



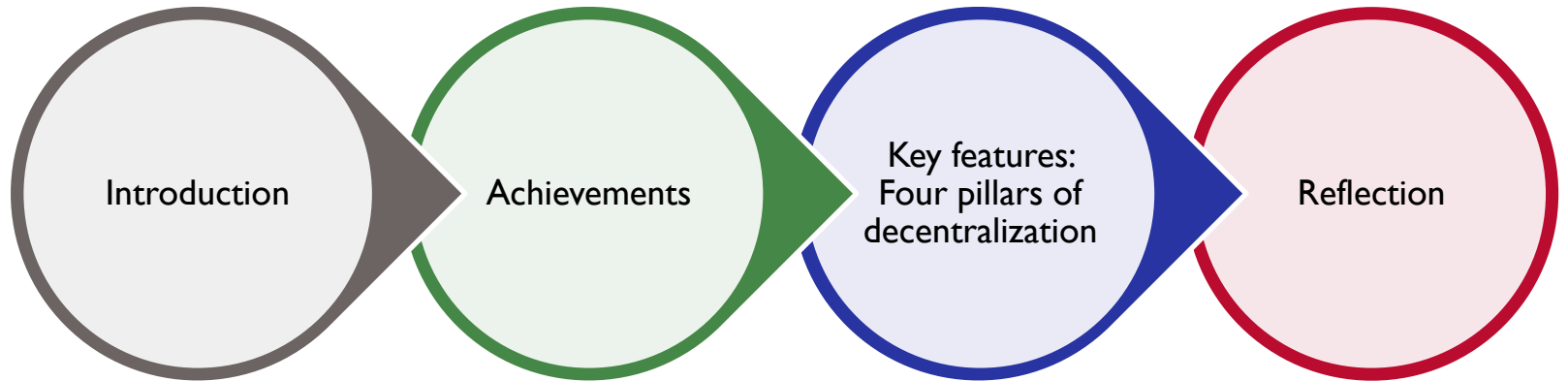
TWO DECADES OF FISCAL DECENTRALIZATION IN INDONESIA

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USAID ECONOMIC GROWTH
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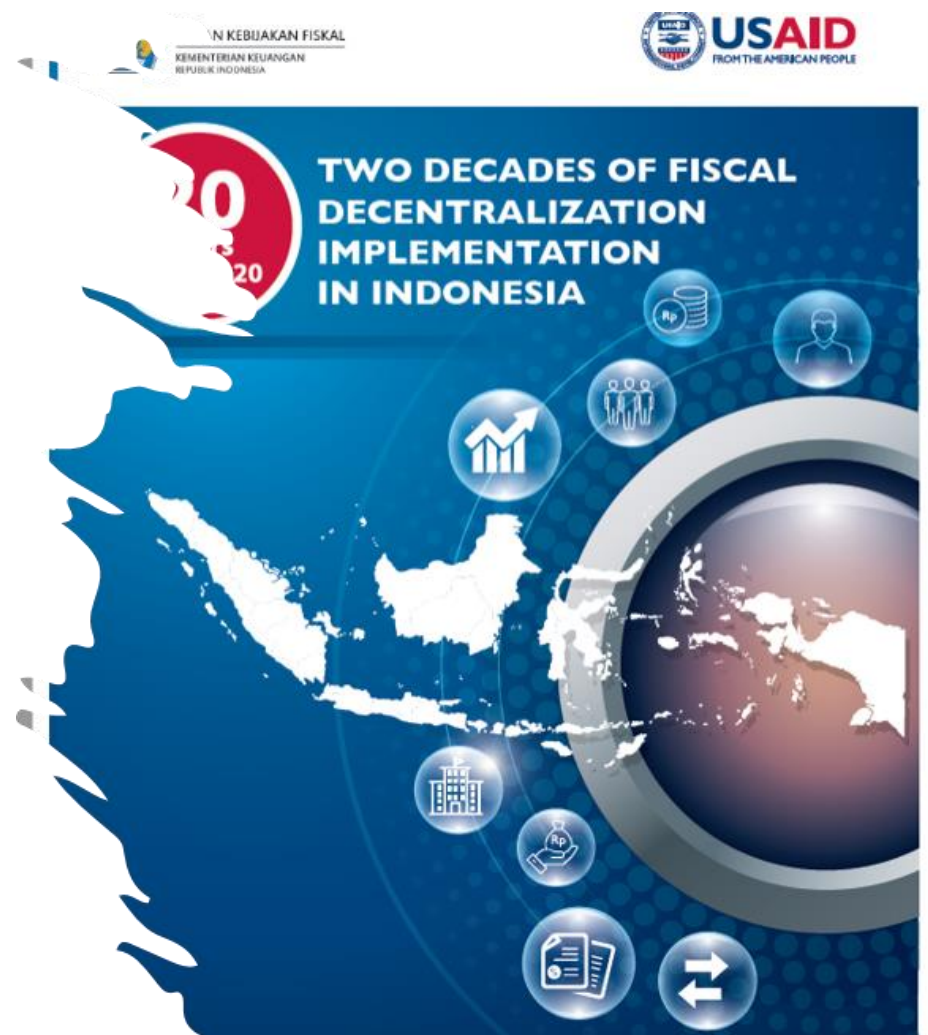
Outline



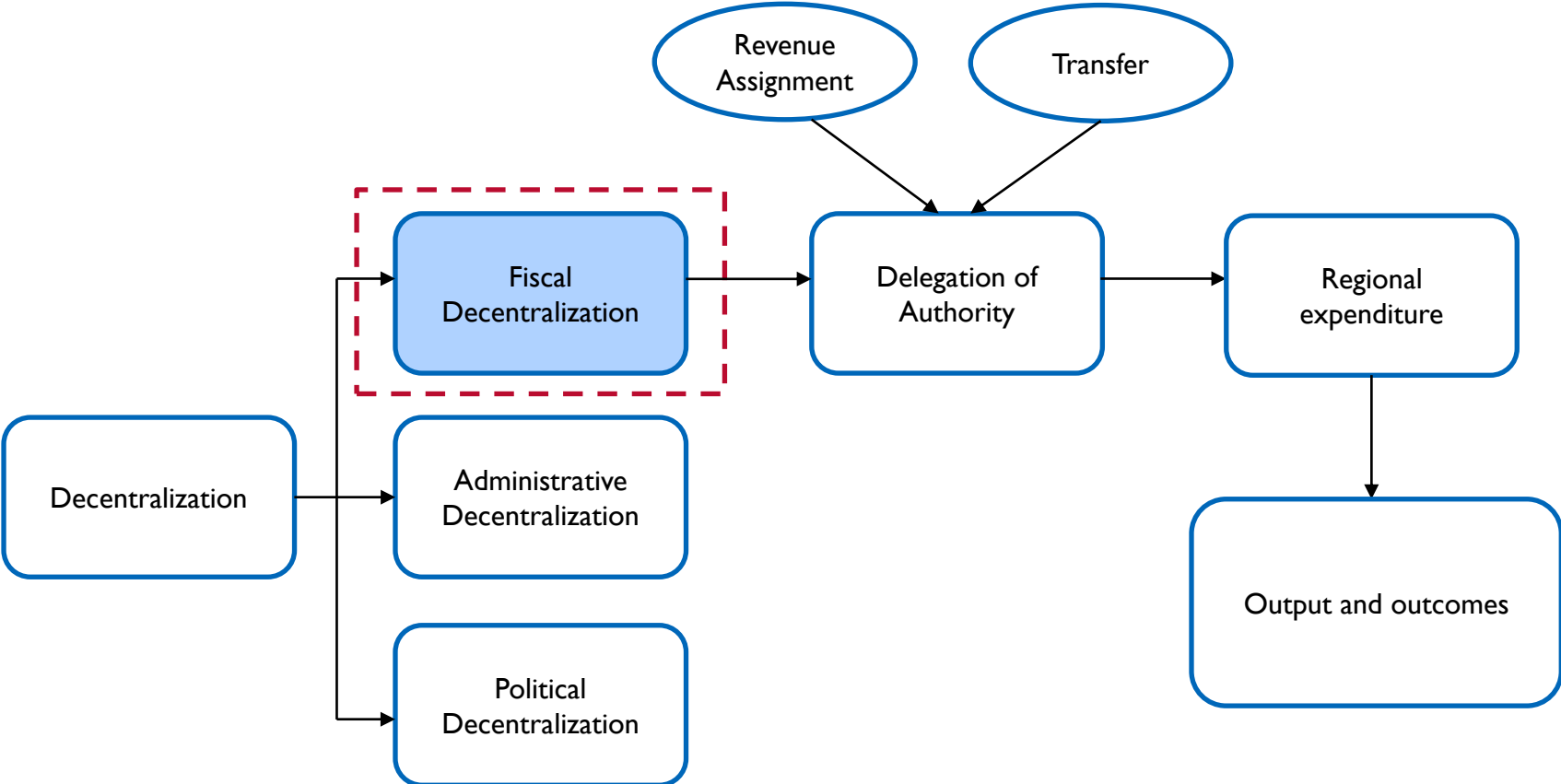
I. Introduction

- In 1999, Indonesia passed the Law 22 on Regional Government and Law 25 on Financial Balance between Central and Regional Governments, which marked the beginning of decentralization era
- With these Laws effective in 2001, Indonesia moved from centralized country to become one of the most decentralized country in the world – known as the “Big Bang” of decentralization
- Comprehensive decentralization: political, administrative, and fiscal; implemented all over the country.
- Decentralization gives political, administrative, and fiscal power to sub-national governments (province and district)

- This presentation provides reflection on 20 years implementation of **fiscal decentralization** in Indonesia (2001 – 2020), outlining *key features, dynamic, achievements, and lessons learned* from the past 2 decades
- USAID Economic Growth Support Activity (EGSA) collaborated with the Fiscal Policy Agency, Ministry of Finance of Indonesia, to conduct the review of two decades of fiscal decentralization to inform future policies
- E-book is available in Bahasa Indonesia and English



Implementation of Decentralization in Indonesia



Milestones – Key Regulations

Law No. 22 /1999 on Regional Government and Law No. 25 of 1999 on Fiscal Balance



The beginning of law on decentralization

1999

Amendment to Law No. 22 and 25/1999 on Regional Government and Fiscal Balance

- Granting broad authority to regions
- Regional governments regulate and manage their own government affairs based on the principles of autonomy
- The presence of intergovernmental transfer



2001 – 2003

2004

Amendment to Law No. 32/2004 on Regional Government & New Law on Villages (Law No. 6/2014)

- New term for intergovernmental transfer and regional revenue sources
- New allocation for villages fund starting on 2015 APBN



2014

2021

Supporting Laws post-decentralization era

- Law No. 34/2000 on Regional Taxes and Retributions
- Law No. 21/2001 on Special Autonomy for Papua Province
- Law No. 17/2003 on State Finances



Supporting law on Fiscal Decentralization

- Law No. 28/2009 on Regional taxes and retributions
- Law No. 13 /2012 on the Privileges of the Yogyakarta Special Region
- Law No. 11/2006 on Governance of Aceh



Amendments to Law No.21/2001 on Special Autonomy for Papua

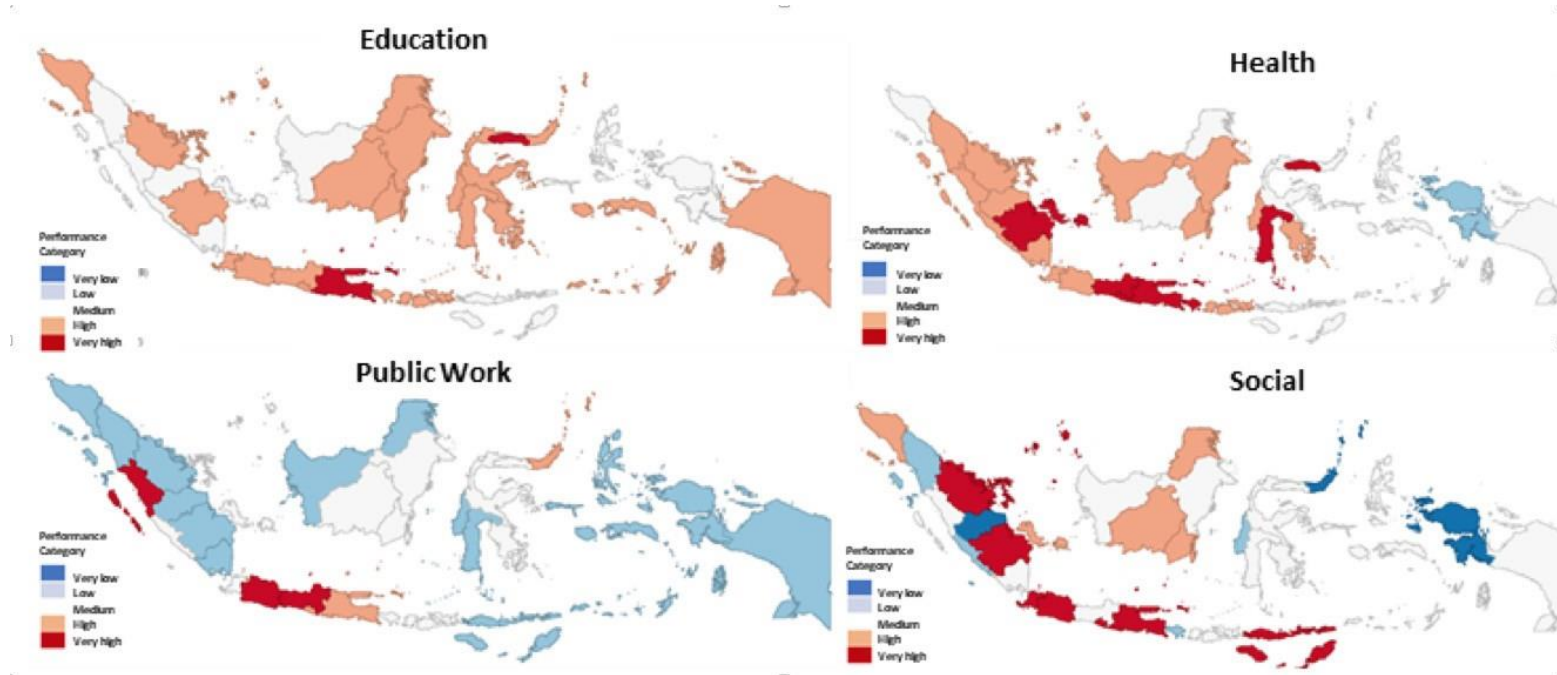
- Papua Province as a special autonomous region will receive additional revenue from the APBN in the form of:
- Tax DBH and Natural Resources (SDA) DBH in the context of special autonomy
 - Papua Special Autonomy Fund
 - Infrastructure Additional Fund



2. Achievements in Two Decades

Indicator	Result	... but....
Regional economic development	Improved	Disparity persists → widened horizontal disparity
Poverty rate		
Human Development Index (HDI)		
Education: years of schooling, teachers' qualification, student/teacher ratio		Relatively low quality of spending
Health: life expectancy		
Infrastructure	Improved in quantity	Relatively low quality output
SNG PFM capacity	Improved: lower dependency to transfer; increased local revenue	Disparity persists

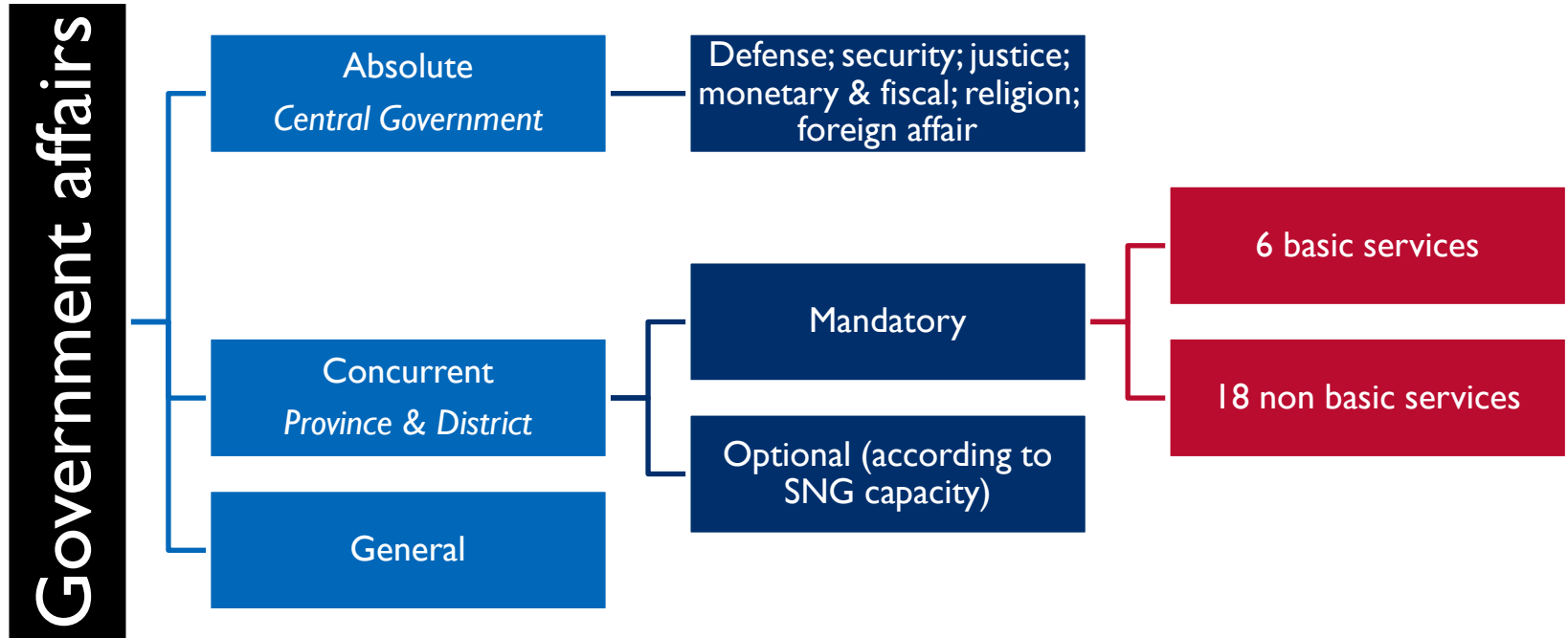
Performance: Education, Health, Public Works, Social Affairs (2020)



3. Key Features: Utilization of Four Pillars of Fiscal Decentralization

- **Delegation of authorities** from Central to SNGs (Province and District)
 - Clear distribution of responsibilities between different levels of government as regulated by the Law
- These responsibilities are **funded** through:
 - Decentralized revenue (some of taxes/retributions transferred to SNGs)
 - Intergovernmental transfers
 - Local own-source revenue
- SNGs are **empowered** (administrative and fiscal) to create and execute their own budget
 - Routine expenditure
 - Capital expenditure
 - Financing
- **Continues effort** by the Government to tweak the decentralization formula and implementation

3.1 Delegation of Authorities (Law 23/2014)

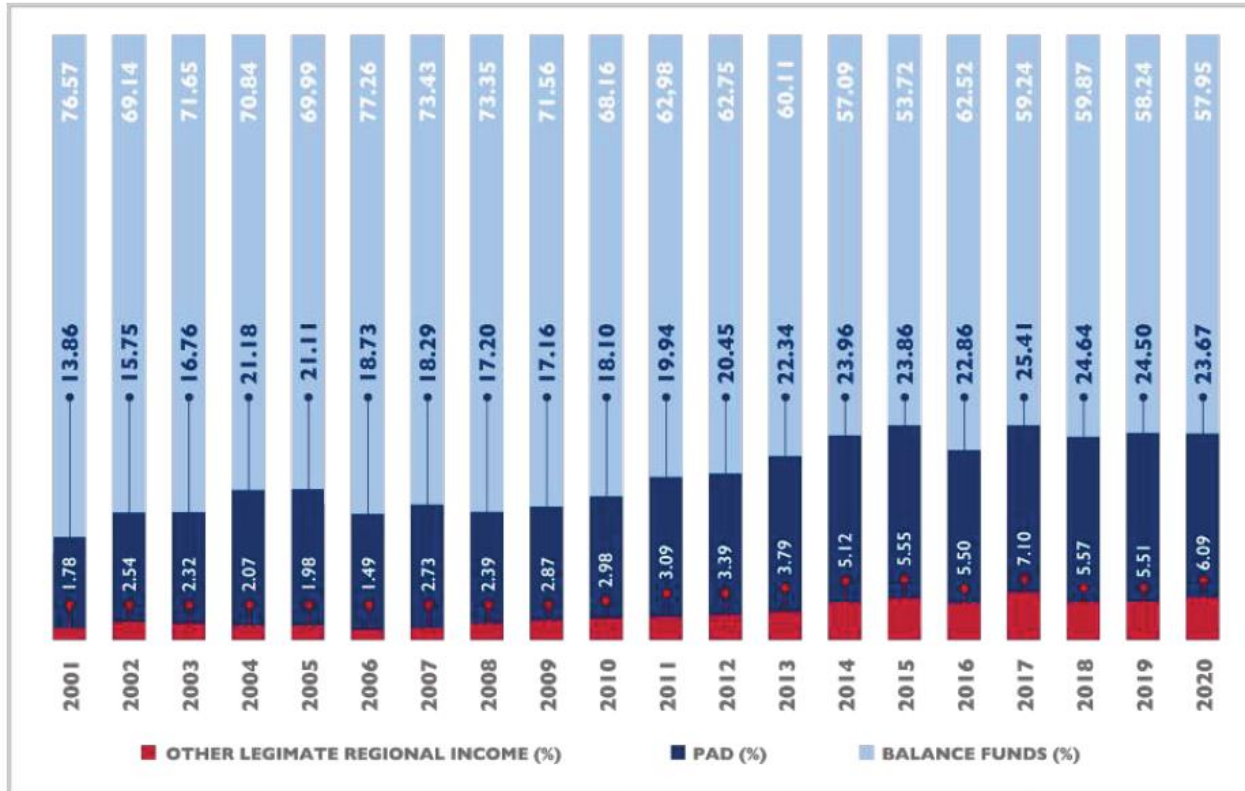


3.2 Revenue Assignment

SNGs created various new retributions → inefficient, burdening local economy

Law 18/1997 CLOSED LIST	Law 34/2000 OPEN LIST	Law 28/2009 CLOSED LIST
<ul style="list-style-type: none"> • 3 Provincial taxes: • 6 District taxes: • 30 types of retribution 	<ul style="list-style-type: none"> • 4 Provincial taxes • 7 District taxes • 27 types of retribution 	<ul style="list-style-type: none"> • 5 Provincial taxes • 11 District taxes • 30 types of retribution
<ul style="list-style-type: none"> • New type of tax must be legalized through a Government Regulation • Added the Motor Vehicle Fuel Tax (PBBKB) 	<ul style="list-style-type: none"> • SNGs can set create their own taxes and retribution 	<ul style="list-style-type: none"> • Closed list of taxes as regulated in the Law • Transfer of Property Tax (PBB) and Property Sales Tax (BPHTB) from Central to District • Added Cigarette excise
<ul style="list-style-type: none"> • Sets the maximum rate for District taxes • Sets uniform rate for Province taxes 	<ul style="list-style-type: none"> • Sets the maximum rate for District taxes • Sets uniform rate for Province taxes 	<ul style="list-style-type: none"> • Sets the maximum rate for each type of tax (except for Vehicle Tax) • Sets uniform rate for cigarette excise

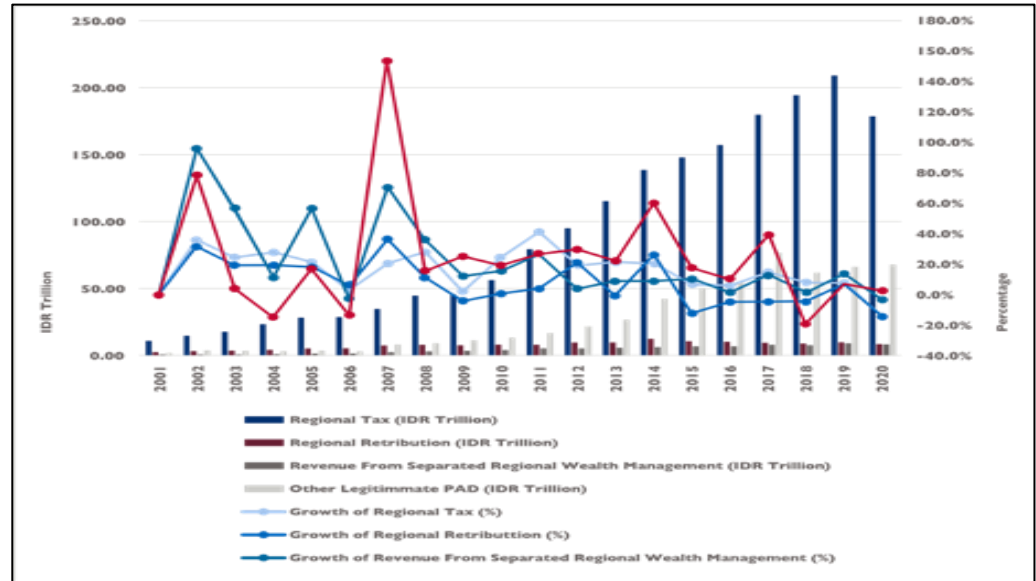
SNG Revenue Composition



- SNG revenue:
 - Transfer
 - Own-source (PAD)
 - Other revenue
- Transfers still dominates SNG revenue, although at decreasing rate
- Increasing importance of PAD, average annual growth 16.7%

Own-source Revenue (PAD)

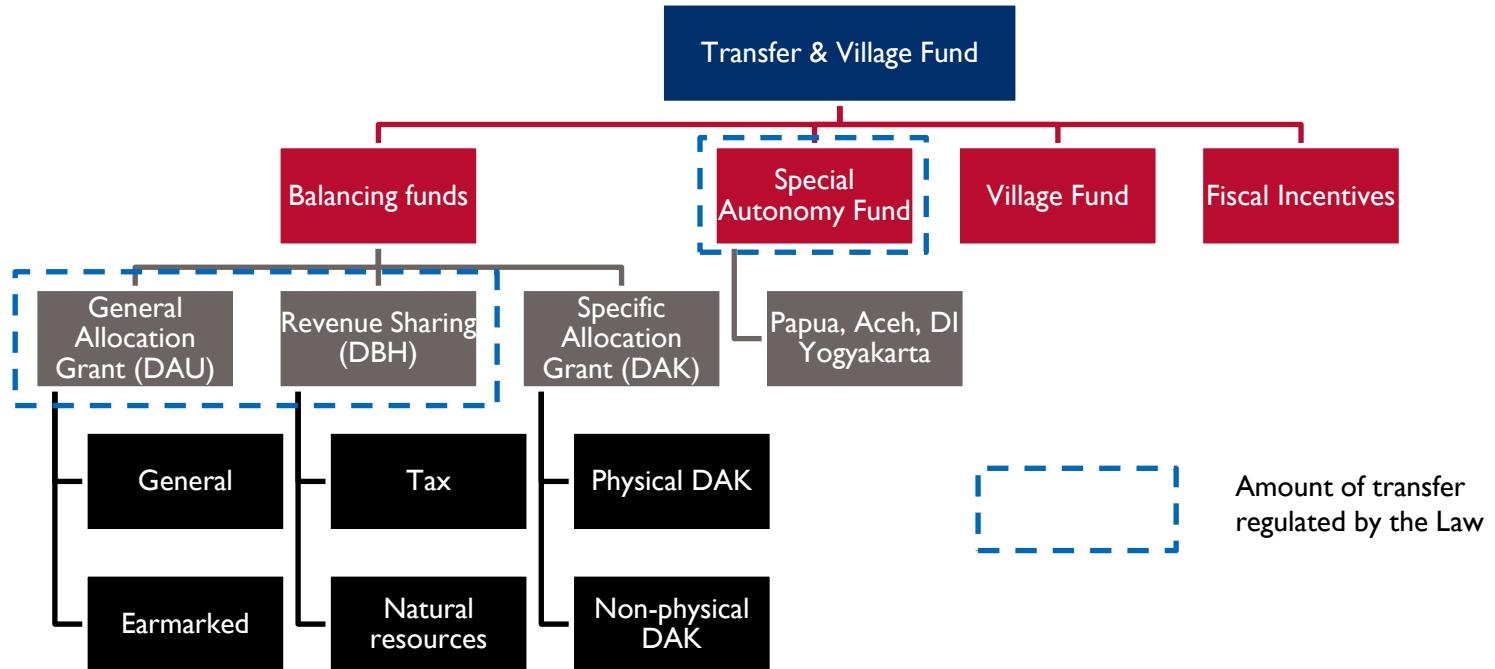
- 70% of PAD comes from regional taxes, which grew at 17% annually
- Main sources of revenue:
 - Province: vehicle registration, vehicle sales tax
 - District: property tax, property sales tax, streetlamp retribution
- Local tax/GPD ratio grew from 0.79% (2001) to 1.38% (2019); low annual growth at 1.2%
- National tax/GRP ratio: 12% (2001) to 11.15% (2019)



Observation on Decentralized Revenue

- SNGs experimented/innovate to improve their local revenue
 - Cashless and online payment
 - Third party payment point (Post office, Bank, Convenience Store)
 - Incentives and disincentives
 - Streamlining local retributions
- Challenges
 - Low tax-payer registration and low compliance in some areas
 - Limited human resources capacity and infrastructure → updating the tax base, valuation, collection, confiscation, etc.
 - Weak law enforcement
 - SNG dissatisfaction because the big-ticket items (e.g Income Tax, Oil & Gas) are Central taxes
- Moving forward
 - Shared tax base between Central and SNGs
 - Improving governance and law enforcement

3.3 Transfer Funds: Continuously Evolving Concept

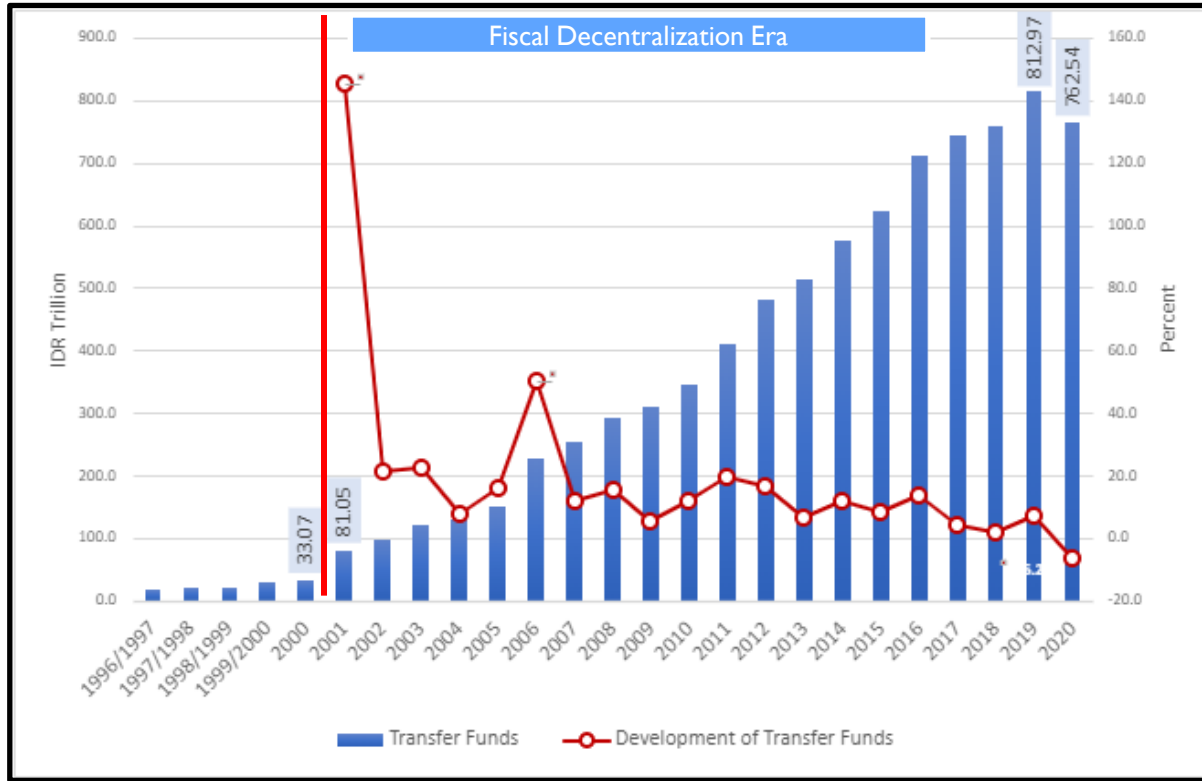


Evolution of Transfer and Village Fund

		2001	2004	2008	2010	2013	2015	2016	2017	2018	2019	2020
BALANCING FUNDS	General Allocation Fund (DAU)	Fixed amount (25% Nat'l Revenue) Block grant							No longer fixed allocation 25% earmarked for infra		Introduction of Additional DAU for Urban Village administration	Focus on COVID countermeasures & economic recovery
	Revenue Sharing (DBH)	Block Grant	Earmarked: Reforestation, Education	Added: Tobacco Excise Earmarked for industrial & social dev				Annulment of earmark for education		50% Tobacco excise: support Universal Health Insurance (BPJS) 50% of Reforestation Fund: forest fire		Focus on COVID countermeasures & economic recovery
	Specific Transfer (DAK)	Physical DAK 10% matching fund						Added: Non-physical DAK	Eliminate the matching fund Proposal base		Focus on COVID countermeasures & economic recovery	
NON BALANCING FUNDS	Special Autonomy Fund (Otsus)	Papua (20 years) Aceh (20 years)				Added: DI Yogyakarta						
	Village Fund						Introduction of Village Fund					Focus on economic recovery
	Local Incentive Fund (DID)				Introduction of DID							Add'l DID for economic recovery

Since 2016 → notable changes in technical requirements for Balancing Funds

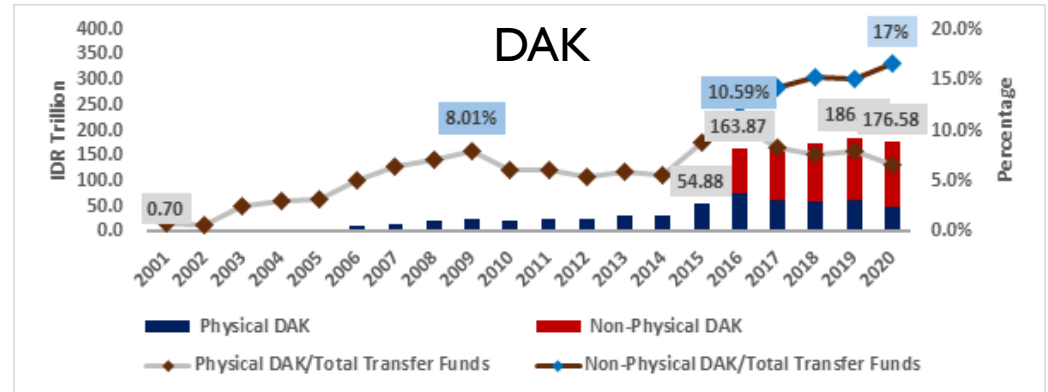
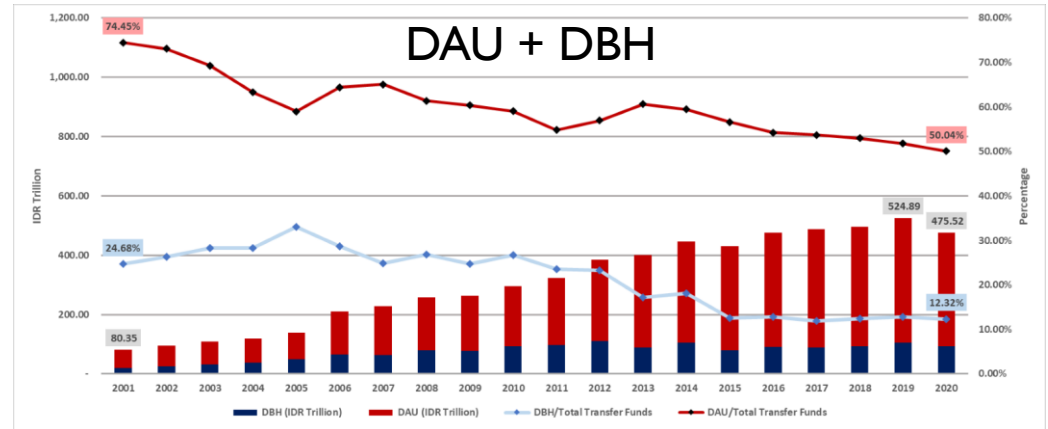
Development of Transfer Fund



- Prior to decentralization, transfer exist to finance central government affairs in the region
- The amount of transfer increased 145% between 2000 to 2001
- Since 2001, it has grown 10x from IDR 81 trillion to IDR 813 trillion (2019), growing at 13% annually
- Diminishing share of Balancing Fund (transfer) to SNG revenue: from 81.6% in 2001 to 57.9% in 2020

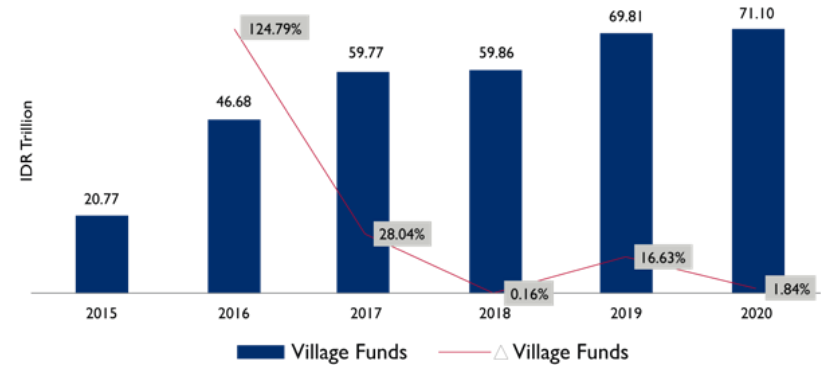
General purpose (DAU), Revenue Sharing (DBH), Specific (DAK)

- DAU and DBH contribute to more than 50% of total transfer → diminishing importance over time
- DAU continues to favor low fiscal capacity regions → contributing to reduce fiscal imbalance
- Physical DAK counts for <10% of total transfer, while non-physical DAK is 17% of total transfer
- Majority of physical DAK allocation is for infrastructure lagging regions
- Non-physical DAK provides operational support to basic services (e.g basic education, health)



Village Fund

- Started in 2015, still finding the best formula for allocation
- Fund sourced from Central and District Governments
- Financial support for village development, such as village infrastructure, health posts, local market, etc
- Village administration must prepare and get the Village Budget (APBDes) approved by District Government before the money is disbursed
- From 2015 - 2021, average annual allocation grew by 34.4%. Fund realization reached 99.3%
- Significant increase in output (number of village facilities constructed) in 5 years; gradual decrease in number of village poor; improved Gini Ratio in rural areas.



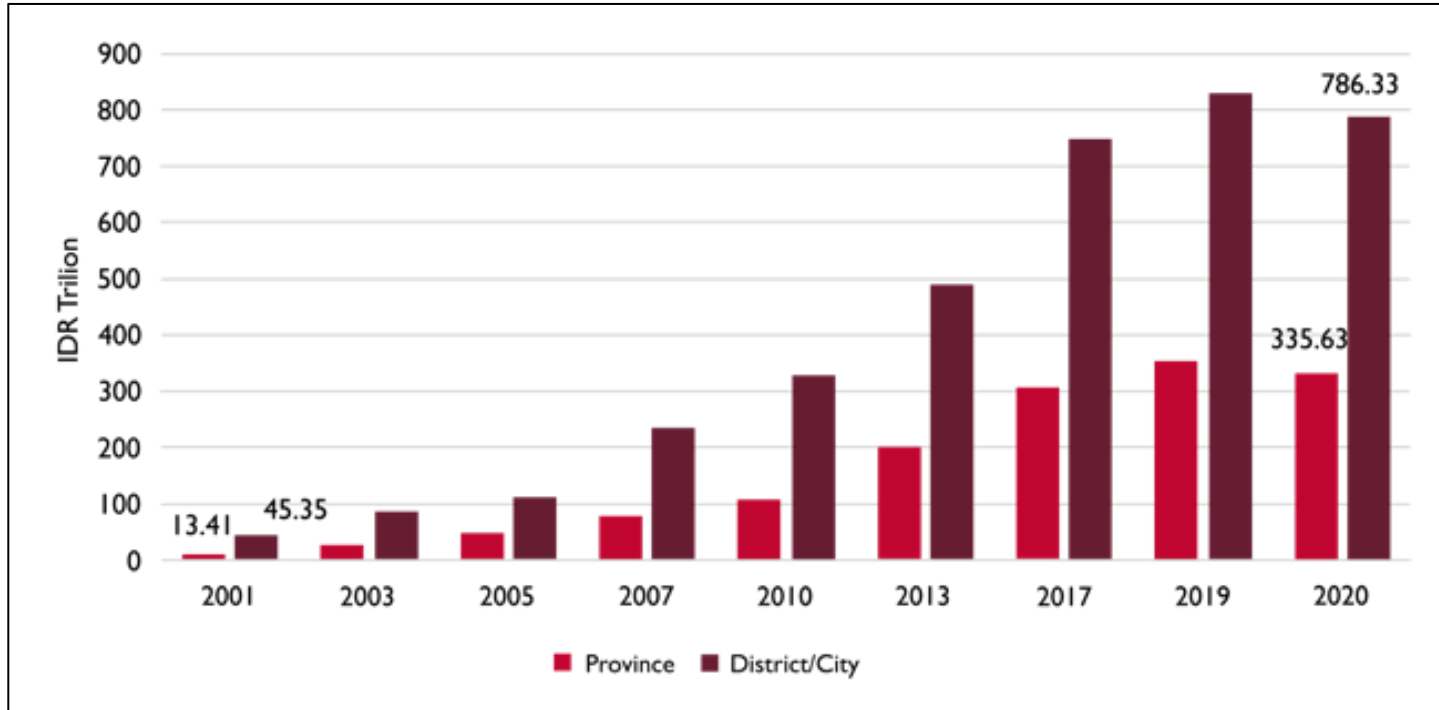
Observation on Transfer & Village Fund

- Transfer remains the largest revenue for SNGs, although its importance is decreasing as OSR increased
- DAU, which is based partially on number of civil service and fiscal capacity, may create disincentives for SNGs – increasing correlation between DAU and personnel expenditure over time
- Resource rich regions tend to neglect other economic sectors – vulnerable to commodity price fluctuation
- DAK is becoming more varied over the years – insufficient to finance a full project
- Difficult to measure the performance of DAK (physical and non-physical), so performance is measured in realized disbursement → allocation is not determined by past performance
- Outcomes of Special Autonomy Fund in Papua is lagging due to governance problem
- The ever-changing criteria for Local Incentive Fund (DID) created unclear signal to SNGs of which performance being evaluated and rewarded

3.4 SNG Expenditure: Category

Before 1999	2002	2005	2019
<ul style="list-style-type: none">• Routine: personnel, goods, interest• Development	<ul style="list-style-type: none">• Apparatus and public service• General administration: personnel, goods, travel, maintenance• O&M: personnel, goods, travel, maintenance• Capital expenditure• Revenue sharing and assistance	<ul style="list-style-type: none">• Indirect: personnel, interest, subsidies & grants, social assistance, revenue sharing• Direct: personnel, goods, capital	<ul style="list-style-type: none">• Operational: personnel, goods, interest, subsidies & grants, social assistance• Capital expenditures• Transfer: revenue sharing, financial aid

Development of SNG Expenditure



Average growth: province 20%, district 17%

SNG Expenditure (% of Total)

Sector	Province	District	City
By type (2001 – 2020)			
Personnel	19.6	41.1	46.5
Goods & services	22.6	20.8	24.7
Capital	19.7	23.5	22.7
By function (2003 – 2020)			
Education	21.2	26.8	27.8
Health	8.7	12.6	27.8
Public service infrastructure*	10.2	12.9	13.6

* 2016 - 2020

3.5 Financing

- SNGs are allowed to borrow (but not directly from foreign sources) to finance deficit or finance development project
- MOF and Ministry of Home Affairs will review SNG's loan proposal based on financial and administrative criteria.
- Local Parliament needs to approve borrowing plan
- Regulations are in place for borrowing from different sources (including municipal bonds) but realization is relatively low due to above mentioned review/approval process
- SNGs mostly borrow from Central Government, Regional Development Banks, and SOE infrastructure financing agency. No municipal bond issuance yet.

Observation on Expenditure

- By type:
 - Personnel expenditure decreases significantly (70% in 2001 to 33% in 2020)
 - Capital expenditure is still relatively low at 21%; infrastructure between 10 – 14%
 - Education and health expenditures mostly have exceeded mandatory 20% and 10%, respectively
- Moving forward
 - Improving revenue management through medium-term planning and performance-based budgeting
 - Simplification of program and activities to focus on improving local public service

4. Overall Observation from Two Decades of Experience

- **Fiscal decentralization in Indonesia delivers** → supported by political and administrative decentralization
- **Fiscal decentralization brings service closer to the people** → quality of service and infrastructure should be improved
- **Intergovernmental transfer is a powerful fiscal tool to ensure basic public service delivery** → needs reworking on the incentives/disincentives
- **Under utilization of SNG financing/borrowing options** → second tier SNGs do not have sufficient fiscal capacity to finance large scale projects
- **Weak performance measures** → lacking performance framework → good performance did not influence future transfer
- **Weak M&E from higher level of government**
- **Weak fiscal planning and coordination with Central and other SNGs** → disjointed projects, overlapping program, etc → who should lead the coordination?
- **SNGs' PFM capacity improved over time** → LGs ability to produce standardized budget and financial report → improved local revenue power, lower dependency to transfer

Policy Reflection and Recommendations

- Improve transfer fund management to narrow fiscal capacity disparities and encourage improvement in SNG expenditure
- Future fiscal decentralization policy should strengthen local taxing power while continuing to encourage investment and ease of doing business
- Reallocation of regional expenditure from personnel to optimal public service delivery
- Strengthen SNG's public financial management planning, including planning for financing
- Harmonization of fiscal policy between Central and SNGs to accelerate the achievement of development objectives
- Result of M&E and input from community to inform policy formulation and allocation

THANK YOU



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