Constitution should belong to the nation as a whole. However article 18 A (2) gives some flexibility to the Government of Indonesia to institute revenue sharing arrangements. Recognizing this, the sharing of natural resources revenues—especially oil and gas revenues—contributes to the long felt grievances of resource rich jurisdictions, that they bear the costs of exploitation, while the benefits accrue to the CG. Current tax sharing arrangements try to tread a middle ground in addressing the concerns of the producing provinces and the national equity objectives. However, DAU—the gap filling transfer, mostly (95% in 2011) nullifies the gains of producing provinces and partially (63%) nullifies this for the producing districts as their entitlements for central gap filling transfer is reduced by inclusion of the stated percentage of revenues as part of the fiscal capacity.

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**Box 13.1. Sharing of Natural Resource Revenue**

<table>
<thead>
<tr>
<th>Sharing of natural resource revenues. What is ideal is often not politically feasible</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Ideal:</strong> All net oil and gas revenues are deposited in a heritage trust fund (Norwegian style) owned by all citizens regardless of their place of residence. The assets of this fund are held in perpetuity and could not be drawn down but capital income will be available for current use. All citizens hold equal shares in the trust fund and every citizen receives an annual dividend from this income and a fraction of income is distributed to governments.</td>
</tr>
<tr>
<td><strong>Second best solution:</strong> Centralization of resource rent taxes redistributed through a central fiscal equalization program. Or alternately decentralization of resource rent taxes accompanied by inter-provincial net equalization program where rich provinces contribute to the pool and poorer provinces receive payments from the pool.</td>
</tr>
</tbody>
</table>

Source: Author
13.5. The General Purpose Gap Filling Transfer

13.5.1. DAU: An Overview

The DAU according to Law 34 (2004) is intended to balance revenue means with expenditure needs for sub-national governments, in order to provide central financing in a proportionate, democratic, fair and transparent manner, by taking into account the local potential (fiscal capacity) and conditions and local needs. In 2011, the total pool of this transfer is arbitrarily set at 26% of the central revenues net of tax sharing transfers. 10% of the total pool is allocated to provinces and the remaining 90% to all cities and districts. DAU provides a basic allocation to cover wages in the provinces, cities and districts. Remaining funds are allocated by a formula that determines fiscal gap based upon the differences between fiscal needs and fiscal capacity. The formula factors for both provinces and cities are the same, but receive differential weights due to the peculiar nature of the DAU allocation which has weighted coefficients of variation—the so called Williamson’s Index (see Tables 13.2 and 13.3). The DAU constitutes the dominant source of revenues for provincial and LGs.

Table 13.3. Williamson’s Index, the Equalization Standard in Indonesia, 2005–2011

<table>
<thead>
<tr>
<th></th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
</tr>
</thead>
<tbody>
<tr>
<td>Provinces</td>
<td>0.941</td>
<td>0.769</td>
<td>0.975</td>
<td>0.793</td>
<td>0.802</td>
<td>0.836</td>
<td>0.801</td>
</tr>
<tr>
<td>Cities / Districts</td>
<td>0.630</td>
<td>0.678</td>
<td>0.699</td>
<td>0.710</td>
<td>0.690</td>
<td>0.718</td>
<td>0.694</td>
</tr>
</tbody>
</table>

Source: Ministry of Finance, Government of Indonesia

The fiscal capacity of a province is determined by adding together the 50% of own source revenues, 80% of non-resource tax sharing and 95% of resource and mining tax sharing. The fiscal capacity of a city or district government on the other hand is based upon 93% of own source revenues, 100% of non-resource tax revenue sharing and 63% of resources and mining tax revenue sharing. The weight placed on individual revenue sources to determine fiscal capacity, varies from year to year, as weights are elevated to achieve a given numerical
value for the Williamson’s index. Table 13.2 provides these choices for numerical values of the index for the past few years.

The fiscal needs of provinces and cities/districts are determined separately for each of this group, by developing a composite index based upon relative population, relative area, relative construction price index, the inverse of HDI and the inverse of relative nominal per capita GDP. The weights for the above mentioned factors vary for provinces and districts/cities, and over time, for each group, based upon the specified value to be achieved for the Williamson’s index (see Table 8). The resulting indexes are multiplied by the per capita aggregate spending for the past year to arrive at numerical values of the expenditure need component. The DAU allocation for each jurisdiction is then determined as follows: \[ \text{DAU} = \text{Basic Allocation} + \text{Fiscal Gap (Fiscal needs minus Fiscal Capacity)} \].
The DAU is a gross program and compensates a jurisdiction for excess needs but does not tax regions with excess fiscal capacity. The jurisdictions that display a negative fiscal gap, for example the Jakarta metropolitan region, receive only the basic allocation and the negative fiscal gap is ignored.

13.5.2. DAU: An Evaluation

Indonesia has adopted a highly centralized tax system, with the CG responsible for raising 95% of total revenues. This has been done in the interest of tax harmonization, limiting differentials in sub-national fiscal capacities and lowering tax administration costs. This creates a large vertical fiscal gap (almost 90%) that is filled by revenue sharing and transfers. Revenue sharing by origin—while reducing vertical fiscal gap—accentuates horizontal fiscal inequalities. DAU is the foremost program to bridge horizontal inequities. It is an objective, formula based transfer program. It partially compensates for civil service wages and partially tries to limit the differentials of fiscal capacity across jurisdictions, by focusing on reducing the variations in regional allocation of transfers, as measured by the weighted coefficient of variation. This results in a reduction of the overall level of inequality in fiscal capacity and leads to the redistribution of some income across provinces and cities and districts. However, the current program has important limitations.

A one size fits all approach leads to fiscal inequity

The foremost concern is that the program equalizes jurisdictions that have widely dissimilar responsibilities and characteristics. This is especially true when you group metropolitan areas, cities of varying population sizes and rural municipalities or districts of varying geographical areas—as done under the current program. This violates the most fundamental dictum of transfers that ‘one size does not fit all’. The Constitutional Court of Indonesia, in the South Sulawesi case, ruled that “uniform treatment of different entities causes injustice”. Indeed, it would be a travesty of justice to consider that a small town with a tiny population, such as Puncha, would have similar fiscal needs and capacities to a large city like Bandung. Or for that matter, that a geographically small district area in Tangaron would have similar
revenue means and expenditure needs compared to a large district area in Tangaron.

The existing program ignores the fiscal capacity or fiscal needs of differently sized and classed municipalities; it assumes that they all have equal per capita needs and additional revenue sources outside the factors explicitly considered in the formula. If one examines local finance in other countries, there are wide justifiable variations in per capita revenues and spending across differently sized areas and between rural and urban areas, in light of the diversity of their needs, preferences and responsibilities. Equalizing in this way leads to injustice for all. One cannot possibly have the same standards, levels of access and diversity of services in a small remote district as opposed to a large city.

**A complex approach to equalization**

A second important concern has to do with the choice of the Williamson’s index as the equalization standard. Most industrial countries adopt a simple, transparent, but explicit standard, to reach a broad political and social consensus on the overall amount of equalization payments. This is important because equalization programs can have important efficiency and equity tradeoffs. An excessive standard of equalization can lead to adverse impacts on growth, just as too little equalization can create potential for succession. While equalization standards vary in terms of their relative emphasis on fiscal capacity versus fiscal need equalization, all play some role in ensuring that reasonably comparable levels of public services are provided at reasonably comparable levels of tax burdens across all jurisdictions, to ensure a common political and economic union.

The central focus of an equalization program is to help disadvantaged jurisdictions gain comparable public service standards, in order to allow them to integrate with the wider economy. Indonesia is unique in selecting complex statistical criterion—the weighted coefficient of variation, or the Williamson’s index—as the equalization standard. This choice is unfortunate as it introduces complexity and muddies the transparency of allocation criteria. Further to this, the Williamson’s index has relatively greater sensitivity to outliers. For
example, it is possible to redistribute income among the two top quintiles and have a lower value of the Williamson’s index, while there may be no significant redistribution to the poorest quintile. Its use in determining factor weights is particularly worrisome as multiple distributions of component weights can yield the same index. The use of this index in determining factor weight introduces uncertainty and inequity in allocations as without any material changes in need and capacity factors, changes in weights, alter the allocation of transfers across jurisdictions. In a developing country context, complexity is sometimes cited as a way to hold the politics at bay, as policy makers may not fully comprehend the limitations of a complex design and may hold fire. The Indonesian program cannot be justified on this basis. As Table 4.10 shows, while policy makers may not understand the working of such an index, they have not refrained from forcing the choice of higher variations in inequality in a subsequent year, if the resulting allocations lead to more satisfactory outcomes for their jurisdictions of interest.

*Misjudging fiscal capacity*

A third concern has to do with how fiscal capacity is measured. Various sources of revenues are given arbitrary and differential weights for provinces and cities/districts; and revenues from the DAK are excluded. This gives an erroneous view of the fiscal capacity of various jurisdictions.

*Discouraging local tax efforts*

The use of actual revenues, as opposed to potential revenues, creates disincetive effects for own tax effort. Any increase in own tax effort at the margin is mostly offset by decreases in DAU entitlements.

*Undermining agreements with Special Autonomy Regions*

The Government of Indonesia has entered into special arrangements with Aceh, Papua and West Papua and allows them a greater share of resource revenues through the tax sharing system. The DAU offsets a large part of those gains by including 95% of those gains as increases in fiscal capacity for the provinces and 63% for cities and districts.
Civil servant costs

The basic allocation finances public sector wages. This creates incentives for padding up local rolls. Such perverse behavior in Indonesia is circumvented by central controls over local recruitment and staffing but this undermines local autonomy for hiring and firing and setting terms of employment with local employees. It also ties LGs to the personnel policies of the CG, taking away any incentives they might have to experiment with new public management paradigms to improve accountability for service delivery performance—for example, through contracting out or partnership arrangements within and beyond government agencies. In short, wages compensation creates an incentives and accountability regime that works against good local governance.

Inappropriate indicators of fiscal need

Beyond basic allocation, formula-based expenditure needs determination, as done in Indonesia, has important limitations. Regional per capita income is used twice as a need factor—real per capita GDP adjusted for purchasing power parity in the formation of the HDI—and nominal per capita GDP more directly. Regional per capita income is an imperfect measure of fiscal capacity but not a very useful measure of fiscal need. The inclusion of resources and mining based GDP in both concepts of income inflates the fiscal capacity of resource-rich local jurisdictions, although significant portions of these incomes may accrue to foreigners and non-residents. It also undermines the special autonomy agreements made with resource-rich provinces. Further to this, local jurisdictions may have limited and partial access to taxing these bases—which is the case in Indonesia.

Expenditure need determination uses both fiscal capacity and fiscal need factors that work at cross-purposes. Other than population and area, indicators used have little to no relationship with service needs. There are also multiple hierarchies of arbitrariness in determining relative factor weights. The HDI index uses arbitrary weights for life expectancy, literacy rate, and mean years of schooling and per capita GDP. The Williamson’s index proves arbitrary, as multiple distributions of relative weights can lead to the same value of the index. The use of the Williamson’s index in determining formula factor weights also causes
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Complexity, non-transparency, uncertainty and inequity in individual allocations. Individual jurisdictions entitlements can change from year to year and relative to others with no apparent justification.

Amalgamation and incorporation of decisions

The expenditure need determination component formula is also non-neutral as to the amalgamation and incorporation decisions. Amalgamation of existing jurisdictions leads to lower central transfers for amalgamating jurisdictions and leads to the break up of existing jurisdictions’ benefits (in terms of higher per capita central transfers) (see Table 13.4). No wonder three new provinces have been created and the number of cities/districts mushroomed from 336 in 2001, to 502 in 2010.

Table 13.5. DAU Allocations Rewards Jurisdictional Fragmentation

<table>
<thead>
<tr>
<th>Province</th>
<th>Number of Districts / Cities -2001</th>
<th>Number of Districts / Cities -2011</th>
<th>Total District / City DAU-2001 (billion Rp)</th>
<th>Total District / City DAU-2001 (billion Rp)</th>
<th>% Change in DAU -2001-2011</th>
</tr>
</thead>
<tbody>
<tr>
<td>Kalimantan Tengah</td>
<td>6</td>
<td>14</td>
<td>0.9</td>
<td>5.5</td>
<td>528%</td>
</tr>
<tr>
<td>Yogyakarta</td>
<td>5</td>
<td>5</td>
<td>0.9</td>
<td>2.7</td>
<td>216%</td>
</tr>
</tbody>
</table>

Source: Marwanto Harjowiryöho (2011)

Complex and inequitable allocations

In sum, the gap filling approach is unnecessarily complex, non-transparent and uses a macro approach that is not well grounded in local realities to ensure inter-jurisdictional equity. These manna from heaven transfers also create an incentive and accountability structure that is not conducive to responsible, responsive, fair and accountable local governance. Simpler alternatives as outlined in the following paragraphs have the potential to enhance efficiency and equity of such transfers mechanisms.

13.5.3. DAU Reform Options

In the following, three alternative options for the reform of DAU are presented. Common elements of these three alternatives are:

- One size does not fit all. LGs should be grouped, or clustered, by population size, area and class of LGs;
The adopted formula must have a sunset clause of five years but interim changes in the formula should not be allowed;

The formula must have ceilings and floors to keep yearly entitlements stable and predictable;

The national average (by size and class) gap filling or equalization standard should replace the Williamson’s index. The pool can be adjusted by affordability and allocation determined by standard;

Gap filling or equalization should be determined by size and class of LGs and possibly equal per capita grants to villages;

Fiscal capacity measurements should be based upon potential revenues plus tax shares and other transfers and 50% of resource revenues; and

Fiscal needs measurements should discontinue wages compensation (basic allocation) as well as the use of HDI, the Williamson’s index and other indexes. Instead, consider needs measurement based upon service/client population for each service category.

13.5.4. Alternative 1: Developing a Simpler System

To simplify DAU and to ground it in a local comparative context, one requires meaningful groupings of local LGs. One alternative in this regard, is to have the following classes or clusters:

- Provinces—one group: P1: Provinces excluding Jakarta;
- Cities (kotas)—5 groups: C1 with population over 1 million; C2 with population 500K to 1 million; C3: Population 100–500 K; C4: Population 50-100k; C5: Population under 50k;
- Districts (Kabupatens)—4 Groups: D1: Vast area—1st quartile in area; D2: large area—2nd quartile in area; D3: medium area—3rd quartile in area; D4: small area—fourth quartile in area; and
- Please note that urban kabupatens that are part of large metropolitan areas may be treated just like cities (kotas) and grouped with cities.

The fiscal capacity and fiscal needs would be calculated as follows:

Fiscal capacity will be defined to include PAD, the jurisdiction
applied group average tax effort to own bases, plus tax shares and transfers (DBH Pajak); plus potential natural resource revenues (DBH SD) plus other grants. A simple way to calculate potential own source revenues would be to apply the national average effective tax rate to local non-resource GDP. Potential resource revenues will be similarly calculated by applying national average effective resource tax rated to local resource based GDP only. Due to the instability of resource revenues, the higher public expenditure needs associated with resource exploitation and the exhaustible nature of some resources, only 50% of resource revenues should be counted towards revenue capacity of resource-rich regions. Revenues from specific purpose grants would be fully included. Capital grants and loans earmarked to finance specific projects or to finance centrally determined infrastructure deficiencies would be excluded from such calculations.

Fiscal needs would be calculated for a representative expenditure system of about 10 or less functions, comprising mostly of local operating expenditures. This expenditure system would be differentiated by the size and class of LGs and would have service population indicators as determinants. Weights would be based upon aggregate LG expenditure for the specified function, based on a three or five-year group moving average. Figures 13.4, 13.5 and 13.6 provide illustrative expenditure functions, service indicators and weights based upon 2008 expenditures only.

<table>
<thead>
<tr>
<th>Expenditure Function</th>
<th>Need Indicator</th>
<th>Weight (Share in Aggregate Provincial Spending Last 5 Years)</th>
</tr>
</thead>
<tbody>
<tr>
<td>General Administration</td>
<td>Population (66%) and area (33%)</td>
<td>52.3</td>
</tr>
<tr>
<td>Law and Order</td>
<td>Population</td>
<td>0.7</td>
</tr>
<tr>
<td>Education</td>
<td>School age population</td>
<td>7.4</td>
</tr>
<tr>
<td>Health</td>
<td>Weighted population- higher weights for ages 0 – 5 and 65+</td>
<td>6.1</td>
</tr>
<tr>
<td>Social Protection / Welfare</td>
<td>Number of unemployed</td>
<td>1.1</td>
</tr>
<tr>
<td>Housing</td>
<td>People in public housing or number of public housing units</td>
<td>7.6</td>
</tr>
<tr>
<td>Roads and Transportation</td>
<td>Kms of road</td>
<td>10.0</td>
</tr>
<tr>
<td>Agriculture and Forestry</td>
<td>Land area</td>
<td>6.2</td>
</tr>
<tr>
<td>Others</td>
<td>Population</td>
<td>8.6</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td></td>
<td><strong>100.0</strong></td>
</tr>
</tbody>
</table>

*Source: Author*
The suggested adjustments to the existing DAU system offer significant improvements for the program. These suggestions would lead to the application of simpler, more meaningful and easily understood indicators. The determination of allocation by group would lead to the equal treatment of equals. Factor weights would be objective and stable—as they would be determined by taking the moving average of aggregate spending by the group as a whole. There would be a more clear and transparent need equalization. Both pool and allocation would

Table 13.7. DAU Fiscal Needs Compensation: Alternative for Cities

<table>
<thead>
<tr>
<th>Expenditure Function</th>
<th>Need Indicator</th>
<th>Weight (Share in Aggregate City Spending Last 5 Years)</th>
</tr>
</thead>
<tbody>
<tr>
<td>General Administration</td>
<td>Population</td>
<td>35.0</td>
</tr>
<tr>
<td>Law, Order and Fire Protection</td>
<td>Population and Property Values</td>
<td>1.0</td>
</tr>
<tr>
<td>Education</td>
<td>School age population</td>
<td>20.0</td>
</tr>
<tr>
<td>Health</td>
<td>Weighted population- higher weights for ages 0-5 and 65+</td>
<td>15.0</td>
</tr>
<tr>
<td>Social Protection / Welfare</td>
<td>Number below poverty line or unemployed</td>
<td>1.0</td>
</tr>
<tr>
<td>Housing</td>
<td>People in public housing or number of public housing units</td>
<td>2.0</td>
</tr>
<tr>
<td>Roads and Transportation</td>
<td>Kms of road</td>
<td>10.0</td>
</tr>
<tr>
<td>Water and Sewerage</td>
<td>Land area</td>
<td>9.2</td>
</tr>
<tr>
<td>Others</td>
<td>Population</td>
<td>2.2</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td></td>
<td><strong>100.0</strong></td>
</tr>
</tbody>
</table>

Source: Author

Table 13.8. DAU Fiscal Needs Compensation: Alternative for Districts

<table>
<thead>
<tr>
<th>Expenditure Function</th>
<th>Need Indicator</th>
<th>Weight (Share in Aggregate District Spending Last 5 Years)</th>
</tr>
</thead>
<tbody>
<tr>
<td>General Administration</td>
<td>Population</td>
<td>35.0</td>
</tr>
<tr>
<td>Law, Order and Fire Protection</td>
<td>Population and Property Values</td>
<td>1.0</td>
</tr>
<tr>
<td>Education</td>
<td>School age population</td>
<td>20.0</td>
</tr>
<tr>
<td>Health</td>
<td>Weighted population- higher weights for ages 0-5 and 65+</td>
<td>15.0</td>
</tr>
<tr>
<td>Social Protection / Welfare</td>
<td>Number below poverty line or unemployed</td>
<td>1.0</td>
</tr>
<tr>
<td>Housing</td>
<td>People in public housing or number of public housing units</td>
<td>2.0</td>
</tr>
<tr>
<td>Roads and Transportation</td>
<td>Kms of road</td>
<td>10.0</td>
</tr>
<tr>
<td>Rural Services</td>
<td>Land area</td>
<td>15.0</td>
</tr>
<tr>
<td>Others</td>
<td>Population</td>
<td>1.0</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td></td>
<td><strong>100.0</strong></td>
</tr>
</tbody>
</table>

Source: Author
be determined by formula. The total pool, however, could be constrained by affordability. Nevertheless, there is one major drawback of the proposed design—un-conditional fiscal gap compensation strengthens autonomy, but without accountability to local residents. A second alternative retains this drawback but moves the current program from gap filling to an equalization program.

### 13.5.5. Alternative 2: Developing a Comprehensive Fiscal Equalization Approach

Calculations of fiscal capacity and expenditure would need to follow the same approach as under the gap filling approach described above. However, the surplus or deficiency of per capita fiscal capacity and per capita expenditure needs, with reference to average or other explicit standards of equalization, would be calculated. The jurisdictions in net deficiency positions would receive equalization payments from the center that would be equivalent to the net deficiencies calculated after taking into account the net positions, with respect to capacity and needs. This alternative has the clear advantage of having an explicit standard of equalization to determine the total pool as well as distributions. It has the disadvantage of having complex and controversial determinants of expenditure need equalization—as has been the experience in Australia.71

### 13.5.6. Alternative 3: An Almost Ideal Approach

Under this option, fiscal capacity equalization follows the same approach as under alternative number 2. However, expenditure need compensation would be done through output-based operating transfers for merit public services, where allocation would be based upon the share of service population, with no conditionality on spending. Instead, there would be customized conditions on service delivery performance, in terms of service access and quality for individual jurisdictions and providers, for the continuation of the grant program. The design for

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such transfers was spelled out in an earlier section. In addition to these operating transfers, there would also be a need to have a capital grant and capital market access program to deal with infrastructure deficiencies, as discussed in the following section. This alternative would further simplify the determination of grant pool and allocations. But the most important advantage of this alternative would be that it would preserve local autonomy, while enhancing accountability to LG residents.

13.6. Evaluation of the Specific Purpose Grant (DAK)

13.6.1. DAK: An Overview

According to Law 33 (2004) the primary objective of this grant is to finance, in selected regions, the infrastructure needs of basic public services that are of high national priority, but are still considered regional government responsibilities. Another stated objective is to provide special assistance to certain regions and to accelerate regional development and the achievement of national priorities. LGs with lower than average fiscal capacity are expected to receive higher priority in financing their infrastructure deficiencies. DAK funds are earmarked to finance capital expenditures only, and operating costs are ineligible to receive grant financing. DAK is a closed-ended matching grant program requiring that a minimum of 10% of total costs of the project must be met by the recipient’s own resources. Matching is considered necessary to ensure local ownership of the project. In 2011, the CG has established 19 national priority areas for DAK assistance. These include: education, health, road infrastructure, drinking water infrastructure, sanitation infrastructure, government infrastructure, maritime affairs and fisheries, agriculture, environment, family planning, forestry, infrastructure in less developed regions, trade facilities, rural electrification, housing and settlement, land transport safety, rural transport, and border area infrastructure.

The allocation of DAK assistance is based on three sets of criteria: general criteria, special criteria and technical criteria. The general criteria established by the Ministry of Finance determines—relative to the national average net (the net of public sector wages and benefits)—the fiscal position of a given district. All districts with below average net fiscal positions are eligible to receive DAK assistance. The special
Section E: Optimizing the Delivery of Public Infrastructure and Services

criteria is intended to provide preferential access to LGs in Papua and West Papua; coastal areas and islands; areas that border other countries; regions of interest for food security or tourism reasons; disaster prone areas; and less developed areas. Relevant line ministries provide designation for special criteria.

The regulation does not provide any specific guidance on what proportion of DAK funds should be made available to meet these special criteria. The technical criteria are set by line agencies, in consultation with the Ministry of Finance, the Ministry of Home Affairs and the Ministry of Planning. These criteria contain a host of macro, service-related, administrative and needs indicators. For example, for education, the indicators include, for primary schools: the total number of classrooms; and the number of classrooms with medium or heavy damage. For junior high schools: the total number of classrooms, rated on a scale of low, moderate and serious physical rehabilitation needs; the needs of the library; the equipment needs for the lab; subjects offered; and language tools and books.

For health services, indicators are included to cover basic services, generic drug needs, pharmacy facilities, and referral services. Basic services indicators include: the community health development index (10%); index area (10%); index population (5%); index ratio health center/sub-district (10%); index ratio poskedes/desa (20%); index health center (35%); and index improving health center (15%).

For roads, indicators include: length of road, road condition, area, population, share of capital spending of total budget, spending on roads and reporting timeliness.

To determine eligibility for DAK allocation, the first requirement is to have a fiscal index of less than one. The second requirement is that the composite fiscal and special criteria index, using equal weights, must be greater than one. Thirdly, the composite fiscal, special and technical criteria index must be greater than one, where the first two indexes receive half and the technical criteria receives half of the total weight. It turns out that almost all districts qualify for DAK access using this process. In the second stage a new composite index is developed that places 20% weighting on composite fiscal and special criteria index and 80% on the technical criteria index. Thus, while total
pool of DAK and allocations to various sectors are arbitrary, allocations among districts and provinces are formula driven.

13.6.2. DAK: An Evaluation

DAK capital grants are intended to provide support for two broad areas, namely: to deal with infrastructure—including administrative structure deficiencies—in relation to unspecified minimum service standards for priority public services and disaster management; and to provide capital assistance to designated areas. Both of the objectives are laudable and closed-ended. Matching capital grants are appropriate tools for this purpose, provided funds for the future upkeep of facilities are available. By overcoming infrastructure deficiencies in poorer jurisdictions, these grants strengthen the economic union by creating a level field for poor regions to compete for labor and capital, while integrating with the wider economy.

These grants enable jurisdictions with limited or no access to capital market finance to create long-lived assets and thereby build their economic capacity to be less dependent on future grants. In relation to the infrastructure argument, such grants may be important for developing the capacity of LGs to provide public services. The delivery of an acceptable level of public services requires both physical and human assets. The latter includes both the acquisition of particular skills, as well as the development of management and administrative expertise. Some of this comes with training and some simply with experience. In either case, extraordinary once-over expenditures will be needed to develop the decision making capacity of LGs where limited capacity existed before. Once these backlogs of human and physical capital are made up, the capacity of LGs to deliver important public services will be put on a sustainable footing.

For capital grants to be effective, they must embody a planning view. The central planning and line agencies must map the entire country, to identify regional deficiencies in relation to national minimum standards in basic infrastructure for merit services. In the absence of such a view, capital grants determined on an ad hoc project-by-project basis become a source of pork barrel politics. Indonesia in the past (pre-2000), under INPRES transfers, took such a planning view of these
grants in setting a national minimum standard of access to primary schools (which were required to be within walking distance of the community served) for the nation as a whole. The CG provided for school construction, while LGs provided land for the schools. This program was highly effective in dealing with infrastructure deficiencies. South Africa has experimented with a formula-based capital grant to deal with infrastructure deficiencies while taking a planning view with limited success. The Municipal Infrastructure Grant formula includes a vertical and horizontal division. The vertical division allocates resources to sectors or other priority areas; the horizontal division is determined based on a formula that takes account of poverty, backlogs, and municipal powers and functions. The formula includes five components:

- Basic residential infrastructure, including new infrastructure and rehabilitation of existing infrastructure (75%). Proportional allocations are made for water supply and sanitation, electricity, roads, and ‘other’ (street lighting and solid waste removal);
- Public municipal service infrastructure, including construction of new infrastructure and rehabilitation of existing infrastructure (15%);
- Social institutions and microenterprises infrastructure (5%);
- Nodal municipalities (5%); and
- Final adjustment: A downward adjustment or top-up is made based on past performance of each municipality relative to grant conditions.

In most countries—including India, the USA and the present DAK program in Indonesia—a planning view is absent, to the detriment of the achievement of their objectives. Experience with ad hoc or formula-driven capital grants shows that they often create facilities that are not maintained by sub-national governments—which either remain unconvinced of their utility or lack the means to provide regular upkeep. Such capital grants are pervasive in developing countries and transitional economies. Most countries have complex processes for initiating and approving submissions for financing capital projects. These processes are highly susceptible to lobbying, political pressure, and grantsmanship and they favor projects that give the CG greater visibility. Projects typically lack citizen and stakeholder participation and they often fail
due to the lack of local ownership, interest, and oversight. In view of these difficulties, it may be best to limit the use of capital grants, by requiring matching funds from recipients (varying inversely with the fiscal capacity of the recipient unit) and by encouraging private sector participation in infrastructure by providing political and policy risk guarantees where appropriate. To facilitate private sector participation, public managers must exercise due diligence to ensure that the private sector does not take the public sector for a free ride or walk away from the project midstream.

DAK has kept politics at bay by developing objective and rigorous processes for eligibility and allocation of DAK funds, but in the process has compromised on the objectives of the grant program as discussed below:

**DAK objectives and eligibility conditions**

DAK objectives require a detailed central planning view to determine eligibility based on deviations from national minimum standards. Therefore, the current use of the fiscal capacity indicator may be inappropriate. In any case, the fiscal capacity indicator being used is highly imprecise as it is a ratio of jurisdictions’ revenues to national average revenues, without normalization for the population, size or class of LGs. Thus all smaller jurisdictions become eligible and larger than average jurisdictions become ineligible regardless of their ability to finance projects from own sources or having access to capital finance. Special criteria, on the other hand, are appropriate, given the legal imperatives. However, such areas would be best treated under a separate grant program. DAK technical criteria are a mixed bag of useful and less useful indicators determined in an ad hoc manner. Technical criteria should be guided by the national priorities set by the CG, in accordance with the areas it wishes to establish national minimum standards.

**Local ownership**

DAK has rightly established a matching requirement to build local ownership of the facilities that are built with grant funds. It has however, not established any clarity on the application of the matching rate. It would be useful to establish a clear criteria on what the local matching
rate should be—which currently varies from 10% to 90% depending upon the relative fiscal capacity (potential revenues) of a jurisdiction within its size class. As part of this strategy, larger, richer jurisdictions must be provided technical assistance to access capital markets rather than grant finance.

**Long term planning**

The DAK program has blossomed into a Christmas tree approach to providing pitiful annual financing to all jurisdictions for 19 services. Rather, the program should provide a long term planning view and availability of financing over the medium-term, rather than on an annual basis. The long-term view for priority attention must be realistic and affordable within the existing budget constraints of the CG.

**Project application versus automatic financing**

The DAK approach to using automatic rather than application based financing is appropriate as it keeps the politics at bay as well as overcomes grantmanship. But this automatic financing should be based upon a central planning view rather than a complex yet arbitrary set of criteria as is currently the practice.

**Tournament or competition based financing**

Both these approaches provide financing based upon the results achieved, to a selected set of winners. Given the lack of access to capital finance or revenue reserves in poorer jurisdictions, such approaches are unlikely to achieve their desired objectives.

**13.6.3 DAK Reform Options**

As discussed above, a simpler and more focused DAK approach would keep politics out of grant determination and allocation, while helping to secure a common economic union, through establishing national minimum standards for national merit services. This requires taking a planning view of infrastructure deficiencies, priority service areas and standards of services. The deficiencies and financing requirements identified across the nation should be spelled out in the national five year plan. Hopefully this planning view would also bring
a substantial part of de-concentrated development expenditures (decon) to this pool, thereby enlarging the financing available to set national minimum standards.

To implement this planning view, the Ministry of Finance, BAPPENAS, and MOHA in partnership with line ministries need to: develop a list of projects; provide details on the medium-term financing available for the completion of these projects; and provide matching requirements (with a matching rate to vary inversely with potential per capita revenue capacity) for eligible jurisdictions. The line ministries could then work with eligible LGs to work out project details, completion schedules and monitoring and evaluation requirements. Of course, as discussed under DAU, it is important to supplement DAK capital grants with simple formula-based (equal per capita based upon service population as the main criterion) output based grants to sustain national minimum standards for merit services.

DAK to special areas identified by legislation would be best carried out under a separate program for the specified areas, rather than be included as a part of the DAK for minimum service standards for services of national priority.

**Does Indonesia Need a Grants Commission?**

For determining the system of grants, one finds four types of models used in practice. The first and the most commonly used practice is for the federal/central government to be placed in charge of making decisions alone. This has the distinct disadvantage of biasing the system towards a centralized outcome, whereas the grants are intended to facilitate decentralized decision making. In India, the federal government is solely responsible for Planning Commission transfers and centrally sponsored schemes. These transfers have strong input conditionality, which has the potential to undermine state and local autonomy. The 1988 Brazilian Constitution provided strong safeguards against federal intrusion, by enshrining the transfers’ formulae factors in the Constitution. These safeguards represent an extreme step as they

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undermine flexibility of fiscal arrangements to respond to changing economic circumstances.

The second approach in practice is to set up a quasi-independent body, such as a grants commission, whose purpose is to design and reform the system. These commissions can have a permanent presence—as in South Africa and Australia—or they can be brought into existence periodically to make recommendations for the next five years, as done in India. These commissions have proven to be ineffective in some countries, largely because many of the recommendations have been ignored by the government and not implemented—as in South Africa. In other cases, while the government may have accepted and implemented recommendations, they have been ineffective in reforming the system because of the constraints they have imposed on themselves—as is considered to be the case in India. In some cases, these commissions become too academic in their approaches and thereby contribute to the creation of an overly complex system of intergovernmental transfers—as has been the case with the Commonwealth Grants Commission in Australia.73

The third approach found in practice is to use executive federalism, central-provincial-local committees or forums to negotiate the terms of the system. Such a system is used in Canada and Germany. In Germany, this system is enhanced by having state governments represented in Bundesrat (the upper house of the parliament). This system allows for explicit political input from the jurisdictions involved and attempts to develop a common consensus.

The fourth approach, is a variation on the third approach, and uses an intergovernmental-cum-legislative-cum-civil society committee, with equal representation from all constituent units but chaired by the federal/CG, to negotiate changes in the existing arrangements. The so-called Finance Commission in Pakistan and the Indonesian body representing key decentralization stakeholders (DPOD) represent this model. This approach has the advantage that all stakeholders—donors, recipients, civil society and experts—are represented on the commission.

Such an approach keeps the system simple and transparent. It is important that, in such forums, only the donors and recipients are voting members; while civil society members and experts serve as observers, provide feedback and technical assistance. An important disadvantage to this approach is that if unanimity rule is adopted, such bodies may be deadlocked forever—as was witnessed in Pakistan in the 90s.

The Indonesian DPOD is an important forum for decisions on grant determination. DPOD’s role in grant determination can be strengthened by requiring that only the cabinet ministers, governors and mayors can vote on matters relating to fiscal transfers and that all these decisions must require a three-fourths majority of the DPOD.

In conclusion, there appears to be no clear advantage in creating an independent grant commission in Indonesia. The grant determination role would be better served by an intergovernmental forum, such as DPOD, supported by a technical secretariat at the Ministry of Finance.

13.7. Conclusion and Recommendations

Over the last decade, Indonesia has made a remarkable transformation from centralized rule to decentralized and democratic local governance. This transformation can be sustained if intergovernmental finance creates the right incentives and accountability regimes for responsive and accountable local governance. Prior to the 2000 reforms, Indonesia had an intergovernmental finance system, the so-called INPRES (presidential instruction) grants system, that was simple, transparent and focused on results based accountability. This paper has called for Indonesia to return to its roots and implement reform options that represent a ‘back to the future’ approach—an approach that draws upon rich and successful Indonesian experiences that have often been cited in public finance literature as examples of better practices in central transfers.74

In recapitulating to strengthen accountable local governance, Indonesia needs to consider the following reform options:

- **Tax decentralization and tax base sharing**: Tax base sharing is feasible for personal income taxes on residence principle. Tax decentralization may be feasible for royalties, fees, severance, production, output and property taxes, sin taxes (gambling, liquor and massage parlors) and local environmental taxes and charges;

- **Output-based per capita operating (non-matching) grants for setting national minimum standards for merit services such as education, health and infrastructure**: These grants should embody simple allocation criteria to LGs, based on service population e.g. school operating grant based upon school age population. LGs would disburse these grants to all providers – government and non-government, as done in Canada, Brazil, Chile, Finland and Thailand.

  Continuity of finance can be assured, by maintaining or improving upon existing standards of access and service quality.

  Such transfers would preserve local autonomy while enhancing simplicity, transparency and citizen based accountability for service delivery performance. Indonesia in the past had a measure of success with a grant program (INPRES grants) that embodied at least some of these features;

- **Fiscal capacity equalization grants**: To enable all jurisdictions to provide reasonably comparable levels of public services at reasonably comparable levels of tax burdens;

- **Capital (matching) grants to fiscally disadvantaged jurisdictions**: These are needed to overcome infrastructure deficiencies in setting national minimum standards for merit services. These grants should be based upon a planning view of identified infrastructure deficiencies and should contain matching requirements that vary inversely with fiscal capacity. These grants, combined with output-based operating grants, will create a level playing field, enable poorer jurisdictions to integrate with the broader national economy and help reduce regional income and fiscal disparities; and
- **Assistance for responsible capital market access** to richer local jurisdictions. The above-mentioned reforms will result in an intergovernmental finance system that is more transparent, objective, predictable and simpler, with a sharper focus on objectives. These reforms may be considered integral elements to any efforts to fine-tune the existing fiscal system in Indonesia’s multi-order governance system. In closing, reform is eternal, we never fully succeed at first but we must keep trying.
14 Incentives for Better Local Service Delivery

Dr. Blane D. Lewis and Professor Paul Smoke

14.1. Introduction

There is growing interest in the use of national incentives to promote LG reform and improved performance in many developing countries across the world, including Indonesia. Much contemporary literature on decentralization sees incentives as embedded features of a good governance system – if the system structure of the system and procedures are well designed, actors in the system will benefit from adopting appropriate behavior and/or will be penalized for not doing so.\(^{75}\) Incentives can also be used incrementally as decentralization is being implemented to encourage actors to adopt specific new ways of performing functions or to reward improved outputs or outcomes. In Indonesia, the use of performance incentives is increasingly seen by the government and donor agencies as being a potentially valuable way of supporting an unevenly and erratically evolving decentralization process that is now more than a decade old.

Many countries have used various performance incentives in different ways and with different effect. In this paper we briefly consider the rationale for adopting LG performance incentives generally and in Indonesia, and we review Indonesia’s limited experiences with incentives to date. We then present a simple framework outlining conceptual, design and implementation issues relevant for considering how to approach performance incentives and summarize selected international experiences. We close with a few comments on the relevance of experience elsewhere for Indonesia and some thoughts on moving forward.

14.2. Performance Incentives for LGs in Decentralized Systems

The need for national performance incentives in a decentralized system may not seem obvious. The mainstream model of decentralization essentially portrays LG autonomy as an absolute right enshrined in constitutional provisions, laws or other enabling regulations. In this view, the role of the center is largely to develop appropriate intergovernmental structures, systems and procedures. If the framework is structured properly, e.g. devolves appropriate expenditure and revenue functions; establishes a hard budget constraint; provides for redressing inter-jurisdictional fiscal disparities etc.; local government behavior is supposed to be primarily driven at the local level by sub-national elections.

A less static view of decentralization frames it as a complex and evolving process, that involves crafting an appropriate balance between national goals and local autonomy. In most countries, central and/or regional governments substantially regulate or attempt to influence LG fiscal behavior, so as to support the attainment of legitimate national priorities. Moreover, it is clear that the theoretical benefits of decentralization can only be realized if LGs have adequate systems, capacity and incentives to behave in a responsible manner and can be held accountable to their constituents. Capacity and accountability are

not built rapidly or easily, and local elections are a blunt and inadequate instrument to stimulate local accountability, particularly in environments where civil society is weak and inclusive collective decision-making is neither well understood nor well established.

In this broader, more dynamic view, decentralization requires a capable center that can develop and enforce appropriate intergovernmental mechanisms; support the enhancement of local capacity; and help to promote a climate for accountable local governance. Reform should be seen as a lengthy process that requires substantial systemic changes, as well as modifications in the behavior of all major actors—central officials, LGs, and civil society.77 Under such circumstances, central incentives for LG performance can play an important role in furthering national priorities, promoting adoption of decentralization reforms and in stimulating behavioral changes intended to further the major goals of decentralization. The caveat, of course, is that the national political dynamics must be such that the CG will create incentives for desirable behavior rather than undesirable behavior.78

14.3. Performance Incentives in Indonesia

Various incentives—some intended and others unintended, some productive and others perverse—currently operate in Indonesia’s intergovernmental fiscal system. Both the revenue—and expenditure—side have been structured into the transfer system, shared revenues, the DAU and the DAK.

14.3.1. Revenue Incentives

The property tax is a central tax in Indonesia, although LGs assist with collections. (According to recent law, the property tax will be completely devolved to local governments by 2013.) The center returns 64.8% and 16.2% of total receipts to point of origin local and provincial...
governments, respectively. The center initially keeps 10% and charges 9% for administration, but its 10% share is given to LGs; 6.5% in lump sums to all places and 3.5% to those meeting the previous year’s property tax revenue target. This provides at best, a small incentive effect given that 3.5% of property tax revenues in 2008 only amounted to about 0.30% of total sub-national revenues (about 0.02% of GDP). Another incentive embedded in the DAU allocation system concerns the treatment of own-source revenues in the equalization formula. The latter is based on the difference between estimated expenditure needs and fiscal capacity. Expenditure needs are derived from a set of proxies (population, area, a cost index, etc.) and fiscal capacity is based on a LG’s other revenues (i.e. besides those from DAK). Potential rather than actual own-source revenues have been used in estimating fiscal capacity, whereas actual revenues are used for all other sources. The former were determined via a simple regression model that specified revenues as a function of gross local domestic product (a proxy for local tax base); a LG’s potential own-source revenue is its own-source revenue as predicted from the estimated model. The intent was to encourage LGs to increase own-source revenues, in the context of the dominance of transfers. It was hoped that LGs would strive to be above the potential revenue line, so that they would be able to ‘keep’ some portion of their own-source revenues alongside DAU allocations. The argument was that the incentive would help guard against the common outcome of declining local tax effort and revenues in the face of large and/or increasing intergovernmental transfers.

As it turns out, Lewis (2005) shows that increases in transfers are, in fact, associated with rising own source revenues. It is doubtful, however, that revenue increases result from the DAU incentive, since it was never well understood by LG officials when it was in operation and has, in any case, since been eliminated. A more likely explanation

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is that, increased transfers lead to increased reserve funds, which in turn lead to increased interest earnings. Recent analysis (Lewis and Suharnoko, 2009) suggests that increased interest earnings on unspent balances may explain up to half of the increase in own-source revenues in the post-decentralization period. Another study (Lewis, 2006) demonstrates that increasing transfers are associated with reduced cost efficiency in local tax administration.

14.3.2. Expenditure Incentives

The MOF has attempted to encourage natural resource rich regions to spend more resources on education. Starting in 2009, sub-national governments have been awarded an additional 0.5% share of state oil and gas revenues, for expenditure on education. Since neither the law nor regulations mention how this will be monitored or enforced, that incentive may not have any real impact.

Incentives have played some role in allocating the DAU, which constitutes about one half of provincial and nearly two-thirds of local budgets. The pool of finance for the DAU is 26% of (planned) net domestic revenues. In 2008 the DAU reached nearly Rp 179 trillion (4.8% of GDP). A large share of the total funds pool (recently about 50%) is allocated to cover the sub-national wage bill. The remainder (except for a small lump sum) is distributed according to a fiscal equalization formula. The stated rationale in Law 32 (2004) for covering salary payments from the DAU, is to ease the local fiscal planning burden associated with transferring staff between the center and sub-national governments and among the latter. Most analysts argue however, that this provision provides a disincentive to rationalize the sub-national civil service.

The DAK is a conditional matching grant, designed by law to encourage capital spending in poor (or specially designated) regions. The matching component is set at a minimum of 10% of the center’s contribution—which has not been exceeded in practice. The DAK

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accounted for less than Rp 1 trillion in 2001 and 2002. By fiscal year 2008, the DAK had grown to Rp 21.2 trillion—around 7% of total local revenue. While still relatively small, DAK is becoming more important, yet there are many competing visions of how the DAK should evolve.

The extent to which the DAK encourages increases in capital spending is a major concern. While most LGs seem to spend the vast bulk of DAK allocated to them, this does not mean, given the fungibility of funds, that DAK distributions actually stimulate capital spending in total. Recent research suggests that an increase in the DAU of one rupiah leads to only about an increase of 0.78 in capital spending. This finding suggests that DAK funded capital spending crowds out capital spending from other sources. The research also suggests that this is a particular problem for local infrastructure investment.82

A key policy concern is that the DAK is becoming fragmented across sectors and uses (as pre-decentralization grants were). The coverage of the DAK in the initial years of operation was limited to education, health, roads, irrigation, and office buildings (for new LGs). By 2008, coverage had expanded to 11 sectors—the original plus potable water, fisheries, agriculture, environment, population, and forestry. By 2011, DAK coverage spanned a total of 17 sectors. In addition, while the DAK was initially focused on a relatively small number of LGs, by 2008, all LGs received at least some DAK. A major reason behind the increasing sectoral and geographic fragmentation of the DAK is that allocation procedures appear to have been non-trivially captured by the DPR.

In 2010, the World Bank approved a US$ 220 million loan for the LG and Decentralization Project, which is intended to improve the accountability and reporting for the DAK. Piloted in four infrastructure sub-sectors—irrigation, roads, sanitation and water—this initiative will use an output-based approach to DAK allocation.83 Other

international development partners, including USAID and AusAid are also engaging in performance-based approaches to improving local service delivery.

14.3.3. Overarching Issues

The above discussion suggests that the Indonesian experience with performance incentives in the intergovernmental fiscal system has been rather ad-hoc and uneven. This lack of a systematic approach is not unexpected in Indonesia, given the multiple central agencies involved, some degree of policy fragmentation within individual agencies, and the lack of overall coordination.

In addition to these concerns about the limited and fragmented adoption of incentives, lax or partial implementation of those that exist would appear to be the rule. Use of property tax and own-source revenue incentives, for example, has been irregular and inconsistent. Equally noteworthy, the effects of incentives have been poorly monitored. Where information is available, the impacts seem to have been limited, and in some cases unintended or perverse.

At the same time, the potential power of incentives is illustrated by a recent (partial) withholding by the MOF of DAU transfers to LGs that did not comply with budget reporting requirements. The noncompliant LGs almost immediately met their obligations, suggesting the positive impact that incentives could have if designed correctly and enforced.

14.4. Incentive Schemes: Objectives and Design

Given the serious concerns about LG performance in Indonesia raised above and the limited and uneven use of incentives to improve the situation, there may be potential opportunities for the government to develop and apply incentive mechanisms more broadly, more creatively and more effectively. Such incentives could play the role of promoting the adoption of reforms and the enforcement of mandates and creating more efficient and citizen-responsive fiscal behavior. Use of performance-based incentives for LGs in developing countries has been relatively limited, so there is not much systematic experience to draw on, but there is some general literature about performance
monitoring and incentives, some of which is LG specific.\textsuperscript{84} There are three broad types of systems/approaches relevant for the development of performance incentives.\textsuperscript{85} The first is performance measurement systems (PMES), which involve a rigorous and systematic effort to measure, record, analyze and compare performance-relevant data against earlier results or defined norms. This is fundamentally a technical exercise, but of course it must be clear what is being measured and for what purpose if it is to have any practical effect. There is a substantial literature on both the ‘why’ and ‘how’ of this topic, and some form of performance measurement is widely used for a variety of purposes in many countries around the world.

The second system/approach is performance management systems (PMAS), which use the information generated by performance measurement systems and other methods and tools to improve management and create incentives for specific actors to meet or exceed defined performance standards. Performance-based grants, which as discussed below have become common in developing countries, and other results-based financing (RBF) arrangements would fall under the PMAS umbrella.

The final set of approaches falls under the umbrella performance improvement models and tools (PIMT). These are used to understand in more detail the specific steps and processes involved in the management and service delivery processes, with the goal of generating operationally specific paths to improved performance. These models and tools can be relatively narrowly focused on a particular aspect of performance or a particular service, or in some cases they can be highly comprehensive. They may be able to provide the basis for the development of a more sophisticated set of incentives for improved performance, such as developing multi-faceted performance based contracts between local and central governments.

In developing countries, most efforts related to LG performance seem to have primarily involved the construction of measurement

\textsuperscript{84} A good review of the conceptual literature on performance incentives and of the application of related mechanisms in developing countries, including in the local government sphere, is provided in Zinnes (2009). Steffensen (2010) provides a detailed review of performance-based grants.

systems and some limited development of performance management systems and tools. More advanced countries with better levels of data and capacity have to some extent used more sophisticated and integrated tools, albeit in differing ways, subject to various challenges and with mixed impact.86

Before reviewing international experience more systematically, we outline a simple framework for thinking about the possible roles, design and implementation of more carefully conceived LG performance incentives than presently exist in Indonesia. First, we review possible broad target purposes of incentives. Second, we consider potential specific objectives that might be pursued within this broader set of purposes. Third, we outline a range of key issues that must typically be considered in designing incentives. Fourth, we provide an overview of major issues and challenges involved in measuring performance. Finally, we note various types of institutional responsibility that must be defined for designing and implementing a performance incentive system.

14.4.1. Broad Target Purposes

There are many purposes to which LG incentives could be put by the CG, ranging from the more limited goal of facilitating the adoption and performance of very specific system and procedural reform programs to the broader goal of promoting larger development and policy objectives.

System reforms

Basic performance incentive efforts sometimes target simple reform adoption, and many of these focus mainly on the development of some limited aspect(s) of the basic intergovernmental fiscal, administrative and legal system and operating procedures. Such technical reforms are generally seen as contributing to improved governance and accountability through more efficient and transparent public sector conduct. Some

accountability reforms may go beyond the basic elements of the system by trying to facilitate more direct engagement with citizens, e.g. through the adoption of participatory approaches or other citizen consultation and feedback mechanisms.

**Fiscal, economic and social performance targets**

Beyond the adoption of basic government system and process reforms, incentives can be used to stimulate improved fiscal behavior/budget performance, more/better local service delivery, and enhanced local revenue generation. These targets can be pursued in a variety of ways outlined below. Incentives can also facilitate behavior that is intended to support other priority public sector goals and policies. These can be broad and multi-faceted, such as economic growth and/or poverty reduction, or more limited, such as pollution control or other pro-environment behaviors.

**Innovation**

Central Governments can use performance incentives to encourage LGs to try new ways of doing business. Examples include the adoption of new types of efficiency enhancing technology; the use of public-private partnerships in undertaking LG service delivery; the pursuit of joint service delivery initiatives with other LGs (inter-jurisdictional cooperation); or efforts that create linkages with community driven development (CDD) activities. These types of initiatives would be appropriate when there are proven benefits from pursuing them, or when the national government wishes to create an environment conducive to experimentation with alternative mechanisms to see if such benefits materialize.

**14.4.2. Focal Objectives**

Within the broader set of target purposes outlined above, the specific focal objectives of a LG incentive system can range from simple adoption of various types of decentralization reforms to a range of improved development outcomes. Incentives could be provided for complex or multiple objectives from the start, or there could be a progression in the evolution of incentives over time from very basic to more demanding.
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Simple reform certification

In the most straightforward case, the incentive program could simply acknowledge that a particular LG has started to use the systems and procedures required under a revised intergovernmental framework. This in effect constitutes a certification that specific measures have been undertaken without reference to how well this has been done. Certification can occur for technical reforms, such as new record keeping systems; new planning and budgeting procedures; for financial management and reporting requirements, etc.; legislative reforms, such as the passage by the local assembly of new regulations for revenue enforcement or public-private partnerships; or for the use of ‘softer’ types of governance reforms, such as the adoption of citizen consultation mechanisms or the opening of a citizen complaints bureau.

Reform adoption performance

A step beyond providing incentives for the simple adoption of technical reforms or governance processes is to reward sub-national government with regard to the extent or technical quality of these reforms. Such performance measurement might focus, for example, on whether budgets and financial reports are prepared in a timely manner; how well actual revenues and expenditures correspond to local budget estimates; whether priorities identified in local development plans are actually funded; if and how often new regulations are actually applied; how frequently citizen consultation exercises occur and the extent of participation in them, etc. Such measures do not necessarily say anything about the impact of the new behavior, but they do indicate some movement beyond the pro forma adoption of reforms.

Aggregate or specific fiscal performance

The Central Government may also wish to provide incentives for LGs to alter their aggregate fiscal/budgetary behavior or the level and composition of expenditures and revenues. LGs may, for example, be running large deficits, running large surpluses and holding substantial idle balances, or assuming unsustainable levels of debt. On the expenditure side, they may be spending an excessive share of their budget on administrative expenses or debt service, or spending too
small a share of their budget on social services targeted by a national poverty strategy or to capital investment in areas where infrastructure levels are documented to be insufficient to meet important economic or social objectives.

There may also be particular legal spending mandates on which the government wants to create incentives for LG compliance. With respect to revenues, there may be concerns that own source revenues in the aggregate account for too low a share of total local revenues or that LGs are not raising as many funds as they could from a particular local revenue source. Incentives can be devised to help to stimulate changes in these or other similar fiscal management or budgetary behavioral patterns.

**Inputs, outputs, or outcomes?**

Regarding service delivery, LGs may be excessively or inadequately using key inputs or significantly under—or over—spending relative to input or cost standards in a particular service sector. For example, teacher-student ratios or class sizes may be very high or very low, or expenditures per kilometer of road may be well below or well above national or provincial averages. In such cases, incentives could be used to try to push LGs to adjust the inputs they use or modify the costs they incur for units of particular inputs. There may, of course, sometimes be good reasons for atypical behavior, such as the locally specific need for special technologies or unavoidable spatial cost variations, and these would need to be taken into account in defining the levels for which incentives would be provided.

Rather than motivate LGs to spend more or less on a particular service, or to increase or decrease specific inputs, or reduce unit costs of service delivery, the CG may wish to provide incentives for certain output levels defined, for example, by the relevant sectoral ministry, a national development or a poverty reduction strategy. Examples would include targeting increases in student enrollment ratios, the number of liters of water produced per LG resident, the number of kilometers of road, etc. In many cases it would be possible and desirable to specify some measure of quality, such as water or roads meeting a certain standard. It would even be possible over time to target incentives to
improvements in outcomes that measure something beyond the direct production of a public service, such as improvements in the literacy level, reductions in morbidity and mortality, etc.

Although any of these focal objectives could be pursued through a LG incentives program, it is clear that they become progressively more difficult to achieve and/or measure as they move from simple reform measures to better outcomes. Certifying the adoption of a new budgeting procedure, for example, can occur rather quickly compared to increasing literacy rates, and the pro forma use of new citizen consultation mechanisms is much easier to document than their effect on the quality of local government interactions with constituents and their eventual impacts.

14.4.3. Key Incentive Design Issues

Beyond the basic decisions about the focal objectives of a LG incentives program, several major design decisions commonly need to be made. Key issues include the degree of flexibility in the program; whether to use absolute or relative performance standards; if incentives should be positive, negative or both; if rewards/penalties should be financial, non-financial or both; whether financial incentives should flow through new or existing mechanisms; the appropriate length of the performance period; whether to support capacity building; how to ensure transparency; and whether it is necessary to pilot the incentives before general adoption.

Flexibility in targets

The degree of flexibility of a program has implications both for the nature of targets and incentives and how they are decided on. At one extreme, an incentive program can define fixed broad expectations, such that each LG would be rewarded for its performance in adopting a particular technical reform, increasing collection of particular revenue, improving a clearly defined aspect of the delivery of a particular service, etc. A less restrictive design would allow LGs to choose from a menu of possible reforms or improvements within or across reform areas and/or revenue-sources and/or service sectors. The most flexible type of design would be open-ended and allow LGs to play the dominant
role in selecting a specific reform or set of reforms. Obviously, this spectrum of options involves different levels of CG direction and LG discretion.

**Absolute versus relative standards**

Another important design feature is the nature of standards on which performance will be evaluated. The most restrictive option is the requirement of absolute standards, such that any participating LG must meet exactly the same requirement for a particular behavior being promoted—whether adoption of a particular budgeting reform or attainment of a particular level of revenue generation or service delivery. Given the diversity of LGs in many countries, absolute standards may be neither practical nor desirable, except perhaps for simple compliance-style reforms, such as adopting a new reporting format or meeting a reporting deadline. There could, however, be absolute standards for different groups of LGs, where the classification depends on CG identification of a set of characteristics that are expected to determine a LG’s need and ability to meet particular standards. It would also be possible to give LGs a say in defining a specific set of reforms or target performance indicators that they believe they can meet over a particular performance period, in effect leading to some individualization of targets over a specific time period, even if eventual requirements are standardized.

**Positive versus negative incentives**

Another set of design decisions has to do with the nature of the incentives, which can be positive and/or negative. Positive incentives would reward LG compliance, or performance with a particular target reform or behavior. Failure to comply or perform to standards could simply result in the lack of a reward, or there could be punitive penalties involved.

**Financial or non-financial**

Penalties and rewards can be tangible or financial, such as technical assistance or funding; or non-financial, such as good or bad publicity. The consequences of performance must be something that matters to
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LGs. If they do not need more resources or care about being publicly sanctioned, then the incentives will not have the desired effect. Both penalties and rewards can be fixed, such as a 20% increase/decrease for meeting/failing to meet compliance or performance standards; or they can be graduated to correspond to the extent to which performance exceeds or lags a specified target level. If penalties and rewards are financial, the source, level and regularity (one-time, for a specified period, or recurring) of funding must be identified. The source of funds can be, for example, the CG budget, a share of sub-national government revenues, or external donor grants or loans.

**Existing or new mechanisms**

Financial resources can be allocated through existing programs, such as unconditional or conditional transfer programs; or special funds can be set up, with or without special management arrangements separate from existing government procedures. If the funds are channeled through an existing arrangement, they can be determined either as a proportion of currently allocated resources (that will become subject to new performance conditions under the program) or they can represent an addition to current funding levels.

**Performance period**

A fundamental design issue relevant for a LG performance incentives system is defining the performance period. Making this decision requires determining how frequently performance measurement is needed in order to stimulate better local government performance. Some simple aspects of compliance or performance may be changed over the course of a single annual budget cycle, while others would be expected to take longer to realize or to measure the effects of (depending on exactly what aspect of performance is being measured). If the evaluation process is at least to some extent based on secondary data (see below), the performance period may be dependent on how frequently these data are collected and how soon after collection they are made available.
Capacity building and technical assistance

A common concern with performance incentive programs in developing country environments is if and how they incorporate capacity building and technical assistance. On the one extreme, centrally prescribed general training and technical assistance can be required of a LG based on a pre-program assessment of capacity, and a LG would have to accept this as a condition for participation in the incentives program. At the other extreme, any capacity building or technical assistance required to meet the conditions of the performance incentive program would be entirely the responsibility of the LG. In between these two extremes are a variety of options. Capacity building and technical assistance might be provided in a targeted way based on what is expected to be needed for a LG to meet specific performance indicators at a particular point in time. Alternatively, the CG might make resources available for an eligible LG to try to meet its capacity building and technical assistance needs however it sees fit. In this latter case, there would have to be an ex-post assessment of how these resources were used, particularly if the LG does not meet its performance targets.

Transparency

The design of a LG performance incentives program, however it is structured, will need to meet basic transparency requirements. This means that there should be clarity on the rules and processes to be followed in implementing the program, and this information will need to be readily available to LGs. The results of the compliance/performance evaluation should also be open and LGs should have the right to appeal if they believe, for example, that the information used in their evaluation is inaccurate or if the evaluation procedures as stated were incorrectly applied. If a broad goal of the performance incentives program is improving accountability, then the results of the evaluation process should also be public information so that residents of a local government will be better able to judge how their local officials are performing and how this compares to other LGs.

Piloting or mainstreaming

Finally, it is necessary to decide whether the incentive program
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needs to be piloted or if it can be immediately mainstreamed into the intergovernmental system. In theory, the more complicated and innovative the mechanism, the more likely it would need to be tested and adjusted before being scaled up for general use. A constraint in this regard is however, that it can be politically difficult to selectively pilot what would eventually become national programs. A related issue is if and how the program will be sustained, which depends on its purpose, the source and reliability of funding, and the institutional arrangements required to keep it going.

14.4.4. Measuring Compliance and Performance

A number of decisions need to be made with respect to measuring compliance or performance for an incentive program. These include whether the measure(s) used should be subjective, objective or mixed; how to select an indicator that accurately measures the appropriate dimension(s) of performance; and how to secure the required data, recognizing the potential advantages and disadvantages of various possible sources.87

Subjective, objective or mixed indicators

One of the greatest challenges involved in designing a performance incentive program is how to measure performance. A key initial decision is whether the performance indicators used in the process will be objective, subjective, or some combination of the two. Generally speaking, objective measures are preferable because they are likely to be easier to measure, verify and to interpret, and they are more amenable to a process that will be repeated.

The data required to construct objective indicators, however, may be unavailable or unreliable. In addition, some aspects of performance are difficult to measure objectively. For example, the performance of participatory governance mechanisms is sometimes measured in terms of the number of people or percentage of an eligible population that

87 Some useful literature on measuring performance, some of it specific to local governments, includes the following: Behn (2003), Hattr (2006), Hildebrand (2007), Ammons (2008) and AGA (2009).
Fiscal Decentralization in Indonesia a Decade after Big Bang

actually participates. In such cases, more subjective measures may need to be used, e.g. LGs can be rated comparatively or relatively on a scale, e.g. from strongest performance (great improvement) to weakest performance (no improvement), by a panel of people with appropriate knowledge.

Such ratings, of course should not be fully subjective—there must be clear guidelines for what the different ratings mean and a well-defined process for preparing the ratings that minimizes overt biases or opportunities for manipulation by those conducting the ratings or local officials. In some cases, it may be useful to develop a composite index based on multiple indicators to capture, for example, the extent to which a new reform is used (objective measure) and the degree to which it has affected how local government decisions are made (subjective measure).

**Choosing an appropriate measure**

There are often many challenges involved in measuring performance, even with objective measures. A central concern is that an indicator needs to accurately represent a desired LG performance result. In some cases, this is relatively clear, while in others it is not. Increases in revenue yields from a particular source, for example, can be considered to represent improved local revenue performance (although the source of the increase and whether deliberate LG behavior was responsible for it may not be evident from such a measure). Increases in local expenditures on a particular service, in contrast, need not mean that the services have improved; in fact, spending increases may prove to be wasteful.

**Sources of data**

The sources of data used to measure performance are clearly important. If existing data sources are considered appropriate and reliable, it is obviously preferable to use them rather than mount a new data collection effort, but this is not always feasible. And sometimes existing data sources may not be accessible to the agency that needs to use them, or they may not be collected and updated on a regular basis. There may also be changes in the way the data items are defined or
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collected over time that complicate their use in a periodic evaluation process. In addition, sometimes desired data may cover different units of analysis, e.g. cost or expenditure data may be LG specific whereas some types of outcome data may only be available at the provincial level, or two data sets may cover different time periods. Such discrepancies must be understood and dealt with to the extent possible in the construction of performance indicators.

14.4.5. Institutional Responsibility

Undertaking a LG performance incentives effort requires a number of decisions about assigning institutional responsibilities for the various tasks involved—design of the system and specific incentive instruments and indicators; collection and verification of data required to prepare the indicators; creation of indicators and preparation of evaluation reports based on them; implementation and enforcement of incentives based on indicators; review, evaluation and revision (as necessary) of the incentive system and process. While the overall process will require direction and oversight from a lead agency, some aspects might be delegated to other agencies or contracted to nongovernmental actors. In early stages, the work might be undertaken by a separate entity funded by international agencies, although this should only be done if there is clarity about how and in which government entity the process would be institutionalized.

14.5. Performance Incentives for LGs: International Experiences

Many, perhaps most countries, adopt various service delivery norms and standards, but these only work if (a) there is a way of monitoring performance (including of course having the data required to do so); and (b) if there are incentives (financial and otherwise) and enforceable sanctions to encourage compliance. Getting information, incentives and monitoring systems into place has proven to be a challenge in many countries (given the complex and diverse considerations discussed above), and there is only limited empirical evidence on the efficacy of incentives (with more work in certain sectors and in more industrialized countries). In addition, very little work looks at the effects of incentives in sectors beyond the sector(s) targeted by incentives, i.e. do health
performance incentives lead to more attention to health and better health outcomes but at the cost of less attention and poorer results in other sectors?

Three broad types of LG performance incentive systems have been used around the world. The first includes sectoral performance incentives that target particular services. Normally these use some type of conditional transfer (based on meeting certain standards). Conditional sectoral transfers may include a matching requirement, such that LGs must contribute to the costs of the target services, although these are not very common in developing countries. Conditional transfers are widely used, although they need not incorporate incentives and they are often used in developing countries to finance services through Sector Wide Approaches (SWAs). In some cases, sectoral approaches move beyond transfers and include broader performance management systems. A few examples of these types of sectoral approaches are outlined below.

A second class of performance incentives includes the type of broader (multi-sectoral, often relatively unconditional) performance-based grants (PBGs) that have emerged in many developing countries in recent years. These PBGs have been used primarily in less developed countries with weaker capacity and that are in the process of developing new or highly reworked local government systems. Not surprisingly, they have targeted basic actions, such as LG compliance with the adoption of new systems and procedures and adherence to formal plans and budgets. PBGs have to date not commonly been based on outputs, both due to data challenges and because basic systems must be built in these environments before there can be high expectations of service delivery. A number of PBG systems are discussed below.

A third and relatively uncommon type of performance incentive includes more comprehensive performance assessment systems that focus on multiple integrated aspects of performance, including the structures, processes and behaviors that contribute to the level and

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88 Broad reviews of various forms of intergovernmental transfers, including conditional, are provided, for example, by Bahl (2000), Bird and Smart (2002), Schroeder and Smoke (2003), and Boadway and Shah (2007).
quality of service delivery outcomes. Such comprehensive systems are highly data and skill intensive, and are likely to be beyond the reach of many developing countries. More information and one example from an industrialized country are provided below for illustrative purposes.

14.5.1. Sectoral Conditional Transfers and Performance Systems

Many industrialized countries use conditional transfers for service delivery in particular sectors that require certain norms and standards to be met, but such approaches have not been very common in developing countries. The rise of SWAps in developing countries\(^89\) and the pressures created by the Millennium Development Goals\(^90\) have created some efforts to use sectoral performance based approaches more widely, particularly in health and education.\(^91\)

Uganda has implemented a highly studied sector-specific education grant system that is illustrative of a basic approach. Two education grants are administered under the Poverty Action Fund, including a School Facilities Grant (SFG) and a Universal Primary Education (UPE) capitation grant.\(^92\) The SFG is conditional and the funds must be used for specific purposes, including building latrines, purchasing desks and updating classrooms. The targets for the program include reaching a classroom to pupil ratio of 1:55, a desk to pupil ratio of 1:3, and a latrine to pupil ratio of 1:40. The UPE capitation grant pays schools grants based on enrolment, essentially making primary education free. It also rewards schools for increasing enrolment numbers.

The results of these grants have been mixed. The conditional SFG has been found to function reasonably well, although there is


\(^{91}\) Some sector specific treatments of performance based incentives and financing include: McMahon (2003), Canavan, Toonen and Elsvainio (2008), Eichner and Levine (2009), and Morgan (2010).


confusion over responsibility delegation; and the UPE has been subject to delays and problems with non-compliance with administrative guidelines.\textsuperscript{93} However, there is no doubt that the reforms, particularly the UPE, have increased school enrolment dramatically. At the same time the quality of education did not necessarily improve; in fact, the rapid growth in school attendance sometimes works to the detriment of education quality. This is a similar lesson from the overall performance based grants system (PBGS)(see below), where service delivery was found to increase, but not necessarily improve in quality.

The health sector in Rwanda has developed a more sophisticated performance based financing (PBF) system over the past decade, but it is important to note that it has been targeted to facilities in localities rather than to LGs.\textsuperscript{94} The system started with three pilot schemes in different localities from 2002–2005. The primary goal was to increase the quantity of health services used (the volume). They worked through various measures that paid hospitals and clinics for the cases admitted, paid bonuses for health staff and granted monies to reinvest in the medical facilities themselves. The schemes covered a variety of health services considered ‘basic’ to the area, including payments for referrals; TB, malaria and HIV/AIDS cases; and obstetrics and preventative care.

The quality of care was also part of the schemes, although it was treated differently across the three pilots. In Butare, quality of care was not included, as it was considered too complex to define and measure. In Cyangugu, district hospitals executed a quality regulation function and awarded bonuses based on results. The scheme in Kigali and Kabgayi developed a set of proxy indicators for quality of care. At health centers, quality was measured in terms of adherence to protocols. At the hospital level, quality was assessed with process indicators (such as timeliness of reports and frequency of supervisory visits).

The results of the three pilot projects were positive. Provinces


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Receiving the PBF had higher numbers of preventative and curative visits, as well as higher volumes of births delivered at the clinic/hospital. Coverage of vaccinations also increased—in the case of measles, by 11 percentage points. The measures of quality of care also showed positive improvements in the PBF provinces. Incentivizing medical staff to get cases and follow the process indicators was shown to have a significantly positive effect.

Due to the success of these three initial PBF schemes, Rwanda adopted PBF as part of the National Health Strategic Plan for 2005–2009. In the national PBF scheme, health centers are reimbursed for the quantity of services provided according to a standardized fee structure for a list of 14 services, adjusted by a composite quality score. Health centers are able to raise revenues by increasing the quantity of the services delivered and by improving quality. Quality is assessed quarterly, and carried out by peer review from a team at a neighboring district hospital using a supervisory checklist. The list measures 13 services and 185 variables.

A hospital/clinic receiving a 100% score would receive the full payment; after the first year of PBF most health centers averaged a score of around 80%. HIV/AIDS care is assessed separately (as not all health centers provide HIV/AIDS care), and allows participating health centers to receive additional revenue. National ministerial panels review assessments of both quality and quantity, and the Ministries of Finance and Health manage cooperation on the PBF.

Results of the national PBF scheme have been generally positive, and the use of this general type of approach is on the rise in health and other sectors.

A number of middle-income countries and newly industrializing countries have also moved towards using sectoral PBGs. India’s 13th Finance Commission has recommended a number of new service delivery incentive schemes, and Brazil uses performance-based grants in a number of sectors, including health. Several other Latin American countries have been increasingly adopting performance based grants for certain sectors, including Chile (primary and secondary education), Colombia (education, health, water and sanitation) and Peru (several local functions plus local contribution to priority national policies,
Sectoral-based performance incentives can be useful if the right kind of data can be regularly assembled, analyzed and used. Simpler systems, such as the education sector program in Uganda can be useful but have limits. More complex systems, such as the health sector program in Rwanda, are more difficult to establish but can likely be more broadly effective. Either can target LGs directly, or local facilities. In the latter case, service delivery may improve but the system may do little to strengthen LGs.

As seen in Uganda with the education sector, simply including incentives for quantity (volume) of service is probably not enough. The PBF system in Rwanda required checks on quality at the health centers, hospitals and clinics, so they have been required to maintain and improve their processes for diagnosis and treatments, at the same time as increasing the cases they oversaw. Without this check, quality may have suffered as the health centers may have focused only on bringing in more cases.

The flexibility in use of funds (upon being rewarded for the quantity and quality of their care), encouraged providers in the Rwanda health care facilities to find innovative ways to increase cases. Many hospitals and clinics generated their own creative incentives to get people to come to the health center, such as paying midwives to bring their patients to the hospital for deliveries.

The well-organized assessment system, in which the formula and data were validated by national agencies helped to make Rwanda’s PBF a success. The peer review system helped to keep costs relatively low for the first assessment rounds; while having another round of review by outside agencies made accountability higher. The combination of horizontal and vertical accountability contributes to a strong assessment structure.

A potential concern with the type of approach used in Rwanda (and a sectoral performance based system in general) is that it may increase inequity by giving an advantage to facilities that are already performing well. Due to the focus on quantity of cases, health centers

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in the same vicinity are competing for individuals. This may work to conglomerate health centers into larger, more profitable entities. If carried too far, health care may become less accessible for people in remote locations or with limited finances. To mitigate this risk, one of the pilots incorporated an isolation bonus. Thinking more broadly about mitigating such risks would be advisable.

14.6. Broader Performance-Based Grant Systems

Many developing countries pursuing LG reform have adopted wide-ranging functional performance-based grant (PBG) systems. Most have focused on process-oriented reforms in LG, generally in functional areas such as financial management, planning, transparency and human resource management. LGs are allowed to participate only after meeting minimum conditions. Beyond the minimum conditions, they may be offered bonuses (or be subject to penalties) for meeting (failing to meet) certain performance targets. These targets, however, are more likely to be based on process requirements than on service delivery outcomes. If outcomes are assessed, often they are assessed in terms of volume (e.g. number of cases admitted to a clinic, increases in school enrolment, etc.). Some countries have incorporated measures of service quality into PBG assessments, but these are usually sector-specific, along the lines of the Rwanda health sector case discussed above.

Uganda was one of the first and most widely publicized countries to adopt a systematic performance-based grant system for local government allocations. With the support of the United Nations Capital Development Fund (UNCDF), Uganda launched a PBG system in the mid-90s in four districts. By 2003, the system was scaled up national (substantially with World Bank funding) to cover all LGs in the country. The Uganda PBG operates from the Ministry of Local Government (MLG), and is primarily concerned with process-oriented LG performance targets to fulfill minimum conditions and annual performance goals. Minimum conditions were determined from the LG regulatory and legal framework. Performance measures cover

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compliance and quality of the development plans, budgeting, financial management and accountability, effectiveness of the procurement and contracting systems, and monitoring and evaluation. After these assessments, allocations for Local Development Funds are made to districts and sub-districts. These funds are discretionary, and LGs generally invest them in local infrastructure.

A noteworthy aspect of the Uganda case, that is expected to help citizens hold LGs more accountable, is the MLG efforts to publicize the PBG system. Details of the scheme were disseminated widely, including the amounts of development funds available to the councils based on their assessed performance in the process areas. The transfers were published in advance through radio, newspapers, public announcements in churches and public notices boards. Although there are not direct service provision targets under this scheme, LGs are under pressure from constituents who want the development funds for their communities. In addition, elected councilors are incentivized to demand high performance from LG staff members, who are generally responsible for the administration of the process/functional areas that are subject to assessment.

Results of the overall PBG in Uganda were initially encouraging in many respects. Mid-term reviews of the system during 2000–2005 were significantly positive. The 2005 mid-term review, using beneficiary assessments and value-for-money audits, stated that the assessment and incentive system had contributed significantly to increased (although not necessarily improved quality) service delivery. The challenge for Uganda’s PBS system is that it never advanced much beyond the measurement of process compliance, and its role in encouraging good LG performance began to deteriorate as its relative importance in the larger grant scheme declined and individual conditional sectoral grants (such as the education grant discussed above) gained prominence.

Both Ghana and Tanzania have newer but similar programs to

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Uganda. Both emphasize performance-linked discretionary development funding for local governments. Similar to Uganda, Ghana and Tanzania reward LG performance in functional areas such as management, human resources, planning and budgeting. In the Ghana Local Service Delivery and Governance Program (2009–2013), process-oriented targets are the basis for grant allocation of District Development Funds, and performance bonuses are awarded for better performance.99 In Tanzania, performance in individually scored functional areas is used to determine a minimum score that allows receipt of a basic grant and also determines performance bonuses beyond that. The functional areas assessed are a bit more ambitious than the earlier programs and include: financial management, fiscal capacity, planning and budgeting, transparency and accountability, interaction between LGs, human resource development, procurement, council functional processes and project implementation.100 Tanzania also offers limited sector-specific grants for agriculture, environmental management and rural water/sanitation.

Many other countries have adopted local development/PBG schemes. In Africa, Kenya, Sierra Leone and Mali have implemented somewhat comparable schemes since 2008, although not all countries based allocations as heavily on performance as others. In Asia, Laos, East Timor, Solomon Islands, Nepal and Bangladesh have adopted similar schemes, and performance is also being taken into consideration in new or in process schemes in the Philippines, Bhutan and Pakistan. With respect to grant allocation formulas, most countries use similar structures: a basic formula based on population, poverty indicators and geography plus an adjustment for local government performance. As in Ghana, Sierra Leone has separate performance grants in addition to the basic LG grants.

Broad-based performance grant systems are increasingly common in developing countries, and they largely follow a variation of the same (substantially compliance based) model. If this type of approach is followed in countries trying to implement a new LG system, it can help

to get into place the basic systems and procedures that are needed for LGs to be able to perform in terms of accountable and efficient service delivery. The system also provides information that members of the public can use in evaluating their elected LG councilors; but collecting, analyzing and disseminating this information requires a concerted effort, a reasonable level of capacity, and in some cases external technical support. There can often be challenges with the accuracy, consistency and fairness of assessments, particularly as they evolve to use more complex measures.

A number of countries that pursue these broad-based systems also have sector-specific PBGs above and beyond the general programs. If countries that start by using general PBG systems head in this direction, they can move beyond the compliance based foundations of mainstream PBG principles towards improvements in service delivery outputs and in the achievement of other goals that might be legitimate targets of intergovernmental transfers. While compliance payments can provide an excellent incentive for LGs to develop their systems and adopt system structures and processes, it does not make sense to continue to pay LGs for meeting their basic, legally mandated obligations.

14.7. Comprehensive Performance Assessment Systems

The term ‘comprehensive’ performance assessment can mean different things, and in fact some of the approaches discussed above—beyond basic input or output conditioned transfers—could be seen as comprehensive in certain respects. Some of the sectoral performance based initiatives discussed above are fairly comprehensive with respect to stimulating better performance in the various aspects of individual sectors, and the broad-based PBG systems could even be considered comprehensive from the perspective of providing incentives for getting all of the basic elements of a new or reformed local government system in place. As used here, however, comprehensive refers to approaches that cover a wide range of processes and outcomes and that explicitly provide incentives for improved performance on a wide range of fronts. Although a few developing countries are promoting more comprehensive LG performance assessment and incentive schemes, they are primarily used (to various degrees) in more industrialized countries. A number
of organizations in the United States promote such comprehensive approaches. For example, the International City Management Association and the Urban Institute promote the development of comprehensive approaches to LG performance assessment and management.\textsuperscript{101} The Association of Government Accountants provides advice on sub-national government use of performance systems to improve service delivery.\textsuperscript{102} Some local membership organizations, such as the New York State Association of Counties, provide information about performance management for improved service delivery to their constituent local governments.\textsuperscript{103} There are many other examples of this nature.

Probably the best-known and best-documented comprehensive LG performance assessment/incentive system is the England Comprehensive Performance Assessment (CPA), which was introduced in 2001 for all LGs in the country. It rates LGs on the quality of service in six different areas: education, housing, social care, environment, libraries and leisure, and use of resources/finances.\textsuperscript{104} It is a combination of a rating system and incentive scheme for LGs, and it incorporates a heavy emphasis on service quality along with an efficiency measure (use of resources) and an overall institutional health indicator (focused on functional/process areas of local government management).

Beyond a rating system, the CPA provides both formal and informal incentives for LGs who perform well. LG councils receiving high ratings do not have to adhere to the same audit and inspection regimes as their counterparts (saving the cost of associated fees), and they enjoy greater flexibility from the CG on other fronts, including borrowing freedom. Poorly performing councils, on the other hand, are


required to submit to increased inspections and monitoring.

Prior to the introduction of the CPA in 2001, England introduced the Best Value framework in 1999. This framework utilized measures called the Best Value Performance Indicators (BVPIs), which were numerical scores for councils on the quality of services. CPA built on the BVPIs by assessing the six service areas listed above, using (where possible) already existing inspectors and agencies (e.g. the Office of Standards in Education). CPA also aggregated and deliberatively weighted the numerical scores as follows: education and social services count four times, housing and environment two times, and libraries/leisure and use of resources once each. In this way, the services deemed most crucial to local development (education and social services) were emphasized within the end, overall performance rating.

The only additional measure added to the overall performance rating was a score of the local council’s ‘ability to improve’. In 2005, the performance assessment was adjusted with a variation in the weighting system and longer (3 year plan) approach to the ‘ability to improve’ measure. The CPA measures service quality, but combines it with a measure of financial efficiency (use of resources) as well as a broader, more ambiguous measure of institutional health (ability to improve). The combination of these three measures into one rating system is a unique aspect of the CPA, which also emphasizes service quality more highly than functionality. Finally, the CPA is linked to performance of elected councilors. Political parties and candidates seeking election are concerned with their CPA rating as voters can use it to evaluate them.

According to a recent comparison of England to Wales, which is not participating in the CPA, the results of CPA are mixed.\textsuperscript{105} There are some strong positive results. First, the CPA did have a positive, significant effect on the service quality index. Results indicated both overall service quality improvements in England as compared to Wales, but also specific positive returns in education (where a sector specific incentive scheme (school league tables) was introduced in the second

wave of the CPA). These positive results in service quality do not, however, extend to the efficiency measure. The study found no correlation between the CPA and more efficient use of council resources. Second, voters rewarded council members who received high CPA ratings. A recent study found a correlation between CPA ratings and the probability of incumbent party re-election, increasing it by seven percentage points. Thus, public awareness of performance measures was an effective tool in the reward/punishment mechanism. This may have a long-term effect of improving services through community accountability.

Overall, the broad-based CPA in England is a valuable approach. It provides information and assessments on many aspects of LG behavior. Although results have been mixed, available information generally indicates the CPA has had an increasingly positive impact on multiple aspects of LG performance and has raised awareness of LG performance among citizens.

On the other hand, the CPA system is complex and rather demanding. England is a country with a highly developed capacity for collecting, monitoring, and evaluating performance data. Well-established and well-staffed national agencies perform much of the assessment. The emphasis on service quality is easier in an environment where most LGs already have an established functional and financial capacity. These factors enabled England to establish, sustain and continue to develop a sophisticated assessment system like the CPA. This is likely to be considerably more difficult in developing countries, and it may be dependent on the provision of external resources and technical assistance.

14.8. New Local Government Performance Incentives in Indonesia

If Indonesia were to adopt a stronger LG performance assessment/incentive scheme, a number of options might be considered. First, it seems unlikely that the type of comprehensive system discussed above is feasible. It is highly complex and demanding, and it does not seem like the right approach to continue advancing reforms in Indonesia.
There are also concerns about using a broad-based PBG system along the lines of those discussed above. To begin with, it might be considered late in the decentralization process to begin using incentives for compliance with LG systems and procedures mandated by the decade old decentralization initiative. On the other hand, many LGs have not fully adopted basic systems and procedures that they are supposed to be using or have not used them well, so some might see a value in this approach, at least for application to LGs with weaker capacity and performance records.

If such an approach were to be adopted however, there are reasons to think it would be insufficient on its own. First and foremost, this style of reform does not directly address dominant concerns about LG performance—persistent inadequacies in services 10 years into a reform effort that generated high expectations. Incentives for simple adoption of reforms thus seem unlikely to be compelling to the CG or citizens. In addition, such incentives would likely have to be significant and long-lived to induce LGs to sustainably change the behaviors they have adopted since decentralization began.

Thus, it seems likely the most feasible next steps for Indonesia involve sectoral performance incentives. One logical way to target performance in sectors is to use conditional transfers. As noted above, these are often used to create incentives for performing local functions that involve key national policy objectives. After a slow start, Indonesia’s nascent DAK has been rapidly growing, and it seems poised to continue on an upward trajectory. As noted earlier, some recent donor projects have been promoting the incorporation of incentives into the DAK.

Although not service delivery specific, a case could also be made to provide incentives for better performance on a number of aspects of aggregate sub-national government fiscal behavior—accumulation of reserves, debt financed, balance between recurrent and capital expenditures, significance of own-source revenues, economic growth, etc. Some of these, as noted above, are already influenced, whether intentionally or not, by central regulations and actions, such as the structure of LG taxes and the allocation of the DAU.

More broadly, the discussion of the DAU above highlighted
problematic incentives created by various aspects of the formula and the way that variables used in its calculation are defined. Although politically sensitive, more systematic study of the effects of the DAU would provide a basis for reform options intended to improve incentives for sub-national performance. Perhaps a more grounded public debate about the effects of the present system would increase the political feasibility of changes over time. There may also be other worthwhile incentives focused on specific problematic aspects of local fiscal behavior. For example, the CG could create incentives for LGs with poor revenue collection performance to improve yields, or penalize LGs with substantial or growing debt arrears.

Any of these options, however, would face a number of political economy and fiscal constraints. For example, we noted above the institutional fragmentation among central agencies that have a role to play in decentralization and LG development. If different agencies develop an ad hoc collection of incentives, some may work at cross purposes, some may be dependent on the adoption of others that do not materialize, and they may collectively confuse sub-national governments about priority reforms and overwhelm their ability to respond.

Finally, a particularly vexing issue concerns the potential moral hazard of transferring more funds to inefficiently operating governments. In general, Indonesian sub-national governments use the funds they spend on service delivery (as opposed to save) inefficiently.\textsuperscript{106} It is probably safe to conclude that all sub-national governments could be operating at least somewhat more efficiently. Under such circumstances, providing additional funds to any LG as an incentive for achieving some desired outcome (i.e. that they could have realized with more efficient use of resources in the first instance) risks rewarding inefficient behavior, at least implicitly. In theory some LGs may be operating ‘efficiently enough’ and therefore arguably more deserving of incentive funds. But identifying sufficiently efficient performers is not easily done in any rigorous way. This makes it difficult to avoid

sending mixed signals in attempting to operationalize performance incentives.

Although these various challenges and concerns are real, there are undoubtedly ways to make progress in creating more robust performance incentives for local governments in Indonesia. Even if incentives are agreed to, however, there will inevitably be a range of problems encountered with design, data collection and processing and the consistent application of the system. Despite the likely challenges involved, the potential benefits that might be realized suggest the value of experimentation and further policy research.
15
Financing Regional Infrastructure and Growth in China

Professor Baoyun Qiao

15.1. Introduction
Over the past few decades, fiscal decentralization has become a common trend around the world. Sub-national governments have obtained more and more revenue, expenditure and borrowing autonomy. Granting borrowing autonomy to sub-national governments has provided them with access to the capital market, so they can invest in infrastructure, with the hopes of them being able to further improve their economic growth. However, there are accompanying risks involved with sub-national borrowing, which cannot be ignored. Singh and Plekhanov (2005) argue that sub-national governments tend to overspend, under-tax, and borrow more excessively than national governments do due to common pool problem, soft budget constraints, interregional competition, unfunded federal mandates, or short electoral cycles, etc.\footnote{R. Singh and A. Plekhanov. 2005. How Should Subnational Government Borrowing Be Regulated? Some Cross-Country Empirical Evidence. IMF Working Paper. No. 05/54.} International experiences have shown that granting borrowing autonomy to sub-national governments, without appropriate liability management, contributes to imprudent borrowing and fiscal crises—as seen in countries such as, Brazil, Mexico, Hungary and Russia. Sub-national debt crises not only compromise a sub-national
governments’ ability to provide certain services, but also potentially jeopardizes the whole country’s financial and macroeconomic stability.

The fast process of industrialization and urbanization in China has generated great demand for regional infrastructure development. Under a decentralized fiscal system—especially with decentralized expenditure assignments—SNGs take almost all of the responsibility for regional infrastructure expenditure in China. SNG financing for infrastructure development—mainly through sub-national debt—has improved social welfare and provided great potential for economic growth and sustainable social and economic development. However, risk remains as China’s economy faces the challenge of increasing sub-national liabilities.

Following Ter-Minassian and Craig (1997), the current literature on sub-national liability management categorizes various management approaches into four groups: market discipline, administrative control and rules-based and cooperative arrangements. However, several key questions remain unanswered in the literature: Why do different countries choose different management approaches? What is the optimal sub-national liability management approach for a particular country? The answers to these questions are important for policy makers—especially those in countries that are in the early stage of fiscal decentralization—to choose appropriate sub-national liability management approaches.

This paper contributes to the literature, by answering these aforementioned questions via an analytical framework of optimal risk control. This analytical framework assumes that the risk associated with sub-national borrowing is influenced by the strength of the country’s fiscal budget constraint—with this strength being measured by a combination of factors including: the country’s current status of intergovernmental fiscal relationship, financial market constraints and the current status of the financial markets. Due to the fact that different countries start fiscal decentralization and sub-national borrowing with unequal strength of budget constraint and market constraint, their marginal benefit and marginal cost of strengthening these two constraints will also vary substantially. Therefore, the optimal choice (which is

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Section E: Optimizing the Delivery of Public Infrastructure and Services

conditional on differing status quo of the budget and market constraints), explains the different sub-national liability management approaches implemented in different countries. An application of our optimal risk approach to the case of China indicates that administrative control could be the optimal approach to contain sub-national liability in the short term while a rules-based approach may work best in the long run.

This paper is organized as follows: section 2 will provide a theoretical background; section 3 will describe a theoretical model for optimal risk control, that serves as a framework to analyze the optimality of sub-national liability management approaches; in section 4, we apply the optimal risk approach to exploring the optimal sub-national liability management approach in China; and finally, in section 5 will offer some concluding remarks.

15.2. Theoretical Background

15.2.1. Intergovernmental Fiscal Relations in China

China’s fiscal reform started in 1994, with a clear objective to improve economic growth. Through these reforms, the framework for China’s current fiscal system was established. Emphasis has been placed on finding solutions to the problem of current spending—at both the central and sub-national levels—by increasing the ratio of fiscal revenue in total GDP and the central share in total fiscal revenue. Table 15.1 shows the trend of the ratio of fiscal revenue in total GDP and the central share in total fiscal revenue.

Within this framework, expenditure responsibilities in China are highly decentralized. The Budget Law confers substantial autonomy to each level of sub-national government and bestows broad expenditure responsibilities. Fiscal decentralization reforms provided LGs with significant local autonomy on various aspects, such as the determination of their own spending priorities and policies on relevant aspects of local budgets. However, expenditure assignments are far from being transparent and clear-cut, mostly because of the presence of extensive concurrent expenditure responsibilities among different levels of government. Specifically, the 1994 fiscal reform restated the pre-reform
Table 15.1. Fiscal Revenues and Expenditures in China, Selected Years, 1990–2009 (billion Rmb)

<table>
<thead>
<tr>
<th>Year</th>
<th>Total Revenue</th>
<th>Central Revenue</th>
<th>SNG Revenue</th>
<th>Total Expenditure</th>
<th>Central Expenditure</th>
<th>SNG Expenditure</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Amount</td>
<td>% of GDP</td>
<td>Amount</td>
<td>% of total</td>
<td>Amount</td>
<td>% of total</td>
</tr>
<tr>
<td>1990</td>
<td>293.7</td>
<td>15.7</td>
<td>99.2</td>
<td>33.8</td>
<td>194.5</td>
<td>66.2</td>
</tr>
<tr>
<td>1995</td>
<td>624.2</td>
<td>10.3</td>
<td>325.7</td>
<td>52.2</td>
<td>298.6</td>
<td>47.8</td>
</tr>
<tr>
<td>2000</td>
<td>1,339.5</td>
<td>13.5</td>
<td>698.9</td>
<td>52.2</td>
<td>640.6</td>
<td>47.8</td>
</tr>
<tr>
<td>2005</td>
<td>3,164.9</td>
<td>17.1</td>
<td>1,654.9</td>
<td>52.3</td>
<td>1,510.1</td>
<td>47.7</td>
</tr>
<tr>
<td>2006</td>
<td>3,876.0</td>
<td>17.9</td>
<td>2,045.7</td>
<td>52.8</td>
<td>1,830.4</td>
<td>47.2</td>
</tr>
<tr>
<td>2007</td>
<td>5,132.2</td>
<td>19.3</td>
<td>2,774.9</td>
<td>54.1</td>
<td>2,357.3</td>
<td>45.9</td>
</tr>
<tr>
<td>2008</td>
<td>6,133.0</td>
<td>19.5</td>
<td>3,268.1</td>
<td>53.3</td>
<td>2,865.0</td>
<td>46.7</td>
</tr>
<tr>
<td>2009</td>
<td>6,851.8</td>
<td>20.1</td>
<td>3,591.6</td>
<td>52.4</td>
<td>3,260.3</td>
<td>47.6</td>
</tr>
</tbody>
</table>

Source: China Statistical Yearbook, 2010
expenditure assignment and provided only basic guidelines for defining the expenditure responsibilities between the CG and LGs. These guidelines illustrate that both the CG and LGs have extensive expenditure responsibilities and that these responsibilities are widely overlapping and very vague. Fundamentally, exclusive responsibilities at the central and sub-national levels are few and far between; the CG tends to be exclusively responsible for national defense issues, while LGs essentially provide all basic local public services, such as urban maintenance and construction expenditures.

The expenditure assignment for sub-provincial governments is at the discretion of the PG. Although sub-national governments at different levels may have overlapping expenditure responsibilities, in practice the main responsibilities for basic public services, such as basic education and health care, are concentrated at the county and lower levels of government. Other public services, such as social security, are concentrated at the provincial and prefecture levels of government. It is important to note that, although there are significant regional disparities in fiscal resources, there tend to be marked similarities in expenditure structure across sub-national governments. For example, in the case of townships, expenditures on government administration count for a high percentage of total expenditure. Expenditures on administrative personnel accounts for 50–70% of total expenditure in some townships, while expenditures on public services are generally low. Another highly variable feature is the importance of expenditures on public relations—particularly for guest expenditures—in both rich and poor townships. Table 15.2 shows the pattern of fiscal expenditure in 2009.

Fiscal decentralization reform over the last two decades has contributed significantly to improving local autonomy. Now each sub-national government has its own budget - though local residents’ input on local expenditure remains limited. Both local expenditure and budget management is conducted through the bureaucratic hierarchy. The legal system framing China’s fiscal decentralization process gives the PGs discretion to determine budget management for all sub-provincial governments. The CG has also increasingly provided guidelines for local expenditure management but the significant autonomy granted by decentralization has meant that sub-national government officials
practice ‘administrative autonomy’ and go beyond the confines and constraints imposed by the local budget and related regulations. A typical case is the widely practiced ‘land finance’.

On the other hand, the revenue assignment in China is relatively better structured than the expenditure side. The legislative power of taxation in China is centralized. Fundamentally, the current system does not provide sub-national governments any autonomy on either the definition of tax base or the determination of the tax rate for almost all taxes. Nevertheless, the CG has designated a list of taxes to be collected by sub-national tax agencies, which are regarded as sub-national taxes.\textsuperscript{109}

\textsuperscript{109} This list includes the urban maintenance and construction tax, vehicle purchasing tax, agriculture and animal husbandry tax, tax on special produces, contract tax, housing property tax, educational surcharge, stamp tax, pollution charge, urban and township land use tax, farmland occupation tax, resources tax, land appreciation tax, vehicle and vessel utilization tax, fixed asset investment tax, slaughter tax, banquet tax, and others.
In general, sub-national taxes have narrower tax bases and less stable revenue yields than the central and shared taxes. Shared taxes represent the most significant source of revenues at the sub-national level. Currently, shared taxes include: the business tax, VAT, the corporate income tax, the individual income tax, and the stamp tax on security transactions. The rest of sub-national budgetary revenues come from transfers. Besides the budgetary revenues, sub-national revenues also include non-tax revenues [such as net profits from State Owned Enterprises (SOEs)] administrative fees, penalty and confiscatory income, income from usage of sea resources, drilling, and others.\(^{110}\)

The current system of tax assignments and revenue sharing dates from the 1994 TSS reform. TSS reform built a clear and relatively stable revenue assignment between the central and provincial governments; more precisely, the CG clarified what were exclusively central level revenues, what taxes would be shared with sub-national governments, and it decentralized some revenue authority to the PG. This arrangement improved the transparency of revenue assignment, and it also helped the predictability of revenue for the government at the provincial level. Meanwhile, the CG has further encouraged the PG to continue the decentralization process of revenue assignment to lower levels of government. At the same time, the fact that there is usually no delineated expenditure responsibilities assignment among different levels of governments—not even between the CG and PGs—makes it difficult sometimes to determine which level of government is responsible for providing what public services, which therefore makes it difficult to obtain the corresponding revenue sources.

This explicit approach to defining revenue assignment for the CG significantly improved its revenue performance. In fact, the CG’s budgetary revenues have continued to increase since the TSS reform. In particular, the recentralization or revenue sharing of the income tax in 2002 and 2003 avoided a steadily declining share for the CG. At the sub-national level a subtle centralization trend can be detected, with the provincial level marginally increasing its share, at the cost of lower shares for the prefecture and the county levels.

\(^{110}\)These are reported net of the planned subsidies to loss-suffering SOEs.
Despite the fact that the 1994 TSS reform did not grant any meaningful tax autonomy to sub-national governments, de facto sub-national governments have gained revenue autonomy by taking other actions, such as: collecting profits from SOEs, levying administrative charges, collecting penalty and confiscatory income and user charges for drilling, etc. Central authorities have also accepted the use of extra-budgetary revenues as a way of exerting local revenue autonomy. In fact, extra-budgetary revenues are one of the important revenue sources for LGs. Currently, extra-budgetary revenues come from revenue of administrative units and institutions, revenue of government funds, self-raised funds by township government, revenues from state-owned enterprises and their administrative department, etc.

In general, all tax bases for the county and township governments are weak—particularly in poor jurisdictions—and differ widely. In addition, local taxes have unstable yields, with high collection costs. County and township governments in poor jurisdictions have depended heavily on a variety of charges and fees on farmers and agriculture taxes. The revenue autonomy of county and township governments has been further diminished in recent years, due to the recent Tax-for-Fee reforms initiated at the central level—which aimed to cut the tax burden placed on farmers.

In 1994, moves under the TSS reform, to separate tax administrations into the State Tax Agency (at the central level) and the provincial tax administration agencies, was intended to lessen the influence and impact of LG authorities on the performance of the tax administration in regard to central and shared taxes. At the same time, the intention was to provide some administrative autonomy to sub-national governments as LGs could use some instruments, such as tax exemptions, to exercise their own revenue autonomy.

China’s transfer system is still evolving. The 1994 TSS reform tried to build a framework for intergovernmental transfer systems in China but was only partially successful. A positive aspect of the reform was that it tried to provide, for the first time in China, a rules-based mechanism for transfers—which moved away from the ad hoc, negotiated transfers of the past. Another objective of the reform was to increase the CG’s share in total revenues, in order to improve its
capacity to redistribute fiscal resources across jurisdictions. On the negative side, the 1994 TSS reform added ‘tax rebates’ to the transfer system, which have had an un-equalizing effect. In practice, the tax rebates were introduced to smooth out resistance to the TSS reform from richer sub-national governments and were justified as a means to provide incentives to the LG to develop the local economy and collect revenues.

The general purpose equalization transfer (known as the ‘transitional equalization transfer’) introduced in 1995 represents only a small portion of all intergovernmental transfers, and therefore is ineffective in addressing horizontal fiscal disparities. Although intergovernmental transfers finance a significant part of local expenditure, the framework for intergovernmental transfers between the CG and PGs has not yet
been well developed. In addition, not much has been done to develop a transfer framework at the sub-provincial level. Table 15.4 shows the trend of fiscal gap for sub-national governments.

Although currently there are hundreds of transfer programs in China, they can be grouped into two main types.

15.2.2. General Purpose Grants

These include general transfers and tax rebates. Equalization transfer is designed to help equalize fiscal disparities across provinces. The distribution is either based on a formula that incorporates objective measurements of fiscal capacity and expenditure needs for the provinces; or, the actual amount distributed is calculated on the basis of the gap between standard current expenditures and standard current needs.

Table 15.4. Fiscal Deficits of SNGs, China, 1990–2009 (billion Rmb)

<table>
<thead>
<tr>
<th>Year</th>
<th>Revenue</th>
<th>Expenditure</th>
<th>Deficit</th>
<th>% of SNG Expenditure</th>
</tr>
</thead>
<tbody>
<tr>
<td>1990</td>
<td>194.5</td>
<td>207.9</td>
<td>13.49</td>
<td>6.5</td>
</tr>
<tr>
<td>1991</td>
<td>221.1</td>
<td>229.6</td>
<td>8.5</td>
<td>3.7</td>
</tr>
<tr>
<td>1992</td>
<td>250.4</td>
<td>257.2</td>
<td>6.8</td>
<td>2.6</td>
</tr>
<tr>
<td>1993</td>
<td>339.1</td>
<td>333.0</td>
<td>-6.1</td>
<td>-1.8</td>
</tr>
<tr>
<td>1994</td>
<td>231.2</td>
<td>403.8</td>
<td>172.6</td>
<td>42.8</td>
</tr>
<tr>
<td>1995</td>
<td>298.6</td>
<td>482.8</td>
<td>184.3</td>
<td>38.2</td>
</tr>
<tr>
<td>1996</td>
<td>374.7</td>
<td>578.6</td>
<td>203.9</td>
<td>35.2</td>
</tr>
<tr>
<td>1997</td>
<td>442.4</td>
<td>670.1</td>
<td>227.7</td>
<td>34.0</td>
</tr>
<tr>
<td>1998</td>
<td>498.4</td>
<td>767.3</td>
<td>268.9</td>
<td>35.0</td>
</tr>
<tr>
<td>1999</td>
<td>559.5</td>
<td>903.5</td>
<td>344.0</td>
<td>38.1</td>
</tr>
<tr>
<td>2000</td>
<td>640.6</td>
<td>1,036.7</td>
<td>396.1</td>
<td>38.2</td>
</tr>
<tr>
<td>2001</td>
<td>780.3</td>
<td>1,313.5</td>
<td>533.1</td>
<td>40.6</td>
</tr>
<tr>
<td>2002</td>
<td>851.5</td>
<td>1,528.1</td>
<td>676.6</td>
<td>44.3</td>
</tr>
<tr>
<td>2003</td>
<td>985.0</td>
<td>1,723.0</td>
<td>738.0</td>
<td>42.8</td>
</tr>
<tr>
<td>2004</td>
<td>1,189.3</td>
<td>2,059.3</td>
<td>869.9</td>
<td>42.3</td>
</tr>
<tr>
<td>2005</td>
<td>1,510.1</td>
<td>2,515.4</td>
<td>1,005.4</td>
<td>40.0</td>
</tr>
<tr>
<td>2006</td>
<td>1,830.4</td>
<td>3,043.1</td>
<td>1,212.8</td>
<td>39.9</td>
</tr>
<tr>
<td>2007</td>
<td>2,357.3</td>
<td>3,833.9</td>
<td>1,476.7</td>
<td>38.5</td>
</tr>
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<td>2008</td>
<td>2,865.0</td>
<td>4,924.8</td>
<td>2,059.9</td>
<td>41.8</td>
</tr>
<tr>
<td>2009</td>
<td>3,260.3</td>
<td>6,104.4</td>
<td>2,844.2</td>
<td>46.6</td>
</tr>
</tbody>
</table>

(adjusted for coefficients that take into account the size of the gap).

Tax rebate was introduced as a ‘hold harmless’ provision, in reference to the fiscal system prevalent just before the TSS reform. The amount of the tax rebate for the VAT and consumption tax is computed according to a formula. The corporate income tax, individual income tax and export tax rebates are based on the base amount—determined on the basis of the nominal collections in a base year. Its relative importance has been rapidly decreasing over time.

### 15.2.3. Specific Purpose Grants

These include gap-filling transfers and earmarked transfers. Gap-filling transfers are mainly designed to address different manifestations of vertical imbalance at the sub-national level, by filling the fiscal gap for local governments. There are a few categories for this transfer and the major types include: revenue returned, transfer for minority regions, transfers for increasing wage expenditure of public employees, transfer for rural fee-to-tax reform and transfer for abandoning the agriculture tax and other transfers. Earmarked transfers include literally hundreds of specific purpose grants associated with a variety of programs at the central level—many of which were developed in hasty fashion. As new problems and challenges have arisen, there has been a tendency to create new earmarked transfers to deal with the problem. Special purpose grants also include subsidies for increased issuing of state bonds.

Similar to the assignments of responsibilities, sub-provincial intergovernmental transfer is at the discretion of the provincial government. Currently, the basic framework for sub-provincial transfers is similar to that of the CG, even though there is significant diversity in

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111 The formula is \( R_t = (S_t + 75\%V_t - S_{t-1} + 75\%V_{t-1}) \times 0.3 \) Where \( R_t \) was the central compensation in year \( t \); \( S \) was revenue from consumption tax; \( V \) was revenue from VAT.

112 In 2001, income taxes became shared taxes as opposed to 100 percent assigned to local governments; the sharing ratio for the central government was 50 percent, and became 60 percent beginning in 2002. The formula is \( R_t = \max\{I_t \times 0.6, I_{2001}\} \)

113 Except Shandong province which received subsidies and also remits to the central government, sixteen provincial governments were on the recipient side which included all eight of the provinces where minority nationalities were concentrated (Tibet, Xinjiang, Inner Mongolia, Ningxia, Guangxi, Qinghai, Yunnan, and Guizhou) and other poor provinces such as Sichuan and Jiangxi. The other fourteen are on the remitting side.
structure across provinces because of differences in the availability of fiscal resources and also because the provincial governments use their discretion to pass on smaller or larger shares of the funds received from the CG.

Although the intergovernmental transfer programs have a multiplicity of objectives, the main purpose for many of the intergovernmental transfers is to provide budget gap filling. Typical examples include: the transfers for increasing wage expenditure of public employees, transfers for rural fee-to-tax reform, transfers for abandoning the agriculture tax, final account transfers, and so on. The ‘general transfer’ is the only one with an explicit equalization purpose — though the pool of funds distributed through it is still relatively small. The main reason for the gap-filling orientation of the transfer system is that the majority of sub-national governments face significant vertical imbalances; as discussed above, a main feature of the current fiscal decentralization system in China is that, while expenditures are highly decentralized, tax revenues remain highly centralized.

The dependency on intergovernmental transfers differs among the different levels of sub-national governments. In recent years, the fast growth of CG fiscal resources has provided the opportunity to introduce several intergovernmental transfer programs. However, the intergovernmental transfer system is still characterized by its lack of stability and predictability. By its design it is not only the CG, but also the provincial, and even the prefecture governments that need to implement intergovernmental transfer programs to fill the budget gap of lower-level governments. Besides the variation in the level of transfer dependency across different levels of government, there are also significant variations across jurisdictions.

15.3. Challenges for China’s Fiscal System

The 1994 fiscal reform mainly solved problems of the intergovernmental fiscal relations with regard to current expenditure. The fast pace of industrialization and urbanization provided strong demand for regional infrastructure development. Regional infrastructure development, in turn, significantly benefited sub-national governments in terms of fiscal revenue as well as being important for political
competition through demands on sub-national government officers to facilitate economic growth. Although fiscal reform provided incentives for sub-national governments to improve economic growth, it did not provide direct fiscal resources for capital spending. Consequently, debt financing for capital expenditure has become an important approach.

Debt financing for capital expenditure has become more popular since 1996. It has significantly improved the economic performance and stimulated economic growth. As of 2010, sub-national governments had invested RMB 5,947 billion on transportation, city infrastructure, and energy construction (with debt finance counting for 62% of the total sub-national debt). A further and RMB 1,021 billion was spent on land development (counting for 11% of total sub-national debt). All of this investment significantly hastened the construction of highways, local freeways, railways, airports and other regional infrastructure, and became a high-quality asset for the sub-national government. Infrastructure growth not only improved economic growth and social welfare, but also provided great potential for future economic development. Meanwhile, sub-national governments have also used debt finance to support projects devoted to regional social construction in the areas of education, health care, housing, etc. There has also been

<table>
<thead>
<tr>
<th>Year</th>
<th>Budget Capital Expenditure (1)</th>
<th>Budget Total Expenditure (2)</th>
<th>(1) as % of (2)</th>
<th>Total Capital Expenditure (3)</th>
<th>(1) as % of (3)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1997</td>
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<td>2.8</td>
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<tr>
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<td>11.1</td>
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<tr>
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<td>13.3</td>
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<td>9,459.1</td>
<td>4.4</td>
</tr>
<tr>
<td>2006</td>
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<td>4,042.3</td>
<td>11.6</td>
<td>11,895.7</td>
<td>4.0</td>
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<td>11.8</td>
<td>15,080.4</td>
<td>3.9</td>
</tr>
<tr>
<td>2008</td>
<td>795.5</td>
<td>6,259.3</td>
<td>12.7</td>
<td>18,291.5</td>
<td>4.4</td>
</tr>
<tr>
<td>2009</td>
<td>1268.6</td>
<td>7,630.0</td>
<td>16.6</td>
<td>25,023.0</td>
<td>5.1</td>
</tr>
</tbody>
</table>

an RMB 1,375 billion debt investment to promote pollution reduction and ecology development and an RMB 402 billion investment in industrial upgrading. This has provided significant potential for sustainable social and economic development in the future. However, there is significant risk of increasing sub-national liabilities. As of 2010, the total sub-national debt was RMB 10,717 billion. In fact, this large volume of sub-national debt has already become a major challenge for China that threatens the government as a financial instrument. Currently, the risks involved with sub-national liabilities come from both the demand side (borrower) and the supply side (lender). How to control this risk, in light of increasing sub-national liabilities, becomes an important task for China’s economy.

### 15.4. Research Methodology

Webb (2004), Singh and Plekhanov (2005) and Liu and Waibel (2008) have all pointed out that sub-national governments tend to borrow excessively due to soft budget constraints; while Freire and Petersen (2003) and Liu and Waibel (2008) highlighted the risks arising from the weak financial market constraint.114 The previous literature fails to recognize that when a policy maker looks for the best approach to manage sub-national liabilities, the objective of the policy maker is not to eliminate all the risks, but to contain the risks with minimum cost—which is the essence of the optimal risk approach. As the level of risk incurred depends on the hardness of budget and financial constraints, sub-national liabilities management approaches should either strengthen the budget constraint, market constraint or both.

To solve the optimal risk control problem, the policy maker must understand the benefit and cost of each candidate and the budget constraint it faces. One key issue that must be emphasized is that most of the measures to control the sub-national liabilities discussed in

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literature are debt-specific. Firstly, it is implausible to rely on these measures alone to fix the whole inter-government relations system and to build a fully-fledged financial market. Measures taken to contain the risks involved with sub-national borrowing do help improve the budget constraint and/or market constraint to some extent. However, strengthening the budget constraint involves a series of reforms of the inter-governmental relations, other than those debt-specific controls—and the same is true for the strengthening of the market constraint.

Controlling sub-national debt risk is not, in itself, a sufficient condition to justify a comprehensive reform of intergovernmental fiscal relationships and financial markets. Such a comprehensive reform has an all-round impact across the country and results in costs that are much higher than the gains from the control of sub-national debt risk. The initiation of such a reform requires careful consideration of the benefits and costs associated, well beyond the scope of sub-national liability management. Therefore, the observed sub-national liabilities management approaches just make amendments to the current intergovernmental fiscal relationships, status of financial markets, or both, in an attempt to fix loopholes that may cause risks.

It is also worthwhile to note that the benefit and cost of applying a certain debt-specific control is related to the status quo of the budget constraint and market constraint. For example, if the status quo budget constraint is already strong enough, then further strengthening it may incur a relatively high cost. The implication is that, the optimal choice for sub-national liability management may change with evolutions in the budget constraint and market constraint.

In summary, all debt management approaches can be categorized into two groups: debt-specific approaches to strengthen the budget constraint (demand side); and debt-specific approaches to strengthen the market constraint (supply side). The goal of the optimal risk approach is to minimize the risks involved in sub-national borrowing at a given level of cost—particularly the loss of economic growth. The solution to this optimal risk approach is dynamic since the marginal benefit and the marginal cost of implementing different liability management approaches may change as the status quo evolves.

The optimal risk model can well explain the observed liability
management approaches adopted by different countries with different budget and market constraint conditions.

Countries such as the U.S. rely on market discipline to contain the sub-national liability, which can be explained by the fact that the budget constraint and market constraint is already strong enough so that the marginal cost of further strengthening budget constraints or market constraints is greater than the marginal benefit. Therefore, no extra effort is needed to further strengthen these two constraints. Market discipline alone is enough to contain imprudent sub-national borrowings. Countries such as Germany, the U.K. and Japan put more efforts into strengthening the budget constraint, through either administrative control or demand-side rules-based controls. Here the marginal benefit of further strengthening the market constraint is smaller than the marginal cost; while the marginal benefit of further strengthening the budget constraint is still greater than the corresponding marginal cost. For example, the financial market in Germany is already fully-fledged, which means that financial institutions and investors in the market have been equipped with the ability to properly price the return and risks involved with lending. Hence, the marginal benefit of further strengthening the market constraint through debt-specific regulations on financial markets may be too small to justify the cost incurred—such as the efficiency loss in the financial market. In contrast, the budget constraint in Germany is not strong enough, due to its history of bailouts from the Federal Government and the large amount of vertical and horizontal inter-governmental transfers. Therefore, the marginal benefit of further strengthening the budget constraint may be greater than the corresponding marginal cost.

For most developing countries, the situation is that both the budget constraint and the market constraint are weak. The marginal benefits of further strengthening both of these two constraints are greater than the corresponding marginal costs. This explains why countries such as Brazil and Mexico adopt rules-based controls on both the demand side and the supply side. For example, the borrowing of sub-national governments in Brazil relies on state-owned banks, which have weak incentives to price return and risks properly. Brazil has had three major sub-national debt crises since the restoration of sub-national democracy. As pointed out in Webb (2004), the agreements to resolve
these crises reinforced the perception that the Federal Government was prepared to provide debt relief to any state making a request. The weak market constraint and budget constraint caused excessive sub-national deficits and repeated debt crises.

To curb imprudent sub-national borrowing, Brazil applies measures to both borrowers and creditors. On the demand side, the new Senate Resolution (SR 78) sets limits on state borrowing and empowers the Senate to forbid some types of borrowing; Law 9696 sets targets for declines in debt, deficit ratios, personnel spending, and growth in own revenues. On the supply side, the National Monetary Council ordered the Central Bank to limit each bank’s total lending to the public sector and to prohibit bank lending to any state in violation of the debt and deficit ceilings. Another measure on the supply side is to privatize the state owned banks so that sub-national governments cannot rely on this privileged financing any more.

15.5. Expected Contributions: the Implications for China

In this section, we first summarize the factors that could lead to imprudent sub-national borrowing in China; then the optimal risk approach described in the previous section is implemented to explore the appropriate sub-national liability management approach for China.

15.5.1. Demand Side Analysis

Among the demand side factors, we highlight the role played by soft fiscal budget constraints and weak local accountability. Other demand-side factors that influence sub-national government debt include: growth expectations, urbanization, wealth effects, and the active fiscal policy of 2008–2009.

**Weak local accountability**

Several factors contribute to the soft budget constraint and weak local accountability of sub-national governments in China:

**Blurred government- enterprise relations**

The government has tended to establish state-owned enterprises in competitive sectors, which blurs the distinction between public and
private sectors. The encroachment of public sector to the private market not only results in efficiency losses, but also creates risky contingent liabilities for sub-national governments, as state-owned enterprise loans are either directly or implicitly guaranteed by the sub-national governments.

**Improperly designed inter-governmental relations**

A major fiscal issue for China to address is the increasing disparity between sub-national government expenditure responsibilities and the revenue available. Although sub-national governments increasingly bear the burden of decentralized expenditure responsibilities, their share of revenues from various sources has, over the past 10 years, never exceeded 50%—this is in sharp contrast to the situation prior to the tax-sharing reform. As pointed out in Martinez-Vazquez and Qiao (2010), the imbalance of expenditure and revenue is largely the consequence of institutional deficiencies in the design of intergovernmental fiscal relations. Sub-national governments bear heavy expenditure burdens, as shown in Table 5.2. Sub-national governments take the responsibility for basic service provisions, including basic education, health care and social welfare. In terms of decentralizing public service provision responsibilities, the current fiscal system assigns few primary and stable revenue sources to sub-national governments. Since 1994 the tax-sharing system has gradually centralized revenue assignments, including value-added tax, corporate and personal income tax, and consumption tax; leaving only business tax to sub-national governments. Moreover, the property tax system, which in international examples generally serves as a main revenue source for sub-national governments, is still in an embryonic state.

In addition, upper-level governments in China tend to assign unfunded, or insufficiently funded mandates to the lower levels, which contributes to the increasing expenditure burden of sub-national governments.

The inappropriate design of intergovernmental fiscal relations in China places high fiscal stress on sub-national governments. The large sub-national fiscal gap directly spurs local debt financing—especially debt services for operational expenditures. Lack of own-source revenues
makes sub-national governments rely heavily on transfers from the CG. What makes the problem more complicated is the lack of transparency in the transfer determination process, especially in the determination of special purpose or ad hoc transfers. Improper intergovernmental relations also generate two more fundamental problems: the common pool problem and the soft-budget constraint problem. Viewing fiscal transfer as a common pool, sub-national governments may overspend and accumulate unsustainable debt to compete for the transfer. The soft budget constraint problem further induces sub-national governments to deliberately reduce fiscal efforts, overspend, and ignore the threat of insolvency, because they expect that the CG to fill the gap and bail them out.

One manifestation of the common pool problem is the irresponsible inter-jurisdictional competitions. The present criteria for local governance evaluation puts a relatively heavy weight on GDP growth, so sub-national governments are inclined to spend more on public investments and collect less tax to attract private investments—in the hopes that the CG will fill the fiscal gap. Cai and Treisman (2004) give specific examples of this competition that compromises local tax collection and leads to more sub-national debt financing.115

**Poor budgetary management**

Slack budgetary management allows sub-national governments to live beyond their fiscal capacity and generate unsustainable liabilities. The main problem with budgetary management is its lack of transparency. Without fiscal transparency, it is difficult for the CG to enforce fiscal discipline, as it is easy to deflect responsibility for imprudent financial decisions. One manifestation of this is that, there is neither an ex ante nor ex post mechanism to regulate soaring sub-national borrowing. This lack of transparency also prevents market disciplines from working so borrowers respond slowly to market signals.

Furthermore, slack budgetary management results in so called ‘feeding finance,’ with reference to the expenditures of LGs in areas

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with concentrated administration costs and in particular personnel costs. ‘Feeding finance’ is partly attributed to the vertical fiscal imbalance, but more importantly, to deficient budgetary management that is not capable of reining in government size and operational expenditures.

‘Feeding finance’ also contributes to the increase in the demand on debt, since most of the fiscal resources have been exhausted and little is left for infrastructure investments. Local officials, faced with the contradiction of limited resources for capital investments and an unrestrained desire to boost GDP, are inclined to use debt to finance public projects to boost local economy. Due to the lack of fiscal transparency and efficient budgetary management, local officials’ imprudent financial decisions are difficult to be detected and punished. What makes things worse is that some local officials in less developed areas may even finance operational expenditure through borrowing, which is believed, by many researchers, to be unsustainable.

**Insufficient exploitation of advantages of “Voting-with-Hands” and “Voting-with-Feet”**

To enhance local accountability, two major types of mechanism that may be designed and practically implemented are ‘voting-with-hands’ and ‘voting-with-feet’ systems. However, their advantages have not been fully explored in China. The ‘voting-with-hands’ mechanism does not function well, as most sub-national officials are directly appointed by upper-level governments. This encourages local officials to be responsible to upper level authorities rather than their local residents. A ‘voting-with-feet’ mechanism requires the free mobility of factors, but some institutional features in China impede the formation of a common market. For example, the rule of residential registration limits the mobility of rural residents into urban areas.

**Other demand side factors:**

**Growth expectations**

As shown in Table 15.6, China has experienced decades of rapid economic growth. Consequently, sub-national government revenues in China show a strong growth trend. It is strongly believed by local
officials that growth will continue for a relatively long period, generating more revenue in the future. Thus, local officials tend to over borrow, as they believe debts can easily be covered by future revenue.

Table 15.6. Growth of the Chinese Economy and SNG Revenue

<table>
<thead>
<tr>
<th>Year</th>
<th>Nominal GDP (billion Rmb)</th>
<th>Growth Rate of Real GDP (%)</th>
<th>Growth Rate of Nominal GDP (%)</th>
<th>SNG Revenue (Billion RMB)</th>
<th>Growth Rate of SNG Revenue (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1990</td>
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<td>-</td>
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<td>2006</td>
<td>21,631.4</td>
<td>12.7</td>
<td>16.0</td>
<td>1,830.4</td>
<td>21.2</td>
</tr>
<tr>
<td>2007</td>
<td>26,581.0</td>
<td>14.2</td>
<td>21.9</td>
<td>2,357.3</td>
<td>28.8</td>
</tr>
<tr>
<td>2008</td>
<td>31,404.5</td>
<td>9.6</td>
<td>17.1</td>
<td>2,665.0</td>
<td>21.5</td>
</tr>
<tr>
<td>2009</td>
<td>34,050.7</td>
<td>9.1</td>
<td>7.4</td>
<td>3,258.1</td>
<td>13.7</td>
</tr>
</tbody>
</table>

Source: Chinese Statistics Yearbook

Urbanization

Figure 15.1 demonstrates the rapid urbanization process that has been experienced in China in recent years. This trend poses great challenges to sub-national governments, in terms of public service provision. Many public projects are capital expenditures, so infrastructure financing through borrowing improves intergeneration equity. The urbanization process shifts the demand curve of sub-national borrowing to the right, resulting in the rise of the equilibrium quantity of debt. Under conditions where the budget constraint and market constraint are strong enough, the increasing sub-national debt
can actually improve efficiency and equity without generating too much risk. However, if both of these two constraints are weak—as in China—the sub-national governments’ desire for over-borrowing, fuelled by urbanization, cannot be well contained.

**Wealth effects**

Under Chinese law, governments hold exclusive ownership of land and are able to finance infrastructure through land transfer fees and banking lending securitized on land.\(^{116}\) Since 2005, revenues from leasing lands have grown rapidly (as shown in Table 15.3) to become one of the most important extra-budgetary financing sources for sub-national governments. Liu (2008) estimated that the proceeds from land leasing and the bank lending securitized on land account for about 80–90% of infrastructure financing by sub-national governments.\(^{117}\)

Rapid increases in real estate prices in recent times, has also

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\(^{116}\) Land users pay a one-time ‘land transfer fee’ to the government for usage of land for 50–70 years.

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provided a boost to sub-national governments’ perceived wealth. An increase in perceived wealth encourages overspending by sub-national governments. Thus, sub-national governments tend to over-borrow, including financing irrational public investments through debt. The situation is exacerbated by the lack of fiscal transparency and market discipline. First, land transactions and proceeds are extra-budgetary. In this case, sub-national governments may finance operational expenditures through land financing. Second, to circumvent the budget law that prohibits sub-national borrowing, sub-national governments set up state-owned local financing platforms that borrow heavily from state-owned banks (using land as collateral). The banks may in return expect bailouts from sub-national governments when insolvency occurs. This creates high contingent liabilities for sub-national governments.

Fiscal policy since 2008

In order to offset negative macroeconomic shocks from the global financial crisis in 2008, the CG of China has adopted a RMB 4 trillion stimulus package to stabilize the economy. The policy is designed so that, the CG and sub-national governments co-share financing responsibility for investment projects covered by the stimulus package. Sub-national governments actually consider the fund to be a special type of matching grant, resulting in the common pool problem. To compete for more grants from the common pool, sub-national governments borrow substantially from the capital market through their affiliated urban development and investment companies (UDICs), and over-invest beyond their fiscal capacity. According to the estimation of the China Banking Regulatory Commission, commercial bank loans to UDICs were worth RMB 7.38 trillion (approximately US$1.10 trillion) by the end of 2009.

15.5.2. Supply side analysis

There are two primary factors on the supply side that contribute to the accumulation of sub-national liabilities in China: weak market constraints and excessive liquidity in the financial market.
Weak market constraint

Market discipline plays an important role in containing imprudent borrowing of sub-national governments. However, inefficient financial governance—especially banking governance in China—prevents financial markets from correcting sub-national over borrowing and contributes to the accumulation of sub-national liabilities.

The causes of inefficient banking governance may be summarized as follows:

- The lack of fiscal transparency and reliable creditworthiness assessment from independent credit rating agencies, means banks have to make decisions based on incomplete fiscal capacity information for sub-national borrowers;
- Inappropriate incentive structures in the bank industry compromise the strength of risk control. The performance assessment usually puts too much weight on quantity targets—such as the market shares and profits. Facing severe competition from rivals, banks—motivated by possible profits—may ignore signals of possible insolvency;
- Banks treat lending to sub-national governments differently to private investment. Banks may tolerate the risk of sub-national insolvency, as soft budget constraint problems reinforce their ability to rely on bailouts. Moreover, bank officials’ willingness to lend to sub-national governments may also be motivated by an unwritten rule: officials in state-owned banks can easily escape from penalties even if losses are incurred due to non-performing sub-national borrowings;
- Interventions by local officials disturb the banks’ decision making. Local officials in China have various channels to influence banks’ loan decisions. Most financial enterprises in China are state owned and need support from sub-national governments to guarantee smooth operations. In particular, sub-national government officials play a significant role in promoting executives of state-owned local financial institutions; and
- Interest rate control policy makes the cost of financing insensitive to the risk of loans. Interest rates in China are still determined
by the Central Bank. Thus, the financial markets are not able to price risks and return correctly. In this case, the interest rate does not fully reflect borrowers’ creditworthiness and financial capacity, therefore, loses its function to curb imprudent borrowing.

**High savings rates and excessive liquidity in financial markets**

It is well known that one of driving forces behind the Chinese economy is its high saving rate. Table 15.7 indicates that the gap between deposits and loans in the banking system have widened over the past decade. Increased saving deposits accumulated in financial institutions exert a pressure on them to speed up lending correspondingly.

**Table 15.7. Deposits and Loans in Chinese Financial Institutions, 1997–2009**

<table>
<thead>
<tr>
<th>Year</th>
<th>Deposits (trillion Rmb)</th>
<th>Loans (trillion Rmb)</th>
<th>Deposits-Loans Gap (trillion Rmb)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1997</td>
<td>8.2</td>
<td>7.5</td>
<td>0.8</td>
</tr>
<tr>
<td>1998</td>
<td>9.6</td>
<td>8.7</td>
<td>0.9</td>
</tr>
<tr>
<td>1999</td>
<td>10.9</td>
<td>9.4</td>
<td>1.5</td>
</tr>
<tr>
<td>2000</td>
<td>12.4</td>
<td>9.9</td>
<td>2.4</td>
</tr>
<tr>
<td>2001</td>
<td>14.4</td>
<td>11.2</td>
<td>3.1</td>
</tr>
<tr>
<td>2002</td>
<td>17.1</td>
<td>13.1</td>
<td>4.0</td>
</tr>
<tr>
<td>2003</td>
<td>20.8</td>
<td>15.9</td>
<td>4.9</td>
</tr>
<tr>
<td>2004</td>
<td>24.1</td>
<td>17.7</td>
<td>6.3</td>
</tr>
<tr>
<td>2005</td>
<td>28.7</td>
<td>19.5</td>
<td>9.2</td>
</tr>
<tr>
<td>2006</td>
<td>33.5</td>
<td>22.5</td>
<td>11.0</td>
</tr>
<tr>
<td>2007</td>
<td>38.9</td>
<td>26.2</td>
<td>12.8</td>
</tr>
<tr>
<td>2008</td>
<td>46.6</td>
<td>30.3</td>
<td>16.3</td>
</tr>
<tr>
<td>2009</td>
<td>59.8</td>
<td>40.0</td>
<td>19.8</td>
</tr>
<tr>
<td>Growth p.a. (%)</td>
<td>16.5%</td>
<td>13.8%</td>
<td>28.6%</td>
</tr>
</tbody>
</table>

Source: China Statistical Yearbook, and the People’s Bank of China

Monetary policy plays a significant role in generating excessive liquidity in the capital market. China incurs a large amount of trade surplus every year. To stabilize the foreign exchange rates, the central bank has to interfere in the market by purchasing foreign currencies. This process contributes to a high growth rate of money supply and excessive liquidities in the financial markets.
Under conditions of excessive liquidity in the capital market and an increasingly widening gap between deposits and loans, the competition among banks for sub-national government borrowers becomes fierce. Banks have to be less picky and tolerate risks involved in some projects to a larger extent. The excessive liquidity and high saving rate therefore shifts the supply curve of loans to the right, but also makes the supply curve of loans flatter—that is, less responsive to risks.

It is clear to see in a demand-supply framework how a rapidly growing sub-national government liability may occur in China. Table 15.8 summarizes different factors, all of which contribute to the increase in the sub-national borrowing at equilibrium.

### Table 15.8. Effects of Different Factors on Equilibrium SNG Borrowing

<table>
<thead>
<tr>
<th>Factor</th>
<th>Demand / Supply Effect</th>
<th>Impacts on Equilibrium Debt Quantity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Soft budget constraint and weak local accountability</td>
<td>Demand Side</td>
<td>Increase</td>
</tr>
<tr>
<td>Urbanization</td>
<td>Demand Side</td>
<td>Increase</td>
</tr>
<tr>
<td>Wealth effects</td>
<td>Demand Side</td>
<td>Increase</td>
</tr>
<tr>
<td>Growth expectations</td>
<td>Demand Side</td>
<td>Increase</td>
</tr>
<tr>
<td>Active fiscal policy since 2008</td>
<td>Demand Side</td>
<td>Increase</td>
</tr>
<tr>
<td>Weak market constraint</td>
<td>Supply Side</td>
<td>Increase; relatively flat supply curve.</td>
</tr>
<tr>
<td>High savings rates and liquidity in financial markets</td>
<td>Supply Side</td>
<td>Increase; relatively flat supply curve.</td>
</tr>
</tbody>
</table>

Source: Author

The effects of all factors can be viewed more clearly in a graph that shows the shifts of demand and supply curves. As illustrated in Figure 15.2, line S (which denotes the initial debt supply) and line D (which represents the initial debt demand) jointly determine the initial equilibrium ($E_0$). Demand side factors distort $E_0$ by shifting the demand curve to the right, indicated by the new demand curve $D'$. The supply side factors have two impacts on the supply curve. These factors shift the supply curve to the right, as they increase the debt supplied for any given interest rate. Moreover, these factors prevent the market from pricing risks and returns correctly, making the supply curve flatter. The two effects jointly pin down the new supply curve.
S’. The new demand curve and supply curve determine the new equilibrium $E_1$. The new equilibrium lies far right from the initial equilibrium, indicating a large increase in the debt.

### 15.6. Optimal Risk Analysis

The previous analysis demonstrates that both budget constraint and market constraint are weak in China, so relying on market discipline alone is not feasible. Further strengthening budget constraint and market constraint will reduce the risk involved in sub-national government borrowing significantly.

On the demand side, both the administrative control and rules-based control are potential candidates to strengthen the budget constraint. However, in the short run, administrative control may work more efficiently than the rules-based control. Although the Chinese economy has been on a transitional path from central planned economy to market economy for 30 years, the government is still used to interfering in the
market with administrative controls. It is conventional for sub-national governments in China to circumvent rules and regulations. The required monitoring of the rule-based approach may incur significant implementation costs in this case. Argentina’s experiences show that the ex ante rules, without strict enforcement, fail to curb imprudent sub-national debts. Added to this, one major characteristic of rules based control is its uniformity: the same rules are applied to all regions and all circumstances with few exceptions. Considering the tremendous regional differences in China, it may be difficult to pin down a fiscal target that fits the situation of all regions. If a uniform rule were imposed, it might generate significant implicit costs, due to the loss of efficiency gains, from catering to heterogeneous demands. The experiences of Argentina and Brazil indicate that it takes time to establish fully-fledged rules that can work effectively. In sum, in the short run, the administrative control may be preferable to rules-based control, in that the marginal benefit of administrative control is larger and the corresponding marginal cost is relatively smaller compared with rules-based control.

However, the adoption of an administrative control approach does not necessarily exclude the rules and regulations. Preparation work can be done to cultivate favorable conditions for rules-based controls to function within—this may include establishing some simple rules (such as the ‘golden rule’) and incubating a culture of respecting rules and regulations. Such preparatory work would gradually increase the marginal benefit of employing rules-based controls and reduce the corresponding marginal cost. In the long run, the balance will finally tilt toward the rules based control once the culture of respecting rules is formed and the regional gap shrinks with the economic growth.

On the supply side, the rules-based control may be preferred to the administrative control, in that the cost of micro-managing financial institutions is tremendous. Since late 90s, the banking industry in China has experienced dramatic changes. Many originally state-owned banks have been transformed into public-listed companies in order to improve corporation governance. Although the government is still the largest stakeholder involved, it is trying to avoid directly interfering with banks. Applying an administrative control over banks to manage
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Sub-national borrowing will reverse these reforms in the banking industry and cause significant efficiency losses. By contrast, a rules-based control, which mimics market discipline, may contain sub-national borrowing at a relatively lower cost. Some good experiences can be drawn from Mexico’s practice where the banks’ capital-risk weighting of loans to sub-national governments is linked to international ratings of creditworthiness—providing incentives for commercial banks to lend money to sub-national governments with high credit ratings.

15.7. Conclusion and Recommendations

This paper has provided an analytical framework of optimal risk control for choosing appropriate sub-national liability management approaches. The optimal risk approach means policy makers can choose appropriate management approaches to reduce risk, by strengthening either the budget constraint or market constraint or both—while taking into consideration the cost incurred through implementing various management approaches. As different countries have unequal strengths of budget constraint and market constraint, their marginal benefits and marginal costs of strengthening these two constraints will also vary substantially. Therefore, the optimal choice, conditional on the status quo of the budget and market constraints, explains the different sub-national liability management approaches implemented in different countries.

We have found that weak budget constraint and market constraint have contributed to imprudent sub-national borrowing in China. An application of our optimal risk approach to the Chinese case indicates that administrative control could be the optimal approach to contain sub-national liability in the short term, while a rules-based approach may work best in the long run.
SECTION F
REFERENCES
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Section F: References


