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Indonesia: Managing Decentralization

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Abstract

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The process of decentralization in Indonesia was initiated after a long period of autocratic rule. Despite the political imperatives, there is a need to carefully sequence the fiscal decentralization to ensure that financing follows the assignment of functions. The functions should be commensurate with the capacity to provide public services. The paper argues for the proper sequencing to avoid jeopardizing macroeconomic stability or the effective delivery of public services.

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[1] This paper draws on joint work with Bert Hofman (World Bank); see Ahmad, Hofman, and Mansoor (2000). Helpful comments from Ke-young Chu are gratefully acknowledged. An earlier version of this paper was presented at a conference on Fiscal Decentrallization, held at the IMF, Washington, DC in November 2000. This paper will be published in the forthcoming book, Ehtisham Ahmad and Vito Tanzi, eds. *Managing Fiscal Decentralisation* (London and New York: Routledge).

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I. Context

The Governance and Fiscal Balance Laws,[2] enacted by the Indonesian Parliament in May 1999, aim to decentralize both political and economic power away from the central government after decades of highly centralized and autocratic rule. The new legislation recognizes political reality—Indonesians across the country want greater involvement in the management of their day-to-day affairs. In particular, the natural resource-rich regions want a larger share of the resource pie—which was seen as having been preempted and often misused by the elite in Jakarta. Thus, the political pressures for decentralization reflect in part the reaction to the demise of an authoritarian regime.

The pressure for decentralization in many parts of the world often is driven by the need for improved service delivery (Dillinger, 1994). However, in Indonesia, distinct ethnic and geographic factors have exacerbated the frustration with central domination, and the demand for decentralization is associated more with control over resources and political and legal autonomy than with a perceived need to improve local service delivery.

The conflicting agendas have had a visible hand in defining the implementation of the decentralization program. From the outset, parliament modified the draft legislation to accommodate demands from producing regions for a share of onshore oil and gas revenues. In addition, the legislation established a floor of 25 percent of domestic revenues (including all oil and gas revenues) for transfers to regions through the General Allocation Fund aimed at supplementing local revenues and equalizing regional needs and revenue capacities. The appeasement of regional interests (especially relating to oil- and gas-rich districts) created an inconsistency in the approach. Furthermore, while Law 22/99 remained vague on functions to be transferred and the process to be adopted, Law 25/99 assured financing for subnational administrations without linking resource sharing to delivery of services. This dichotomy increases the risks from decentralization, in that financing has been assured before the effective devolution of responsibilities, which may have to continue to be borne by the center.

Decentralization, nevertheless, offers considerable opportunities for better governance. In principle, decentralization could improve the local provision of public goods, so that these were tailored to local preferences and became a local responsibility. Combined with more efficient taxation and spending, this should bring greater prosperity to all regions. To actually realize these benefits, however, international experience suggests that decentralization must be properly sequenced and phased. Ill-sequenced reforms can threaten service delivery and result in "capture by local interests," thereby threatening good governance. Moreover, unless decentralization is implemented to be fiscally neutral, it could jeopardize Indonesia's hard-earned stabilization by substantially increasing deficits of general government.

[2] Laws 22/1999 and 25/1999, respectively.

There are many different ways to manage the decentralization process. Political realities and the conflicting perspectives on decentralization generally shape the outcome, as is the case in Indonesia. Yet international experience often provides no more than a guide as to appropriate sequencing. Inappropriately designed institutions may make the overall economy less able to cope with external shocks, however. While the hierarchical and cooperative relationships characterizing Indonesian society may help offset some of the inherent problems (see Hofstede, 1991), traditional response mechanisms may not reflect future responses in a completely different political environment characterized by conflicting interests and incentives. Political issues—particularly the pressures for sharing of revenues—could divert attention from proper sequencing of decentralization measures.

This paper focuses on the key issues that need to be addressed in order to achieve the desired decentralization in a systematic manner and thus secure the benefits without endangering either macroeconomic stabilization or Indonesia's territorial integrity.

II. Institutional Setting

Under Suharto's "new order" regime that governed Indonesia from 1965 through 1999, the country had a very centralized government, albeit with a veneer of decentralization. Law 5/1974 provided the framework for decentralization, but there was little implementation or effective devolution of authority to lower levels of government. Formally, there were three main levels of government: the central government, 27 provinces, and 333 districts. In practice, the center dominated all levels. Indonesia was more a model of deconcentration than of decentralization, with the central government exercising significant control over the appointment of local officials and uses of funds by these officials (Shah, 1999).

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.[3] 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 Habibie government enacted Laws 22/99 and 25/99, responding to pressures for more autonomy, while aware of the fault lines that provincial boundaries might offer to separatists.

[3] 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.

Thus, the legislation focused on decentralization at the district level. This arrangement also suited bureaucrats in Jakarta, since the central government is likely to have more influence over relatively weak districts than over strong provinces. This approach provides the central government a natural role in arbitrating between districts and provinces. However, the negative experience with Law 5/1974 led Parliament to impose a tight deadline for implementation (by June 2001). The specified minimum revenues to be transferred and district-level decentralization were seen as ways to diffuse separatist tendencies in the natural resource-producing regions.

Law 22/99 assigns all government expenditure functions to districts except for finance, foreign affairs, defense, religion, and state administration.[4] Under Law 22/99, the provinces have no hierarchical authority over districts and perform largely coordinating tasks. Also, in the transition period, provinces may undertake tasks that specific districts may not be in a position to perform. Article 11 of Law 22/99 spells out the functions that the district *must* perform—and which cannot be handed back to the provinces—including education, health care, and local infrastructure.

The Wahid administration, relying on regional parties, reinforced the decentralization process. Despite the backing of the president, progress on implementation was stalled by disagreement about whether there should be a "big bang" decentralization to districts (as provided by Laws 22/99 and 25/99), sequenced decentralization to districts, or initial decentralization to the provinces. After some discussion that might have led to a modification of the legislation leading to decentralization to provinces, the opposition from key players within the government led to implementing Laws 22/99 and 25/99 and rapidly devolving responsibilities to districts without modification. The functions to be decentralized to districts are thus defined by default.

III. The Risks

Given the political imperatives, the challenge for Indonesia is to draw on the international experience to maximize the benefits and minimize the risks of the decentralization process. Litvack, Ahmad, and Bird (1998) argue that **design flaws are responsible for failures of decentralization.** Hommes (1995) argues that local governments overspend when they have relative budget autonomy but do not have to raise taxes to support their spending. There can be little accountability if local administrations do not have the ability to modify tax rates: they cannot finance additional expenditures from taxation at the margin that impinges on their own residents (Brosio, 1997). Under the decentralized structure, local Indonesian

[4] The law mandates exclusive authority for the central government over "the fields of international policies, defense and security, judicature, monetary and fiscal, religion, national planning, and macro national development control, financial balance fund, state administration and state economic institutional systems, human resources development, natural resources utilization as well as strategic high technology, conservation, and national standardization."

governments do not have control over rate structure for a major source of revenue, including the property tax—a common source of local owned-revenues in many countries.

Other challenges include provisions to safeguard public services by building local capacity and pooling skilled technical staff; ensuring fiscal neutrality; and establishing an effective budget and public expenditure management system to achieve properly sequenced decentralization **function should follow capacity; revenue should follow functions; and decentralization should be deficit neutral,** i.e., resources transferred from central to district and provincial governments should match the expenditure transferred. If districts fail to deliver assigned services, the central government may need to step in, at a cost to the budget, to avoid service disruptions. This may happen if, for example, districts take responsibility for control of tuberculosis but lack trained staff to follow up. Such improperly sequenced decentralization may lead to a reversal of the decentralization process (Shah, 1999).

Deficit neutrality would suffer with an expansion of spending financed by subnational borrowing based on guaranteed revenue shares or transfers, as has occurred in several countries in Latin America (Ter-Minassian, 1997). To avoid these pitfalls, there have to be sufficient prudential or legal safeguards, especially where capital markets are not sufficiently developed to provide appropriate signals or a disciplining role. Moreover, the ministry of finance (MOF) has to be sufficiently strong (Von Hagen, 1992).

A. Macroeconomic Imbalances

A mismatch between revenues and expenditure functions devolved to regional governments can have serious fiscal implications. Decentralization would lead to a 50 percent increase in transfers to regional governments. For this to be fiscally neutral, the transfer of expenditure responsibilities to regional governments should amount to at least 1.7 percent of GDP. Initial estimates suggested that the provinces would need to take on activities equivalent to about 0.3 percent of GDP, whereas districts would need devolved functions amounting to 1.4 percent of GDP.[5]

In the medium term, once all the functions assigned by Law 22/99 have been decentralized, subnational public services, estimated at about 6 to 9 percent of GDP, would exceed minimum transfers. However, during the initial stages, it may not be possible to decentralize enough staff and development expenditures to absorb the resources being transferred. This is particularly true for the twenty or so districts that benefit from the arrangements for sharing of natural resource-based revenue (see below). In these districts, the local authorities may be under irresistible pressures for new, possibly unproductive spending.

Even after the transition period, a mismatch between the additional transfers and the functions could jeopardize continued public services in the majority of districts that do not

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[5]Ahmad, Hofman and Mansoor (2001) for a detailed assessment of the fiscal implications of Laws 22/99 and 25/99.

benefit from the natural resource-sharing arrangements and possibly also the transfers, as well as in some resource-rich but sensitive regions.

B. Expenditure Assignments and Service Delivery

In the Suharto era, Indonesia relied extensively on "deconcentrated" expenditure functions—that is most public services provided at the local level at the behest of the center, usually with staff paid for directly by the center. Financing came through a plethora of special-purpose grants.[6] Local administrations had little in the way of own-source revenues, and even the property tax was administered by the center and shared with local administrations. The new legislation focuses on devolving expenditures to districts, but is not sufficiently explicit in this regard.

The Governance Law 22/99 requires that virtually all functions be transferred to districts in 2001. It 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). This very broad allocation of responsibilities does not carry much operational significance, and a more detailed specification, taking into account administrative capabilities, needs to be developed.

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 care or the safety net, and the implications these policies may have for financing issues (where these policies affect sectors allocated to lower levels). Given that in the past most of these public services were performed through "deconcentrated" delivery, a minimum requirement for effective continuation of these services into the "decentralized" era would entail that the deconcentrated staff previously employed by the center need to be reassigned to lower-level administrations. As in other countries, such as Colombia, there may be difficulties in attempting to "unload" centrally paid staff onto local administrations. First, staff show resistance to permanent assignment to district-level jurisdictions, with which they have few ties. Second, there may be resistance in the regions to take on such staff, partly because these staff tended to represent Jakarta or come from different ethnic backgrounds. Thus, replacing the entire staff providing current central or deconcentrated functions may not be feasible in the short-to-medium term. To compound the problem, most civil servants outside Jakarta are in provincial capitals and may resist being relocated to districts with fewer amenities. Moreover, it is unlikely that the replacement staff hired in the districts would have the requisite skills to ensure effective and continued service delivery.

[6] See Anwar Shah et al. (1994)

In the short run, appropriate sequencing would suggest that functions, together with the requisite staff, be devolved to the districts and provinces, and that the transfers be sufficient to cover these costs. In the medium term, the devolution of functions provides an opportunity to evaluate improvements in the efficiency of existing public programs, reorienting them more toward the poor, and improving their delivery, including through greater private sector participation. This should then become the foundation for more efficient service delivery. This sequencing to changing employment patterns is contentious, because local governments see decentralization as a means of creating jobs for locals.

One consequence of this lack of attention to continuation of service delivery is that the central government is likely to face a large bill for social expenditure on subsidies, social safety nets, and poverty-alleviation programs that under Law 22/99 are the responsibility of the districts. To address this problem, the National Planning Board (BAPPENAS) would need to formulate proposals to transfer these functions to the districts.

Indeed, the political process that has driven decentralization makes it difficult, at least initially, for Indonesia to seize the potential welfare gains from improved service delivery that is more attuned to local needs. Instead, this lack of planning of expenditure assignments raises risks to service delivery. Thus, a process that should have been driven by local consultations may, in the end, require strong central direction to enable a smooth transfer of services.

C. Arrangements for Financial Management

In the centralized model of the Suharto era, there was little need to develop a capacity for local financial management. Since most of the financing was through special-purpose grants administered by centrally appointed officials, there was little attention to information on actual current spending—generally put together by the Ministry of Home Affairs (MOHA) and made available to the ministry of finance (MOF) with a substantial lag, usually up to two years for expenditures at the district level. The quality of information produced is not verified. The flow of information is not timely, nor suited to provide early warning signals when corrective action might be warranted. These issues have been even more neglected than expenditure assignments. As a result, the central authorities may be unable to monitor outlays, assess the needs of districts and track the use of transfers. The absence of appropriate budget information systems adds to the risks of a breakdown in service delivery. To address this gap in preparations for decentralization, the central government would have to minimize risks of a breakdown in budget management.

Unfortunately, even the expenditure management system at the center is weak, with numerous extrabudgetary funds and poor cash management, accentuating a lack of transparency that has led to numerous avenues for the misuse of resources. As the decentralization process unfolds, the center is attempting to strengthen its treasury functions and the functioning of a treasury single account. Once the central treasury is fully functional, it could provide services also to district level administrations that may lack the resources to establish independent treasury and payment systems of their own.

The lack of transparency in public expenditure management at the center threatens to complicate revenue-sharing arrangements, and there is evidently considerable scope for disagreement. Reform needs to focus on monitoring and control to minimize possibilities of mismanagement or graft and to provide early warning of potential disruption in public service delivery.

The center needs to establish standard budgeting, auditing, and reporting procedures for all local budgets, and mechanisms to monitor the sharing of natural resources revenue and transfers.[7] Central government should require sub-national governments to adopt standardized mechanisms for enhancing transparency and accountability.

The fact that the legislation provided no safeguards against excessive subnational borrowing is particularly worrying, especially given the contingent liabilities facing the center and the overall level of general government debt and contingent liabilities (e.g., for bank restructuring) as the decentralization is implemented.

To help monitor fiscal decentralization during the execution of the budget, regulations should be issued to link the release of revenue sharing and General Allocation Fund allocations to the submission of reports on district/provincial budget execution, and to sanction districts and provinces that fail to submit timely, accurate, and comprehensive fiscal reports. In addition, systems are needed to monitor development and social spending at the district level. In particular, for effective monitoring of special purpose transfers, the center would need to establish the performance it is expecting from local governments for each devolved function, including minimum reporting standards.

D. Subnational Taxes and Charges[8]

Provincial and local taxes and charges are principally regulated by Law 18 of 1997 (Law on Regional Government Taxes and Charges), which came into effect during 1998. This law rationalized local taxes, and eliminated a number of nonproductive taxes and charges. Under the law, the taxes assigned to provincial governments include the motor vehicles transfer tax; motor vehicles registration tax; and fuel tax. The rates for these taxes are set by the central government, within ranges specified in the law. The motor vehicle transfer tax, the largest source of provincial tax revenue, is levied at the time of resale of a motor vehicle. Currently, the first sale is taxed at 10 percent of the value, while subsequent sales are taxed at 1 percent of the value. The motor vehicle tax is an annual tax on the value of the vehicle. The current tax rate is 1.5 percent. For both taxes, the determination of value is done by the MOHA

[7] The General Allocation Fund (GAF) and Special Allocations.

[8] This section is largely based on Ahmad and Krelove (2000).

periodically and made available to provincial governments who then collect the tax. The fuel tax is a new provincial levy at 5 percent shared with district governments.

District governments are authorized under the law to levy a number of small taxes: hotel and restaurant tax; entertainment tax; advertisement tax; street lighting tax; base mineral extraction tax; and water tax. Districts have some flexibility in choosing rates for these taxes within specified maxima, but changes must be approved by the MOHA after consultation with the MOF.[9]

Although districts receive most of the revenues from the land and property tax, they have no control over the rate structure and it is like a shared-source of revenue administered by the center. The complicated sharing arrangements for the land and property tax are designed to introduce "equalization" elements into the tax. However, this equalization function would become redundant with a large general allocation transfer (exceeding the combined revenues from the land and property tax), also distributed on the basis of "equalization" principles.

The Fiscal Balance Law 25/1999 also introduced revenue sharing for oil and gas. For onshore oil, 15 percent of non-tax revenues are to be distributed to sub-national governments, of which 3 percent to the producing province, 6 percent to the producing district and 6 percent to be shared by non-producing districts in the producing province. For on-shore gas, 30 percent of the non-tax revenues are to be shared, of which 6 percent to the producing province, 12 percent to the producing district and 12 percent to the non-producing districts in the producing province. This formulation is relatively opaque, further complicated by the inclusion of offshore oil within 12 miles. Also, the non-producing provinces may need to be compensated by an "equalization" transfer system that reduces the interregional disparities created by the oil and gas sharing formula.

This arrangement is opaque, subjects the local producing governments to the full variance in international oil and gas prices, and may be implemented before the expenditure devolution is effective, thereby providing revenues to some districts that they may not be able to use effectively. In the absence of effective safeguards and monitoring mechanisms, the possibilities for misuse of resources are magnified.

It is not a priori evident that the sharing of resources with a producing region will in itself satisfy the aspirations of separatists—since by definition they could always do better by keeping all the revenue generated in the region. Thus, for the center and the producing regions it may be difficult to establish the politically acceptable level of resource sharing, particularly of oil and gas revenues, and there is plenty of scope for building up further resentment. National unity would thus have to rest on other factors, such as the services that the center could provide with greater efficiency, national defense and the fact that the center

[9] In addition, Article 2 of the law allows local and provincial governments to introduce new taxes by local regulation, subject to approval by the MOHA, provided they meet a number of criteria.

is, in principle, better able to smooth expenditures given its access to many sources of revenues, and the volatility of natural resources prices.

In addition to adding to "unsatisfied aspirations," the sharing of oil and gas could:

- 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 non-producing districts in a province than producing districts;[10] and
- complicate the functioning of a grants system.

Yet, special provisions may need to be found to "compensate resource-rich regions," and encourage them to stay part of Indonesia, akin to the asymmetric decentralization in many parts of the world. One way of addressing the dilemma could be to emphasize improvements in public services as the main objective of decentralization. Within the context, the central and regional governments in resource-rich districts could agree on the targeted improvements to be achieved.

IV. The Decentralization Legislation: Laws 22/99 and 25/99[11]

A. Macroeconomic Context

Ahmad, Hofman, and Mansoor (2001) provide an illustrative scenario of the macroeconomic effects of the proposed decentralization of public finances to the regional level. Many of the calculations are based on assumptions rather than stated policies, and the results should therefore be interpreted with great care. For simplification, regional government is treated as one level.

The regional share of general government spending will eventually more than double to over 40 percent with full implementation (Figure 1). Some 60 percent of the development budget will be managed at sub-national 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 (Figure 2).

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

[11] This section draws on Ahmad, Hofman, and Mansoor (2000).

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 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. Regions without oil, gas, or forestry, resources will find it difficult to finance their decentralized expenditure responsibilities. 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. Any domestic borrowing is not taken into account in the projections. Own revenues may increase in the future (e.g., by devolving control over the rate structure of the land and building tax), but this is likely to be offset by a cut in special grants.

Figure 1. Impact of Decentralization

(Billion rupiah)

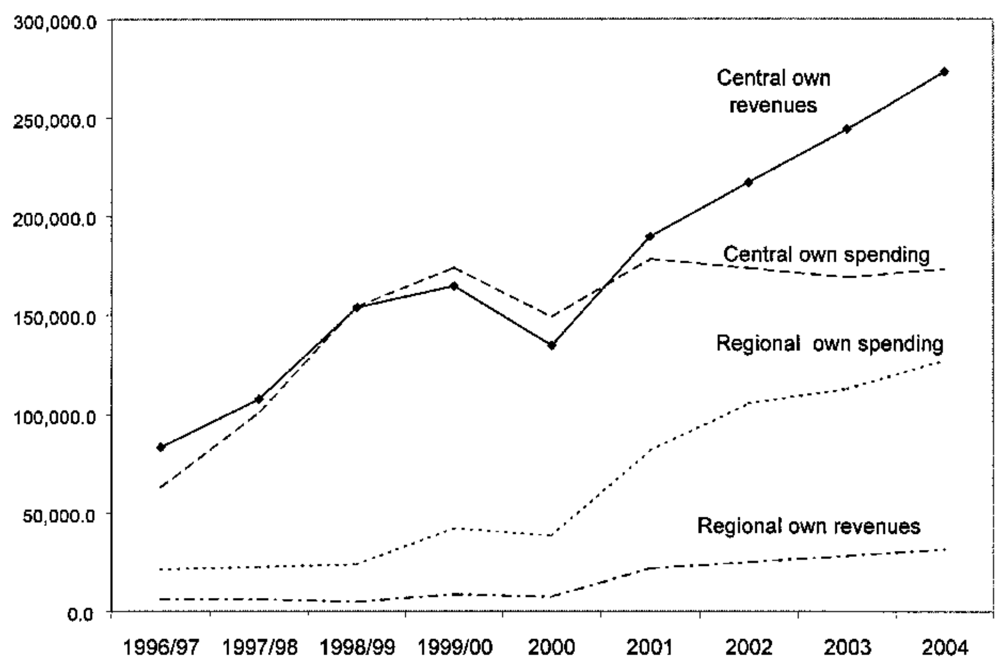
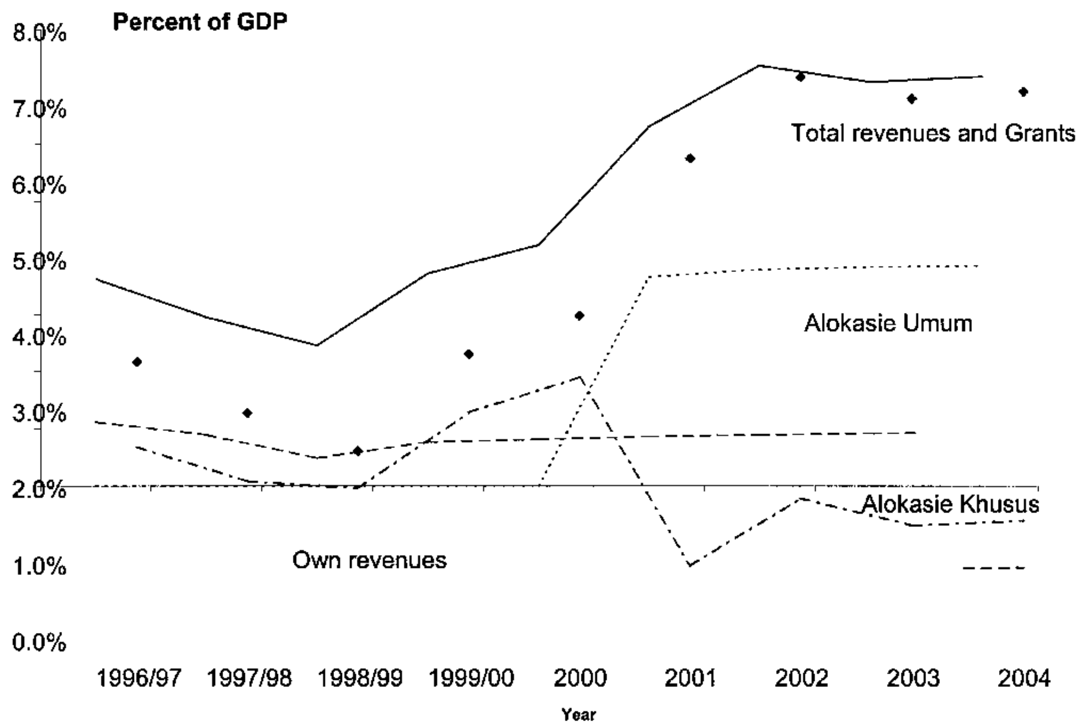


Figure 2. Regional Revenues

(Percent of GDP)



B. Vertical Fiscal Imbalances

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

(1) "*Pre-reform policy*," as implied by the 1999/2000 central and sub-national 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 pre-reform 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 1) 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).[12]

- Under the expenditure assignments and budget estimates for 1999/2000, the implementation of the new legislation increases the central government deficit by about 1.2 percent of GDP, as a result of the oil and gas revenue sharing and a sharp increase in general allocation transfer.[13] Alternatively, if the central government is to maintain the budgeted level of deficit, it has to transfer expenditure responsibilities of about 1.2 percent of GDP to lower level governments in 1999/2000 terms.

C. 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 were 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, 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 Sulawasi Selatan to 70 percent in Kalimantan Barat in 1997.[14] It is expected that even larger variations in expenditure needs exist across districts and municipalities.

The old 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

[12] The government's medium-term fiscal objective is to restore budgetary balance.

[13] The amounts to be transferred are a function of the oil price, which had risen from US$10.50 per barrel (assumed in the 1999/2000 budget estimate) to more than US$30 per barrel by mid-2000. A US$1 per barrel increase results in a 0.1 percent of GDP increase in revenue net of oil subsidies, most of which is transferred to the local governments.

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

Table 1. Impact of the Fiscal Balance Law Using 1999/2000 Data

(In billions of rupiah)

		New Policy	
	Old Policy 1/	Old 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 (excluding 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(+)/surplus (-)	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 (+)/surplus (-)	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

Source: Ahmad, Hofman, and Mansoor, 2001.

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

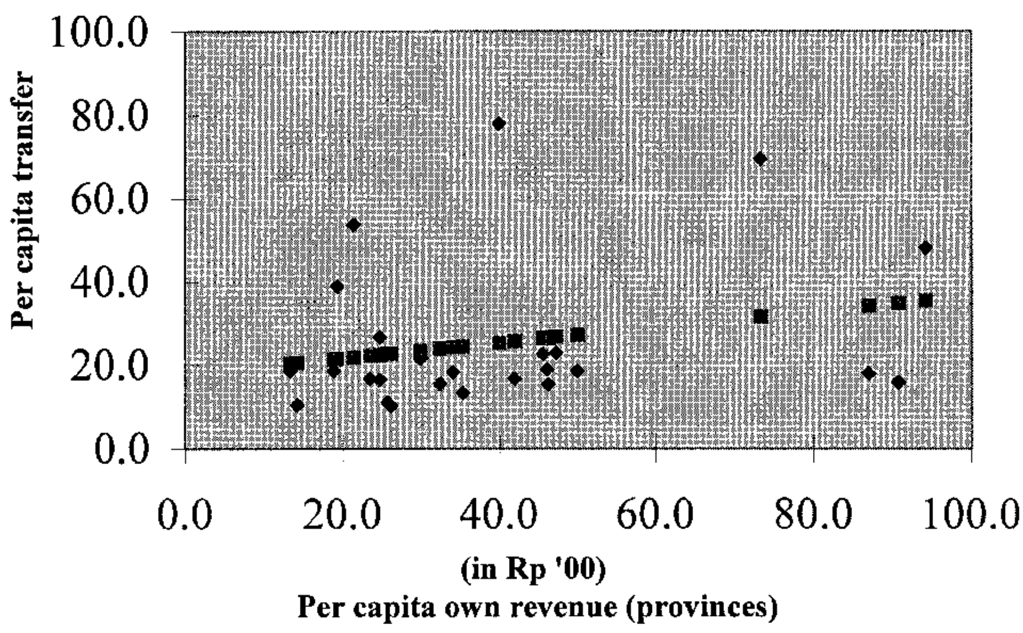
2/ Under existing expenditure assignment, deficit is treated as residual.

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

across regions. However, the **transfer system was 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.

Based on 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 (Figure 3), and had no statistically significant relationship with per capita GDP. A similar analysis using district level data for 1996/97 suggests that per capita transfers to districts were significantly and positively correlated with per capita own source and shared revenues and had no relation with per capita GDP.

Figure 3. Disequalization Under the Current Transfer System



D. The Fiscal Balance Law and Horizontal (Dis)Equalization

The sharing of oil and gas revenue, as required by the Fiscal Balance Law, would lead to further imbalances in regional revenue capacities, as the sources of oil and gas revenue are concentrated 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 non-producing 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 non-producing districts in the producing province.[15] Based on very conservative assumptions of oil and gas prices, it is estimated that, if the Law were implemented fully 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 almost no oil and gas revenue (see Table 2).

The sharing of oil and gas revenue exacerbates horizontal differentials with the coefficient of variations across 26 provinces (excluding Jakarta) increasing 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 2).

Despite the obvious need for an equalization transfer, care has to be taken to ensure that the initial allocation of funds does not vary too greatly from the distribution of public service expenditures—to prevent a major disruption in the delivery of such services.

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[15]The Law, however, does not specify the method for distributing the 6 percent oil revenue and 12 percent gas revenue to non-producing districts.

Table 2. 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
Mean	25.2	4.0	29.2
Standard deviation	17.8	11.1	26.3
Coefficient of variation	0.70	2.77	0.90

Source: Ahmad, Hofman, and Mansoor, 2000.

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

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