IMF and World Bank Resident Mission

Indonesia: Decentralization—Opportunities and Risks

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I. OPPORTUNITIES AND RISKS

The new Governance and Fiscal Balance Laws 22/1999 and 25/1999 passed by the Indonesian Parliament are attempts to decentralize both political and economic power away from the central government after decades of highly centralized and autocratic rule. During the parliamentary debate on the Fiscal Balance Law, which concluded at the end of the Parliament's tenure, the government agreed to strong demands from producing regions for a share of onshore oil and gas revenues. In addition, the legislation establishes a floor of 25 percent of domestic revenues (including all oil and gas revenues) for transfers to regions through the general allocation fund.

The new legislation recognizes political reality—Indonesians in different parts of the country want greater involvement in the management of their day to day affairs. This is a common aspiration around the globe. There are considerable opportunities in the process. The expectation is that there will be an enhanced local provision of public goods, tailored to local preferences and considerations. This should greater prosperity for all Indonesian citizens, in the context of enhanced economic activity across Indonesia.

International experience suggests that ill-sequenced reforms can vitiate the objectives and advantages of the decentralization process. The danger is that effective service delivery can be threatened, even in places where the state presently provides such services, that there can be a "capture by local interests" threatening good governance, and that Indonesia's hard earned stabilization might be jeopardized.

There are many different ways to manage the decentralization process, and Indonesians have to work out for themselves what model suits them best. It would be inappropriate to copy any particular model, be it that of Australia, Canada, Chine, India, Russia, the United States or any other large country. Yet, it would not be sensible to repeat the mistakes made in Russia, Colombia or Brazil. Given the very tight time-frame envisaged by the authors of Laws 22 and 25/1999, there is very little scope to make mistakes.

The World Bank has been actively involved in the sectoral issues for very many years, and the effective service delivery and capacity building, together with good governance, are matters of great interest to Bank management. The IMF has no preconceived notions about the nature or pace of devolution that a country may wish to adopt. However, the sequencing of measures is of critical importance, since inappropriately sequenced measures (while justifiable in their own time) may endanger the economic stability that the authorities have worked so hard to achieve.

The Fiscal Affairs Department and the World Bank have fielded two joint missions over the past twelve months to advise on a range of issues—including the possibilities and options for the decentralization of expenditure responsibilities, the devolution of revenues, design of transfers and fiscal management of the decentralization process. We have been keen to offer technical options for the key issues raised by the authorities. We also feel that it is essential to discuss the issues and options openly, with the regions and local interests participating fully in the debate.

In this presentation, we focus more on the risks, in order to highlight the key issues that need to be addressed in order to achieve the desired decentralization in a systematic manner.

II. THE RISKS

The proposed implementation of the revenue devolution provisions before there has been an effective decentralization of expenditures, including the administrative staff, is to us the key risk. This threatens macroeconomic stability, as well as the continued provision of services at the local level during a potentially volatile period of political and economic transition. *To review the new legislation, the authorities should establish a consultative body* (described below) that would also be able to reach out to newly elected parliamentarians

The focus of the joint FAD-Bank work has been to address issues, options and the necessary ingredients in a reform timetable—including the steps that are needed before key measures (such as the design of general purpose grant formulations) can be effectively designed and implemented. For instance, there is a tendency in many countries to work on formulae for transfers, even before it is known what functions are to be transferred and to which level of government.

A. Issues to be addressed

- **Vaguely defined expenditure responsibilities.** Very general statements are contained in the legislation concerning the devolution of all expenditure functions to the district level—with provinces playing a largely coordinating role. Insufficient account has been taken of the differential capacity of districts to absorb these functions, nor the appropriateness of assigning all these functions to the lowest tier of government. As will be seen in the papers being presented in the conference, it is not clear whether the administrative staff can be transferred smoothly from the center to the regions for the effective implementation of the desired devolution of expenditures.

- **Over-specification of transfers and revenue-sharing.** Relative to the vagueness on the expenditure devolution, the strategy of rigidly defining revenue-sharing and the level of transfers could introduce significant imbalances in regional and central government finances.

➢ **The floor on transfers to general allocation fund of 25 percent of domestic revenues may create macroeconomic imbalances.** In the short run, while expenditures cannot be devolved in a hurry, this stipulation could generate a substantial additional central government deficit—while at the same time, it is likely that districts will not be able to use effectively the additional transfers (except perhaps to increase staff salaries). In the longer run, when the actual devolution of expenditures will require revenue transfers exceeding the 25 percent limit, this floor is likely to become redundant. But, when the floor is actually binding, it poses a macroeconomic problem.

- **Sharing of fluctuating oil and gas revenues will pose a number of budgeting difficulties.** The sharing of natural resource revenues has raised expectations on the part of producing regions. Despite increased regional inequalities caused by this type of sharing, the expectations of producing regions have not been assuaged. In addition, the fluctuation of oil and gas revenues means that budgeting the revenue-share from this revenue head will be quite problematic.

- **The implementation of the oil and gas sharing will enhance regional disparities, unless offset by the "equalization" transfers**. The latter cannot become effective without a sharper delineation of expenditure responsibilities, which can be made to stick.

- **Sharing of the land and property tax on urban and rural assets undercuts the potential for local accountability.** Since revenues from this source are to be shared, district and municipal governments will be unable to vary rates on this "traditional local tax base"—thus eliminating the property tax as a source for enhanced local accountability.

- **Lack of transparency and possibility for misuse of public funds.** In the absence of strong managerial oversight and before local political accountability takes hold, transferring resources without effective responsibility is inviting misuse of public funds.

The work of the FAD-Bank missions suggests that a period of at least two and a half years will be needed in order to achieve effective implementation of the legislation, including the revenue devolution. The authorities should

- **move quickly to begin planning the effective devolution of expenditures** that would govern the size of the resource pool to be transferred;
- **establish the basis for own-revenues** at the regional level, so that there can be accountability at the margin for additional expenditures needed by the lower level of administration, and also for the design of an incentive-compatible general allocation grants mechanism;
- **begin work immediately on the establishment and implementation of an effective grants administration**; and

- **convert most existing special-purpose programs** (including the SDO program for personnel and Regional Development Funds[1]) **into broad block-grants**; and add to the grant as central government and deconcentrated personnel are transferred to lower levels.

B. Reforming the revenue assignments

Reforming the revenue assignments will entail a revision of Law 18/1997, in order to allow regional government to have access to own-revenue sources.

The revenue-sharing arrangements associated with the oil and gas non-tax, on-shore revenues are opaque and may not be acceptable to the producing regions, or to poorer regions of Indonesia that would be disadvantaged by the new arrangements.

A more transparent mechanism to assure natural resource revenues to producing regions is through a combination of royalties (these may require amendments in the production-sharing contracts), production excises, as well as potentially space to impose a certain number of percentage points on the corporate income tax. These options need to be assessed, along with measures on the establishment of an untied general allocation grants mechanism to address the requirements of poorer regions as well as maintaining the incentives to invest, raise own revenues and manage expenditures efficiently in all regions.

C. Establishing a Grants Administration

The equalization grants are essential to the continued integrity of the Indonesian State. These grants should be untied, but issues of accountability need to be addressed. The grants system needs to be neutral and transparent in both operations and output.

- **Organization and location:** For acceptance by regional governments, the grants administration should be located so as to generate the greatest trust on the part of the provinces and districts.

- **Design:** As recognized by the Fiscal Balance Law, the distribution of equalization grants should be based on relative expenditure needs and revenue capacities. But the revenue capacity aspects cannot become functional until there is the possibility of utilizing own-revenues at the margin.

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[1] The SDO funds refer to subsidies for personnel hired by district/municipal governments for decentralized functions. The Regional Development Funds were previously known as the INPRES grants.

- **Responsibilities:** Expenditure assignments need to be defined as an input to the work of a grants commission. For regions that are unable to manage assigned responsibilities, ***contracting-out*** of functions should be encouraged.

- **Information base:** The existing data base, as reviewed by the mission, has in the short run provided a basis for a potentially comprehensive set of **models and allocation criteria**. Additional effort, however, is needed to improve the collection of information on tax bases.

- **Involvement of regions.** Proposals need to be discussed extensively with the regions, particularly the districts—for this purpose, associations of districts need to be instituted. Also the members of the proposed grants administration need to invest a great deal of their time in the field, to consult with member administrations. Central ministers are unlikely to have the time to perform such detailed functions.

- **Coordination for grants administration.** The authorities should establish immediately a joint working group consisting of staff members from the Ministries of Finance and Home Affairs, and related official agencies, and academics, to begin to collect data and construct models for the equalization grants system.

D. Timetable

The mission has developed a **sequenced timetable** for the establishment of the grants administration, involving the logical links between the various policy components, and the full implementation of the decentralization proposals. **A period of two and a half years is needed at the minimum to make the proposals functional—see section III.**

E. Follow-up

The World Bank **[Homi's instructions]** is prepared to continue with assistance in the sectoral areas (education and health, infrastructure) to ensure effective service delivery. The Bank is also prepared to assist with civil service reform, the absorption of deconcentrated and central staff by regional authorities, and in the longer term, to assist with the development of rules that would govern hiring and lay offs.

Mr. Hofman, together with the FAD Advisor, Mr. Piperno, will also assist in the coordination of donor efforts to ensure that there is effective and well orchestrated support to the efforts of the Indonesian authorities to achieve a massive transformation in a relatively short period of time.

III. THE DECENTRALIZATION LEGISLATION—AN EVALUATION

A. The New Bills

At the end of April 1999, the Indonesian Parliament passed two bills concerning (1) Regional Governance 22/1999; and (2) Fiscal Balance between the Central and Regional Governments 25/1999. The former was drafted by the Ministry of Home Affairs and the latter by the Ministry of Finance.

The Regional Governance Law

The Regional Governance Law (henceforth Governance Law) focuses on enhanced ***administrative and political decentralization***, particularly at the regency (district) and municipal levels. District regents, or city mayors, are to be elected by regional assemblies. After decades of highly centralized diktat, the movement toward multiparty elections, particularly at central and district levels, should lay the foundations for greater accountability in government operations and improved efficiency in the delivery of public services.[2] Although the political reforms are important in setting the stage, the sequencing and design of the devolution of administrative responsibilities and financial arrangements will be critical in ensuring macroeconomic stability and integrity of the Indonesian State.

The Governance Law contains the only references to the ***devolution of expenditure responsibilities***. These are defined in very general terms, assigning most functions to the regency/district level—including "public works, health, education and culture, agriculture, communications, industry and trade, capital investment, environment, land, cooperative and manpower affairs (Governance Law, Article 11)." There is a recognition in the Ministry of Home Affairs and in other government departments that this very broad allocation of responsibilities does not carry much operational significance, and that a more detailed specification, taking into account administrative capabilities, needs to be developed. The Governance Law accepts that some districts may not be able to perform all the assigned responsibilities—and that these may be reallocated to other districts or to provinces, and associated resources would follow. Since funding for decentralized functions is to be made mainly through a general allocation, and increased reliance on own-source revenues,

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[2]Lower levels of government are known as regions. Provinces are allocated few decentralized responsibilities, and serve as a coordinating layer, but without authority over the tertiary tier, and as agents for the central government for "deconcentrated" central functions. The third tier is composed of districts (also known as regency regions) and municipalities, and will be the main decentralized level of government, with elected regents and mayors. Since provinces are to function also as agents of the center, the appointment of provincial governors requires Presidential approval.

including user charges, it may be difficult to extract the relevant funds for the reassigned function. Consideration should be given to contracting out services that cannot be provided by a district-level government.

Another issue, insufficiently developed in the present legislation, is the role of the central government in determining policy objectives, such as minimum standards for education, health or the safety net, and the implications these policies may have for financing issues (where these policies affect sectors allocated to lower levels). These issues will be examined further in the session on expenditure assignments.

Although the Governance Law is vague on the specification of expenditure devolution—and lacks a realistic estimate of the sequencing of such devolution, the Fiscal Balance Law specifies in detail the minimum amounts to be transferred to lower level administrations. This strategy runs the ***risk that functions may not follow stipulated financing***, opening up the possibility that major macroeconomic imbalances and rigidities may ensue. The experience of countries in Latin America, such as Colombia, has clearly illustrated the potential dangers of such a strategy and sequencing.

The wording in the Governance Law regarding fiscal and financial matters refers to central government responsibility without specifying the relevant agencies. Further, as the proposed development of implementing regulations suggests, much of the primary responsibility appears to lie with the Ministry of Home Affairs. Examples of this are “tariffs and procedures for local taxes and charges,” as well as “guidance of local governments budgets.” Furthermore, the mission suggests extreme caution in relation to the granting of “specific tax and non-tax incentives for local governments.” Primary responsibility of policy making in the fiscal and financial area should be that of the Ministry of Finance.

The Fiscal Balance Law

The Fiscal Balance Law covers a number of areas well, with an appropriate level of detail. These include the design of a grants system with general allocation, to be based on expenditure needs and revenue capacities, supplemented by special purpose transfers. The legislation also avoids a potential difficulty by not specifying the formulae to be used. The sections on borrowing and subnational financial information systems are also generally well designed.

But the bill contains a number of **shortcomings** that could potentially threaten macroeconomic stability and compromise the effectiveness of the planned decentralization.

Own-source revenues: Although both the Governance and Fiscal Balance bills recognize the possibility of own-source revenues at the lower levels of government, the main such source given international experience—the land and buildings tax on urban and rural property—is treated as a shared source of revenue. This means that districts in particular will have no significant own-source revenues to use at the margin if additional expenditures are needed—and thus **overall accountability** of the decentralized system will be severely constrained.

Shared revenues—land and property tax: As pointed out in the report of the December 1998 mission, complicated sharing arrangements for the land and property tax are designed to introduce "equalization" elements. This equalization function becomes redundant when there is a much larger general allocation transfer (far exceeding the revenues from the land and property tax) that is also to be distributed on the basis of "equalization" principles.

Shared revenues—oil and gas: In order to appease the demands from oil and gas producing regions, the Fiscal Balance bill was revised in Parliament to include sharing of onshore oil and gas revenues with the region. However, expectations raised by this measure were not satisfied by the realities on the ground. The province of Riau expected Rp 17 trillion, but would have received only Rp 0.7 trillion under the sharing formula. We understand that the formula is being re-estimated to treat oil and gas fields within 12 miles of the coast as "onshore." In addition to the "unsatisfied aspirations", the sharing of oil and gas will:

- actually widen regional disparities (see below);
- prove difficult to administer, particularly at district level, as volatile oil prices lead to a divergence between budgets and realized revenues;
- in some cases may provide more revenues to nonproducing districts in a province than producing districts;[3] and
- complicate the functioning of a grants system.

B. Regional Finance: Preliminary assessment of Laws 22 and 25[4]

Macroeconomic Context

We provide an illustrative scenario of the macroeconomic effects of the proposed decentralization of public finances to the regional level. At this stage, many of the calculations are based on assumptions rather than stated policies, and the results should therefore be interpreted with great care. In addition, because at this stage the division of responsibilities between central, provincial, and district government has not yet been settled, we treat regional government as one level. Projections for the individual provinces and districts are not yet available, because the formula that distributes the general grant—the largest source of funding for subnational government—is not known yet.

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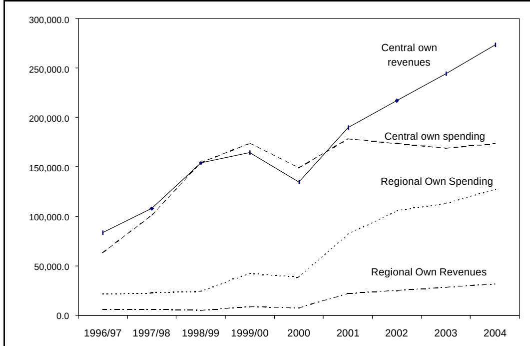
[3] This would depend on the number of non-producing districts receiving transfers relative to the number of producing districts in a province.

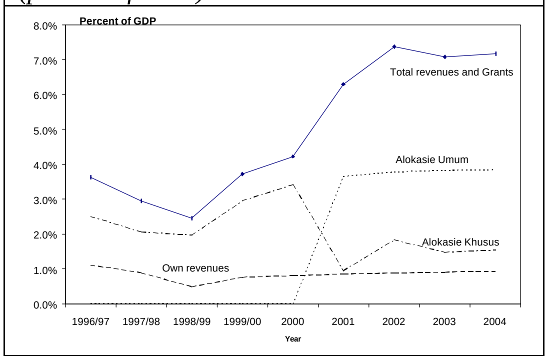
[4] Thanks to Ali Mansoor, IMF, for work on the projections.

Overall, Indonesia's current framework for regional autonomy (Laws 22 and 25 of 1999) will significantly decentralize Indonesia's Government, with the intention to begin implementation starting 2001. The regional share of general government spending will eventually more than double to over 40 percent with full implementation (Fig.1). Some 60 percent of the development budget will be managed at subnational levels. Under the framework, the districts will manage most of the Government's services, including health, education, and infrastructure. Regional tax revenues, however, will rise only slightly, and the difference be made up by grants from central to regional governments. The largest component is the General Grant (*Alokasie Umum*) which will consist of least 25 percent of domestic revenues (Fig. 2).[5]

Figure 1: Impact of Decentralization
(Bn. Rupiah)



A. Figure 2: Regional Revenues
(percent of GDP)



Key Assumptions

The current projections assume that there will be a gradual transfer of personnel to the regions, and a gradual increase in wages (5 percent above inflation). Note that the projections *assume that the regions actually absorb the civil servants transferred to them*. The reason is that the main trust of decentralization is to merge kanvils with dinasses, and therefore transfer the payroll from central government to the regions. This is the only way in which decentralization will not lead to a sharp increase in the general government deficit, threatening the economic stabilization achieved.

For now, the projections do not assume any increase in non-tax revenues of the regions. This is clearly unrealistic, as there is much potential for additional sub-national taxation and user charges and levies that would flow to the regional budgets[6]. However, Law 18/1997 for now puts a limit on the possibilities for additional revenues at local level. Moreover, although the equalization formula is yet to be determined, the concept currently developed in the MOF is one in which own revenues (of whatever nature) would—less than proportionally—reduce the general grant allocation.

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[5] However, the exact coverage of domestic revenues is still under debate. For instance, the central government wants oil revenues already shared to be excluded from this definition.

[6] See background paper by Ahmad and Krelove (this conference).

The general grant and regional own resources will have to cover some of the development expenditures devolved to the regions. Overall, regional development spending will rise to some 4 percent, whereas specific grants from central government are unlikely to be higher than 2 percent of GDP. The general grant of some 3.8 percent of GDP will cover personnel spending (2.5 percent) but then leaves only 1.3 percent of GDP as a contribution to development spending. Thus some 0.7 percent of GDP will have to be covered by own revenue sources, and borrowing. For regions with oil, gas, or forestry, this is undoubtedly easier to than for those without these natural resources.

For now, the assumption in the projections is *no* local borrowing. The implicit assumption here is that international borrowing is done by the center, and passed on to the province as a specific grant. This is not a realistic assumption, but it is likely that—if the regions can borrow from abroad—their special grants would be reduced. Domestic borrowing is likely to be limited, by a formula similar to the one stipulated by MOHA at present. For now, domestic borrowing is not taken into account in the projections. Own revenues may increase in the future (e.g. by devolving the land and building tax) but this is likely to be offset by a cut in special grants.

How to set up a regional budget envelope

For regions, a way to project their own resource envelope is the following:
(i) take the region's share in the SDO as indicative of the share in the *alokasie umum*. 90 percent of the *alokasie umum* goes to the district, 10 percent to the province; (ii) take the current share of the region in development grants, and assume that this is the future share in the *special grants* from the center to the regions. Assume *no* or very little development spending at provincial level; (iii) consider realistic targets for own revenues, e.g. growing slightly faster than GDP. Combine (i) (ii) and (iii) to get the budget envelope. Then, on the spending side, assume that 70 percent of the *alokasie umum* is taken by personnel costs, and 10 percent by material costs from "inherited" operations. Assume a gradual decline of development spending on *existing* projects—including those transferred from the center. Take 20 percent of revenues as a "contingency" to absorb any shortfall on grants or own revenues. What is left—if any—is available for new policy. If there is a deficit, savings and resource mobilization measures will have to be designed and implemented.

TableSummary General, Central and Regional Government Financial

Percent of GDP	1996/97	1997/98	1998/99	1999/00	2000	2001	2002	2003	2004
Period Flows	Apr-Mar	Apr-Mar	Apr-Mar	Apr-Mar	Apr-Dec	Jan-Dec	Jan-Dec	Jan-Dec	Jan-Dec
						General Government			
Total revenue and grants	16.3%	16.5%	15.7%	15.3%	15.6%	16.3%	16.9%	17.1%	17.2%
Central	15.2%	15.6%	15.2%	14.5%	14.8%	14.6%	15.1%	15.3%	15.4%
Regional	1.1%	0.9%	0.5%	0.8%	0.8%	1.7%	1.7%	1.8%	1.8%
Oil	2.7%	3.2%	2.5%	2.8%	2.7%	2.6%	2.5%	2.2%	2.0%
Central	2.7%	3.2%	2.5%	2.8%	2.7%	2.4%	2.3%	2.0%	1.8%
Regional	0.0%	0.0%	0.0%	0.0%	0.0%	0.2%	0.2%	0.2%	0.2%
Gas	1.0%	1.2%	1.5%	1.5%	1.5%	1.2%	1.1%	1.0%	0.9%
Central	1.0%	1.2%	1.5%	1.5%	1.5%	1.1%	1.1%	0.9%	0.8%
Regional	0.0%	0.0%	0.0%	0.0%	0.0%	0.1%	0.1%	0.1%	0.1%
Property& Land	0.4%	0.4%	0.4%	0.3%	0.3%	0.3%	0.3%	0.4%	0.4%
Central	0.4%	0.4%	0.4%	0.3%	0.3%	0.0%	0.0%	0.0%	0.0%
Regional	0.0%	0.0%	0.0%	0.0%	0.0%	0.3%	0.3%	0.4%	0.4%
Forestry & other natural resources	0.0%	0.0%	0.1%	0.3%	0.3%	0.3%	0.3%	0.3%	0.3%
Central	0.0%	0.0%	0.1%	0.3%	0.3%	0.1%	0.1%	0.1%	0.1%
Regional	0.0%	0.0%	0.0%	0.0%	0.0%	0.3%	0.3%	0.3%	0.3%
Other	12.2%	11.7%	11.2%	10.3%	10.8%	11.9%	12.5%	13.2%	13.5%
Central	11.1%	10.8%	10.7%	9.6%	10.0%	11.0%	11.6%	12.3%	12.6%
Regional	1.1%	0.9%	0.5%	0.8%	0.8%	0.9%	0.9%	0.9%	0.9%
Total expenditure and net lending	15.3%	18.0%	17.6%	19.0%	20.6%	20.0%	19.5%	17.7%	16.9%
Central	11.4%	14.7%	15.2%	15.3%	16.4%	13.7%	12.1%	10.6%	9.8%
Regional	3.9%	3.3%	2.4%	3.7%	4.2%	6.3%	7.4%	7.1%	7.2%
Current expenditure	8.9%	10.8%	12.4%	14.2%	16.2%	13.5%	12.3%	11.0%	10.4%
Personnel	4.4%	4.0%	3.5%	4.5%	4.7%	4.9%	4.8%	4.8%	4.7%
Central	2.8%	2.6%	2.3%	3.0%	2.7%	2.4%	2.2%	2.2%	2.1%
Regional	1.6%	1.4%	1.2%	1.6%	2.1%	2.4%	2.7%	2.6%	2.6%
Goods and non-labor services	1.6%	1.3%	1.2%	1.2%	1.3%	0.9%	1.0%	1.1%	1.2%
Central	1.3%	1.0%	1.0%	0.9%	1.0%	0.5%	0.6%	0.6%	0.7%
Regional	0.3%	0.3%	0.2%	0.3%	0.3%	0.4%	0.4%	0.5%	0.5%
Subsidies	0.3%	3.0%	4.2%	3.7%	2.9%	1.9%	1.2%	0.5%	0.2%
Central	0.3%	3.0%	4.2%	3.7%	2.9%	1.9%	1.2%	0.5%	0.2%
Regional	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Transfers	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%
Central	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Regional	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%	0.1%
Interest	1.2%	1.9%	3.2%	4.1%	6.5%	5.1%	4.8%	4.1%	3.8%
Central	1.2%	1.9%	3.2%	4.1%	6.5%	5.1%	4.8%	4.1%	3.8%
Regional	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Other current expenditure	1.2%	0.5%	0.3%	0.5%	0.7%	0.7%	0.4%	0.4%	0.4%
Central	1.2%	0.5%	0.3%	0.5%	0.7%	0.7%	0.4%	0.4%	0.4%
Regional	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Development expenditure and net lending	6.4%	7.2%	5.2%	4.9%	4.4%	6.5%	7.2%	6.7%	6.6%
Central Government	4.6%	5.8%	4.4%	3.1%	2.7%	3.1%	3.0%	2.8%	2.6%
Regional Governements	1.8%	1.4%	0.9%	1.8%	1.8%	3.4%	4.2%	3.9%	4.0%
Overall Balance	1.0%	-1.5%	-1.9%	-3.8%	-5.0%	-3.7%	-2.6%	-0.6%	0.2%

	Regional Governments								
	1996/97	**1997/98**	**1998/99**	**1999/00**	**2000**	**2001**	**2002**	**2003**	**2004**
Total revenue and grants	**3.6%**	**3.0%**	**2.5%**	**3.7%**	**4.2%**	**6.3%**	**7.4%**	**7.1%**	**7.2%**
Oil	**0.0%**	**0.0%**	**0.0%**	**0.0%**	**0.0%**	**0.2%**	**0.2%**	**0.2%**	**0.2%**
Gas	**0.0%**	**0.0%**	**0.0%**	**0.0%**	**0.0%**	**0.1%**	**0.1%**	**0.1%**	**0.1%**
Property& Land	**0.0%**	**0.0%**	**0.0%**	**0.0%**	**0.0%**	**0.3%**	**0.3%**	**0.4%**	**0.4%**
Forestry	**0.0%**	**0.0%**	**0.0%**	**0.0%**	**0.0%**	**0.3%**	**0.3%**	**0.3%**	**0.3%**
General Allocation	**0.0%**	**0.0%**	**0.0%**	**0.0%**	**0.0%**	**3.6%**	**3.8%**	**3.8%**	**3.8%**
Other Own Revenue	**1.1%**	**0.9%**	**0.5%**	**0.8%**	**0.8%**	**0.9%**	**0.9%**	**0.9%**	**0.9%**
Specific Transfers from Central Government	**2.5%**	**2.1%**	**2.0%**	**3.0%**	**3.4%**	**1.0%**	**1.8%**	**1.5%**	**1.5%**
Total expenditure and net lending	**3.9%**	**3.3%**	**2.4%**	**3.7%**	**4.2%**	**6.3%**	**7.4%**	**7.1%**	**7.2%**
Current expenditure	**2.1%**	**1.8%**	**1.5%**	**2.0%**	**2.5%**	**2.9%**	**3.2%**	**3.2%**	**3.2%**
Personnel	**1.6%**	**1.4%**	**1.2%**	**1.6%**	**2.1%**	**2.4%**	**2.7%**	**2.6%**	**2.6%**
Goods and non-labor services	**0.3%**	**0.3%**	**0.2%**	**0.3%**	**0.3%**	**0.4%**	**0.4%**	**0.5%**	**0.5%**
Subsidies	**0.0%**	**0.0%**	**0.0%**	**0.0%**	**0.0%**	**0.0%**	**0.0%**	**0.0%**	**0.0%**
Transfers	**0.1%**	**0.1%**	**0.1%**	**0.1%**	**0.1%**	**0.1%**	**0.1%**	**0.1%**	**0.1%**
Interest	**0.0%**	**0.0%**	**0.0%**	**0.0%**	**0.0%**	**0.0%**	**0.0%**	**0.0%**	**0.0%**
Other current expenditure	**0.0%**	**0.0%**	**0.0%**	**0.0%**	**0.0%**	**0.0%**	**0.0%**	**0.0%**	**0.0%**
Development expenditure & poverty alleviati	**1.8%**	**1.4%**	**0.9%**	**1.8%**	**1.8%**	**3.4%**	**4.2%**	**3.9%**	**4.0%**
Central Government financed	**1.0%**	**0.8%**	**0.7%**	**1.3%**	**1.2%**	**0.0%**	**0.0%**	**0.0%**	**0.0%**
Own financed	**0.8%**	**0.6%**	**0.2%**	**0.5%**	**0.5%**	**3.4%**	**4.2%**	**3.9%**	**4.0%**
Overall Balance	**-0.3%**	**-0.3%**	**0.1%**	**0.0%**	**0.0%**	**0.0%**	**0.0%**	**0.0%**	**0.0%**

Vertical fiscal imbalances

To assess the implications of the Fiscal Balance Law for vertical fiscal imbalances (i.e., the mismatch between revenue and expenditure at the central, provincial, and district levels), a simulation of the rules for general allocation and revenue sharing prescribed by the Law was conducted using a number of assumptions. These assumptions were:

- 15 percent of onshore oil revenue will be distributed to subnational governments, of which 3 percent to provinces, and 12 percent to districts.

- 30 percent of onshore gas revenue will be distributed to subnational governments, of which 6 percent to provinces, and 24 percent to districts.

- For simplicity, it was assumed that the sharing of other taxes (land and building taxes, and revenues from forestry, non-oil and gas mining, and fishery) between provinces as a whole and districts as a whole will remain unchanged.[7]

- 25 percent of central government domestic revenue, including oil and gas revenues, will be distributed to subnational governments under a general allocation.

[7] The Law changes the current revenue sharing rule (45 percent for the center and 55 percent for subnational governments) for the forestry royalty to a 20 percent: 16 percent: 64 percent division between the center, provinces, and districts. The Law also stipulates that 80 percent of the revenue from fishery will be distributed equally (in lump-sum terms) to districts. Currently, 100 percent of the revenue from fishery accrues to the center. Because the size of these revenues are very small, for simplicity, the simulation assumes that the new sharing rules do not alter the distribution of non-oil and gas revenue sharing as a whole.

- 10 percent of the general allocation will be given to provinces and 90 percent to districts.

- The general purpose grants under the Regional Development Funds (formerly INPRES grants) and the SDO for decentralized personnel will form part of the general allocation, and all specific purpose grants[8] under the Regional Development Funds will be classified as special allocation under the Law.[9]

Using data from the state budget and estimated provincial and district budgets for 1999/2000, three scenarios are undertaken:

(1) "*Current policy*," as implied by the current central and subnational budgets;

(2) "New policy under existing expenditure assignment," which shows the additional budgetary deficit or surplus that would be generated by the implementation of the Governance Law at each level of the government, if the existing division of expenditure responsibilities is unchanged; and

(3) "*New policy under reassignment of expenditure responsibilities*," which shows the extent to which central government expenditure responsibilities have to be devolved to local levels, if each level of the government is to maintain its current level of fiscal deficit.

The simulation results (see Table 3) suggest the following:

- The rules for oil and gas revenue sharing and general allocation **will significantly increase the central government deficit** (or require a sharp reduction in central government expenditure).[10] Under the current expenditure assignments and budget estimates for 1999/2000, the implementation of the new legislation will lead to an increase in the central government deficit of about Rp 14 trillion, or 1.2 percent of GDP, as a result of the oil and gas revenue sharing (about Rp 2 trillion for subnational

[8]The specific purpose grants under the Regional Development Fund for provinces are earmarked to the following sectors: primary education; health services; roads, irrigation, and water supply; environmental protection; and culture and religion affairs. The specific purpose grants under the Regional Development Fund for districts are earmarked for infrastructure; health and education; environmental protection; agriculture; and transfers to lower level governments.

[9]The Planning Board (BAPPENAS) provides this interpretation.

[10] Note that the government's medium-term fiscal objective is to restore budgetary balance.

governments) and a sharp increase in general allocation (about Rp 12 trillion). [11] Alternatively, if the central government is to maintain the budgeted level of deficit, it has to transfer expenditure responsibilities of about Rp 14 trillion to lower level governments.

- The revenue sharing and general allocation rules will lead to a **drastic increase in fiscal transfers to district** level governments. Under the current expenditure assignment, this implies a budget surplus at the district level of about Rp 13.5 trillion, as a result of the sharing of oil and gas revenue by districts (about Rp 1.5 trillion) and the sharp increase in general allocation to districts (about Rp 12 trillion). If the higher level governments are to maintain the deficit levels in the current budget, district governments will have to take over expenditure responsibilities of about Rp 13.5 trillion, a nearly 50 percent increase from the current level.

[11] Note that the amounts to be transferred are a function of the oil price, which has risen from $10.5 per barrel (assumed in the 1999/2000 budget estimate) to over $25 per barrel in early 2000.

Table 3. Impact of the Fiscal Balance Law on Vertical Imbalances and Expenditure Assignment: 1999/2000

(In billions of rupiah)

		New Policy	
	Current Policy l/	Current expenditure assignment 2/	Reassignment of expenditure responsibilities 3/
Central government			
Domestic revenue	142,204	142,204	14,204
Expenditure and transfer	219,604	231,518	217,694
Expenditure	190,337	190,337	176,513
Transfers	29,267	41,181	41,181
General allocation	23,637	35,551	35,551
Special allocation	5,630	5,630	5,630
Oil and gas sharing	0	1,910	1,910
Deficit	77,400	91,224	77,400
Provinces (excl. Jakarta)			
Revenue and transfer	9,068	9,283	9,283
Own and shared revenue	3,661	3,661	3,661
Oil and gas revenue	0	382	382
Transfers	5,408	5,240	5,240
General allocation	3,687	3,520	3,520
Special allocation	1,721	1,721	1,721
Expenditure	9,068	9,068	9,283
Deficit	0	(215)	0
Districts and lower (excl. Jakarta)			
Revenue and transfer	29,205	42,695	42,695
Own and shared revenue	5,700	5,700	5,700
Oil and gas revenue	0	1,528	1,528
Transfers	23,505	35,467	35,467
General allocation	19,714	31,676	31,676
Special allocation	3,791	3,791	3,791
Expenditure	29,205	29,205	42,695
Deficit	0	(13,490)	0
		(In percent)	
Memorandum items:			
General allocation as percent of domestic revenue	16.6	25.0	25.0
Provincial general allocation as percent of total general allocation	15.6	9.9	9.9
District general allocation as percent of total general allocation	83.4	89.1	89.1
General allocation to Jakarta as percent of total general allocation	1.0	1.0	1.0
		(In billions of rupiah)	
General allocation to Jakarta	236	356	356
Special allocation to Jakarta	118	118	118

Sources: Ministry of Finance; and Fund staff estimates.

1/ Provincial and district level data for "current policy" are estimates based on 1998/99 budget data and previous years' budget outcomes, and do not necessarily match the 1999/2000 budgets.

2/ Under existing expenditure assignment, deficit is treated as residual.

3/ Under reassignment of expenditure responsibilities, expenditure at each level of government is adjusted to maintain the budgeted level of deficit

- Given the working assumptions about the provincial budgets, the rupiah value of expenditure responsibilities of provincial governments will remain virtually unchanged under the new policy relative to the current policy scenario. However, the composition of the functions to be performed by provincial governments may have to undergo substantial changes as a result of the devolution of central functions to provinces and provincial functions to district governments.

- If the specific purpose grants under the Regional Development Funds are included in the definition of general allocation (25 percent of domestic revenue), the magnitude of the change in vertical imbalance implied by the Law can be reduced by about Rp 5.5 trillion. In other words, the required transfer of expenditure responsibilities under Scenario 3 will be about Rp 8 billion, rather than Rp 13.5 trillion.

Existing horizontal imbalances

Indonesian local governments capacities to raise revenue from their own sources and revenue-sharing arrangements vary significantly. In 1996/97, per capita own-source revenue and shared revenue in East Kalimantan (including provincial and district levels) was 5.4 times that in Nusa Tenggara Barat. If Jakarta is included in this comparison, the ratio of maximum to minimum level of per capita own-source and shared revenue among provinces would reach 27.

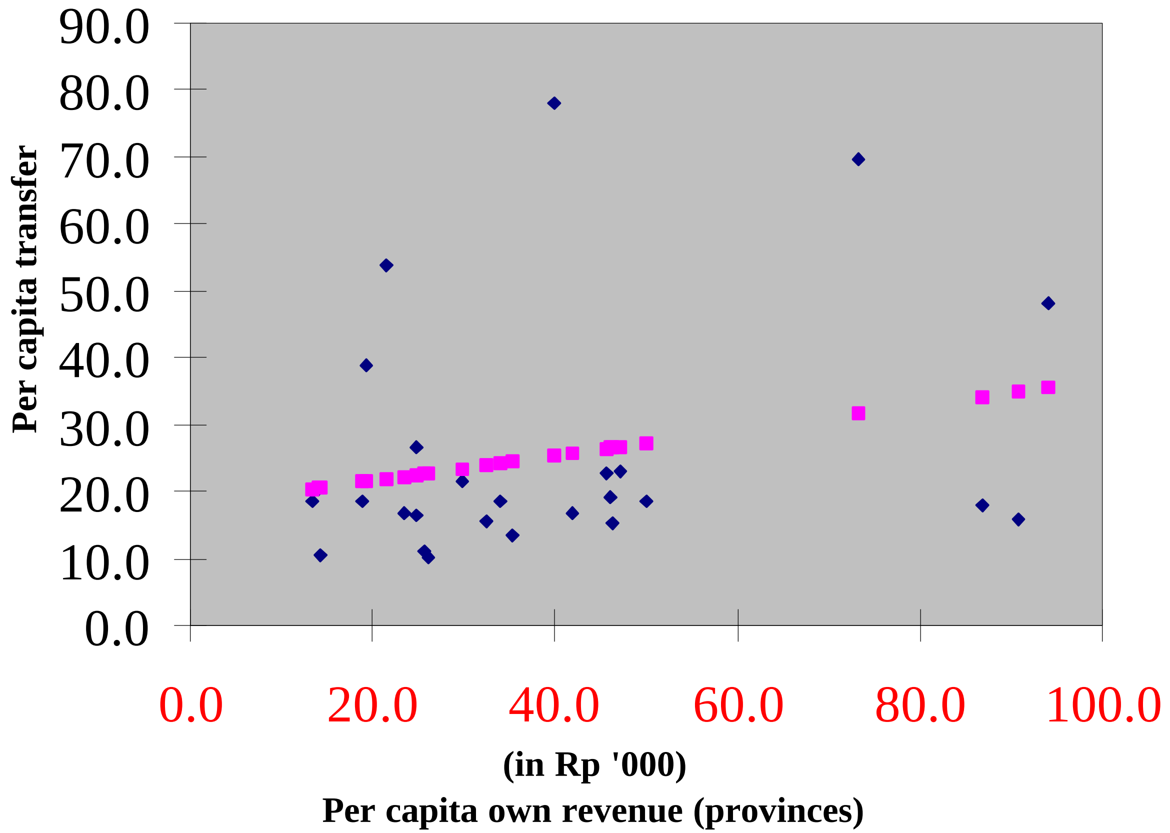
Local expenditure needs also differ vastly across provinces and districts. For example, at the provincial level, the average number of years of schooling ranged from 3.5 in East Timor to 7.1 in Maluku in 1996; life expectancy ranged from 55 years in East Nusa Tenggara to 70 years in Jakarta in 1997; poor quality roads as a proportion of the total length of provincial roads ranged from 24 percent in Sulawesi Selatan to 70 percent in Kalimantan Barat in 1997.[12] It is expected that even larger variations in expenditure needs exist across districts and municipalities.

The current intergovernmental transfer mechanisms, including the Regional Development Funds and Routine Expenditure Funds for decentralized staff salaries (SDOs), contain some elements that are designed to equalize revenue capacities and compensate for differences in expenditure needs across regions. However, the **transfer system is highly segmented**, with many subprograms distributed on a range of different, and sometimes conflicting criteria, resulting in a very weak equalization effect on local governments' abilities to provide public services, and may even be **disequalizing** when measured by revenue capacity.

Using provincial data, simple regressions show that the per capita transfer to provinces in 1997/98 was positively related to per capita own-source and shared revenues (Chart 1), and

[12]Data from the Ministry of Home Affairs.

Chart 1. Disequalization Under the Current Transfer System



had no statistically significant relationship with per capita GDP.[13] A similar analysis using district level data for 1996/97 suggests that per capita transfers to districts were significantly and positively correlated with per capital own source and shared revenues and had no relation with per capita GDP.

The Fiscal Balance Law and horizontal (dis)equalization

The sharing of oil and gas revenue, as required by the Fiscal Balance Law, would further disequalize regional revenue capacities, as the sources of oil and gas revenue concentrate in a small number of provinces and districts. According to the Law, three percent of onshore oil revenue will be distributed to provincial governments based on production origin, six percent will be distributed to the producing districts, and the other six percent will be distributed to nonproducing districts in the producing province. Similarly, six percent of onshore gas revenue will be distributed to provincial governments based on production origin, 12 percent will be distributed to the producing districts, and the other 12 percent will be distributed to nonproducing districts in the producing province.[14] Based on very conservative assumptions of oil and gas prices, it is estimated that, if the Law were implemented for the 1999/2000 budget, about Rp 2 trillion would be distributed to local governments as a result of the oil and gas revenue sharing, and three provinces (Riau, East Kalimantan, and Di Aceh) would receive about 82 percent of the total local share. For Riau and Di Aceh, the provincial governments' oil and gas receipts would amount to 70-80 percent of their existing revenue capacities. In the meantime, 21 provinces would receive zero or near zero oil and gas revenue (see Table 4).

To assess the extent to which the sharing of oil and gas revenue would exacerbate the distribution of revenue capacities, we calculated the coefficient of variations[15] of per capita provincial revenue (including from own sources and shared sources) before and after the oil and gas revenue sharing. Preliminary results show that the coefficient of variations across 26 provinces (excluding Jakarta) would increase from 70 percent to 90 percent due to the oil and gas revenue sharing. In other words, the average deviation of per capita revenue capacity from the national mean would rise by nearly 30 percent (see Table 4).

The Law requires that an equalization transfer program—the general allocation—be set up to offset, at least partially, the existing and newly created revenue disparity. As the formula for the general allocation has not been determined, it is difficult to measure its impact on

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[13]Per capita GDP is sometimes used as a proxy of revenue capacity, or a partial indicator for social and development expenditure need.

[14]The Law, however, does not specify the method for distributing the 6 percent oil revenue and 12 percent gas revenue to nonproducing districts.

[15]The coefficient of variation is defined as standard deviation divided by mean.

Table 4. Revenue Capacities of Provincial Governments, 1999/2000

(In thousands of rupiah)

	Per Capita Existing Revenue Capacity	Per Capita Oil and Gas Revenue	Per Capita Total Revenue Capacity
Dista Aceh	18.99	16.60	35.59
Sumatera Utara	22.66	0.11	22.77
Sumatera Barat	18.65	0.00	18.65
Riau	53.71	40.58	94.29
Jambi	21.57	1.54	23.10
Sumatera Selatan	20.29	2.88	23.16
Bengkulu	18.56	0.00	18.56
Lampung	10.38	0.00	10.38
Jawa Barat	16.83	0.67	17.50
Jawa Tengah	13.31	0.00	13.31
DI. Yogyakarta	22.99	0.00	22.99
Jawa Timur	18.40	0.36	18.77
Kalimantan Barat	16.57	0.00	16.57
Kalimantan Tengah	48.10	0.00	48.10
Kalimantan Selatan	26.69	0.00	26.69
Kalimantan Timur	78.01	39.49	117.49
Sulawesi Utara	15.50	0.00	15.50
Sulawesi Tengah	18.03	0.00	18.03
Sulawesi Selatan	18.52	0.03	18.55
Sulawesi Tenggara	15.39	0.00	15.39
Bali	38.97	0.00	38.97
Nusa Tenggara Barat	11.08	0.00	11.08
Nusa Tenggara Timur	10.28	0.00	10.28
Maluku	16.77	0.06	16.83
Irian Jaya	69.60	1.99	71.59
Timor Timur	15.92	0.00	15.92
Mean	25.2	4.0	29.2
Standard deviation	17.8	11.1	26.3
Coefficient of variation	0.70	2.77	0.90

Sources: Ministry of Finance; and Fund staff estimates.

Note: Jakarta is excluded from the above table as available statistics do not distinguish between its provincial and district functions.

regional equality. An illustrative example of how an equalization transfer program can be designed using data that are currently available in Indonesia, will be presented later in the seminar, to illustrate that it is possible to achieve a significant degree of equalization of local capacities for the provision of public services.

General conclusions that emerge from the above analyses are that:

- **The magnitude of expenditure devolution required by the Law would be overwhelming,** especially considering the very limited administrative capacities at the district level.
- **To achieve the legally mandated degree of decentralization will surely take much longer than one year.**
- Implementing the proposed oil and gas revenue sharing and a full 25 percent of domestic services for general allocation in the next budget ahead of expenditure devolution, is likely to **lead to a substantially larger fiscal deficit at the central level**, as lower level governments are not ready to absorb fully their mandated responsibilities.
- **If this process is not managed with prudence and skills, it could pose a threat to macroeconomic stability.** Oil and gas shares and moves toward a larger share of domestic revenues for the general allocation should be gradually phased in over a period of time.
- **With weak management and uncertain political accountability at the local level, there is potential for "capture of funds" by interest groups.**

IV. Sequencing And Implementation Timetable

We believe that the time it will take to implement the Governance and the Fiscal Balance laws has been underestimated. Also, with the change in the timing of the budget process[16] beginning in the fiscal year for the calendar 2001 budget there will be relatively little time to implement measures that have not even been discussed so far (e.g., regarding the expenditure assignments) with regional leaders and civil society.

In looking at the feasibility of what is required by the legislation, the FAD-Bank team has simplified the process by identifying only 29 tasks requiring action before the transfer of functions to the regions can be achieved and for the grants commission to be fully functional. There are obviously many more than this that could be specified, but the study is limited to the more important and not considered the administrative details too closely. As illustrated in Chart 3, even assuming 'best practice' in governance, management and administration, and

[16] The beginning of the budget year will be forward from April to January from 2001.

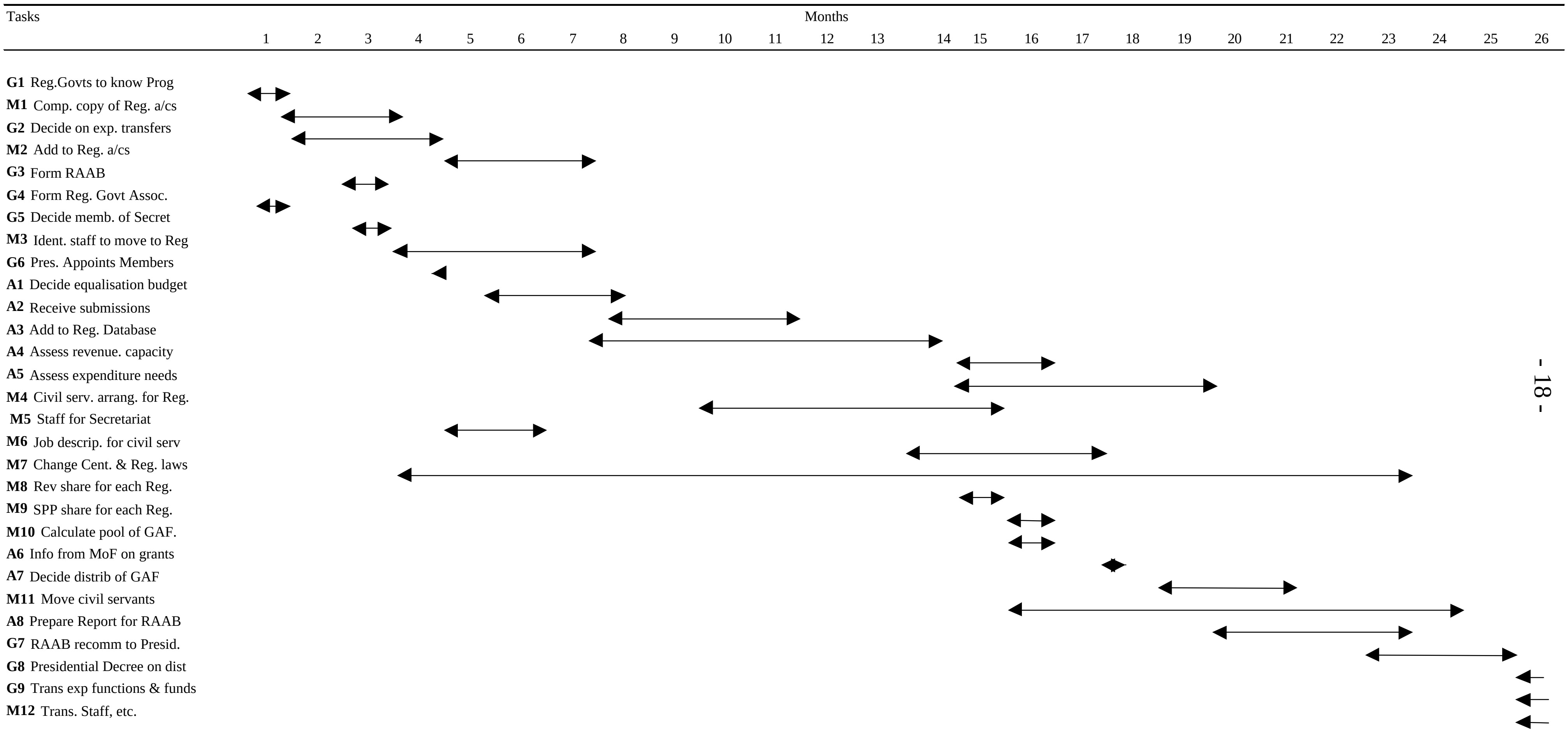
limiting the process to a general level of detail, the tasks involved cannot realistically be done within a two-year period. More detail of the tasks specified are given in Table 3, and it would be beneficial if the Ministries of Finance, Home Affairs, or the Coordinating Ministry were to expand these efforts and put together an overall plan for the implementation of the new laws.

In all probability, it may take twice as long as shown, if it is to be done successfully. For example, only 18 months are allowed for the first report on the distribution of the general allocation fund grants (item A8, Table 5). In Australia, for example, where the organization doing the same sort of work with eight States (the Commonwealth Grants Commission) had many years experience in the field, the first simultaneous review of the States' relative need for funding took nearly four years. In China, for example, the establishment of an equalization grants mechanism was undertaken in a small way almost four years ago, and development work is still underway.[17]

We would caution against attempts to fully introduce certain elements of the "package", such as the oil and gas sharing and the 25 percent floor for the general allocation transfers, without completing the requisites described in the sequencing timetable (Chart 3), including in particular the expenditure assignments, institutional arrangements for a grants commission and the formulation for distribution.

[17]China began with a formula-based equalization system with a small scale (about 0.5 percent of central government revenue) in 1996, which covered only 18 out of 30 provinces and used a quite simple formulation. Over the next few years, the size of the equalization system was gradually expanded, the distribution formula has been and continues to be improved with the support of a better database.

Chart 5. Sequencing for Implementation of Decentralization Laws



Note: For details of each task, see Table 8.

Table 5. Sequencing of Implementation Measures–Timetable

Governance	Assessment	Management	Comments
Let Regional Governments know the program to be followed to achieve move to autonomy. G1		Prepare computer record of the most recent year's accounts, in comparable form, for each province and district. M1	Ministry of Home Affairs should be able to do this. M1
Decide and get agreement to the expenditure functions to be transferred to each province and district. G2			
Form the Regional Autonomy Advisory Board (see Comment). G3			It may be necessary to add some members, particularly the regional representatives, later than this.
Form the Regional Government Association. G4			
		Reconstructing and adding to the accounts of all the provinces and districts (created above) so that the comparable data set now matches the new range of revenues and expenditure responsibilities (see comment). M2	Either the Ministry of Home Affairs or the Ministry of Finance could do this, but it would be better if time allows it to be delayed until the Secretariat is established.
Decide on the qualities being sought for members of a 'grants commission' and get appropriate people to accept the task. G5		Identify staff to be moved from one level of government to another. M3	
Presidential Decree appointing members of the Secretariat (grants commission). G6		Expand facilities for civil servants in provincial/district offices etc and re-write regulations and conditions under which current staff are employed. M4	
		Secretariat to be given staff and other resources, particularly computing power. M5	
	Decide the scope and structure of the equalization budget to be used in the work leading to the distribution of the General Allocation Fund. A1	Establish revised job descriptions etc under which transferred staff will be employed. M6	
	Call for and receive submissions from the Regional Governments on why their costs might differ from others. A2		

Table 5. Sequencing of Implementation Measures—Timetable (Concluded)

Governance	Assessment	Management	Comments
	Obtain the comparable financial database prepared in M2 and add to it all the data needed to do the assessments (population, area GDP etc for each province and district) A3	Change Central Government, provincial and district laws so that the changes come into effect on July 1, 2001 and employees' transfers can occur. M7	
	Assess the own-source revenue capacity of each province and district A4	Calculate revenue sharing distribution for each province and district (Min. of Finance). M8	
	Assess the expenditure needs of each province and district. A5	Finalize the details of special purpose payments (SPPs) that each province and district will receive (Min. of Finance). M9	
		Calculate the size of the pool of funds that will be available in the General Allocation Fund to be distributed according to equalization Min. of Finance). M10	
	Receive information from Ministry of Finance on the size of the pool, the distribution of the SPPs and the revenue sharing. A6	Move civil servants to new areas as required. M11	
	Decide the distribution of the General Allocation Funds for each province and district that is to be recommended to the Regional Autonomy Advisory Board. A7		
	Preparation of the Report and other documentation to go to the Regional Autonomy Advisory Board and the provinces, districts and other parties to ensure adequate transparency. A8		
Regional Autonomy Advisory Board accepts or amends the distribution recommended and proposes a distribution to the President. G7			
Presidential Decree on Distribution. G8			
Transfer expenditure responsibilities and financial capacity to Provinces and Districts. G9		Transfer personnel and other resources to Provinces and Districts. M12	