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NEW INTERGOVERNMENTAL TRANSFERS IN DECENTRALIZED INDONESIA: KEY CHALLENGES

MAJOR ISSUES TO BE PRESENTED

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1. This presentation aims at clarifying major constraints in the new intergovernmental fiscal transfer system in Indonesia, which has initiated the drastic decentralization program since fiscal year 2001 (FY2001). While a major target of this presentation is to assess block grant transfer system, which plays a major role in the intergovernmental fiscal relations in decentralized Indonesia, this presentation also discusses matching grant allocation system and revenue sharing mechanism in the overall context of Indonesia's decentralization. Some policy recommendations derived from the analyses are discussed for each key topic.

2. A key objective of decentralization is to move decisions closer to the people to make public service delivery more responsible to local demands. To this end, one of key challenges for any responsible (central) government is how to guarantee a reasonable balance between expenditure responsibilities and revenue instruments available to local governments to avoid basic service delivery disruptions. A basic principle is; first should come the expenditure responsibilities to local governments, and then the assignments of revenue responsibility should be determined. Without understanding fiscal needs for local governments to conduct newly devolved responsibilities, it is not possible to give economically efficient revenue assignments to local governments. A lack of the balance can even worsen public service delivery to local people after the implementation of decentralization.

3. After long continued centralized regime, the Government of Indonesia (the Government) has been undertaking a drastic decentralization program since January 2001. The hierarchical relationship between provincial and local governments called *Kota* (municipality or city) and *Kabupaten* (district) was eliminated, and all local government became fully autonomous and responsible for planning, management, financing, and major public service deliveries (public works, health, education, agriculture, communication, industry and trade, investment, environment, land matters, cooperatives, and human resources). While the provincial governments also act as autonomous regions, they retain a hierarchical relationship with the central government. At the same time, about 2 million civil servants who had worked in the regional offices of the central ministries were transferred to local governments. With the implementation of the decentralization, Indonesia has started moving from one of the most centralized to one of the most decentralized countries in the world.

4. Indonesia's intergovernmental fiscal relations were drastically changed after the decentralization. Before FY2001, there existed two central transfers to regions: (i) subsidy to regions (SDO), which was mainly used to finance salaries of local civil servants; and (ii) regional development funds (INPRES) for development expenditures. Since January 2001, both transfers were eliminated and instead combined into general allocation fund (DAU), a block grant, set at a minimum of 25 percent of total domestic revenues in the national (central) budget. DAU became a mainstay of the new intergovernmental transfers in Indonesia. The Government also expanded revenue sharing system, which assigns each regional government its share of revenues from taxes on personal income, land and building, transfer of land and buildings, forestry, mining, fisheries, oil, and gas. Another newly introduced transfer was special allocation fund (DAK), a matching grant, which aims at penetrating nationally prioritized projects at regional level and/or financing projects which have spill over effects across regions. Further, the Government revised regional taxes and levies law to strengthen regions' revenue mobilizing capacities.

5. After the decentralization, total amounts of central transfers to regional governments (revenue sharing, DAU, and DAK) were drastically increased. The amounts in FY2001 and FY2002 were

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Rp.81.7 trillion and Rp.98.0 trillion, or 5.7 percent and 5.8 percent of GDP, respectively, which were much higher than Rp.33.5 trillion or 3.7 percent of GDP in FY2000. At least, at the aggregate level, it can be said that local governments acquired higher financial capacities. However, it was made clear that some regions were suffering from financial gaps in their budgets, despite drastic increase in their revenues. The key cause of the problem is the imbalance between the new revenue assignments and expenditure responsibilities in determining DAU allocation to each region.

6. ***Block Grant***: A main objective of DAU is to equalize fiscal capacities across the regions to finance their expenditure needs including additional fiscal costs to finance newly devolved functions. To this end, the Government prepared a DAU allocation formula that incorporates fiscal needs and capacity of all regions. However, actual allocations were not perfectly based on the formula due mainly to political factors or lobbying activities by some resource rich regions. As a result, DAU has not yet achieved the expected equalizing effect. Key constraints are: 1) "*hold harmless*" component (no region could receive less DAU than the previous year); and 2) missing 25 percent of natural resource revenue sharing in fiscal capacity calculation in the formula. Our simulation exercise shows that more formula based allocation can improve horizontal fiscal balances. The Government is moving to this direction by increasing the weight for formula allocation, however, further efforts are required to socialize the original purpose of DAU. In the short-term (if the Government can not remove the above two constraints due to political reasons), a feasible solution is to allocate increasing pie of DAU only to regions which really suffer from lack of fiscal resources, by fixing the allocation amounts to regions which enjoy additional revenues due to these constraints.

7. The Government also needs to incorporate cost estimations to achieve minimum service standards (SPMs) into the DAU allocation formula, especially its fiscal needs calculation. However, this issue needs to be addressed in the medium- and long-term, since operational and workable SPMs can be prepared after long continuing try and error processes. A risk is that computed costs for SPMs will require much higher resource transfers to regions, which will elicit discussion within the Government to increase total pool of DAU (currently fixed at 25 percent of net domestic revenues). Rough and ready incorporation of SPM cost estimation into the DAU formula will require another revision of DAU formula in the near future. Further, this issue must be carefully considered in the overall context of the current hard budget constraints of the central government budget. In the meantime, it is desirable not to rush in incorporating SPM cost estimation into the DAU allocation system.

8. ***Matching Grant***: It must be emphasizes that the lack of policy tools or instruments to promote nationally prioritized projects at local level is a key challenge for Indonesia's decentralization. Even after the decentralization, the Government needs to foster nationally prioritized projects at regions without unnecessary interferences in regional government affairs. The Government needs to establish a clear linkage between the central and regional governments in planning and budgeting. DAK, as a matching grant, needs to play a major role to this end. However, to make it possible, the Government needs to clarify some key issues including: 1) identification of eligible regions; 2) technical criteria by sectors: 3) matching rate setting; and 4) disbursement mechanism. A key issue to be realized by the Government is the original purpose of DAK. DAK was introduced to finance nationally prioritized projects and/or spill over projects at regions, not to improve horizontal fiscal imbalances. However, at least, judging from DAK allocation criteria for FY2003, the Government failed to pay enough attention to this issue. DAK should not be utilized as an equalizing tool, which must be achieved by DAU allocation.

9. ***Revenue Sharing***: Highly unequalzing effects of current revenue sharing system and too delayed disbursements to regional governments need to be realized as key challenges for the Government. A bulk of sharing revenues from personal income tax and property related taxes goes to some limited regions, in particular to Jakarta, which enjoys about 50 percent of total sharing amounts to regions. Further, sharing revenues from natural resources concentrated to the limited resource rich regions. Delayed disbursement of sharing revenues created serious difficulties in financial management at regions. In FY2001, a major part of these revenues were disbursed to regions at the very last stage of the fiscal year. This is a key factor explaining the relatively large budget surpluses recorded in FY2001 regional budgets. The Government needs to streamline the complicated calculation process of sharing revenues, in particular those from natural resource sectors, to enable timely disbursement to regional governments.