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Introduction

After decades of operating a highly centralized system, the Government of Indonesia (GOI) embarked on a substantial program of decentralization in the wake of the financial and political crisis that emerged in 1997. Law No. 22 laid out a broad framework for general administrative and political decentralization, and Law No. 25 of 1999 (supplemented by Law No. 34 of 2000) outlined a system of fiscal decentralization. These laws particularly focused on defining a stronger role for local governments, or regions (kotamadya and kabupaten, the former Level II regional governments) as opposed to provincial (former Level I regional governments).

Indonesia has struggled during the past few years to move forward with the detailed design and implementation of the decentralized system outlined in the 1999 decentralization laws. One key issue is clearly identifying the set of functions that local governments can and should undertake—the so-called “expenditure assignment” question. This paper very briefly reviews relevant conceptual principles of expenditure assignment, summarizes the history of expenditure assignment in Indonesia and new
arrangements under the emerging situation, and considers outstanding expenditure assignment issues that Indonesia has yet to deal with.

**Basic Principles**

The conventional wisdom about expenditure assignment among levels of government from the fiscal federalism literature is well known. Among the broad functions of the public sector—stabilization, distribution and allocation—the first two are widely considered to be the responsibility of the central government. Sub-national governments do not necessarily undermine stabilization, and they could potentially contribute in a positive way, but this would not be an appropriate expectation given the typical characteristics of local revenue and expenditure systems. Sub-national governments can also contribute to intra-jurisdictional redistribution, but there are limits on how far this can go because of the potential effects of significant inter-jurisdictional tax and expenditure differentials on location decisions. In addition, only the central government can alleviate fiscal disparities across sub-national governments.

The fiscal federalism approach gives considerable attention to the potentially important role of sub-national governments in allocation. This is considered to be substantial where demand for public services is not uniform across sub-national jurisdictions. Welfare would be enhanced through decentralization because residents in different jurisdictions could choose the mix of public activities that best matches their preferences. This could happen via movement of citizens to their preferred location and/or the articulation of public service demand through collective decision-making in each jurisdiction. Exceptions to the general rule of decentralizing to maximize allocative efficiency include services that exhibit economies of scale in production or that generate inter-jurisdictional externalities. Transactions costs involved in service responsibility transfers must also be taken into account.
There is a small literature that considers the extent to which the conventional literature on expenditure assignment, which was developed largely in the context of the United States and other industrialized nations, is relevant in developing countries. A number of explicit and implicit assumptions underlying fiscal federalism may be violated in some developing countries. The applicability of conventional models of public choice and the existence of an adequate legal basis for an effective intergovernmental system, for example, are among the potential concerns. Even if basic assumptions are essentially valid, local conditions that are fairly common in developing countries can substantially affect the way fiscal federalism principles should be interpreted. Widespread poverty, for example, may make preferences more homogeneous across local jurisdictions, justifying greater centralization. This could be offset, however, by substantial spatial diversity in local environments and economic bases, and/or by the existence of widely dispersed and poorly linked settlements. More generally, a variety of cultural, political and institutional conditions can influence the need and prospects for fiscal decentralization. Since these factors can vary widely across countries and can move the system in different directions, their relative importance must be understood in analyzing a specific case. In fact, it is generally recognized that there is no single best assignment of expenditure functions, and that what is appropriate could vary over time as a country develops.

The principles for assignment of services to local governments as developed in the fiscal federalism literature and summarized above at a very general level are fairly clear, and there is no need to elaborate on them further here. Many countries, both industrialized and developing, generally do in fact follow these principles in a very broad way. A lack of formality and clarity in assignments among levels of government, however, is common in developing countries, and sometimes functions are co-provided among levels in ways that undermine accountability and complicate service
delivery. In addition, a number of inefficiencies occur in developing countries with some frequency, such as the centralization of investment authority for services that local governments have operational responsibility for, and central provision of public utilities that are more appropriately sub-national functions. Less common is the practice of assigning major social services to sub-national governments, which is particularly problematic where adequate central financial support is not forthcoming.

**Options for Approaching Expenditure Assignment and Fiscal Decentralization**

In the real world, service assignment is not a purely technical matter, and it cannot be separated from the broader process of decentralization. A mature decentralized system has at least six principal characteristics:

- A basic enabling framework that assigns definitive legal or constitutional status to sub-national levels of government;
- Clearly defined functions and responsibilities for each level of government;
- Appropriate local sources of revenue over which sub-national governments are given some control to establish a link between benefits and costs of local services;
- Adequate development of the local political system, such that constituents can place appropriate demands on local governments and hold local officials accountable for their performance;
- Sufficient technical and managerial capacity to allow local governments to meet the legitimate demands of their constituents and any mandates essential to achieve key national objectives; and
- An appropriately designed system of intergovernmental relations—including technical and fiscal support mechanisms—to bridge capacity gaps and to provide incentives for local governments to meet their responsibilities.

These characteristics of a decentralized system are, of course, closely interrelated. The principal benefit of decentralization, as noted above, relates to the gains inherent in local governments having the ability to be more accurately responsive to the people than the central government can be. For this to occur, basic political, fiscal, technical and
managerial capacities are required. In early stages of decentralization, few of these features are typically in place in a developing country.

Two basic approaches can be taken to fiscal decentralization. One extreme is to focus on designing the structure and basic elements of the decentralized system—an enabling framework (including borrowing powers), expenditure and revenue assignments, and intergovernmental relations (including fiscal transfers, technical support, and local performance incentives). It is then the responsibility of local governments to meet the requirements. This “sink-or-swim” approach favors more competent local governments. Weaker local governments may be much slower to meet the basic requirements of the system, and some of them may fail.

An alternative “developmental” approach is to design a deliberate process in which the above features of an effective decentralized system are developed together gradually with support from higher levels of government. Critics argue that such an approach requires substantial central capacity, can become excessively bureaucratized, and may be taken over by centralists who want to prevent genuine decentralization. Proponents argue that “sink or swim” cannot work until local governments have reached some threshold level of capacity, and they consider both elaboration of an enabling framework for local governments and creation of a process to develop the capacity of weak local governments as central tasks of decentralization.

In terms of expenditure assignments, the basic normative principles outlined above are not difficult to apply at the most general level in the context of a particular country (Some complications are elaborated below). Similarly, principles of revenue assignment intergovernmental transfers are relatively clear. Certainly there are tradeoffs and complications involved in designing the elements of fiscal decentralization, but the
greatest challenges arise in implementation, i.e., exactly how and when to share multi-
faceted functions and revenues among levels of government.

These implementation challenges are relevant for both the “sink-or-swim” and
“developmental” approaches to decentralization. No matter what a constitution or law
says or how eloquently it says it, central government agencies rarely desire to
decentralize services, particularly if this involves a loss of prestige and resources. Thus,
they almost invariably try to slow the process down. In addition, the developmental
approach specifically recognizes that if too many sectors are decentralized too rapidly to
inadequately capacitated local governments, they will perform poorly. If this happens,
central agencies against decentralization can use poor local performance as an excuse for
keeping services centralized. Thus, a decentralization strategy is critical for expenditure
assignment and all aspects of decentralization. We will return to this later in the paper,
but we first outline some specifics of expenditure assignment in the Indonesia case.

An Historical Perspective on Expenditure Assignment in Indonesia

Concerns for political unity have historically dominated the design of government
institutions in Indonesia, with lower levels of government serving substantially as agents
of the central government. A number of efforts to delegate some responsibilities to sub-
national governments have been instituted over the years through various statutes and
regulations. One of the most important statutes prior to the recent 1999 legislation was
Law No. 5 of 1974, which provided a general framework to guide the distribution of
functions among levels of governments. The law named 19 functions to be in the local
government realm. It also mandated that any transfer of power from the center to sub-
national levels had to be specified by parliamentary regulation. Specific regulations to
implement this legislation were very slow in coming or never materialized.
Nearly fifteen years later, the 1987 GOI policy on urban development declared the provision of urban infrastructure a largely local responsibility. Some attempts were made to clarify specific roles where service provision was a shared central and regional function, as through regulations pertaining to health and public works issued in 1987. Responsibilities for public service provision, however, remained highly centralized, as indicated by the dominance of the central government in total expenditures—more than 75% in the early 1990s, not including conditional transfers to sub-national governments. In addition, responsibilities varied substantially across different levels in different regions as a result of ad hoc, bureaucratic decisions of the central and provincial governments. Some local functions were heavily managed by the center, and analysts argued that public sector accountability was compromised because citizens did not know precisely who was responsible for particular services.

In the early 1990s, additional policy moves again suggested an intended further movement away from a strict view of centralization as necessary to preserve national unity and promoting economic growth. There was an emerging perception that the highly centralized fiscal structure was imposing large political and economic costs on the country. Accordingly, Government Regulation No. 45 of 1992 was issued to outline a broad framework for the transfer of responsibilities to sub-national governments, with an emphasis on Level II (kotamadya/kabupaten) regional governments.

Perhaps the most innovative feature of Government Regulation 45 of 1992 was its call for a gradual transfer of resources and responsibility to Level II governments. The process was to be managed by the inter-ministerial Regional Autonomy Advisory Board (the earlier version of the present entity of the same name—DPOD), in consultation with regional governments and the central agency concerned. The transfer was to be based on a system developed by the Ministry of Home Affairs (MOHA) to assess the capacity,
condition and needs of regional governments to assume responsibilities. The resulting
ratings were intended to allow for a differentiated and gradual assignment of
responsibilities. This approach recognized Indonesia as a vast and diverse country where
sub-national governments have non-uniform capacity and interest in assuming new
functions. All function transfers were to be accompanied by budget transfers at least
equal to current expenditures. This rating process was problematic and did not work as
expected, but it did recognize some previously ignored key dimensions and complexities
of decentralization.

Shortly after the passage of the regulation, the World Bank conducted a study that
recommended various services for decentralization to all or selected local governments.
Most of the recommendations were never adopted. The GOI moved slowly on developing
its own regulations up to time of the political and economic crisis of 1997, and some
expenditure decentralization continued during the 1990s. Revenue collection, however,
has become more centralized, and local elections attempting to create a more genuine
decentralized system were not held until after the 1999 laws were passed.

The New Expenditure Decentralization Efforts in Indonesia

Law No. 22 of 1999 prescribes a set of limited functions for both the central and
provincial governments and establishes a residual structure for functions of local
government. Article 11 also names eleven sectors specifically under the jurisdiction of
the local governments:

- Public works
- Health care
- Education and Culture
- Agriculture
- Communications
- Industry and Trade
- Capital Investment
- Environment
• Land
• Cooperatives
• Manpower

The provisions of Law 22 are, like many similar laws around the world, fairly
general. There is a lack of clarity about whether these assigned sectors are truly
mandatory. There is no distinction among these eleven sectors, nor is there a range of
possible authorities defined within each. Different levels of government commonly carry
out different aspects of many of these sectors in other countries, but the legislation does
not provide much guidance on decomposing services into components or sharing them
among levels. The idea that all local governments can fully undertake all aspects of all of
the listed functions is unrealistic and undesirable. In some sectors, such as public works
and communications, services need to be connected to larger networks to ensure the best
possible performance. Other sectors, such as health and education, generate externalities
and involve certain types of specialized services that typically require some role for
higher levels of government. Still other sectors, such as capital investment and industry
and trade, usually require some degree of central involvement to meet key national
objectives and to reduce possibilities for non-constructive competition among the
regions. There is little guidance in the legislation, but subsequent regulations attempt to
take some account of these considerations.

Other potential risks arise from the lack of differentiation and prioritization of the
sectors to be decentralized. For example, left on their own, local governments may
choose to focus on functions that generate revenues and neglect those functions that are
difficult and costly to discharge. There is also the reality that local governments have
very different administrative and political capacities, so that treating them all the same
will lead to very different levels of performance, as discussed more fully below. Finally,
there has recently been a rapid sub-division of kotamadya and kabupaten. In the past two
Since the passage of Law No. 22 of 1999, the expenditure assignment focus of the GOI has been on two issues. The first is on clarifying in a more detailed way the specific expenditure responsibilities of local governments. The second is on defining minimum service standards for the decentralized sectors. We now turn to a discussion of each.

Clarifying Local Government Service Authorities

A number of clarifying regulations and decrees have been issued since the 1999 laws. Government Regulation 25 of 2000 more fully details specific sectors and authorities within those sectors that are the mandatory responsibility of central and provincial governments. Local governments are allowed to assume any unreserved functions. Presidential Decision Memo 5 of 2001 requires the MOHA to implement a process of acknowledgment of authorities by local governments. Under this process, sectoral agencies created model lists of authorities to be undertaken at the local level. Based on the model list, each local government was requested to propose a composite list of authorities that would become its responsibility. These lists are reviewed, verified and revised by central government, with final acknowledgment by each local government.

Initially MOHA developed model lists of authorities in consultation with relevant sectoral ministries and distributed them to the local governments. This process predated their formal regulatory basis, Presidential Decision Memo No. 5 of 2001. There was some concern that consultation with the relevant sectoral ministries and guidance provided to the local governments was inadequate. As the local governments began preparing their lists, MOHA began a more formal process to revise the initial agency model authority lists with greater consultation with the sectoral ministries. Revised model lists were issued for each sector, usually in the form of instruction letters from...
each agency’s secretary general, in 2001. Again, there has been some concern raised that
MOHA did not provide enough guidance to the sectoral agencies and that the process and
criteria by which MOHA evaluated the revised sectoral lists was not very clear.

While this was going on and subsequently, many local governments submitted
their proposed lists of accepted authorities and formalized them through the issuance of
local regulations. MOHA initiated a process to review these in June 2001 as per
Presidential Decision Memo 5 of 2001. Concerns were raised that the submissions from
the regions were based on the initial lists prepared largely by MOHA, but they were
evaluated against the revised lists later prepared by the sectoral ministries.

As of December 31, 2001, 316 of the 348 regions had submitted their lists of
authorities, and these have since been verified with notes regarding particular issues or
problems. A number of problems have been identified with the outcomes.

- Certain sectors assigned to the local governments remain under the control of
  the center. A contentious example is land titling.

- A number of sectors are not clearly dealt with in either Law 22 of 1999 or
  Government Regulation 25 of 2000, so there continues to be debate over how
to deal with them. Examples include family planning and the statistics bureau.

- In a few cases, sectoral laws and regulations conflict with Law 22 of 1999.
  Under the law, for example, capital investment is assigned to the local
governments, but existing regulations place it under the national investment
coordinating board, BKPM. Forestry is an example where the center has
passed new regulations since Law 22 of 1999 to define a strong role for itself.

- A number of local governments have included on their list of authorities
certain functions that are clearly identified as central authorities. At the same
time, some local governments have failed to include authorities that are
supposed to be their responsibility.

Clearly, the process of defining and establishing the details of the authorities to be
assumed under Law 22 of 1999 has been fraught with problems. In the haste to move
forward with the definition of functions, there was an initial lack of direction from
MOHA, and the local governments were asked to develop lists of authorities before
models had been properly developed by relevant sectoral agencies. As a result, the local government lists were apparently more inconsistent in content and quality and should be acceptable. Now more formal model lists of authorities exist, but there is a sense that they are still uneven and have not been subject to clear criteria in being reviewed by MOHA. This negotiation-oriented process (as opposed to a standards-oriented process) has led to some inconsistencies and conflicts between local and national agencies. Some negotiation is inherent in such a process as absolute standards are difficult to define. Adequately detailed standards, however, are needed, and there must be clear rules and procedures to govern the negotiated aspects of the process. Another concern is that there is apparently no legal mechanism to require the local governments to take on functions even if they are classified as mandatory by central government. Similarly, it is not clear what local governments can do to ensure that they can claim service authorities that are legally supposed to be theirs.

It appears that there has been and will continue to be additional review and modification of the model authority lists defined by the relevant central agencies for local governments by MOHA and central sectoral agencies. These will form the basis for further interaction with the local governments with the goal of getting them to revise their individual lists of authorities. Exactly how this is happening and will continue to happen is not clear from available information.

**Defining Minimum Service Standards**

In addition to moving forward with defining authority lists for the local governments, the GOI has been working on minimum service standards (SPM) for the decentralized services. These were not mentioned in Law No. 22 of 1999 and do not have a statutory basis, but some analysts argue that they represent a way to more clearly specify and enforce local statutory functions. Government Regulation No. 25 of 2000
mandates the development and implementation of SPMs to measure the service delivery performance of local governments as a responsibility of the central and provincial governments.

Government Regulation 105 of 2000 indicates that local government budgets should be performance-oriented and include service standards that permit measurement of budget performance. MOHA is assigned responsibility for the establishment of a general approach, technical guidelines and reporting procedures for local financial management. Government Regulation 108 of 2000 focuses more broadly on the evaluation of local government performance, particularly with respect to the responsibilities of local government heads in managing their responsibilities. The regulation specifically stipulates that performance standards should be developed based on a number of dimensions: impact, use, results, outputs and inputs.

Throughout these regulations, there is not much information regarding the specifics of the proposed standards and exactly how and by whom they should be developed and used. Logically, these standards could serve a number of purposes. First, they can provide some clearer definition to the service authorities discussed above. Second, they provide information for planning local service delivery, and by logical extension, a benchmark for monitoring and evaluating service delivery performance. Third, these standards allow the central government to weigh in on defining its expectations in terms of national priorities. Finally, the proposed standards provide one element needed for costing services through what the GOI calls standard spending assessments (SSA). These can assist with developing local budgets, assessing budget performance, and providing the Ministry of Finance with better information on which to develop an improved “fiscal gap” formula for the Dana Alokasi Umum (DAU) revenue sharing program. There is, however, a possibility that the use of minimum standards
could lead to an unreasonably heavy demand on DAU funds. Thus, the design of minimum service standards must take into account affordability concerns.

The GOI has followed a fairly centralized approach to the development of the SPMs, although there is recognition that standards cannot be uniform nationally because of different characteristics of local governments as well as differences in resource availability across regions and local governments. Thus, there is a provision for adapting SPMs to local conditions, capabilities and past achievements. The adjustment of SPMs to local conditions is assigned to the provinces.

The process for developing SPMs to date has been very similar to the approach to service authority lists discussed above. In 2000, MOHA asked the central sectoral agencies to develop SPMs linked to their model service authority lists. As of December 2001, SPMs had been issued through ministerial decrees for agriculture, communications, cooperatives/small enterprises, education, fisheries, health, industry, manpower, public works, and transmigration. As of the same date, SPMs for three mandatory sectors, capital investment, environment and land, had not been prepared. MOHA has requested the sectoral agencies to continue development of the SPMs.

Many of the same concerns raised about the development of the service authority lists have also been raised about the SPMs. First, MOHA did not prepare technical guidelines for sectoral agencies to use in preparing the SPMs. Second, the submissions of the sectoral agencies were reviewed in 2001 by MOHA without any obvious set of appropriate evaluation criteria. Third, it is far from clear how and on what basis the provinces will be able to adapt the SPMs to better tailor them to differences across local governments, or if they have the capacity and resources to do so.

As a result of the process through which SPMs have been developed, they have apparently ended up looking very different from each other. Some SPMs are general
statements of goals, with no attempt to define specific indicators and standards. In other cases, conceptual indicators were developed without attaching quantifiable indicators to them. In still other cases, the standards are highly detailed technical specifications related to inputs that do not necessarily translate neatly to service delivery outputs.

A number of additional concerns have been raised about the SPMs and the process by which they have been developed. They include the following:

- Variability in terms of being based on international standards that are unrealistic for Indonesia vs. local standards that may be too low to meet intended objectives. There is a particular concern that failure to attain unrealistically high standards could be used as an excuse for recentralization.

- Lack of clarity about whether the implementation of SPMs will be done nationally and for all sectors at the same time or whether this will take place in stages.

- Lack of attention to the actions that could be taken, if any, in case a local government does not achieve the standards.

- Lack of clarity about if and how SPMs should be adjusted over time to reflect changes in local conditions, budgetary resources and local priorities.

- How SPMs could be used to develop sectoral standard spending assessments to guide budget formulation and monitoring and assist the GOI with further development of the intergovernmental transfer system.

Like the process of developing local government lists of authorities, the process of defining and establishing minimum service standards has been uneven and problematic in terms of both process and results. Much additional work needs to be done to develop an appropriate set of minimum service standards for Indonesian local governments.

**Outstanding Issues in Indonesia’s Ongoing Expenditure Assignment**

The GOI approach to the expenditure assignment dimension of the ongoing decentralization has centered on the development of local government lists of assigned authorities and minimum service standards. Both of these efforts are important, but both have been problematic, as discussed above, and together they are not sufficient to
complete the expenditure assignment task successfully. A number of outstanding issues require further consideration by the GOI. Some of these are specific to expenditure assignment, while others are more generally relevant for the broader process of decentralization. Key considerations include: clarifying the general principles of sectoral decentralization underlying the expenditure assignment process in Indonesia; finding a balance between local autonomy and central control in making expenditure assignments; improving the development and use of guidelines and criteria for expenditure assignments; considering the possibility of asymmetric expenditure assignment based on local government capacity; taking into account the need to phase in the implementation of expenditure assignments based on a realistic schedule; and clarifying the role of the center in developing local government capacity to realize the potential benefits of sub-national service delivery, and more generally, fiscal decentralization. Each of these is discussed in turn.

**Clarifying General Principles on Sectoral Decentralization**

As noted above, it does not seem reasonable that all of the sectors laid out as the responsibility of local governments in Law 22 of 1999 can be fully decentralized to the local level. This is recognized in subsequent regulations, but neither the law nor the regulations has clearly justified the selection of particular sectors for decentralization or clarified the basis for sharing responsibilities within individual sectors. Some formal elaboration of the most important general principles to be followed in making decisions in each sector would be extremely useful. These principles, which should be broader than the fiscal federalism generalities outlined above but less detailed than the guidelines that are needed for each individual sector, could be issued by MOHA. Broader deliberation, however, perhaps through DPOD or some other inter-ministerial forum, would be appropriate.
A second, equally critical element of the foundation for expenditure decentralization is a clarification of which services are truly obligatory and which can be provided at the discretion of the local governments. There has been some debate on this issue in terms of the letter and intent of Law 22 of 1999, but the law itself is clearly too general to serve as a definitive guide on this question. Some apparently see the development of lists of authorities and minimum service standards as a proxy for establishing obligatory functions, but this is not appropriate. These mechanisms can be used to formalize service assignments and standards, but clearer direction on the specifics of obligatory functions would be desirable prior to the final development of the individual lists of authorities and minimum service standards.

Finding a Balance between Local Autonomy and Central Control

Inherent in decisions about local government expenditure assignment is a need to balance the local autonomy that is supposed to be characteristic of a decentralized system and the need for the central government to establish standards to meet national priority service needs adequately. These issues are particularly important in a developing system where some local governments may be able to adequately define service delivery, and local citizens may be uninformed about their rights as citizens and/or may be inadequately empowered to hold their local governments accountable to them.

It is certainly acceptable international practice for a central government to define obligatory expenditure functions. Some local public services generate positive externalities and/or meet national redistributional goals. It is not necessarily reasonable, however, for the GOI to expect all of these obligatory functions to be provided immediately in all local governments upon finalization of the local government lists of authorities, as discussed more fully below. The GOI thus faces the choice of whether to prioritize the phasing in of obligatory functions, or, alternatively, to allow individual
local governments to exercise some autonomy in deciding which obligatory services are the highest priority among their particular populations. In this regard, it is important to recall that alleged benefits of decentralization are derived substantially from local governments’ expected superior responsiveness to the preferences of local people.

Some might argue that allowing for differentiated preferences in a developing country with significant political, administrative and technical weaknesses at the local government level is a secondary concern that should only be permitted after all basic obligatory functions that meet national priority needs are being provided. Others might worry that this maintains for a potentially long period of time “administered” local governments that are more accountable to the center than to their constituents. If a more administered path is chosen, some way of developing accountability to local people must be adopted. Although the adequate delivery of basic services may be a significant enough improvement over the status quo to build the credibility of local governments in the eyes of their constituents, the importance of creating an environment in which citizens more actively engage their local governments cannot be overemphasized. People must learn how to hold their local governments accountable to them if decentralization is to succeed. It is difficult to see the mechanism for doing this if local services, their levels, and their priority are entirely mandated by the central government.

Similar issues arise with the development of minimum service standards. The GOI seems aware of the danger of developing standards that are too high to be met, but even relatively modest standards for a large number of obligatory functions raises questions about the ability of local governments to meet all of them according to some uniform schedule. It also raises other concerns regarding the degree of autonomy that should be allowed to local governments in modifying standards for at least certain types
of services and the extent to which local governments should have discretion to choose at least some of the sectors in which they will first try to meet the standards.

**Improving the Use of Guidelines and Criteria**

Much of the above discussion on the ongoing experience of expenditure assignment in Indonesia focuses on problems that have arisen because detailed standards were not used in developing model lists of authorities and minimum service standards. Clearer guidelines and criteria from MOHA based on decisions about the general principles advocated above would assist central sectoral agencies to develop more appropriate and fully articulated model lists of authorities and minimum service standards. The sectoral lists of authorities and minimum service standards should in turn provide a consistent and appropriate level of detail to guide local governments in systematically developing their individual lists. These guidelines can also serve as a benchmark against which to evaluate the acceptability of the individual local government lists of authorities and the performance of local governments in meeting minimum service standards. A number of issues are particularly important to take into account in improving and fine-tuning the guidelines:

- **Components of a sector:** Sectors are not single-stage homogeneous entities. In fact, most involve multi-faceted, multiple stage activities. For example, providing “health” includes a variety of activities ranging from simple local clinics to multi-function hospitals. Recognizing detailed sub-components of a sector is important because each may be subject to the limitations of decentralization outlined above, such that an individual activity may exhibit economies of scale, spillover effects, or be intended to yield substantial redistribution of incomes or wealth. Furthermore, the technical nature of some service components may be so great as to exceed the capacity that local governments should in general have or be reasonably expected to
develop. Even if many components of a sector meet the test for decentralization, a role for higher levels of government in coordination is extremely important if the components of a service partly spread across levels are interrelated. These factors are important considerations in developing lists of authorities.

- **Capital and Recurrent Expenditure Responsibilities:** A critical dimension of many sectors that merits special mention is capital investment. In some sectors this has historically been a major item funded by substantial resources from both GOI and the international donor community. In considering principles for sharing sectoral responsibilities, it is important to recognize that the separation of capital investment responsibilities from recurrent expenditure responsibilities—whether across levels of government or at a particular level of government—has created problems in many countries. Centrally managed investment, for example, has resulted in a situation in which many completed infrastructure facilities have been turned over to local governments that either did not consider these facilities a priority or did not have the resources and expertise to operate and maintain them. This has certainly been the case historically in Indonesia, where public investment has been centrally driven and central agencies may be reluctant to give up their major responsibilities for infrastructure development. In addition, the ability to provide obligatory local services that meet some minimum standard clearly requires appropriate infrastructure facilities. Thus, specific attention to arrangements for development expenditure responsibilities is essential.

- **Type and characteristics of local governments:** Kotamadya and kabupaten are typically rather different entities. Not only are they likely to have somewhat different general service needs, but appropriate assignments and standards for at least certain services or sub-components of services may be somewhat different between them.
Their geographical location in the highly agro-ecologically diverse Indonesian archipelago and their degree of urbanization, among other characteristics, will influence the appropriate mix and level of public services.

- **Intra-jurisdictional differences**: Within a local government, there can be great differences in service needs and appropriate standards, such that a single type of service activity or a single service standard across an entire local government would not be appropriate, at least in some sectors. This is particularly true in a country like Indonesia, which has relatively few local governments for the size of the country and its population. This means that many local governments are large and extremely diverse. Not only can the specific set of appropriate local services differ within jurisdictions, but the technologies used to provide individual services, appropriate service levels/standards, and service cost guidelines can also vary widely. Heavily rural areas, for example, will require fewer and somewhat different services than cities, and even services common to both may have different standards. Equally important, there is a range of other settlement types between sparsely populated rural areas and densely populated metropolitan areas. These factors are relevant in making expenditure assignments and developing minimum service standards. Fortunately, Indonesia has an institutional structure below the local government level—kecamatan, kelurahan, desa—that can provide a useful starting point for thinking about intra-local government service need differentials. Care must be taken, however, not to be too formulaic, as there may also be differences in needs across each type of sub-local institutions, at least in some local governments.

Available information suggests that none of these aspects of expenditure assignment—components of sectors, capital vs. recurrent expenditures, types and characteristics of local governments, and intra-jurisdictional diversity, have been
adequately and consistently taken into account for all sectors in the Indonesian expenditure assignment process. Fuller consideration of at least some of these aspects would undoubtedly improve the local government lists of authorities and the minimum service standards.

**Differential Treatment of Local Governments Based on Capacity**

There are great differences among local governments, even among those of a particular type, in their capacity to assume expenditure responsibilities. Normative service assignments can be determined through more clearly articulated guidelines defined on the basis of local authority type and physical characteristics, as suggested above, but it is questionable whether actual service assignments should be based solely in these factors. An asymmetric approach based on differential local government capacities would seem to be justified.

There is some broad recognition of the need for differential treatment in the way Indonesia is approaching the definition of expenditure authorities. The lists of individual local governments are based on model lists prepared by sectoral agencies as adjusted to reflect the realities on each local government. As discussed above, however, it is not clear that the differentiation is based on appropriate and transparent standards that adequately account for different needs and circumstances of the local governments and their sub-jurisdictions. Equally important is whether the capacity of local governments to meet their responsibilities has been taken into account. Even if target expenditure functions and standards are tailored to the conditions of a particular local government, this does not necessarily mean that the local government has the ability to meet these targets. Although it can be politically and administratively difficult to differentially treat local governments of a particular type and other similar characteristics differently, treating those with weak capacity as if they can handle the same normatively desirable
responsibilities as stronger local governments invites failure. It is doubtful that this reality has been adequately or systematically considered in developing lists of service authorities in Indonesia, although local governments are allowed to voluntarily surrender to the provinces functions that they find themselves capable of providing. Thus far, this has not happened, suggesting that a different approach to the capacity issue is needed.

**Developing a Strategic Process for Implementation**

Even if a consensus can be forged on expenditure assignments and service standards and capacity differences have been taken into adequate account, there is an enormous degree of hard work involved in implementation. There appears to have been little consideration of the implementation problem in Indonesia’s ongoing decentralization efforts. There are two critical dimensions that need to be considered. First, as suggested above, agreeing on service assignments and standards does not mean that they can all be implemented at once. There are issues regarding priorities and sequencing, and there must be rules and a process for determining how to proceed with implementation. Second, there is the issue of capacity highlighted above. A local government with weaker capacity is going require a slower and possibly different schedule for phasing in the services it is expected to provide under decentralization and meeting the minimum service standards to which it is subject.

More generally, an effective fiscal decentralization program requires a strategic implementation approach designed to phase in reforms in a gradual, pragmatic way. Initial steps should probably be undertaken in sectors and functions for which rapid success is most likely. This requires prioritizing reforms, focusing on simple tasks that don't overwhelm local capacity. Even if initial reforms are defined modestly, however, they should be based on a broader conception of ultimate public service goals. In some cases, sequencing might need to be based on the most urgent priorities instead of those
that are the easiest to implement, although this may risk taking advantage of an opportunity to establish that decentralization can work effectively.

**Linking Expenditure Assignment with other Elements of Fiscal Decentralization**

Having argued for a strategic approach to expenditure assignment and implementation, it is important to emphasize that such an approach also requires that the various elements of fiscal decentralization programs be closely linked. These elements, as outlined earlier in the paper, include not only expenditure assignment, but also revenue assignment, intergovernmental transfers, political accountability, and administrative and technical capacity. There are a number of potential concerns in this regard for Indonesia.

- **Local Access to Revenues:** If decentralization of revenue authority and the development of intergovernmental transfers exceeds decentralization of services and the development of service delivery capacity, there is no reason to believe that the revenues made available to the local governments will be used effectively. This has happened in many countries. In the Indonesia case, enhancement of local own-source revenues has been modest except for the newly adopted sharing of natural resource based taxes, but there have been extremely generous intergovernmental transfer allocations provided under the DAU. There is in fact a concern that some local governments are receiving more grant resources than they can productively use. The DAU is in part intended to be a fiscal equalization program, but developing such a program requires that it be possible to measure both the (reasonable) costs of meeting clearly defined (including affordability) expenditure needs and the revenue capacity of local governments. The development of minimum service standards and standard spending assessments discussed above, if appropriately defined and applied, will eventually assist the GOI with quantifying expenditure needs and improving some of the key information required to better target the transfer system.
• *Resources for Local Public Investment:* Although the DAU has sometimes been depicted as a recurrent transfer system, it does in fact incorporate some non-recurrent functions by using former total APBD (budget) data, including routine and development expenditures of the dismantled deconcentrated offices, as one basis for calculating local allocations. This does, not mean, however, that these resources are sufficient to cover the capital expenditure needs of the local governments, which would need to somehow be defined in a reasonable way. Having taken few steps to develop the Dana Alokasi Khusus (DAK—–the special allocation fund commonly seen as a way to conditionally or semi-conditionally finance sectoral capital investments), the GOI has not clearly established a transfer mechanism specifically for development expenditures. The GOI must decide if the DAU is sufficient for both capital and recurrent expenditures. If not, developing the DAK should be an important priority. Developing borrowing opportunities for local governments, which are currently very limited in Indonesia, would also provide access to another important source of funds for local governments to use in developing infrastructure. Government policy documents indicate a strong awareness of this need, but there has been little concrete action to date.

• *Local Political Development and Accountability:* Fiscal decentralization mechanisms cannot be expected to work without an adequate degree of local political development and accountability. Educating citizens, elected local government officials and local government staff about their rights and responsibilities is a broader exercise. As noted above in several places, some local choice in prioritizing expenditure assignments and implementation sequencing can support local political development, although technical support will be required in some local governments.
• Local Administrative and Technical Capacity: The importance of taking local
government capacity into account in initial expenditure assignments and service
standards was already highlighted above. This starting point, however, must be
progressively built on, and local capacity—and governance—must be built over time
to the point where local governments can provide the full complement of local
services that meet local preferences and national priorities at the highest appropriate
standards possible.

The central government has considerable leverage to encourage the progression of
an overall process of decentralization that gradually builds all aspects of the system. In
this regard, the GOI can strategically use access to grants, loans and technical assistance
to encourage the gradual adoption of new responsibilities and procedures, the
development of political mechanisms, and other key decentralization reforms.

Concluding Comments

Assigning expenditure responsibility, like other aspects of fiscal decentralization,
is not just a technocratic exercise. Nor is it a fully political exercise in which the center
should negotiate on an ad hoc basis a set of service assignments and standards with local
governments. Well-defined technical guidelines for sectoral decentralization and service
standards are needed, and GOI could clearly improve on what it has accomplished thus
far. There should be flexibility in the application of these guidelines, but the flexibility
should be based on transparent rules and processes that allow for adaptation to the great
differences among and within Indonesian local governments. This flexibility, however,
should ideally be able to respond not only to the physical and demographic diversity of
local governments, but also to their great differences in capacity to assume responsibility
for services that would be considered normatively desirable based on other
characteristics. In developing these rules and processes, it is important to carefully balance the need for some local autonomy with legitimate national priorities.

One danger of this type of approach is that the assignment of expenditure functions will be statically defined based on present capacities of local governments. Perhaps the greatest challenge for expenditure assignment in Indonesia is how to tie the process into a broader strategy for implementing decentralization. As local government capacity—technical, administrative, and political—improves, greater service responsibilities can be assigned with the expectation of adequate performance. Similarly, as local governments catch up with infrastructure investment backlogs, they should be expected to provide additional services at higher standards. The phasing in of additional responsibilities has obvious implications for revenue requirements, the appropriate structure and allocation of intergovernmental transfers, and the development of better local government access to credit.

This way of thinking about expenditure assignment, and fiscal decentralization more generally, may seem unduly and unworkably complex to some observers. It is certainly more demanding than simply defining normatively desirable expenditure assignments and leaving the local governments to “sink or swim.” It does require the central government to think more strategically about how to phase in the implementation of expenditure assignment and other aspects of fiscal decentralization, and it requires a degree of coordination that Indonesia has thus far been unable to achieve.

Some observers might also interpret this gradual, strategic approach as undermining Law No. 22 of 1999. In reality, it is an attempt to phase in the system outlined in the legislation at a realistic pace. Poor decentralization performance is often the result of giving local governments too much functional responsibility and/or control over resources too rapidly and without appropriate capacity building and local
governance development support from the central government. By effectively slowing down the process of fiscal decentralization, this approach reduces the likelihood that some of the worst potential problems of fiscal decentralization will be realized. By providing local governments with support and incentives, it is much more likely to result eventually in a sustainable system that adequately delivers on at least some of the potential benefits of decentralization in most areas of Indonesia.

Notes


2 Decentralization is also desirable because expenditure decisions are tied more closely to real resource costs in smaller jurisdictions, and there are said to be opportunities for greater experimentation and innovation when there are multiple service providers.

3 These should be provided at higher levels, although it is often more practical to pursue alternative policies with the same overall effect, including cooperative agreements among sub-national jurisdictions, or subsidy or regulation by a higher level.


An enabling environment for decentralization can begin with constitutional or legal mandates for some minimum level of autonomy, rights and responsibilities for sub-national governments. This provides a foundation on which to build decentralization, but it does not guarantee that it will be realized. Many countries with constitutional clauses and laws on sub-national government have not managed to decentralize successfully.


Article 18 of the Constitution states: “Because the State of Indonesia is a unitary state, Indonesia, therefore, will not have within its jurisdiction areas which have the character of states.” Clearly the founders intended independent Indonesia to be a unitary country without “states within states.”

These included: small-holder agriculture; animal husbandry; inland fishery; small-scale rubber plantations; large plantations; sea fisheries; forestry; education and culture; public health; local public works; small-scale industry; small-scale mining and quarrying; housing; traffic management and transportation; general administration; labor welfare; social welfare; tourism; and local enterprises and projects.


See Shah and Quereshi (1994) for more detailed information.

Under the 1992 regulation, the following functions were reserved for the center: 1) defense and security affairs; 2) judicial system; 3) foreign affairs; 4) part of general affairs concerning heads of regions; and 5) other administrative affairs that could be implemented more effectively by the center as compared to other levels of government. All other functions were to be considered for transfer to sub-national governments. The regulation also specified functions for Level I governments: 1) inter-local (Level II) affairs; 2) affairs not central to development of a Level II government; and 3) affairs implemented more effectively and efficiently by Level I as compared to Level II regional government. “All other affairs” of Level I governments were to be transferred to Level II governments. These regulations obviously left substantial room for interpretation.

An alternative inter-ministerial local government rating system was being piloted under DPOD at around the same time, as discussed in Smoke and Lewis (1996). Both systems

15 See Shah and Quereshi (1994). A number of services were recommended for assignment to all local governments, including fire protection, local police protection, primary education, refuse collection, neighborhoods parks and recreation, street maintenance, local transit services, traffic management, local libraries, and local by-laws enforcement. In addition, land-use planning and secondary education were recommended for decentralization to larger local governments, and others were recommended for metropolitan areas (transportation, water supply, sewage disposal, refuse disposal, preventive health, hospitals, electric power distribution, air and water pollution, special police services, special libraries, regional parks, and regional planning). Finally, some functions were recommended for decentralization to provincial governments (college and university education, hospitals, public housing, social welfare, inter-municipal roads, and environmental protection.) Provincial governments were recommended to retain an oversight role for local governments and the central government to continue to develop overall policy and standards for both provincial and local governments.

16 Numbers from the World Bank and the Ministry of Finance indicate that sub-national expenditures as a percentage of total national expenditure grew from 16.62 percent in 1990 to 22.97 percent in 1995 to 27.78 percent in 2001. Over the same period, sub-national revenues as a percentage of total national revenues first rose from 4.69 in 1990 to 6.11 percent in 1995, then declined to 3.39 percent in 2001.

17 There are different views on whether the new system in Indonesia is “ultra vires” (functions are legal only if legally specified) or “intra vires” (functions not specifically prohibited or assigned to another level are allowed), also referred to as “general competence.”

18 It was not possible to review all of the regulations and sectoral lists of authorities prior to drafting this paper, so I cannot be more definitive on the extent to which these matters are properly taken into account.


20 The examples provided here and others are elaborated in Peform Project (2002).

21 Note that this has not necessarily translated into major problems or confusion at the local level. In many cases there has apparently been a smooth transfer of functions and personnel from the dismantled deconcentrated sectoral offices to the local government sectoral departments. That does not mean, however, that the correct functions have been
transferred or even that the new lists of authorities have been followed in effecting the transfers.

22 MOHA, however, does not have power to dictate how regions must manage their finances, so guidelines produced by MOHA are only suggested standards.


24 See Ferrazzi (2002) for a more detailed discussion of this issue.

25 Article 7 of Law 22 of 1999 gives the central government the right to establish national standards.


29 This will be difficult to determine until local government expenditure and revenue assignments are more fully clarified and a sense of the recurrent fiscal situation relative to capital investment needs is known. This is far from a straightforward process, but greater progress in this regard is critical if Indonesia is to more fully rationalize its fiscal decentralization efforts.