

## CRITICALLY EXAMINING THE ARRANGEMENTS OF FISCAL DECENTRALIZATION IN INDONESIA

Rizqi Bachtiar<sup>1</sup>

### *Abstract*

*As an implication of the implementation of decentralization in Indonesia, the authority to manage income and spending autonomously by local governments in Indonesia is undeniable. However, the power should be managed and used proportionally. The central government should not lose its control of the local governments, while the local governments maintain the authority to manage its area. This paper examines the proportions of the fiscal authority given by the central government to the local governments in Indonesia. In short, this research finds that in general, the framework of fiscal decentralization in Indonesia is going well. Some research also offers positive findings of fiscal decentralization in Indonesia. However, there are also some serious problems resulting from the implementation of fiscal decentralization in Indonesia, such as vertical fiscal imbalance and corruption. These problems need to be reduced by issuing technical and specific regulations and by ensuring that those regulations are both monitored and implemented.*

**Keywords:** *corruption, fiscal decentralization, Indonesia, local government*

### *Abstrak*

*Sebagai sebuah implikasi dari pelaksanaan desentralisasi di Indonesia, wewenang untuk mengelola pendapatan dan pembelanjaan secara mandiri oleh pemerintah daerah di Indonesia tidak bisa terelakkan. Namun, kewenangan tersebut harus dikelola dan digunakan secara proporsional. Pemerintah pusat seharusnya tidak kehilangan kontrolnya terhadap pemerintah daerah, sementara pemerintah daerah dapat mempertahankan otoritas untuk mengelola wilayahnya. Makalah ini mengkaji proporsi otoritas fiskal yang diberikan oleh pemerintah pusat kepada pemerintah daerah di Indonesia. Singkatnya, penelitian ini menemukan bahwa secara umum kerangka desentralisasi fiskal di Indonesia berjalan dengan baik. Beberapa penelitian juga menawarkan temuan positif tentang desentralisasi fiskal di Indonesia. Namun, ada juga beberapa masalah serius yang dihasilkan dari pelaksanaan desentralisasi fiskal di Indonesia, seperti ketidakseimbangan fiskal vertikal dan korupsi. Masalah-masalah ini perlu dikurangi dengan mengeluarkan peraturan teknis dan spesifik dan dengan memastikan bahwa peraturan-peraturan tersebut dapat dipantau dan diimplementasikan.*

**Kata Kunci:** *desentralisasi fiskal, Indonesia, korupsi, pemerintah daerah*

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<sup>1</sup> Lecturer of Governmental Science Program, Faculty of Social and Political Sciences, Universitas Brawijaya

## **INTRODUCTION**

As an implication of the implementation of decentralization in Indonesia, the authority to manage income and spending autonomously by local governments in Indonesia is undeniable. The authority, commonly called fiscal decentralization, becomes an integral part of the implementation of decentralization in Indonesia since it changes the power pendulum that was once centralized in the central government into the local governments.

Fiscal decentralization in general means budgetary authority, such as making decisions of revenues and expenditures, being given to local governments/sub-national governments (SNGs) by a central government (Bahl, 2008). Porcelli (2009) refers to this system as decentralizing income and spending being implemented to empower SNGs. The argument from Porcelli above is likely giving the explanation that decentralization is not only a matter of power transfer but also a matter of empowerment. The explanation is in line with the research from Fedelino and Ter-Minassian (2009) that the objectives of fiscal decentralization are a state's stabilization, equalization of services and efficient allocation of funding.

However, in order to empower at the SNG level, central government needs to consider the potential risks of the given authority to SNG, because it could destroy the decentralized system itself (Ahmad & Tanzi, 2002). The arrangements of fiscal decentralization ought to be granted by the central government in balanced proportions. The proportion means the central government does not lose its control of SNG, while the SNG maintains the authority to manage its area.

In order to study the proportions of the authority given by the central government to SNG, this paper analyses the system of fiscal decentralization in Indonesia. Indonesia is chosen because the country has been implementing decentralization for more than a decade. Furthermore, "Big Bang" decentralization in Indonesia (Hofman & Kaiser, 2002) allowed fiscal decentralization to become deeply implemented in this country (de Mello, 2010).

## **METHODOLOGY**

This research is a desk-based research that focuses on the investigation of the arrangement of fiscal decentralization in Indonesia. In order to base the arguments, the

research uses secondary data, such as books, journals, acts, and some governmental publications. Case study approach is also utilized in this research in order to explore deeply about fiscal decentralization in Indonesia. The case study is based on the dynamics of citizen participation in the government in Indonesia and how the parliament works in order to aspire people's voices. This research is divided into two part of the discussions. First, the system of fiscal decentralization, namely the power given by the central government to SNG, the systems of SNG grants and taxes in Indonesia, is analyzed by using a particular framework. Then, whether the concept and practice of fiscal decentralization in Indonesia are good or bad, based on the findings presented above, is considered.

### **THE FINANCIAL POWER GIVEN BY CENTRAL GOVERNMENT**

In order to assess fiscal decentralization in a particular country, Boschmann (2009) introduces a framework of fiscal decentralization that contains two main points: income assignments and spending assignments. This framework guides this examination of the fiscal power that has been decentralized to SNGs in Indonesia.

#### ***Expenditure Assignments***

Carefully defining who has the responsibilities to expend the budget, in both central and local government, is important in order to establish financial accountability and avoid overlapping and redundancy (Boschmann, 2009). Thus, decentralization needs a legal framework to set both expenditure and income assignments. Boschmann (2009) suggested that legal framework informing, for example, revenue and spending regulations is needed to achieve the aims of fiscal decentralization. Related to Boschmann's idea, fiscal decentralization in Indonesia is regulated by a particular law that has been changed twice. The first regulation of decentralization in Indonesia is Law No. 22/1999 on Local Government and then revised to become Law No. 32/2004 on Local Government. In order to improve implementing decentralization in Indonesia, the regulation has recently changed to Law No. 32/2004 on Local Government. The regulation contains several regulations related to fiscal activity in Indonesia's decentralized governments.

Related to spending assignments, Article 298 of Law No. 23/2014 on Local Government reveals that a SNG has the right to spend its budget to provide basic services and to address the selective sector. Basic services consist of public health, food security,

basic education, public works, transportation; whereas agriculture, manufacture, trade, tourism, and fishery are examples of the elective sector (Law 23 No. 23/2014 on Local Government; Prasetiamartati, 2013). However, there are six functions, based on Article 10, Law No. 23/2014 on Local Government, that are not decentralized to SNGs: foreign affairs, defense, police, justice, monetary and national fiscal issues, and religious affairs. This classification of the function is important to fit and benefit the SNG in order to deliver public services, while the central government focuses on conceptualizing state policies to make general regulation and to control the implementation of fiscal decentralization in local government (Boschmann, 2009). By having spending authority as mentioned in the law above, SNGs tend to facilitate better regional economic growth (Hariyanto, 2012). This finding is strengthened by the fiscal policy in Indonesia to guarantee the funds from the central government will not decrease from the previous year. Thus, it allows SNG to spend more money to enhance public services.

However, spending authority in local government tends to encourage the abuse of power, such as 'marking up'; when the SNGs try to unofficially inflate their real spending (Indonesia Corruption Watch, 2006 cited by the Directorate General of Budget, 2007). Presidential Order Number 70, the Year 2012, on Procurement and Services seems to have stimulated this bad behavior by allowing SNGs to choose regional projects' winners by direct appointment; by-passing the open tender procedure. Although the spending system of fiscal decentralization in Indonesia is well covered by clear regulations (Thomas et al., 2014; Law 23, the Year 2014, on Local Government), the specific regulation in SNG's spending needs to be developed to combat corruption cases, such as 'marking up'.

### ***Income Assignments***

Income assignments refer to what kind of revenues should be decentralized (Boschmann, 2009). Boschmann also suggested that, in consequence of fiscal decentralization, SNGs should control their own incomes. Article 279, Paragraph (2), Law No. 23/2014, on Local Government reveals that there are four financial powers that are given by the central government to SNGs in Indonesia. First, SNGs have an authority to get their own revenue from certain resources, such as local taxes and local levies. The local revenue is then shared between SNG and central government, commonly called the Revenue-Sharing Fund (*Dana Bagi Hasil/DBH*). The Public Expenditure and Financial

Accountability (PEFA) report in Indonesia (2012) reveals that DBH contributes almost a quarter of total revenue in SNGs (Thomas et al., 2014).

Second, SNGs have the right to obtain certain funds; commonly called equalization, or balancing funds from central government's general allocation fund (*Dana Alokasi Umum/DAU*), special allocation fund (*Dana Alokasi Khusus/DAK*) and DBH. The 2012 PEFA report, for Indonesia, explains that more than half of total SNGs' funding comes from DAU, while DAK is the lowest proportion of balancing fund for local governments at 6.4 percent (Thomas et al., 2014). The results of the report are confirmed by other research that finds the revenue of SNG is dominated by funds from central government or DAU (German Development Institute, 2007 cited in Boschmann, 2009). Such conclusions suggest that SNG in Indonesia rely strongly on DAU. They also reveal that most spending on state revenues (*Anggaran Pendapatan dan Belanja Negara/APBN*) comes from the transfer of budget funds to the SNGs (Thomas, et al., 2014).

Third, the central government has to fund the implementation of special autonomy for certain specified regions and fund for adjustments, such as via the incentives fund (*Dana Insentif*). The 2012 PEFA report in Indonesia revealed that the amount of the special autonomy fund and the adjustment fund provided by central government depended on the performance of the SNGs (Thomas et al., 2014). The SNGs which have good audit-reports will receive extra funds.

Lastly, the SNGs have a right to borrow money from any sources, such as central government, other SNGs, banks and private citizens (Article 300, Law No. 23/2014, on Local Government). However, the International Monetary Fund (IMF) warned SNGs to avoid excessive debt in order to establish fiscal stability (Fedelino and Ter-Minassian, 2009). For that reason, the central government in Indonesia has tight regulations in order to prevent the adverse impact of over-borrowing in SNGs. The upper limit of accumulated deficits to be paid by local loans is 0.3 percent of total gross domestic product (GDP); for annual deficits of SNGs, the maximum for loans is 4.5 percent of total GDP (Thomas et al., 2014).

### ***Analysis of the Fiscal Power in Local Government***

Overall, Law No. 23/2014 on Local Government tends to be comprehensive, regulating fiscal decentralization in Indonesia. Sections four and eleven of the above law clearly explains grants given by the central government, together with details of the

process of intergovernmental transfer. The comprehensiveness of information and regulations relevant to the fiscal decentralization gains Indonesia an A score, which is the highest score by PEFA in 2012 (Thomas et al., 2014).

However, in spite of clear revenue and spending assignments in Indonesia's SNGs as mentioned above, there are some abuses of power related to fiscal decentralization in Indonesia. The Ministry of Finance, as cited in Kompas (2015), a national Indonesian newspaper, reveals that the most common corruption cases in SNG are related to abusing financial authority, pertaining to budgeting, taxes, levies, procurements, and grants. The cases happen because of the vulnerability of the SNG's bureaucracy when confronted by the strong interests of local individuals or groups (Kompas, 2015). Therefore, the bureaucratic system in Indonesia's SNGs needs to be improved, in order to enhance the untainted implementation of fiscal decentralization.

## **THE SYSTEM OF GRANTS**

In this section, every type of transfer, such as DAU, DAK and DBH is examined using some points introduced by the World Bank (2010); namely the definition, the aims and the methods of grants' transfers. Generally speaking, the intergovernmental transfer system in Indonesia is formula based (Bappenas, 2011); the system of allocating grants based on each region's condition (Boschmann, 2009).

### ***The General Allocation Fund***

DAU is an unconditional grant where the fund given by central government can be granted to SNG without any requirements and which can be freely used (World Bank, 2010). The World Bank (2010) reveals that this grant is also defined as an equalization grant; as mentioned above because it is used in that capacity among SNGs. It means that the total amount of budget given by the central government is different from region to region; depending on each region's capacity. Article 290, Law No. 23/2014 on Local Government mentions that the total amount of DAU granted is based on the margin budget needed between a region's capacity/revenue and the fiscal needs in that region. The total amount of DAU has increased by approximately 14 percent per year, showing that DAU is an important grant in Indonesia, particularly for solving horizontal inequalities among regions (World Bank, 2010).

However, the World Bank (2010) noted that the problem of transfer grants in Indonesia is caused by a mismatch between actual revenues and expenditures for all levels of government; commonly called a vertical fiscal imbalance (VFI) (Ruggeri et al., 1993). In 2008, based on VFI calculations, the financial condition in Indonesia's central government was a deficit, while SNGs were in surplus (World Bank, 2010). This condition resulted from the allocation of some funds by the central government to SNGs, although the functions to finance some policies had been delegated to SNGs (World Bank, 2010). Thus, despite allowing SNGs to fund their policies using the budget granted, the central government is still financing affairs that are now the responsibility of regional authorities. The problem can be solved by identifying and revising financial policies in Indonesia, when and where necessary, to make clearer the responsibilities among different level governments.

### ***The Special Allocation Fund***

Based on Article 41, Law No. 33/2004 on Fiscal Balance, the SNG which receives DAK has to provide matching funds up to at least 10 percent of the total allocation of DAK. Therefore, DAK is included as a matching grant (World Bank, 2010); a grant given by the central government to a SNG, accompanied by conditional regulations, such as a funding contribution from SNG (World Bank, 2001). Article 40, Law No. 33/ 2004, on Fiscal Balance reveals that the total amount of DAK is based on criteria considering the ability and probity of finance in various SNGs.

The research from Lewis (2013) finds that DAK is the significant fund for stimulating some expenditure of capital. The most influential DAK's fund to stimulate the capital spending is in the education and health sectors (Lewis, 2013). However, although DAK has narrowed the fiscal gap among SNGs, the monitoring guidance of DAK's impact among different level governments is not properly provided in Indonesia (Bappenas, 2011). This condition makes the impact of any intergovernmental transfer systems difficult to research.

### ***Revenue-Sharing Transfers***

DBH is the fund that is allocated from a certain income of APBN to reduce the financial imbalance between central government and the SNGs (Article 1, Paragraph 49, Law of the Republic of Indonesia 23, the Year 2014, on Local Government). The income

of DBH comes from taxes and non-taxes. Taking an important role to guarantee the level of decentralization, DBH is included as an unconditional grant where the SNGs can use the fund unconditionally (World Bank, 2010). In this part, the author has focused on the system of non-taxes, because the system of taxes is examined in the next section.

The most revenue from non-taxes in Indonesia comes from exploiting natural resources by totaling \$17 billion (Thomas et al., 2014). The process of exploiting natural resources is usually carried out by SNGs because members of SNGs know better about the real condition in their area. This authority is strengthened by Article 289, Paragraph (4), Law No. 23/2014, on Local Government, that reveals SNGs have some authority to exploit natural resources, such as license fees of forest utilization or exploitation.

However, the authority emerging from decentralization tends to be improperly used by some SNG leaders. At the end of the year 2015, Indonesia suffered from widespread haze caused by forest fires, especially in some regions of Kalimantan and Sumatra (BBC, 2015). The disaster is caused by excessive deforestation to establish palm oil plantations by companies given permits to cut down the trees by SNG (Edwards, 2015). According to Edwards (2015), the permit is easily given because the SNG leaders have an unofficial agreement with the owner of the palm oil companies, in which the companies get new plantations and local leaders receive illegal payments. In conclusion, although the regions have the authority to gain money from exploiting their natural resources, in some cases that authority is used to benefit the decision makers, rather than delivering better services to the local community.

## **SYSTEM OF TAXES**

Based on Articles 281 and 289 of Law No. 23/2014, on Local Government, local taxes are included as DBH in which the SNGs have the authority to collect revenue from some taxes locally and share it with central government by a specific proportion. Bappenas (2011) explains that the amount of the local tax rate is determined by each SNG. According to the Directorate General of Tax (2012), there are some taxes that are levied by SNGs; for example vehicle tax, company or business tax and parking tax. The proportion of profit sharing from taxes is different for every type of tax. For example, SNG has 12 percent of the profit from income tax, while 90 percent profit is given to the local government in property tax (Directorate General of Financial Balance, 2012). The



different proportions depending on who has the responsibility to collect such taxes. The World Bank (2010) explains that the central government taxes tend to give a smaller proportion to SNG, while the local taxes tend to give the highest proportion to the SNGs. There are two important aspects of the tax systems that influence whether the local taxes are good or bad; namely accountability and impact of local revenue (Bahl, 2008).

Accountability of local taxes revenue in Indonesia depends on political will in every SNG. In the Explanatory Provision of Article 262, Law No. 23/2014, on Local Government, it stipulates that a SNG has to give an annual report and information needed to by citizens to ensure transparency in SNG; but without providing comprehensive regulations to make local taxes accountable. The accountability of local taxes is commonly unnoticed because people tend to think that the benefit of a grant is greater than from local tax; therefore people tend to pay little or no attention to local taxes (Bahl, 2008). This situation reveals that accountability in local taxes is not a government priority. However, the city of Surabaya implements online local taxes, where people can access the information regarding their local taxes and can pay their local taxes by using the Internet (Revenue Agency of Surabaya, 2012). The policy makes local taxes accountable and transparent because people can freely access the information of allocation of local taxes and the local taxes' impact in developing the region; transparency is both established and maintained. Thus, although accountability of local taxes depends on the political will from each SNG, the central government ought to provide a stricter set of regulations to ensure the management of local taxes is accountable.

Related to the increasing regional revenue from tax collecting, Bahl (2008) explained that generally, local taxes make little impact in mobilizing SNGs' overall revenues because SNGs rely on fund transfers from central government, such as DAU. However, the World Bank (2010) revealed that the SNGs are getting benefits of sharing revenue from taxes in Indonesia, especially property taxes, which are continuously increasing year on year. The condition is caused by a lump-sum system of sharing, where every SNG has the same proportion of taxes' income. Eventually, this helps SNGs which have smaller populations to get revenue from property tax as much as from other, more populous SNGs.

However, the capacity for collecting local taxes could hinder the overall system of local taxes (Kurniawan, 2009). CNN Indonesia (2015) reported that there are some

civil servants in the tax agency in Jakarta who were arrested by police as a result of stealing taxes. In addition, Lewis (2006) revealed that the lack of efficiency in managing local taxes makes more than half of the revenue used for administrative only. The condition can decrease the income from local taxes and impacts on delivering public services in SNGs. Therefore, the local taxes potentially increase regions' revenues, but tax collection needs a tight, well-ordered system to make both the process and the revenue appear transparent.

### **OVERALL PERFORMANCE OF FISCAL DECENTRALISATION**

Based on the evidence, research and findings presented above, in general Indonesia has a good enough framework of fiscal decentralization. Every aspect of the policy is trying to be regulated by a specific regulation. Some international reports where Indonesia managed to get a satisfactory score in several aspects of fiscal decentralization are evidence that Indonesia is serious in improving the decentralization system.

Nevertheless, oligarchic politics, corruption and very dependent on central government's funds are still the main problems of the implementation of fiscal decentralization in Indonesia. Irresponsible officials try to find loopholes so that fiscal decentralization provides group or personal benefits for them. Some of those use regulation to back their action. For example, the funds transferred from the central government in the fiscal year should not be left over. If the funds are left over, then the next fiscal year funds from the central government will be reduced by the assumption that the local government has not been able to use and absorb the budget. The regulation is used by those irresponsible officials to spend the funds in various ways, one of which is by holding fictitious activities (*see Nailufar, 2017; Tanjung 2018*). The action, of course, is a form of corruption.

Therefore, some progressive action from the central government is needed to solve the problems. One of the ways is by issuing technical and specific regulations on fiscal decentralization. Derivative regulations on fiscal decentralization must be regulated in detail. Furthermore, the regulations need to be focused on the outcome of the policy rather than just output. Rewards and punishments on the use of the funds by local governments can also be considered.

## **CONCLUSION**

Having general regulations informing every aspect of fiscal decentralization indicates Indonesia has a good framework for implementing that decentralization. Some research also offers positive findings of fiscal decentralization in Indonesia. However, there are also some serious problems resulting from the implementation of fiscal decentralization in Indonesia, such as vertical fiscal imbalance and corruption. These problems need to be reduced by issuing technical and specific regulations and by ensuring that those regulations are both monitored and implemented.

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