1. Introduction

James Alm, Jorge Martinez-Vazquez and Dana Weist

Indonesia is currently facing some severe challenges, both in political affairs and in economic management. One significant part of this challenge is the decentralization program, whose laws were first passed in May 1999 and subsequently put in operation in January 2001. For political reasons, this program was enacted and implemented in an extraordinarily short period of time, and has often been referred to as the 'Big Bang' decentralization. With the resignation of President Suharto in 1998, many provinces and regions in Indonesia demanded more decentralized governance. In its own transition from a corrupt and highly centralized dictatorship to a democratic market economy, the process of decentralization in Indonesia was perceived by many as a new bridge to democracy and to a more efficient and fairer government. The process of decentralization is now well underway, and it promises to have many wide-ranging effects. However, there remain numerous questions about this program. This edited volume is a collection of original papers, written by a group of scholars with direct experience in Indonesia and policy makers who have been personally involved in the decentralization process. The chapters in the volume take a hard look at the many effects of decentralization on economic and political issues in Indonesia.¹ They cover the wide impacts of decentralization: the political and economic forces that contributed to the passage of the decentralization laws, the assignment of expenditure and revenue functions across levels of government, the design of intergovernmental transfers, the control of local government borrowing, natural resource revenue sharing, and an assessment of the progress that has been made in the initial years of the decentralization.

Part I discusses the history and politics of the 'Big Bang' decentralization. In Chapter 2 Bert Hofman and Kai Kaiser trace the history behind the laws from a political economy perspective. They characterize the decentralization as 'radical' in its speed and breadth, with the government of Indonesia (GOI) facing huge challenges in implementing the 'Big Bang'. They also show that many of the initial policy recommendations for decentralization were not firmly grounded in fiscal analysis, in large part because much about

decentralization was unknown or uncertain and detailed information on expenditure needs and regional revenues was unavailable. However, they emphasize that the many fears expressed by insiders and outsiders have not in fact been realized: surprisingly little went wrong in the logistics of this program. Further, as decentralization has proceeded, the government has increasingly relied on detailed fiscal analysis as part of the design and implementation of the decentralization. Technical teams were established, with representation among government departments, leading academics and research institutions; substantial time was devoted to coordination across departments; and considerable effort was channeled toward strengthening analytical capabilities – including improving the quality of fiscal data and developing simulation models. This analytical base and monitoring of outcomes is to be commended, and should be continued, emulated in other ministries and departments, and strengthened in the future. However, Hofman and Kaiser also conclude that several key issues have now started to emerge, some of them touching the very nature of decentralization itself. In addressing these issues, the government needs to carefully balance its desire to maintain a unitary state with the aspirations of the regions and the opportunities offered by a more decentralized system of government, and it also needs to continue to utilize the analytical capabilities that have been established.

In Chapter 3 Dwight King reviews the basic decentralization laws, including the ones passed since May 1999, and then tests some hypotheses about the relationships among administrative decentralization (deconcentration), political reform, and decentralization using a district data set, in particular trying to answer why political reform, decentralization, and governance reforms have progressed further in some districts than in others. Strikingly, he concludes that the ongoing decentralization presents a paradox. There is undeniable evidence of heightened social conflict, increase in lawlessness, persistent economic stagnation, and continued political instability, which some take as evidence that Indonesian democracy is a mirage. However, there is also undeniable evidence that central government power has been peacefully and constitutionally transferred, that the military has refused to intervene despite provocations, and that the democratically elected parliament has made steady progress on major constitutional reforms ever since it was seated in 1999. King believes that these developments suggest that the conflict and instability that have marked Indonesia during the past three years are less manifestations of democratic backsliding than they are of a second struggle to consolidate and deepen democracy while simultaneously identifying and removing the non-democratic elements from the previous regime.

Ryaas Rasyid brings an insider's perspective to the decentralization in Chapter 4. As a former Minister of Regional Autonomy in the GOI, he was a main proponent – perhaps the main proponent – of the decentralization.

Rasyid traces the history behind the passage and implementation of the decentralization laws, and concludes that central government was woefully unprepared to enact the reforms. Indeed, he believes that many of the problems that have emerged surrounding the decentralization reflect a general and widespread lack of support for the decentralization itself from many at the center. Many ministers considered the policy to be a 'threat' to their own ministries, and attempted on many occasions to slow down, delay, or even reverse the reforms. Rasyid concludes that decentralization can only succeed if the central government strengthens its commitment to decentralization.

It is well recognized that intergovernmental fiscal relations are a system, and all of the pieces must fit together. We can generally think of intergovernmental fiscal systems as being composed of four pillars: expenditure assignment, local revenue mobilization, intergovernmental transfers, and local borrowing. The next two parts examine the details of these pillars.

In Part II, Chapter 5 by Paul Smoke traces the details of the expenditure assignment of the 'Big Bang.' Smoke identifies expenditure assignment – clearly stating the set of functions that local governments can and should undertake – as a key preliminary step in the decentralization process in Indonesia. In his chapter, Smoke reviews the basic principles of expenditure assignment; outlines the experience with expenditure assignments in Indonesia, both from a historical perspective and in light of the new arrangements; and highlights a number of outstanding expenditure assignment issues that Indonesia has yet to address.

The recent Indonesian experience clearly shows that expenditure assignment is not purely a technical matter. This step cannot be separated from the broader process of decentralization and many of these decisions are ultimately of a highly political nature. Because of political reasons, mainly the fear of centrifugal separatist forces at the provincial level in the periphery of the country, Indonesia's new decentralization assigned practically all decentralized services to the local governments, which at the time practically emasculated any incipient political power of provincial governments. But as Smoke points out, this is nothing new. Concerns for political unity have historically dominated the design of government institutions in Indonesia.

The sharpest distinguishing feature of the new expenditure assignments is that the law explicitly sets a limited number of functions for both the central and provincial governments and assigns all other residual functions to local governments. Currently there is a lack of clarity on the assigned functions and practically no guidance on how to share some of the functions among levels of government. Subsequent regulations have attempted to clarify assignment issues but there is still a need to provide definite authority lists for the local governments. More recently, the GOI has been working on the

introduction of minimum service standards (SPM) for all decentralized services as a way to more clearly specify and enforce local statutory functions. It is far from clear that the ultimate result of the SPMs will be those intended.

In Chapter 6 Robert Simanjuntak and Raksaka Mahi focus on the revenue side of the decentralization. They present evidence that the local tax base in Indonesia has been unproductive in its yield and unfair in its incidence, and the decentralization has had little impact on local taxes. Local governments remain highly dependent on central government for the vast bulk of their revenues. Consequently, Simanjuntak and Mahi conclude that reform efforts should concentrate on some combination of looking for alternative additional local taxes and improving administration of the existing taxes. However, recent reform efforts have not resulted in any real improvements. Simanjuntak and Mahi examine common criteria for 'good' taxes and then apply these principles to a long list of possible local government taxes in Indonesia. They recommend in particular the abolition of 'nuisance' local taxes, improving the existing local taxes (e.g. entertainment tax, street lighting tax), improving administrative capacity, and looking for new local taxes. In this regard, they believe that the land and building tax, the land and building transfer tax, the building permit fee, and the business registration tax are especially good candidates for assignment from central government to local governments. They also recommend the consideration of allowing local government 'sur-charges' on some existing central government taxes. These various reforms would increase revenue autonomy of local governments and thereby improve the decentralization process.

In Chapter 7 Machfud Sidik and Kadjatkiko bring both the revenue and the expenditure sides together in their analysis of the decentralization, in the process cutting across many substantive issues. They argue that, given the institutional complexities in Indonesia, any reform of fiscal decentralization policy will be a painstaking process, and its implementation will take some time. Nevertheless, they believe that an initial phasing-in of reforms program could begin right away. Indeed, they note that the Ministry of Finance has already mapped out a work plan that incorporates the necessary transitional arrangements, including building the alliances and coalitions that will prove so important in implementing this far-reaching agenda.

Part III moves on to measures that can close the 'fiscal gap' left between the tax and the expenditure assignments. Bambang Brodjonegoro and Jorge Martinez-Vazquez contribute to the ongoing debate on intergovernmental fiscal reforms in Indonesia in Chapter 8. They note the need to expand local revenue autonomy rather than substantially changing the existing tax sharing system; they also identify the achievements and additional reforms needed for the main formula-based equalization transfer, the *Dana Alokasi Umum* (DAU), the need for developing a carefully designed conditional transfer

system (the *Dana Alokasi Khusus*, or DAK), and the importance of an overall decentralization strategy. These recommendations are founded both on empirical analysis and on a systemic view of intergovernmental fiscal relations.

As Brodjonegoro and Martinez-Vazquez note, Indonesia has achieved significant progress in designing and implementing a new system of transfers, albeit with ample scope for further improvement. In relatively short order, a stable, formula-based, equalization transfer – the DAU – was designed, implemented, and subsequently improved. The DAU is one of the most important components of Indonesia's intergovernmental fiscal system. Its significant funding (25 percent of government revenues) and general purpose nature provide the fuel for regional autonomy. Equally important as the achievements in designing and implementing the DAU were the use of quantitative (fiscal) analysis to assess outcomes and recommend reforms for the policy process, and the emphasis on transparency and consultation. They note that continued effort must be directed to improving the quality of indicators of fiscal capacity and expenditure need. It would also be worthwhile to reconsider the adequacy of the weights applied in the formula, including the split between provinces and regions, as well as the weights of the component factors. For example, it appears that population is relatively underweighted in comparison to other factors.

A second hallmark of the design and implementation of the DAU was consultation with stakeholders and transparency, which complicated the process but also contributed to better understanding among stakeholders (including regional governments, the DPOD, and other departments and ministries.) Consultation and transparency should be developed further, including in the design and implementation of the conditional transfer system (or DAK). Simplicity is an element of transparency that is often overlooked. In developing the conditional transfer system, effort should be devoted to avoiding a proliferation of transfers.

Brodjonegoro and Martinez-Vazquez point to the need to consider a more formal institutionalization of the analysis and consultation in the form of a Grants Commission or other body, as used, for example, in Australia, India, and South Africa. In addition to formalizing the institutional responsibility for monitoring and improving the allocation of the DAU, it is also necessary to formalize some of the rules of engagement, perhaps through the decentralization strategy that they note is sorely lacking. For example, the following concerns need explicit decisions:

- Under what procedures and criteria should the government change the key DAU parameters in the future (e.g. the 25 percent share of revenues, the split between provinces and regions, the factors included in the formula, and their weights)?

- What are the government's equalization objectives, and how will it know that it has achieved these objectives?
- Will resource-rich regions always receive a DAU allocation?
- How long will the transition period last? Especially, how long will the 'hold-harmless' and contingency fund provisions remain in force?

A Grants Commission would assure that the demanding activities of monitoring and enhancing the equalization system were done on a regular basis by an objective body.

One of the most politically charged and divisive issues in fiscal decentralization in Indonesia is how to share fiscal revenues from the extraction of natural resources between the regional governments where these resources originate and the rest of the nation. In Chapter 9 Roy Bahl and Bayar Tumennasan evaluate the system of sharing natural resource revenue in Indonesia against the criteria that are most often discussed in international forums. The share of 'mining and quarrying' in GDP is quite large in a number of countries, exceeding 10 percent in 29 of 100 countries for which they find data and accounting for more than one-fifth of GDP in 13 countries. The share in Indonesia is especially large, at 10.1 percent or about five times higher than the international median. Of the countries in the East Asian region, only Mongolia and Papua New Guinea are more heavily dependent on natural resources than is Indonesia.

Bahl and Tumennasan evaluate the arguments for and against sharing natural resource revenues with regions. On the one hand, these payments may be seen as compensation for the economic and social costs of natural resource extraction; a share of natural resource revenues may also be justified as payment for using up an exhaustible resource. On the other hand, some policy analysts and political leaders argue against natural resource revenue sharing, largely on the basis that it is the national government that is assumed to 'own' the natural riches. There is a concern about tying the finance of essential local government-provided services to an unstable revenue flow, and a fear that local governments could not efficiently spend such a large revenue windfall. These arguments are often based on political notions of fairness, and are almost always emotionally charged. These issues are even more complicated in Indonesia because the revenue sharing argument is confounded by the ethnic and cultural differences between the natural resource regions and the rest of Indonesia.

Although few policy analysts or politicians believe that there should be no natural resource revenue sharing, an important issue is the magnitude of the share. In addition, there is much debate on whether – and how – natural resource revenue sharing should affect the DAU transfer, and there are concerns that local governments with large mining sectors will make unwise use

of, and rely too heavily on, the windfall revenues that come from an unstable source of natural resource industries. There are few accepted answers to these questions. Bahl and Tumennasan evaluate these issues in the specific context of Indonesia, and then examine various reform options in terms of the specific fiscal instruments that might be used.

Given the significant deficiencies in local infrastructure in all regions of Indonesia, finding ways to finance new capital investment at the sub-national level has become a critical component of the new decentralization system. In Chapter 10 James Alm and Sri Mulyani Indrawati note that Laws No. 22 and No. 25 grant much flexibility to provinces and local governments in borrowing (although government has prohibited regional borrowing except from central government through end 2002). Regional governments are allowed to issue long-term debt to finance local infrastructure, and short-term debt to manage cash flow requirements, subject to certain controls. These controls are particularly important in Indonesia, since past regional borrowing was often managed improperly (with particularly weak repayment rates for the RDA), and substantial contingent liabilities may arise from regional borrowing. Controls on regional borrowing include a formula-defined borrowing limit for each jurisdiction; a minimum debt-service coverage ratio for each jurisdiction; and Ministry of Finance approval for foreign loans (but without a central government guarantee.) Alm and Indrawati conclude that these controls are acceptable in the transition period, but that in the long run effort should be directed to developing functioning local capital markets that impose their own discipline, as well as promoting other activities to develop a strong intergovernmental fiscal system (e.g. transparency, standardized fiscal information, accounting standards, and regular audits). This is a rich agenda of reforms that will require considerable effort to implement.

In this regard, it is worth mentioning that two technical issues deserve further discussion in developing Indonesia's borrowing framework: the use of 'intercept' mechanisms to strengthen repayment schemes, and assigning appropriate risk weights to subnational debt. While intercept mechanisms have been successfully used to enhance repayment rates in other countries, the danger is that they may be perceived as an 'automatic' payment mechanism that weakens incentives for thorough assessment of creditworthiness. Mexico's federal government recently discontinued its use of intercept provisions because the practice had transferred repayment risk entirely to the federal government, which was expected to bail out state governments who did not repay their debt.²

Establishing prudential regulations that limit (and/or apply a risk weighting to) the share of bank assets held in regional loans can also restrict the supply of regional debt to more creditworthy entities. Risk-weighted capital adequacy ratios defined by the Bank of International Settlements are being

used increasingly by countries such as Colombia, South Africa and Mexico to regulate the supply of local borrowing that is issued, and held by development banks or commercial banks.³

Three general issues merit further consideration in Indonesia's borrowing framework: (1) strengthening the framework to avoid central government bailouts of regional governments that borrow irresponsibly; (2) removing restrictions against on-lending of donor funds for development projects; and (3) establishing a financing framework that clearly defines the mix of loan and grant financing, and imposes greater uniformity in terms and conditions (e.g. interest rates, repayment terms, commitment fees, feasibility standards).

With regional autonomy, central government must be prepared for local governments to fail, without giving them a bailout; that is, government should impose a hard budget constraint on sub-national governments, so that these sub-national entities cannot expand expenditures without bearing their full costs. Avoiding a central government bailout typically requires defining legal remedies for creditors and the central government (possibly including local bankruptcy regulations); providing technical assistance to weak local governments to avoid fiscal failure; and establishing a control board or other oversight mechanism to work out loan repayments, service delivery arrangements and other issues arising from fiscal failure. Colombia, Hungary and South Africa have formal, legislatively determined workout procedures for sub-national entities that have either defaulted or are about to default on their debt service payments.

Legal restrictions against on-lending impede the flow of donor assistance to local governments, which accounts for 50 percent of development spending. While such restrictions have been overcome through legal technicalities, the regulations should be changed to permit on-lending and to strengthen the terms and conditions under which it is practiced so that economically and financially viable projects are financed, market-based interest rates are used, and loans are repaid promptly and consistently.⁴

With regional autonomy, investment projects will move to the regions, which have substantially different capacities to finance investments. Regional governments can use their own resources, borrowing (presumably through a revised on-lending mechanism) or special purpose transfers (DAK) to finance these projects. The government should establish a clearly defined financing framework that specifies the loan–grant mix of financing for these projects, based on the creditworthiness of the regional government and type of project. For example, regional governments with strong creditworthiness might only be eligible for loans for investment projects, whereas poorer local governments would be eligible for capital grants and loans. Without a consistently defined financing framework, capital grants might 'crowd out' potential local borrowing, or poorer regional governments may not provide

adequate infrastructure because of an inability to borrow. The financing framework could also provide consistency in financing terms among government and donor financing, including interest rates, repayment terms, commitment fees, conditionalities and covenants, and other financial details that would promote the development of a market-based financing system.

Part III of the volume offers an initial assessment of progress of the new decentralization process in Indonesia by three Indonesian policy makers and experts closely linked to many of the decisions made early on laying down the basic architecture of the system. In Chapter 11, Marsillam Simandjuntak assesses the existing risks in the decentralization process despite its unavoidability. For him, decentralization has become one of the few solutions to the Indonesian national problems, if not the only one, left. Simandjuntak examines in some depth the current Indonesian belief that decentralization presents a solution to various national problems because it allows the use of local means to cope with local challenges. There are many potential pitfalls behind that position, but as Simandjuntak puts it, recent history demonstrated well that national problems could never be solved by national efforts or by centralized policies. His conjecture for the future is that under decentralization and competition among sub-national governments, each national problem may be solved in terms of manageable regional portions. The important question remaining is, of course, what will make all that possible, since the current decentralization effort was started more as a declaration or an affirmation of intent, than as a planned set of steps. But, according to Simandjuntak, the lack of preparation was not due to a lack of understanding what is required, but simply because there was not enough time to do it. Thus we can remain optimistic about the future, provided policy makers continue to give priority to decentralization policy and that there is sufficient stability and effectiveness at central government level. Successful decentralization will require a strong and self-confident central government. Simandjuntak is not overly optimistic that the current government under President Megawati will meet the necessary requirements. Some of the challenges ahead, Simandjuntak identifies, include electoral reform, formation of the Constitutional Court, and the role of the police and the military in a decentralized Indonesia.

In Chapter 12 Made Suwandi takes a longer term perspective on the decentralization process, and asks whether Indonesia can learn from its already long experience with decentralization. In particular, he asks what should Indonesians do and how should they react as the demand for decentralization increases over time. He concludes that answering this question will require a 'delicate balance' between local autonomy and nation building.

More specifically, he believes that the government has already provided an adequate legal framework and has issued sufficient regulations. Of course, additional detailed regulations are likely still to be required as the decentralization

proceeds, but the existing regulations are more than enough to provide a legal basis for local governments to provide required services. Instead, he argues that if there are still problems and delays in delivering services, they are caused mainly by the inability of local governments to use the existing regulations to carry out their role. To deal with this issue, it is important to support all tiers of government in understanding their new roles in a reformed public sector. In particular, he believes that it is necessary – and urgent – to improve local governments' capacity to carry out their functions, in arranging and managing local government functions, institutions, personnel, finance, representation and service delivery. The improvement of these capacities should be the most important item in promoting decentralization reform in Indonesia at the present time.

For Anggito Abimanyu in Chapter 13 the sustainability of decentralization policy, indeed of the entire Indonesian economy, will depend heavily on whether the government of Indonesia can deliver a sustained economic recovery through 2004. The issue that could derail the process is the lack of fiscal sustainability. What rings the alarm bells for Anggito Abimanyu is that Indonesia has very little tradition for showing concern about the sustainability of government finances prior to the economic crisis of 1997. His chapter assesses the major components of a fiscal sustainability strategy for Indonesia, focusing on the potential impact of decentralization on the central government accounts and the ability of the central authorities to conduct macroeconomic stabilization policies.

As others have stated at other times and for other countries, decentralization is not an end but a process, not a destination but a journey. Indonesia has started on this process with many successes and also significant problems that demand attention. In the final part of the volume, Chapter 14 by Anwar Shah and Theresa Thompson reflects on the 'silent revolution' in public sector governance sweeping across the globe, which has aimed to move decision making for local public services closer to the people. Shah and Thompson examine the different motivations for decentralization, assess successes and failures in decentralization across continents and draw lessons for the future of decentralization in Indonesia. They find the program of decentralization implemented by Indonesia commendable on a number of counts, including by-passing the provinces, given the fragile nature of the Indonesian union; or providing resources to match responsibilities in an unconditional manner, thus promoting flexibility and autonomy of decision making at local level. Shah and Thompson also applaud the significant efforts to redress historical grievances of the resource rich regions. However, in their opinion, the long-term success of decentralization in Indonesia is not assured as the program has failed to recognize and provide incentives for local governments to be accountable and responsive to their residents.

The last chapter is a postscript by Jorge Martinez-Vazquez and Jameson Boex. Since all other chapters in the volume were papers written for the conference held in Atlanta in May 2002, an update was needed. In the year after the conference was held several important changes took place and several other changes did not occur as expected. In their review, Martinez-Vazquez and Boex emphasize the major obstacles to progress and suggest the main priority areas for successful decentralization reform. The authors identify as the most formidable obstacle to continued progress in decentralization reform the lack of overall vision and the weak commitment to the decentralization agenda by the country's top leadership. Much has been achieved in the implementation of decentralization reforms in Indonesia since 1999, but despite the advances, there is a clear slow-down in the reform agenda. Fortunately, none of the challenges ahead is insurmountable and thus there are reasons to remain optimistic about the future of decentralization in Indonesia.

NOTES

1. The chapters in this volume were originally papers presented at a conference entitled 'Can Decentralization Help Rebuild Indonesia?', held in Atlanta, Georgia in May 2002, at the Andrew Young School of Policy Studies, Georgia State University.
2. During the 1995 economic crisis in Mexico, states suffered a debt crisis and all states received bailouts from the federal government; some states received subsequent bailouts for particular infrastructure projects. In Mexico, state debts were guaranteed by their *participaciones*, which were collateralized and only partially intercepted by the federal government.
3. For example, South Africa recently increased the credit factor for sub-national debt from 0.1 to 1.0. Higher capital adequacy ratios require lenders to increase their ratio of net worth to loans to sub-national governments, and to make provision for potential non-performing sub-national debt, based on debt-service-to-savings ratios.
4. The characteristics of financially viable and sustainable financial intermediaries are described in George Peterson and Sonia Hammam, *Building Local Credit Systems*, World Bank Urban Management Program Policy Paper, August 1997.