

**DECENTRALISATION, INTERGOVERNMENT GRANTS
AND EQUALISATION**

SOME PRINCIPLES AND ADMINISTRATIVE ISSUES

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TABLE OF CONTENTS

	Page
INTRODUCTION	1
DEVELOPING AN INTERGOVERNMENTAL GRANTS SYSTEM.....	2
Design Options for a Grants Systems	2
Equalisation in Perspective	5
Getting Equalisation Assessments Done.....	6
DATA AND OTHER REQUIREMENTS.....	9
The Data Issues.....	9
Gaining the Confidence of Governments.....	12
A GRANTS SYSTEM FOR INDONESIA.....	13
Establishing Decentralised Governments	14
Objectives and Principles of a Grants System.....	16
Establishing a Grants Mix	17
Establishing a Grants Body	18
Determining the Methods of the Grants Body	19
Conclusion.....	19

DECENTRALISATION, INTERGOVERNMENT GRANTS AND EQUALISATION: SOME PRINCIPLES AND ADMINISTRATIVE ISSUES

1. This paper is in three parts. The first part looks at the options a nation has in developing an intergovernmental grants system and the decisions that have to be taken. It does not set out to provide a model that should be followed but simply raises the issues and discusses them in what I think is a logical order. The circumstances of each nation will determine the answer to many of the questions and the ultimate design of a grants system that best fits those circumstances.

2. The second part looks at some of the data and other requirements of a grants system. The objective is to provide a framework for thinking about the issues and where data and other information might come from.

3. The third part concentrates more on the issues confronting Indonesia at present and looks at how the questions it faced, or still faces in developing an intergovernmental grants system, have been approached. It includes comment on the contents of the Regional Governance and Fiscal Balance Laws passed by Indonesia in mid 1999 and discusses what still needs to be done. Again, it should not be seen as a model for Indonesia to follow, but only as input into the thinking of how the issues might best be resolved. Ultimately, it is the Indonesian people who can best take account of the economic, cultural and political circumstances that must be faced in developing and implementing an intergovernmental grants system that suits Indonesia.

Introduction

4. All nations face issues concerning the distribution of services within their boundaries, whether it is the distribution between individuals, functions or areas. Even absolutely unitary nations (those very small number of very small nations that have only one group of government decision makers) have to ask how their policies impact on each group of individuals within the nation and whether all groups are being provided with each service to the extent intended by government.

5. The larger a unitary nation becomes, the more complex the issues it faces in assessing the 'correctness' of service provision distribution, and the larger the administrative task of trying to ensure that the intended balance is achieved between functions, individuals and regions. For these reasons, and based on good governance, there is a natural tendency as nations become larger to move to a regional structure of administration. But this often leads to tension between regions when the central administration is deciding on the distribution of resources across regions. In attitude at least, the central government's regional administrations become separate groups of government decisions makers — they want to make independent decisions.

6. However, moving from a unitary state to having more than one level of government creates another problem. It formalises the position of regional authorities and necessitates decisions about the distribution of service provision and taxing responsibilities between

different levels of government. These decisions necessarily complicate the issues concerning the distribution of funding because no distribution of revenue raising capacity between levels of government can match the annually varying costs of the service provision responsibilities given to each level of government. A redistribution of fiscal capacity is necessary and this is usually achieved by a grants system.

7. As a general rule, it is sufficient to say that efficiency in tax collection is easier to achieve if done by a more centralised level of government. On the other hand, services for individuals in particular are probably provided more effectively and efficiently by giving responsibilities to more localised levels of government. The usual situation in a non-unitary state is therefore for the central government to raise more revenue than it needs and for the local levels of government to raise less than they need — a top-heavy vertical fiscal imbalance. To overcome this, nations establish a grants system to redistribute funds to provide additional funding to the other (lower) levels of government. This paper is written from that perspective.

DEVELOPING AN INTERGOVERNMENTAL GRANTS SYSTEM

Design Options for a Grants Systems

8. Additional funding for lower levels of government can be distributed through one of three types of grants. The structure of a national grants system is determined by the mix of:

- (i) tied grants for recurrent purposes;
- (ii) tied grants for capital purposes; or
- (iii) untied grants.

9. **Tied or United Grants.** The initial question in deciding whether to use tied or untied grants is the extent to which the central government wants to have some say or control over the way local governments spend their grant funds. Untied grants are spent at the complete discretion of local government and can be used as they see fit for any purpose, either capital or recurrent. They are, in effect, no different to revenues local government raises from its own sources.

10. The use of tied grants is often about control, a power that can be used beneficially, but can also be misused. It is legitimate for a central government to use tied grants to achieve nationally agreed objectives such as a minimum level of schools education. A difficulty with tied grants, however, is that the distribution can often become too greatly influenced by politics and thoughts of the next election, and the distribution of services funded by the grants becomes only a secondary consideration.

11. The question of principle as to whether tied grants are used becomes one of the authority that is to be given to the lower levels of government. No matter whether the conditions are considered to be very specific or very general, tied grants reduce the decision making authority of the lower levels of government and thus reduce their sovereignty. For

this, and budget flexibility reasons, tied grants are not usually favoured by local governments.

12. There is also the question of what conditions are to be put on the tied grants. The issue here is how specific to be in what the funding is for. Is a road grant, for example:

- to be used to force the local governments to maintain specific roads between specific towns and cities to specific standards and to make sure that the bridges on those roads are all replaced with concrete structures 14 metres wide and capable of taking trucks of 70 tonnes; or
- simply given to the local governments in the relevant areas for road and bridge maintenance as they see fit, on an assumption that local issues and needs are better understood by local governments.

There is a tendency for the former situation to develop — often because of mistrust in local government or for a perceived political benefit — but it tends to duplicate administration and create inefficiencies. The latter type of condition is much easier for the local governments to accept and maintains more of their sovereignty.

13. One condition frequently considered for tied grants needs special mention. It is the concept of ‘matching’. It is always tempting for central governments to establish conditions for tied grants under which local governments have to match the central government input in some way. This is generally an inefficient procedure as, on a one-for-one matching for example, a dollar spent is only costing the local government 50 cents. In capital grant programs, a matching requirement can result in expensive designs or inefficient building practises. In recurrent grant programs, matching might result in nothing at all if local governments can simply allocate part (or all) of their pre-existing expenditure on the function to satisfy the matching requirement.

14. **Grants for Capital or Recurrent Purposes.** Whether grants are for capital or recurrent purposes is, of course, the other question that has to be asked when deciding the structure of the grants system. The first issue here is whether it is the level of infrastructure or recurrent expenditure that should be enhanced. This can be a straightforward question, but can be very complicated, and the answer may depend in part on whether the grants are tied or untied. Central and local governments may also have different perspectives on this.

15. Whether the grant should be for capital purposes is a fairly straightforward question in areas such as roads where the service method is fairly standard — we will not improve roads greatly unless we build or rebuild them. It can be a more difficult question in services such as education and community health care where services can be provided in a number of ways that require different capital:recurrent resource mixes. Local governments will often talk about the confidence they have in the longevity of the grant program and the influence of this on their spending decisions. They will usually prefer a capital grant. If a tied recurrent grant program is abolished, local government can be left trying to maintain the higher level of service to which its people have become accustomed, without having the financial capacity to do so. If on the other hand, they have built capital facilities with a tied grant, they can simply continue to use those facilities, but to the level to which they can afford the recurrent expenditure.

16. Increasingly, one of the objectives of governments in both unitary and decentralised countries is to achieve a more even distribution of service provision across the population, in accordance with need. In many nations, the existence of a grants system assists in the capacity to achieve this. It provides an agency that has a specific reason to look at what is being achieved in different regions, and an easier method by which additional effort to achieve greater equality can be targeted.

17. Whether the objective of a more even distribution of service provision is better achieved through tied or untied grants depends on the degree of freedom that local governments are to have. Tied grants are usually about dictating outcomes; untied grants are more frequently about redistributing capacity to allow more even outcomes to be produced, if that is the decision of local governments.

18. Clearly, if sufficiently specific conditions are applied, tied grants can be used to achieve equality of service provision across whatever range of services is required, but the more services treated this way, the greater the administrative effort. But to achieve ultimate equality of services, the basis on which the tied funds are distributed must also take differences in the revenue raising capacity of the local governments into account. If only differences in demand and cost are used to decide the distribution of tied grants, the ongoing differences in revenue capacity will mean the levels of service will always be different.

19. Differences in revenue capacities are also much more likely to move on an annual basis than expenditure need differences because they move with economic cycles and regional differences in industrial structures etc. Depending on the nation concerned, it may be that revenue raising differences are, in fact, the only determinant of fiscal capacity differences that is worth assessing. On the other hand, it is hard to imagine how allowing only for demand and cost differences in service provision could ever result in a distribution of grants that could produce equality of service provision across regions.

20. **Untied Grants.** Because they can more logically take account of differences in revenue raising capacity, and thus take into account a wider concept of differences in fiscal need, untied funds are usually a significant feature of a nation's grant system. Very frequently, it is the distribution of the untied funds, based solely on differences in revenue raising capacities, through which the central government tries to achieve its objective in terms of equality of opportunity to access government services. The use of untied grants reduces the central government's ability to dictate the social outcomes achieved, but it is administratively more simple and increases the ability of local government to better meet local needs. Increasingly, both developed and developing countries are moving this way and it is on this assumption (and the fact that Indonesia has already passed decentralisation legislation) that the balance of this paper has been written.

21. The Commonwealth of Australia, which has been examining these issues for nearly seventy years, has developed an all-encompassing objective of fiscal equalisation which is stated to be that:

State Governments should receive funding from the Commonwealth such that, if each made the same effort to raise revenue from its own sources and

operated at the same level of efficiency, each would have the same capacity to provide services at the same standard.¹

22. Canada, that has also been operating a system of equalisation grants for several decades, has a more limited objective inherent in its statement of principle, and countries that have entered the field much more recently, such as China and South Africa, have started off with very much more limited expectations.

Equalisation in Perspective

23. **Competing Objectives.** Having decided that equalisation is a social objective to be achieved through its grant system, a nation needs to place that objective into perspective. Clearly, it is not the only social objective of government, and social objectives are only one of a number of legitimate groups of objectives of governments. Governments must set the scope of the equalisation objective. It could be decided, for example, that while equalisation is the primary objective in education and health services, the development and maintenance of the roads system should be more attuned to economic need and greater funding should be allocated to those roads that service industry. In such circumstances, the roads objective might be better met by using tied funding, while the distribution of education and health services might be subject to wider equalisation and untied funding arrangements.

24. Wherever one level of government raises the revenue and another spends it to provide the services, it will be claimed by some that the system has built-in inefficiencies because of this split in responsibilities — accountability for expenditure is reduced because the spending government is not the revenue collecting government. The end question is whether or not any inefficiency it produces is greater than the problems that would exist if we continued with a unitary nation, or we had a multi-level system without a grant system..

25. In any case, recipient governments always have an incentive to use their funds as efficiently as possible. As long as the matching conditions discussed earlier are not included in tied grant arrangements, I do not think there is a lot to the accountability and inefficiency argument.

26. **Equalising Outcomes or Capacity.** Whether equalisation is aimed directly at the outcomes to be achieved in each region or at the ability of regions to provide equal services, is a question of where decisions on public sector service provision are best made. In a country that is small and has great similarity of economic and social circumstances within its borders, these decisions can more likely be taken by the central government, but such a country is likely to be a unitary nation anyway. I would argue that, in any nation that has felt it necessary to have separate regional government offices (either for administrative, social or cultural reasons), flexibility of service provision methods and levels is justified. While equalisation is an objective, this flexibility is best achieved by providing greater authority to local governments and the use of untied rather than tied grants.

¹ *Report on General Revenue Grant Relativities, 1999, Volume 1, Main Report, Commonwealth Grants Commission, Canberra, Australia, 1999, P 4.*

27. Where social objective of equalisation in specific functions sit in terms of overall government objectives (for example, the relative priorities of defence and education) will be an important input into the amount of funds made available to achieve or improve equality of services. However, this amount will also be influenced by the size of the vertical fiscal imbalance and the way the total pool is distributed between tied and untied grants. If the redistribution of funds (the vertical fiscal imbalance) is insufficient to overcome the measured horizontal imbalance between units of local government, no grants system can achieve the equal provision of services to all residents that need those services.

28. ***The Equalisation Standard.*** Whatever the size of the equalisation pool, one question that must be faced is the standard to which services are to be equalised. It is possible to establish systems aimed at equalising to either a national average standard or a nominal standard. The Australian statement of principle provided earlier is clearly based on the national average of what is being achieved by State governments. Even where the pool of funds is small relative to the horizontal inequalities, the grant system could be based on the attainment of minimum standards and those regions that are achieving higher than the minimum standards could be expected to reduce their level of service. Unless this expectation was placed on the high level regions, the system could not be truly said to be based on equalisation. However, this use of the actual average of what is happening at the recipient government level is not the only possibility. In reality, a lesser equalisation objective is likely to be set where the pool is too small to achieve full equalisation and the higher regions are allowed to remain where they are until the others catch up. In effect, what happens in the Canadian system where the very wealthy Provinces keep the benefits of some of their extra revenue raising capacity.

29. In Australia, there is an ongoing but quiet debate about whether the standards to which funding provision is equalised should be adjusted from the actual experience of the States to take account of:

- best practice levels of efficiency rather than the average of the actual levels of efficiency; and
- internationally agreed minimum standards for services rather than the actual levels of service provision (where international minimum standards are higher than actual).

30. If the nominal standards are higher than the highest level of service currently being attained by any State, this change could be made in Australia without changing the claim that the system is based on equalisation principles. It would, however, require a great deal more work to achieve the equalisation needs calculations and has not, to date, been considered necessary.

Getting Equalisation Assessments Done

31. ***Establishing a Grants Body.*** Once it has been decided that equalisation based untied grants are to be an element of a nation's grant system, it is necessary to decide who is to make the decisions on the size and distribution of the funds, and how they are to go about the task. The first question faced here seems to be the relationship of the grants body to

either or both levels of government involved. Based on international experience, the most frequently used options are to have either:

- (i) a separate authority established by the central government and reporting to both it, and through it to the local governments; or
- (ii) to have the task done by a section of the Ministry of Finance.

32. Whether the work of the body is to cover both the size of the transfer and its distribution is one element of this consideration. It may be more difficult for the body to maintain its independence of the central government on the issue of distribution if it is also the body that recommends the size of the pool, an issue that is much more closely related to central government fiscal policy. I have assumed for the purposes of discussion that the grants body is not responsible for recommending the size of the transfer, only its distribution.

33. Both the separate authority model and the Ministry of Finance model can and do work well — which one is chosen should be determined, as much as anything, by the circumstances of the nation involved. In their circumstances, both have advantages. The separate authority can have the advantage of independence from the economic policy areas of the central government, and is also somewhat removed from the perception of political influence. The Ministry of Finance option can have greater power to obtain information from local governments and is closer to the central government when issues of membership of the group, for example, are being considered.

34. Australia, South Africa and India all use a separate authority. Canada, China and Denmark use the Ministry of Finance model. The law in Indonesia has established something of a hybrid where there is something like a separate authority but its membership is largely from within government, thus greatly reducing its independence. But this is no reason why the Indonesian model cannot work. Whatever approach is used, the most important ingredient is confidence — that is, confidence of the central government that the agreed principles and objectives have been applied, and confidence of local governments that the resulting distribution is fair and that decisions have been made without ‘fear or favour’. For the purposes of discussion, I have assumed a separate grants body.

35. ***The Size of the Grants Body.*** Much of the effort towards building confidence relates to the outputs of the grants body and will be covered shortly. What needs to be discussed here is membership of the body and how that can influence confidence. On membership generally, the basic questions seem to be how many should be in the group and to what extent they should represent outside agencies or jurisdictions.

36. The more established Commissions like Australia and India have opted for a small group of members that bring specific expertise and experience to the task. Most frequently, these are academics, retired senior bureaucrats or business people. South Africa, on the other hand, has a much larger Commission, many of whom represent a specific Province. The Indonesian law is somewhat closer to the South African experience.

37. In Australia, it is believed the smaller Commission works best because it is easier to achieve unanimity of views during the process of an inquiry and create transparency (and

therefore less likelihood of non-acceptance of the results) and it is easier to involve all members in all elements of inquiries. The Australian States actually have input into who is appointed to the Commission, thus further increasing the likelihood of them having confidence in the Commission's results.

38. In India, the Commission is not a permanent body and is re-established every five years or so. In Australia, the Commonwealth Grants Commission has existed since 1933 and benefits greatly from the long continuity of its experience. I can see no benefits in having a non-permanent body, if there is sufficient work to justify it. In Australia, the Commission carries out a major review of how funds should be distributed between States every five years (the last was reported on in 1999), and does annual updates of the calculations between reviews. It has also been used to advise the Commonwealth Government on:

- (i) the funding arrangements and levels appropriate to the larger Territories as they were given self government, and accepted the same powers and responsibilities as the States;
- (ii) the appropriate levels of funding for and the administrative systems of the very small Island Territories that are part of the country — Christmas Island, the Cocos (Keeling) Islands and Norfolk Island;
- (iii) the appropriate distribution between the States of the Commonwealth funding to be distributed by the States to municipal government on the basis of fiscal equalisation; and
- (iv) the appropriateness of the distribution of Commonwealth funds spent on programs aimed at improving the provision of services for indigenous Australians (a current inquiry).

39. **Objectives of Commission.** Whatever decision is taken on the establish of the grants body and how it is made up, an essential element is that it receive clear guidance from governments, particularly the central government, on the objectives of the grants system and the principles that should be the basis of distribution of the funds. The objectives and principles must be known, and if possible acceptable to, all recipient governments. Prior agreement on the objectives and principles has the capacity to greatly reduce the anguish of individual regions after the results are known. Once the central government has provided this information, its interest in the work of the grants body can be greatly reduced. Government can be left to consider the size of the grants to be distributed, and the distribution can be left to the independent authority established to recommend on that issue.

40. As well as having prior knowledge of the objectives and principle governments have set down for the grants distribution, it is important that the grants body decides and publishes very early, some of the operational principles it will apply in its work. Based on the experience of the Commonwealth Grants Commission in Australia, three are of particular importance. They are:

- (i) the concept of policy neutrality or grant design efficiency;

- (ii) the involvement of recipient governments in the inquiries; and
- (iii) openness and transparency in all aspects of the work.

41. The second and third of these will be discussed shortly as they relate to increasing the confidence recipient governments are likely to have in the outcomes of the grant body's work. The first is a principle that can influence the outcomes themselves. It is that policy decisions and actions of an individual recipient government should not influence the grant of that government. The grant distribution model must, as far as possible, be neutral to the actions of individual recipients. Where it is not, a grant design inefficiency is seen to exist because local governments can change their budgetary decisions to manipulate the grant distribution outcome. This must not be allowed to happen.

DATA AND OTHER REQUIREMENTS

The Data Issues

42. An essential element of any equalisation grants system is that there is an assessment of the relative fiscal needs of the units of government at the recipient level. This might be limited to an examination of the relative revenue raising capacities of the local government units, as happens with Provincial funding in Canada, or include some or all of the expenditure responsibilities that have been given to local government. The Australian State funding system, on the other hand, probably examines the most complete range of activities undertaken by recipient governments, but a considerable degree of equalisation can be achieved without such a complete coverage. Where a country's regions do not experience great difference in per capita costs of providing services, for example, there may be no need at all for expenditure assessments.

43. Whatever the scope of the equalisation budget that is decided on (that is the range of revenue sources and expenditure functions to be examined), data availability will be a major issue. Data for an equalisation grants system is of two types:

- (i) the data necessary to examine the accounts of the recipient governments on a comparable basis; and
- (ii) the data necessary to assess the relative fiscal needs of the recipient governments, that is:
 - data to assess the relative revenue raising capacity of each unit of government;
 - data to assess the relative level of demand for services in each jurisdiction; and
 - data to assess differences jurisdictions face in the unit cost of providing services.

44. **The Financial Data.** The data needed for the examination of the accounts of local government on as comparable as possible a basis can, of course, only come from those units of government. The need for the data is naturally linked to the standard chosen in setting the objectives of equalisation — an equalisation to the average experience, for example, necessitates the availability of this data. Its availability is also essential in any ‘audit’ or reality check of the outcomes, no matter what standard is being equalised to. It can be easily used to see how the final grant distribution is related to areas with either low revenue capacity, high service demand or high cost structures. The financial data should be as comparable as possible between units of government, although this is more important on an annual basis than it is over time.

45. If the nation uses the Government Finance Statistics (GFS) model of the United Nations, comparability should not be a major problem. But it usually is. The structure of local governments’ charts of account differ as they see fit and the accounting standards and methods used by local governments, even in the same nation, often also differ. It might be expected that a central or national statistical collection body, such as Indonesia’s Central Bureau of Statistics, would ensure that they standardise for structural and accounting policy differences so that national accounts can be more readily assembled, but this is not always the case. In practice, it is easy for differences in structure to be overlooked, particularly where the GFS structure appears to have been used. What are even more hidden, and more difficult to overcome, are the differences in accounting methods that have been used to compile the original accounts.

46. I know that the Indonesian Ministries of Finance and Home Affairs have been wrestling with these problems for some years and have, in recent times, been looking at them with renewed vigour so that the new Regional Governance Law and Fiscal Balance Law can be fully implemented. This is a positive step.

47. **The Assessment Data.** The attributes necessary for the data needed to assess the relative fiscal needs of recipient governments are that it be comparable, reliable and acceptable. The issue of comparability often precludes the use of data collected by recipient governments for management purposes as this is rarely comparable between governments. The unacceptability of this data is sometimes difficult for local government to accept as it performs their individual tasks well and they tend to use it for comparisons they wish to place before the grants body.

48. The test of reliability is one that must be applied to make sure the data specification and collection processes were sufficiently well based to produce data that is not flawed so as to benefit one type of local government unit over another. For example, surveys are frequently structures so that the data are less reliable in small or remote areas and, if used for grant distribution purposes, the resulting data can skew the results away from the equalisation objective.

49. Ultimately, however, the acceptability test is the most important. Is the data acceptable to both the grants body and the recipient jurisdictions? If it passes this test, even if there are known deficiencies in its comparability and reliability, it can probably be used in the assessments of relative fiscal need.

50. For revenue capacity assessments, the type of data needed relates to the revenue bases available to the local governments being assessed. These might be the legislated revenue base, a proxy for that base or a general indicator of economic or other activity in the jurisdiction that adequately measures relative access to the revenue base. As an example of the legislated revenue base being used, it may be that data exists on the value of the land on which land taxes are levied in each jurisdiction. If the legislation behind the land tax is sufficiently uniform and the methods and recency of the valuations are sufficiently comparable, it would be acceptable to simply use the values that are being used by the local governments.

51. Where activities such as mining and forestry are a government revenue source, there are more likely to be differences between regions in their approach to revenue raising because these activities are more frequently subject to special concessions to encourage employment and investment in particular areas. Here, the legislative revenue base is very difficult to arrive at and is, in any case, subject to policy decisions that could well introduce grant design inefficiencies into the assessment of need. In these circumstances, it might be better to get data on the value of production and use this as a proxy for the revenue base. This could be justified on the assumption that it is value of output that is being taxed and that the data are more comparable if we move away from what is actually happening, but stay with data from the industries concerned.

52. In other areas, it may be that the best or most relevant data that are available relate not to the industry or activity being taxed, but to general indicators of the relative size of the local economies — gross domestic product, average levels of wages or retail turnover. These may not be closely related to the legislative source of the tax but might be the most applicable, comparable and acceptable data available.

53. The data used to measure local governments' expenditure requirements is of a quite different nature and is usually more difficult to obtain. Its availability often depends on the type of service being considered and the ability to use such sources as national census data. Its comparability, when available, is often better than for revenue data because it is more frequently collected by a central agency, thus avoiding many of the definitional inconsistencies that are found elsewhere, but its reliability is often suspect because it is survey based. In general, the sources of data for expenditure needs assessment are much more difficult to find because they are diverse, and are not collected as often so that timeliness also becomes a problem in terms of acceptability.

54. When looking at the demand for services, data often relate to the population. For many general indicators, total population can be used, but then quite small age and sex groups and regional distribution data might be required so that patterns of service need within each region can be measured. Hospitals, for example, can be used by everyone in the population, but the actual use is very highly influenced, among other things, by the age and sex structure of the population, so these differences have to be taken into account. Similarly, a region with a higher percentage of its population in the five to twelve years age group will, other things being equal, have a higher per capita demand for schools education services.

55. Often, data on the variables relevant to the provision of the service is known for management purposes, and even collected by a central statistical authority, but there has

been no need to look more closely at the composition of the client base or at what influences different groups within it to use services more or differently to others. The difficulty here is that every service provider can tell you 'with certainty' that this group or that group uses their service more, but they have no data to tell you how much more, and this is what is required.

56. Looking for data relating to differences in the unit cost of providing services is even more problematic. How do economies of scale differ in the public sector? What influence does distance from the capital city or the regional centre have on cost structures? Does the large size of some cities create its own cost problems? These are not usually the subject of data needed for management because they are much more specifically about inter-regional comparisons and there is usually no need for the management of any specific region to make such comparisons. However, in Australia at least, these unit cost differences have been found to be very important influences on the relative fiscal needs of the States.

57. It is also beneficial to the grants body if it has a collection of regions' service delivery policy documents. It is beneficial to know what the policy differences are and how they might be influencing actual revenue collections, service demand and unit cost. This helps avoid any influence of policy differences on the final distribution (grant design inefficiencies), and gives a firmer base for the reality checks done on the final results before they are made public. It is also a valuable tool, when published, for regional governments when they are analysing the grants body's findings or deciding on adjustments to their service provision policies.

Gaining the Confidence of Governments

58. I believe this to be one of the most important aspects of any grants system. No grant distribution system will be in existence long unless both the government providing the funds and the governments receiving them have sufficient confidence in the procedures and the outcomes. There are several important ways in which this confidence can be established and maintained.

59. All governments that are part of the system must have some ownership of it. Preferably, they should all be involved in:

- (i) agreeing on the principles and objectives of the system;
- (ii) agreeing on how those principles and objectives will be implemented;
- (iii) agreeing on how many people should be on the grants body, and where that body should fit into the administrative structure;
- (iv) agreeing who should be appointed to the grants body; and
- (v) agreeing with the grants body on the process to be used to determine the relative fiscal needs of each region.

60. Once the work of determining the regions' relative needs has started, the regions should be able to:

- (i) have some say in what the grants body should examine as functions of special concern within the assessment process (this could be either a particular revenue or expenditure function of local government, or something more general like the impact of sub-standard data over a range of assessments);
- (ii) provide written submissions to the grants body;
- (iii) talk with the grants body about those submissions and any other matters relevant to the inquiry;
- (iv) have the grants body visit their area so that they can be shown the situation; and
- (v) if time permits, discuss the grants body's preliminary assessments with it.

61. For its part, the grants body can assist in governments gaining its confidence by:

- (i) making sure its activities are public and that it is known that the public can attend as observers if they wish;
- (ii) distributing information to all local governments so that they are aware of the arguments being made by others, and thus have a better understanding of the task being faced;
- (iii) providing all local governments with complete information on the basis of the assessments, so that it can be seen that there is no hidden agenda in the grants distribution; and
- (iv) immediately after the results are known, making data bases available to local government so that they can do their own research and better understand both the grants system and the drivers of their own budgets.

A GRANTS SYSTEM FOR INDONESIA

62. With the passing of the Regional Governance Law and the Fiscal Balance Laws in Indonesia in mid 1999, many decisions relating to its future grant system were taken or initiated. This part of the paper looks at the actions necessary to establish and fund the proposed decentralisation system in Indonesia. It also comments on how the decisions specified in the new Laws (and the clarifications and draft regulations that were available in May 1999) comply with the overall requirements for establishing a system.

63. The discussion is based on the sequence of events used earlier in the paper and discusses the sequencing problems created by the new Laws. In doing this, I have classified the sequence of decisions relating to decentralisation into five groups. Those relating to:

- (i) establishing decentralised governments;
- (ii) deciding on the objectives and principles of a grants system;
- (iii) establishing a grants mix;
- (iv) establishing a grants body; and
- (v) determining the methods of the grants body.

Across each of these activities, it is most desirable, if not essential, to involve local government.

Establishing Decentralised Governments

64. In order, the major decisions that had to be made to establish decentralised government in Indonesia, from a public finance system perspective, were deciding:

- (i) what expenditure functions were to be given to local government; and
- (ii) how local government was to be funded.

65. I believe the order to these decisions is critical to the future process. The provision of services to the public should be seen as the prime function of government and thus drive the decisions on how to best allocate responsibilities across levels of government. The allocation of revenue sources to local government should be a result of many things, including the expectations of any grants system and the expenditure allocation decisions. What has happened under the new Laws in Indonesia is that the expenditure responsibilities of local government have been specified in very vague terms only, while the revenue capacities and grant funding arrangements have been laid out in great detail.

66. ***Allocating Expenditure Responsibilities.*** Chapter IV of the Regional Governance Law provides what we know of the powers allocated to each level of Government. It says that:

- (i) the central government shall have authority in the fields of international relations, defence and security, judicature, monetary and fiscal, and religion [Article 7(1)];
- (ii) the central government shall have authority in the fields of national planning, macro national development control, financial balance fund, state administration, state economic institutional systems, human resources development, natural resource utilization, strategic high technology, conservation and national standardization [Article 7 (2)];
- (iii) the authority of Provinces shall include the field of inter-regional and municipality governance [Article 9 (1)];
- (iv) regions have the authority to manage national resources, either natural, artificial or human [Article 10 (1) and the clarification document];

- (v) regions and municipalities have responsibilities in marine areas, to the extent of one-third of the marine area of the Province [Article 10 (2) and (3)] (there are additional indications that this is to be interpreted as within a 12 kilometre limit); and
- (vi) functions that must be performed by regions and municipalities shall include health, education and culture, agriculture, communication, industry and trade, capital investment, environment, land, co-operative and manpower affairs [Article 11 (2)].

67. These parts of the Law were not expanded on in the clarification documents available in May 1999 and leave too much under dispute. Are regions and municipalities, for example, to have full responsibility for all health and education services, including university research schools and super-specialty health services such as heart-lung transplants in major hospitals, or did the legislators have something more limited in mind? These parts of the Law give the Provincial level of government very few service delivery responsibilities: is that what was intended?

68. On the revenue side, however, the Fiscal Balance Law, clarification documents and draft regulations available in May 1999 were very specific as to how revenue should be distributed between the levels of government. The sources of local government revenue were specified as being:

- (i) their share of revenue from:
 - land and property taxes;
 - taxes on the acquisition of land and building rights;
 - oil and gas; and
 - forestry, public mining and fishing.
- (ii) the General Allocation Fund (this was specified to be 25 per cent of total central government revenue and was to be distributed as untied funds according to equalisation requirements, with 10 per cent of the fund going to provincial governments); and
- (iii) the Special Allocation Fund (tied grants).

69. As an example of the detail in which the system of revenue sharing was laid out, the draft regulations in relation to land and property taxes states that the distribution was to be:

3 per cent	to the central government for administration
7 per cent	divided equally over all Indonesia
x per cent	Based on the percentage of revenue originating from rural plantations, the nonblock cutting forestry sector, general mining, and land, oil and gas regions

	.2x	to producing provinces
	.8x	to producing regions
y per cent		Based on the percentage of revenue originating from the block cutting forestry sector and offshore oil and gas
	.5y	equally divided to all provinces and regions in Indonesia
	.02y	to provinces based on population
	.02y	to provinces based on area
	.02y	to provinces based on original income in previous year
	.02y	to provinces based on GDP excluding oil and gas
	.02y	to provinces based on GDP from oil and gas
	.08y	to regions based on population
	.08y	to regions based on area
	.08y	to regions based on original income in previous year
	.08y	to regions based on GDP excluding oil and gas
	.08y	to regions based on GDP from oil and gas

70. The distributions methods inherent in these detailed allocations appear to have given insufficient thought to the functional responsibilities allocation in the Regional Governance Law and will almost certainly result, when combined with aspects of the grants system, in the provinces having large surpluses unless these arrangements are changed. There are also a number of administrative difficulties that are likely to arise. Are data available, for example, to allocate GDP, excluding that resulting from oil and gas, across every region in Indonesia? In Australia, it is only after many years effort that we have been able to achieve a much less ambitious regional split of GDP, and the data are still treated by many with some suspicion.

Objectives and Principles of a Grants System

71. In this field, the primary questions facing Indonesia in establishing its decentralised government and public finance system were:

- (i) the way local government would be funded through own-source revenue, shared revenues and grants;
- (ii) the extent to which equalisation of local government services would be a national objective; and
- (iii) the extent to which central government transfers need to be untied to meet the equalisation objective.

72. ***The Funding Mix for Local Government.*** As with the relationship between expenditure responsibilities and revenue capacities, the first of these questions seems to have been largely answered without sufficient thought having been given it. The size of the revenue available to some local governments will almost certainly be determined by the revenue

sharing arrangements written into the Fiscal Balance Law. But there are also other problems. The lack of local government control over land taxes — a revenue base closest to the usual responsibilities of local government — has severely limited the capacity of those levels of government to be responsive to local needs. As described above, the revenue sharing arrangements that have been established are often cumbersome, impractical and cannot be justified in terms of the amount of funding involved from the sources of revenue. The complication is particularly unnecessary because many of the distributions of shared revenues seem aimed at equalisation which will, in any case, be achieved through a much larger pool of funds in the General Allocation Grant.

73. ***Setting the National Objectives.*** In the development of both the Regional Governance and the Fiscal Balance Laws, there seems to have been considerable thought given to the objectives of the new system. In the introduction and clarification to the Regional Governance Law, there are several mentions of an equitable or even distribution [of services]. This is made very clear in the Fiscal Balance Law where it is stated that the General Allocation Fund is to be distributed ‘with the objective of evenness in the inter-region financial ability to finance the need of their expenditures’ [Article 1 (18)]. This is expanded on in the clarification document where it says that the general allocation funds will be allocated with the objective of equality by considering the regions’ revenue raising potentials, areas, geographic conditions, populations and levels of income.

74. These commendable objectives, however, do not appear to have been considered in any quantified manner when deciding on the structure of the grant and shared revenue system. The establishment of the shared revenue arrangements, such as that for land and property taxes described above, places substantial revenues into the resource rich provinces and regions and has, in all probability, increased the inequality in regional fiscal capacities. Whether the minimum 25 per cent of total State revenue to be transferred as untied funding is sufficient to overcome the pre-existing inequalities is doubtful, and that doubt has been increased because of the revenue sharing arrangements.

75. If the untied funding has to be increased beyond 25 per cent of total State revenue to achieve equalisation, the increase can be either at the expense of tied grants (the Special Allocation Funding) or the central government’s budget result. The reduction in Special Allocation funds will be against the wishes of local government, but the negative impact on the central government’s budget if they do not will be detrimental to the nation.

76. If we can assume anything from all this, however, it is that the majority of the central government transfer to local government is likely to be made through the General Allocation untied funding. By establishing this, Indonesia has at least increased the chance of the system succeeding by placing the emphasis on grant funding that can be used more easily to achieve its equalisation objectives.

Establishing a Grants Mix

77. The two questions for consideration in this area are:

- (i) the extent to which grant funding for local government would be distributed between tied and unties funding; and

(ii) the split of the tied funding between capital and recurrent purposes.

78. The split between tied and untied funding does not appear to have been confronted at all. In the Fiscal Balance Law [Article 7 (1)], the size of the untied (General Allocation) funding has been specified at a minimum of 25 per cent of total central government revenue collections, but the Law is silent on the size of the untied funding transfer (the Special Allocation Funding). Maybe this is just as well, otherwise central government budget management might be more difficult.

79. Similarly, there appears to have been no consideration given to the split of tied funds between capital and recurrent purposes.

Establishing a Grants Body

80. Indonesia has been quite specific in its new Laws about what sort of body it wants to control the equalisation system and recommend the distribution of the General Allocation Funds. Under Article 115 (2) of the Regional Governance Law, it has established the Regional Autonomy Advisory Board (the DPOD) which shall consist of:

- the Minister for Home Affairs (Chairperson);
- the Minister for Finance (Vice Chairperson);
- other Ministers as required;
- two provincial government (the higher level of region) representatives;
- two regency government (the lower level of region) representatives;
and
- two municipal government representatives.

81. It has also established a secretariat to provide administrative support for the DPOD. This is under the leadership of the head of the Regional Autonomy Section in the Ministry of Home Affairs and the head of the Central and Regional Financial Balance Section in the Ministry of Finance.

82. This is a most unusual structure. It could be seen, however, as the secretariat doing the work within a Ministry (or two), as in Canada, China and many other countries, and then reporting to an independent authority. The problem is that the DPOD can hardly be seen as independent because it has at least two central government Ministers as Members. It could also be seen as the DPOD being a Committee of the central government, but then the influence of the local government representatives would be assumed to be minimal.

83. The other difficulty with the DPOD is that at least six members — possibly the majority — represent interests in the outcome. This is likely to make it very difficult for them to reach unanimous decisions and is thus likely to decrease the transparency and openness with which they operate. In turn, these inadequacies are likely to increase the level of discontent, or at least doubt, when the outcomes become known.

Determining the Methods of the Grants Body

84. In this area of development, the questions confronting Indonesia related to:
- (i) setting the principles, objectives and methods for the DPOD;
 - (ii) how best to collect relevant data; and
 - (iii) giving local government appropriate access to the DPOD and its secretariat during the process.

85. ***Setting the Principles and Methods.*** In the first of these areas, the framework established by the Laws, the clarifications and regulations has, I think, been a little too detailed. The setting of principles and objectives has been good but the detail of the methods of assessment laid out in the draft regulations relating to the Fiscal Balance Law are too prescriptive. I think they give the DPOD and its secretariat too little room to move as a result of either their own research or the input that might reasonably be expected from local government.

86. ***Collecting the Data.*** The new Laws have, however, given a solid base from which to collect comparable financial data from local government. Article 86 of the Regional Governance Law specifies the timing local government must adhere to in the preparation and publication of their budgets and accounting statements. Article 27 of the Fiscal Balance Law commits the central government to the establishment of a Regional Financial Information System where the accounts of the regions will be made publicly available, and Article 28 obliges local governments to submit information relating to their finances to the central government. These are positive steps.

87. At this stage, I am unable to comment on the degree to which local government has had, or will have, access to the DPOD and its secretariat during the process, but see this as an essential element of a grants system. It is crucial to the establishment of trust and confidence in the process and the outcomes.

Conclusion

88. As are other nations, Indonesia is facing some difficult questions now that it has taken the decision to improve equity in the deliver of services to its citizens. The objective, however, is most commendable and has the capacity to reduce at least some tensions within society. The Regional Governance and Fiscal Balance Laws of 1999 are positive steps towards decentralisation within the nation, but there have already been some mistakes made in the sequencing necessary to establish an overall system of decentralised government. By raising the issues and making suggestions, this paper tries to assist in moving forward from what the new Laws have achieved and gives a framework for future decisions.