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LOCAL PUBLIC FINANCE AND ECONOMIC DEVELOPMENT: The Indonesian Context*

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This paper considers the relative centralization or decentralization of public finance, and relates the equity and efficiency issues to the special features of developing economies. The paper considers the centralization of taxation and service provision in Indonesia in relation to these theoretical principles and indicates ways in which we may expect decentralization to proceed in the Indonesian context.

I. Introduction

For the past two decades considerable attention has been paid in the public finance literature to the conditions under which the centralized or decentralized provision of public services is preferred (See, for example, Oates [1972]). The theoretical considerations have typically been framed in the context of a developed country, and conditions have been identified in which centralized or decentralized taxation and service provision improves economic efficiency. In similar contexts, conditions have been derived in which the effects of decentralized provision upon interpersonal equity can be established.

There are, however, additional considerations in deciding upon the appropriate level of centralization arising from the economic objectives of developing countries. These issues, of course, embrace the central equity and efficiency notions of standard theory. In general, however, the development issues are broader; they include the design of incentives for improved public administration and for the mobilization of revenues in support of public projects. They also include considerations of the ways in which experience in the management of public affairs can be accumulated and exploited in day-to-day decision making.

In general, however, even when these more complex issues are considered, neither central government provision nor local government provision of services is likely to dominate for all services, except for very small countries. The "optimal" configuration of revenue flows and service provisions is likely to be a marbled pattern (e.g. Olson [1986]), with some public activities, for example sanitation facilities, undertaken at the very grass-

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roots level of government, and with other kinds of activity, for example, national defence undertaken only by the central government. Similarly, some sources of revenue are reserved to different levels of authority.

These conclusions about relative levels of decentralization need not imply that governments be "federal" in any political sense, but merely that there be a hierarchy of responsibilities allocated to different regional levels of government. This allocation may be perfectly consistent with either a federal or a unitary political structure.

In analyzing the appropriate level of decentralization of public service provision, two different approaches can be identified. The first is an attempt to derive from abstract principles the appropriate level of responsibility for service provision and taxation for different kinds of services. In following this approach the important issues include: the production and cost functions for various services; the technical character of the goods produced; the structure of demands for each of goods; and the distribution of income. An alternative approach, less general as a theoretical device but perhaps more useful practically, attempts to uncover the relative advantages of centralized and decentralized provision by empirical observation — that is, by observing existing governmental structures and the efficiency and equity underlying the arrangements under which services are currently provided. The normative problem is then to ascertain the direction and the magnitude of changes in the current structure of service provision and taxation which would represent improvements in economic efficiency or in equity.

In some formal sense, with no transaction costs and with no preexisting institutions, the analyses beginning from the deductive and the inductive approaches would lead to similar conclusions. The key difference, of course, is that transaction costs, preexisting institutions, and the capabilities of different levels of organization to administer taxation and service systems vary substantially, especially in the context of the developing world. Thus the context and the specifics of organizational structures and service requirements are crucial to analyzing the normative questions: *Which* level of government should provide *what* kind of services? *Which* level should engage in *what* kinds of taxation?

This paper considers the question of centralization of government finance with some reference to Indonesia. In many respects, Indonesia represents an ideal case for the analysis of centralized and decentralized finance. First, its level of development and its governmental structure lend themselves to consideration of these issues as practical tools in the development process. The country ranges from industrialized sections surrounding the capital and a few other cities on the densely populated island of Java to sparsely populated and greatly under-developed regions in outlying islands. Second, the existence of a unitary political structure and a strong central government means that the provision of services by any level of authority could be mandated by the national government, at least in principle.

Third, the geographic dispersion of the country means that some decentralization of service provision is inevitable, whether this decentralized provision is undertaken by agents of the central government or by locally constituted authorities, who are only indirectly responsible to the national government. The island character of the nation makes internal boundaries more salient and makes decentralized provision of some services rather necessary. Fourth, decentralization is potentially important politically in Indonesia

in light of cultural differences among the populations which make up the country, and the political objectives of the national government. These objectives include, on the one hand, integrating diverse populations more directly into a national conscience, while preserving, on the other hand, the regional character of political support. Fifth, Indonesia is an especially interesting case because of the great variations within the country in resource bases, populations, and other endowments. Finally, there are a set of historical factors important both to Indonesia and to other countries at similar stages of economic development.

The plan of this paper is as follows. In Section 2 below, we consider rather abstractly the important issues in choosing the level of responsibility for service provision. We consider efficiency in resource allocation, equity among citizens, revenue capacity, administrative capability, and a selected set of dynamic issues. Much of this theory is based upon models developed to analyze the financing and provision of government services in the industrialized world, with special reference to North America, Europe and Australia. In Section 3 we consider how the specific development objectives of less industrialized countries affect the choice of national or local provision of services and the methods for financing service provision. In Section 4 below, we utilize some of these concepts to understand the structure of service provision and government finance in Indonesia and to interpret current trends. This section is hardly intended to "explain" public finance choices or to "forecast" likely developments in Indonesia, but is intended rather to provide some specific context for the centralization issues which are currently debated within the context of economic development.

2. Appropriate Decentralization

2.1 Static Issues

As noted above, considerations of central versus local public finance can be summarized in terms of the standard criteria of equity and efficiency. Consider first the issue of efficiency and resource allocation. In this context, the choice between service provision at the local level or at higher levels depends upon quite specific conditions of supply and demand. Take first the supply or production side; if local services are produced by constant returns to scale (that is, with constant unit costs), then it follows that there are no cost sharing advantages from provision by larger governmental units. On the other hand, if there are decreasing costs in service provision, if there is a lumpiness in the structure of cost, it follows that citizens will benefit from lower costs if they band together to consume public services in larger collectives. It is equally possible to find diseconomies of scale in production. These can arise from a more top-heavy heavy organization or overhead structure in larger public enterprises, from a more cumbersome structure of decision making, or from a reduced flexibility obtaining in larger organizations. These organizational economies and diseconomies may be as important as engineering notions of scale in determining the shape of the average cost curve. Nevertheless, other things being equal, the optimal scale of government for service provision is larger (smaller) for services in which there are scale economies (diseconomies) than in which the returns to scale are constant.

It is important to distinguish between economies arising from the scale of operations and those arising from a more dense pattern of population. Accounting for density (that is, holding density constant), decreases in average costs with numbers served suggest that provision by a larger government unit is efficient.

Second, consider the technical characteristics of different government services. If a service is a pure private good, then it follows that the individual recipients of that service can be charged for it, and those who do not pay for the service can be excluded from consumption. In this circumstance, it is technically easy to produce public services at lower as well as at higher levels of government. In contrast, consider the opposite extremes of pure public goods. Two arguments suggest that these latter goods are provided efficiently by a higher level of government. First, under the cost conditions described above, for public goods the marginal cost of supplying the good to an additional person is zero (since for public goods all share equally in the service level provided). Second, the public nature of the good suggests there are likely to be spillover problems associated with the provision of the good by lower levels of government, especially by adjoining localities. These problems can be avoided by more centralized provision of the service.

For goods in between the public and private extremes, for example, private goods with congestion, there are some cost savings which arise from provision to a larger group of consumers. This larger group, however, also degrades the quality of service through congestion (Buchanan [1965]).

Consideration of these technical characteristics of the service and the structure of cost leads to the conclusion that when publicly provided goods depart from the simple text book models of constant returns to scale and a purely private nature of government production, the potential for efficiency gains from provision by a higher level of government (or at least a larger size of government) tends to increase. These gains arise from the production or supply side.

Now consider the demand conditions associated with public services. First, for goods which have any public dimension, collective provision involves some compromise among the demands of individual citizens. In the absence of any cost saving advantages from larger jurisdictions, this suggests that a given service should be provided by small local governments, that is, by the lowest level of government feasible. Under conditions of local provision to groups of citizens with homogeneous tastes, the compromises which must be made for collective provision are likely to be smallest. Second, for those public services which are private goods available to consumers in amounts they can freely choose, the scale of government providing service is irrelevant. When citizens need not compromise their individual demands to consume collectively, they are better off not to do so.

Ultimately, the efficiency condition for provision of service depends upon a balancing of the cost savings arising from jurisdictions of larger size and scale, on the one hand, and the welfare reducing compromise which must be made when larger groups of citizens are constrained to consume some common level of service, on the other hand. With government provided private goods, the efficiency losses from imposition of a common level of consumption are eliminated, but efficiency does require a metering mechanism whereby charges to consumers reflect service consumption. Where it is infeasible to

charge for services rendered, the distinctions which underly the prescription for service provision by lower or higher levels of government may be blurred.

Now, consider the issue of equity between citizens or among groups of citizens. Here again the appropriate level of government to provide a service will depend upon the evaluation of the service as a private good or as a good having some value over and above its value to private citizens (Musgrave [1959]) — a “merit good.” For purely private goods, there is no reason to override the preferences of citizens at the lowest level of government feasible, according to the efficiency analysis above. For a merit good, by definition, there is reason to provide minimum standards or to insure that all citizens consume some level of the good regardless of their ability to pay or even their own preferences.

The consumption of merit goods can be stimulated by intergovernmental grants, even if they are produced and distributed by local governments. A grant program will stimulate production, and the matching rate can be chosen to reflect the relationship between the “true” social value and the purely private value of the service (Gramlich [1977]).

Block grants can be used to redistribute resources across regions .

A related issue in equity concerns the variation in available resources across regions or governmental jurisdictions. If variations in resources among regions are larger, then it may follow that regions with abundant resources could tax themselves at quite low levels (i.e., at low effective tax rates) to provide public services. This violates some notions of equity and may suggest a system of compensating grants from central authorities, perhaps earmarked for the provision of certain services.

Thus strong notions of equity need not dictate central provision of government services. Grant finance can stimulate service provision and can compensate for disparities in income and resources.

2.2 Development Issues

In the context of developing countries there are at least three additional issues which have important implications for the choice of centralized versus decentralized government finance. These issues are essentially dynamic in nature and include: the effects of centralization on revenue capacity; the relationship between the level of government providing services and administrative efficiency; the effects of centralization on dynamic efficiency or administrative responsiveness.

Revenue capacity can include an enhanced ability to raise revenues by levying and collecting certain taxes locally. It can also include the ability to recover costs for area-wide public services from tax revenues generated in those areas. The former is an issue in tax administration; the latter is a rough approximation of user charge finance described above.

The tax administration issue can cut two ways. On the one hand, local authorities may possess an inherent comparative advantage in the valuation of local land and property for tax purposes and in the estimation of agricultural output. Similarly, for the taxation of mobile financial resources or even the total incomes of individuals, national authorities may possess a natural comparative advantage. On the other hand, local authorities may be initially less well trained and less capable of revenue collection regard-

less of their inherent comparative advantage.

The second issue, administrative efficiency in service provision and tax collection, can also cut two ways. The presumption that central government employees are more competent (because they are recruited nationally) may be completely offset by the specialized knowledge of local officials about adaptations of services to local conditions or about potential economies of service production in particular.

Thirdly, the dynamic and responsiveness issues tend to favor greater scope for service provision and taxation at lower levels of government. The advantages of local provision may include both adaptability in service production and also increased flexibility in administration. It may thus be worth sacrificing some of the short run efficiency of central government provision to reap the long run benefits of local provision by more adaptable local officials. If there are any long run comparative advantages to local service provision, then incentives provided by central government can help raise the level of competence of local authorities, the better to exploit these advantages.

In addition to these three issues of revenue capacity and administration, other aspects of developing societies will affect the choice between centralized or decentralized service provision. In particular, at low levels of provision a wide variety of public services can be considered "merit goods" (e.g., basic literacy) or may have important spillovers (e.g., inoculation against disease). In both of these cases, as noted above, the level of government for service provision may be more centralized than for services in similar categories in more highly developed countries (i.e., for secondary education instead of basic literacy; for hospitals instead of inoculations; etc.). Note, however, that intergovernmental grants may accomplish the same objectives as more centralized service provision.

3. Decentralization in the Indonesian Context

Indonesia is the fifth most populous country in the world, with over 175 million persons spread over an archipelago which extends the equivalent of the distance from Seattle to Washington, D.C., or from Ankara to Dublin.

The country is a unitary state, not a federation; consequently, all levels of government are, in effect, branches of the central government. Governors are appointed by the President; they are his representative in, and the chief administrators of, the twenty seven Provinces. This administrative authority extends to the regional and local offices of the central Ministries. As a consequence, the heads of such offices are responsible to both their Ministerial directorate and to the provincial Governor.

The unitary structure of the state was a political choice in response to perceived and real threats to national unity. The size, ethnic, cultural and religious diversity of the country are clearly a challenge to its national identity. Consequently, it is important that decentralization and local autonomy fit within legitimate concerns for preserving national unity.

3.1 Central Government Contribution to Local Service Provision

Over 70 percent of the funds which local governments in Indonesia spend are received from the central government in the form of grants. These include expenditures for

current account activities as well as investment expenditures on capital account. In addition to these grant funds, local governments also receive grants-in-kind from the central government in the form of infrastructure for local services built by central government agencies, in particular the Ministry of Public Works. These grants-in-kind constituted about 70 percent of all urban related development expenditures for *Repelita IV*, the five year plan period which ended with the 1988/89 financial year.

3.2 Regional and Local Finances

Central Government grants to lower levels of government are highly targeted. Provincial and local government accounts are divided into "Routine," for recurrent expenditures, and "Development," essentially for capital expenditures. Central government grants for local government personnel expenditures (abbreviated *SDO*), account for about two-thirds of routine revenues (and pay about 90 percent of local government salaries).

Development revenues (some of which, although spent by local governments, do not pass through their annual accounts) are dominated by central government grants called *Inpres (Instruksi Presiden)* which are awarded by sectoral categories. These grants have in the past amounted to 90 percent of development revenues. Currently *Inpres* comprise about 84 percent of local development revenues, mainly because of reductions in a single *Inpres* category, targeted for the building of primary schools.¹

There are only three exceptions to the narrow targeting of *Inpres* grants. One grant goes to Provincial governments (but portions of it are passed on, at the Governor's discretion, to localities). A second major grant goes directly to local governments. These two grants currently represent about 30 percent and 25 percent respectively of all *Inpres* grants. However, these Province and local government grants are untied only to the extent that a portion (for example, about 70% of a Province's grant) may be spent on projects proposed by the grantee. There is, moreover, a clear pattern of projects acceptable to the central government, mainly roads and bridges, irrigation maintenance, and water resources development and maintenance.

The third grant, *Inpres Desa* is given to local governments and is not tied to any sector. The grant may be spent for whatever localities deem appropriate for their development. All other *Inpres* are for specific sectors and for specific activities within the sector.

As noted, about 70 percent of Provincial and local revenue is composed of rather narrowly defined categorical grants. The other 30 percent is composed of own-source revenues which may be spent more flexibly. The chief sources of revenue are general taxes (for Provincial governments) and user charges (for local governments). The income from government enterprises also constitute modest sources of revenues.

¹ This grant had been instrumental in creating sufficient places for near universal primary education. Since achieving that objective, the size of the grant has been reduced from about 43 percent of all *Inpres* grants in Government of Indonesia (GOI) Fiscal Year (FY) 1986/87 to about 15 percent in GOI FY 1988/89. Many of the resources that previously went to building primary schools have been transferred to road construction and maintenance, which has grown from about 14 percent to about 34 percent during the same period.

The property tax in Indonesia is *de jure* a central government tax, but in practice it is essentially a local tax, at least in so far as the distribution of the net proceeds is concerned. Ten percent of property tax proceeds is retained by the central government; nine percent is allowed for collection costs; the rest is passed on to the Provinces (16 percent) and the local governments (65 percent). Local governments are responsible for collections from most individual taxpayers, while collections for certain classes of properties, such as plantations and high value properties in Jakarta, are the responsibility of regional offices of the central tax office. The tax rate is set by law (at one half of one percent of assessments), and the assessment ratio (currently 20 percent) is set at the discretion of the Minister of Finance. Valuations and assessments are the responsibility of the central government.

Property taxes are potentially a most important source of local revenues. About one third of local non-grant routine revenues are currently derived from the property tax. Limited field surveys suggest that the potential revenue from better administration is several times current levels at the present assessment ratio.

3.3 Local Taxation

Local and regional governments levy over one hundred different taxes. The overall tax take is small relative to total revenues, however, and only a few taxes raise significant revenues. Provincial governments collect about 24 percent of their total routine revenues from taxes. For local governments the proportion is only 6 percent. Taxes at the provincial and local levels are equivalent to about 0.6 percent of Gross Regional Domestic Product (GRDP).

Over 75 percent of provincial level tax revenues are received from two taxes, both related to motor vehicles. An annual vehicle registration tax and a vehicle transfer tax constitute the bulk.

Entertainment taxes (37.5 percent) and hotel and restaurant (18 percent) taxes provide over half of tax revenues to the local governments. Other relatively significant local taxes include a business registration tax, a street lighting tax, and an advertisement tax.

3.4 User Charges

Noteworthy user charges are for water supply, health services, refuse collection, markets, parking, bus stations and taxi stands, and the supply of official documents. Charges contribute about 60 percent of local governments' own revenues.

Some local governments own a variety of commercially oriented enterprises. In addition, many local governments have created enterprises to carry out certain public services. Most common among this group are the water supply enterprises. Bus companies and solid waste management enterprises are also included. These enterprises all contribute part of their incomes to local government revenue, but as noted above, the total revenue contribution from these sources is small.

These summaries of central government-Provincial fiscal relations conceal a great amount of variation. Table 1 indicates some of the variation in revenue sources among Provinces. It presents per capita tax and user charge revenues (own source revenues) and per capita transfers from the central government under the *SDO* and *Inpres* grant pro-

Table 1
PER CAPITA PROVINCIAL REVENUES 1986/1987

	Taxes and User Charges	SDO	Inpres	Total Transfers	Total Revenues
A. Per Capita Revenues by Province* (in Rupiah)					
1. D.I. Aceh	2,046	10,720	2,775	15,885	24,212
2. Sumut	3,482	12,888	1,261	16,076	19,649
3. Sumbar	2,759	2,871	2,706	7,720	30,530
4. Riau	4,285	2,328	3,946	12,924	30,415
5. Jambi	2,369	2,467	5,744	10,868	29,718
6. Sumsel	2,500	3,049	2,200	8,399	22,388
7. Bengkulu	2,755	6,219	10,604	18,857	39,051
8. Lampung	2,288	8,124	1,657	11,588	17,370
9. DKI Jakarta	—	12,780	1,267	17,615	48,591
10. Jawa Barat	1,753	9,618	387	10,981	16,385
11. Jawa Tengah	1,794	11,620	422	12,729	20,029
12. DI Yogyakarta	3,416	16,442	3,344	21,909	32,791
13. Jawa Tengah	2,522	9,816	383	11,331	18,458
14. Kalbar	1,576	11,940	3,524	18,455	27,102
15. Kalteng	1,906	18,213	8,703	33,113	46,210
16. Kalsel	2,382	17,533	4,337	25,021	32,560
17. Kaltim	6,359	14,999	6,452	27,535	43,000
18. Sulut	3,048	20,185	4,177	28,478	33,477
19. Sulteng	1,860	17,321	6,447	27,092	37,181
20. Sulsel	2,013	1,709	1,504	5,009	22,634
21. Sultra	1,932	3,414	9,157	15,435	37,891
22. Bali	4,445	16,330	3,761	22,053	33,077
23. N.T.B.	1,003	1,865	3,256	6,467	21,945
24. N.T.T.	1,572	1,492	3,275	6,691	28,941
25. Maluku	1,027	2,744	6,075	12,715	31,720
26. Irian Jaya	1,838	6,250	7,309	28,806	68,420
27. Timor Timur	1,435	7,961	15,898	29,451	53,965
Average:	—	9,683	1,689	13,264	23,613
B. Correlation with Measures of "Need"					
1. Infant mortality	0.11	0.17	0.02	0.06	0.00
2. Percent below Poverty	0.03	0.01	0.08	0.13	0.17
3. Percent urban	0.90	0.04	0.08	0.01	0.09
4. Percent with piped water	0.59	0.03	0.08	0.01	0.09
5. Per Capita GRDP	0.05	0.00	0.01	0.03	0.05

Note: *These figures include "Memorandum Account (UKPP)" revenues accruing to provincial governmental accounts.

- Consolidated city and province of Jakarta is excluded from part B.

Source: 1985 Population estimates from *Statistik Indonesia 1985* (BPS, 1985), Table 3.1.2. Measures of "need" from : *NUDS Final Report*, United Nations, September 1985, Table 5; *Poverty in Indonesia : Associated Factors and Poverty Issues*, World Bank, March 1983.

grams. Clearly the variation in revenues per person is substantial, and the reliance upon own source revenues varies enormously among the provinces. The table also presents the simple correlation coefficient between the level of central government per capita transfers to the provinces and available measures of need for resources. There are quite weak relationships between transfers and measures of poverty and infant mortality. Similarly there is no systematic relationship between urbanization and central government transfers. Resource transfers to Provincial governments do not seem to be compensatory at all. (See Azis [1989] for a more extensive discussion and criticism of disbursement patterns.)

4. Some Implications of the Theory

As discussed in Section III, this pattern of finance proved effective in expanding services and infrastructure at the local level rapidly in response to increased oil prices in the 1970's and early 1980's. Nevertheless, even in a period of increased government revenues, the theory of appropriate decentralization noted in Section II suggests that there are three kinds of efficiency losses.

First a large fraction of local assets has been created by the central Ministry of Public Works and turned over to the local governments for operations and maintenance. However, the local authorities have had little meaningful involvement in the choice, planning or execution of these investments and have received none of the personal benefits associated with the management of these development activities in Indonesia. As a result, local governments have an inadequate incentive for ensuring the proper operation and management of the assets passed on to them in a "turnkey" fashion. These assets are thus subject to more rapid deterioration. This feature is by no means peculiar to Indonesia or to the relationship between central and local authorities in that country. For example, Mera [1989] indicates that centralized provision of infrastructure by public works ministries is quite typical of developing societies. More generally, he argues that the "turnkey" provision of public facilities to regional and local authorities inevitably leads to undermaintenance and increased depreciation.

Second, in a country as large and diverse as Indonesia, the investment priorities of the central government agencies cannot always be in accordance with local priorities or needs. Inefficiencies in resource allocation occur as a consequence. Planning and execution of works controlled from Jakarta for areas that are physically remote and varied, as well as sometimes culturally different, inevitably result in some failed designs, inappropriate standards, and problems in execution. Thus, inefficiencies can occur in administration and service delivery as well as resource allocation.

Finally, local governments have weak incentives to increase local tax base revenues when a greater payoff comes from persuading central government bureaucrats to increase the flow of grants. In the period of high world prices for oil and export commodities, the return to "grantsmanship" could be very high indeed.

These efficiency losses may have been quite tolerable when rapid investment in infrastructure and public services was necessary and when resources were plentiful, but under current circumstances, the efficiency losses are magnified. With declining commodity prices, the losses from centralized provision may be perceived to be even higher.

The decline in oil (and other commodity) prices in recent years has resulted in dramatic falls in the level of central government revenues. World Bank data indicate a 13 percent reduction in Indonesian oil revenues and a corresponding 23 percent decline in government investment between 1985/86 and 1986/87. During the two year period 1984/85 to 1986/87, there was a 27 percent reduction in aggregate development expenditures. Some sectors suffered contractions of as much as 50 percent (e.g., irrigation) and 60 percent (e.g., agriculture).

Transfers to local governments were protected to a substantial extent in these budget cuts, reflecting the government's concern to mitigate the effects of adjustment on the larger segment of the society. Recurrent transfers actually increased slightly from 1985/86 to 1986/87.

Regional development expenditures also rose. Housing and human settlements development expenditures, which are essentially for local services, increased. However, health and population and education development expenditures, which have substantial local components, declined by over 20 percent. Ensuring the continuance of those programs which have direct impacts on the everyday lives of Indonesian citizens makes both economic and political sense. Consequently, the constraints on overall resources give added impetus to efforts to increase local government responsibility and authority for financing development programs at that level.

The Government of Indonesia has been actively exploring strategies toward decentralization. A number of services, including water supply, sanitation, solid waste management, public transport, local road development and maintenance, and local irrigation services are already transferred or in the process of transfer to regional and local governments. These services, in the Indonesian context, all exhibit the characteristics for efficient provision at the local level, as suggested by the discussions of section 2 of this paper. To be fully effective, however, accompanying measures in finance and administration are necessary.

The theory of decentralized public finance thus suggests efficiency gains from a move towards reduced reliance on categorical grants and an increased reliance upon block grants; a decreased reliance upon turnkey public works programs, and an increased local voice and control over infrastructure investments; an increased emphasis on local taxation and own source revenues.

The apparent political unity of the diverse and far flung regions of the country also make increased decentralization of finance more appealing as a national strategy.

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