# 6 Twelve years of fiscal decentralization: a balance sheet

*Blane D. Lewis**

## 6.1 INTRODUCTION

The prevailing view among many policy makers, policy advisers and other interested observers in Indonesia is that decentralization has been somewhat of a disappointment. This assessment derives from the observation that local public service delivery has improved little, if at all, since the government began implementing its regional autonomy program in 2001, despite an apparently significant transfer of funds to provinces and districts to discharge their newfound responsibilities. A number of theories have been put forth to explain the seemingly meagre results of decentralization, each with its own set of policy reform prescriptions.

The main intent of this chapter is to review the experience with decentralization since 2001, to critically assess various explanations for the failure of regional autonomy to significantly improve local services and to gauge the prospects for reform going forward. First, the chapter provides a brief review of the history of fiscal decentralization in Indonesia (section 6.2). Next, it examines some of the empirical evidence on decentralized service delivery outcomes (section 6.3). It then discusses and appraises the standard rationales for poor service outcomes (section

* The author has served as an adviser to the Indonesian government on matters related to fiscal decentralization for many years, under the auspices of the Harvard Institute of International Development, the United States Agency for International Development and the World Bank, among others. The views in this chapter are the author's own and should not be attributed to any of the organizations for which he has worked.

6.4). In section 6.5, the chapter offers an alternative explanation for inadequate decentralized service delivery, and in section 6.6 it evaluates the near-term policy reform agenda for decentralization. The chapter concludes with a consideration of the likelihood of successful reform.

## 6.2 A BRIEF HISTORY OF FISCAL DECENTRALIZATION

Indonesia is a unitary country comprising central, provincial and local levels of government. Until 2001, the regional administration of public affairs operated through a hierarchical, multi-tiered and parallel system of deconcentrated central government agencies and nominally autonomous subnational units.[1] Throughout most of its history, Indonesia's public sector was counted among the most centralized in the world (Smoke and Lewis 1996; Lewis and Smoke 1998).

Many observers would date Indonesia's modern administrative and fiscal decentralization program to Law 5/1974 on Basic Principles on Administration in the Regions. This legislation did indeed provide a basis for greater involvement of decentralized subnational governments in the provision of those public services that existed at the time. In the early 1990s some implementing regulations were written and a pilot program for regional autonomy was undertaken, but little real progress was made in operationalizing the general principles outlined in the early law over the succeeding 25 years (Brodjonegoro and Asanuma 2000; Lewis 2002b).

Decentralization became more of a political imperative in the late 1990s, after the Suharto regime fell, and under the successive stewardships of Presidents Bacharuddin Jusuf Habibie and Abdurrahman Wahid. At that time, in the wake of East Timor's secession, decentralization was seen as a way of holding the country together. The impetus to move forward in a more assertive fashion derived from an important decree issued during a special session of the People's Consultative Assembly (Majelis Permusyawaratan Rakyat, MPR) in 1998. Under the MPR mandate, Indonesia embarked on an ambitious program of fiscal decentralization, perhaps one of the largest such experiments in the world (World Bank 2007).

The decentralization effort had its genesis in two laws, both promulgated in May 1999, one on administrative matters (Law 22/1999 on Regional Government) and the other on fiscal and finance issues (Law 25/1999 on the Fiscal Balance between the Central Government and the Regions). In December 2000, the national parliament (Dewan Perwakilan Rakyat, DPR) passed an additional and essential piece of decentralization legislation on subnational government taxation, Law 34/2000 on Regional Taxes and Levies. In late 2004, Indonesia initiated a redesign of its basic decentralization framework by issuing revisions to the two major pieces of legislation: Law 32/2004 on Regional Government and Law 33/2004 on the Fiscal Balance between the Central Government and the Regions. In 2009, the DPR finalized an amendment to Law 34/2000 on subnational taxes (that is, Law 28/2009), completing the second-generation design of the decentralization system. The government is currently revisiting the design of its legal and regulatory system for decentralization yet again with a view to making improvements in the near future, some time after the presidential and general elections in 2014.

Administrative and fiscal decentralization of the public sector has been complemented by active developments in national and local-level democracy. Representatives of subnational parliaments (Dewan Perwakilan Rakyat Daerah, DPRD) have been popularly elected since 2001; these parliaments, in turn, elected subnational government executives. Since 2004, however, executive heads have been chosen through direct elections.

Current laws and regulations decentralize significant responsibilities to subnational governments, especially in the social and infrastructure sectors. Subnational expenditure now makes up about half of consolidated government spending net of interest payments and subsidies. Local (as opposed to provincial) governments carry out most subnational spending; local government expenditure makes up three-quarters of the total subnational spending (World Bank 2012).[2]

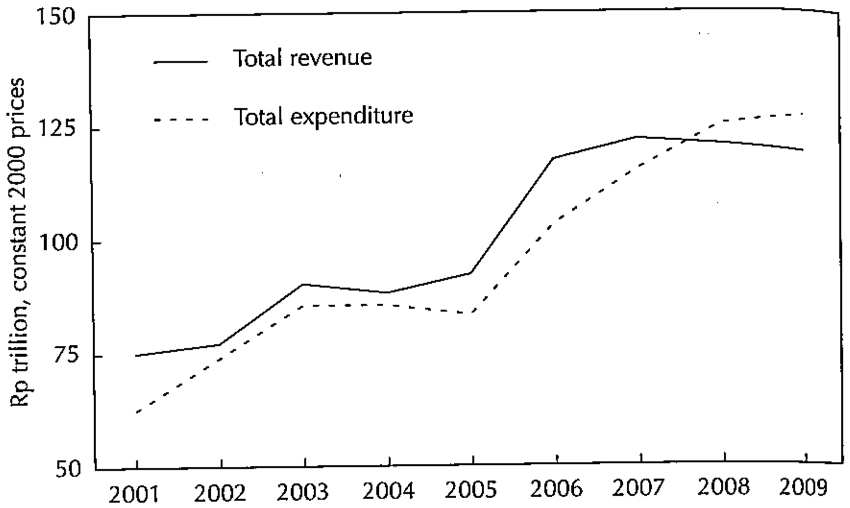
As in many developing countries, however, tax revenues in Indonesia remain very centralized (Lewis 2003b, 2003c). As a result, inter-governmental transfers dominate as a source of revenue for subnational governments, although they have almost complete discretion over how these transfers are spent (Lewis 2001, 2002a). The decentralization legislation also allows subnational governments to borrow for infrastructure development from a variety of sources: government, private financial institutions and capital markets.[3] All things considered, Indonesia has gone

1 In this chapter the term 'subnational' refers (collectively) to provinces and districts/municipalities. Districts/municipalities (or *kabupaten/kota* in the Indonesian language), which comprise the lowest tier of subnational government in Indonesia, are called 'local governments'.

2 This chapter focuses on local governments because of their relative importance in subnational fiscal affairs and service delivery.

3 See, for example, Lewis (2003a, 2007a), Lewis and Woodward (2010) and Petersen and Tirtosuharto (2013).

*Figure 6.1* Local government expenditure and revenue, 2001–09




*Source:* Directorate General of Fiscal Balance, Ministry of Finance.

from one of the most fiscally centralized countries in the world to one of the most decentralized (Alm, Aten and Bahl 2001; World Bank 2007).

Figure 6.1 shows the changes to real aggregate local government spending and revenue between 2001 and 2009, the time period for which relevant subnational budget realization data are available.[4] Local government expenditure increased from 2001 to 2003 and then remained stable through 2005; spending then increased steadily until 2008 when it flattened out. Local government revenue followed a similar pattern until 2006, then remained fairly even until the end of the period.

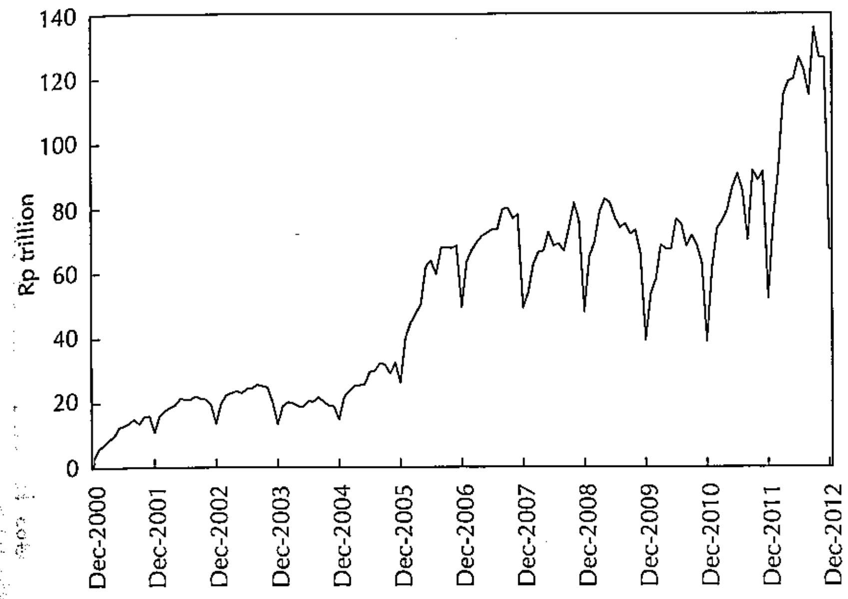
The difference between total revenue and total expenditure in any given year indicates the annual local government surplus (or deficit). Figure 6.1 illustrates nicely the well-known build-up of fiscal reserves among local governments until 2007 (Lewis and Oosterman 2009). By 2008, however, total local government spending exceeded total own-source and transfer revenues, implying that local units had begun to draw down on their significant reserves.

Figure 6.2 shows local government bank deposits from 2001 until the end of 2012 and provides a different view of the accumulation of reserves at the local level. It illustrates two main points. First, it indicates that for

4 The lag in subnational fiscal data becoming available from the Ministry of Finance has increased considerably since 2001. The data for 2010, for example, are not expected to become available until late 2013 or early 2014.



*Figure 6.2* Local government bank deposits, 2001–12




*Source:* Bank Indonesia.

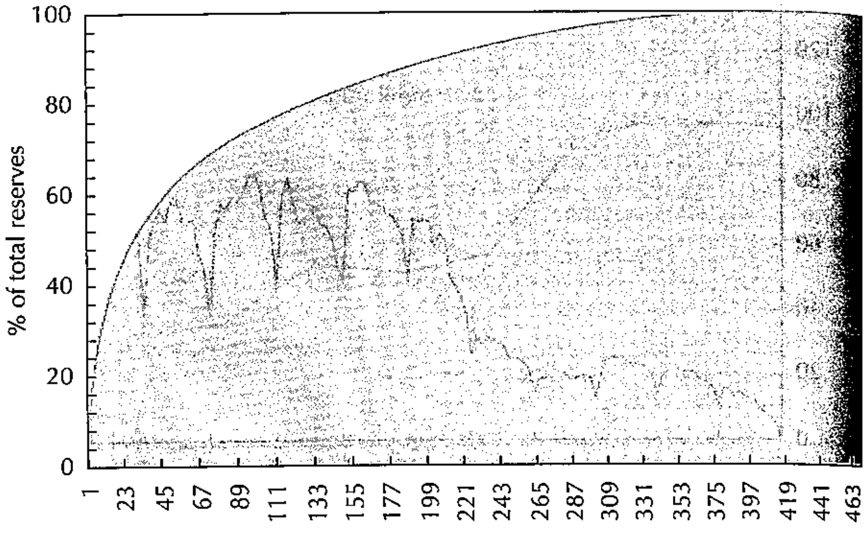
any given fiscal year local governments tend to stockpile their revenue until the last quarter of the year, at which point they quickly deplete their available resources. This clearly shows the well-known tendency of local governments to delay a significant proportion of their spending until the last couple of months of the year.

Second, the figure shows the pattern of reserve accumulation across fiscal years. As can be seen, local governments saved considerably from 2001 through 2006, especially during the latter year. Local governments began to draw down on their reserves in 2008 (as indicated also in Figure 6.1), with the depletion lasting through 2010. The process of accumulation began again in 2011 and accelerated in 2012. The source of the rise in reserves in 2011 and 2012 seems to have been a significant increase in the general purpose block grant in those two years (Lewis and Smoke, forthcoming).

Total reserves are quite concentrated, especially in large urban centres and in districts rich in natural resources. Figure 6.3 shows the cumulative distribution of reserves across numbers of subnational governments;[5] it

5 The data, which come from Bank Indonesia, do not allow a breakdown between the provincial and district levels of governments.

*Figure 6.3* *Cumulative distribution of bank deposits across subnational governments, 2011*




*Source:* Bank Indonesia.

illustrates the concentration of reserves in a relatively small number of places. Table 6.1 provides a list of the top subnational government savers; the reserves of the 10 places listed in the table, all either large metropolitan cities or districts rich in natural resource revenues, comprise nearly one-third of total reserves.

In per capita terms, the reserves are clearly concentrated in natural resource-rich areas of the country. Figure 6.4 shows per capita reserves in 2010 and 2011 by island group and for the nation as a whole. Per capita reserves in Kalimantan are considerably larger than those found elsewhere and they increased significantly (by about 50 per cent in nominal terms) between 2010 and 2011.

Table 6.2 shows local government expenditure and revenue for 2001–09 by share of major budget category. In the most recent years for which data are available (2008–09), local governments spent just over a quarter of their expenditure budgets on general administration. Another 10 per cent was assigned to health, almost one-third to education and slightly less than a quarter to infrastructure. Local governments spent just under half of their budgets on personnel, about 15 per cent on goods and services (including maintenance) and around one-third on capital expenditures.

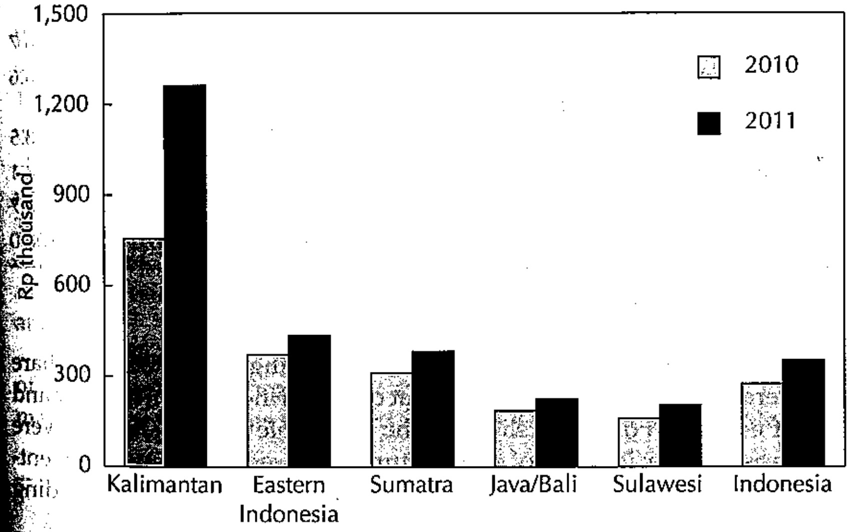


*Table 6.1* *Top subnational government savers, 2011 (Rp billion)*

| | Province | District/city | Reserves (Rp billion) | Cumulative reserves (Rp billion) | Cumulative (%) |
|---|---|---|---|---|---|
| 1 | DKI Jakarta | Central Jakarta | 7,489.7 | 7,489.7 | 9.3 |
| 2 | East Kalimantan | Samarinda city | 3,509.5 | 10,999.3 | 13.7 |
| 3 | West Java | Bandung city | 3,096.4 | 14,095.7 | 17.6 |
| 4 | Riau | Pekanbaru city | 2,086.9 | 16,182.5 | 20.2 |
| 5 | East Java | Surabaya city | 2,085.6 | 18,268.1 | 22.8 |
| 6 | East Kalimantan | Kutai Kartanegara district | 1,813.5 | 20,081.6 | 25.0 |
| 7 | Riau | Bengkalis district | 1,652.9 | 21,734.5 | 27.1 |
| 8 | Aceh | Banda Aceh city | 1,606.8 | 23,341.3 | 29.1 |
| 9 | Papua | Jayapura city | 1,338.9 | 24,680.2 | 30.7 |
| 10 | South Kalimantan | Banjarmasin city | 1,174.5 | 25,854.8 | 32.2 |

*Source:* Bank Indonesia.

*Figure 6.4* *Subnational per capita reserves by island group, 2010 and 2011*




*Source:* Bank Indonesia.

*Table 6.2* *Local government expenditure and revenue by major budget category, 2001–09 (%)*

| | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 |
|---|---|---|---|---|---|---|---|---|---|
| **Expenditure type** | | | | | | | | | |
| By sector | | | | | | | | | |
| General administration | 32.2 | 29.4 | 33.1 | 37.3 | 39.7 | 43.5 | 31.4 | 25.7 | 26.7 |
| Health | 6.1 | 6.4 | 6.6 | 6.9 | 7.0 | 6.6 | 8.7 | 9.7 | 9.7 |
| Education | 35.7 | 35.0 | 32.3 | 33.6 | 30.7 | 24.7 | 29.1 | 29.5 | 31.0 |
| Infrastructure | 12.0 | 13.1 | 15.0 | 12.1 | 12.8 | 15.1 | 19.2 | 24.7 | 22.0 |
| Other | 14.0 | 16.2 | 13.1 | 10.1 | 9.8 | 10.1 | 11.6 | 10.5 | 10.6 |
| | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |
| By economic classification | | | | | | | | | |
| Staff | 55.2 | 49.8 | 47.2 | 52.5 | 49.4 | 42.0 | 45.9 | 44.5 | 44.0 |
| Goods & services | 18.4 | 20.9 | 20.3 | 19.4 | 20.8 | 22.1 | 17.1 | 17.4 | 14.8 |
| Capital | 17.9 | 19.7 | 22.4 | 18.3 | 20.7 | 27.1 | 29.3 | 29.8 | 32.5 |
| Other | 8.5 | 9.7 | 10.1 | 9.9 | 9.1 | 8.8 | 7.7 | 8.3 | 8.6 |
| | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |
| **Revenue type** | | | | | | | | | |
| Own-source revenue | 6.7 | 8.0 | 7.6 | 8.3 | 7.8 | 6.8 | 7.7 | 7.3 | 7.3 |
| Inter-governmental transfers | | | | | | | | | |
| Shared tax revenue | 7.4 | 8.1 | 8.9 | 11.2 | 11.0 | 10.5 | 8.7 | 8.6 | 8.7 |
| Shared natural resource revenue | 10.9 | 10.2 | 9.6 | 7.2 | 12.6 | 10.1 | 8.2 | 9.9 | 8.6 |
| General purpose grant | 70.3 | 67.9 | 62.8 | 62.1 | 55.8 | 60.8 | 60.5 | 57.7 | 58.5 |
| Special purpose grant | 1.1 | 0.8 | 3.0 | 3.0 | 3.1 | 5.7 | 6.9 | 7.3 | 8.1 |
| Other | 3.6 | 5.1 | 8.1 | 8.2 | 9.6 | 6.2 | 8.0 | 9.2 | 8.7 |
| | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |

*Source:* Directorate General of Fiscal Balance, Ministry of Finance.

Expenditure shares fluctuated somewhat during the period. The share of general administration declined, that of health increased modestly and that of education dropped slightly. The most noteworthy changes were for infrastructure; its share of expenditure increased by about 10 percentage points between 2001 and 2009.[6] The share of personnel spending

6 Infrastructure spending comprises both capital and routine spending. Capital spending on infrastructure dominates routine spending in the sector. From



declined during the period, as did that of goods and services, while the importance of capital expenditures grew quite significantly.

As Table 6.2 indicates, inter-governmental transfers are by far the main source of revenue for local governments, comprising over 90 per cent of total local budgets. These transfers are of four main types: shared tax revenues, shared non-tax revenues (from natural resources), general purpose grants (Dana Alokasi Umum, DAU) and special purpose grants (Dana Alokasi Khusus, DAK). The DAU is quantitatively the most important transfer, making up almost 60 per cent of total local government revenue. Shared tax revenue and shared non-tax revenue each comprise about 9 per cent of total revenue, while the DAK makes up about 8 per cent of the total. Own-source revenue contributes only around 7 per cent of local government revenue.

Revenue shares have also changed somewhat over the period. The share of own-source revenue essentially remained flat during the period studied here, while that of shared tax revenue increased modestly and that of natural resource revenue decreased. The DAU has exhibited the most change; its share fell from 70 per cent in 2001 to less than 60 per cent in 2009. The share of the DAK, meanwhile, rose from just 1 per cent to about 8 per cent over the time frame.

## 6.3 DECENTRALIZED SERVICE DELIVERY OUTCOMES: A SYNOPSIS

When decentralization began in 2001, the general and strong expectation was that local public service delivery would much improve (Lewis 2005). This expectation was based on standard fiscal decentralization theory, which suggests that proximity of local governments to their constituents allows the former to better identify and respond to the service delivery needs of the latter (at least when compared to the central government). The effectiveness of decentralized service delivery has fallen short of expectations, however. Service delivery outcomes in major sectors such as health, education and infrastructure have proven decidedly mixed, at best.

Immunization rates have increased quite rapidly throughout much of the country but progress in reducing both child malnutrition and maternal mortality has stagnated in recent years (World Bank 2012). Net

2001 to 2009, for example, it made up just over 70 per cent of the total (not shown in Table 6.2). See Lewis and Oosterman (2010) and Lewis (2013a) for a discussion of capital spending and the impact of various transfers on such expenditure.

school enrolment rates have risen at all levels (except primary school, where rates were already near 100 per cent) but the quality of education remains problematic. While Indonesian students' reading scores on the Programme for International Student Assessment (PISA) examination improved steadily between 2000 and 2009, their maths scores did not advance and their science scores actually deteriorated (World Bank 2012).

Perhaps most problematic is the lack of improvement in infrastructure services. Some progress has been made on a few service delivery indicators; district road length, for example, has grown on average by 3.5 per cent per year since 2001. But road quality has deteriorated; about 40 per cent of district roads are currently classified as in poor condition, up from 35 per cent in 2001. Access to water services has also declined since decentralization; the percentage of households with access to safe water has actually dropped from 50 per cent to 48 per cent (World Bank 2013).

Indonesian businesses consistently identify the poor quality of infrastructure as a severe constraint on their operations. A recent survey by Regional Autonomy Watch (2011) found that nearly 40 per cent of enterprises throughout the country identified infrastructure as the single most important restriction on their business activities. (No other constraint was cited by more than 15 per cent of respondents.) Firms reported difficulties with most types of traditional infrastructure but singled out roads, and to a lesser extent power, as particularly problematic. Thus poor infrastructure is not only a 'consumer service' delivery problem in Indonesia but also one that constrains economic growth (Day and Lewis 2013; Lewis 2013b; Lewis and Niazi, forthcoming).

Indonesian public services also do not fare well from an international comparative perspective. The nation generally performs in the middle range of countries in the region on most health and education delivery indicators – typically better than Cambodia and India, for example, but worse than Thailand, Vietnam and the Philippines. But it ranks among the worst-performing countries in the world in terms of the quality of its infrastructure and, within the region, better only than the Philippines (World Bank 2013).

## 6.4 STANDARD RATIONALES FOR DEFICIENT SERVICE OUTCOMES: A CRITICAL REVIEW

A number of reasons have been offered to explain Indonesia's unsatisfactory local service delivery outcomes. Not surprisingly, perhaps, the explanations offered by the various institutions involved in the delivery of services differ considerably. Subnational governments and some central line agencies, such as the Ministry of Education and the Ministry of Public Works, argue that levels of provincial and district funding are inadequate. (The subnational governments want larger untied grants while the central agencies want more funds under their own control, of course.) Other central government departments, such as the Ministry of Finance and the Ministry of Home Affairs, claim that a lack of subnational implementation capacity is the main constraining factor. Finally, many international agencies, including the World Bank, focus on various inadequacies in the inter-governmental fiscal system to explain the poor outcomes.



### Levels of funding

The argument that regions, in general, lack sufficient funds to deliver improved public services seems implausible. Transfers to subnational governments now make up approximately one-half of the state budget, net of subsidies and interest payments, or about 6 per cent of GDP. It is hard to see how central–local transfers could be much larger than they are given the country's current fiscal circumstances. Qualitative evidence suggests that Indonesian local governments are better funded than their counterparts in most countries in the region (Lewis and Searle 2011). Although it is difficult to obtain hard data with which to compare a wide range of countries in the region, recent analysis shows that transfers to third-tier subnational governments make up only 0.4 per cent of GDP in India and 3 per cent in the Philippines, compared with approximately 5 per cent of GDP in Indonesia (Lewis 2013f). All things considered, it would appear that Indonesian local governments, in general, have sufficient funds to deliver services at a better standard than they currently do.[7]

A more credible proposition is that subnational governments spend their funds in an inefficient and ineffective manner. They spend too much on administration and personnel, for example, and not enough on actual service delivery. Recent analysis shows that administrative spending by districts in Indonesia, which amounts to more than one-quarter of total budgetary expenditure, far exceeds international best practice, which posits reasonable administrative spending of less than 5 per cent of budgets (Lewis 2006; Sjahrir, Kis-Katos and Schulze 2013). Other research implies that local government spending on personnel has a positive effect on education and health service outcomes only up to

7 Of course, given distributional problems related to transfers, it may be that some districts do not have enough funds to deliver services well. The argument here, however, is that most local governments are sufficiently financed.

some point, beyond which the impact is negative (Lewis 2013d).[8] More broadly, the general level of spending appears to have little or no effect on a wide range of service outcomes (Lewis and Pattinasarany 2011; World Bank 2012).

There is one dimension of the funding inadequacy argument that appears more legitimate, however, and that concerns subnational loan finance. Subnational governments in Indonesia have borrowed exceedingly little both before and since decentralization. In real terms, total subnational borrowing - including that by water enterprises (*perusahaan daerah air minum*, PDAM) - over the past 35 years has amounted to less than 1 per cent of current GDP (Lewis 2007a). Contrast this with the situation in the Philippines, for example, where local governments have borrowed about 1 per cent of GDP per year in recent years (World Bank 2013). Of course, part of the explanation lies in the fact that the Philippines has dedicated financial institutions to lend to local governments for the construction of infrastructure whereas Indonesia does not. In any case, inadequate borrowing is not typically what proponents of the funding shortfall argument have in mind. In fact, subnational governments in Indonesia continue to show limited interest in borrowing for capital development - they typically (and unrealistically) prefer to have all their funds in grant form (Lewis and Woodward 2010).

### Capacity

The issue of subnational implementation capacity is somewhat less straightforward to examine than the funding question. It is notoriously difficult to define and measure capacity well; there is no hard evidence in Indonesia that can be used to inform the debate. Indonesia is still a developing nation, so the capacity of subnational governments to deliver services tends not to be as high as it is in more modern countries. At the same time, experience shows that there is a great deal of variation across subnational governments in Indonesia, with the best among them being quite well run (Lewis 2010).

A specific illustration often used to bolster claims of a lack of capacity concerns the subnational build-up of fiscal reserves. The argument made is that subnational governments have insufficient capacity to spend even the funds they are allocated. However, as was shown in section 6.2 of this chapter, reserves tend to be concentrated in a relatively small number of places. This fact argues against the generality of the claim. Moreover, it is not clear that the fiscal reserves are in any way excessive, even

8 The point at which the effect of spending becomes negative was estimated to be around the 60th percentile of current district spending.



for those local governments that do maintain significant balances. It has been demonstrated, for example, that a not-implausible decrease in the price of oil could reduce revenue-sharing transfers to oil-rich local governments significantly; and that these reduced transfers could lead to the total elimination of fiscal reserves in a relatively short time, if local governments were to draw down on those reserves in order to maintain spending at a constant level (Lewis and Oosterman 2009). This calls into question the logic of even trying to spend all funds that are allocated.

Still, one may easily agree with the argument that a lack of capacity surely constrains local policy development and program execution to some extent, in some places. Deficiencies in local government planning and financial management (and, especially, the links between the two) merit some mention in this regard (Lewis 2010). The important question about potential capacity shortfalls, however, is to what extent they occur and where. The view here is that capacity constraints are not binding for a very large number of places. Otherwise put, the vast majority of subnational governments could deliver better quality services now with the capacity they already have.

### Inter-governmental framework

A number of potential difficulties with the current inter-governmental fiscal arrangements have been raised over the years. Perhaps the most frequently discussed are the limited and improper role of provinces; unclear and unsuitable expenditure assignments; inadequate tax decentralization and own-source revenue mobilization; and the inappropriate structure and design of various inter-governmental transfers. Specific issues directly related to these areas of difficulty have been thoroughly reviewed elsewhere,[9] and recapitulation of the various arguments, conclusions and proposals for reform is beyond the scope of the current chapter. The discussion below focuses instead on two additional and broader issues that cut across each of the aforementioned problems: the 'one-size-fits-all' nature of the inter-governmental system, and the nearly complete dearth of fiscal incentives to encourage improved performance at the local level. These cross-cutting issues arguably subsume most other concerns.

9 The role of provinces is discussed in Ferrazzi, Dwiyanto and Effendi (2013); expenditure assignments in Lewis and Chakeri (2003) and Adrison, Martinez-Vazquez and Nurhalim (2013); tax assignments and own-source revenue mobilization in Lewis (2007b), Lewis and Sjahrir (2009) and Smoke and Sugana (2013); and inter-governmental transfer design and implementation in Lewis (2001, 2002a, 2002b), Shah, Qibthiyyah and Dita (2012), Agustina et al. (2013) and Lewis and Pattinasarany (2013).

It is unmistakably the case that the inter-governmental system treats local governments as if they were broadly similar entities. Expenditure and tax assignments are essentially the same for all districts, and the allocation of transfers (with the obvious exception of natural resource revenue sharing) tends not to differentiate sufficiently among types of local governments. Large municipalities, small and medium-sized cities, and rural districts are all treated more or less equivalently from a fiscal point of view. This aspect of the system clearly has some negative impact on the proper determination of subnational fiscal needs and capacities and therefore on the appropriate resourcing of provincial and local governments (that is, from an equalization standpoint). Its effect on actual service delivery is less clear, however, since level of funding appears to be weakly related to the quality of services.

The second issue of incentives in the inter-governmental system, or the lack thereof, has received significant attention in the past few years (Lewis and Smoke 2009, 2012). Two separate concerns may be identified in this regard. One relates to the so-called inadvertent or perverse incentives that exist in the framework, and the other to constructive incentives that might purposely be embedded in the system. The conventional wisdom is that the system needs to be redesigned to expunge perverse incentives, which negatively influence service delivery outcomes. In addition, many policy advisers have advocated that the government should incorporate more positive or constructive incentives into the system through the development and use of performance grants.

Recent studies cast doubt on at least some of the conventional wisdom, however. Lewis (2013e) and Lewis and Smoke (forthcoming), for example, argue that there is no empirical evidence to suggest that the magnitude of inter-governmental transfers, in general, provides a disincentive for local governments to increase their own-source revenues, as many observers have suggested. Neither does the evidence support the widely held assertion that the DAU, in particular, strongly discourages own-source revenue generation. On the other hand, the evidence is at least consistent with the assumption that the DAU provides an incentive for local governments to increase local personnel spending. However, since local governments probably want to spend funds on staff salaries and allowances anyway, any specific incentives in the DAU to promote such increased spending are likely to be redundant.

Research does seem to support the orthodox point of view on performance grants, at least tentatively. Indonesia is currently conducting two main experiments with inter-governmental performance grants: the DAK reimbursement scheme, and the water and sanitation grant (*hibah*). These programs have been in operation for a couple of years, and preliminary impact evaluations have now been carried out for both (Lewis 2013c, 2013g). The initial evidence suggests mixed but promising results.



The DAK reimbursement scheme appears to have led to improved reporting on project implementation in a limited number of circumstances and to more stimulative local government capital spending. The water and sanitation initiative seems to have resulted in some increased local government equity investments in water enterprises (PDAM) and in more household water connections, especially for the poor. Beyond that, however, the Indonesian experience demonstrates that the design of successful performance grants is a challenging exercise and that positive effects are not easily achieved. Expectations about the impact of performance grants should therefore be measured carefully against the real prospects for success (Lewis and Smoke 2009, 2012).

### Summary

The findings of this section do not support the argument that subnational governments are insufficiently funded, in general, although they should be given better access to finance for local infrastructure development. The claim that lack of subnational management capacity severely constrains service delivery also seems exaggerated, for all but a limited number of places. The uniform treatment of heterogeneous subnational units in policy design and implementation is clearly a problem for the proper resourcing of provinces and districts. The extent to which this approach affects the quality of local service delivery is unclear, however, since it appears that the level of funding has little to do with service outcomes. Perhaps it is best to think of this dimension of decentralization policy as more of a problem-in-waiting. The assertion that perverse incentives in inter-governmental transfers have major deleterious local fiscal effects seems mostly unfounded. Finally, the limited initial experience with inter-governmental performance grants appears positive in terms of encouraging better service delivery, although care must be taken not to overstate the likely positive impacts. In any case, while the legitimacy of some of the above obstacles is acknowledged, taken together they would seem insufficient to explain the meagre outcomes for local public service delivery under decentralization.

## 6.5 AN ALTERNATIVE EXPLANATION FOR WEAK SERVICE OUTCOMES

An alternative explanation for poor service delivery outcomes would focus on the lack of downward accountability of local governments towards their constituents (Lewis 2010; Wihardja 2013). It is well known from international experience that weak accountability and poor public services go hand in hand (Lewis 2010). Accountability in this context actually has two separate dimensions: an appeal from citizens for improvements to service quality, and a response by local governments to meet constituents' demands. Appeals from citizens implicitly presuppose in the first instance the existence of some reasonable measure of dissatisfaction with the status quo.

In Indonesia it turns out that citizens actually seem quite satisfied with the quality of local public service delivery. A fairly large survey found that 78 per cent, 90 per cent and 85 per cent of respondents were at least somewhat satisfied with the quality of local administrative, health and education services respectively. Less than 30 per cent of the randomly selected households in the study indicated that they wanted better administrative and social services and were willing to pay for them. In fact, only 7 per cent of households had ever formally complained about the quality of local government services. Of those that had not complained, more than 90 per cent said it was because they had no complaints about service quality (Lewis and Pattinasarany 2009). Other studies have reported similarly high levels of satisfaction with local public services in Indonesia (Research Triangle Institute 2006).[10]

So it would seem that the lack of downward accountability at the local level in Indonesia may in large measure be a function of insufficient citizen demand for higher service quality. This, in turn, provides a clear and robust explanation for the lack of observed improvements in local public service quality under decentralization. That is, if citizens are already reasonably satisfied with the quality of service delivery, there would seem to be little reason for local governments to strive to improve it. Of course, enhancing the quality of service delivery might reasonably be taken as a local government obligation, but most local officials in Indonesia apparently do not see it as such.

## 6.6 NEAR-TERM POLICY REFORM AGENDA

A reasonable policy agenda could be derived from the preceding discussion of constraints on improving local service delivery. Such an agenda

10 These high levels of satisfaction may be due in part to a courtesy bias among respondents. In the present context, Lewis and Pattinasarany (2009) conclude that while such a bias probably is present, it does not reverse the conclusion that Indonesians are quite satisfied with the quality of local public services. They argue that a more likely explanation for citizens' high levels of satisfaction relates to their low expectations of service quality.



might include the development of a special purpose vehicle for lending to subnational governments for infrastructure as well as specific, well-targeted capacity-building efforts. Policy makers might also focus on restructuring the system to account for the considerable heterogeneity that exists among local governments in Indonesia. This would entail reforming expenditure assignments, tax assignments and transfer allocation methods across local governments of different types: large municipalities, small and medium-sized cities, and predominately rural areas, for example. In addition, given the recent positive experience with intergovernmental incentive programs, the central government might expand its efforts to develop and implement performance grants. It is recognized, of course, that executing this agenda would be a major undertaking.

In any case, this does not seem to be what the Ministry of Finance has in mind, judging by current draft revisions of Law 33/2004 on the Fiscal Balance between the Central Government and the Regions. Instead, the ministry seems to be opting for a minimalist approach to reform of the inter-governmental system. Its line of attack implicitly assumes that for the most part the inter-governmental fiscal system is working quite well; in its view, tinkering at the margin may be called for but there is no need for a major overhaul. Many officials may recognize that there are problems with service delivery, of course, but they do not seem to believe that such difficulties are the fault of the central–provincial–local fiscal framework. The prevailing strategic view is that it is the ministry's job to deliver the funds to meet stated grant objectives, which focus largely on equalizing fiscal capacity across subnational governments of similar types (that is, provinces and districts), and to a lesser extent assuring neutrality in allocations, and that when this happens local public service delivery will take care of itself.

## 6.7 CONCLUSIONS: PROGNOSIS FOR SUCCESSFUL REFORM

There are two main problems with the Ministry of Finance's stance on the state of inter-governmental fiscal relations. First, the system does not perform particularly well even by its own standards – fiscal equalization and neutrality. It is well known that the current system of transfers results in wide disparities in resource allocation;[11] and the discussion above on perverse incentives suggests that the system is less neutral than it might be (at least with regard to staff expenditures). Second, principles of fiscal equalization and neutrality in grant design and allocation work

11 See, for example, Lewis (2002b), Arze (2005), Hofman et al. (2006), Fadliya and McLeod (2010) and World Bank (2012).

well in terms of assuring reasonable service delivery outcomes only in situations where there is strong local demand to guide (and insist on) the supply of public services. As noted above, this seems not to be the case in Indonesia. If the Ministry of Finance cannot be counted on to take a more proactive approach to inter-governmental fiscal policy design and implementation along the lines discussed above, then there is not much hope in the short term that service delivery outcomes will improve, even at the margin.

Of course, the other possibility is that the quality of local services in Indonesia is already good enough and that there is no real need for improvement. The objective evidence seems to indicate that this is not true, but on the other hand, it appears as if Indonesian citizens themselves are reasonably satisfied with the amount and quality of local service delivery. At least, they report that they are content and they declare that they are unwilling to pay for improvements to public services. If this is the situation, then Indonesians may already have the decentralized system of government that they want and deserve.

The view in this chapter is that the status quo is not acceptable, however. As such, it would seem that perhaps the most important initiative that could be undertaken to reform the fiscal decentralization system would be to convince the citizens of Indonesia that they deserve better and to encourage them to express their demands to their district leaders. Only then will local governments be forced to make good on the theoretical benefits of decentralization. This is clearly an objective that can only be realized in the long term.

## REFERENCES


Adrison, V., J. Martinez-Vazquez and E. Nurhalim (2013) 'The reform of expenditure assignments at the local level in Indonesia', in *New Visions for Decentralization in Indonesia*, World Bank, Jakarta.

Agustina, C.D., A. Ehtihsam, D. Nugroho and H. Siagian (2013) 'Political economy of natural resource revenue sharing in Indonesia', in *New Visions for Decentralization in Indonesia*, World Bank, Jakarta.

Alm, J., R. Aten and R. Bahl (2001) 'Can Indonesia decentralise successfully? Plans, problems and prospects', *Bulletin of Indonesian Economic Studies*, 37(1): 83–102.

Arze, J. (2005) 'Fiscal equalization impact of changes to DAU allocation mechanism', unpublished paper, World Bank, Jakarta.

Brodjonegoro, B. and S. Asanuma (2000) 'Regional autonomy and fiscal decentralization in democratic Indonesia', *Hitotsubashi Journal of Economics*, 41(2): 111–22.

Day, J. and B.D. Lewis (2013) 'Beyond univariate measurement of spatial autocorrelation: disaggregated spillover effects for Indonesia', *Annals of GIS*, 19(3): 169–85.





Fadliya and R.H. McLeod (2010) 'Fiscal transfers to regional governments in Indonesia', Working Paper No. 2010/14, Crawford School of Economics and Government, Australian National University, Canberra.

Ferrazzi, G., A. Dwiyanto and C. Effendi (2013) 'The future role of the province in Indonesia in public service delivery and financing: understanding and assessing options', in *New Visions for Decentralization in Indonesia*, World Bank, Jakarta.

Hofman, B., Kadjatmiko, K. Kaiser and B.S. Sjahrir (2006) 'Evaluating fiscal equalization in Indonesia', unpublished paper, World Bank, Jakarta.

Lewis, B.D. (2001) 'The new Indonesian equalisation transfer', *Bulletin of Indonesian Economic Studies*, 37(3): 325–43.

Lewis, B.D. (2002a) 'The general purpose grant', in B. Resosudarmo, A. Alisjahbana and B. Brodjonegoro (eds) *Indonesia's Sustainable Development in a Decentralization Era*, Indonesian Regional Science Association, Bandung.

Lewis, B.D. (2002b) 'Indonesia', in P. Smoke and Y.-H. Kim (eds) *Intergovernmental Transfers in Asia: Current Practice and Challenges in the Future*, Asian Development Bank, Manila.

Lewis, B.D. (2003a) 'Local government borrowing and repayment in Indonesia: does fiscal capacity matter?', *World Development*, 31(6): 1,047–63.

Lewis, B.D. (2003b) 'Property tax in Indonesia: measuring and explaining administrative (under-) performance', *Public Administration and Development*, 23: 227–39.

Lewis, B.D. (2003c) 'Tax and charge creation by regional governments under fiscal decentralisation: estimates and explanations', *Bulletin of Indonesian Economic Studies*, 39(2): 177–92.

Lewis, B.D. (2005) 'Indonesian local government spending, taxing and saving: an explanation of pre- and post-decentralization fiscal outcomes', *Asian Economic Journal*, 19(3): 291–317.

Lewis, B.D. (2006) 'Local government taxation: an analysis of administrative cost inefficiency', *Bulletin of Indonesian Economic Studies*, 42(2): 213–33.

Lewis, B.D. (2007a) 'On-lending in Indonesia: past performance and future prospects', *Bulletin of Indonesian Economic Studies*, 43(1): 35–57.

Lewis, B.D. (2007b) 'Revisiting the price of residential land in Jakarta', *Urban Studies*, 44(11): 2,179–94.

Lewis, B.D. (2010) 'Indonesian fiscal decentralization: accountability deferred', *International Journal of Public Administration*, 33(12): 648–57.

Lewis, B.D. (2013a) 'Local government capital spending in Indonesia: impact of intergovernmental fiscal transfers', *Public Budgeting and Finance*, 33(1): 76–94.

Lewis, B.D. (2013b) 'Urbanization and economic growth in Indonesia: good news, bad news and (possible) local government mitigation', *Regional Studies*, available at http://rsa.tandfonline.com/doi/abs/10.1080/00343404.2012.748980?journalCode=cres20.

Lewis, B.D. (2013c) 'DAK reimbursement performance grant impact analysis: district counterpart funding, reporting, and capital spending', policy note prepared for World Bank, Jakarta.

Lewis, B.D. (2013d) 'Explaining district education and health outcomes in Indonesia', analytical note prepared for World Bank, Jakarta.

Lewis, B.D. (2013e) 'Intergovernmental transfers and perverse incentives in Indonesia: unmet assumptions, unsatisfactory recommendations', policy note prepared for World Bank, Jakarta.

Lewis, B.D. (2013f) 'Municipal revenues, expenditures, and access to infrastructure services in India', background paper prepared for South Asia Urbanization Flagship, World Bank, Washington DC.

Lewis, B.D. (2013g) 'Water *hibah* impact: local government investments in PDAM and the establishment of household water connections', report prepared for Indonesian Infrastructure Initiative (IndII), Jakarta.

Lewis, B.D. and J. Chakeri (2003) 'Central development spending in the regions post-decentralisation', *Bulletin of Indonesian Economic Studies*, 40(3): 379–94.

Lewis, B.D. and T. Niazi (forthcoming) 'Fiscal decentralization in Indonesia: local infrastructure impact and finance', in Asian Development Bank, *Subnational Public Sector Finance and Financial Management in Asia*, Asian Development Bank, Manila.

Lewis, B.D. and A. Oosterman (2009) 'The impact of decentralization on subnational government fiscal slack in Indonesia', *Public Budgeting and Finance*, 29(2): 27–47.

Lewis, B.D. and A. Oosterman (2010) 'Subnational government capital spending in Indonesia: level, structure and financing', *Public Administration and Development*, 31(3): 135–228.

Lewis, B.D. and D. Pattinasarany (2009) 'Determining citizen satisfaction with local public education in Indonesia', *Growth and Change*, 40(1): 85–115.

Lewis, B.D. and D. Pattinasarany (2011) 'The cost of primary education in Indonesia: do schools need more money?', *Education Economics*, 19(4): 397–410.

Lewis, B.D. and D. Pattinasarany (2013) 'A new intergovernmental capital grant for Indonesia: a polemic in support of economic growth', in *New Visions for Decentralization in Indonesia*, World Bank, Jakarta.

Lewis, B.D. and B. Searle (2011) 'Asia-Pacific', in United Cities and Local Governments (ed.) *Local Government Finance: The Challenges of the 21st Century*, Edward Elgar, Cheltenham.

Lewis, B.D. and B.S. Sjahrir (2009) 'Local tax effects on the business climate', in N. McCulloch (ed.) *Rural Investment Climate in Indonesia*, Institute for Southeast Asian Studies, Singapore.

Lewis, B.D. and P. Smoke (1998) 'Reply to Beier and Ferrazzi', *World Development*, 26(12): 2,213–17.

Lewis, B.D. and P. Smoke (2009) 'Incorporating subnational performance incentives in the Indonesian intergovernmental framework', in National Tax Association (ed.), *NTA Proceedings from the 101st Annual Conference in Philadelphia, PA*, National Tax Association, Washington DC.

Lewis, B.D. and P. Smoke (2012) 'Incentives for better local service delivery: international experience and relevance for Indonesia', in *Fiscal Decentralization in Indonesia a Decade after the Big Bang*, Ministry of Finance, Jakarta.

Lewis, B.D. and P. Smoke (forthcoming) 'Intergovernmental transfers in Indonesia: local incentives and responses', *Fiscal Studies*.

Lewis, B.D. and D. Woodward (2010) 'Restructuring Indonesia's sub-national public debt: reform or reversion?', *Bulletin of Indonesia Economic Studies*, 46(1): 65–78.

Petersen, J. and D. Tirtosuharto (2013) 'Capital financing by Indonesian local governments: will subnational bonds (finally) play a part?', in *New Visions for Decentralization in Indonesia*, World Bank, Jakarta.

Regional Autonomy Watch (2011) 'Local economic governance: a survey of business operators in 245 districts/municipalities in Indonesia, 2011', Regional Autonomy Watch and Asia Foundation, Jakarta.



Research Triangle Institute (2006) 'Government opinion polling summary report', unpublished paper, USAID Local Government Support Project, Research Triangle Institute, Research Triangle Park, North Carolina, November.

Shah, A., R. Qibthiyyah and A. Dita (2012) 'General purpose central-provincial-local transfers (DAU) in Indonesia: from gap filling to ensuring fair access to essential public services for all', Policy Research Working Paper No. 6075, World Bank, Jakarta, June.

Sjahrir, B.S., K. Kis-Katos and G.G. Schulze (2013) 'Administrative overspending in Indonesian districts: the role of local politics', Discussion Paper Series No. 24, Department of International Economic Policy, University of Freiburg, Freiburg, July.

Smoke, P. and B.D. Lewis (1996) 'Fiscal decentralization: a new approach to an old idea', *World Development*, 24(8): 1,281–99.

Smoke, P. and R. Sugana (2013) 'Subnational own-source revenues and shared taxes in Indonesia: taking stock and looking forward', in *New Visions for Decentralization in Indonesia*, World Bank, Jakarta.

Wihardja, M.M. (2013) 'Political and institutional obstacles to delivering public goods and services', draft report, World Bank, Jakarta.

World Bank (2007) *Decentralizing Indonesia*, World Bank, Jakarta.

World Bank (2012) 'Indonesia subnational public expenditure review: optimizing subnational performance for better services and faster growth', World Bank, Jakarta.

World Bank (2013) 'Subnational debt policy technical assistance', World Bank, Manila.