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Indonesia's decentralization after crisis

Ideally, decentralization should be managed so that the devolution of fiscal resources occurs in line with the devolution of spending. In reality, politics determines the devolution of resources, often with little regard for spending responsibilities. What can be done?

Indonesia offers lessons for other countries interested in ceding power to local governments

Indonesia has a three-tier unitary government structure, with 26 provinces and about 330 districts spread over some 13,000 islands containing more than 300 ethnic groups. Despite its diversity and size, Indonesia has one of the world's most centralized fiscal systems. In fiscal 1999 revenue collected by the central government amounted to 94 percent of general government revenue, and about 60 percent of subnational spending was financed by central transfers. Since the early 1970s several proposals have been made for fiscal decentralization, but the key elements have never been implemented. Indonesia's overly centralized system results in tenuous links between local demands and decisions on local public services, weak mechanisms for local accountability, and ad hoc allocation of fiscal resources across regions.

Today, however, Indonesia is on the verge of a major decentralization. Triggered by the financial crisis of 1997, the resignation of the Soeharto government, and the weak public support for the Habibie government, demands for political and fiscal decentralization increased in 1998. In April 1999 Parliament hastily adopted two laws requiring that drastic decentralization measures be implemented in fiscal 2001 in a "big bang" fashion. The Law on Regional Governance specifies the political and administrative responsibilities for each level of government under a decentralized structure, while the Law on Fiscal Balance delineates the new division of revenue sources and intergovernmental transfers, including sharing of oil and gas revenues.

This note discusses key issues for Indonesia's decentralization process, assesses the proposed implementation strategies, and offers lessons for other countries. It draws on recent work by the World Bank, the International Monetary Fund, and an international conference—organized by the IMF, the Bank, and the University of Indonesia—called "Indonesia: Decentralization Sequencing Agenda," held in Jakarta in March 2000.

The new decentralization laws

The two new decentralization laws cover all major aspects of fiscal and administrative decentralization. Under the laws, all public service delivery functions except defense, foreign affairs, monetary and trade policy, and legal systems will be decentralized to subnational governments. Most public services, including education, health, and infrastructure, will be delivered by districts and cities, with provinces performing only the role of coordinator. The previous hierarchical relation between provinces and districts or cities will be abolished. Any task not specified in the law will fall to districts or cities. The subnational share of government spending will reach more than 40 percent, up from 19 percent in fiscal 2000.

Public service responsibilities should align with revenue and administrative capacities at each level of the government

The central government will share revenue from natural resources with subnational governments. Subnational governments will receive 15 percent of onshore oil revenue, 30 percent of onshore gas revenue (including offshore gas within 12 miles of the coast), 70 percent of forestry revenue, and 100 percent of fisheries revenue—all shared on an origin basis. In addition, the minister of finance has granted 20 percent of personal income tax revenue to provinces, though this is not in the law. The central government must also transfer at least 25 percent of its revenue after sharing to subnational governments through a general-purpose allocation; 10 percent of this will go to provinces and 90 percent to districts. The general-purpose allocation will be based on formulas aimed at equalizing the fiscal capacities of subnational governments to meet their spending needs.

The laws reflect pressures from regions, especially resource-rich regions, for increasing fiscal autonomy and, more generally, for political and administrative freedom after decades of authoritarian rule. Districts were chosen as the main level for autonomy because of the military's strong objections to provincial autonomy. The military—burned by regional unrest in the 1950s—feared that provincial autonomy would enhance rather than abate centrifugal forces.

Risks of the new laws

IMF and World Bank experts found that Indonesia's decentralization process, as structured by the two laws, contained serious risks:

- The Law on Regional Governance is too general in assigning spending responsibilities—and so threatens effective service delivery. Rather than clarifying responsibilities, the implementing regulations for the law have confused regional governments, because the regulations specify only the center's remaining responsibilities. Because of this lack of clarity in the assignment of functions, the decentralization of revenue under the Law on Fiscal Balance could exacerbate macroeconomic imbalances.
- Decentralizing most functions of public service provision to districts may not be compatible with government capacities, or in line with economic principles of scale and spillover.
- Political decentralization is incomplete. Although regional parliaments were elected in July 1999, many regional heads were appointed by the old government and will be replaced by elected heads only when their terms expire. As a result the key element of local government accountability may be missing for years to come.
- The proposed sharing of oil and gas revenues would distribute significant revenue, most of which is not from royalties or taxes on resource rents, to a small number of provinces and districts. This arrangement would exacerbate regional disparities in revenue and is inconsistent with the objective of equalizing transfers. In addition, highly volatile oil and gas revenues are not ideal sources of local revenue, and would create considerable uncertainty for local budgeting.
- The coincidence of administrative and fiscal decentralization renders nearly impossible the design of an objective equalization scheme. Cost differences among regions cannot be determined because most functions were financed through the central budget. Moreover, information is not available on current costs for each function, impeding the determination of the aggregate transfers needed to finance the decentralized functions.
- The Law on Fiscal Balance does not provide regional governments with new taxing powers. Regions have only limited autonomy over small taxes such as water use taxes and street lighting taxes. Thus local governments cannot cover additional local spending through taxes on local residents—compromising local accountability.
- The timetable for implementing the new laws is extremely tight. International experience indicates that at least two years are needed to prepare detailed

regulations for functional devolution of major services and to establish a system for administering grants. Hasty implementation could interrupt important local public services.

Preparations for implementing the laws have been slow because of the political transition and lack of coordination among key ministers. For example, lacking a clear definition of regional functions—which should be provided by the Ministry of Home Affairs, Ministry of Regional Autonomy, and other ministries—the Ministry of Finance was not able to propose detailed financing arrangements and simulate their likely distributional impact. The coordinating body for decentralization was finally created in April 2000—a year after the two laws were promulgated—but not all regional members have been appointed. As a result the Regional Autonomy Advisory Council is not yet operational, and consultations have been regional. There has been little progress on identifying additional taxing powers for local governments, and little effort has been made to strengthen district governments. And with a recent cabinet reshuffle, the Ministry of Regional Autonomy was merged with the Ministry of Home Affairs, and the champion of decentralization was assigned a different task.

Given the practical difficulties in managing this process, a different approach—devolving key functions, at least initially, to provinces rather than districts—attracted the attention of some policymakers. When first suggested, this approach gained political momentum. But it petered out after strong opposition from the Ministry of Regional Autonomy, the champion of decentralization. It was argued that the central government was tainted by the past—a decentralization law passed in 1974 was never implemented because of delays by the center—and it would be impossible to delay or phase decentralization this time. "The regions want the power and the money now," an official of the Ministry for Regional Autonomy said when asked whether an alternative strategy for decentralization was possible (*Financial Times*, 26 April 2000).

Lessons from Indonesia's experience

Because of the fluid nature of Indonesia's decentralization, it is difficult to draw definitive conclusions on the benefits and drawbacks of the various approaches proposed or taken by the government. Nevertheless, the current policy debate has made clear the importance of process design in minimizing the risks of decentralization. Several lessons can be drawn from Indonesia's experience.

First, simultaneous political, administrative, and fiscal decentralization is difficult—if not impossible—to manage. From an economic perspective, decentralization should be managed so that the devolution of fiscal resources occurs in line with the devolution of spending, avoiding macroeconomic instability and disruption in local service delivery. But the political process determines the pace and manner of resource devolution, often with little regard for spending responsibilities, especially in a new democracy.

A well-designed process can help minimize the risks of decentralization

Second, even if rapid fiscal decentralization is politically imperative, it may still be feasible to avoid a disruption in service delivery by taking a phased approach to decentralization. That is, spending responsibilities can be devolved to a level of government in line with its administrative capacities. As lower level governments increase their capacities, responsibilities can be devolved further. Of course, to determine the appropriate level for each service, one needs to take into account the area of benefits and economies of scale as well.

Third, every effort should be made to avoid delays in establishing regulations that detail the responsibilities of various levels of government, including for service delivery, minimum standards, and personnel management. Accurately pricing each local responsibility—and so mapping out resources and responsibilities—is almost impossible in the early stages of decentralization. But not assigning spending responsibilities can exacerbate vertical imbalances and compromise accountability. A practical short-term solution is to transfer to local governments central government personnel who are performing public services under the deconcentrated arrangement, in parallel with their financing.

Fourth, local governments should be assigned one or a few substantive taxes over which they have some rate autonomy, to ensure local accountability and fiscal discipline. Indonesia, for example, should move toward a system that assigns property taxes to subnational governments by fiscal 2001, and should expand other local revenue bases. This is an essential component of a sound local fiscal system, and helps avoid local pressures for increasing financing resources that lead to illegal revenue-raising activities.

Local governments should be assigned one or a few substantive taxes over which they have some rate autonomy

Fifth, in an economically and ethnically diverse country like Indonesia, the central government has to maintain sufficient fiscal resources to ensure reasonable equalization and minimum service standards across regions. Sharing natural resource revenues with producing regions—especially when they include consumption and corporate income tax revenues from natural resource production, and when they are concentrated in a few provinces—could generate substantial inequality across regions. If such an arrangement is adopted, its unequalizing impact will have to be offset by a formula-based general transfer system.

Sixth, given the reasonable data availability and technical sophistication of Indonesia's Ministry of Finance staff and involved academics, it is feasible and desirable to establish a general transfer system that takes into account both local revenue capacities and spending needs. But attention needs to be paid to the fact that the move to a new, formula-based system may drastically lower transfers to overstaffed local governments. To avoid radical civil servant retrenchment—and to increase the political acceptability of the new transfer scheme—the assessment of spending needs can take into account the number of civil servants in the initial stage, and reduce the weight attached to this factor over a number of years.

Finally, recognizing the inherently political nature of decentralization, it is necessary to establish as the first priority a political forum in which decentralization can be discussed among representatives of all levels of government.

This note was written by Jun Ma and Bert Hofman (both Senior Economists, PREM Sector Unit, East Asia and Pacific Region). *The authors received support from PREM's Decentralization Thematic Group and from EASPR's teams on decentralization and subnational economics.*

If you are interested in similar topics, consider joining the Decentralization Thematic Group. Contact Jennie Litvack (x80519) or click on Thematic Groups on PREMnet.