

**School of Management
John Curtin Institute of Public Policy**

**Getting Good Outcomes from Sub-National Governments:
A Case Study on Indonesian Fiscal Decentralisation**

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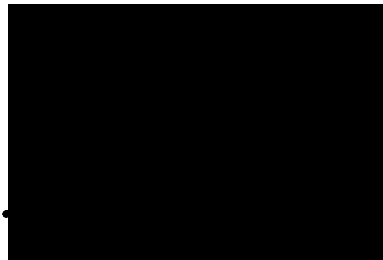
DECLARATION

To the best of my knowledge and belief this thesis contains no material previously published by any other person except where due acknowledgement has been made.

This thesis contains no material which has been accepted for the award of any other degree or diploma in any university.

The research presented and reported in this thesis was conducted in accordance with the National Health and Medical Research Council National Statement on Ethical Conduct in Human Research (2007) – updated March 2014. The proposed research study received human research ethics approval from the Curtin University Human Research Ethics Committee (EC00262), Approval Number # HRE2017-0742.

Signature:



Date: 07 May 2021

*The difficulty lies not so much in developing new ideas as in
escaping from old ones.*

(John Maynard Keynes)

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LIST OF ABBREVIATIONS

AK	<i>Alokasi Kinerja</i> (Performance Allocation)
AM	<i>Alokasi Minimum</i> (Minimum Allocation)
DAK	<i>Dana Alokasi Khusus</i> (Specific Allocation Fund)
DAU	<i>Dana Alokasi Umum</i> (General Allocation Fund)
DBH	<i>Dana Bagi Hasil</i> (Revenue Sharing Fund)
DID	<i>Dana Insentif Daerah</i> (Local Incentive Fund)
DPR	<i>Dewan Perwakilan Rakyat</i> (the House of Representatives)
DPRD	<i>Dewan Perwakilan Rakyat Daerah</i> (Local Council)
EU	European Union
GRDP	Gross Regional Domestic Product
GST	Goods and Services Tax
HDI	Human Development Index
IGFRs	Intergovernmental fiscal relations
IGFTs	Intergovernmental fiscal transfers
MoF	Ministry of Finance
MoHA	Ministry of Home Affairs
MPR	<i>Majelis Permusyawaratan Rakyat</i> (the People's Consultative Assembly)
PAT	Principal-Agent Theory
PBG	Performance-Based Grant
UNCDF	United Nations Capital Development Fund
VAT	Value-Added Tax

ABSTRACT

This thesis assesses Indonesia's fiscal decentralisation policy from 2001 to 2018 and in particular its attempts at ensuring sub-national government performance. These employed both methods suggested in the 'second generation' theory of fiscal federalism: constraints and incentives. After delivering years of much increased Inter-Governmental Fiscal Transfers (IGFTs), from 2010 the central government started to introduce performance-based grants. Then, in 2015 the central government put a prestigious Award, which is only given to the top achievers, as an addition to the fiscal reward. However, at the same year the central government also started to be more directive to its IGFTs. Increasing tied grants proportion from total IGFTs allocated, transforming tied grants allocation and disbursement's mechanisms, and even putting 'earmarked' to a naturally block grant's type of allocation, became the main policies.

Fiscal decentralisation is needed to make decentralisation of tasks and responsibilities more meaningful. The so-called 'first generation' of fiscal federalism theory focused on defining sub-national government fiscal autonomy and suggested different policies to establish this – either giving massive local taxing power or huge amounts of IGFTs. The 'second generation' of fiscal federalism theory focused more on ensuring sub-national government *performance* and, how to make them act responsibly in their spending. Suggestions included limiting fiscal flexibility by imposing tied grants or creating fiscal incentives through performance-based grants to encourage sub-national governments to be responsible and deliver better outcomes from their fiscal discretion.

This thesis canvasses central government and sub-national government perspectives on the fiscal decentralisation experience to date. The respondents from Directorate General of Fiscal Balance, Ministry of Finance, were selected to represent the central government's view because the fiscal decentralisation policies are driven from this unit. The sub-national government sample was selected based on different demographic, geographical, fiscal and human resources capacity characteristics. Semi-structured interviews were designed to answer three sub-themes of the thesis.

First was the Local Incentive Fund (DID), which was followed by the introduction of the prestigious *Dana Rakca* Award to the best performers among 542 sub-national governments. The research assessed whether this policy acted as a stimulating factor for sub-national governments that have different capacity to compete for the fiscal reward and award. Moreover, as much as performance-based grants being endorsed in the ‘second generation theory’, this thesis tried to explore more details on what challenges that arises from putting the theory into practice.

Secondly, recent transformation of the central government IGFT policy, with increased use of tied grants and the creation of ‘earmarked’ grants, raises question over the value of introducing performance-based grants in the context of sub-national governments that have diminishing fiscal discretion. Furthermore, it also raises a question of whether imposing tied grants would hold back the improvements of more advanced and mature regions.

Finally, the assessment also extends to Indonesian inter-governmental structural relations. The agenda of re-asserting provincial authority is undermined by the central government still opting to deal directly with municipalities and regencies, rather than establishing hierarchical relation through provinces. This conveys the central government distrust to provincial governments and, at the same time, disregards those provincial governments that actually have the capabilities to manage municipalities and regencies within their jurisdictions.

The findings reveal a complicated inter-governmental fiscal and structural relationship, and lead to conclusions on how to create a better policy approach based on decentralisation’s basic principle of acknowledging different regional interests, preferences, needs and capabilities. The asymmetric approach to fiscal decentralisation policy is suggested as an alternative in accommodating those diverse situations among sub-national governments.

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1

INTRODUCTION

1.1 Background

Many countries have ethnic, cultural, and geographical diversities that result in differences in local interests, preferences or identities. The policy approach of decentralisation emerged in transitional, developing, and industrialised countries in response to the failure of central planning to acknowledge different public needs across jurisdictions (Oates, 1999; Boex & Simatupang, 2008). Decentralisation recognises that government needs to be closer to local people to have adequate knowledge of their needs.

Under decentralisation, devolving functions, tasks and responsibilities to lower tiers of government is the preferred option (Devas, 2008). Those lower tiers of government then require funding to follow those devolved functions, tasks and responsibilities. Thus, both assignment of responsibilities and fiscal transfers are essential to make decentralisation meaningful. In an article about sequencing fiscal decentralisation, Bahl and Martinez-Vazquez (2006) point out the importance of a clear responsibilities assignment in calculating sub-national government's expenditure requirements.

1.1.1 Indonesia's Big Bang

Indonesia is an archipelagic country with more than 17,000 islands; 1,340 different ethnic groups; 718 language groups; and 6 main religions. The extent of economic disparity can be seen in the 2018 Gross Regional Domestic Product (GRDP) figures: 58 per cent of total GDP generated by Java, 21 per cent by Sumatera, 8 per cent by Borneo, 6 per cent by Sulawesi, and only 2 per cent by the eastern regions. Despite this, Indonesia has had a firmly unitary government for almost the entirety of its post-colonial history and has had a deep 'aversion' to federalism (Ferazzi 2000; Reid 2007). After 54 years of centralised government, though, Indonesia finally took the step of decentralising. This gained momentum following major political upheaval in 1998. The fall of the New Order regime under President Soeharto's leadership had created

several reform agendas, which included the promotion of local autonomy to address economic and development inequalities. The eagerness to deliver this reform agenda was shown in the stipulation of its legal framework, which came about a year after President Habibie's interim government took the place of the fallen New Order regime.

Law No. 22 (on Regional Governance) and Law No. 25 (on the Fiscal Balance Between Central and Regional Government) of 1999 provided the first legal bases for the central government to regulate central–local structural and functional responsibilities and fiscal relations. These laws marked the 'big bang' transformation of a highly centralised country to a decentralised country. However, only two years after their promulgation a series of discussions was undertaken regarding revising these laws, the main reason being that the central government acknowledged that the two laws were hastily established and flawed (Rasyid, 2004). The laws were revised by Law No. 32/2004 on Regional Governance and Law No. 33/2004 on the Fiscal Balance Between Central and Regional Government. The Act was a proof of the central government's eagerness to refine its practice to address concerns and re-evaluations resulting from its previous policies as embedded in the law.

While the central government has subsequently further revised the law on regional governance through Law No. 23/2014, there have not been any changes to the specific law concerning the fiscal relations between central and sub-national governments. There have, however, been many changes in fiscal decentralisation practice. These have been implemented by inserting new clauses into the Law of Annual National Budget passed before the beginning of every fiscal year.

At the beginning of its 'big bang' approach, the central government's focus was establishing sub-national government fiscal autonomy. However, along the way, there were issues with the policies. The primary concern was about monitoring and accountability, with the central government allocating immense fiscal resources to sub-national governments but lacking the ability to ensure that sub-national governments spent those resources appropriately. As important as it was to provide a highly discretionary budget for sub-national governments, the central government was facing challenges in ensuring sub-national government performance so as to achieve the theoretical benefits of decentralisation.

1.1.2 Dilemmas of Fiscal Autonomy

Countries implement decentralisation because they believe it will generate better outcomes – better public service delivery, empowerment of citizens, responsive public management etc. – which will eventually create prosperity equally throughout the nation. Fiscal federalism – commonly known in unitary countries as fiscal decentralisation – is a key mechanism for countries seeking to achieve those outcomes. The theory of fiscal federalism has evolved to match the growing demand for getting good outcomes from sub-national governments.

The first generation of fiscal federalism theory concerned ways to achieve local fiscal autonomy. One of the aims of decentralisation is to empower sub-national governments and use their better knowledge of local public needs to improve prosperity and public service delivery in the regions. Therefore, sub-national governments need a high degree of fiscal autonomy to be able to deliver their delegated tasks and responsibilities independently.

Some authors focused on localising central tax or revenue-raising as the best pathway to create fiscal autonomy (Shah, 1999; McLure Jr, 1999). Devolving taxation can improve sub-national government accountability and make them less reliant on the central government (Bahl & Linn, 1992). Others contend that localising taxation is not always administratively economical. Hence, as with the concept of the central government's income redistribution role (Musgrave, 1959), the central government needs to distribute some portion of its collected taxes to sub-national governments in the form of intergovernmental fiscal transfers (IGFTs). However, supporting sub-national governments financially through IGFTs creates sub-national government that is heavily reliant on the central government.

1.1.3 Grants and Incentives

The second generation of fiscal federalism theory involved a change of focus. It pointed out that, regardless of where sub-national government fiscal resources come from, the amount of funding accruing to sub-national governments due to fiscal decentralisation is massive. Therefore, the central government needs to create policies that enable it to ensure that sub-national governments use their fiscal resources

appropriately, with a performance indicator being achievement of the desired outcomes of decentralisation in the first place.

There were two approaches identified in the second-generation theory. The first is to restrict sub-national government fiscal discretion and limit its flexibility by using tied grants. This approach holds that tied grants make sub-national governments perform better because the central government, as the principal, can control the sub-national government's (the agent's) spending behaviour (Levaggi, 2002). The second approach recommends fiscal incentives be given to sub-national governments as a reward for their performance in achieving desired outcomes on essential indicators. Steffensen and Larsen's work (2005) on Performance-Based Grants provided conceptual insights into implementing fiscal incentives as an instrument in implementing fiscal decentralisation. Meanwhile, other works see the design of the fiscal structure as being essential as an instrument of incentives to sub-national governments.

1.1.4 Indonesia's Policy in Ensuring Good Outcomes

Indonesia's fiscal decentralisation journey was experiencing a similar issue – how to get the most out of its massively increasing IGFTs (which increased from IDR 33.1 trillion in 2000 to IDR 766.3 trillion in 2017). The data from 2000 to 2017 show that, notwithstanding several high fiscal capacity sub-national governments, on average, IGFTs accounted for 70 to 80 per cent of sub-national government budget revenue. A large proportion that would be wasted if it is not administered and allocated properly.

After a decade of pursuing fiscal decentralisation, the central government began efforts to obtain more value for funds being transferred to sub-national government. Having been praised for its success in making the 'big bang' transition from a highly centralised to a deeply decentralised approach, the Indonesian government wanted to move to the next level in terms of getting the desired decentralisation outcomes.

Despite there having been no formal amendment of Law No. 33/2004, the central government has substantially transformed its fiscal decentralisation policies. The focus of this transformation has been on using fiscal transfers to ensure sub-national government performance. The massive and growing amounts of intergovernmental fiscal transfers, which from 2006 to 2017 accounted for around one-third of the National State Budget (APBN) total expenditures, became a major concern for the

central government, particularly in relation to the significance of benefits created by giving fiscal autonomy to sub-national governments.

From 2010, the central government started to introduce performance-based fiscal incentives in the form of a Local Incentives Fund (DID). This provides financial rewards for high-achieving sub-national governments. The central government also combined financials reward with an award system for the top three provinces, top five municipalities and top ten regencies in terms of financial performance.

Subsequently, since 2015, the central government has put more emphasis on tied grants, which includes an increased allocation, changing the Specific Allocation Grant (DAK) mechanism into a proposal-based system, and creating more rigid requirements for its transfer mechanisms. The central government also added conditionality requirements into block grant transfer mechanisms. These new policies, it is believed, will bring the outcomes expected from the sub-national governments.

Meanwhile, Law No. 32/2004 on Sub-national government was revised again through Law No. 23/2014. One of the policies of significance under the new law is the strengthening of provincial functions and responsibilities, and consequently the reduction of municipality and regency functions and responsibilities. The argument for this arrangement was that the central government saw a lack of synergy and coordination in the regional governments, which it thought undermined decentralisation practice and inhibited good decentralisation outcomes.

The new responsibilities system marked another milestone in the relationship between central and sub-national governments, which is highly influential in Indonesian decentralisation practice. Before the reform era of 1998, the government structural hierarchy consisted of three tiers: the central government, the provinces and the municipalities or regencies. The municipalities and regencies are at the same level, but their geographical situation, development and economic level, and their population density, became the criteria for central government in distinguishing between them.¹

¹ Another distinction concerns administrative government under both entities. Both have an administrative subordinate called *Kecamatan* that supervises several *Kelurahan*. However, while we can find an entity called a 'village' under a Regency there is none under a Municipality. The village is at the same level as *Kelurahan* but, unlike the head of *Kelurahan* who is administratively appointed by the regents and mayors, the village has the special privilege of holding elections to select the head of the village.

This hierarchy provided the bureaucratic chain in Indonesia for many years, with the lower tier of government reporting and responsible to its direct upper-level government. Then, Law No. 22/1999 explicitly abolished the hierarchy between provinces and municipalities or regencies, which created complications in terms of supervision, responsibilities and task allocation. The central government has tried to address these issues, and the most recent law tends to strengthen the provinces by giving them more strategic roles to coordinate municipalities and regencies. However, there is still one defect in the law – namely, it has no explicit clause mentioning hierarchical structure, as it did before the reform era.

1.2 Scope and Objectives

This thesis assesses the Indonesian central government's fiscal decentralisation policy in engaging with the issue of sub-national government performance. Given the fiscal reliance of sub-national governments, IGFTs have been seen as a valuable tool to control sub-national government performance and the Indonesian central government faces the challenge of how to optimise it in achieving better decentralisation outcomes.

First, the research will explore the Indonesian experience in implementing performance-based fiscal incentives as endorsed in second generation fiscal federalism theory. The aim here is to obtain a deeper knowledge of what works and what does not work: practice-based knowledge of the kind of complications that need to be addressed in designing and applying performance-based fiscal incentives.

Secondly, the research will examine the fundamental transformation of Indonesia's fiscal decentralisation policy, especially its IGFT regulations and transfers mechanism since 2015. The Indonesian central government also appears keen to implement the approach of limiting flexibility, identified in the second generation of fiscal federalism theory. The research seeks a better understanding from the Indonesian experience of the benefits and difficulties in practising a flexibility-limiting approach. This thesis focuses on the transformation of Specific Allocation Fund (DAK) regulations. The Special Autonomy Fund and the Village Fund are also categorised as tied grants, but they are not included in the study. Additionally, it will be interesting to examine whether endorsing a flexibility-limiting approach and encouraging performance through offering fiscal incentives can be implemented at the same time.

Devolving tasks and responsibilities would be less meaningful without the practice of fiscal decentralisation; likewise, fiscal decentralisation would be ineffective in the absence of appropriate tasks and responsibilities being allocated between tiers of government. Setting up the assignment of functions and expenditure responsibilities of sub-national governments is the first step in implementing fiscal decentralisation, because the appropriate assignment of revenues requires knowledge of expenditure assignment (Bahl, 1999). Subsequently, the central government needs to set up a fiscal decentralisation policy strategy that can ensure the delivery of good outcomes from sub-national governments. Therefore, it is also essential to assess the Indonesian structural arrangement, tasks and responsibility assignment as elements of the central government's efforts to get better decentralisation outcomes from sub-national governments.

The research will assess whether the Indonesian central government has adopted an appropriate fiscal decentralisation policy approach to support its effort to get better outcomes from sub-national governments. The research will address three specific questions.

1. Has a performance-based grant system, in the form of the Local Incentive Fund (DID), succeeded in encouraging improved sub-national government performance? Or is it merely a formality because the central government simultaneously chooses to control sub-national government performance by increasing use of tied grants, which limiting local-level budget discretion?
2. Has the transformation of the Indonesian intergovernmental fiscal transfers (IGFTs) policy been able to foster sub-national government performance?
3. Has the Indonesian structural tasks and responsibilities assignment provided a sound base to support fiscal decentralisation policy in getting good outcomes from sub-national governments?

1.3 Significance

This research contributes to the literature of the second generation of fiscal federalism theory and the literature on the practice of fiscal decentralisation in general. It provides practice-based details on the experience of implementing both approaches used to

improve sub-national government performance identified in the second-generation theory. Theoretically, the two approaches are opposite to each other, yet the Indonesian practice has been to use them in parallel. Therefore, we will try to reveal whether the practice is indeed an ambiguity of policy or a combination of both is actually a potential new approach. Furthermore, it provides an up-to-date understanding of the complex and ambitious process of an Indonesian fiscal decentralisation policy that also must engage with the issue of sub-national government performance in utilising fiscal resources.

The research also aims to benefit the central government in Indonesia by suggesting a better policy framework for its fiscal decentralisation program. The findings may be a useful resource for the revision of Law No. 33/2004 on Fiscal Relations between Central and Sub-national governments.

1.4 Thesis Structure

The thesis is divided into nine chapters. Chapter 1 is an introductory chapter explaining the background, scope, objectives and significance of this study. Chapter 2 is a review of literature concerning theoretical perspectives on the practice of fiscal decentralisation and sub-national government performance. It contains the theoretical perspectives and centralisation–decentralisation terminology that form the basic knowledge of central–sub-national government relations. The review explores arguments for and against decentralisation and explains the issues of fiscal decentralisation policy covered in the so-called first- and second-generation theory of fiscal federalism. Specific attention is given to the concept of performance-based fiscal incentives. The chapter also covers the theoretical perspectives on implementing asymmetric decentralisation, in order to broaden our knowledge of alternative approaches to decentralisation.

Chapter 3 reviews literature comparing fiscal decentralisation in three countries. It will explore not only the fiscal decentralisation aspects but also each country's political background as an influence on its government's structural arrangement. The chapter also reviews each country's strategy in engaging with sub-national government performance. The three countries examined are China, Canada and Spain, with each illustrating a specific approach and practices that offer valuable lessons.

Chapter 4 discusses the Indonesian fiscal decentralisation program, which is the case study of this research. It provides descriptive details about the ambitious project of Indonesian fiscal decentralisation policy since the beginning of the reform era in 1999. Similarly to the organisation of the country reviews in Chapter 3, this chapter also outlines the Indonesian political context that led to the so-called ‘big bang’ decentralisation approach. It also examines the post-reform choice of governmental structural arrangements, which affect fiscal relations and sub-national government’s performance management.

Chapter 5 explains the methodology used in conducting the research. The explanation of methodology outlines and justifies the qualitative nature of the study, data-gathering techniques, data collection process and analysis. The chapter also explains the ethical issues and some limitations regarding the research.

Chapters 6 to 8 contain the research findings and discussions separated into three different themes based on the three research questions mentioned earlier. Chapter 6 contains findings and discussions about the use of performance-based fiscal incentives in Indonesia. Chapter 7 contains findings and discussions about the Indonesian central government’s efforts to utilise intergovernmental fiscal relations and fiscal transfer policies to encourage better outcomes from sub-national governments. Chapter 8 covers the findings and discussions regarding how the Indonesian government’s structural, tasks and responsibilities arrangement contributes to sub-national government business processes and performance.

Finally, Chapter 9 identifies the lessons to be drawn regarding a policy approach that can foster good outcomes from sub-national governments in Indonesia based on the research findings. This chapter also includes recommendations for further research in the area of fiscal decentralisation policy and sub-national government performance management.

FISCAL DECENTRALISATION AND THE PERFORMANCE OF SUB-NATIONAL GOVERNMENTS: THEORETICAL PERSPECTIVES

2.1 Chapter Preview

The case for fiscal decentralisation has been theoretically developed over a number of years. Based on its use, fiscal decentralisation is not a stand-alone concept. It emerges as a requirement whenever a country starts to take the path of decentralisation. The creation of local autonomy will only be meaningful if sub-national governments are also given the fiscal resources to execute their devolved powers. In this way, sub-national governments can fully engage in managing their development and public services delivery. Therefore, a proper fiscal decentralisation policy is a necessary step for a country that wants to implement decentralisation. Over time, improvements or new approaches to the theory of fiscal decentralisation have been suggested.

This chapter will track the conceptual development of decentralisation theory, starting from the theory of central–sub-national government relations regarding centralisation and decentralisation. The review will include commonly used theoretical definitions in preference to centralisation–decentralisation terminology, as well as other definitions better served to describe the reality of centralisation–decentralisation practice. It will also explain the division of political, administrative and fiscal aspects concerning decentralisation. This discussion will convey that centralisation–decentralisation does not necessarily correlate with national structure (i.e. unitary or federal).

This chapter will also consider the ways in which decentralisation may not always be beneficial. While many people view decentralisation as the best solution in tackling development inequality, lack of public service delivery and weak local economic growth, some scholars pose contrasting views about the challenges and limits of implementing decentralisation. For example, recent research from Cavusoglu and

Dincer (2015) concludes that fiscal decentralisation may reduce income inequality but only in rich states.

This chapter will follow the theoretical discourse on the implementation of fiscal decentralisation through the development of its so-called first and second generation versions. Both versions cover issues emerging from the practice of fiscal federalism. The discussion begins with the debate about providing fiscal resources for sub-national governments, and the most recent concern of how to ensure those fiscal resources are well spent. Particular attention will be given to performance-based fiscal transfers, which have been identified in the second generation theory of fiscal federalism as one way to ensure sub-national governments' performance.

Finally, this chapter includes some discussion of asymmetric policy approaches towards the practice of decentralisation; this includes administrative, fiscal and performance management aspects. The aim of this is to emphasise what lies behind the theory, and how the asymmetric approach can offer different perspectives in getting good outcomes from sub-national governments by considering their different capacities.

2.2 Central–Sub-National Government Relations

The relationship between central and sub-national governments is a crucial element of any political system that has multiple levels (Phillimore, 2013). Integral to this is an understanding of how governmental functions, tasks and responsibilities are divided or shared among the tiers of government. Decentralisation has been an essential public sector reform in many countries (Devas, 2008; Shah, 1999; Smoke, 2015). It is considered to promote better and more equally distributed development and provide adequate public services (Devas, 2008).

A federal form of government is often advocated for its ability to decentralise decision-making and accommodate local preferences, political participation and accountability (Shah, 2007). Federalism can be regarded as a constitutional institution, while decentralisation is an outcome of policy choice (Blume & Voigt, 2011). However, 'decentralisation' does not correlate to federalism: some federations have become

more centralised, while many unitary nations are becoming more decentralised.² A unitary nation may decentralise by delegating power to local authorities, while in a federation the state or provincial governments are the ones that determine the functions of its local governments (Smoke, 2015). Meanwhile, from the public administration theory point of view, decentralisation is not exclusively owned by the new public management (Bahl & Martinez-Vazquez, 2006) type of reforms, because traditional public administrations have also implemented decentralisation (Levy, 2002).

Furthermore, decentralisation includes fiscal, political and administrative aspects that have a different correlation with the effectiveness and efficiency of governance (O'Dwyer & Ziblatt, 2006). O'Dwyer and Ziblatt (2006) find that fiscal decentralisation has only a modest relationship to effectiveness, while administrative decentralisation has low impact and political decentralisation does not have any importance at all. However, in terms of efficiency, they did find a correlation between political – but not fiscal or administrative – decentralisation and efficiency. So, decentralisation has a complex relationship with the quality of governance. Therefore, we need to have detailed knowledge about decentralisation and its characteristics in central–sub-national government relations.

2.2.1 Centralisation and Decentralisation

Decentralisation can occur in response to ethnic, cultural or geographic differences (Oates, 1972; Alesina & Spolaore, 2003; Boex & Simatupang, 2008). Such factors make for different local preferences because people with different ethno-cultural backgrounds often exhibit a different mix of public goods preferences (Schakel, 2010). Additionally, economic and ideological differences can lead to decentralisation. Democratic political systems, we can assume, are more responsive to heterogeneous preferences. So, when a single political party dominates and citizens lack meaningful choice, centralisation can be expected to prevail (Alesina & Spolaore, 2003; Schakel, 2010).

Decentralisation is defined as a transfer or delegation of legal and political authority, resources and processes to plan, make decisions and manage public functions from

² Shah (2007) and Phillimore (2013) acknowledge this phenomenon and conclude there is no necessary correlation between decentralisation and the form of a government.

central government to lower-tier government, such as autonomous sub-national governments and regional development authorities (Rondinelli, 1980; Faguet, 2005; Boex & Yilmaz, 2010). Hence, many authors, such as Oates (1972; 1999), Page and Goldsmith (1987), Rodden (2004), Devas (2008) and Watts (2005), perceive decentralisation as a shift of authority from central government to sub-national governments so that they can bring the government closer to its people.

In practice, claims are not always consistent with the definition. Most developing nations promote their decentralisation as a devolution despite retaining supervisory powers for the central government, which continues to hold a large portion of financial roles and force sub-national governments to comply with national development policies and plans (Rondinelli, 1980). Therefore, a different point of view defining centralisation and decentralisation based on countries' practices is introduced by Schakel (2010). Schakel's empirical research suggested centralisation as a concentration of authority in a single tier of government, while decentralisation involves diffusion or sharing of authority between tiers of government. He argues that the words 'concentration, diffusion, or sharing authority' offer a better understanding of the practical meaning of decentralisation, rather than a shifting or moving away of functions and authorities of the central government.

Fukuyama (2004) writes that decentralisation debates are focused on what is called 'delegated discretion', which supports the famous 'decentralisation theorem' introduced by Oates (1972); this theorem requires a jurisdiction to have control over a geographical area, and provide local public services that would internalise the benefits and costs of providing those services.

For a public good – the consumption of which is defined over geographical subsets of the total population, and for which the costs of providing each level of output of the good in each jurisdiction are the same for the central or for the respective local government – it will always be more efficient (or at least as efficient) for local governments to provide the Pareto-efficient levels of outputs for their respective jurisdictions than for the central government to provide any specified and uniform level of output across all jurisdictions. (Oates, 1972, p. 35)

Decentralisation does not transform into practice in a single form. The basic concepts concerning forms of decentralisation are mentioned by Rondinelli (1980). First, he made a distinction between functional and areal decentralisation. Functional decentralisation involves delegating specific functions and authorities to national

ministries' field offices or agencies that operate across jurisdictions; areal decentralisation transfers the public functions to local political entities, such as provinces, municipalities and regencies. Rondinelli's second distinction, between deconcentration, delegation and devolution, is more gradual. Deconcentration is the lowest degree of decentralisation, because it merely transfers administrative workloads to regional staff, without the ability to make decisions. At the other end of the spectrum is devolution, where public functions are transferred to regional units or sub-national governments that do not operate under the formal command structure of the central government.³ Delegation sits between those two; it is more advanced than deconcentration because it includes decision-making authority, but is less extreme than devolution because it still falls within the formal command structure of the central government.

Pollitt, Birchall and Putman (1998) draw three distinctions between forms of decentralisation. The first distinction is that between political and administrative decentralisation, which are differentiated based on the allocation of authority between levels of government. The second is between competitive and non-competitive decentralisation, and their third distinction is between internal decentralisation and devolution, with the latter two pairs correlating to internal service management. Competitive decentralisation uses competitive tender results in contractual relations based on a principal-agent relationship in allocating functions, while non-competitive decentralisation uses an expansion of responsibilities in areas like finance, audit and human resources. Internal decentralisation is the opposite of devolution, where responsibilities are delegated to front-line staff of the central government's regional or local offices.

The task of devolving authority, functions and responsibilities is not a simple one. The functional perspective suggests an optimal jurisdictional size that is achieved when the jurisdiction manages to internalise externalities and secures benefits of scale on public goods, which means each policy has a different jurisdictional size (Schakel, 2010). Another consideration in the functional perspective is scope effects and transaction

³ Devas (2008) only mentioned deconcentration and devolution as forms of decentralisation, and he considered devolution as a political or democratic decentralisation that make local governments accountable to its local constituents, even though in some extent also accountable to the central government. So, it is not completely separate as suggested in Rondinelli (1980).

costs (Hooghe & Marks, 2003). Geys and Konrad (2010) discuss how to determine the optimal allocation of tasks across tiers of governance, finding that the theories of Stigler (1957), Musgrave (1959), Oates (1972; 1999) and Inman and Rubinfeld (1997) only make the allocation theory unclear as there are multiple trade-offs to take into account. Therefore, Geys and Konrad (2010) conclude that, in reality, it is difficult – indeed, almost impossible – to attain an ideal allocation of tasks across tiers of governance.

2.2.2 Pros and Cons of Decentralisation

Countries introduce decentralisation in the expectation that it will bolster economic development and bring prosperity across the country, provide better public services, empower local citizens and enhance responsive public management and good governance. Unfortunately, those are projected benefits based on ‘often-heroic assumptions’ (Smoke, 2015). Empirical research often finds little evidence of the benefits or outcomes expected by countries.

An empirical study of cross-country panel data from 1970 to 1989 concludes that fiscal decentralisation does not have a positive effect on economic growth (Davoodi & Zou, 1998). On the other hand, some evidence that decentralisation has a significant positive relationship with economic growth is suggested by Iimi (2005), who tried to readdress the hypotheses using instrumental techniques and different timeframe (between 1997 and 2001). A more balanced study found that fiscal decentralisation has an optimum degree that can promote economic growth (Thießen, 2003); however, delivering a level of decentralisation above the optimum will only reduce growth.

These different conclusions show that the correlation between decentralisation and economic growth has mixed empirical evidence, which may not be entirely reliable due to methodological problems (Martinez-Vazquez & McNab, 2003). Martinez-Vazquez and McNab (2003) suggest researchers look at other impacts of decentralisation, such as consumer and producer efficiency, macroeconomic stability, the geographical distribution of resources, corruption and elite capture. Moreover, even though Akai, Hosoi and Nishimura (2009) believe that fiscal decentralisation is

conducive to stabilising economic growth, they admit that different data sets covering different periods or countries complicate the empirical evidence⁴.

There are also other empirical findings regarding decentralisation. A study conducted in the United States of America concluded that fiscal decentralisation could reduce income inequality but only in rich states (Cavusoglu & Dincer, 2015). Increased fiscal disparity, economic instability and conflict over resources that may lead the country to break up are among the dangers and pitfalls of decentralisation warned of by Prud'homme (1995) and Tanzi (2001), who also argue that decentralisation results in more significant corruption. The latter has been challenged by Fisman and Gatti (2002), who provide empirical evidence of a robust and negative correlation between decentralisation and corruption.

2.3 Fiscal Decentralisation

Early views of fiscal decentralisation involved sub-national governments providing and paying for local public services to create an efficient allocation of public resources (Oates, 1972). Fiscal decentralisation is an aspect that tightly correlates to the practice of delegating or sharing functions, tasks and authorities between central government and sub-national governments (Alam, 2008). The sub-national governments cannot perform those delegated or shared responsibilities without sufficient financial resources, and hence there is a mutual relation between the devolution of decision-making power and fiscal decentralisation. Both are needed to make decentralisation meaningful (Devas, 2008). Some authors (Akai & Sakata, 2002; Stegarescu, 2005; Boex & Simatupang, 2008) use fiscal assignment and the extent of discretion in its use to measure the degree of decentralisation in a nation.

Setting up the assignment of functions and expenditure responsibilities of sub-national governments is the first step in implementing fiscal decentralisation, because appropriate assignment of revenues requires knowledge of expenditure (Bahl, 1999). Furthermore, Bahl (2000) suggests analysing how well the actual assignment of responsibilities fits the expenditure capabilities given to sub-national governments as a way to examine the adequacy of assigned functions to lower tiers of governments.

⁴ A similar suggestion also comes from Baskaran, Feld and Schnellenbach (2016).

The question of fiscal decentralisation, or fiscal federalism as economists term it,⁵ is not only ‘how much to provide?’ but also ‘where should the funding come from?’ The term ‘money follows function’ reflects the concept of matching the assigned own-source revenues and transfers with the assigned tasks (Bahl, 1999). However, there are different views on whether the best means is through enlarging tax-collecting power or through intergovernmental fiscal transfers (IGFTs). Furthermore, recent authors are more concerned with ensuring fiscal transfers that can create desirable outcomes at the local level.

2.3.1 First Generation Theory

Oates (2005) and Weingast (2009) describe the early literature on fiscal federalism as the ‘first generation theory’. The focus was sub-national government’s source of revenue in exercising discretion in providing local public goods. The first generation held that sub-national governments must have a high degree of fiscal autonomy, to be achieved by assigning tax capacity to the local level (Shah, 1999; McLure Jr, 1999). The central government must ensure that sub-national governments can generate sufficient revenue to finance their activities in providing public goods. Besides that, revenue assignment can force sub-national governments to become more accountable to local taxpayers, and less reliant on central government (Bahl & Linn, 1992).

However, certain conditions – such as the income redistribution role of central government (Musgrave, 1959; Arrow, 1969; Samuelson, 1954), horizontal imbalances, economies of scale and administrative efficiency (McLure Jr, 1999; Tanzi, 2001; Devas, 2008) – make it unlikely that sub-national governments will be able to fulfil their roles solely from own-source revenues. The role of IGFTs became crucial in addressing those issues. The central government collects some taxes, which are more cost-efficient when collected centrally, and then uses the IGFTs as a tool for income redistribution both from wealthy individuals to more impoverished individuals and from rich regions to poor regions. Therefore, the objectives of IGFTs are not only to address vertical imbalances but also to reduce horizontal imbalances due to fiscal disparity among regions, and as an administrative justification in collecting taxes

⁵ For political scientists, one cannot have fiscal federalism without the existence of federalism; for economists, the notion applies equally to unitary systems of government (e.g. Indonesia).

centrally. Moreover, IGFTs should also be designed to offset externalities through matching grants,⁶ such as conditional spending on services that are still underfunded due to their significance for the nation as a whole.

There are three main types of IGFTs that are broadly used in many countries: revenue sharing, general allocation or block grants, and specific allocation or tied grants.⁷ The discretion in utilising the money is the key in differentiating between block grants and tied grants. The sub-national governments have full discretion in managing general allocation grants, including the freedom to allocate to sectors and prioritise programs. According to its discretionary level, revenue sharing is also considered a form of block grant because it is not earmarked.⁸ It is the implementation of an administrative process that collects taxes – and in some countries also natural resources revenue – centrally and afterwards transfers the funds to their origins. Conversely, sub-national governments cannot do the same with tied grants because they are directed in detail by the central government on the sector and kind of activities on which the funding must be spent. The sub-national governments act as the executive committee, following guidelines provided by the central government as the steering committee.

Additionally, all types of IGFTs are intended to create vertical and horizontal balance, and usually other objectives that differ between IGFTs. Countries typically use the general allocation as a block grant to address horizontal imbalances between regions. These imbalances arise because each sub-national government has different potential in generating both centrally collected taxes (that are subsequently redistributed) and locally collected taxes and fees as own-source revenue. Moreover, not all regions are gifted with revenue-creating natural resources. Hence, there are ‘rich’ and ‘poor’ regions. Meanwhile, tied grants are aimed at financing national priorities that are executed at the local level by sub-national governments. In other words, tied grants are a tool for the central government to influence the sub-national government’s spending.

The next challenge for the central government is allocating IGFTs. Understanding the potential implications for sub-national government’s fiscal capacity, some authors, such as Sidik (2007) and Devas (2008), believe the formulation used in allocating

⁶ The objectives of IGFTs are summarised from Ma (1997), Bahl (2000), and Bird and Smart (2002).

⁷ The types of IGFTs are explained in Ma (1997), Bahl (2000), Kadjatmiko (2006) and Devas (2008).

⁸ The common definition of revenue sharing; however, in some countries, e.g. Indonesia, there are certain kinds that are earmarked to certain kinds of expenditure (matching grants).

IGFTs should be transparent, using objective factors such as expenditure needs, fiscal capacity, poverty rate and performance factors. In many developing countries, IGFTs have become the leading source of sub-national government's budgets (Shah, 2007).

The concept of allocating IGFTs has faced severe challenges both politically and theoretically. No matter how rigid and transparent the formula is, in practice there are always concerns and dissatisfaction from sub-national governments over how much money they receive based on the formula result. Politically, there are demands from more prosperous regions to reduce centrally collected taxes, and thereby increase their revenues (Tanzi, 2001). The consequence is, of course, a decrease of the central government's fiscal capacity to support poor regions so that they can reduce the fiscal gaps needed to provide public needs. In the jargon of economists, this phenomenon positions fiscal decentralisation as 'superior goods', which are more desirable when income increases (Tanzi, 2001).

Rodden (2003) argues that a sub-national government's budget that relies mostly on central government transfers will potentially risk the overall budget by producing ineffective programs. It may lead to rent-seeking activity from the sub-national governments because there will be a tendency to increase their fiscal needs while ignoring efforts to increase their fiscal resources through optimising their own-source revenue (Bahl & Linn, 1992). Moreover, it will eventually burden the national budget, especially when the national government has to give bailouts to inefficient and ineffective sub-national governments (Tanzi, 2001). In other words, it is like punishing rich and fiscally efficient regions, but at the same time rewarding regions that become poor because of their inefficiency.

2.3.2 Second Generation Theory

Given the fungibility of money, Bird and Smart (2002) argue that IGFTs allocated based on needs and capacity cannot provide any assurance that sub-national governments will use it according to the central government's wish, unless the central government can monitor compliance or put specific performance criteria as a condition of transfers. Rodden (2003) also writes that a potential risk to the national budget can occur when sub-national governments are given transfers while the central government cannot control their efficiency and effectivity. These issues subsequently become a

central theme –as Oates (2005) explains, ‘the second generation theory’ of fiscal federalism focuses on ways to control sub-national governments’ fiscal autonomy.

While Oates (2005) only implies that the first and second generation theories are not in conflict, Weingast (2009) points out explicitly that the second generation complements the first generation by ensuring sub-national government’s efficiency and effectiveness in utilising the transferred money. Thus, the second generation theory focuses on enhancing the practice of fiscal federalism introduced in the first generation theory. It tries to address some potential problems of moral hazard that would hinder good outcomes.

According to Oates (2005) there are two IGFTs methods used in the second generation theory, each reflecting a different point of regarding the methods applied to the issue of sub-national government performance in creating good outcomes. The first method addresses the issue by restricting sub-national government’s fiscal discretion, while the second one suggests fiscal incentive mechanism from central government as a tool to control sub-national government performance.

The first method suggests that the central government should transfer specific or earmarked budgets rather than provide a lump-sum budget to sub-national governments. Some authors advocate conditionality of transfers because the role of sub-national governments is merely the agents of the central government. Therefore, conditionality is very much looked-for, especially when essential functions such as education and health also become the responsibilities of sub-national governments (Bird & Fiszbein, 1999). Sub-national governments may perform better if the central government limits their flexibility through the use of ‘double budget constraint’ (Levaggi, 2002), which prescribes not only the overall budget but also the precise distribution of the expenditure on specified programs (Oates, 2005).

However, the theoretical challenge is that conditionality runs counter to the importance of fiscal autonomy for sub-national governments. IGFTs consist of block grants and tied grants that will determine the degree of fiscal autonomy, because both grants come at a different level of discretion. Tied grants, which place conditionality on transfers, reduce fiscal autonomy and this, according to Devas (2008), makes fiscal decentralisation less meaningful.

The second method is similar to that identified by Weingast (2009). It involves the use of fiscal incentives in producing local economic prosperity and ensuring better public services. It tries to provide high discretion and fiscal autonomy to sub-national governments while at the same time controlling their performance through the use of fiscal incentives.

Contract-based management under the new public management framework, and the demand for good governance under the new institutional economics approach, provide the economic rationale for performance-oriented transfers (Shah, 2007). The new public management suggests changing from permanent to contractual employment with a view to using fulfilment of contract performance as a way to strengthen accountability. Meanwhile, the new institutional economics approach believes that opportunistic behaviour from government officials in using asymmetry of information between citizens as principals and government officials as agents would create dysfunctional governance in the public sector. Therefore, output-based grants as a means to implement results-based accountability can empower citizens to increase their information base and reduce transaction cost in demanding action (Shah, 2007).

This second method could supplement Boex and Simatupang's (2008) propositions about measuring the degree of decentralisation. It measures the level of control or discretion in a sub-national government's share of public spending, which addresses concerns about using only the ratio of a sub-national government's own-source revenue to total revenue in determining the degree of decentralisation.⁹ The degree of decentralisation is measured by how much control or discretion the sub-national government enjoys over financial resources. So, the second method explained in Oates (2005) could serve as a solution for how to control sub-national government's performance without reducing, or even eliminating, its discretion in managing fiscal resources.

This method is known in the literature as the performance-based grant (PBG) (Steffensen & Larsen, 2005; UNDP, 2005). The PBG is the fiscal incentive instrument that is most discussed in the literature and is considered as a central government

⁹ Akai and Sakata (2002) previously acknowledged both measurement methods by including two models or equations in their Autonomy Indicator. This measures the ratio of local government revenue compared to total revenue in two different ways, first excluding federal grants and then including such grants based on their discretionary use.

strategy to control sub-national government performance. In short, the central government defines local behaviour and uses PBGs to penalise undesirable behaviours and reward desirable behaviours. The method aims not only to create accountability to the central government but also to implicitly create an opportunity for leaders of sub-national government to demonstrate their performance to local constituents.

There are two fundamental dimensions that distinguish PBGs mentioned in Steffensen and Larsen (2005). The first is the type of performance that the grant is trying to leverage by determining its focus, whether institutional or service delivery. The second concerns the usage of funds – whether they are for multiple purposes, giving sub-national governments discretion or earmarked for specific purposes.

PBGs differ from common IGFTs, which are transferred to sub-national governments to comply with directives in performing a particular function. PBGs are linked to performance in a pre-determined area, with access to and size of funding serving to incentivise sub-national government's performance improvement (Steffensen & Larsen, 2005). PBGs attempt to include conditionality, such as the achievement of specific desirable goals, in accessing a grant. They aim to encourage a positive change in some aspects of the sub-national government's performance. The central government set those goals in the form of minimum conditions and performance measures. Sub-national governments must show that they have met the goals established in the grant legislation or rules to get access to the grant.

The most effective way for sub-national governments to achieve success is through supporting a PBG transfer scheme that has a robust, coordinated capacity-building process and support to sub-national governments (Steffensen & Larsen, 2005). The performance system will give sub-national governments the incentive to utilise capacity-building support effectively, while the capacity-building support will incentivise sub-national governments to improve their performance.

The literature also identifies another instrument in implementing fiscal incentives beside PBGs, namely designing a comprehensive fiscal structure. The literature discusses how fiscal structure can be used as an incentive mechanism in two ways. The first is allowing sub-national governments to keep a large portion of the taxes collected locally; the second is closely linking local revenues and expenditure

(Wildasin, 1997). An excellent local economy and strong tax effort will eventually serve as a fiscal incentive because it is the outcome that rewards or punishes sub-national governments. In this context, sub-national governments will obtain fiscal incentives by demonstrating proper effort in developing the local economy and increasing tax efforts.

If a sub-national government's pro-business policy can promote local market development, it will eventually increase the local tax revenue base. This is how the fiscal incentive mechanism works, and is also considered as an innate reward for sub-national governments. Therefore, a critical aspect of this method concerns whether sub-national governments can get a significant portion of the increased tax revenue as a result of their policy. If they can still get a significant portion, the increase would serve as a fiscal incentive. It would have a strong influence on the sub-national governments in creating a supportive policy for local market development. Conversely, if sub-national governments' rewards are unrelated to their policy efforts – or, even worse, negatively related – then there is no fiscal incentive for sub-national governments to support local market development (Jin, Qian & Weingast, 2005).

2.4 Ensuring Sub-National Government Performance

Sub-national governments are the tier of government closest to the people. They have an enormous capacity to deliver real outcomes at the local level and pursue objectives that can bring good outcomes to the quality of life of their citizens. The central government has assigned a wide range of IGFTs to support local budgets following the extensive assignment of capacity and functions. However, the absence of adequate attention to incentives and disincentives arising in consequence of allocating a large share of IGFTs may lead to unexpected complications for sub-national governments' performance and long-term sustainability (Boschmann, 2009).

Decentralisation, as a concept of public sector reform, does offer great hope for local people to improve regional development and public service delivery. However, its theory promotes expected benefits based on assumptions, which, if those assumptions are unfounded, undermines the reform process and may lead to failure. IGFTs, while intended as a remedy, may in fact raise noteworthy matters that need further attention. Therefore, focusing on results-driven sub-national governments requires an

understanding of how to define sub-national government performance, and the means by which central governments can control it.

Performance measurement in decision-making is one of the keys of successful public management reform, along with accurate databases and measurement methodologies (Wescott & Jones, 2007). Adequately meeting public needs should be a matter not only of quantity but also of quality. The quality of services is an essential issue in performance management of sub-national governments and should be a priority for countries (Mellor, Mowlana & Jovie, 2003). This raises the question: why does it have to be specifically in sub-national governments?

The aggregate of local-level political and institutional dynamics are decisive for decentralisation outputs. The central government must ensure the effectiveness and accountability of locals, which can be achieved by maintaining a balance between the nature of competition among local economic actors, the openness and competitiveness of local politics, and the coherence and organisational capacity of local civil society while delegating decision-making authority (Faguet, 2005). The term ‘institutions of accountability’ is also mentioned in Shah (1999) as an essential factor to bring success in decentralising decision-making authority. So, understanding decentralisation must begin with knowing the sub-national governments’ work performance.

In many cases decentralisation practices are driven by initial enthusiasm about expected benefits, followed by dissatisfaction with assessed results because of inadequate practical knowledge of how decentralisation is supposed to work (Smoke, 2015). Therefore, adequate systems, capacity and incentives are essential to make sub-national governments behave responsibly and to hold them accountable to the local constituents (Lewis & Smoke, 2012). As seen in the discussion about second generation theories of fiscal federalism, authors suggest that sub-national government performance should be the focus of attention. Similarly to Faguet’s (2005) proposition that national achievements are simply the aggregate of local performance, several researchers suggest theories that encourage central government to use fiscal incentives as a tool in ensuring sub-national governments performance. They believe that incentives for sub-national governments can be crucial in the reform process, especially in constructing fundamental systemic changes and reshaping all major actors’ behaviour and mindsets (Lewis & Smoke, 2012).

Furthermore, putting the issue into broader context we can correlate the issues of central–sub-national governments described through principal–agent theory (PAT). PAT emerged from research into risks and incentives trade-offs in the insurance industry (Spence & Zeckhauser, 1971). It was an effort to find appropriate ways for the insurance company, as the principal, to control the insurance holder’s (the agent) misconduct behaviour. The terms ‘moral hazard’ and ‘hidden activity’ are used as a justification that emerged from the principal’s information asymmetry regarding the agent’s behaviour to establish incentives mechanisms to eliminate, or at least reduce, the potential ‘moral hazard’.

Miller (2005) summarises several core assumptions regarding the principal–agent model outlined by Hölmstrom (1979) and Shavell (1979). The first is ‘agent impact’, whereby every agent’s actions have an impact on the principal’s target; the second is the principal’s information asymmetry; the third is preferences asymmetry between the principal and the agent; and the fourth is the principal’s superior bargaining ability. These core assumptions lead to the use of outcome-based incentives instead of monitoring the agent’s individual actions, and trade-offs between efficiency in incentives with efficiency in risk-taking behaviour.

2.4.1 What Defines Good Performance?

‘If you cannot define performance, you cannot measure or manage it’ (Armstrong & Baron, 1998). This is precisely the message that performance management tries to carry in the area of public service delivery. Performance management in the public sector is defined as the incorporation and use of pre-determined performance elements, such as efficiency, effectivity, robustness and transparency, which are measured to provide information to assist public sector managers in decision-making (Dooren, 2010).

Nations that are implementing decentralisation expect efficient outcomes from inter-district competition. This acts as a check on political power, similar to the way in which market competition acts as a check on corporate power. It can give citizens a better insight into how effective their sub-national government is in delivering public goods and services, and collecting related taxes.¹⁰ However, competition breaks down in the

¹⁰ The theory is drawn from Tiebout (1956) and Brennan and Buchanan (1980).

absence of reliable and transparent information. If sub-national governments fear that their local constituents will hold them accountable (e.g. through competitive elections) or that businesses might opt to re-locate to better-managed provinces or municipalities, every sub-national government will strive to achieve optimal outcomes. Nevertheless, the pressure to achieve optimal outcomes disappears if comparative benchmarks are not available. Therefore, it is essential to produce and share performance benchmarks.¹¹

Outcomes and processes can become options for measurement indicators, as mentioned in a report from the World Bank (2008). Identifying outcome levels under decentralisation, such as the number of students enrolled at school or average waiting time in health facilities, is advantageous in targeting geographical interventions and observing the outcomes' evolution over time. However, this approach does not provide a robust understanding of how these outcomes originated, nor does it offer policy guidance to sub-national governments. The reason for this is that outcomes tend to improve gradually. Therefore, it may penalise poorer provinces or municipalities – irrespective of the quality of their sub-national governments – if the central government focuses only on outcomes. Moreover, it may risk producing graphical-trend stagnancy over the years, discouraging effort, and thus does not provide much incentive to sub-national governments.

On the other hand, assessing performance that originates in sub-national government processes seems to be an ideal practice. The quality of processes that it establishes in order to achieve its development goals, and the success of these processes as they translate into outcomes, should be reflected in sub-national governments' performance. However, relying solely on process variables to capture performance can result in premature and misleading conclusions because of their hypothetical and untested nature, and may not provide evidence linking processes to outcomes.

Lewis and Smoke (2012) discuss the dilemma of choosing between inputs, outputs and outcomes as variables to define performance. Inputs as indicators are used in assessing cost efficiency by comparing a sub-national government's relative cost on similar budget spending activities or services providing, such as expenditure per kilometre of

¹¹Argument for creating Local Government Performance Management (LGPM) taken from the World Bank (2008).

roads or the ratio between teacher and students. However, geographical conditions can result in spatial cost variations that need to be considered in assessing performance. Lewis and Smoke (2012) therefore suggest using outputs, or even outcomes at some point in the future, as indicators to incentivise performance.

Another perspective comes from the PAT literature that encourages outcome-based incentives in tackling the ‘agency problems’. Even if it is possible to monitor and gather complete information regarding the agent’s actions, it would involve a high cost burden. Moreover, in the end what matters most to the principal is the outcomes achieved (Miller, 2005). Meanwhile, Fenna (2010) specifically discusses the use of benchmarking for performance measurement, and mentions that in the public sector the ultimate goals of a government are outcomes. The government obviously produces outputs but these only serve as pathways to achieving the expected impact on society (Fenna, 2010).

Many forms of decentralisation outcome identified in the literature – such as better public services, equitable local economic development, good governance, accountability and responsive public management – empower local people and give them a voice, and support the state’s integration. A publication from the World Bank (2008) suggests four areas of performance: public financial management, fiscal performance, service delivery and investment climate. Each of those four ‘pillars’ of performance breaks down further into several categories, and each category contains indicators. The four ‘pillars’ are chosen because they represent the impact of decentralisation on sub-national government’s responsibilities in four ways – the increased responsibility for immense IGFTs from the central government, broadened fiscal powers, the demand to improve local service delivery and infrastructure, and the ability to shape the local economy. Nevertheless, notwithstanding these expected benefits and performance from decentralisation, Smoke (2015) points out that the nature of reform and expected goals of decentralisation are generally based on a country’s specific contexts.

2.4.2 Measuring Performance

The United Nations Capital Development Fund (UNCDF) has been piloting performance-based grants (PBGs) in developing–low and middle-income countries

since the early 1990s. The fact that sub-national governments obtain more than 60 per cent of their revenue from IGFTs triggered this initiative.¹² The PBGs were set as an integral element of IGFTs that can provide incentives for sub-national governments to improve their performance in a range of areas.

The complexity of service and the need for accountability also become the grounds of performance assessment. More discretion is required every time a service becomes more complex. More discretion means more autonomy, which, in turn, requires accountability, which eventually requires performance measurement. The challenge is how to create reliable measurement tools to avoid misleading conclusions. Another challenging is whether performance measurement can link professional complexity with accountability.

Creating a set of indicators to measure performance is an essential step in managing performance. The central government needs to carefully determine individual components to set as indicators. Most PBG practices rely on generic indicators, such as planning, financial management, fiscal effort and transparency, rather than using output-based service delivery indicators. Moreover, the use of minimum conditions seems necessary to ensure primary fiduciary and safety measures are met first, or, in other words, as the entry point before rewarding the grants based on the carefully-created set of indicators.¹³

The central government can also adopt sophisticated econometric techniques to control outcome components not attributable to sub-national government's processes. Additionally, it can accurately measure how different 'processes' contribute to outcomes. However, the weakness is that this may not comply with the requirements of transparency and simplicity, which are essential if the central government wants common citizens to understand and trust the results.

Another technique is using a 'balanced' or 'weighted' scoring system as a performance measurement strategy. The method aims to assess the qualitative performance of individual sub-national governments and to describe relative performance differences between sub-national governments. This kind of performance measurement usually

¹² See Steffensen (2010)

¹³ See Steffensen and Larsen (2005)

focuses on planning and public financial management processes, and improvement in sub-national government's accountability and transparency. A survey of 15 developing and middle-income countries published by Steffensen (2010) reveals that this type of performance measurement is the most commonly practised. The weak point of this method is that it cannot directly measure service delivery outcomes, such as poverty reduction, because its measurement method tends to emphasise the process and intermediate output.

In addition to the 'weighted scoring system', Steffensen (2010) also reviews various measurement systems – such as performance-based budget systems, credit rating systems, user satisfaction surveys, value for money audits, sub-national government performance benchmarking systems and contract management – that can be used to assess sub-national government's performance and to link with PBGs. In general, most of these monitoring and evaluation systems are linked with PBGs and IGFTs. Only a few have no financial consequences in terms of fiscal incentives, such as citizen evaluation reports and report cards, which are used only to monitor development and to identify sectors that need improvement.

Despite claiming that the PBG initiative had positive impacts, the UNCDF admitted that PBGs were not equally useful in all circumstances. They require carefully designed and robust performance measurement settings. Moreover, the UNCDF recommended that it is vital for governments to frequently review and adjust the assessment methods, performance indicators, fiscal incentives scheme and IGFT mechanism. Hence, Fenna (2010) cites the difficulties of measurement as one of the challenges of imposing benchmarking as a performance monitoring method in the public sector.

2.4.3 Rewards and Punishments

In terms of implementing 'benchmarking' in public sector performance assessment, Fenna (2010) explained that sanctions, usually involving financial penalties or rewards, are the common consequences of benchmarking results. He points out 'naming and shaming' as another form of sanction that may effectively reach the assessed, who may then respond with a desired behaviour. The challenge is how to create incentives for desirable behaviour rather than undesirable behaviour (Lewis &

Smoke, 2012). Moreover, such a system should also pay attention to its attractiveness in influencing sub-national governments to perform and bring out their best.

Rewards and punishments for sub-national governments are expected to occur as a result of performance monitoring. Even though citizens would probably care most about results, sub-national governments that are doing their utmost to achieve outcomes with the resources available to them should also get rewards in the form of incentives even if their efforts have yet to be reflected in outcomes.

Forms of reward and punishment can be financial or non-financial. Countries may use performance rewards and punishments by relating them to the employment and career status of sub-national government staff. Alternatively, countries with devolved and elected sub-national governments, may use performance monitoring as a condition to access PBGs as fiscal incentives or as part of their IGFT allocation formula. Countries that design comprehensive fiscal structures can also create similar fiscal punishment and rewards to PBGs.

An appropriate design for PBGs should be able to influence upward, downward and horizontal accountability systems (Steffensen, 2010). Upward accountability aims to strengthen the relationship between sub-national governments and the central government. Downward accountability is meant to encourage a strong relationship between sub-national governments and their constituents by establishing reliable public information to improve transparency. Horizontal accountability aims to improve communication between elected local politicians and decision-makers among the sub-national government's staff and civil servants.

In addition, central government support for sub-national government's capacity-building and technical assistance would be the most effective element in practising PBGs, especially capital development PBG schemes (Steffensen & Larsen, 2005). Capacity-building and technical assistance can improve weak sub-national government performance. This suggestion is similar to Robinson's (2007) argument that devolution of service delivery responsibility will be inefficient and have adverse outcomes if it is not accompanied by efforts to strengthen sub-national government's capacity. Lewis and Smoke (2012) mention the two forms such support may take. The first is the central government provides and facilitates sub-national government's

capacity-building and technical assistance. The second is that the central government sets capacity-building and technical assistance as targets to be achieved by sub-national governments. Hence, the central government will provide specific fiscal incentives subject to the sub-national government's performance.

2.5 Asymmetric Policy Approach

As previously mentioned, ethnic, cultural and geographical differences, as well as economic and ideological differences, may all lead a country to pursue decentralisation. Therefore, it may not be wise to force symmetric rules across heterogeneous regions. Several researchers suggest that, in reality, it is common for federalist – or even unitary – countries to practice asymmetric regulations in managing sub-national governments (Bird & Ebel, 2006; Wehner, 2000). This enables variation in how much, and which, authority is given to individual sub-national governments.

2.5.1 Asymmetric Decentralisation

Conceptually, the rule of law should apply equally to all. However, in the context of decentralisation, those differences mentioned above mean that doing so would create asymmetric outcomes, which may make decentralisation beneficial for some regions but not so much for others (Bird & Ebel, 2006). In addition to such decentralisation pitfalls, many discussions of decentralisation ignore geographical differences (Prud'homme, 1995). It is absurd, Prud'homme points out, to think of applying decentralisation equally to cities and villages, with their very different capacities. There must be different treatment between large cities, which have more potential to benefit from decentralisation, and smaller jurisdictions (Bahl & Linn, 1992).

The practice of asymmetry using constitutional rules could manifest in the form of different degrees of autonomy or powers, different degrees of representation in the central or federal government, different application of central laws, or possibly limited application only to certain constitutional entities within a country (Bird & Ebel, 2006). However, an asymmetric approach may also be evident only in practice, i.e. it may not be embedded constitutionally but instead be implemented based on a political agreement.

Political asymmetry and unequal capacity are also reasons for applying asymmetric decentralisation (Wehner, 2000). Political asymmetry is usually practised to ease central–local tensions that involve secessionist demands. The province of Quebec in Canada, the Basque Country in Spain and three provinces in Indonesia (Aceh, Papua and West Papua) are examples of this political asymmetry. Unequal capacity refers to fiscal and administrative capacities. Sub-national governments have different own-source revenue potential (terminologically, rich and poor regions). However, administrative capacity – in terms of sub-national governments’ capability to deliver devolved tasks, functions and responsibilities – does not always align with regional fiscal resources; rich regions do not necessarily have greater administrative capacity than poorer ones.

Asymmetric decentralisation is characterised not only by its reasons but also according to its duration, scope and forms (Wehner, 2000). Duration refers to whether the policy is adopted in a transitional sense or permanently; scope concerns which levels of government will be operating asymmetrically; and forms are the aspects – fiscal and/or functional – that will be arranged asymmetrically.

2.5.2 Asymmetric Fiscal Decentralisation

Delivering an asymmetric approach in fiscal decentralisation includes customisation of revenue authorities and IGFT treatment for sub-national governments at the same tier. The asymmetric approach is implemented through different direct central spending, different central taxes, different revenue responsibilities or different IGFTs (Bird & Ebel, 2006). Establishing asymmetric regulation of how sub-national governments should operate starts with sequencing fiscal decentralisation policy into several steps, according to Bahl and Martinez-Vazquez (2006), who argue that a central government should implement its revenue and expenditure assignment sequentially, not simultaneously, and suggest beginning with expenditure assignment. The administrative capacity of a sub-national government becomes an essential aspect of classifying fiscal powers. The aim is to acknowledge different capabilities in delivering mandated tasks and functions among sub-national governments. Bahl and Martinez-Vazquez suggest the central government set up a system whereby sub-national governments with better capabilities are allocated more expenditure responsibilities than those with limited capabilities. The central government should

also create a clear set of rules and mechanisms concerning the movement of a sub-national government from one level to another.

After classifying the expenditure assignments, the central government needs to set the minimum standard of service provision, along with its costs. The result will give the central government data to consider in formulating the tax assignment. The whole process of sequencing is based on the 'money follows function' rule in fiscal decentralisation.

IGFT design, fiscal discipline, regulation of the civil service, and political accountability are also elements of fiscal decentralisation identified by Bahl and Martinez-Vazquez (2006). Each is viewed as an 'important part of the puzzle' in practising fiscal decentralisation, but they do not need to all be imposed at once.

Additionally, Bahl and Martinez-Vazquez argue that the central government should acknowledge unequal capacity across sub-national governments by setting asymmetric fiscal powers. Some sub-national governments could rely on grants and have limited tasks and responsibilities to fund, while others may be given more fiscal powers, not only in relation to taxation but also the ability to borrow, to fund even greater tasks and functions. These would depend on each sub-national government's capacity.

2.6 Conclusion

Decentralisation is often perceived as a reform program that can offer many benefits. In turn, devolving tasks, functions, responsibilities and authorities entails fiscal decentralisation. Conversely, the implementation of fiscal decentralisation assumes a clear distribution of tasks, functions, responsibilities and authority among tiers of government. The combination of these aspects, along with the central government's ability to control sub-national governments' performance, is essential to achieving the desired benefits of decentralisation.

A range of concepts arises in giving guidance for any country that wants to formulate its fiscal decentralisation policy. The first generation theory of fiscal federalism provides the rationales for fiscally empowering sub-national governments in delivering devolved responsibilities. It leads to the conclusion that even if sub-national governments are given the power to collect their own revenues, central government

income redistribution in the form of IGFTs is crucial. However, the first generation theory fails to address concerns over how to allocate funding across regions, what kind of IGFT to allocate, whether and when to assign more or less discretion and, most importantly, how to make sure IGFTs are controllable in terms of being used properly by the sub-national governments.

The second generation theory of fiscal federalism focuses on two methods that might resolve those concerns. However, it still leaves conceptual gaps in both methods. Oates (2005) reminds us that limiting sub-national government’s budget discretion through tied grants reduces local autonomy even if decentralisation is formally implemented. Meanwhile, performance-based fiscal incentives can provide local autonomy, but they raise problematic issues about the appropriate mechanisms and indicators to use in deciding whether or not a sub-national government should receive a fiscal incentive. Moreover, the fiscal incentive approach raises questions regarding its ability to motivate, or even compel, sub-national governments to perform well.

Table 2.1
Highlights of the First and Second Generation Theory of Fiscal Federalism

	First Generation Theory	Second Generation Theory
Policy Focus	Establishing sub-national government’s fiscal autonomy	Ensuring sub-national government’s performance in creating good outcomes
Policy Implementation	<ol style="list-style-type: none"> 1. Improving local taxing powers through massive tax assignments 2. Limited tax assignments, relying more on IGFTs 	<ol style="list-style-type: none"> 1. Limiting-flexibility method, give more tied grants in creating good outcomes 2. Offering fiscal incentives as a reward of sub-national government’s ability in utilising its fiscal discretion wisely to create good outcomes

The research on designing IGFTs, and the incentives that the central government generates through them, remains an exciting topic in the second generation theory of fiscal federalism. The literature seems to suggest policy-makers must choose between limiting local flexibility through tied grants and creating a fiscal incentive for local outcomes achievement. This raises the question of whether these are the only options for controlling sub-national governments. Might there be new insights into how to combine fiscal incentive and tied grants as national policies? Are there non-monetary

forms of incentive, especially for countries that have devolved administration with elected sub-national governments? Should their treatment be different across sub-national governments, especially in a nation with immense geographical diversity and resources disparity?

The concept of asymmetric approach in practising decentralisation is a way to acknowledge different capabilities among sub-national governments. It includes not only differentiating tasks, functions and responsibilities across sub-national governments but also varying their authorities and fiscal powers. A sub-national government may start delivering mandated tasks, functions and responsibilities based on its current capabilities, with these being expected to grow over time.

Above all, the conceptual perspectives relate the sub-national government performance issue with the concept of principal–agent theory (PAT). The PAT core assumptions provide a common ground that has seen increasingly broad application of PAT, extending beyond the economic literature. Welz (2020) discusses the extension of PAT concepts to other disciplines, such as political science from the 1980s and international relations since the late 1990s. This extensive use has resulted in the PAT core assumptions evolving to address more complex situations.

One of these situational complexities is discussed by Miller (2005). He emphasises the research on public bureaucracy by Weingast and Moran (1983) and Weingast (1984), and employs several world political crises to illustrate paradoxical reformulations of what he calls ‘conventional’ PAT. First, the conventional form of PAT promotes bilateral bargaining instead of ultimatum bargaining. It tends to encourage cooperative principal–agent relationships, rather than the principal’s domination of the agent. Second, it reveals that while principals may pursue their self-interest, agents must not respond to that self-interest in order to maintain their credibility. Thus, it shifts the previous understanding that the agent should always seek to satisfy the principal’s preferences. Miller also addresses the conventional PAT concept that moral hazard is embedded only in the agent’s behaviour, arguing that potential moral hazards also arise for the principal. Thus, a contributing agent is preferable to a passive agent as it could counter the principal’s moral hazard.

PAT is just one of several approaches used in the study of policy implementation that regard the implementation stage as crucial in public policy research. Researchers in the 1970s downplayed the potential pitfalls of policy at the implementation stage because of their belief that implementation was unproblematic. Howlett (2019) cites Mayntz (1979), who believed the success or failure of a policy depended on the behaviour of the agency implementing the policy. Howlett also cites the example of Pressman and Wildavsky's (1973) writing on US urban and social welfare implementation difficulties in the 1960s. Thus, he argued that the 'back-end' activities of policy-making are also influential, rather than analysing only the 'front-end' of policy-making.¹⁴ The essential insights from implementation theories of public policy, including the complexities mentioned in PAT, provide additional guidance on how to approach the methodological plan for this research, as explained in Chapter 5.

Decentralisation is also a type of reform that tends to be more diverse and complicated in the implementation stage (Smoke, 2015). Despite the trend towards decentralisation in many countries since 1979, Devas (2008) writes that the approach seems to be cyclical. Correlating theories with country experiences would also help improve knowledge of this specific subject. Moreover, a nation's specific conditions may offer different insights in looking at the terms 'tasks assignment', 'fiscal relations' and 'incentives' as the key issues in generating good outcomes from sub-national governments. Therefore, before explaining the methodology of this research, the next two chapters will look at three countries' experiences which may provide useful lessons for the Indonesian fiscal decentralisation policy improvements, and the Indonesian journey of fiscal decentralisation practice, including its recent policies of encouraging good outcomes from sub-national governments.

¹⁴ 'Front-end' refers to agenda setting, policy formulation, and decision making, while 'back-end' means policy execution activities that translate the 'front-end' outputs into practice.

3

FISCAL DECENTRALISATION IN PRACTICE: COUNTRY COMPARISONS

3.1 Chapter Preview

Fiscal decentralisation – giving fiscal autonomy to lower tiers of government to support their assigned roles and responsibilities – is more complicated in practice than in theory (Smoke, 2015). Every aspect of decentralisation can influence a country's achievements. Both the design of tiers of governments, along with the clarity of responsibility assignment among them, and the design of fiscal decentralisation policy to create a fiscal resources distribution sufficient to meet the needs of sub-national governments in performing those responsibilities have been continuously assessed.

According to political scientists, one cannot have fiscal federalism without federalism; however, in the view of economists the approach is equally applicable to all states. Therefore, fiscal decentralisation or fiscal federalism does not necessarily correlate to a specific system of government (Phillimore, 2013). This is particularly relevant given the fact that while federal systems, such as the USA and Australia, have become quite fiscally centralised, some unitary countries, such as China and Indonesia, are to some extent practising fiscal federalism.

This chapter will take lessons learned from specific countries' experiences in practising many aspects of decentralisation. The exploration will start by presenting each country's political background to understand its goal in designing its government structures and distribution of responsibilities. It will then explore how federal and unitary states manage their fiscal relations, how they put fiscal autonomy into practice and, more importantly, how they ensure sub-national governments' fiscal autonomy can be relied upon to generate good outcomes for their citizens.

The countries selected for reviews are China, Canada and Spain. China represents a unitary state with the characteristics of large territory and population. Its program of

fiscal federalism started with massive fiscal authorities for provinces, in both revenue and expenditure aspects. Then a turning point saw the central government reclaim most of the generated revenue but still empowering the provinces to take expenditure responsibilities by backing them with IGFTs. Canada, despite some criticisms and dissatisfaction from several provinces, is still regarded as the textbook best-practice system of fiscal federalism (Hueglin & Fenna, 2015). We will also assess the country's efforts and challenges in controlling its sub-national governments' performance. Finally, Spain has undergone substantial decentralisation since 1978 and exhibits many features of federal practice. We will assess its experience in implementing asymmetric fiscal decentralisation, which is considered to have been successful in fostering its sub-national governments' performance.

The chapter will specifically draw lessons from three essential aspects of decentralisation in the selected countries. The first will be the political and institutional aspects that form the political background to what has been happening in each country and how they influence the structural relations between tiers of governments. The second is the practice of intergovernmental fiscal relations (IGFRs), with a focus on each country's policies and transformations. Finally, the chapter will explore the fiscal implications for each country of its choice of IGFR policies, and especially the impact on sub-national governments' performance.

3.2 Fiscal Federalism in China

Despite China's highly centralised political power, its experience in moving to an administratively and fiscally decentralised system has many insights to offer. The fiscal decentralisation reform agenda has been identified as a fundamental aspect of the country's transition to a market economy, which has seen China ranked as the top performer in economic growth worldwide (Shen & Zou, 2015). However, increased economic growth is never considered as a single objective in implementing fiscal decentralisation. Fiscal disparities, development inequality and public service delivery are also essential. Therefore, China's policy journeys and transformations, and the lessons they offer, are also of interest.

3.2.1 Political and Institutional Contexts

China is a unitary state ruled by a single-party system, the Chinese Communist Party (CCP). The country does recognise a separation of powers between the legislature, the executive and the judiciary in its constitution; however, the dominant and central role of the CCP as the only party acknowledged in the constitution leads Podger and Yan (2013) to regard China as lacking *de facto* separation of powers. The main reason for this view is the CCP's role in appointing party members across all arms of government. Researchers such as Cai (2008) and Edin (2003) note that even more significant roles and powers were given to the party from 2002 until 2012. Hence, it is proper to say that China is politically centralised.

China's large population is, in some ways, reflected in its government institutional arrangements. China has five levels of governance, from the highest national level to the lowest level of the township. The central government has the authority to set high-level policies on all aspects of government activity. The second level consists of 22 provinces, five autonomous regions, two special districts and four large metropolitan areas. The third level consists of 333 municipalities and municipal-level districts. The fourth tier is the county-level, comprising 2010 counties, autonomous counties and county-level cities. The lowest level consists of 41,636 township, town districts, autonomous township-level areas, and district offices.¹⁵

In 1978, China shifted its previously centrally planned and administered government to what Zheng (2007) describes as *de facto* federalism and Landry (2008) considers as one of the most decentralised countries in the world. However, it was not a straightforward process, given China's long history of central control and a command economy. There was a consensus on the need for decentralisation, but leaders were split over the content, scope, pace and extent of the reform agenda (Harding, 1987).

Due to these competing views, the Chinese government decided to pursue a modest reform path. Instead of creating a shock to the system, it adopted a dual-track reform strategy (Naughton, 2008). On the one hand, to guide economic development and prevent economic instability, the central government retained overall control of

¹⁵ The number of local governments are as mentioned in Podger and Yan (2013) and Shen, Jin and Zou (2012), according to the China Statistical Yearbook 2006.

economic policy and strictly regulated any projects falling under specific categories. On the other hand, it made the revolutionary decision to give socioeconomic management powers to lower-level governments in order to accelerate economic growth.

The structural arrangements of the Chinese system of government are designed such that each level of government is responsible and accountable to the next highest level within each jurisdiction. Therefore, the distribution of socioeconomic powers is also hierarchical. The central government delegates socioeconomic powers to the provincial-level government, then the provincial-level government delegates administrative authority to municipal-level governments within each of the provincial jurisdictions, and so on until the lowest level of government.

China's monopolistic and centralist political system, which enables strong top-down mandates, makes for a unique approach to decentralisation. The central government controls lower-level governance by setting a performance management system. The sub-national leaders are accountable to the central government as their boss. Successful sub-national leaders are given incentives and a chance of promotion, while those who underperform can easily be sacked or demoted. This contrasts with countries with strong democratic arrangements, whether unitary or federation, where all the sub-national leaders are accountable to their local constituents. Thus, in democratic countries it is not within the central government's power to replace underperforming sub-national leaders. This so-called 'Regionally Decentralised Authoritarianism' is the main factor that distinguishes China's institutional reforms from federalism (Xu, 2011).

Another unique feature of China's institutional arrangements and decentralisation practice is the different socioeconomic management powers given to different sub-national governments. An example of this asymmetric decentralisation is the Province of Guangdong. In 1979, the central government gave special administrative power to sign economic agreements with foreign companies, without the obligation to request central government permission, solely to Guangdong Province (Vogel, 2011). Later, in 1980, Shenzhen, Zhuhai, Shantou and Xiamen cities within Guangdong Province administration were given Special Economic Zone status, not given to any other cities within the province. Furthermore, by 1994 the central government had also expanded giving special administrative power to 16 municipalities to be independently able to plan and implement their development.

Greater power is one form of incentive for successful sub-national leaders. It is also the reason why China's sub-national governments do not have the same tasks and decision-making powers. The Province of Zhejiang's achievement in increasing the size of its economy, which was largely driven by just a few counties within the province, has in fact created a new problem due to limitations on authority. Those counties were unable to create significant projects fast enough because they had to wait for approval from higher-level governments, which can take up to two years. Through a careful assessment using economic performance as the indicator, Zhejiang Province decided to devolve greater economic management powers to 13 counties within its jurisdiction. A few years later, Zhejiang Province devolved further economic powers to two of those counties that had demonstrated particular economic success. The powers devolved to those counties made them equal to the municipality-level, the next highest level of government.¹⁶

3.2.2 Intergovernmental Fiscal Relations (IGFRs)

The transformation journey of China's IGFR policy offers an exciting lesson in fiscal federalism practice. After a massive change to its IGFR policy from 1980 to 1993, China's central government reached a turning point in 1998. The fiscal contracting system was replaced with a separating tax system. Both systems recognised the IGFT mechanism in their practice, but they differed in their tax collection and revenue-sharing system. The following sections detail both systems to help better understand how each system worked and why the system was changed.

A. Fiscal Contracting System

Prior to the reform of 1979, China practised centralisation in planning, financial and administrative authority. The fiscal relationship between the central and sub-national governments has been described as 'unified revenue collection and unified spending'. Although the provincial governments collected most of the revenue generated from within the province – over 80 per cent on average, including taxes and most profits from state-owned enterprises – they did not have the power to manage and use it.¹⁷

The massive change from central planning to one of the most decentralised countries in the world had a significant impact on China's IGFRs. From 1988, the fiscal

¹⁶ See *Yu and Gao (2013)*

¹⁷ See *Shen et al. (2012)*.

contracting system began to be fully implemented. The central and provincial governments divided the revenue according to pre-determined sharing schemes in the form of fiscal contracts. Each province had to make a fiscal contract with its subordinates to support the provinces in meeting their revenue targets. This type of contract forced provinces to at least collect revenue according to the contracted targets. Failing to meet the targets would decrease the province's spending capacity, as they had to make up the deficit. Meanwhile, any surpluses from their revenue collection target would certainly benefit their budget as the central government did not ask for more than the amount that had been contracted. Furthermore, this system gave provincial governments discretionary spending power, along with the power of assigning roles and responsibilities to lower tiers of governments. The main objective of the fiscal reform was to promote local economic development by increasing the provincial governments' responsibilities and fiscal autonomy.

China's intergovernmental fiscal relations during this 'fiscal contracting' era also consisted of additional transfer payments from the central government to provinces. It was a kind of revenue redistribution, or horizontal fiscal equalisation, to fill the fiscal gaps in some provinces that had higher expenditures compared to their fixed local revenue. These types of provinces were allowed to keep all of the fixed revenue and were also granted shared revenue from the central government. In addition, the central government also gave these 'deficit' provinces fiscal grants that generally fell into two types: earmarked subsidies, such as price subsidies for urban residents to compensate them for food price increases; and matching grants, consisting of 'special purpose grants' for disaster relief and poverty reduction, and 'capital grants' for local construction and infrastructure investment.¹⁸

Additionally, there was another category of revenue called 'extra-budgetary revenue', which consisted of tax surcharges and user fees levied by central and provincial government agencies, as well as some earnings from state-owned enterprises. It initially emerged in the 1950s but only became institutionalised after the reform and was not subject to sharing with the central government. In 1978, total extra-budgetary revenue was less than the total budgetary revenue – about 10 per cent and 31 per cent

¹⁸ Ibid; see also Wong, Heady, Chan and West (1997), Bahl (1999), and Zhang and Martinez-Vazquez (2003).

of GDP respectively. Post-reform, extra-budgetary revenue increased to 16 per cent of GDP, while budgetary revenue decreased to 16 per cent of GDP (Jin et al., 2005).

B. Separating Tax System

The fiscal contracting system, however, weakened the central government because the central government heavily relied on local tax collection. The situation reduced the central government's fiscal power to the point where it was unable to bridge fiscal disparities and struggled to fund basic public services. The situation generated mistrust between central and provincial governments regarding their fiscal relations. The central government thought that provincial governments were the cause of fiscal decline because of their poor effort at collecting taxes and their tendency to switch budgetary revenue into extra-budgetary revenue, which they were not required to share with the central government (Ahmad et al., 2002). Meanwhile, the provincial governments viewed the central government as lacking consistency and commitment because the fiscal contract rules repeatedly changed. Moreover, they felt that their ability to create surplus revenue had become the object of 'predatory behaviour' from the central government (Shen et al., 2012).

Since 1994, tax sharing reform has replaced the 'fiscal contracting system' with, as Jin et al. (2005) call it, 'the separating tax system'. The main objective of this fiscal reform was to maintain the proportion of revenues collected centrally at around 60 per cent of total revenue and keep the central expenditure to only 40 per cent so, that the central government can allocate the remaining 20 per cent for intergovernmental transfers (Zhang & Martinez-Vazquez, 2003). The 1994 reform acknowledged three categories of tax separation: central taxes, local taxes and shared taxes. The simplified tax structure, which was divided into those three categories, can be seen in Table 3.1.

The new system redefined 'local revenue' as revenues from local taxes and the local portion of the shared taxes (Bahl, 1999). Income taxes from all enterprises (other than central government enterprises), business tax from the sales of services, and personal income tax were the major sources of sub-national government's budget revenue. The value-added tax (VAT), of which 25 per cent belongs to the provincial government and which is treated equally across provinces, is the most notable shared tax. Another fundamental policy of the 1994 reform was the establishment of the National Tax Services (NTS), whose duties were to collect central fixed revenue and shared revenue.

The NTS had offices in every province. Meanwhile, the duty to collect local taxes was assigned to Local Tax Services.

The separating tax system gives strong fiscal power to the central government, while sub-national governments are heavily dependent on shared taxes (Shen et al., 2012). The central government’s revenue budget obtains significant income from major profitable taxes – VAT, company income tax and personal income tax – because the central government has a more significant shared percentage.

Table 3.1
China Tax Assignment

Taxes	Central (%)	Local (%)
Central Taxes		
Tariffs	100	0
Consumption Tax	100	0
Shared Taxes		
VAT	75	25
Business Tax	3	97
Stamp Tax on Security Exchange	97	3
Personal Income Tax	60	40
Company Income Tax	60	40
Local Taxes		
Resource Tax	0	100
Urban Maintenance and Development Tax	0	100
Urban Land Using Tax	0	100
Agriculture and Related Tax	0	100
Tax on Contracts	0	100
Tax on the Use of Arable Land	0	100
Vehicle Purchasing Tax	0	100
Other Local Taxes	0	100

Source: Shen (2008)

Sub-national governments received several types of IGFTs. The first was a type of fiscal equalisation transfer called a ‘general-purpose grant’. This type of IGFT was introduced to address regional fiscal disparities issues. It was the first formula-based grant in China determined by three factors: standard revenue of the province; standard expenditure of the province; and the portion of the province’s fiscal gap to the total

fiscal gap (Shen et al., 2012). The second was a type of tied grant that is transferred to fund special projects, such as capital infrastructure, and social benefits. Both of these transfers have grown significantly. Nevertheless, the trend shows that the special purpose grants or tied grants have outpaced the growth of the general-purpose grant (Shah & Shen, 2006).

Another type of IGFT introduced in China's 1994-fiscal reform was the tax rebate. It was a type of hold-harmless policy¹⁹ from the central government in order to maintain the funds received by the sub-national governments from taxes such as VAT, excise tax, personal income tax and company income tax, which became centrally collected. Using 1993 tax revenue as the base of calculation, the central government wanted to ensure that the amount from the specified percentage shared to sub-national governments was not less than the amount received by the sub-national governments in 1993 when those taxes were still locally collected. Moreover, in the case of VAT and excise tax, the central government also ensured that sub-national governments would receive an additional 30 per cent every year from the growth of these taxes.

C. Province-Managing-Counties

Another breakthrough on China intergovernmental fiscal relations has been explained and analysed by Wang, Zheng and Zhao (2012), Liu and Alm (2016) and, most recently, Ma and Mao (2018). Even though a few provinces had already initiated the reform since 1994, with further provinces following in 2004, the official endorsement of this 'Province-Managing-Counties' (PMC) reform only came in 2008.

The PMC reform replaced the previous conventional 'Prefecture-Managing-Counties' system. Initially, the intergovernmental relations between tiers of government in China was conducted hierarchically – the central government managing provinces, the provinces managing prefectures, the prefectures managing counties, and the counties managing townships. However, the PMC reform disrupted this relations because it enables provinces to connect directly to counties.

Furthermore, the PMC reform had several consequences for the fiscal relationship between provinces, prefectures and counties. First, the counties shared their tax

¹⁹ Hold-harmless is a policy to ensure the recipient of funds (i.e. local governments) would be allocated at least the same amount they had the previous year, even though the actual calculation might result in a decrease.

revenue with the provinces instead of the prefectures (the counties' direct superior level). Second, prefectural government cannot intervene and burden counties' government expenditures. Third, county governments receive fiscal transfers directly from provinces. Finally, counties and prefectures must make their own budgets and financial reports. In summary, the PMC reform sought to take away prefectural governments' previously high level of fiscal authority, which was suspected of hindering local economic growth.

The implementation of the PMC reform was conducted gradually and through non-compulsory adoption into the provinces' systems. Initiated by Zhejiang and Ningxia provinces in 1994, it was then followed by several other provinces from 2004. The central government began to officially encourage the PMC reform in 2008, and by the end of 2011 there were 21 provinces and 1028 counties, or approximately 53 per cent of total counties, practising the new system (Han & Kung, 2015). Notably, counties within a province that adopts PMC reform need not necessarily be included automatically to implement the system – the province selectively involves counties under its jurisdiction.

3.2.3 Fiscal Implications and Intergovernmental Performance Management

Some studies (Jin et al., 2005; Wang & Chang, 1998; Hsu, 2004; Shen et al., 2012; Lin & Liu, 2000; Han & Kung, 2015) suggest that China has created a set of fiscal incentives along with its decentralisation policy with the main focus of developing its economy and stimulating sub-national governments to perform well, especially in market-supportive activities. These studies report that China's IGFRs have been able to stimulate sub-national governments with strong fiscal incentives and, at the same time, reduce fiscal disparities by improving horizontal distribution across provinces in budgetary spending. It also led China to have a fast development of non-state enterprises. Furthermore, it has encouraged local prosperity in China because local expenditures have been closely linked to the revenues they generate. Therefore, these studies conclude that China has provided the 'correct' incentives by designing its fiscal structure as a tool for local development.

Furthermore, China's post-1994 intergovernmental fiscal arrangements have influenced sub-national government's policy choices. The changing assignment of the

excise tax to central government and business tax to sub-national governments has shifted the pattern of sub-national governments only developing distilleries and tobacco companies to instead developing a wider range of business sectors (Zhang & Martinez-Vazquez, 2003). Another study finds evidence that sub-national governments shifted their efforts from nurturing industrial growth to ‘urbanising’ China by developing real estate and construction sectors when the shared rate of enterprise income tax to sub-national governments was reduced (Han & Kung, 2015).

However, research conducted by Shen (2008) indicates that China’s market-oriented objectives have undermined several essential objectives of decentralisation. First, there is a mismatch between core public services funding obligations and sub-national government’s collected revenue; around three-fourths of overall government spending on education and health care in 2003 comes from sub-national governments financing, but sub-national governments can only collect 41.4 per cent of overall government revenue, including shared taxes. Hence, many rural and poor localities cannot provide adequate public services due to their low fiscal capacity (Shen & Zou, 2015). The efforts of central government in giving earmarked grants were considered insufficient. The IGFTs from the central government may have corrected vertical fiscal imbalances in aggregate but did not provide equal capability across sub-national governments in public service provision. Second, the IGFTs’ design emphasised the overall amount of transfers, which significantly increases over time, but was considered ineffective because it did not support vital social services funding or reduce regional disparities. The equalisation grant has an insignificant role in equalising redistributive impacts.

Another empirical study by Martinez, Qian, Wang and Zou (2006d) argues that decentralisation expenditures did not have a significant impact on economic growth, economic disparity, fiscal resource growth, fiscal disparity or relative spending on social services. They also noted that provincial and sub-provincial autonomy had different results: provincial autonomy accelerates the growth of fiscal revenues, while the sub-provincial autonomy tends to decelerate that growth. Adverse impacts also arose from some types of IGFTs; while general transfers tended to improve the growth of fiscal revenue, the tax rebate created disincentives in stimulating fiscal resource growth.

Another issue with China's decentralisation policy outcomes is performance measurement, which has been described as leading China into 'accountability paradox' whereby improved accountability appears to hold back government productivity (Chan & Gao, 2009). Additionally, greater accountability may not encourage sub-national governments to meet all given targets because of conflict between those performance targets (such as conflict between economic development and environmental protection targets, for example). It is difficult for sub-national governments to pursue agricultural production goals and, at the same time, protect recovered forests.

Ma and Mao (2018) conclude that the shift to PMC has fostered local economic growth. However, using the data from Henan Province from 2001 to 2011, Wang et al. (2012) report that counties implementing PMC tend to have lower public education expenditure than those that are not. It seemed that the GDP-oriented goal has led to counties focussing more on urban development expenditure than on social expenditure.

3.3 Fiscal Federalism in Canada

Canada is a federal country where the provincial governments retain substantial fiscal autonomy. This offers valuable insight, given that other notable federal countries such as the United States of America and Australia have moved in the opposite direction. In this context, Canada is regarded as demonstrating fiscal federalism 'best practice' compared to other federations.

3.3.1 Political and Institutional Contexts

The second largest country in the world by area, Canada has a long history of federalism, which was established in 1867. Historically, the federation of Canada consisted of only four provinces: Ontario, Quebec, New Brunswick and Nova Scotia. Quebec is a predominantly French-speaking province, while two of the others are mostly English-speaking and one is bilingual. Therefore, Canada has made French and English its official languages. There are now ten provinces and three territories.²⁰

²⁰ Siegel (1980) and Boadway (2007).

Canada recognises two levels of governments – federal and provincial/territorial – in its constitution. There is only one reference in Canada’s constitution to local governments, which come under the exclusive jurisdiction of the provinces. Therefore, each of the provinces and territories can establish its own legislation to arrange local governments under its jurisdiction. They have total discretion in managing the organisational and financial structure of their local governments.

According to the constitution, the federal government is exclusively responsible for a number of public services, such as trade and commerce, banking and currency, census and statistics, defence and foreign affairs, citizenship, marriage and divorce, criminal law and penitentiaries, patent and copyrights, and unemployment insurance. Meanwhile, provincial governments are responsible for sectors such as administration of justice, civil and property rights, public lands and natural resources, health, licensing, incorporation of a company, and municipal institutions. Education and social welfare are also constitutionally assigned to provincial governments but, in keeping with their discretionary powers in managing local governments, they may share responsibilities for these sectors between the province and its local government. The provincial governments assign local services – urban highways, urban transportation, drinking water and sewerage, waste collection, electric power supply, fire protection, public order and safety including the police – entirely to local governments. Furthermore, the federal and provincial governments, in addition to their respective exclusive powers, have joint responsibilities for pensions, agriculture and immigration.²¹

Generally, provincial and territorial governments have local governments in the form of cities, municipalities, towns, parishes, townships, united townships and villages. Quebec, for example, currently has 1111 local governments; it has previously been criticised for the number of local governments, which was initially as high as 1600, some of which were considered too small (Siegel, 1980). Ontario, on the other hand, has begun to encourage the restructuring of cities, towns, townships and villages, which were administered separately, into a two-tier system of regional municipalities.

²¹ See Boadway (2007) and Boadway and Watts (2004).

The Ontario government even offered funds to assist counties in studying the possibilities of restructuring into the two-tier system.

3.3.2 Intergovernmental Fiscal Relations

The provinces play an essential role in Canada's IGFRs. The fiscal power given includes access to all revenue sources, expenditure management, fiscal allocation to local governments, and decision-making on capital development investments that come from borrowings. Furthermore, the federal government also arranges fiscal transfers in the form of equalisation grants to address regional fiscal disparities and specifically tied grants to ensure adequate public services.

A. Revenue Assignment

The constitution sets up a revenue system whereby provincial governments are able to gain access to all major tax bases, such as income tax, consumption tax and payroll tax. The ability of provincial governments to access these major taxes does not eliminate the right of federal government to access them too. This system of Canadian revenue assignment is known as 'joint tax occupancy' (Paul et al., 2008). It may appear as double taxation, but the Canadian federal government anticipated this and has made the system more taxpayer friendly and prevented excessive tax burdens.

Provincial governments can also own and manage revenues from the natural resources within their own jurisdiction. Therefore, in addition to shared tax bases, there are some that are not available to the federal government, such as resource tax, health premiums and property tax. However, due to each provincial governments' legislation about the establishment of local governments under their jurisdiction the property tax, along with local user fees, is assigned mostly to local governments as a revenue source.

Federal–provincial fiscal relations are based on asymmetric agreements. They are asymmetric because the federal government does not apply a one-size-fits-all fiscal arrangement. Tax harmonisation, for example, does not bind all provinces and territories, who can choose whether or not to join the agreements, which certainly will have different fiscal consequences. The provinces have to accept the federal tax base and the tax rate. Furthermore, each province that joins the agreement is allowed to choose a provincial rate to apply to federal tax liabilities and is also allowed to take on a set of tax credits. As another example, the federal government differentiates the way

it formulates fiscal transfers to provinces and to territories. Fiscal transfers to the provinces are based on revenue-raising capacity, while expenditure requirements are used as bases for transfers to territories (Boadway, 2007).

Nine out of ten provinces have opted to join personal income tax harmonisation. The exception is Quebec, but it seems that its tax base is similar to those provinces who have joined the harmonisation agreement (Boadway & Watts, 2004). For corporate income tax the three largest provinces have not joined the harmonisation agreement, but, again, their bases of tax do not differ too much from the federal rules. Moreover, these three provinces share the same rules with the federal government in allocating income to provincial jurisdictions (Boadway & Watts, 2004). Only four provinces harmonise their sales tax with the federal goods and services tax (GST). Three of them are fully harmonised, which means they are fully compliant with federal rules. The other one, Quebec, runs its own VAT regulations and performs as the agent by collecting VAT for the federal government.

B. Horizontal Fiscal Equalisation

As well as other countries implementing fiscal federalism, the Canadian federal government's basic policies are to manage vertical and horizontal fiscal imbalances to meet the requirement stated in *The Constitution Act 1982*, section 36 point (2):

Parliament and the government of Canada are committed to the principle of making equalisation payments to ensure that provincial governments have sufficient revenues to provide reasonably comparable public services at reasonably comparable levels of taxation.

The provinces' high level of revenue-raising ability, and the additional revenue-raising which is exclusively owned by the provincial government, creates regional disparities as a consequence. Alberta, a province with immense oil and gas reserves, and the large province of Ontario, which has been a manufacturing centre, create significant disparities in term of fiscal capacity compared to other provinces. Fiscal equalisation transfers are used to address this issue and to comply with section 36(2) of the constitution.

The federal government has established two main fiscal transfers. The first is the federal equalisation program, using unconditional transfers aimed at those provinces whose fiscal capacity is below the national standard. The federal government

calculates the average fiscal capacity per head that the provincial government received from major tax bases and other sources confined to one or some provinces. Interestingly, the federal government excludes the wealthiest province (Alberta) and the four poorest (Newfoundland, Nova Scotia, New Brunswick and Prince Edward Island) from the calculation. This calculation method has been criticised as perverse with regard to those provinces not included in the formula. Using that formula, the so-called generic solution, an increase of tax revenue has different implications for the equalisation transfer amount for provinces whose revenue is used as the average national standard versus those who are excluded, disadvantaging the latter (McLean, 2003).

The second mechanism is more of a social transfer, because it aims to support provincial social program expenditure. It consists of two sector transfers, the Canadian Health Transfer (CHT) and the Canadian Social Transfers (CST). Both provide an equal per capita transfer to all provinces. Unlike the equalisation program, this type of transfer is conditional, even though it is rather general.

C. Hourglass Federalism

In 2004, the federal government initiated a significant change to intergovernmental fiscal relations: moving from Federal–Provincial–Local funding to direct Federal–Provincial and Federal–Local arrangements.²² The 2004 federal budget was a launch of what Courchene (2005) called ‘hourglass federalism’. It was a federal government policy to directly connect their budget to cities and citizens squeezing out the provinces.

The reason why Courchene (2005) named the 2004 federal budget as the formal launch because it was initially triggered since 1995 where the federal government cut CHST for provinces from \$18 billion to \$11 billion, and also folded the Canada Assistance Plan (CAP) and the Established Programs Financing (EPF). The cut required provinces to adjust their budget especially to cover the health expenditures. Consequently, provincial governments had to reduce other expenditures, including local government’s needs to fund public services.

²² See Leo (2006) and Courchene (2005)

Then, in 1997 the federal government introduced the Canada Child Tax Benefit (CCTB), endorsing the narrative of collaborative federalism between federal government and provinces but practically regarded as a new federal budget mechanism that directly transferred fund to middle and low-income families. Then, in 2004, the federal government eventually released direct grants for cities infrastructures and educational grants for middle and low income Canadian.

At one end, cities are happy because federal government can fill in their provinces hard budget constraint. However, at the other end Courchene (2005) reveals the fact, by quoting the Tom Kent statement that the federal government could just increase cash transfers to provinces from 16 per cent to 25 per cent, instead of introducing 'new deal' in the federal budget that eventually lead provinces to this 'hourglass federalism'.

3.3.3 Fiscal Implications and Intergovernmental Performance Management

Similarly to China's experience when implementing the fiscal contracting system, giving significant fiscal revenues to the provinces has limited the Canadian federal government's fiscal capacity to address fiscal disparities and ensure citizens receive the same quality of public services across the country.

A. Vertical and Horizontal Fiscal Imbalances

The assignment of responsibilities to the provincial governments, together with the accessibility to collect major taxes and provincial own-source revenue setting, make Canada a high-level fiscal federalism country. The impact of these revenue arrangements is described by Boadway (2007); according to the data in 2005, provincial governments can raise more revenue in aggregate than the federal government. A mixture of independently acting sub-national governments and the ability to raise significant revenues to match responsibilities is the reason Canada's fiscal federalism is considered best practice.

Looking at fiscal capacity, vertical fiscal imbalances seem not to be a major issue in Canadian fiscal federalism. Nevertheless, from a fiscal needs point of view, vertical imbalances are an issue in practice. Provinces have struggled fiscally to fulfil their responsibilities, while the federal government has succeeded in producing large budget surpluses. Provincial governments need to boost their revenue to match the rapid

growth of their fiscal needs, especially in healthcare. Therefore, their choice is to either modify the tax room or increase intergovernmental fiscal transfers.

Modifying the current tax arrangements so that provinces retain more tax revenue would certainly reduce federal revenue and increase the fiscal gap, with federal revenue already lower than aggregate provincial revenue. Maintaining large tax room and a vertical fiscal gap has been argued as necessary to finance equalisation transfers. Furthermore, it is also needed to influence provincial social program design by allocating conditional grants.

Meanwhile, increasing intergovernmental transfers could return the federal government to facing an unsustainable debt problem. It should be noted that previously the federal government addressed the debt problem by cutting its expenditure significantly, from 15.7 per cent of GDP in 1993–1994 to only 12.6 per cent in 2004–2005, with one of the strategies implemented being reducing and simplifying intergovernmental transfers (Boadway, 2007).

Economic and natural resources disparities also contribute to different capabilities across the provinces in raising their own revenues. The effect is horizontal imbalances that have been problematic for the federal government to solve. The first problem concerns federal government fiscal limitation. On the one hand, the federal government needs to make sure that low fiscal capacity provinces can still provide an equal standard of public services, as required by the constitution. On the other hand, the federal government suffers a lack of fiscal capacity to allocate more significant transfers. The second problem concerns the equalisation formula, which is considered ‘predatory’ by the provinces, especially those that are not included in the calculation of the average national standard of revenue (McLean, 2003).

B. Accountability and Performance Management

The federal government has tried to use its spending power through fiscal transfers to control the performance of the provincial governments (Fafard, 2013). In the argument over increasing federal transfers for healthcare, the federal government has introduced additional performance measurement for the provinces. Since the late 1990s, the federal government tried to encourage a jointly agreed set of performance indicators

for all provincial governments, based on federal government fiscal transfers allocated for healthcare.

The idea of a performance measurement system is not new in Canada. Since 1993, there has been a common understanding among Canadian governments of the importance of performance reporting as a management tool to enhance accountability (Fafard, 2013). Provincial and territorial governments have put effort into making themselves accountable especially in healthcare service delivery. The Province of Alberta, for example, increased publicly available information regarding its healthcare system (Baker et al., 1998), while Ontario established the Ontario healthcare delivery system with the aim of ensuring high-quality services (Veillard et al., 2010).

However, Fafard (2013) writes that the federal government's measures seem to be difficult to execute, for two main reasons. First, this is likely to be a case of conceptual debate on the nature of the federation, where the compliance of the provinces and territories has been uneven in reporting the indicators. Some provinces, such as Quebec and Alberta, view healthcare as falling within provincial jurisdiction. Thus, in their view it is not a subject for evaluation by the federal government or a third party appointed to overview provincial government performance. As much as they agree that accountability is crucial, it has to be to their own provincial citizens and should involve comparison with other provinces.

Second, it is argued that there is little evidence that the voters' preferences are strongly influenced by healthcare performance. It is unlikely voters would punish the provincial government for poor performance in an area that is a shared responsibility with the federal government (Cutler, 2004; Anderson, 2008).

The practice of performance measurement self-conducted by provincial governments to their local governments has not yet been satisfactory. The practice in Ontario, for example, was assessed as not improving accountability to the citizens (Schatteman, 2010); similarly, while the performance reporting system in Quebec was useful to government officials, it did not treat citizens as stakeholders of the performance reporting (Hildebrand & McDavid, 2011).

3.4 Fiscal Federalism in Spain

The Kingdom of Spain has many federalist features in its intergovernmental practice (López-Laborda, Martínez-Vázquez & Monasterio, 2007). The asymmetric set-up is acknowledged in its 1978 Constitution. The Spanish experience offers us a perspective on implementing an asymmetric approach to fiscal decentralisation. It is notably acknowledged as having been successful in implementing asymmetric decentralisation of its expenditure responsibilities (Bahl, Martínez-Vázquez & Board, 2006).

3.4.1 Political and Institutional Context

Spain is one of the oldest countries in Europe, after France. It was established through the decision of several kingdoms to unite. Three years after the death of General Franco, the Spanish government adopted the Constitution of 1978, which became the start of a new democratic era that introduced territorial autonomy and self-management principles as well as decentralisation. Reflecting Spain's historical background – which included the influence of almost forty years under a dictatorship, as well as a common view that federalism could not respond to the nation's need to establish unity across the diverse regions – saw the 1978 Constitution emerge not as a firm ideological statement but more as a pragmatic solution. Even though the newly stipulated constitution regarded Spain as a unitary state under a parliamentary monarchy, the features embedded in the constitution are considered to reflect a federalist approach.²³

The Constitution of 1978 recognised autonomous communities and local governments as the sub-national governments. Autonomous communities served as the intermediate level of governance, while local governments fall under the autonomous communities' regulatory powers. The local governments consist of two tiers, provinces and municipalities. All these local governments have the privilege of autonomy in asymmetric arrangements.²⁴

Asymmetric decentralisation is the term used to describe the Spanish journey in giving autonomy to its sub-national governments. The approach taken was embedded in the

²³ See Lopez-Laborda et al. (2007)

²⁴ See Argullol & Bernadí (2006) and León (2012)

Constitution of 1978 and reflected the strong sense of local identity prevailing in such areas as Catalonia and the Basque Country. It was a ‘way of life’ to rebuild the nation after experiencing a destructive civil war and over 30 years of authoritarianism.²⁵

Autonomous communities were a new level of government introduced by the Constitution of 1978. Before that, the provinces were the next administrative structure below the central government. Autonomous communities were formed based on historical, cultural or economic similarities among provinces. Some were formed from the amalgamation of several provinces, but there were also single provinces that were reincarnated as autonomous communities. These autonomous communities then became the backbone of Spanish decentralisation.

The Constitution of 1978 assigned some responsibilities exclusively to the central government. These include defence, international representation, justice, national police, regulation and economic planning, financial system regulation, customs matters, income and wealth distributions, basic social legislation and funding, and national infrastructure related to more than one autonomous community, as well as commercial ports and airports. These are exclusively owned, in the sense that authority in these areas is restricted and will not be shared with autonomous communities and local governments.

Meanwhile, the assignment of responsibilities to autonomous communities was specified in Article 148 of the Constitution of 1978. In general, the responsibilities devolved to autonomous communities as an intermediate level of governance are: all levels of education, health, agriculture, industry, energy and mining, environment, tourism and domestic trade, social services, historical and artistic patrimonial protection, housing and territorial arrangement, and regional infrastructure within each autonomous community. These areas of responsibilities are not exclusively owned, unlike the responsibilities of the central government described above; the central government has the ability to intervene or share authority with the autonomous communities in these areas.

The asymmetric arrangement was the underlying concept of the central government’s classification of seven autonomous communities as ‘fast track’ and the other ten as

²⁵ See Lopez-Laborda et al. (2007), Bosch & Durán (2008), and Busquets & Sanjaume-Calvet (2019)

‘slow track’. The division was a way to acknowledge different capabilities and readiness among those autonomous communities in delivering devolving responsibilities assigned in the Constitution of 1978. Those included in the ‘fast track’ had full authority to deliver all of the main areas of responsibilities. Meanwhile, the autonomous communities in the ‘slow track’ had responsibility for delivering a limited number of responsibilities. Education and health were the two most notable responsibilities that differentiated the ‘slow trackers’ and the ‘fast trackers’.²⁶

As of January 2002, however, the distribution of responsibilities has become more homogeneous as the ‘slow trackers’ eventually took on those two crucial responsibilities. Nevertheless, while they are now more homogeneous in terms of main functions or sectors of responsibility, in practice each autonomous community has a certain degree of difference because the process of determining assigned responsibilities was done individually.

Another distinctive characteristic of the Spanish decentralisation is how it assigned responsibilities from a ‘menu’. The classification of the 17 autonomous communities into ‘fast track’ and ‘slow track’ was not originally a top-down assignment imposed by the central government; rather, the autonomous communities chose the ‘menu’ items that they thought appropriate for them at the time.

The third level of governance in Spain is local government, which consist of two tiers, provinces and municipalities. Currently, there are 50 provinces and 8110 municipalities. Basically, the territory of a province consists of several municipalities. However, as explained before, some autonomous communities were formed only from a single province and there is therefore no two-tier administrative government below these autonomous communities.²⁷

According to the Local Government Act, the provincial government has the obligation to participate in the coordination of local administrations with the autonomous communities and central government. Moreover, the Act states that the province also has powers covering the coordination of municipal services in meeting the minimum standard of service provision; providing legal, economic and technical assistance for

²⁶ See Lopez-Laborda et al. (2007), Bosch & Durán (2008), and Busquets & Sanjaume-Calvet (2019)

²⁷ See Suarez Pandiello (1999)

municipalities; providing supra-municipal service provisions; and developing and administering the specific interests of the province.

Meanwhile, there are asymmetric responsibilities assigned to municipalities based on the size of their population. Generally, all municipalities should provide public lighting, rubbish collection, road cleaning, water supply, sewerage, cemeteries, food and drink control, and street paving. Public parks, public library, markets and waste treatment are additional services that should be covered by municipalities with a population of more than 5000. Then, the provision of civil protection, social services promotion, firefighting and prevention, public sports facilities and slaughterhouses are another addition to municipalities that have more than 20,000 inhabitants. Lastly, local environmental protection and urban transportation are an important addition for municipalities with more than 50,000 people. It should be clearly noted that, basically, there are no restrictions on municipalities providing the additional responsibilities regardless of their population. However, for them, the assignment is only optional; for those that meet the criterion, those responsibilities are mandatory.

The Spanish decentralisation journey has put more emphasis on empowering autonomous communities. The central uses the autonomous communities as a crucial, pivotal institution to foster the success of its decentralisation practice. The autonomous communities are not only gradually given more responsibilities by the central government, but also deliver local governments' areas of responsibilities where the local government cannot manage the tasks.

Recently, there has been consideration of encouraging a 'second decentralisation' by granting more expenditure powers to the municipalities. However, the idea has not progressed, mainly because of the capacity limitations of the municipalities. Many of them are too small and have established cooperative arrangements across local governments to provide essential public services like water, rubbish collection and social services. Despite the suggestion of adopting an asymmetric approach and empowering the provinces as the main actor for this 'second decentralisation', there has not been any change to the Spanish focus in practising decentralisation.²⁸

²⁸ See Argullol & Bernadí (2006)

3.4.2 Intergovernmental Fiscal Relations (IGFRs)

In terms of fiscal relations, even though autonomous communities are at the intermediate level and superior to the local governments, the central government has maintained a direct relationship with local governments. In addition to letting local governments raise their own revenue, the central government also makes direct transfers to local governments, instead of going through autonomous communities. So, the fiscal relationship between autonomous communities and local governments is insignificant. The term used in López-Laborda et al. (2007) is a ‘bifurcated fiscal system’, where the central government connects directly with both the intermediate level and the structure below the intermediate level.

Apart from its evident asymmetric approach, the underlying concept of the Spanish fiscal decentralisation policy reflects three objectives. The overall arrangement of Spanish fiscal relations was concentrated into the block of sufficiency, the block of solidarity and the block of autonomy (Suarez Pandiello, 1999), with all revenue assignments, tax powers and designed fiscal transfers being set in relation to these principles.

A. Revenue Assignment

The asymmetric approach in the Spanish revenue assignment can be seen from the establishment of a ‘common regime’ and a ‘charter regime’ (‘régimen foral’ in Spanish). The charter regime gives additional benefits to two autonomous communities, the Basque Country and Navarre, compares to the rest, which are included in the common regime. Those two autonomous communities were given special roles mainly for political reason, which has been a source of tension between the Spanish central government, the Catalonia Communities and the Basque Country.²⁹

In the early stages of the Spanish decentralisation, there was no revenue assignment; the central government only gave the autonomous communities lump-sum general grants to cover their expenditure needs. Then, in the first version of the Autonomous Communities Financing Act (LOFCA), passed in 1980, the central government started to recognise a devolved revenue power called ‘ceded taxes’ and received revenue

²⁹ See Suarez Pandiello (1999)

sharing from central government taxes. However, the practice before 1997 treated the ‘ceded taxes’ like other versions of tax sharing – the autonomous communities could only administer and collect revenue, without any discretion or ability to regulate.³⁰

From 1997, the ‘ceded taxes’ have truly become taxes in their own right thanks to the central government’s decision to grant discretion to the autonomous communities. The discretion allows autonomous communities to set the tax rate and create tax credits and allowances. However, for the ‘common regime’ communities, the central government, through its State Tax Administration Agency (AEAT), became the institution that collects and distributes revenues between the central government and the autonomous communities.³¹

The ‘common regime’ communities are also able to collect their own regional taxes and surcharges. Unlike the ‘ceded’ taxes, the autonomous communities have full authority in collecting, administering and regulating these taxes and surcharges. However, they must always comply with the requirement that they not create regional taxes and surcharges using similar types of taxes to those already charged by the central government and municipalities.

In contrast to the common regime, the two charter regime autonomous communities enjoy more fiscal autonomy. While the common regime communities were only given some portion of revenue for several ‘ceded taxes’, such as personal income tax, VAT and excise duties, the charter regime communities were able to acquire all such revenue. Moreover, under the specific financing system Act for each of the charter regime communities, they have access to more types of taxes and collect a greater portion of it than of the ‘ceded taxes’. These taxes are corporate income taxes, non-resident income tax and insurance premiums tax. Moreover, besides performing the collection and administration on their own, the charter regime communities have the power to regulate their own fiscal system, except for indirect taxes, VAT and excise duties that are restricted according to European Union (EU) regulations on harmonising government taxes.

³⁰ See Bosch & Durán (2008)

³¹ See Almendral (2002)

The central government assigned revenue powers not only to the autonomous communities, but also to local governments. The municipalities have been assigned a high level of authority in managing local taxes. Except for property tax, they can set tax rates, allowances and tax credits as long as they do not violate the regulation written in the laws. The central government has also given the municipalities the authority to administer those local taxes. However, for small municipalities that may lack skilled personnel and administrative capability, the central government can delegate the task to the province as the next highest level of government, or even to the autonomous communities as the regional government.

B. Fiscal Equalisation System

After the LOFCA was passed, ‘revenue sharing in central government taxes’ was the term used for the general equalisation grant given to the common regime communities. Nowadays, the grant is called the ‘Sufficiency Fund’. Basically, it is calculated based on each autonomous community’s fiscal gap, which is the difference between its fiscal needs and fiscal capacity.

The method of calculating the fiscal needs was also modified to replace the previous ‘net effective cost’. The new method uses several indicators to calculate regional expenditure needs. The central government uses three different sets of indicators to calculate three different areas of regional expenditure. These areas are health services, social services and common services (which include education responsibilities). Among the different sets of indicators, population size gets the greatest weighting.

Since 2002, the central government has provided different kind of fiscal transfers for each of the areas of regional expenditures. First, it provides a general fund, low-density correction fund and relative income fund for the common services sector. It also gives a ‘guarantee of minimums’ fund for autonomous communities that received less funding in total compared to their base year. Then, to anticipate significant deviation in expenditure growth over the years, the central government sets minimum and maximum financing growth in consideration of the community’s base year amount. Second, a general health finance fund and temporary disabilities savings fund are calculated for the health services sector. Finally, the central government grants a specified amount based on the number of elderly people as the calculation variable for

social services expenditure. The total calculation for these three areas of expenditure is regarded as the expenditure need of each autonomous community.³²

In addition to the ‘Sufficiency Fund’, which is regarded as an unconditional grant, the autonomous communities also receive tied grants from the central government and also from the European Union. The aim of this type of grant is to foster more balanced regional development, income, public services and wealth. One example is the Inter-territorial Compensation Fund, which is transferred as investment projects for poor autonomous communities whose per capita income is below 75 per cent of the EU average. Another example is Basic Public Services Equalisation Grants, which serve as additional transfers in the form of tied grants and are only given if there is a more than three per cent annual increase for service provision needs in an autonomous community compared to the national average.

The fiscal gaps formula also has other consequences, especially for prosperous communities under the common regime. Autonomous communities that have higher fiscal capacity compared to their fiscal needs would be required to remit ‘negative grants’ from the excess fiscal capacity. This ‘negative remittance’ is added to the ‘Sufficiency Funds’ alongside the revenue received by the central government. So, the concept establishes a cross-subsidy from rich regions to poor regions within the common regime communities.

Meanwhile, the charter regime Basque Country and Navarre do not receive any equalisation grants. This is because they are already given significant tax powers, which ensure they are able to fund their expenditures needs without having to rely upon or ask for additional central government transfers.³³

Instead of receiving fiscal transfers from the central government, the charter regime communities have a similar obligation to those common regime communities that have excess fiscal capacity. The charter regime communities are also required to remit a form of ‘negative transfer’ to the central government as a contribution to support the central government in providing sufficient levels of public goods and services across the nation. The Basque Country calls the ‘negative transfer’ a ‘quota’, while Navarre

³² See Bosch & Durán (2008)

³³ See Carbonell & Alcalde (2008)

refers to it as a ‘contribution’. The calculation of how much to remit uses a complex formula that takes into account all central government’s revenues obtained from the charter communities and applies an ‘imputation index’ for each.

For local governments, there are two types of direct transfer from the central government. The first is revenue sharing from personal income tax, the VAT and excise duties. The central government applies different formulas in calculating revenue sharing. Provinces, as well as municipalities with more than 75,000 people, receive a certain percentage of those shared taxes. On the other hand, the central government used three sets of variables – population, the inverse of the tax capacity, and fiscal effort – to create an index formula to calculate how much revenue to transfer to medium and small municipalities. Additionally, provinces and large municipalities enjoy additional fiscal transfers called ‘Complementary Funds’, which are used as a ‘hold-harmless’ tool.³⁴

3.4.3 Fiscal Implications and Intergovernmental Performance Management

The practice of Spanish fiscal decentralisation has been viewed as limiting the fiscal autonomy of its sub-national governments. Bosch and Durán (2008) cite the limited legal power to modify Spanish ‘big taxes’ (income tax, VAT and excise duties) that are shared as ‘ceded taxes’ and the lack of administrative involvement of the autonomous communities as two reasons for this conclusion. Normatively, autonomous communities only have the ability to modify income tax, not VAT or excise duties. Moreover, in practice the autonomous communities never exercise this capacity; only the central government modifies these taxes.

The Spanish fiscal equalisation system was also the subject of criticism from Bosch and Durán (2008). They point out several weaknesses in the formula used to calculate the Sufficiency Fund. They argue that, based on existing fiscal equalisation analysis, there has been a practice of excessive redistribution from high fiscal capacity regions to poorer ones, benefiting the poorer regions. They believe that the central government should implement partial equalisation, which will enable rich autonomous communities to keep some of their fiscal surplus.

³⁴ See Lopez-Laborda et al. (2007)

However, some studies view the Spanish model and approach to fiscal federalism (despite ongoing challenges) as successful (Lago-Peñas, Fernández-Leiceaga & Vaquero-García, 2017). They argue that asymmetries are the logical way to accommodate different preferences regarding the extent of decentralisation, as long as the central government can maintain an optimal degree of asymmetry. Other research supporting the conclusion that the Spanish experience has been successful notes the findings of the positive effect of Spanish revenue assignment on regional economic growth (Gil-Serrate, López-Laborda & Mur, 2011; Cantarero & Gonzalez, 2009). Recent research on the impact of Spain’s fiscal decentralisation on income inequality by Martínez-Vazquez, Lago-Peñas and Sacchi (2017) also found that there have been positive results. Finally, research suggests a positive effect of decentralisation on regional health, education and roads services (Solé-Ollé, 2009).

3.5 Comparative Conclusions

The following table summarises the countries’ experiences described in this chapter in relation to the key theoretical points of the first- and second generation theory of fiscal federalism discussed in Chapter 2.

Table 3.2
Countries Comparisons Based on the Key Issues of First and Second Generation Theory

	China	Canada	Spain
Sub-national government’s Fiscal Autonomy	At the beginning, assigned massive local taxing powers, but then changed to redistribution of revenue by central government by allocating IGFTs	Assigning massive local taxing powers by allowing provinces to access major tax sources	Asymmetric arrangement for autonomous communities: 1. Those in ‘foral regime’ given massive local taxing powers 2. Others in ‘common regime’ have limited taxing powers and can only get limited shared revenue from central government
Managing Sub-national government Performance	Creating incentives for sub-national governments that can promote economic growth directly through intergovernmental fiscal structure	Creating Health and Social Transfers, a type of tied grants but still rather general	Asymmetric authorities and responsibilities by categorising autonomous communities into ‘fast track’ and ‘slow track’

China has significant similarities to Indonesia in that it is a country with a unitary political system. It is particularly interesting for its ‘U-turn’ on its revenue assignment policy. China gave a ‘field’ example of shifting policy from fiscally independent sub-national governments to sub-national dependency on central government transfers as a consequence of its vision of establishing a ‘strong’ central government.

In the beginning, China chose to give more revenue to sub-national governments but then reversed its direction in response to concerns about a ‘weak’ central government. However, some authors conclude that China still managed to encourage sub-national governments to achieve their ultimate goal of increasing economic development by formulating tax arrangements that benefited the sub-national governments if they succeeded in increasing their economic development. Moreover, instead of giving additional fiscal incentives in the form of performance-based grants, China’s central government uses its centralist single-party political system to control sub-national governments’ performance.

Moreover, China’s form of fiscal incentives directly increased sub-national tax revenue as a result of the sub-national governments’ efforts in encouraging a ‘market-friendly’ policy. Meanwhile, the theoretical perspectives discussed in Chapter 2 suggest performance-based grants as fiscal incentives, which has also been encouraged in the second generation of fiscal federalism.

Despite its success in stimulating market-oriented sub-national governments and regarded as providing the ‘correct’ incentives for them, China’s performance target still has challenges to overcome. China was able to create economic growth that was financially beneficial to the nation’s budget but still unable to redistribute the wealth to support sub-national government social expenditures. Meanwhile, China’s GDP-oriented goal tends to make counties focussed more on urban development rather than public education (Wang et al., 2012). Furthermore, its GDP-oriented goal created a dilemma for sub-national governments, especially regarding performance conflict between economic development and environmental protection targets.

China’s political centralisation, which influences its approach of reward and punishment to control sub-national governments’ performance, does not correlate with the Indonesian situation. Despite the ‘unitary’ label, Indonesia has a similar political

system to federalist countries such as Canada. There are democratic elections for all provincial and municipal/regency-level leadership positions, as well as of provincial parliament and local council members. The multi-party system, to some extent, also increases the intricacy with the governors and the president potentially belonging to different political parties. This applies to governors' and mayors' party as well.

Canada, meanwhile, is a developed and fully democratic country with a genuinely federal system of government. Although the figures are aggregate rather than individual, the data show that fiscal federalism in Canada allows provinces to earn more revenue, excluding fiscal transfers, than the federal government. Therefore, wealthy provinces are not dependent on federal government transfers.

However, the objective of making provinces less dependent on federal government transfers is offset by serious fiscal imbalances. The disparity between provinces has pushed the federal government to find a fiscal transfer formulation that can make provinces fiscally equal. This formula has been challenged due to its unequal or 'predatory' effect between richer and poorer provinces.

Furthermore, the Canadian federal government's attempt to introduce more conditional transfers to influence sub-national governments' performance in the health sector is also under question. Provincial governments' compliance issues arising from Canada's system of federation, and the effectiveness of linking the performance measurement system with reward and punishment using democratic elections, are two factors that raise such questions. Meanwhile, the provinces' preference to supervise their own performance management does not show better results regarding the effectiveness of their performance management system.

The new budget deals from the federal government allocated for cities and Canadian citizens in 2004, marked a new era of federal–local government's direct fiscal relations without the intermediary of provinces. Courchene (2005) saw the phenomenon as 'hourglass federalism', where the provinces in Canada are being left squeezed in the middle. Instead of reinstating the federal government's cash transfers to overcome the provincial hard budget constraints due to the previous cut on their cash transfers, it became the entrance for federal government to directly allocate budget for local governments. Even though it did not concern the local governments, but it concerned

scholars like Courchene (2005) and Leo (2006) who started to question the shift of federal–provincial–local government’s fiscal relations to federal–provincial and federal–local governments fiscal relations. However, the Canadian practice do not add new authority and tasks for the local governments, it is simply just connecting the allocation directly to local governments, instead of giving it through provinces.

The experience of Spain offers a different approach in implementing aspects of decentralisation. An asymmetric approach was embedded in the national constitution, rather than just included in practical regulation. Moreover, the Spanish experience has more comprehensively applied the asymmetric approach to decentralisation.

Spain started its decentralisation path by offering a list of main responsibilities for the autonomous communities to choose from based on their readiness to meet those responsibilities. Although the autonomous communities gradually became more homogeneous with regards to responsibilities, there are still differences. Furthermore, the country also applied an asymmetric treatment to fiscal relations. The central government classifies autonomous communities into ‘common regime’ and ‘charter regime’, with different tax powers and forms of intergovernmental fiscal support.

To some extent, China and Canada also have an asymmetric policy, but this approach was partial and the policy was not constitutionalised. China’s asymmetric policy can be seen in the special authorities given to provinces, municipalities or even counties, based on their economic performances. Some examples are the authority given exclusively to Guangdong Province to sign economic agreements with foreign companies without the obligation to request central government permission, and the establishment of Shenzhen, Zhuhai, Shantou and Xiamen cities as Special Economic Zones. There was also the expansion of authority for 16 municipalities out of 333, to be independently able to make and implement their own development plan. The case of Zhejiang Province and its counties showed an even more extreme asymmetric approach; the powers devolved to those counties even made them equal to their municipality-level government. Nevertheless, China did not adopt an asymmetric arrangement for its fiscal relations.

Meanwhile, Canada, does not apply asymmetric responsibilities among provinces. However, the Canadian government arranged federal–provincial fiscal relations, in

terms of revenue assignment, using asymmetric agreements. One example is tax harmonisation, where provinces can opt whether to join the agreements or not, with fiscal consequences. Another example is the way the federal government formulates fiscal transfers to provinces and territories. Fiscal transfers to the provinces are based on revenue-raising capacity, while expenditure requirements are used as bases for transfers to territories.

One similarity between the three countries' experiences is the use of intermediate or second-level government as an essential 'playmaker' in achieving decentralisation goals. In China, which has five levels of governments, the second level consists of provinces, autonomous regions, special districts and large metropolitan areas. Meanwhile, provinces and territories in Canada, and autonomous communities in Spain, are the entities used as the intermediate level. They have been given significant roles and responsibilities in order to become hubs connecting central or federal government with lower local governments such as municipalities, regencies, counties and townships.

If we used the span of control theory, we could see that the central government is optimising gradual or tiered supervision that enables it to have more effective and efficient control. It is better for a central government to control and supervise 13 or 17 intermediate level governments – or even 33, in the case of China – rather than directly dealing with hundreds, or even thousands, of lower-level governments. In Spain, even though IGFTs are transferred directly from the central government to all tiers of government, it does not change the structural accountability of municipalities under the autonomous communities, nor the authority of autonomous communities over their municipalities.

4

FISCAL DECENTRALISATION IN INDONESIA: BACKGROUND AND POLICY TRANSFORMATIONS

4.1 Chapter Preview

Consisting of 17,500 widespread islands comprising approximately 1.9 million square kilometres of land and 3.5 million square kilometres of sea, Indonesia as an archipelago state home to 633 identified major tribes with their unique languages and cultures. Those islands and tribes are currently divided into 34 provinces and 508 municipalities/regencies.

Highly diverse cultures and geographical characteristics are considered the main factors that create unique and different needs among the citizens (Boex & Simatupang, 2008). Despite the risks highlighted by Prud'homme (1995), Tanzi (2001) and others, decentralisation has been perceived as the most appropriate way to manage different public needs across this diverse society.

Not until 1999, however, did the decision to decentralise arise. More than half a century after proclaiming Indonesian independence in 1945, centralist development policy was abandoned. Gaining momentum after the fall of the Soeharto regime in 1998, the endorsement of comprehensive local autonomy was put on the reform agenda. In 2004 a more radical change occurred, as local citizens were given the right to elect their provincial governors and municipal mayors/regents, and new laws on fiscal decentralisation were passed. Indonesia has, as a result, gone beyond mere delegation of functions and responsibilities administratively, to decentralising politically and fiscally.

The regime of fiscal decentralisation gives sub-national governments, together with local councils, the responsibility of managing their own budgets. The issues are quite similar to the development of fiscal federalism's conceptual framework described as first and second generation theory. The first generation is about defining fiscal

autonomy: ‘who can have more revenue?’; ‘should locals be dependent on or independent of central transfers?’; and ‘even if sub-national governments are dependent on central transfers, should they be given more unconditional transfers or more earmarked transfers?’.

The early years of Indonesian fiscal decentralisation focused on setting IGFTs and optimising local tax authorities. Law No. 33/2004 revised the initial fiscal decentralisation regulation, Law No. 25/1999 on Fiscal Balance between Central and Regional Government. The new law changed some of the IGFT classifications, such as the addition of personal income tax and also geothermal energy royalties, as shared revenue. Moreover, the revision law classifies the re-forestation fund as a type of natural resources shared revenue, unlike the earlier law that classified it as a Specific Allocation Fund (DAK). Then, Law No. 28/2009, which was promulgated as a revision to Law No. 34/2000 about Local Taxes and Surcharge Fees, assigned the tax on land and building (PBB) and tax on the transfer of property ownership (BPHTB) from rural and urban sectors to municipalities and regencies. This re-classification meant both sources of revenue sharing no longer existed as a type of IGFT. All of these changes were developed using the main idea of finding a way to establish a sufficient level of fiscal autonomy at the local level.

The second generation theory, meanwhile, concerned itself with how to ensure or control the fiscal autonomy given, so that the sub-national governments performed their responsibilities well. The discussions focused on using fiscal incentives to stimulate sub-national governments to perform well. The theoretical perspectives examined in Chapter 2 explain the use of performance-based grants as a tool in providing fiscal incentives. However, the countries comparison in Chapter 3 illustrated China’s version of giving direct fiscal incentives through its fiscal structure setting. So, in this chapter we will describe the Indonesian practice of performance-based grants, which correlates to the theoretical perspectives.

This is what happened in Indonesia at the end of the first decade of its ‘big bang’ decentralisation. From 2010, the central government introduced a type of fund, called the Local Incentive Fund (DID), allocated and transferred based on certain performance criteria. The idea was to encourage sub-national governments to improve

their performance by providing guidance on what kind of indicators the central government wanted sub-national governments to meet.

However, from 2015 the central government also introduced a policy to increase tied grants, so that it can ensure sub-national governments will spend IGFTs only for the intended sector. This is another method of the second generation theory for encouraging good outcomes, as discussed in Chapter 2. Nevertheless, this time the allocation mechanism changed from a ‘top-down’ into a ‘bottom-up’ process. The sub-national governments submit funding proposals about every sector of development they need. Then, the central government assesses those proposals and allocates funding based on national priorities. Not only was the allocation process rigid, but so also was the transfer and payment mechanism from the central government. The objectives, of course, as the central government claimed, were, first, to ensure development at the sub-national government level had more focus and was in line with the central government priorities and, second, to ensure the quality of sub-national government spending.

This chapter will describe Indonesian fiscal decentralisation practice and the policy development that correlates with its political and institutional history, starting from the historical background that influenced its choice of a unitary rather than federal system. Then, the political journey from the proclamation of independence to the reform era will give an insight into why a decentralisation path was finally chosen, and what the factors were that made Indonesia decide to have a ‘big bang’ rather than sequencing the reform process. Furthermore, we will explore the different structural tiers of government before and after the reform era, including the democratic impact of the election of the head of sub-national governments.

This chapter will also describe the central government’s efforts in establishing intergovernmental fiscal relations after the so-called ‘big bang’ decentralisation took place in 1999. The chapter will detail the transformation of Indonesian IGFTs, including allocation and transfer mechanisms, and policy regarding revenue assignment. Moreover, it will specifically explain the performance-based grant initiative, including the changes to the indicators used to assess sub-national governments.

4.2 Political Dynamics, Institutional and Tasks Arrangements

The choice of unitary statehood was influenced by the historical Indonesian independence movement, with the existence of separate movements in each region believed to be the main reason the country had failed to free itself from Dutch colonisation for over 300 years. The need and desire to unite became the narrative of nationalist movements to gain independence.³⁵

When the Soeharto regime was in charge, the president sought a more stable political situation and economic development through its authoritarian and centralist approach. This lasted for over 30 years, until a major economic recession provided momentum for Indonesia to become one of the most democratic nations with a ‘big bang’ decentralisation policy. The nation’s history acknowledges this as the reform era, and we will explore the country’s approach in establishing intergovernmental structural relations among tiers of governments.

4.2.1 Political Dynamics³⁶

From 1509 to 1945, Indonesia was under colonial rule by the Portuguese and the Dutch or occupation by the Japanese. Colonial rule was a consequence in part of the lack of unity between regions ruled by different kingdoms. Nationalist movements only began to develop in 1905 and gained momentum from 28 October 1928, when Indonesian youth from all regions gathered and declared Indonesia to be one entity. From that point, the fight against colonialism became stronger and more prominent, and the country was finally able to proclaim its independence on 17 August 1945. The 1945 constitution was the first basic legal framework that formed Indonesia. It was agreed among the founding fathers of Indonesia to state in the constitution that it is a unitary country.

The early years of independence were used to gain the recognition of the international community. Most resistance, of course, came from the ex-coloniser, The Netherlands. After several years of armed hostilities between the people of Indonesia and the Dutch military forces, the government of The Netherlands finally conceded Indonesian

³⁵ See Reid (2007) and (2010).

³⁶ See Hofman and Kaiser (2004), Ferrazzi (2000), Kingsbury (2013), King (2004) and Goumenos (2008).

sovereignty. The acknowledgement was stated in the roundtable conference agreement of 27 December 1949, which was held in The Hague at the initiative of the United Nations. However, The Netherlands acknowledged the independence and sovereignty of the United States of Indonesia, a federal state. The Republic of Indonesia that proclaimed its independence on 17 August 1945 was only acknowledged as one of the states, which together with the other 15 separate states, became autonomous sub-national governments under the United States of Indonesia. Thus, as a consequence, Indonesia's 1945 constitution was changed to the United States of Indonesia's Constitution of 1949.

The implementation of Indonesia as a federal state only lasted for about eight months. On 17 August 1950, President Soekarno declared the temporary 1950 constitution, which declared Indonesia to be a unitary country. The passing of federalism reflected the sentiment among the Indonesian 'founding fathers', who felt federalism was counter to their desire for unitary governance. The 'founding fathers' believed that federalism was an obstacle to constructing a nationalist identity throughout the regions. The experience of being scattered during the Dutch colonialism meant federalism was seen as a system that would only disintegrate the country. Moreover, it was seen as an 'alien-imposed federalism' for two reasons: first, federalism was seen as a Dutch 'divide and rule' strategy implemented during colonisation; and second, there was a desire to reject any systemic legacy from the colonial period.

However, the constitution committee failed to agree on a new refined constitution, forcing President Soekarno to make a presidential decree on 5 July 1959. The decree abolished the democratically elected constitution committee, reinstated the 1945 constitution and established an appointed temporary People's Consultative Assembly (MPRS) and House of Representatives (DPR-GR). Soekarno's political policies, which made him a lifetime president, and his protection of the Indonesia Communist Party, triggered unrest. The unstable political situation and worsening domestic economic condition made the people unhappy and led to a series of rallies until 12 March 1967, when he was finally impeached through the MPRS decree.

The impeachment of Soekarno was ultimately the beginning of the Soeharto regime, which was called the New Order. The regime aimed to bring stability and consolidate the country. Therefore, political and regional instability were fundamental issues of

concern to the New Order policy approach to national and regional development. An authoritarian, hierarchical structure from the central to provinces and local governments, and centralised development decisions were regarded as the New Order's policy trademark.

Formal and legitimate legislative elections in the New Order era were first held in 1971 and became regularised every five years from 1977. Elections were to form the House of Representatives (DPR), which was supplemented by several unelected factions from the military, regional bureaucrats and group representatives, forming the People's Consultative Assembly (MPR). The President of the Republic of Indonesia was elected through the MPR.

In 1973, the Soeharto government simplified the multi-party system, limiting it to two political parties and one Functional Group, which was not a political party *de jure* but was *de facto*. The Functional Group claimed to represent civil servants and the government workers' union, including their family members, across the country but refused to be called a political party. Over six legislative elections – in 1971, 1977, 1982, 1987, 1992 and 1997 – the Functional Group positions were uncontested and it dominated the DPR, varying from 62 per cent to 74 per cent. Together with the numbers of unelected members forming the MPR, the political system was very comfortable for Soeharto, who extended his power for 32 years.

During this period, Soeharto managed to make Indonesia one of the foremost developing countries, with rapid economic growth until the regional economic crisis hit Asian countries in 1997, and eventually had a significant impact on the Indonesian economy. Pressure groups – unhappy with the New Order, development inequality among regions, suspected high levels of corruption, collusion and nepotism within the government, and income disparities between social groups – used the momentum and forced Soeharto to step down from the presidency on 21 May 1998.

Habibie, the interim president, faced the challenge of not only restoring the country's economy but also addressing problems concerning democratic practice, separatist issues in some regions, the demand for full regional autonomy, and the eradication of corruption. During a brief period, the central government, along with the DPR, introduced new laws to accommodate the growing demands in these regards.

Law No. 2/1999 was introduced as a legal framework for new democratic legislative elections for all tiers of government. This law permitted people to form political parties to contest that year's legislative election. There were 180 parties registered but only 48 parties that were administratively qualified. Nevertheless, the number of parties involved was still much greater than during the New Order period.

In the same year, Law No. 22/1999 made political decentralisation more attractive. In the New Order era, local councils (DPRD) could only endorse some candidates, to then be selected and approved by the central government. Under Law No. 22/1999, the DPRD enjoyed the discretion to elect governors, mayors and regents through their internal democratic process. Thus, the local constituents elected their representatives at the DPRD, then those local representatives endorsed and voted on candidates for governor, mayor and regent. This process was, however, criticised as creating an 'elite capture' and 'little kings' who were not accountable to the central government or to local constituents.

Habibie tackled separatist issues in some regions and the demand for full regional autonomy by ordering his minister to draft a law to be used as the legal framework for regional autonomy. Decentralisation, with its promotion of full regional autonomy, seemed very attractive to the local citizens. From then, in addition to tasks and fiscal resources being assigned to sub-national governments, the number of provinces increased from 26 to 34 and the number of municipalities and regencies from 283 to 508 by 2017.

Law No. 32/2004, which revised Law No. 22/1999, changed the democratic mechanism for electing governors, mayors and regents. The new law on sub-national government enabled local constituents to elect their executive leader directly. Since then, the local constituents have exercised their democratic rights by electing not only their legislatures but also executive leaders, from national to local levels.

The enhancement of democratic culture under the reform era has made the Indonesian political landscape more dynamic. Unlike the New Order era, which was dominated by a single political entity, the political parties winning legislative elections have kept changing. Moreover, no single party has managed to win more than 50 per cent of parliamentary seats. Therefore, parties have generally formed permanent coalitions to have a stronger voice in the parliament.

However, the coalitions of parties at national, provincial and municipality/regency level may differ. It is possible that two parties might be opposed at the national level, but when it comes to the lower legislative level they become allies. This phenomenon is driven by the fact that the position of sub-national government's executive leaders cannot be taken for granted by a legislative election winner, whether national or local level, due to the presidential system, where a person's electability may be greater than that of the winning party's candidate.

4.2.2 Institutional and Tasks Arrangements

During Soekarno's presidency, there were several attempts at promoting regional autonomy through the establishment of Law No. 1/1945, revitalised by Law No. 1/1957. However, none of these laws was ever implemented due to outbreaks of regional unrest.

In the New Order era, the issue of regional autonomy was raised again through Law No. 5/1974, but this too was never fully implemented. The central government kept exclusive budget control. In 1996, the central government selected 26 provincial governments to undertake an experiment in autonomy. However, the central government assigned tasks but did not assign commensurate resources and facilities, and the experiment was unsuccessful. The effort was then interrupted by popular unrest against the Soeharto regime.³⁷

At the beginning of the reform period, interim President Habibie created the State Ministry of Regional Autonomy, which was later merged by President Abdurrahman Wahid into the Ministry of Home Affairs (MoHA) on 23 August 2000, to further formulate administrative, managerial and bureaucratic sector policy for sub-national governments and monitor implementation. Meanwhile, the Ministry of Finance (MoF) has responsibility for formulating and regulating fiscal decentralisation policy.

After the State Ministry of Regional Autonomy initiated a draft and discussed it with DPR, Law No. 22/1999 on Sub-national government was introduced as a legal framework for regional autonomy. It was accompanied by Law No. 25/1999 on Fiscal Balance between Central and Regional Government, which was drafted and proposed

³⁷ See Hofman & Kaiser (2004)

by the MoF. These laws mark the beginning of regional autonomy and fiscal decentralisation practice in the reform period.³⁸

Throughout the reform period, there have been three revisions to the laws about sub-national government. The issues being refined concerned restructuring intergovernmental relations and task assignments, along with some regulations the central government intended to improve the practice of decentralisation in Indonesia.

As has been mentioned, Law No. 22/1999 was the first to be passed. It arranged the assignments of all central government tasks directly – bypassing provincial governments – to municipalities and regencies. Exceptions were made in the sectors of foreign affairs, fiscal and monetary, security and defence, justice, and religious affairs, which remained exclusively the central government's functions. However, Law No. 22/1999 did not specify tasks at the level of operational detail.

Government Regulation No. 25/2000 was established to specify task assignments between government entities. It used the concept of residual functions, making a 'negative list' of functions and tasks for central government and provincial governments. Meanwhile, other functions and tasks not mentioned in the regulation became the responsibility of municipality or regency governments. The idea promoted in the first policy on decentralisation was to limit central and provincial government functions and broaden municipalities' and regencies' authority. It also divided functions between central, provincial and municipality or regency levels.

These task assignments changed the employment status of more than two million civil servants, about two-thirds of civil servants at that time, from central government employee to sub-national government employee. The central government also transferred around 239 provincial-level offices, more than 3900 local-level offices and over 16,000 service facilities, such as schools, hospitals and health centres as a consequence of the law. Table 4.1 provides recent data on the proportion of central, provincial and municipality/regency-level governments.

³⁸ See Rasyid (2004) and King (2004)

Table 4.1
The Proportion of Government Employees in Indonesia

Employment Status	2013	2014	2015	2016
Central Government	891,804	909,426	944,893	918,444
Provincial Government	295,621	297,774	312,093	301,781
Municipality/Regency Government	3,175,380	3,248,103	3,301,439	3,154,124
Total	4,362,805	4,455,303	4,558,425	4,374,349

Source: State Employee Agency (BKN)

The provinces were recognised not only as autonomous units but also as the extensions of the central government in the regions. Therefore, provinces' tasks included coordinating issues across municipality and regency boundaries within their territories, backstopping municipalities or regencies that could not yet perform their functions, and performing deconcentrated³⁹ tasks. However, unlike the former Law No. 5/1974, which acknowledged tiers of governments between provinces and municipalities or regencies, the new law contradicted the provincial coordination role because it explicitly stated that there was no hierarchical relation between provincial and municipality/regency levels. This article made it hard for provinces to coordinate municipalities and regencies to tackle inter-jurisdictional regional issues. Moreover, the division of tasks made it impossible for provinces to interfere by coordinating or harmonising policy on municipality or regency functions, where they exercised no authority.

Discussion of a revision began in 2001, only two years after the law was passed. Some of the arguments noted that Law No. 22 of 1999 had been drafted over a brief period. Interim President Habibie took over on May 1998, and a year later the law was promulgated. Furthermore, the drafting and discussing processes were imperfect because there was little feedback from the politicians, who were at the time distracted

³⁹ 'Deconcentrated', as defined by Rondinelli (1980), means offloading workload from central government to local staff without the ability for them to decide how those functions or tasks are to be performed.

with preparations for newly regulated legislative and executive elections. Additionally, the drafting did not involve intensive consultation with the regions.⁴⁰

The law on sub-national government was finally revised in 2004 when the DPR passed Law No. 32. The law tried to refine several issues, including intergovernmental relations and functions. The idea was to use concurrent functions instead of residual functions in arranging task assignments. Aside from the six exclusive functions of the central government, the law acknowledged concurrent functions between central, provincial and municipality/regency levels. The article explicitly mentioning hierarchical relation between provinces and municipalities or regencies was removed, and the law only defined provinces and municipalities or regencies as autonomous sub-national governments that have equal relations. However, the approach of having concurrent functions, combined with the status of provinces as an administrative extension of the central government in the regions, implicitly gave power to the provincial government to make policies on similar sectors with municipalities or regencies that related to inter-jurisdictional issues.⁴¹

After ten years of implementation, the law on sub-national government was revised again by the establishment of Law No. 23/2014. The most notable addition of this law is an article about the state's territorial division. Article 2 stipulated that the Unitary State of the Republic of Indonesia consisted of provinces and that provinces consist of municipalities and regencies, which implicitly affirms the existence of hierarchical tiers of government. Other additions concern regional governance interrelations, the abolition of the regional leaders' election mechanism (already regulated in another specific law), the obligation to provide well-managed public services, and encouragement of public participation in regional planning.⁴²

4.2.3 Asymmetric Sub-National Government Autonomy⁴³

Among the 34 provinces, there are currently five that enjoy special privileges regarding their autonomy, which includes local laws, politics, administration and financial support. The five provinces are Aceh, Papua, West Papua, Jakarta and

⁴⁰ See King (2004) and also Rayid (2004)

⁴¹ See Rasyid (2004)

⁴² The stipulation of Law number 23/2014 marked a new era of Local Government task and authority assignment that will be analysed further in the thesis.

⁴³ See Butt (2019) and also Kingsbury (2013)

Yogyakarta. As a consequence of being under the respective provinces, the special autonomy arrangements also affect the municipalities and regencies within those provinces' jurisdictions. However, the extent of privileges varies across these five provinces due to differences in why and when each of the provinces was given special autonomy status.

First, the Province of Aceh – previously named Nanggroe Aceh Darussalam in the early practice of its special autonomy in the year 2001 – was given the special status due to its history of decades of armed conflict between secessionists and the Indonesian army during the Soeharto regime. The major reason for the secessionist demands was the behaviour of the New Order regime, which used its military forces extensively against the Acehnese, resulting in massive human rights abuses. Another reason was unfair economic and financial returns from the central government. Aceh was an oil- and gas-rich region which felt economically discriminated against because while the central government gained immense revenue, very little of it came back to the people of Aceh, leaving their needs for public goods and services unmet.

Law No. 11/2006 is the current legal basis for the Province of Aceh's practice of its special autonomy. The law abolishes the initial special autonomy law for Aceh, Law No. 18/2001, which was passed in the early years of the reform era. The first law had already given Aceh extensive power and privilege to rule and administer its territory. Moreover, it also gave Aceh a greater share of higher oil and gas revenue and a higher level of Special Autonomy Funds related to its 'special' status from other regions (except for Papua). The details of these funds are outlined in the next section of this chapter. However, the secessionist movement, which started in 1976, did not end until two years after the disastrous 2004 tsunami hit Aceh and the central government succeeded in establishing a Memorandum of Understanding with the secessionist leaders in Helsinki. The current legal arrangements for Aceh's special autonomy are a result of the peace agreement. The previous arrangements concerning administrative and financial powers remain the same, but in the current law the province is granted even more social and political powers. Acehnese religious and cultural beliefs can now be imposed through embedding Sharia Law as the province's criminal law. Moreover, the Acehnese are also eligible to create a local political party that can compete in democratic elections for provincial, municipality and regency legislative councils as

well as direct elections for governor, mayors and regents as the sub-national government's executive leaders.

The provinces of Papua and West Papua were originally a single province at their integration into the Republic of Indonesia in 1969. The integration process was a result of a referendum, which was the beginning of an ongoing armed campaign seeking independence. The referendum was a choice given to the Papuans on whether they wanted to join Indonesia. Despite the result, which was officially recognised by the United Nations, the secessionist 'Free Papua Movement' (OPM) believed that the referendum was unfair due to duress, with Indonesian military forces intimidating the Papuans to choose in favour of integration.

Papua and West Papua have a similar background, which form the political and social grounds that eventually led to them gaining special autonomy status. Moreover, like Aceh, Papua and West Papua are also natural resources-rich regions that were treated unfairly – economically and socially – by the central government during the Soeharto regime. The reform era had actually tried to 'balance the book' through Law No. 21/2001 and Law No. 38/2008, which – in addition to dividing the former Papua Province into two provinces – provided significant natural resources revenue sharing, additional special autonomy funding and additional infrastructure funding to accelerate the region's development. These funds will also be detailed in the next part of this chapter. However, unlike Aceh, the secessionist problem in Papua and West Papua has not been resolved. Moreover, the Papuans do not have exclusive political rights, in terms of establishing a local political party, or any locally determined criminal law as the Acehnese do.

The other two provinces given special autonomy status are Jakarta and Yogyakarta. Unlike Aceh, Papua and West Papua, these provinces were not granted 'special' status for political and economic reasons. Jakarta was 'special' because it is the capital of Indonesia. The 'specialness' comes in the form of its administrative status; the mayors are appointed by the governor, which means, institutionally, they are the governor's subordinates within the same entity. Unlike other municipalities, where the local constituents can directly elect their mayors in democratic elections, the people of Jakarta can only elect the governor. Furthermore, since the municipalities are just administrative subordinates of the province, the people of Jakarta elect only national

parliament and provincial-level local council members, because they do not have municipality- or regency-level local councils. In terms of IGFTs, there are no differences from the common provinces.

The Province of Yogyakarta has the reverse democratic rights compared to Jakarta: the people of Yogyakarta have the right to elect mayors and regents democratically, but not the governor. This situation occurs because of Yogyakarta's strong cultural background. The kingdom of Yogyakarta is the house of one of the most respected royal families in Indonesia. The Sultan Hamengkubuwono IX, who led the kingdom, made a significant contribution to the Indonesian fight to gain and retain its independence as a unitary country. His agreement to become part of Indonesia during the early years of independence gave strong legitimacy to the country's leader at the time. He also financially assisted the Indonesian government during those early years of independence. Moreover, the people in Yogyakarta have always been very loyal to their Sultan and believe that the Sultan and his predecessors are the only legitimate leader to rule their province as a governor.

Therefore, the central government has acknowledged Yogyakarta as a Special Region since 1950, a status that was respected even during the Soeharto regime. The recently established Law No. 13/2012 further strengthens its position as a Special Region, not only approving the absence of democratic elections for governor but also, in contrast to Jakarta and other common provinces, creating rights to receive special autonomy funding as additional IGFTs.

4.3 Intergovernmental Fiscal Relations (IGFRs)

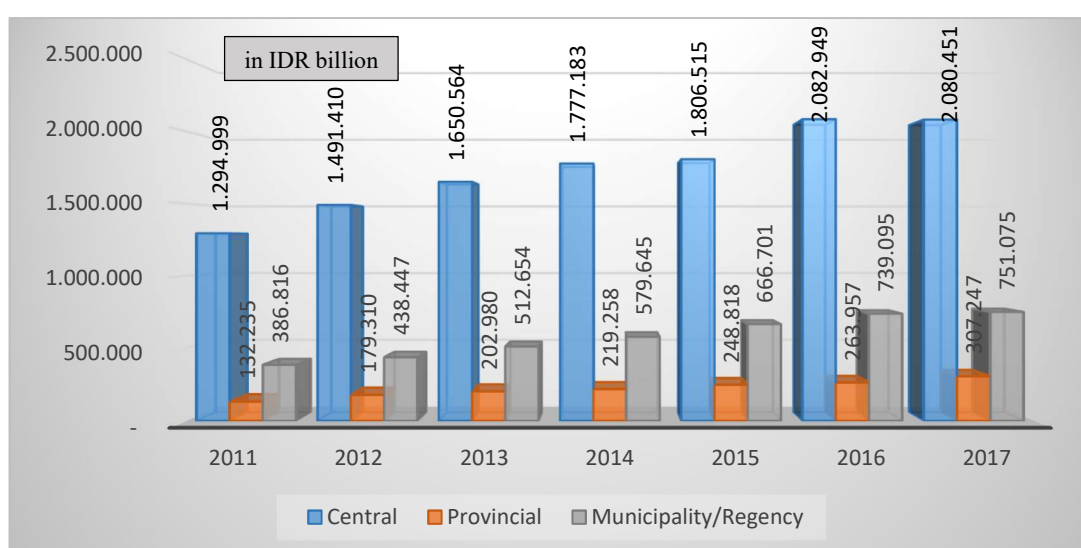
Law No. 25/1999, revised by Law No. 33/2004 on Fiscal Balance between Central and Regional Government, was a turning point that launched the ambitious program of fiscal decentralisation in Indonesia. The aim was to transform a highly centralised budget using tied grants into a set of fiscal transfers that gave more discretion to sub-national governments in planning and executing their budget. The law enabled sub-national governments to receive greater amounts from natural resources revenue sharing.⁴⁴

⁴⁴ See Harjowiryo (2012)

It also introduced two new intergovernmental fiscal transfers, the General Purpose Fund (DAU) and the Specific Purpose Fund (DAK). Adding to the ambitious program was Law No. 34/2000, which gave broad taxing authority to sub-national governments; this was then revised by Law No. 28/2009, which not only tried to refine the previous law but also became the legal basis for assigning land and building tax as one of the local taxes.

However, those laws were not the only legal sources for fiscal decentralisation in Indonesia. Specific laws obliged the central government to allocate extra funds to specific regions, entities and sectors; these include special autonomy laws, the law on villages and annual central government budget laws. The existence of these laws become an integral part of the fiscal relations between central and sub-national governments. Figure 4.1 shows a comparison of total expenditures for each level of government.

Figure 4.1
Comparison of Government Expenditures



Source: processed from the Ministry of Finance database

4.3.1 Intergovernmental Fiscal Transfers (IGFTs)

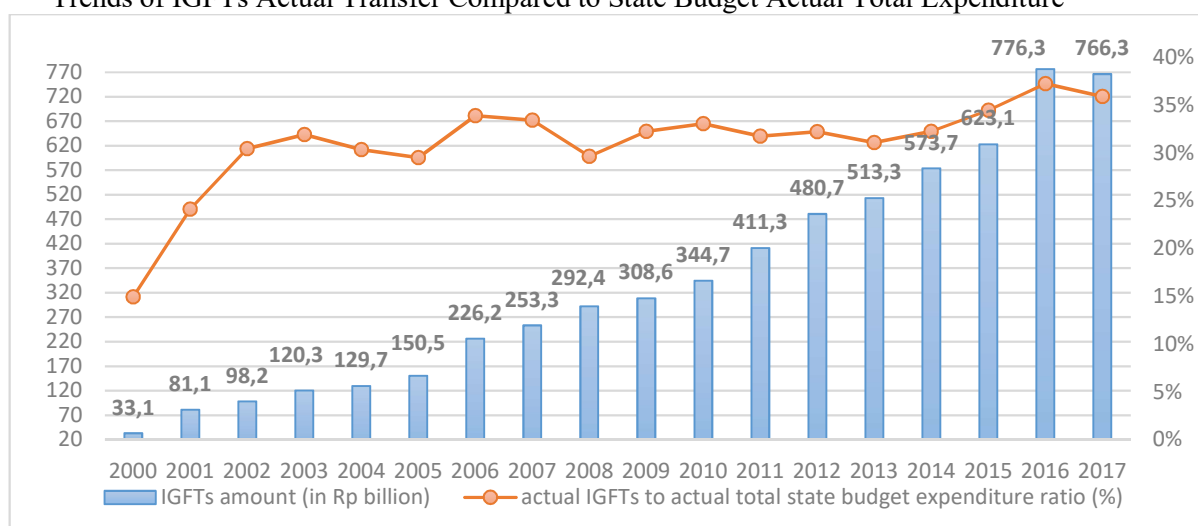
Following the ‘big bang’, the central government began to include an allocation of IGFTs for all provinces, municipalities and regencies in the state budget. In the fiscal year 2000, the central government transferred approximately 15 per cent of the total state budget expenditure, or around IDR 33 trillion. In 2001 the amount increased

significantly, to approximately 24 per cent of state budget's expenditure or around IDR 82 trillion. The recent allocation of IGFTs in 2017 was around IDR 766 trillion, or approximately 36 per cent of the total state budget expenditure. More data can be seen in Figure 4.2.

Those funds are transferred directly from the central government to each province, municipality and regency. The central government currently has to monitor the transfers to 542 sub-national governments, since there is no hierarchy in distributing the fiscal transfers, consistent with the institutional arrangements. The central government's task is even more difficult because it has to evaluate all sub-national governments' performance in using tied grants.

Before 2013, the central government allocated and transferred a Balance Fund, Special Autonomy Funds and Adjustment Funds to sub-national governments. The Province of Yogyakarta Special Fund was added in 2013. The increase in IGFT percentage since 2015, as shown in Figure 4.2, was partly the result of a new type of transfer called the Village Fund. In 2016, most of the Adjustment Funds were re-classified into specific allocation transfers in the Balance Funds. Only one of the Adjustment Funds, the Local Incentives Fund, is classified as a separate type of IGFT.

Figure 4.2
Trends of IGFTs Actual Transfer Compared to State Budget Actual Total Expenditure



Source: processed from the Ministry of Finance database

*2016 and 2017 based on state budget allocation, not actual transfer

In addition to arranging types of IGFTs and its allocation formula, the central government tries to stimulate sub-national government performance by refining the

transfer mechanism every year through a Minister of Finance regulation on the management of IGFTs. The regulation imposes requirements for sub-national governments to have the funds transferred. A recent regulation for the transfer of General Allocation Fund (DAU) in 2017, for example, requires sub-national governments to submit their general infrastructure expenditure report by 31 January in order to have the DAU transferred in March, and submit detailed reports by 31 July to have the DAU transferred in September. The reason for this is that the central government added a requirement that sub-national governments must allocate at least 25 per cent of their block grants, which come from DAU and Revenue Sharing (DBH), for infrastructure expenditure.

Another example is the mechanism for the Specific Allocation Fund (DAK), which requires sub-national governments to provide the current year's local budget and previous year's DAK utilisation report by 31 March in order to have the first-term DAK transferred in April. Furthermore, they must submit the utilisation report for the first-term DAK in April, and it must show evidence that at least 75 per cent of the fund has been used in order to get the second-term transfer. The same requirement applies to the third and fourth or final transfer for that year. The only difference is the deadline dates, which are 30 June, 30 September and 15 December respectively.

A. Balance Funds

Balance Funds are allocated based on Law No. 25/1999, which was then revised by Law No. 33/2004. The differences between the two laws are the formulation criteria and the classification of funds. There are three types of Balance Funds that the central government must deliver to sub-national governments.

1) Revenue Sharing Fund (DBH)

This transfer is intended to reduce vertical fiscal imbalances through redistribution of revenue collected by the central government to its origin and municipalities or regencies within the same province. There are two sources of revenue shared, tax and natural resources.

In Law No. 25/1999, the types of tax revenue shared are tax on land and building (PBB), and tax on the transfer of property ownership (BPHTB). Law No. 33/2004 added a new revenue-sharing scheme for personal income tax (PPH personal) and tobacco production excise, which commenced in 2009. However, Law No.

28/2009, which assigned BPHTB and PBB from rural and urban sectors to municipalities and regencies, means both sources of revenue sharing no longer exist. The PBB revenue sharing left are those from the mining, forestry, and farming sectors.

Meanwhile, the natural resources revenue being shared is derived from oil and gas, general mining, forestry and fishery. Revenue from geothermal energy has also been introduced since 2009 based on the article in Law No. 33/2004. Moreover, the revision law classifies re-forestation funds as DBH, unlike the earlier law that classified it as DAK.

Basically, DBH is a type of block grant, but some DBH transfers are earmarked. The earmarked funds are tobacco production excise funds to finance health programs related to the anti-smoking campaign, and re-forestation funds. There was one more earmarked fund, the additional 0.5 per cent central government share from oil and gas revenue to finance basic education, but in 2016 the central government abolished the earmarking and classified it as one of the block grants.

Each type of DBH has its portion and formulation to be shared. Not all shared revenues go to the region of origin or where the income comes from. Some percentage of the shared revenue is transferred to other regions within the same province. Furthermore, there are asymmetric sharing percentages for DBH from oil and gas revenue due to the special autonomy status of Aceh, Papua and West Papua. The regular share for central and provincial government for oil revenue is 84.5 per cent and 15.5 per cent respectively, while for gas revenue it is 69.5 per cent and 30.5 per cent respectively. However, the balance is reversed for Aceh, Papua and West Papua, becoming 15:85 per cent for oil revenue and 30:70 per cent for gas. More details can be found in the Appendix 5.

2) *General Allocation Fund (DAU)*

DAU is another type of block grant used in Indonesian fiscal decentralisation; it is given to sub-national governments and used as an equalising grant to reduce horizontal imbalances. Law No. 25/1999 regulated the ceiling amount to be allocated through DAU at a minimum of 25 per cent of domestic revenue, but this was revised in Law No. 33/2004 to a minimum of 26 per cent of net domestic

revenue. From that total ceiling amount, 10 per cent is allocated to provinces and 90 per cent to municipalities and regencies.

The two laws also had a difference in the allocation formula. Under the earlier law, the allocation was formulated by multiplying the total amount available to a weighted proportion of each province, municipality and regency. The weighted proportion comes from the calculation of each sub-national government's fiscal gap, which is the difference between potential fiscal capacity and fiscal needs. Potential fiscal capacity was calculated by averaging the sub-national government's revenue and adjusting it using gross regional domestic product (GRDP), manufacturing potential, natural resources potential and human resources potential. Meanwhile, fiscal needs are calculated by averaging sub-national government expenditures and adjusting the result to each sub-national government's specific conditions: total population, total area, geographical condition and number of poor people.

The formulation under the current law is accumulating basic allocation, which is the amount of the sub-national government's employee salary, and the fiscal gap. The component of fiscal needs accounted for is population, total area, price cost index, Human Development Index and GRDP per capita index. The sub-national government's fiscal capacity consists of its own-source revenue and revenue sharing from the central government.

The formulation of DAU has been criticised as 'one size does not fit all' by Shah, Qibtiyah and Dita (2012). They argue that the formula cannot be similarly applied to all jurisdictions, with their widely unique characteristics, so the central government needs to cluster sub-national governments by population, area and class. Furthermore, they suggest that the current formula should be changed, with needs measurement based on population for each service category.

3) *Specific Allocation Fund (DAK)*

This was initially a type of conditional or tied grant scheme allocated from the central government budget (APBN) to sub-national governments, mainly to finance physical capital investment and limited-period financing of operational and maintenance needs matched with national priorities in several sectors of sub-national government responsibility. There was only one category of DAK until

2016, when the central government classified the physical DAK into three categories: regular, assignment and affirmative. There were also changes to the IGFT classification in 2016, when fiscal transfers previously classified as ‘Adjustment Funds’ or ‘Other IGFTs’ were added and classified as ‘Non-Physical DAK’.

Law No. 33/2004 required sub-national governments to provide matching funds of at least 10 per cent of the total DAK allocated in each sector. However, the central government abolished that requirement in 2016, putting a special affirmative policy in the annual law on the central government’s budget so that the action can be considered legal.

DAK formulation was originally based on general, special and technical criteria. The general criteria consider the financial capacity of the regions, while special criteria emphasise the characteristic of the regions. Technical criteria are more specific and are established by line ministries. However, a proposal-based DAK was introduced in 2016 as a new approach to allocation. Governors, mayors and regents are all required to propose their own physical and infrastructure projects to be assessed by an intra-ministerial team from the central government.

Balance Funds are the main component of IGFTs in Indonesia and have the most significant allocation compared to other classification of IGFTs. Among the three types of Balance Funds, DAUs form the most considerable portion. DBHs were the second largest until 2015 but were overtaken by DAK in 2016 because of the re-classification of most of the Adjustment Funds as DAK.

B. Adjustment Funds

Initially, Adjustment Funds was a term used for several types of IGFTs provided as a calculation adjustment from the previous year’s allocation of Balance Funds. Then, it also started to become a place for some of the central government’s initiatives in the form of affirmative policy for regional development. Both elements were included in the annual state budget law as the legal bases for the Adjustment Fund.

Due to its nature as a yearly budget agreement, the continuity of such affirmative policy funds – whether they would be allocated again for the coming year’s state budget – depended on the parliament’s decision. Thus, we can only find some funds –

like the Fiscal Decentralisation Strengthening Fund (DPDF), Local Infrastructures and Facilities Strengthening Fund (DPIP), Educational Infrastructure Development Acceleration Fund (DPPIP), Local Infrastructure Development Acceleration (DPPID) and Local Infrastructure Adjustment Funds (DPID) – in particular fiscal years. However, the allocation of these kinds of parliamentary initiative ceased in 2012 because it was found by the National State Auditor (BPK) and the Corruption Eradication Commission (KPK) to be an avenue for some corrupt parliamentarians to extract money from sub-national governments.

There was another form of Adjustment Fund that had already been discontinued because it was only a pilot project. This was called the Sub-national government and Decentralisation Project (P2D2), which served as an incentive for sub-national governments that performed well in utilising their infrastructure, irrigation and environment sector DAK. The program was funded from the World Bank's loan agreement and was discontinued after the contract ended.

Afterwards, the only types of transfer allocation in the Adjustment Fund were those that came from the previous year's Balance Funds calculation adjustment, those that are mandated in specific laws, which must be re-allocated every year, and those that are endorsed by line ministries to support their programs in the regions. When the re-classification of IGFTs took place in 2016, the Balance Funds calculation adjustment was considered as part of the DBH or DAK, depending on which type of Balance Funds was derived from the calculation adjustments. Meanwhile, the mandated transfers are classified as Non-Physical DAK due to its nature as a tied grant not for physical or material expenditures. Types of Adjustment Funds that were re-classified as Non-Physical DAK are:

- a. Schools Operational Subsidy (BOS)
- b. Teachers Professional Incentive (TPG)
- c. Teachers Additional Income (Tamsil)
- d. Remote Areas Teachers Incentive
- e. Health Operational Subsidy (BOK)
- f. Family Planning Operational Subsidy (BOKB)
- g. Early Childhood Education Operational Subsidy (BOP PAUD)
- h. Cooperatives, Small and Medium Enterprises Capacity-Building Fund
- i. Civil Administration Service Fund

C. Special Autonomy Funds

Special Autonomy Funds were allocated based on Law No. 21/2001 on Special Autonomy for the Province of Papua, Law No. 35/2008 on Special Autonomy for the Province of West Papua, and Law No. 11/2006 on the Governance of Aceh. In 2012, the Province of Yogyakarta Special Region was also given similar funds due to its special status as a region.

These types of funds serves as an additional IGFT solely for those provinces. Nevertheless, the source, formulation of funds and regulation on how to use it differ across the funds. The provinces of Papua and West Papua receive an additional 2 per cent of total national DAU allocation that must be used to finance the education and health sector. From that additional 2 per cent, 70 per cent goes to the Province of Papua, and the rest is for West Papua. Both provinces also get an allocation of Additional Infrastructure Funds. Moreover, both provinces have the additional privilege of receiving 70 per cent DBH from oil and gas exploitation, while normal provinces receive only 15 per cent for oil and 30 per cent for gas.

The Province of Aceh also receives 2 per cent of the total national DAU allocation only from the first year of allocation until the fifteenth year, and 1 per cent from the sixteenth to twentieth years of allocation. However, gets the same portion of DBH from oil and gas. Aceh's special autonomy requires the province to use the funds only for financing development and infrastructure maintenance, empowering people's economy, alleviating poverty and financing education, social and health sectors.

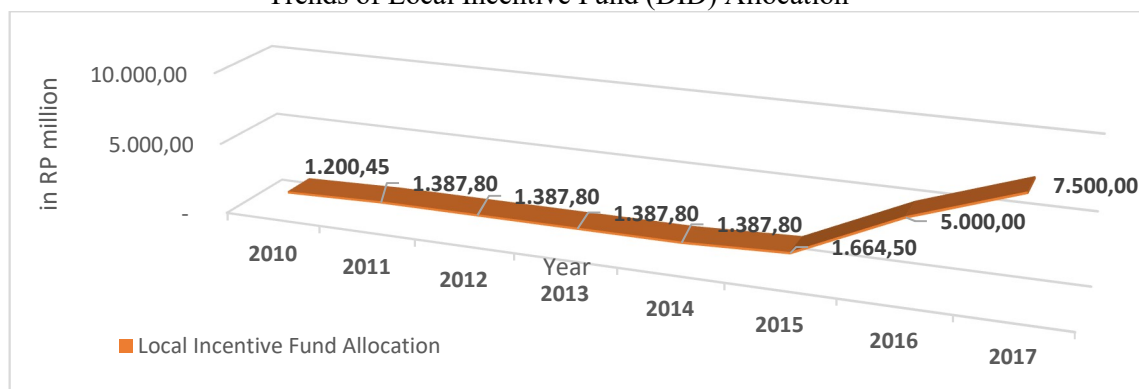
Law No. 13/2012 does not have any specific formulation for allocating the Special Autonomy Fund for the Province of Yogyakarta Special Region. Every year its allocation is subject to discussion between the central government and national parliament (DPR).

D. Local Incentive Fund (DID)

This type of IGFT was introduced in 2010 to stimulate sub-national governments' performance by giving financial rewards. The total amount provided in the state budget from 2010 to 2015 ranged between IDR 1.2 trillion and IDR 1.6 trillion. In 2016 and 2017, it was increased significantly to IDR 5 trillion and IDR 7.5 trillion respectively (see Figure 4.3). However, despite the increase in allocation, the average amount does

not differ too much because the number of sub-national governments receiving the incentive also increased significantly. In 2010, when it was first introduced, 54 sub-national governments received the incentive; in 2017 the incentive was given to 317 sub-national governments. The amounts allocated in 2010 ranged from IDR 19 billion to IDR 38 billion, with the range becoming even wider in 2017, from IDR 5 billion to IDR 65.3 billion. This represents an increase in the highest amount a sub-national government can get but also a significant decrease in the lowest amount.

Figure 4.3
Trends of Local Incentive Fund (DID) Allocation



Source: processed from the National Budget Allocation laws provided in the Ministry of Finance website

In the beginning, the formulation of DID consisted of primary performance criteria, financial performance criteria, education performance criteria, and economic and welfare performance criteria. The primary performance indicators were the audit completion of the sub-national government's financial statement and the establishment of the sub-national government's coming year budget within the required time frame. The primary performance indicator became the entry point for a sub-national government to be shortlisted in the next step of the calculation.

Shortlisted sub-national governments were then further assessed and ranked against a set of financial, education, economic and welfare indicators. The indicators were weighted 50 per cent for financial performance, 25 per cent for education, and 25 per cent for economic and welfare. Detailed indicators for each performance criterion can be seen in Table 4.2.

In 2016, not only was the total amount increased significantly but the allocation formula was also changed. The central government introduced the minimum allocation (AM) and Performance Allocation (AK) method in allocating DID. Sub-national governments are now assessed and ranked using a new set of performance indicators. The new assessment resulted in some sub-national governments receiving only AM or AK, but some can get both.

Table 4.2
Performance Indicators Used in Allocating Local Incentive Fund (DID) 2010–2014

No.	Indicator	Weight
Financial Performance		50%
1	Audit opinion on Sub-national government Financial Statement	35%
2	Establishment of coming year's local budget within the required time frame	35%
3	Increase in local own- source revenue	15%
4	Establishment of Sub-national government Financial Statement within the required time frame	15%
Education Performance		25%
1	Level of school participation	50%
2	Human Development Index (HDI) shortfall reduction	50%
Economic and Welfare Performance		25%
1	Economic growth	35%
2	Reduced level of poverty	30%
3	Reduced level of unemployment	20%
4	Fiscal capacity cluster	15%

Source: DG of Fiscal Balance, MoF

Table 4.3
Indicators Used in Calculating Performance Allocation of Local Incentive Fund (DID)
2015–2017

No.	Indicator	Weight/Score
Fiscal Health and Financial Management Performance		50%
1	Actual local own-source revenue compared to actual total local revenue	1 – 4
2	Actual local revenue compared to budgeted local revenue	1 – 4
3	(Actual total revenue + actual financing revenue) compared to (actual total expenditure + actual total financing expenditure)	1 – 4
4	Growth on actual local tax and charge revenue compared to actual total local revenue	1 – 4
5	Actual local tax and charge revenue compared to actual regional GDP from non-oil and gas sector	1 – 4
6	Actual capital expenditure compared to actual total expenditure	1 – 4
7	Actual employee expenditure compared to actual total expenditure	1 – 4
8	Actual total expenditure compared to budgeted total expenditure	1 – 4

No.	Indicator	Weight/Score
9	Actual fiscal space compared to actual total revenue	1 – 4
10	Local budget deficit compared to total local budget revenue	1 – 4
11	Actual previous year's budget surplus compared to actual total expenditure	1 – 4
Public Basic Service Delivery Performance		25%
1	Education sector performance (Primary and Junior High School Participation Index and literacy ratio)	1 – 4
2	Health sector performance (vaccinated toddler ratio and medical assistance during birth ratio)	1 – 4
3	Public works performance (houses with proper access to clean water ratio and houses with good sanitation)	1 – 4
Economic and Welfare Performance		25%
1	Economic growth	1 – 4
2	Reduced number of poverty	1 – 4
3	Reduced number of unemployment	1 – 4
4	Inflation management	1 – 4

Source: DG of Fiscal Balance, MoF

Table 4.4
Clusters in Allocating Performance Allocation (AK) of Local Incentive Fund (DID)
2015–2017

Category	Score Interval
AA+	94 – 100
AA	88 – 94
AA-	81 – 88
BB+	75 – 81
BB	69 – 75
BB-	63 – 69
CC+	56 – 63
CC	50 – 56
CC-	44 – 50
DD+	38 – 44
DD	31 – 38
DD-	25 – 31

Source: DG of Fiscal Balance, MoF

Minimum Allocation is given if a sub-national government manages to get an unqualified audit assessment and establish a sub-national government budget within the required timeframe. Furthermore, sub-national governments that receive AM will compete with other sub-national governments, which have at least a qualified audit evaluation, to receive the AK. They are assessed based on the indicators presented in Table 4.3. Those sub-national governments will then be ranked into several clusters (see Table 4.4). The central government decides which cluster is used as the minimum

passing grade. Sub-national governments within or above that passing grade cluster will receive AK. However, the amount given differs depending on which cluster the sub-national government falls into. The higher the cluster, the more significant the amount of AK they will receive.

Since 2018, the central government has significantly revised the assessment method for DID. First, it simplified indicators used in each existing category. Second, it added more categories to the assessment. The main addition comes from integrating some line ministries awards (see Table 4.5). So, in the 2018 assessment, there are 10 categories that are classified based on inputs, process, outputs and outcomes. Each category has its own set of indicators. Third, the central government allocated fiscal incentives for each of these 10 categories, unlike the previous DID which only gave fiscal incentives based on the rank of the total score from all categories. Fourth, there is no longer a minimum allocation of incentives given to sub-national governments who obtained an unqualified audit assessment and established their local budget regulation on time. These two indicators are still used, but only for eligibility to enter the competition for fiscal incentives based on those 10 categories.

Table 4.5
Categories and Its Indicators for the Local Incentive Fund (DID) 2018

No.	Indicator
Fiscal Health and Financial Management Performance	
1	Actual local tax and charge revenue compared to actual regional GDP from non-oil and gas sector
2	Actual capital expenditure compared to actual total expenditure
3	Actual total expenditure compared to budgeted total expenditure
4	Actual non-earmarked revenue compared to actual total revenue
5	Actual budget surplus compared to actual total expenditure
Public Basic Service Delivery: Education Sector	
1	Average time of schooling for age 15–25
2	Junior High School Participation Index
3	Schooling Life’s Expectancy
Public Basic Service Delivery: Health Sector	
1	Percentage of children under two years old in stunting condition
2	Percentage of children five years old who have been fully vaccinated
3	Percentage of birth assisted by a medical worker
Public Basic Service Delivery: Infrastructure Sector	
1	Percentage of households with clean water access
2	Percentage of households with proper sanitation
3	Percentage of excellent quality level roads
Citizen’s Welfare	
1	Poverty rate

No.	Indicator
2	Human Development Index
	Ease of Investment
	Based on the PTSP Award given by the Capital Investment Coordinator Agency
	Sub-national government's Governance Practice
	The Ministry of Home Affairs' evaluation report (EKPPD) based on Sub-national governments' Self-Assessment Report (LPPD)
	Local Development Planning
	'Pangripta Nusantara' Award for Best Planner, Best Progressive Planner, and Best Innovative Planner from The National Planning Agency
	Public Service Innovation
	Award based on the assessment from the Ministry of Administrative and Bureaucratic Reform
	Government Institution Performance Accountability System (SAKIP) Report
1	A Self-Assessment Report on government institution's performance planning, measuring, reporting, internal evaluation and achievement
2	The Ministry of Administrative and Bureaucratic Reform gives the score and rank based on the SAKIP report submitted

E. Village Fund

The Village Fund is the most recent type of IGFT and was implemented as a consequence of the promulgation of Law No. 6/2014 on Villages. The law mandated that all villages be given an amount to support village development and the people's economic empowerment. Institutionally, the village is regarded as a subordinate of regencies, and naturally becomes one of the objects of regencies' budget expenditure programmes. Creation of the Village Fund is meant to re-position the villages as a subject of development that can exercise discretion in planning their expenditure based on each village's unique needs and characteristics.

The amount allocated has been increasing since its first implementation in 2015. The central government allocated IDR 20.76 trillion, IDR 46.9 trillion and IDR 60 trillion for 2015, 2016 and 2017 annual state budgets respectively. From the total Village Fund allocated in the annual state budget, 90 per cent is allocated equally to all villages. The remaining funds are allocated based on a formula that considers population, poverty number, total area and the level of geographical difficulty in reaching the village. Although it has not yet been achieved, the current President of the Republic of Indonesia intends to allocate the country's 74,954 villages with at least IDR 1.4 billion per village.

The implementation of village funding is currently facing significant challenges in creating control and evaluation mechanisms for utilisation of the funds. The number of villages is enormous in the context of monitoring, even if each local government was assigned to do it. According to the Indonesian Corruption Watch, there have been 110 corruption cases involving 139 people regarding the utilisation of Village Funds from 2016 to 10 August 2017. Moreover, the Financial and Development Monitoring Agency (BPKP) has reported deficiencies on the use of the Village Fund that indicate the central government needs to provide better monitoring and assistance for the village community.

4.3.2 Revenue Assignment

Before the reform era that created the ‘big bang’ decentralisation, the central government acknowledged very few taxes and charges as sub-national government revenue. Law No. 5/1974 provided an open list of 39 local taxes and 150 local charges as own-source revenue for sub-national governments. Then Law No. 18/1997 revised the regulation and made a closed list of nine local taxes and 30 kinds of local charges.

When the reform era came, the central government passed Law No. 34/2000 and regulated an open list of local taxes and charges. It contains 11 kinds of local taxes and 30 types of local charges. Moreover, this new law gave permission for sub-national governments to impose other local taxes and charges that were not explicitly included in the law. The open-list approach eventually led to sub-national governments creating new local taxes and charges that were inconsistent with official criteria and had undesirable economic effects (Smoke & Sugana, 2012).

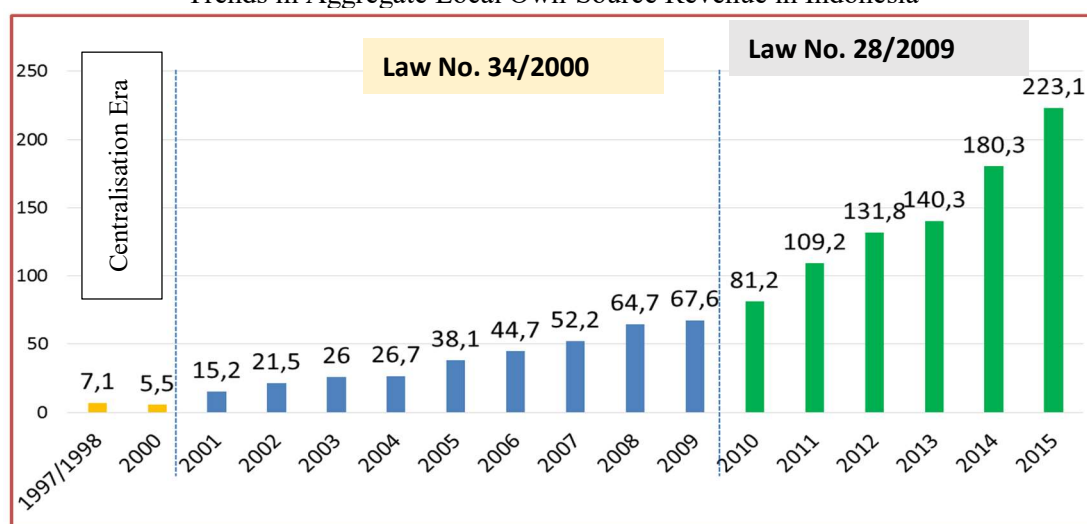
Nine years later, a new law on local taxes and charges was established to replace Law No. 34/2000. Law No. 28/2009 set up a closed list of 16 local taxes and 32 local charges. The most notable feature is a regulation that assigns tax on land and building for rural and urban sectors (PBB-P2), ownership transfer fees (BPHTB) and taxes on cigarettes as local taxes. It is believed these taxes, especially PBB-P2, will increase municipalities’ and regencies’ own-source revenue.

Over time the amount of local own-source revenue has significantly increased in aggregate. Before Law No. 34/2000, total local own-source revenue collected by all sub-national governments was only between IDR 5.5 trillion and IDR 7.1 trillion. This

increased threefold to IDR 15.2 trillion at the beginning of the implementation of Law No. 34/2000 and reached IDR 67.6 trillion in 2009, just before the revisions under Law No. 28/2009.

There were some transition years for municipalities and regencies, especially regarding their readiness to collect PBB-P2, before Law No. 28/2009 could be fully implemented. The revision started to show a significant increase in 2012, when the aggregate of local own-source revenue reached IDR 131.8 trillion. The number was even higher in 2015, at IDR 223.1 trillion nationally. Full trends can be seen in Figure 4.4.

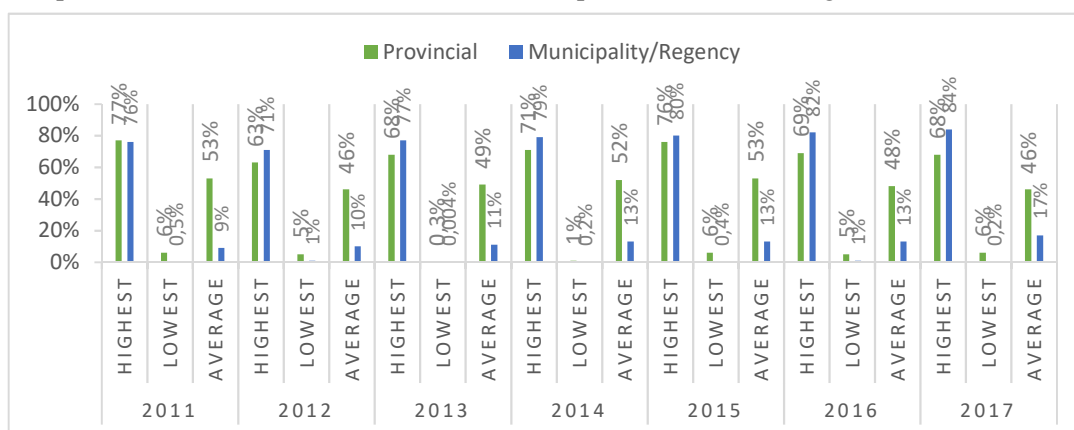
Figure 4.4
Trends in Aggregate Local Own-Source Revenue in Indonesia



Source: the Director General of Fiscal Balance, MoF presentation slide

To illustrate the inequality of local own-source revenue capacity, using 2014 data the average proportion of local own-source revenue compared to total sub-national government revenue was 13 per cent for municipalities and regencies, and 52 per cent for provinces. Even though the aggregate looks promising for sub-national governments to reduce their dependency on central government transfers, the ratio details are not yet satisfactory, with local own-source revenue in municipalities and regencies ranging between 0.2 per cent and 79 per cent of their total revenue, and between 1 per cent and 77 per cent of total revenue for provinces.

Figure 4.5
Proportion of Local Own-Source Revenue Compare to Sub-national government Revenue



Source: processed from the Ministry of Finance database

The central government aims to improve the fiscal capacity of sub-national governments by increasing their ability to collect local taxes and charges. Therefore, this becomes one of the indicators of performance for the assessment of Local Incentive Funds. In this way, the central government hopes that sub-national governments become less dependent on transfers. However, a conflicting view arises where the central government does not intend to make own-source dominant over central transfers (Ministry of Finance, 2010). Thus, it should be asked how to make a sub-national government that does not have significant own-source revenue less dependent on central transfers.

4.4 Chapter Conclusion

Indonesia's historical background under colonialism influenced its people's perspective on the need for a unitary form of nationhood. Federalism, as well as being seen as a colonial legacy, was considered unsuitable as it might threaten the unity of the country. Therefore, despite local political practice after the fall of Soeharto regime, and the asymmetric approach illustrated by the existence of special autonomy regions, Indonesia maintains its standing as a unitary country.

The major shift from 54 years of centralisation to an administratively, fiscally and democratically decentralised country has brought many challenges for Indonesia in ensuring good outcomes for its citizens. Policy-makers keep learning from the policy literature and keep revising regulations as a result of policy practice evaluation. The institutional and task arrangements have gone through three legal framework changes

over 18 years of decentralisation with the objective of establishing the optimal assignment of tasks between central and sub-national government.

Law No. 22/1999 and Government Regulation No. 25/2000 were the first legal bases of the reform era framework for intergovernmental relations in practising decentralisation. Except for foreign affairs, fiscal and monetary policy, security and defence, justice, and religious affairs, which remained exclusively central government functions, the decentralisation approach promoted in the first policy involved limiting central and provincial government functions and broadening municipalities' and regencies' authority. The law made fundamental changes to the structure of government entities, explicitly stating that there was no hierarchical relation between provincial and municipalities or regencies. Moreover, it assigned tasks to municipalities and regencies directly, bypassing provincial governments.

Law No. 32/2004 removed the article from the former law concerning the absence of any hierarchical distinction between provinces and municipalities or regencies, but it acknowledged provinces and municipalities or regencies as autonomous sub-national governments with equal relationships, meaning there was no actual change to the relations between provinces and municipalities or regencies. However, the approach of having concurrent functions, combined with the status of provinces as an administrative extension of the central government in the regions, implicitly gave power to the provincial government level to make policies on similar sectors with municipalities or regencies that related to inter-jurisdictional issues.

Ten years later, Law No. 23/2014 was promulgated, replacing Law No. 32/2004. The new law indicated from the central government intent to strengthen the provincial government's role as an essential hub connecting central government expectations with the local governments' achievements. The most notable addition under this law is Article 2, which states that the Unitary State of the Republic of Indonesia consists of provinces and provinces consist of municipalities and regencies, which implicitly meant to re-establish hierarchical tiers of government.

Meanwhile, fiscal relations policy has produced two laws on fiscal balance between central and regional governments and two laws regarding local taxes and charges. These have been accompanied by a new law on villages, special autonomy laws, and

the annual state budget law, which becomes a tool for accommodating new initiatives and affirmative policies through IGFTs that are not regulated under any other laws.

However, the current practice of Indonesian fiscal decentralisation has changed greatly from the stipulations in Law No. 33/2004, even though it still provides the formal legal framework of Indonesian IGFRs (since no new law has been promulgated to replace it). The allocation of DAK using a proposal-based system, the types of DAK, the elimination of the obligation for the sub-national governments to provide 10 per cent matching funds from the DAK funds allocated to them, and the introduction of Local Incentive Fund (DID) for high-performing sub-national governments, are examples of current policies that are not found in Law No. 33/2004. These new policies showed the eagerness of the central government to ensure that sub-national governments can produce good decentralisation outcomes for their people. Laws about revenue assignments to sub-national governments have not had a satisfactory impact because, despite significantly growing in aggregate, as of 2014 local own-source revenue in municipalities and regencies only contributed between 0.2 per cent and 79 per cent of their total revenue, while for provinces the figure was between 1 per cent and 77 per cent.

Changes in the relevant laws are driven by two different line ministries. The laws on sub-national government – which include the classification of authorities and allocation of responsibilities between central, provincial and municipality/regency levels – came from the Ministry of Home Affairs. Meanwhile, the Ministry of Finance handled the laws concerning fiscal decentralisation policy. There are lengthy processes of public hearings and legislative debates involved in developing such laws. However, the specific issues we are discussing in this thesis are not concerned with the laws *per se*. This thesis seeks to assess the challenges of, and draw insights from, the actual delivery of fiscal decentralisation policy. This includes policies embedded in Ministerial regulations. The research also addresses changes in the delivery of Indonesian IGFT policies, changes that are then legitimated through the National Annual Budget Law because the Ministry of Finance could not authorise them under the specific law on intergovernmental fiscal relations. The researcher understands that these new initiatives will become the substance of the new law on intergovernmental

fiscal relations. Therefore, the researcher believes that the findings extracted from the fieldwork will contribute significantly to shaping the policy approach of the draft law.

The literature on decentralisation and country comparisons suggests different views on how to design intergovernmental fiscal relations and formulate intergovernmental fiscal transfers that can encourage sub-national government performance in meeting decentralisation objectives. Similarly, decentralisation practice in Indonesia suggests several new insights through its efforts to ensure sub-national government performance, which focus not only on overall fiscal relational design and transfer allocation formulas but also on details on the IGFT transfer's mechanism, which is revised each year. Moreover, it also offers a form of performance-based fiscal incentive to stimulate sub-national governments. Therefore, it will be interesting to examine whether these changes to the structural arrangements, task assignments and the IGFT mechanism create positive impacts and drive sub-national governments to perform better. It will also be interesting to assess whether the introduction of performance-based fiscal incentives does eventually encourage sub-national government performance and become the grounds for setting their performance targets. At the same time, question should be asked regarding the policy of introducing performance-based incentives among sub-national governments with less discretion due to the current policy of increasing tied grants and, to some extent, earmarking some parts of the block grants.

5

RESEARCH METHODOLOGY

5.1 Introduction

The implementation theory, briefly mentioned in Chapter 2, argues that previous views of the potential pitfalls of policy at the implementation stage were incorrect. The work of Mayntz (1979) and Pressman and Wildavsky (1973) provided the basis for Howlett (2019) to argue that the ‘back-end’ activities of policy-making are also influential, rather than analysing only the ‘front-end’. Therefore, Howlett believed the success and failure of a policy would depend on the behaviour of the executive agency implementing the policy.

Furthermore, principal–agent theory (PAT) raises a red flag where implementation focuses only on controlling the behaviour of ‘the agent’. The core assumptions of PAT evolved into a more complex view, especially when it comes to the area of public bureaucracy. Miller (2005) cites articles by Weingast and Moran (1983) and Weingast (1984), along with several world political crises, as illustrating such situational complexities. These complexities, in turn, suggest new assumptions in the relationship between ‘the principal’ and ‘the agent’. First, bilateral bargaining is more desirable than ultimatum bargaining because it tends to encourage cooperation rather than the principal’s domination of the agent. Secondly, ‘the principal’ may also have the potential for moral hazard due to having self-interest. Therefore, ‘the agent’ needs to keep their credibility by not always acting to meet the principal’s preferences.

The practice of fiscal decentralisation involves central government designing and regulating the policy, and sub-national governments executing their responsibilities according to the central government’s policy framework. The Indonesian example showed how dominant the central government’s role was in formulating and imposing fiscal decentralisation policy that obviously affected sub-national governments. The argument for such dominance is that those rules of the game are essential for central government to ensure sub-national governments are performing the desired behaviour.

However, we have to realise that the central government formulated the policy according to its self-interested point of view. At this point, the proposed new assumptions regarding the principal–agent relationship need to be put into perspective in determining the design and methodology of the current research. The aim is to choose a research design that can identify both central government and sub-national government perspectives on the optimal policy approach to generate good outcomes for the public. The researcher believes that the drawing on practical experience from each level of government will provide valuable insights and resources for Indonesian fiscal decentralisation policy- and decision-making.

This research focuses on the role and impact of Indonesian fiscal decentralisation policy and regulation in ensuring good outcomes from sub-national governments. Since 1999, several new and revised laws and central government regulation have provided the legal basis for fiscal decentralisation practice. The policy has been quite dynamic, especially over the last nine years, due to the central government’s eagerness to ensure all moneys transferred to sub-national governments were being used appropriately to generate good outcomes for the local citizens. These policy revisions have brought significant changes in how the sub-national governments operate. Therefore, it will be crucial to seek the views of all stakeholders to present a better understanding of how the policy and its impact on practice was experienced by sub-national governments.

5.2 Qualitative Nature of the Study

The research seeks to explore in greater depth the findings from the primary and secondary data. Therefore, the research favours a qualitative approach because of its capability to explore and understand meanings and interpretations from the experience of the stakeholders (Ritchie et al., 2014).

Liamputtong (2013) mentions at least three reasons for conducting qualitative research in social sciences. First, qualitative research will be beneficial for researchers to develop theories that capture the complexity of the problem under investigation. The exploration of real-life practice may address gaps identified in the literature regarding the approaches suggested in the second generation theory of fiscal federalism.

Secondly, qualitative research is chosen because the researcher needs to have a better understanding of the context of the issue under investigation. The concept of performance-based fiscal incentives, or the limiting-flexibility approach, are viewed as crucial to controlling sub-national governments' performance, but we need to understand better how it should be implemented. Moreover, we need to determine whether or not the implementation of both approaches truly has met its general objective.

Third, qualitative research is conducted to explore silenced voices regarding the issue under investigation. The central government sets Indonesia's fiscal decentralisation policies. The researcher believes that it is important to explore the perspectives and lived experiences of sub-national government officials regarding the topic under investigation. Meeting and interviewing people can give the researcher a more detailed perspective that may not be present in the literature (Creswell, 2012). It will allow the interview participants to express in detail their views on the topic being researched. This is important for the research as the aim is to expand the existing knowledge of the second generation theory of fiscal federalism.

This project will use a case study approach to develop the research results. Creswell (2012) defines the case study approach as a method to explore a case or multiple cases with detailed and in-depth data collection from various sources over a period of time. The PAT perspective may also be relevant as a base in determining the methodology and data collection used in this research. To address the research questions, this research canvasses the opinions and experiences of Indonesian central and sub-national government officials collected via interviews.

5.3 Data-Gathering Techniques

In a qualitative case study research, it is quite common to use interviews as the data collection method (Yin, 2014). These may be structured, semi-structured or unstructured. This research has chosen to use semi-structured interviews because the other two types are not suited to this research due to its nature and for practical reasons. The structured interview provides closed questions that can be quantified to test a hypothesis, and are therefore more suited to quantitative research (Saunders, 2000). While the unstructured interview suits a qualitative approach, it is more beneficial for

observational fieldwork, which would require a longer time for collecting the data (Berg, 2012).

The semi-structured interview can explore the views of government officials and their experience in practising fiscal decentralisation in Indonesia. The ability to set themes and to be flexible concerning the narrative and the sequence of questions is very useful in achieving the research objectives. There were two sets of questions used because of the different perspectives being explored – that of the central government officials who make the policies and that of the sub-national government officials who are affected by the policies.

The researcher set three interview themes: intergovernmental structural relations, intergovernmental fiscal transfer policy, and performance-based fiscal incentives practice. Central government officials were asked the following key interview questions.

1. What are the central government's views on Indonesian intergovernmental fiscal relations?
2. What has been the central government's strategy to ensure the intergovernmental transfers for sub-national governments can bring good outcomes on local citizens?
3. What are the central government's arguments in introducing performance-based fiscal incentives and its expected outcomes from the sub-national governments?
4. What are the central government's views on the relation between tiers of governments in Indonesia and its tasks arrangements?

Meanwhile, key questions for the sub-national government officials addressed the following.

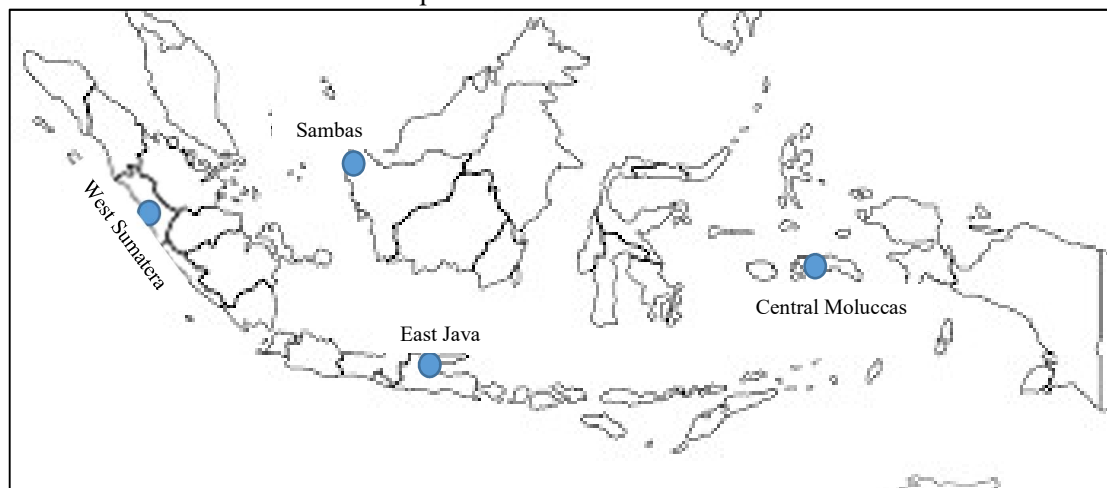
1. The sub-national government's views on Indonesian intergovernmental fiscal relations.
2. The sub-national government's views and experiences in complying with the intergovernmental transfers' regulations.
3. The sub-national government's views about performance-based fiscal incentives and its experiences on the impacts of the scheme on its behaviour in achieving certain desirable performances.

4. The sub-national government's views and experiences on the relation between tiers of governments in Indonesia and its tasks arrangements.

Eleven central government officials were interviewed, comprising two echelon II, eight echelon III and one echelon IV official from the Directorate General of Fiscal Balance in the Ministry of Finance. Meanwhile, 24 sub-national government officials from four selected sub-national governments at the provincial and municipality or regency level were interviewed.

Regional selection took into account different fiscal and geographic characteristics and aimed to capture the western, middle and eastern regions of Indonesia. Interviewees from the four sub-national governments represented two provinces and two regencies. The four sub-national governments are located on different major islands from the west to the east of Indonesian territory. The two provinces selected were the first and second rank of overall best-performing provinces according to the central government's assessment in 2017. The first is East Java Province, which has a high fiscal capacity. It is located in the most populated island in Indonesia, the island of Java. The other province is West Sumatera; it has only a medium fiscal capacity and is located on the island of Sumatera, in the west of Indonesia. The two regencies selected both have low fiscal capacity, but they have different spatial characteristics. The Sambas Regency consists of a significant area of land that also serves as the territorial border between Indonesia and Malaysia, which is located on the island of Kalimantan. The other, the Central Moluccas Regency, is an archipelagic regency located in the Moluccas archipelago in the east of Indonesia.

Figure 5.1
Maps of Fieldwork Locations



5.4 Data Collection

The semi-structured interviews at the Directorate General of Fiscal Balance, Ministry of Finance, began by identifying government officials who headed specific units that directly determine the central government's fiscal decentralisation policy. The interviewees selected were the Director of Fund Balance and its head of divisions, which include the Division of General Allocation Funds (DAU), Division of Physical Specific Allocation Fund I and II (DAK Fisik I and II), Division of Tax and Natural Resources Shared Revenue, and Division of Fund Balance's Policy Formulation. Other interviewees came from different directorates and included the Director of Financing and Non-Fund Balance Transfers, and the heads of the Division of Emergency Fund Grant and Sub-national governments Fiscal Incentives Fund, the Division of Local Own-Source Revenue Improvements, and the Division of Local Own-Source Revenue Policy Formulation.

At the sub-national government level, the focus was on interviewing officials from the Local Revenue and Fiscal Management Department, the Local Development Planning Agency, the Local Public Infrastructure Department and the Local Health Department. Contact persons from selected sub-national governments were listed by the Directorate General of Fiscal Balance and this list was obtained with the permission from that institution. Then, each selected sub-national government was sent a letter through those contact persons. The letter explained the research topic and its objectives, and requested permission to conduct several interviews with the previously mentioned

local departments and agencies. At the time indicated in the letter, the researcher met with the contact person and was given direction on the interviewee candidates and where to meet them. All interviews were conducted using the interviewees' first language, the Indonesian language.

5.5 Data Analysis

The semi-structured interviews were recorded in the form of audio files. Therefore, the analysis is based on the languages, words and tone of the interviewees. The research did not include gestures or expressions as a variable of interpretation.

All the interview recordings were transcribed by a professional transcriber. The researcher then undertook a review of the whole results and made several edits to address unclear words and acronyms. The transcription documents are written according to the language used in the interviews, Indonesian.

The researcher then classified every answer from each interviewee into the three previously established themes, intergovernmental structural relations, intergovernmental fiscal transfer policy and performance-based fiscal incentives practice. Every answer was viewed on the same question from all interviewees to put all their experiences and perspectives into the findings.

5.6 Limitations

The semi-structured interviews sought to discuss the interviewee's experiences in implementing Indonesian fiscal decentralisation policy from the year 2001, when the first law regarding intergovernmental fiscal relations commenced, to the recent (at the time of the interviews in 2018) policy approach. During that time, the Indonesian fiscal decentralisation policy was extremely dynamic in terms of revising its technical regulation every year. Therefore, the analysis given in the thesis is limited to the policy up to the year 2018. Meanwhile, the secondary data used and analysed in the thesis are extend only to the year 2017.

Furthermore, the tied grants regulations and mechanisms that became the object of this research are limited to *DAK Fisik* and *DAK Non Fisik*. The thesis does not cover the

Special Autonomy Fund and Village Fund, which are also classified as tied grants. The thesis mentioned them in Chapter 4 only to provide a comprehensive background to Indonesia's fiscal decentralisation policy and the types of IGFTs. The Special Autonomy Fund and Village Fund are recommended as subjects for separate research.

5.7 Ethical Issues

The data collection through semi-structured interviews was conducted after approval was obtained from the Curtin University Human Research Ethics Committee. The instruments used in gathering the data fully complied with the National Statement on Ethical Conduct in Human Research. The formal letters were sent to the designated central and sub-national government institutions after the researcher obtained ethics approval.

The interviews were conducted voluntarily. Each interview candidate from central and sub-national governments was shown the Participant's Information Sheet and Consent Form. The interviews were conducted after they gave the required consent to the researcher and signed the consent form.

6

ASSESSING THE POLICY: PERFORMANCE-BASED FISCAL INCENTIVES IN INDONESIA

6.1 Chapter Preview

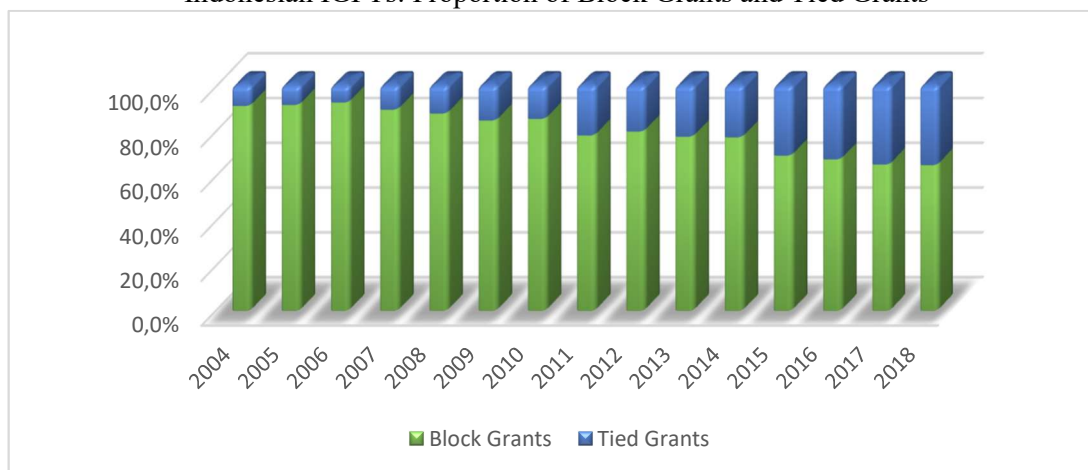
As discussed in Chapter 2, the main objective explored by the second generation theory is how to improve outcomes from sub-national governments. There are two methods suggested in the theory. The first is encouraging the use of performance-based fiscal incentives to stimulate better outcomes from sub-national governments. The second is practising limiting-flexibility and heavily control sub-national government's spending through the use of tied grants. This chapter will focus on the former, while the latter will be discussed in the following chapter.

It is understandable that governments implement performance-based fiscal incentives to motivate sub-national governments to exercise their fiscal autonomy wisely. In other words, they are encouraged to improve their spending quality to achieve better outcomes for their local people. The fiscal incentives are then given as a reward for success in producing good outcomes. This was the intention when the Indonesian central government introduced performance-based fiscal incentives in the form of the Local Incentives Fund (DID) in 2010. Despite almost two decades of fiscal decentralisation, the performance-based fiscal incentive has only been introduced in the last ten years. The concept is still evolving to find the most appropriate system. Six years after its introduction, in addition to significantly increasing the amount of allocation, the central government transformed the assessment's indicators and added several line ministries' awards as new categories in obtaining the DID fund.

However, the data show that the trend in block grants allocation has been declining since 2007. The highest decline occurred in 2011 and 2015, with a decrease of 7.4 per cent and 8.2 per cent respectively (see Figure 6.1). The facts show that by the time the central government started to introduce performance-based fiscal incentives, the sub-national governments had less discretion in spending. 'Fiscal autonomy' should mean

that sub-national governments have sufficient budget discretion to manage and decide their programs and priorities based on their needs and current situations. So, it would be unusual to implement performance-based fiscal incentives in the context of low-discretion sub-national governments.

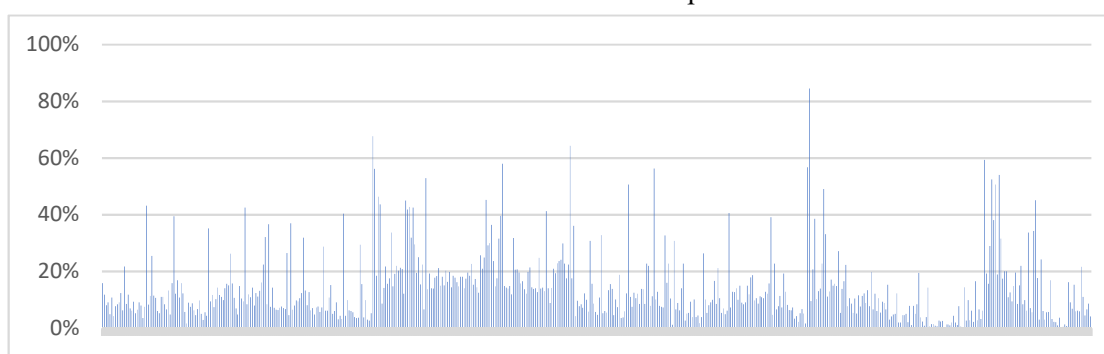
Figure 6.1
Indonesian IGFTs: Proportion of Block Grants and Tied Grants



Source: processed from the DG of Fiscal Balance, MoF database

Individually, there were sub-national governments that did have fiscal autonomy because their local own-source revenue accounted for more than 50 per cent of total revenues, but these were few; only 13 out of 542 sub-national governments in 2017 (Figure 6.2 shows the spread across 542 sub-national governments). The other sub-national governments were placed in a situation in which measures to ensure they create good outcomes and show excellent performance in managing their spending are being enforced, while in practice they decide most of their spending based on the central government's directives.

Figure 6.2
Local Own-Source Revenue Proportion 2017



Source: Ministry of Finance (data from 34 Provinces and 508 Municipalities/Regencies)

Given those facts, the researcher conducted several interviews to assess the implementation of the performance-based fiscal incentives scheme in Indonesia. The interviews were conducted with 11 central government and 24 sub-national government officials. The interviews sought to understand the goals of the central government in implementing performance-based fiscal incentives among mostly fiscally dependent sub-national governments. The researcher also aimed to explore the sub-national governments' knowledge and experiences of the Local Incentive Fund (DID) scheme.

As noted in Chapter 5, the interviewed sub-national government officials came from two provinces and two regencies. The two provinces, East Java and West Sumatera, were respectively the number one and number two achievers for provinces in 2017. East Java has a high fiscal capacity, while West Sumatera has only a medium fiscal capacity. The two regencies represented, Central Moluccas and Sambas, have low fiscal capacity and have never received the award.

This chapter divides the interview findings into several topics: first, the stimulating factors that drove the sub-national governments' eagerness to obtain the DID; second, the continuing challenges of performance-based fiscal incentives policy in Indonesia; third, the impact of DID assessment variables on sub-national government performance targets; and finally, the clustering alternatives that could be used in assessing sub-national governments.

6.2 Stimulating Factors

The introduction of DID would be wasteful if it could not ultimately stimulate sub-national government performance. Since the scheme involves money given as incentives to sub-national governments, we may need to inquire whether the amount is sufficient. The interview findings revealed that the amount of money is still tempting, especially for sub-national governments with low fiscal capacity. However, it was not the central government's intention to focus solely on financial incentives. The central government also wanted to promote the element of prestige, which they believed would provide more stimulation to sub-national governments.

6.2.1 Prestige and Money: Combining Financial Rewards with Achievement Awards

According to CG8,⁴⁵ DID was the central government's response to growing expectations of fiscal decentralisation. CG8 recounted that the early years of fiscal decentralisation focused on how to better allocate funding and make appropriate and accountable transfer mechanisms. Then the expectation increased to encompass outcomes. People started to question whether the money given to sub-national governments has been used wisely and generated good outcomes for the local community. Moreover, CG8 noted the issue of whether fiscal decentralisation policy can ensure the achievement of national objectives such as poverty and inequality reduction. Besides improving the reporting and monitoring system, the central government introduced DID to address these sorts of concerns. It rewarded sub-national governments based on the central government's assessment of selected indicators.

CG8 added that DID is a monitoring and evaluation instrument that provides fiscal incentives. Therefore, the central government has tried to maintain the sufficiency of the amount of incentive in stimulating sub-national governments to achieve optimum performance and a race to the top. CG8 said that the early allocation of fiscal incentives was considered insufficient and ineffective. CG8 mentioned that from 2010 to 2015, the amount ranged only from IDR 1.2 trillion to IDR 1.6 trillion. Then it began to increase significantly, to IDR 5 trillion, IDR 7.5 trillion and IDR 8.5 trillion for 2016, 2017 and 2018 respectively. The main reason for the increase was that the central government wanted to emphasise the role of the fiscal incentive by embedding it as a type of fiscal transfer intended to improve sub-national governments' performance.

Despite the increasing amounts, CG8 admitted that the fiscal incentives seemed insignificant compared to the total of IGFT allocations, which amounted to IDR 766.2 trillion. CG6 revealed that the central government only wanted to use the fiscal incentives reward as a 'lollipop'. CG6 and CG8 said that the central government was more focused on making DID a strategic policy in stimulating performance by giving not only fiscal rewards but also awards. Since 2016, the central government provides

⁴⁵ CG is a code given for central government's interviewees, while LG is for local government interviewees. The numbers following the code, i.e. CG1–CG11 and LG1–LG24 are to differentiate each interviewee.

trophies called the *Dana Rakca* Awards. CG1 explained that it is a ‘grand champion’ award, given directly by the president, for the top three provinces, top five municipalities and top ten regencies, according to who gets the most fiscal incentives from the categories awarded. Meanwhile, those who received a ‘passing grade’ assessment result of ‘BB’ to ‘AA+’ but were not in the top three, top five or top ten, only receive fiscal incentives.

The Local Incentive Fund, even though it is a way to encourage sub-national government to perform well, it is only ‘lollipop’. We design DID as a reward and award. Nevertheless, psychologically, we intend to endorse the award. The reward is just a logical consequence of getting the award. Because psychologically, the award would raise the prestige of sub-national government’s leaders, so they could feel encouraged to perform well. The design of DID is that we try to improve the sub-national government’s performance by giving an award. However, then, it will not be significant if it is only an award. We should also give money incentives. (CG6)

The DID is not only an incentive tool but also an instrument for monitoring and evaluating. Because by rewarding DID, we can eventually know how far do sub-national governments respond to this situation and to improve their performance. So, I reckon this DID not only seen from the fiscal side, but now we want to improve the DID to become a powerful instrument, even though the amount is not much. Not much in terms of comparing it with the total of IGFTs allocation. However, it has a strategic role. Because through this DID, besides the amount, as I explained earlier also given an award, besides the reward also given the award. Sometimes non-money form has more prestige. Now we see that eventually, this DID has become prestigious for sub-national governments. (CG8)

CG5, CG6 and CG8 believed that this strategy could leverage the prestige of DID to stimulate sub-national governments in achieving good outcomes performance. CG8 pointed to the enthusiasm from the sub-national governments who received the award, who publicised it with a big banner in the middle of their regencies or municipalities. However, CG8 brought up the fact that there are many sub-national governments asking why they did not get the incentive and the award and seek the central government’s advice on what should be improved in their performance to achieve the award. CG1 added that sub-national governments who only received fiscal incentives also argued that if they could not get the trophy, then the central government could at least gave them a certificate of honour.

Really great, because the award is tangible. It can raise people’s trust. The people’s trust in general, and also investor that will see this region is thriving. Because from

what I have seen, we thought in the last two years on how to make this DID prestigious. So, we came up with the award. Several are given directly by the president at the National Palace, while the rests are given through the Ministry of Finance. When we went to the regions, we saw big banner written with ‘Congratulations...’, that gave a sense of pride to the people and also trust to the sub-national government, meaning they have good performance. There have been many letters coming in from the regions, and also in a conference forum they asked, and sometimes they invited us too, facilitated us through ‘KOMPAK’ or whatever, they eager to understand what is DID, the point is how can they get it. What do they need to improve at the sub-national government? (CG8)

So, we intend to give the best achievers with an award. It is called ‘*Nagara Dana Rakca*’. Previously, the ‘Dana Rakca’ Award was given to sub-national governments that managed to combine minimum allocation with performance allocation. However, now, ‘Dana Rakca’ Award is given to best achievers, top three provinces, top five municipalities, and top ten regencies. The rests, they only get the money. However, there are complaints from sub-national governments, ‘Sir do not be like this, Sir, give us certificates too or a kind of that’. (CG1)

LG1, LG4, LG8, LG10, LG14 and LG17 confirmed that the main point about the DID is its prestige not only for sub-national governments as an organisation, but especially for the governors, mayors and regents. LG14 said that combining the award with fiscal incentives motivates his sub-national government because they felt appreciated and supported.

DID fund? Interesting because, yeah, I mentioned earlier the sub-national government’s fiscal capacity is declining. If we get that extra fund, it will make our budget stronger. Prestige or the money? I think it depends on the local leader. Here, our governor always pushed us to become number one at everything. (LG17)

The motivation. If we do not get the reward, if the reward is in the form of money, there must be an improvement, but if the reward is only in the form of an award, there should be but not too significant, because sub-national governments think that there has to be strong appreciation to endorse performance. Now, this incentive is part of the measurement, and it is really remarkable, not because of the money, but we felt appreciated and supported for making improvements. Those who are lazy should be abandoned, but those who have achievements are given extras. (LG14)

Both, sir. Number one is the prestige, and number two is the money. With this, the governor as the head of the region called on the regencies and municipalities within his region, how we improve performance related to state fiscal management in achieving the desired output. (LG8)

Moreover, LG4 said that the large or small number of fiscal incentives as a reward is a relative point of view. According to LG1, LG4, LG8, LG10, LG17 and LG18, for limited fiscal capacity regions like theirs, all additional funding from the central government is attractive. LG8 added that it could make municipalities and regencies in his province's jurisdiction envious and stimulate them to work and perform better.

This is very interesting, sir. I mean with the DID all sub-national governments, the province/municipalities/municipalities, within the region of West Sumatera, it creates jealousy among local governments that did not get the DID. This jealousy, how can the province get it, some other municipalities get it, while we did not? It triggers some kind of motivation among local governments. When we visit them, they always asked us for bits of advice on how to get this DID. (LG8)

I think that both are important, but probably the prestige. However, in terms of the amount of money, for sub-national governments with limited fiscal resources felt the fund so much helpful. The Province of West Sumatera for example, we only have IDR 2.4 trillion of own-source revenue. Compare to the others, we are around the middle level. When we got the incentives from DID, we felt really blessed because the extra fund can support our local programme financing. So, yeah, both. Prestige is most certainly, I mean of course there has to be a prestige for the governor, mayors or regents. (LG10)

6.2.2 Local Leader's Commitment

LG8 mentioned that his sub-national government's success was because of the governor's commitment to improve performance. Previously, the governor was not aware of the existence of DID and the *Dana Rakca* Award. However, when he was notified that the Province of West Sumatera had received it, he was then very determined to improve the province's achievement. LG8 reported that the governor even felt the need to keep encouraging municipalities and regencies within his jurisdictions to have excellent fiscal management through bimonthly top executive meetings and by setting performance requirements for local governments to collect shared revenue. Furthermore, LG17 mentioned that his governor is the kind that always demands his staff be number one in every aspect of the central government's assessment.

Meanwhile, LG24 said that the governor of her region used the top executive meeting to evaluate local governments' performance on several indicators, especially the ones that became national priorities. The governor always gave warnings to local

governments that were still underperforming because the governor realised that provincial achievement on indicators also depends on local government outcome achievements.

I mean that, yeah, when we got the DID, Mr Governor gathered all local departments. The sector that is not yet performing got pressure from the governor. Including this DID, we came second best provinces in Indonesia. The governor was surprised that we got so much incentives reward. This became stimulation to achieve better. The governor said, 'We are second best now, why don't we become number one next year?' That is our governor's character, sir. We can be number one, why should we become number two, three or four. (LG8)

Praise the Lord. There are only two regencies here that have not been given unqualified opinion for its financial statement. From 19 regencies and municipalities, around two or three that have not got it, if I am not mistaken. Yes certainly endorsing. We have bimonthly local government's leader meeting sir, always endorsing. So do we at the provincial level. If there are regencies and municipalities' share from the province, automatically if the decree has been established, we do not have to wait for regents to ask. There is also a warning from the governor, if the fiscal management were not improving, we would delay the shared revenue transfers. (LG8)

If we talk about the provincial level, we will not see local governments individually, we will accumulate it, but when we are giving intervention, we still use provincial targets. It means that even though you have reached your local government's target, but at the provincial level, it has not been achieved yet. It must be pursued, so we advocate, the head of the provincial health department advocated the local governments' leaders, it has always been like this. Moreover, the local governments [regencies and municipalities] are willing to fulfil it because the governor will check them. (LG24)

6.2.3 How to Spend The Incentive Money

Another aspect of the attractiveness of the performance-based fiscal incentives policy concerns how and where sub-national governments can spend the money. The central government recently changed the directive on the use of the fiscal incentive. CG8 revealed that, previously, sub-national governments that received the fiscal incentive could only use the money for the education sector. From 2016, however, the central government gave discretion to the receiving sub-national government on the use of DID. The central government encourages sub-national governments to use the fund by prioritising essential public services improvement, but it is not compulsory. In the future, if agreed, CG1 said that the financial reward could be directed to go back to

local departments or agencies that contributed significantly to winning the reward, instead of being used for other sectors.

Until 2015, it [the incentive money] was only around 1.2, 1.6 [IDR trillion] and it can only be spent for the education sector, and it was not effective enough to encourage sub-national government's performance. Then, the central government realise that it can be one of the instrument to encourage the sub-national government's performance. Hence, since 2016, DID became IDR 5 trillion, in 2017 became IDR 7.5 trillion, 2018 IDR 8.5 trillion, which is a huge leap and even the spending requirement is not only for education sector, and it is the sub-national government's discretion to decide, but we only advise to prioritise basic public services provision for the local people. (CG8)

We wanted to direct it. Well, 'directed' is not the exact word, but yeah directed in the means of according to sub-national government's priority. In the future, if agreed, we want some part of DID money goes back to the contributing sector. If they worked hard for example, then from the sector they can get DID money, but then after that, they do not receive any 'feedback', they would become sluggish again, the employees become demotivated. Moreover, in the end, usually, the sub-national governments would use it for public works, infrastructures. Then, colleagues from the education and health sector are wondering why would even we worked hard and being tired like this. There are some concerns like those in the regions. Not all regions but some regions where the employees do not have any extra incentives allowance, which they needed. If they give contribution but get no 'feedback', it could make them uncomfortable. (CG1)

Furthermore, LG4 pointed out that it is essential to regulate the use of fiscal incentives by sub-national governments explicitly and in detail. LG4 did not see the attraction of DID if the applicability is limited and unclear.

I prefer to take a point of view of what can we do with the fund from DID? Because I think how large the amount of fund is entirely relative, but anyway we never got the fund, only God knows when we can get the incentives. I understand that it is the performance that must be achieved. It becomes a prestige also for the sub-national government. (LG4)

6.3 Ongoing Challenges of Practising Performance-Based Assessment

The interviews captured several important challenges arising from the Indonesian experience in practising performance-based fiscal incentives. These pointers would need to be addressed in improving current practice.

6.3.1 Setting the Right Indicators and Raising Assessment Level

CG1 explained that the indicators used for DID assessment are those that are currently national priorities, such as the percentage of children with stunting condition. Additionally, CG1 said that the central government only chooses indicators that are accessible to all sub-national governments, so that they have the same opportunity to compete. Forest management, for example, is not used as an indicator because only seven provinces perform this task. Instead, the central government was planning to treat it as a grant project, applying pay for results or output-based assessment.

Furthermore, CG1 reported that the selection was also concerned with the magnitude of an indicator. CG1 took one of the indicators in the education category, the number of students attending school, as an example. The critical point for the central government to decide is which level of school it wanted to use. The central government decided to assess at the level of junior high school because it had a more significant impact than the other level.

Yes, we put indicators that are currently national priorities. The simplest example is stunting. Stunting has become a national concern that we need to overcome immediately. We put it as one of the indicators, its weighted portion even more significant, 50 per cent, compared to vaccinated toddlers or labour assisted by health workers. Other than that, we also put access to drinkable water. So, the indicators that would give high magnitude for the expected outcomes. Education, for example, we put three that really have high magnitudes. Students participating at junior high school, why junior high school? not from elementary to senior high school? For what? Where is the critical point? At junior high school. The principle of DID is fairness, and all sub-national governments must have equal opportunity to get it. Like forest management that only consisted of seven provinces if I am not mistaken, for only hundreds of villages. So, we cannot accommodate it. (CG1)

Furthermore, CG8 said that the indicators and criteria used in assessing sub-national governments have been revised three times. The most recent version provides the incentive based on sub-national government performance in each category assessed. It is meant to meet two objectives: first, to define what kind of performance the sub-national governments have achieved that led to them receiving the incentives; and, second, to provide options for sub-national governments regarding which category that they wanted to focus on and compete in.

CG1 explained the reasons the central government kept changing the indicators (other than to match them with current national priorities). The first is because the central government wants to raise the challenge level. Previously, sub-national governments that received an unqualified evaluation for their financial report were guaranteed the minimum incentive allocation, which could be increased depending on their performance in other sectors. Currently, due to the number of sub-national governments getting unqualified evaluations, the central government tried to raise the bar by eliminating the minimum allocation incentive for those who already fit the criteria. It will only be used as an eligibility requirement to make the shortlist of sub-national governments that have the right to be assessed and compete to get the highest incentive amount they can.

The second reason is that, based on the central government's evaluation, there are indicators that are not appropriate for use with sub-national government performance. Indicators such as economic growth, the inflation rate and the level of unemployment have been excluded because they are outcomes of the fiscal and monetary function, which is one of the six functions exclusively owned by the central government.

There are sub-national governments that eager or highly motivated to get the DID by making good performances. However, others want to get DID only by giving formality performances. This is what we tried on DID, sharpen the criteria over the years. What we can do to improve this is that in the last few years sub-national governments feel that if they already manage to get unqualified financial audit opinion, they will automatically get DID. Now is no longer like that. We try to improve the criteria. Getting unqualified opinion for three years in a row, for example, then you can get DID. Otherwise you cannot. (CG1)

Yes, one of the reason is that it is beyond the sub-national government's control. How local economic growth was not entirely sub-national government's responsibility. Moreover, if it relates to high capital investment. That is the responsibility of a higher-level institution than sub-national governments. (CG1)

Nevertheless, LG17 thought that synchronising sub-national governments' performance indicators with national priorities sometimes creates problems. First, it can force the sub-national governments to re-set their development plans in the middle of the execution. LG17 cited the example of when the newly elected president issued a new National Middle-Term Development Plan (RPJMN), while the governor had made a Sub-national government Middle-Term Development Plan (RPJMD) a year

earlier and already started to execute the first-year plan. Second, each central government unit tends to endorse new targets and indicators for sub-national governments that were not previously planned. LG22 and LG23 revealed the difficulties of budgeting and executing programs to achieve new performance indicators that were not previously planned and documented in their Strategic Plan. They mentioned that they could not suddenly insert new programs that did not have any attachment or correlation with the Strategic Plan because it can affect their financial statement's audit result.

We had the governor election first. We made RPJMD [Local Medium Term Development Framework]. Then, Mr Jokowi [the president] was elected and made RPJMN [National Medium Term Development Framework]. Like it or not, the provincial government had to adjust with the central government. So, we had to change ours. This change brought consequences as it was costly, time-consuming because we had to discuss it with the local council. Just that. The point was performance indicators. (LG17)

Because, sir, we [provincial] along with regency and municipality government are unlike the ministry that forced us, 'This is important, here from another sector important too', we cannot be like that. For us, the most important thing is that the essential public services have already in line with the RPJMD and consistently executed, how far is the progress, those are the focus. Must be in line with our RKPD [Sub-national government Working Plan], that was it. Must be prioritised. (LG22)

If we see from the planning structure, all the planning schedule from January was already clear, how is the RPJMD, Renja [the working plan], RKPD, all of those already have planned, and that limitation cannot be broke. For us, only working on those planning documents have already made us hectic. Not mentioning the additional program endorsement, SDGs, *Gemas* [People's Healthy Life Movement], Healthy City, Children friendly city, blah blah blah. Moreover, all others [ministries] that want to accentuate its indicators: 'Here, mine is important'. Too many indicators, but do not think how much our fiscal capacity is. (LG23)

Moreover, LG3 said that at the sub-national government level, the inability to understand an indicator led to unwise decisions regarding which division should be held accountable for each of the performance indicators. The Human Development Index (HDI), for example, covers different sector variables. LG3 mentioned that at his sub-national government, the HDI had been set as the local development planning unit's performance indicator, while the elements that make up the HDI are the responsibilities of other divisions according to their specific sectors.

6.3.2 Some New Categories: Similar Reports with Different Formats, Wasted Sub-National Government Time

CG8 explained the reason why there are more categories added into DID assessment. CG8 acknowledged that, previously, not only did the Ministry of Finance give the award for sub-national government achievements, but other line ministries also gave awards using a different focus of assessment. However, the Ministry of Finance is the only one that gave fiscal incentives along with the award. Therefore, in the 2017 assessments, the central government started to include these other awards, each as an additional individual category, and gave fiscal incentives to those who received awards. CG8 claimed that even though not all line ministries' awards are included yet, the categories, indicators and criteria have become more comprehensive than before.

Actually, the basic idea was, at first, we did have thought if each ministry gave awards, while then it did not have any impact fiscally. So, it was, at first, how to make this DID as the umbrella to a few awards that have been given previously. So, we have to be selective and, as a matter of fact, our thoughts were also the ministries' expectation. They said that all these years we had given award without the money, while how come the Ministry of Finance can be so easy in giving the financial reward. Well then, it is 'tit for tat'. We tried to accommodate some awards that we thought appropriate. (CG8)

CG1 and CG8 said there are possibilities for other awards to be included as long as they align with the accessibility and significance principles. However, CG6 said that they would be very selective in adding new awards from line ministries because they wanted to keep the award focus on assessing sub-national governments' fiscal planning and execution, and which of those provide the optimum value for money, outputs and outcomes that benefit the citizens. Other than that, CG6 added, another reason is that they wanted to ensure that the number of fiscal incentive rewards for each category remained attractive. If there are too many awards included as new categories, while the total fiscal incentives allocated do not increase significantly, then the number of incentives for each category will consequently decrease and might reduce the attractiveness of the reward.

Well, we will always evaluate which one is the most... for example, ease of investing would almost probable be changed because the BKPM [Capital Investment Coordinating Agency] gave it once every two years, there is no annual continuity. We will probably look for something better. I received a proposal of sub-national government's competitiveness from KPPOD [Local Autonomy Supervision

Committee]. However, we are questioning the stand of KPPOD, is it the responsible institution in determining that indicator? Then, there are also indicators like forest management, smart city, the environment too, land conversion. Just now, I also received a proposal from PT SMI about including financial management of debt. So, there are many coming in that we have to evaluate whether those indicators are appropriate. Of course, the appropriateness principles, for now, is, first is fairness, second is data sustainability. Do all sub-national governments have the data. Well, at least 80 per cent or 90 per cent sub-national governments have it. That can be considered as fair. If it is only 50 sub-national governments, that is unfair. Such as e-government, we used e-procurement, why, because e-procurement is relatively easy. From 542 sub-national governments, 525 sub-national governments, according to LKPP, used it. While e-planning, from 542 sub-national governments, BAPPENAS could only provide 86. If we used that, there would only 86 sub-national governments that can receive it. Then, e-budgeting is even worse. The Ministry of Home Affairs cannot give data about the list of sub-national governments that use e-budgeting based on the ministry's standard. (CG1)

Madame Minister expects that DID would still, even though the term is 'lollipop', but still have to bring the mission that it must have focus, focus on the enhancement of sub-national government's effort. The effort on what? Thus, we cannot directly decide, 'Here, Ministry of Agriculture, what award do you give?' or any other ministry make what kind of award, then we accommodate them all. If it is like that, then there is no more focus. Whereas our focus is 'Nagara Dana Rakca', means the guardian of state finance. By doing what? Efficient spending, expenditures that give the most values for money, best output, best outcomes, for the sake of the people. That is the genuine concept of state finance. We cannot just accommodate everything in it. If the money stays that much, it will make each category have little amount, making it unworthy. If it is unworthy, people will leave it. Even though the prestige is still there, but if the money is unworthy, it will eventually be left out. (CG6)

Nevertheless, LG1 mentioned three out of five line ministries' awards adopted in the central government's fiscal incentives that overlapped with and contradicted each other. Those are the Sub-national governments' Governance Evaluation Report (LPPD) created by the Ministry of Home Affairs (MoHA), the Sub-national government Planning Assessment (PPD) created by National Development Planning Agency (Bappenas), and the Accountability and Performance Report for Government Institutions (LAKIP) created by the Ministry of State Employee Empowerment and Bureaucracy Reformation (PANRB). LG1 considered the PPD overlapped the LPPD because both assess sub-national government planning, but the LPPD is more comprehensive because it assesses from the planning stage to the execution stage. Meanwhile, the LPPD conflicts with the LAKIP; a sub-national government might

have a high score in LPPD but be given a low score in LAKIP due to different indicators and reporting standards.

The problem is the different performance indicators. It is better only to use one because these performance reports can overlaps each other. For example, a sub-national government got the development planning award while its financial report was only given qualified opinion, or a sub-national government has a high score in LAKIP report while its local performance report [IKD] was low. Based on our experience, we were told by the [PANRB] to change our Strategic Plan due to not complying with the ministry's regulation. If we did not change it, then later the performance score would be low. You can imagine the confusion when our work was judged as incorrect when we breakdown our mid-term development plan using the guidance from the [MoHA], meanwhile we were evaluated by the other ministry using their own set of guidelines. (LG1)

Another issue facing the sub-national governments due to the obligation to submit reports using different standards and guidance is that sub-national governments must put significant effort into complying with the LPPD and LAKIP reporting standards. LG1, LG2 and LG17 admitted that it confused sub-national governments. LG3, LG14 and LG17 said that it is not efficient given their limited human and financial resources. They stated that the whole year they were kept busy preparing reports in order to comply with each of the line ministries' requirements.

We, at the sub-national government, are confused. It is said that our *'biological father'* is the MoHA because they have the tasks and functions to regulate sub-national governments. Nevertheless, in terms of development planning, we must comply with BAPPENAS, then in terms of performance indicators, we must comply with the Ministry of PANRB. Every year we have to make different types of report such as LAKIP, LKPJ and LPPD, which are all similar. It is about the annual fund or budget accountability report. (LG17)

It is a hassle. I mean like this, the truth, in reality, it has been a hassle to us. For example, at the beginning of the year in January to February, the programme compiler [sun-gram] are making LAKIP reports. They were kept busy compiling the material, assessing the performance. At the same time, other departments at the regent's office were also asking us to provide LKPJ report. Later on, our organisational department would also ask us to make LAKIP SKPD [Sub-national government Agency] for them to compile to become sub-national government's LAKIP. There are so many reports to fill in, and who is the object? All the SKPDs would have to provide the data. We often thought that if only those reports can be simplified, we may have more time to do other [productive] activities. Because those reports have similar substances, the budget execution report. However, we do think that the intention of those reports is

good so that it could become tools for evaluation. It is just that too many entities asking for it. (LG3)

I think we have too many reports. Financial report, LAKIP, LPPD, LKPJ, and then evaluation report, then the new Acceleration Team [TEPRA] report. If you see the substance, it is all similar. Each of the entities demanding for the reports is not making synergy, repeated over and over again, and put the burden on us. It is often that we put too much efforts and human resources just to do administrative things. I think the intention is right, to motivate sub-national governments, to create standard of what is considered as good or bad performance, so we will not be assessed using inappropriate indicators. However, on the other side, you could imagine LAKIP, LPPD, TEPRA, financial report, LKPJ, presented to the local council, then presented again to the provincial government. Too energy consuming, just to make this very thick evaluation report for each document. (LG14)

LG4 added that reports such as LPPD and LKIP are considered a formality. LG4 thought that DID indicators other than the line ministries' awards are the ones that can encourage sub-national governments to focus on working and performing better, without the obligation to compile their working result into another form of reports.

If I am to choose, I would prefer the indicators initially set up as the Local Incentive Fund before it was combined with the other line ministry's reports. We just work, and compare the statistical results to its indicators. Unlike now, adding the category with the reports-related assessment. From what I have seen, there was nothing essential in making those reports. We make them just like a routine formality, instead of triggering us to perform better. It is challenging to compile each of those reports, especially gathering the data. However, if we just focus on the previous-initial 22 indicators of Local Incentive Fund, I think it is all complete. (LG4)

6.3.3 Creating Fair Scoring System

Understanding how the central government establishes the scoring system is another ongoing challenge in implementing performance-based fiscal incentives. LG8 described the uncertainty from a sub-national government perspective within his provincial jurisdiction about how the central government calculated scores in the assessment process. The sub-national government was confused because, based on outcomes, they had achieved more than the surrounding sub-national governments yet those sub-national governments could receive higher fiscal incentives.

Yesterday I gave a lecture at the Municipality of Sawahlunto Sir. So, the Sawahlunto government were asking that the variable's criteria are the same, why other sub-national governments received more DID funds than them. They mean, from the variables, from the required measurements, as a matter of fact, they are better than the

other sub-national governments, but the other sub-national governments can receive higher DID funds, how does the central government calculate that? (LG8)

CG1 admitted that, as previously explained, the enthusiasm of sub-national governments in pursuing fiscal incentives was quite high. They visited the central government's office not only to ask advice on how to get the incentives but also to raise questions about outcomes that they thought were unclear and dissatisfying. CG1 ensured that the central government did its best to provide a fair scoring method for assessing local governments. CG1 took the example of the poverty rate indicator, explaining that it would be easier to decrease the poverty rate by 10 per cent in Papua than by 1 per cent in Java. On the other hand, it would be unfair to only take into account the actual percentage of poverty rate because underdeveloped regions would not be able to compete. Therefore, the central government combines two factors: the improvement or incremental percentage, and the poverty percentage rate itself. Other than that, CG1 mentioned that each indicator has a different weighting, with the central government assigning more weight to indicators based on their current importance to the national agenda.

6.4 DID Assessment Variables Had No Influence on Sub-national Government Outcomes Target

Another essential query to this research is the likelihood of sub-national governments referring to DID's variable of indicators. Those categories are sub-national government fiscal management, the level of public services in education, health and infrastructure sectors, and the level of local citizens' prosperity reflected through the poverty level and the Human Development Index.

LG1, LG3, LG4, LG15, LG19 and LG20 said that their sub-national government never viewed the DID award as its primary target. LG1, LG3 and LG4 felt that their sub-national government never received the award or the associated rewards, so they were currently more focused on realising their development plans than on check-listing DID indicator requirements.

Moreover, LG9, LG12, LG19 and LG20 said that their sub-national governments' performance targets are set based on the region's potential, not on the best outcomes for DID purposes. Their primary focus is to achieve their governments' targets regardless of whether they will receive fiscal incentives or not. They believed that the reward would eventually come even if they do not refer specifically to DID indicators.

LG20, LG22 and LG23 said that the sub-national governments' point of reference is always the RPJMD, which is made in line with the RPJMN, and LG20 believed that DID indicators are taken from the RPJMN. However, LG4 thought that he would likely begin to synchronise his sub-national government's performance indicators with DID indicators because LG4 believed those indicators are the core outcomes for sub-national governments to achieve.

For us, we did not put much attention to DID, because we never received it. Secondly, we also never specifically discuss it, such as 'Oh, we need to get that DID'. We were probably more busy with how we can provide the public needs mentioned in the Musrenbang [Development Planning Meeting]. Those kinds of things that have been achieved in our planning documents. Not even in putting it as the target. I think that will eventually follow. When we already manage to provide public needs, and we can increase revenues, then advance the region. I think it will eventually follow. So, getting the DID is not within our agenda. (LG3)

We never thought of getting into that level. Our target would probably be adjusting to the local fiscal capacity. So, for fulfilling roads and everything, we probably want to look at the national standard, 60 per cent excellent, now we are already 50 per cent. So, even though it will be gradual, 2018, 2019, using the funds from DAU, we could fulfil that. (LG15)

So far, we refer to Renstra [strategic planning]. So, what we are doing is based on Renstra. There are no thoughts at all in getting incentives, but I do not know what the top-level executives think. (LG19)

Honestly no. So, we just flow as it is. I mean, yeah, well yesterday the directive from our governor is to optimise performance. It means we try to fulfil every target that becomes the central government's assessment. LKPP, LKPD, we fulfilled all of them. If that become one of the indicators, we feel grateful for it, but that is not our primary target, to get the DID, no. (LG20)

As I told you that the Regency of Sambas has not put those indicators as a reference. Nevertheless, since you mentioned it, I have just attended the Leaders Training Level III, I will make those targets as a reference. Those targets are actually sub-national government's target. No matter how many, if we commit, consistently, those are what we use. Becoming the IKU [Key Performance Indicator]. So actually, if the regents want to re-nominate, those 22 indicators could receive attention. (LG4)

LG17 revealed that the Mayor of Surabaya, who has been acknowledged for her excellent programs and results by the public, thought those types of performance award categories are 'just another central government's project'. She did not care

about those indicators but instead focused on how to help the poor local citizens within her jurisdiction in getting adequate access to health and education.

It depends on the head of sub-national governments [governor, mayors/regents]. Our governor always aims for number one in every category. However, Mrs Risma [Mayor of Surabaya] is different. She always underlined that those awards are '*just another central government's project*', all that matters to her is the local people are prosperous. So it became a paradox when we all know what her programmes are and how she works, but she was only given C score for her LAKIP if I am not mistaken. She said, 'Who cares about the central government's assessment, the most essential is that my people are prosperous'. That is all, period. (LG17)

6.5 Clustering Should Be Based on Capabilities, Not Status

CG8 said that the central government currently only uses clusters based on the status of sub-national governments (provinces, municipalities and regencies) because it is assumed that the status will reflect similar characteristics. CG8 admitted that there is consideration of basing the cluster on the sub-national government's maturity of governance level. However, CG8 mentioned the fear that sub-national governments would be satisfied just by becoming the best of the worst, not the best of the best.

We actually did that kind of thing, clustering, but only based on the administrative level, which is provincial, regents, and municipalities. It is not based on advanced sub-national governments cluster, or underperform sub-national governments at another cluster. We thought about it, but we think that administrative clustering should be sufficient because we believed every province, every regency, and every municipality, generally have similar characteristics within the same administrative level. Even if we made something like first, second, and third division, and each division champions were given awards, we are worried that those sub-national governments would be over satisfy just becoming champions at the third division. (CG8)

However, LG3 thought that the sub-national governments most likely to receive DID at present are those who are already well-advanced in development and fiscal capacity. LG18 added that the central government must first consider whether the sub-national governments already have sufficient funds to meet their fiscal needs, then it can make further demands about performance. LG3 and LG18 believed that fiscally self-sufficient and well-developed regions have more budget discretion to allocate to the human resources capacity-building in the area of fiscal resources management. LG18

thought that the gaps in high-quality human resources would make poor and underdeveloped regions unable to compete for the best performance.

Nevertheless, here is what I thought. I mean the Award is essential, but what are the actual needs in a particular sub-national government? The award is strongly related to performance indicators, which have to be in line with the local fiscal needs. Perhaps we must also consider underdeveloped regions who do not have equal human resources (quantity and quality), so maybe we need to give them a solution too. So, the gaps are not too high between those regions that received the Award and those who did not, especially within the southern area of our province jurisdiction, which is mostly underdeveloped. (LG18)

Higher fiscal capacity means the region has resources to maintain and improve its performance, and more prominent opportunity to retain the Award. Those kinds of regions can improve its human resources capacity in managing a better local fiscal budget, made LAKIP reports that could get AA or BB score. They must have a better chance. So, how about the underdeveloped regions? Each sub-national governments has their burdens and problems, which make it hard for them to gain the DID if those indicators are used. I mean I do not mind DID for sub-national governments that can improve their performance and compete. But, for those who are just starting to develop, maybe the [best] policy is not DID or maybe still using DID but different kind of assessment. (LG3)

It is true, I agree, that if you want to pull off the indicators, look at how much fiscal budget are they managing? Do not treat the Municipality of Sawahlunto equally with the Municipality of Padang, which is the capital municipality for the West Sumatera Province. Clearly, they have a significant difference in the fiscal budget. We should make a range – for example, under IDR 1 trillion and above IDR 1 trillion. So, we can identify whom are they equal to and should compete against. (LG8)

LG6 emphasised that not all sub-national governments have immense natural resources, which affects their fiscal capacity. Meanwhile, LG8 mentioned that sub-national governments do not necessarily have a similar level of fiscal budget, even though they have the same status as municipalities, for example. LG8 continued that we cannot assume the Municipality of Sawahlunto is similar to the Municipality of Padang because the fact is they have a different level of fiscal budget. LG18 said that sub-national governments have different human resources capabilities and believed that the DID assessment should consider making a cluster based on those capacity gaps.

6.6 Chapter Conclusion

Looking at the number of intergovernmental fiscal transfers, the Indonesian central government has shown genuine commitment to fiscal decentralisation. The amounts have kept increasing, from IDR 33.1 trillion in 2000 to IDR 766.3 trillion in 2017. However, one of the issues identified over the first decade of Indonesia's fiscal decentralisation was how to ensure the moneys transferred are spent efficiently and effectively. This concern led the central government to introduce some features to encourage sub-national government performance.

China, one of the countries chosen for comparison in this research, also practised fiscal incentives but not in the form of additional fiscal rewards given after a series of achievement. The Chinese method was to create incentives by sharing tax revenue that will stimulate sub-national governments to undertake market-supportive activities, such as business tax and personal and company income tax. The more local businesses advanced, the greater the impact on the sub-national government's revenues. The Indonesian experience offers different insights to enrich the literature. It was a practical example of capturing insights into the benefits and challenges of implementing performance-based fiscal incentives as described in the theory.

As explained in Chapter 2, variables used for benchmarking, scoring system, reward and punishment, and attractiveness are essential points to address in implementing PBGs. The policy of DID in Indonesia, revealed practice-based details that correlate to those pointers. Furthermore, the case study added a new pointer to address disparities as a consideration to make clusters of sub-national governments based on similarity of capacity.

In 2010, the central government began to implement a performance-based fiscal incentive known as the Local Incentive Fund (DID). The idea was to give financial rewards to sub-national governments that meet specific performance indicators set by the central government. The quantum of fiscal incentives given was not very significant in the first five years of its implementation, only around IDR 1.2 trillion to IDR 1.6 trillion. In 2016, however, in addition increasing the fiscal incentives up to IDR 5 trillion – and then to IDR 8.5 trillion in 2018 – the central government also added an award or trophy, called the *Dana Rakca* Award. It was given to the top three

provinces, top five municipalities and top ten regencies in terms of performance and was designed to add more prestige to the previous practice of performance-based fiscal incentive.

The findings from the interviews were that combining performance-based fiscal incentives with formal awards created a massive boost in the attractiveness of the policy. The interviews revealed that, regardless of their fiscal limitations, sub-national governments are eager to obtain the incentive fund. Moreover, the motivation was not only about adding money to their account but also about the prestige. Embedding a sense of prestige in the policy eventually triggered sub-national government leaders to strengthen their commitment and drive their staff to achieve better outcomes.

However, the stimulus only seemed attractive to sub-national governments that believed they could realistically compete for it. For sub-national governments that have already managed to achieve significant outputs and outcomes, the attractiveness comes with the belief that aspires them to improve their performances and still be the best. Meanwhile, for sub-national governments that were still in the bottom level of performance, the attractiveness is low and comes with a utopian feeling on whether they could reach that level or not. The doubts were mainly reflecting their level of fiscal capacity and human resources capability.

The central government has tried to address issues of inequality by clustering regions – whether province, regency or municipality – based on status and using an asymmetric scoring method. The central government realised that the sub-national governments started their development from various levels; some may start with above national average statistical indicators, but others are still far below the average. So, the central government combined the last statistical number position and incremental statistical number improvement to use as the method of scoring.

Nevertheless, the transformation of minimum criteria required a list of indicators, which are designed to become more and more challenging over the years, and have contributed to utopian thinking from the current low-achieving sub-national governments. From 2010 to 2015, the Supreme Audit Board audit evaluation became the entry point for sub-national governments in accessing DID funds. It should be noticed that the DID assessment uses T-2 data, which means that the 2010 to 2015

assessment was based on 2008 to 2013 achievement. The data show that between those assessment periods, the number of sub-national governments that received an unqualified evaluation was 13, 15, 15, 35, 76 and 73 respectively.⁴⁶ Therefore, the central government broadened the eligibility requirement to include those sub-national governments that received a qualified audit evaluation. Despite being used for different purposes, in 2016 and 2017 the central government still used the audit evaluation to guarantee the minimum allocation of DID. In those years, 162 and 312⁴⁷ out of 542 sub-national governments respectively received unqualified audit evaluations. This time the central government was strict, with the minimum allocation only awarded to those that received unqualified evaluations.

The requirement changed in 2018, when 378 sub-national governments that received unqualified audit evaluation did not necessarily receive a minimum allocation of DID. Instead, the evaluation was used only as an eligibility criterion to enter the competition for DID funds. The requirement was similar to the earlier years' entry point requirement. However, in 2018, it was exclusively for those that received unqualified evaluation, meaning the other 164 sub-national governments did not have the opportunity to receive DID funds.

In the researcher's view, by raising the bar the central government has made 164 sub-national governments feel further away from qualifying for DID rewards. Instead of aspiring to become the best and to compete not only for the funding but also for the awards, it is understandable that these sub-national governments lost motivation. Even if they could earn an unqualified evaluation in future years, it could not necessarily guarantee them getting DID funds because there was no longer a minimum allocation provided. They would have to compete further to earn the DID funds. The increasingly large number of sub-national governments receiving unqualified evaluation became the basis for the central government's conclusion that the requirement was becoming too easy to achieve. However, the central government accidentally undermined the motivational effect for the other 164 sub-national governments.

Another challenge that needs to be resolved is the inclusion of three out of five new categories that require sub-national governments to make different forms of

⁴⁶ See Appendix 6

⁴⁷ As explained, the number comes from T-2 data, in this case is 2014 and 2015

substantially similar reports. Those are the Sub-national governments' Governance Evaluation Report (LPPD) created by the Ministry of Home Affairs (MoHA), the Sub-national government Planning Assessment (PPD) created by National Development Planning Agency (Bappenas), and the Accountability and Performance Report for Government Institutions (LAKIP) created by the Ministry of State Employee Empowerment and Bureaucracy Reformation (PANRB). The sub-national government's officials complained that too much time was spent in making the required reports, which overlapped substantially. The central government needs to synergise the line ministries so they do not demand separate versions of assessment reports.

Finally, the interview findings revealed that the current clustering of sub-national governments in the DID assessment is too simplistic. The separation of groups of sub-national governments based on their status as provinces, regencies, and municipalities ignores the fact that among each of the clusters there are substantial geographical, fiscal, and human resources disparities. Current policy is not taking these disparities into account. An analogy to this is that it is unfair to put primary school, junior and senior high school, and university students in the same class and expect them to compete with each other.

TRANSFORMING INTERGOVERNMENTAL FISCAL RELATIONS AND FISCAL TRANSFERS POLICIES TO ENSURE RELIABLE OUTPUTS AND SIGNIFICANT OUTCOMES

7.1 Chapter Preview

As explained in Chapter 4, Law No. 33/2004 on Fiscal Balance Between Central and Regional Government establishes the intergovernmental fiscal transfers (IGFTs) framework in Indonesia. The General Allocation Fund (DAU) and the Revenue Sharing Fund (DBH), except for three of the latter's items that are tied grants, are generally classified as block grants. Meanwhile, the Specific Allocation Fund (DAK) is classified as a tied grant.

However, in practice, DAK was not the only tied grant. The Special Autonomy Fund for four provinces, which emerged from the mandate of the Special Autonomy laws, is also a tied grant program. Furthermore, the Adjustment Funds, which previously emerged from national Parliament (DPR) member's budget rights but then changed into the *DAK Non-Fisik*, which includes types of transfers coming under the mandate of sectoral laws, are also tied grants. The most recent is the Village Fund, which was listed as a consequence of the new law on villages. These are all considered tied grants because the funds are specifically directed to certain development activities or sectors.

Nevertheless, much has changed in the practice of fiscal decentralisation in Indonesia since 2015. Some new regulations no longer entirely follow Law No. 33/2004. The central government has created a new set of rules every year, using the Annual National Budget Law as the legal basis for changing several fiscal decentralisation policies. The new rules were introduced because of the central government's determination to encourage improved performance from sub-national governments. It is thus necessary to have a good understanding of these new rules, including policy

backgrounds and objectives, to assess policy challenges arising from decentralisation in practice.

This chapter details the findings from semi-structured interviews involving a total of 35 government officials from different units in central and selected sub-national governments. The interviews were designed to assess the practice of controlling sub-national governments' performance by designing fiscal relations and intergovernmental fiscal transfer mechanisms. The participants were interviewed about the journey of Indonesian fiscal decentralisation policy and its impact in producing good decentralisation outcomes. The interviews also sought to understand current efforts to transform fiscal relations and fiscal transfer policies and the vision of the central government in making such arrangements.

The chapter will provide an overview of how the central government directs its fiscal decentralisation policy. We also want to know the consequences sub-national governments must cope with while implementing the recent and often-changing central government regulations. The interview findings captured the central government's argument that increasing IGFTs over the years demonstrates its commitment to decentralisation. Moreover, the trend towards fewer discretionary IGFTs, shown in table 7.1, represents not so much a diminishing commitment, but, rather, an effort to optimise decentralisation results.

The interviews also uncovered different views among central and sub-national governments on which types of IGFTs should be promoted, based on their experience in administering the policy. The debate on whether to favour block grants as a way of acknowledging and enhancing sub-national governments' discretion and autonomy, or increasing the proportion of tied grants, is the primary policy challenge for the Indonesian central government. Then, examining the practical mechanism of IGFTs in more detail, the impact of block grants regulations revisions, changing tied grants allocation method, and additional rigid requirements in executing the tied grants are also captured in identifying the challenges of using IGFT policy to encourage significant outcomes from sub-national governments.

Table 7.1
Proportion of Indonesian IGFTs

	Block Grants	Tied Grants	%	
			Block Grants	Tied Grants
2004	118,831.26	10,891.77	91.6%	8.4%
2005	138,552.85	11,947.98	92.1%	7.9%
2006	210,784.43	15,609.80	93.1%	6.9%
2007	227,732.46	25,524.74	89.9%	10.1%
2008	257,927.31	34,506.17	88.2%	11.8%
2009	262,544.05	46,041.18	85.1%	14.9%
2010	295,754.98	48,972.63	85.8%	14.2%
2011	322,442.70	88,882.06	78.4%	21.6%
2012	385,351.64	95,293.43	80.2%	19.8%
2013	399,602.35	113,658.09	77.9%	22.1%
2014	445,158.28	128,544.72	77.6%	22.4%
2015	432,605.73	190,533.88	69.4%	30.6%
2016	480,895.78	229,361.09	67.7%	32.3%
2017	501,459.52	264,879.79	65.4%	34.6%

Source: processed from Ministry of Finance database (in IDR billion)

The interviews also revealed the sub-national governments' practical difficulties in increasing their local own-source revenues. Despite encouragement from the central government, practical issues are burdening sub-national governments due to discrepancies between the general regulations and the specific conditions of individual sub-national governments.

In conclusion, the chapter emphasises the importance of adopting an asymmetric approach in designing Indonesian fiscal relations and IGFT policies. Looking at the interview findings and the fiscal capacity disparities among Indonesian sub-national governments, the researcher believes an asymmetric approach could better support sub-national governments to flourish under their unique situations and characteristics.

7.2 Fiscal Relations and Fiscal Transfers: The Guiding Principles and Strategy

One can detect three important guiding principles in the interviewees' answers: imposing expenditure assignment before revenue assignment; ensuring value for money being transferred; and endorsing increased but controlled IGFTs.

However, different views were offered when it came to the question of what type of IGFTs would best define those principles. Surprisingly, the opposing views were not

merely the central government's perspectives versus the sub-national governments' arguments; the preferences among sub-national government officials were divided too.

7.2.1 Expenditure Assignment Before Revenue Assignment

CG1 said that the nation's unitary form made fiscal decentralisation in Indonesia more inclined to the expenditure rather than the revenue side. CG6 remembered that policy-makers were concerned about the country being torn apart if they devolved revenue powers rather than the expenditure. However, they tried to compensate by creating a large proportion of block grants and a small proportion of tied grants to address the aim of local autonomy.

CG3 and CG5 also explained why the central government opted for expenditure assignment: first, the maturity level of sub-national government was considered low; and, second, the fiscal needs gap between regions is too high. LG2 said that in her regency the own-source revenue potential is so low that fiscal transfers are essential. LG10 added that regencies and municipalities within his provincial jurisdiction have only 10 to 15 per cent own-source revenues, which is why fiscal transfers are badly needed.

So, at that time we made a decision, if we created decentralisation model that gave full authority to collect taxes, and at the same time we also gave freedom of spending to sub-national governments, we were worried if at that time we chose that kind of policy, we would be torn apart. Therefore, the design is what we eventually gave, collectable local taxes, which are relatively small such as hotel tax, restaurant tax, C type mining products tax, and et cetera. Nevertheless, at the same time, we gave enormous authority to do the spending. Thus, we gave a massive amount of transfers. So the collectable local taxes are small, own local revenue sources are small, added with massive transfers. The block grants were the most significant transfers. Hence, the DAU is enormous, then revenue sharing also significant, then tied grants are small. That was the design of fiscal decentralisation at that time. (CG6)

So, why the central government tended to prefer expenditure assignment, firstly because of the sub-national government's maturity itself, and secondly in terms of equality where every sub-national government had different fiscal needs. (CG5)

The fiscal autonomy degree measured through the proportion of own-source revenues in comparison to total local budget revenues, it is deficient. As an illustration, the Province of West Sumatera, the fiscal autonomy degree is around 30 to 40 per cent. However, the fiscal autonomy degree for its regencies and municipalities are only 15

per cent, many of them even under 10 per cent. So, it is hard to depend on own-source revenues, and consequently, have to depend on the central government's fiscal transfers. (LG10)

Local fiscal autonomy cannot apply globally because each sub-national government has different condition and natural resources potentials. Regency of Sambas, for example, the own-source revenues are meagre. Taxes, user charge fees, are meagre, so local fiscal autonomy for Sambas, remain the same, expecting dominant fiscal transfers. (LG2)

CG4 understood that, ideally, establishing fiscally independent sub-national governments should be achieved through optimising revenue assignments. However, before taking that path, the central government must first ensure that all the infrastructure needed to generate and increase local revenues is in place across all jurisdictions. CG1, CG2 and CG4 were of the view that, under the current development conditions, devolution of revenue powers would only widen regional fiscal disparity. Expenditure assignment is thus the right policy for the time being. The central government can still endorse national priorities to sub-national governments through fiscal transfers while reducing economic and fiscal disparity. Nevertheless, CG1, CG4, CG5 and CG7 added that eventually – if and when all the regions have developed equally, or the fiscal disparity is considered low – revenue assignment could become the primary means of fiscal decentralisation.

We can reduce IGFTs later, when? By the time those sub-national governments are already developed, can have 'their own show', and already become new centres of the economy. By then, the central government should no longer make an equal distribution. To be honest, I see IGFTs nowadays are like 'small rain shower' spread equally across regions. In the future, we should only focus on poor regions that need attention. (CG1)

Ideally, it is like that, establishing local [fiscal] independency through own-source revenues. However, if we want to go that way, there certainly has to be an equal level of infrastructure among sub-national governments. If we let that loose, meanings each sub-national government is expected to become [fiscally] independent while they do not have equal capacity to increase its own-source revenues, then it would result in higher gaps among sub-national governments. So, the most appropriate instrument now is through IGFTs, which towards will improve local fiscal independency through own-source revenue collection, but before they have been helped to build infrastructure that can support them to increase local revenues. As we know, to increase revenues on each sub-national government, obviously the economic level of the people there must be good, that is number one. Then, number two, the supporting

instrument like regulation, human resources, other tools, or for example, space for investment, etcetera. It must be pushed into that direction, with the IGFTs, it must go that way. (CG4)

Even though there is still a large portion of tax revenue sharing, I think, for Indonesia, we cannot fully assign to sub-national governments. National budget distribution function still needs to take a dominant role. Due to each sub-national governments' condition, unequal economic growth, development inequality, if we just assign all to strengthen with own-source revenue, it will make disparities, the one already developed will become more advanced faster, while the ones still underdeveloped that do not have much potential yet, will be tougher for them to catch up. So, the proportion to balance or these local transfers seem still needed, that kind of central government's distribution. (CG2)

In order to have optimum results for sub-national governments, let say a few years later many sub-national governments are helped, its local revenues become significant, we will go back to the concept where IGFTs will become less. For example, the province of DKI Jakarta, when its own revenues are sufficient to fund all its budget, we do not allocate them any DAU, we do not give them DAK. The expectation is that there will be many sub-national governments like DKI, which means we do not have to allocate DAU and DAK for them. (CG7)

7.2.2 Value for Money Being Transferred

CG1 and CG8 thought that the primary objective of decentralisation is to provide adequate public services equally in all regions. CG8 argued that the more tasks are given to sub-national governments, the more the fiscal resources that need to be allocated. CG8 added that the central government would indeed endorse sub-national governments reducing their fiscal dependency. However, in the context of fulfilling their fiscal needs to provide adequate public services, which forced the central government to allocate more IGFTs, CG8 saw no reason why this should not occur. CG1 and CG8 believed that it does not matter which fiscal resources are used in funding sub-national governments' programs – local own-source revenues or IGFTs.

Here, the disparity is high. The central government gave IGFTs with an expectation that it would strengthen, drive the local economy, which if the level gets high enough, it would eventually make increase significant local revenues. That is the expectation. Thus, the indicator currently showing a high dependency of sub-national governments over IGFTs, I think that is not a problem. (CG1)

We cannot merely make a dichotomy on which one should be more prominent because we have an aim to accelerate the achievement of national priority, like minimum service standard. We need to achieve that equally across the nation. (CG8)

However, CG3 thought that fiscal decentralisation is not about how much is allocated and transferred to sub-national governments *per se*. It is more important to look beyond the money and consider how it can bring value for money and generate excellent outcomes. CG3 quoted the Minister of Finance as saying that the central government might quickly increase the allocation for Village Funds, for example, but would it solve the problem of poverty in the villages?

Is it when the IGFTs are declining, fiscal decentralisation then regarded as being successful because sub-national governments are becoming independent? The minister saw it differently. She thought that it is not about whether the fund from IGFTs, through central government spending, or make it all as local revenues *per se*. The value for money and development outcomes as a result of fiscal transfers are the focus. So, it is not about the money, the minister said we could increase Village Fund, but has it solved the problem of poverty in villages? (CG3)

CG5 used an analogy, describing the current fiscal relations practice as swinging like a pendulum away from the early practice. Previously, CG5 and CG7 said, it tended to enrich sub-national governments' functions and gave them considerable discretion in planning and executing their budget by letting them collect whatever local revenues they wanted, in addition to large block grants. The current practice, in contrast, wants to take more control of sub-national government budgets by limiting discretion, mostly through increasing specific grants, directing the use of block grants and imposing limitations on what kind of local taxes and charges sub-national governments can collect. CG5 and CG7 added that the central government is more focused on not only increasing the amount of IGFTs but also ensuring that those funds create reliable outputs and significant outcomes – or, as CG6 described it, 'value for money' – that sub-national governments need to be aware of in spending their budget.

Well, this is one of the central government's tool to evaluate and correct early years of fiscal decentralisation policies. So, it is expected that, after Law Number 23 and will be followed by the revision of Law Number 33. We will go to phase two that will focus on sub-national government's output, intermediary outcome, and final outcome. This is where we are heading. (CG5)

At least now sub-national governments started to think hard about value for money. Why? Because they must realise that the money they have will become fluctuated. The

trends, [DAU] this last two or three year, were actually declining. They must think about priority spending before anything else. That is where they started to think about efficiency and scale of priority. In the old days, they can just sit back and relax, no worries the money will be fixedly transferred to them. Nevertheless, now, they must have clear priorities, so when they got a cut on their IGFTs, they can cut non-priority spending. Hence, indirectly, that is a way to encourage their performance. (CG6)

DAK or *DAK Non-Fisik*, including perhaps DAU and DBH, Village Fund, we no longer transfer them for free. There are reporting requirements, or specific performance and output targets that the sub-national governments need to achieve, then we can transfer the fund. So, from the allocation and transfer mechanism side, we tried to correct the sub-national government's behaviour and performance achievement. Moreover, on the other side, we want to make the process parallel. We do not want just to allocate and then control it. What should be more ideal is that we can encourage sub-national governments to perform well voluntarily. Not because the allocation policies or the transfer mechanisms are controlled, but because sub-national governments consciously realise that they must perform well. (CG7)

7.2.3 Increased but Controlled Intergovernmental Fiscal Transfers (IGFTs)

CG1 argued that it is incorrect to say that the central government lacks commitment to fiscal decentralisation when one looks at the type and range of taxes assigned to sub-national governments. CG1 and CG2 mentioned that the increasing number of IGFTs over the years is evidence of the central government's commitment to fiscal decentralisation. CG2 expressed a view about the need to consider the national budget structure in determining the central government's stance on fiscal decentralisation. CG2 disclosed that since 2016, the proportion of IGFTs in the National State Budget is greater than the national line ministries/agencies expenditure. This proportion is a sign of how serious the central government is in its effort to enhance regional development.

They often said that now IGFTs are higher in number than the central government expenditures. That is evidence of the central government's commitment when IGFTs are higher, that shows commitment. (CG1)

Currently, this is what we are trying to balance first. We already talk about decentralisation, but how come the central government's expenditure is still higher? Thus, over the last three years, the gaps are narrower, between line ministries' expenditure with IGFTs, even last year in 2016, IGFTs was higher. (CG2)

Despite the commitment shown in increasing IGFTs over the years of fiscal decentralisation, the central government does not seem satisfied as it has changed some

fiscal transfer policies with immediate effect. Even though Law No. 33/2004 provides the formal legal basis for Indonesian fiscal decentralisation, many of its features have been abandoned in practice. The transformation of tied grants allocation and the associated transfer mechanism, the introduction of performance-based grants and the emergence of non-physical tied grants are some of the transformations that are not only replacing the regulations under current law but also adding to it. The objective is, undoubtedly, to address the issue of the ability of sub-national governments to convert the transferred money into good outcomes.

CG7 characterised the early practice of Indonesian fiscal decentralisation as an 'overdose'. Along the way, the central government found there were sub-national governments that did not perform well or where the condition was not improving. CG7 and CG10 believed that the central government therefore felt the need to control the transferred funds so they became more efficient and had a real impact on the local people. CG6 was convinced that whenever decentralisation is implemented, the central government must always be able to control it. Implementing decentralisation does not mean the central government is losing control over the sub-national governments.

CG10 and CG6 admitted some sub-national governments perform well, but that was because of the occasional good governor, mayor or regent. However, CG6 thought that the central government cannot always depend on individuals and count on a good candidate being elected. For that reason, CG6 supported the view that the central government needs to create a controllable transfers system that can ensure sub-national government spending quality.

So, if we review the concept, we compare early fiscal decentralisation practice, we can see the literature from experts, and many people would say that our fiscal decentralisation was an overdose. So, we had set the level too high in giving discretion to sub-national governments. There we give you money, please spend it. We never assess the performance, open list of local own-source revenues, they could collect whatever taxes and user charges that have not been listed by the central government. After we evaluated, and it turned out there were many sub-national governments that did not have a good performance, or its regions were not improving much even after the local autonomy era. In reality, sub-national governments have human resources problem, economic growth, local leadership problem, which are not ideal yet. We transferred many fiscal resources, but, in facts, the performance is still miserable, public services are worst, infrastructure is inadequate. Based on those facts, this is why we pushed the fund's allocation, hundreds of trillion money sent to sub-national

governments must be more efficient, must give real impacts to the local people, to the increase of public services and infrastructures. How? Like it or not, it is supposed to be like that. We control the funds' transferred, starting from its allocation to its transfer's mechanism, as you said now with extra rigid requirements, and even 'earmarking' the block grants. (CG7)

Including yesterday, the concerns from the minister, the funds are enormous enough, before it was 80 trillion, if I am not mistaken, now it is 700 trillion, the increase is almost ten times, but the results was none. There were lots of lousy school facilities, inadequate health facilities, poor roads and bridges. Meanwhile, it was expected that with local autonomy, the services are made closer to the lowest decision-maker. It was expected to work, but until now it is still too far away, even though there are one or two sub-national governments did okay, it depends on the local leadership. Banyuwangi, Regency of Badung, and a few others are more advanced because their leadership was excellent. (CG10)

Because we overview that based on the evaluation of 15 years of experiencing, it turns out that with block grants, the regional development performance is nationally dissatisfying. There are some exceptional sub-national governments, and also some that are lagging. Means that it really depends on who is the head of the sub-national government or its elite level officials. Thus, to avoid that, so now we thought, let us just improve the specific grants so that the regional developments' planning is in line with the national development planning. So, the development direction of this republic would become more apparent. It is being directed that way, strengthened tied grants. Even though the block grants will still be dominant, the tied grants will become stronger. Because when we are practising a massive decentralisation, at that same time the central government needs to have firm control over it. Because if it is loose, it will not make any difference at all, everything fall apart. (CG6)

7.2.4 Controlling Sub-National Government's Performance: Tied Grants, Block Grants with Incentives, or Asymmetric Treatment?

CG1 admitted there had been a trend towards re-centralisation in recent years. In addition to shifting some sub-national government roles and functions to the provincial level, which acts as the central government's representative in the regions, the central government has also been leaning more towards tied grants over block grants. Seeing the results of almost 20 years of decentralisation convinced CG1, CG2, CG5, CG6, CG7 and CG10 that shifting to tied grants is the most suitable policy in Indonesia. Even though there might be some resistance, they believed that tied grants are better and more effective than block grants because of the central's government ability to

control their use and the inability of most sub-national governments to manage their fiscal budget wisely.

The disparity of public services among sub-national governments is still high. Thus, want it or not, we need to catch that up, and the possible way, looking at 17 years of practising decentralisation, that is what we thought. The total allocated DAU is being held to its baseline, and DAK will be the one to increase. (CG2)

Fiscal transfers started to evolve. If previously we tend to transfer block grants, lately the directions are, including regulation in the law about local autonomy itself, and the law about sub-national governments, actually readjusting functions and responsibilities that were given to sub-national governments. Similar things happen to the block grants. DAU is still considered block grants, but now we enforce through the Annual National Budget law that 25 per cent of it is for infrastructure spending. DAK is strengthened, we increase the amount of allocation, the technical guidelines are getting tighter, more performance-based. (CG6)

Well, in the future, the spirit would very much tend to decrease block grants, increase tied grants, because experiencing decentralisation for almost 20 years, if we assigned sub-national governments too much authority, for example, DAU, the outputs and outcomes are becoming more unclear, the policy between central and local are not linked, the priorities did not match. The only one that can be directed is only DAK, physical and non-physical because it was directed. So, especially for the law revision, DAU will be kept to its baseline, while DAK will get an accelerated increase. (CG10)

Regarding budget allocation, CG10 and CG6 revealed that the Minister of Finance has directed that tied grants be increased while keeping the General Allocation Fund (DAU), which comprises block grants, down to its baseline. At the moment, the total DAU allocated is at 28.7 per cent of net government domestic revenue (PDN Netto), while the law only requires the central government to allocate 26 per cent.

LG7, LG8, LG19 and LG24 supported the idea of more tied grants instead of block grants, but for different reasons. For LG7 and LG19, they make it easier for sub-national government to expend IGFTs funds appropriately since there are clear directives. LG8 said that it is easier for sub-national government to allocate tied grants in the local budget because they avoid political intervention from the local council. Meanwhile, LG24 felt that executing tied grants was safer regarding financial and compliance audits because the rules are more explicit than for block grants.

I prefer specific grants. Do not transfer to the sub-national government in the form of block grants. Specific grant has more definite programmes and goals. So, we do not

have an intervention, budget politicisation. DAK, for example. The local council never touch it in the budget planning meeting because it already has specific directives from the central government. However, if it is block grants, The local council member would use it for their political interest. This is according to my experience doing budget planning meeting with the local council. (LG8)

Specific grants would be more suitable because the concept can capture sub-national government's needs, the funding is from central, the regulations are clear, so synchronisation between local and central are also apparent because the system itself requires it, what are the sub-national governments' needs, what are the central government wants, it is connected. (LG7)

According to us, we do not have any problem with specific grants, which is limiting or less discretion, because when there are no limitations, we could get confused. At the time, we, at the local level just want to play safe legally, and with the specific grants, it already has clear directives that, you can only do this not that, you can only spend on this and not that. (LG24)

In contrast, LG1, LG2 and LG3 preferred block grants to tied grants. They argued that block grants provide the necessary discretion to allocate funds to support national priority based on local circumstances.

The general one [DAU], because for now the amount of 800 billion, if I am not mistaken, we could see the exact number later, the fund that can be used for development from that amount is too small. We got 800 billion of General Allocation Fund, around 700 billion we used it for employees' salary expenditure. So, the remaining that can be used for development is very small, only around 20 per cent of the General Allocation Fund. Hence, probably this DAU that should be expanded. For DAK, we always restricted to technical guidelines. (LG1)

For me, on one side it is better having block grants because the sub-national government have more discretion in spending it based on their needs and conditions. However, on the other side, DAK is okay, as long as the regulation is not too complicated. DAK is specifically directed. Thus, it will not go anywhere, the sectors are already apparent, like for facilities, essential public services, we are comfortable because when we discuss local budget with the local council, they cannot touch it because it is already determined. The problem is, its transfer's mechanism sir, every year is getting more complicated. Well, indeed, the central government does not want the fund to be idle for too long at the sub-national government. So, the central government transfers based on our actual needs, how much do the actual work transaction needs, but on the other hand is rendering difficulties, because the report is too complicated. (LG2)

Actually, we prefer block grants rather than tied grants. For example, we hoped that we could get massive DAK funds to build roads and bridges. However, the central government also provide DAK to build markets, irrigation, which are also national priorities. We needed to improve those sectors too, but for now, in the context of our region, we wanted to focus on building roads and bridges first, and the other later. Nevertheless, it is not that we refuse the tied grants, we still accepted it of course, but maybe the central government would need to review inter-sector allocation proportion for each sub-national government. (LG3)

CG10 suggested that the central government would need to refine the IGFT mechanism's objectives. Block grants need to be allocated to fulfil essential public services, while tied grants need to be allocated based on each sub-national government's unique characteristics. So, each sub-national government would only get DAK for specific sectors that it genuinely needed, not for all sectors provided in the DAK list.

Furthermore, CG4 believed that the utilisation of tied grants and block grants must be balanced and also consider conditionality. He argued that tied grants should be endorsed when there are specific targets from the central government that require all sub-national governments to establish. However, block grants would still be important to give discretion for sub-national governments to decide their development plan. Similarly, CG3 noted that the choice of giving block grants or tied grants depends on funding purposes. The best way to actualise national priorities is by strengthening tied grants, such as *DAK Fisik*, while other non-national priority local expenditures should use block grants instead.

We want to resettle the spirit or philosophy of autonomy or fiscal decentralisation. Until now, DAK is not settled in its true philosophy. Almost all sub-national governments received DAK, and the sectors are also similar. In the future, those different potentials and characters are supposed to embed in DAK. If the characters are similar, because the sub-national governments execute essential public services, then the mechanism is utilising General Allocation Fund [DAU], with the criteria that all sub-national governments must have. (CG10)

In my opinion, it depends on the conditions. If there were specific targets, such as quality of public services or for the people's wealth, based on specific conditionality, tied grants should be endorsed. On the contrary, if the central government want the sub-national governments have a role in deciding their development plan, then it should be directed to block grants. For me, perhaps fifty-fifty. (CG4)

Nevertheless, CG3 argued that, ideally, the central government would apply asymmetric decentralisation because of the variation in sub-national government conditions and performance. The central government could allocate more significant block grants to those with a good record in providing public services and who showed maturity in their practice of governance; most others, who are still underperforming, should be given tied grants instead. Similarly, LG14 also suggested different treatment and support for different sub-national governments' conditions.

The choice of whether to allocate tied grants or block grants depends on funding purposes. Mr Putut [Director of Fund Balance] even said that, if necessary, we should make asymmetric decentralisation, that would be more ideal. If the sub-national government already matures, have a convincing system of governance, such as Surabaya, Bandung, and Banyuwangi, which its level of governance can be measured, independent, can become good, can assure excellent public services, well just give them block grants. Nevertheless, for regions like Papua and Sulawesi, which public services are still far away from excellent, the level of governance is under question, the central government's trust is still in doubt, then we give them tied grants. That would be more ideal. (CG3)

The system, firstly, reward and punishment should be improved, means that good-performing sub-national governments must be appreciated, and non-performing ones need to be supported but not spoiled. Secondly, sir, sub-national governments that cannot improve, because of underdeveloped circumstances, geographical conditions, then their human resources are also falling behind, those kinds of things would need to be given certain variables of minimum allocation. (LG14)

7.3 Customising Block Grant Arrangements and Its Consequences

Since 2007 the proportion of block grants within total IGFTs has been declining. In 2007, the figure was 89.9 per cent, decreasing 3.2 per cent from the previous 93.1 per cent. In 2018, it accounted for only 65.2 per cent of total IGFTs. Not only are block grants declining as a proportion of total IGFTs, but the central government has also introduced several new policies for block grants and, specifically, the General Allocation Grant (DAU) as the most significant source of block grants. The central government now 'earmarks' 25 per cent of block grants to be utilised for infrastructure projects and has released a floating DAU allocation policy. The interviews captured several problems arising from these policies. Furthermore, the interviews also captured the central government plan in reformulating DAU based on its assumptions and the sub-national governments' pleas concerning those assumptions.

7.3.1 'Earmarking' Block Grants is Absurd for Poor Sub-National Governments

CG10 said that the central government had created another way to control sub-national governments in spending DAU. CG1, CG2, CG6, CG9 and CG10 highlighted the recent trend in DAU becoming more like tied grants in that the central government sets requirements for how it may be used. They mentioned that the new IGFT regulation requires sub-national governments to allocate at least 25 per cent of their overall block grants to infrastructure projects. However, CG6 said that the central government did not want to diminish the meaning of the block grant. Therefore, the central government only requires sub-national governments to submit a report so that the central government can evaluate their progress in utilising block grants.

Nevertheless, LG10 believed that the 25 per cent 'earmarking' would be hard to manage for sub-national governments with low own-source revenue. LG13 revealed that even without this policy his sub-national government, unlike rich sub-national governments, could not allocate meal allowance for their civil servants. LG13 added that operational costs for an archipelagic sub-national government like his are higher than for wholly land-based sub-national governments, especially those that already have good road access to reach their smallest communities.

From the transfer point of view, 25 per cent block grants for infrastructure is burdening. There are sub-national governments that may feel unburdened, like DKI Jakarta, because their local own-source revenues are bigger, so they do not depend on the central government. However, for other sub-national governments that really depend, and not mentioning problems in executing infrastructure, must have felt really disturbing. Actually, if we conclude, almost 75 per cent of sub-national governments in Indonesia, either provinces or regencies and municipalities, have a fiscal dependency on the central government. (LG10)

There is so much money, one billion allocated to a village, while the regency also has obligations to fulfil, but we have such limited resources. We need to fulfil 25 per cent for capital expenditures. It is tough to comply because of some variables we need to fulfil. Then, 10 per cent must be allocated from DAU as additional Village Fund, 10 per cent for the health sector, so does certain per cent for education. The DAU fund has to be split like that while other obligatory responsibilities need to address, such as salary. Let me tell you, the Regency of Central Moluccas is even unable to pay meals allowance when the Minister of Finance regulation was established. We could not go into the area. How else would we talk about performance? Because DAU has already sucked into those expenditures. (LG13)

As I said previously, the routine expenditures, how could we equate operational costs at our regency's geographical situation in the Moluccas with others like Toraja Regency for example? Our official travelling expenses are costly. Other regencies may only have to pay less than IDR 100,000 to reach the next closest regency. Nevertheless, here, we even have to spend hundreds of thousands just to reach to the sub-districts. This transportation costs certainly have a significant impact on our budgeting plan. We need high operational costs just to execute an infrastructure project. Not mentioning if we have a community development programme, need to socialise our policies. In the end, we have no more space in our budget. (LG13)

This last response also implies that even though, by formula, the calculations in allocating DAU take into account regional cost differences, these differences are not fully reflected in the end result. This is because there are other variables in calculating each sub-national government's fiscal needs, such as population, total area, price cost index, Human Development Index and the gross regional domestic products (GRDP) per capita index. It may also confirm the critique by Shah et al. (2012) describing the formulation of DAU as 'one size does not fit all', because the formula cannot be uniformly applied to jurisdictions with widely varying characteristics.

7.3.2 Floating DAU Allocations Put Sub-National Governments in Danger

CG6 and CG9 explained another new policy of flexible DAU allocation based on *PDN Netto* variance calculated in the National Budget Revision (APBN-P). In the middle of the fiscal year, the central government usually revises its National Budget (APBN). Previously, sub-national governments were unaffected because they received a fixed amount of DAU. The new arrangements can cause their DAU in the same fiscal year to change, either increasing or decreasing. CG6 and CG9 believed this policy could educate sub-national governments' performance in spending quality because it will force them to become more efficient, to know what to prioritise and to be more prudent in budgeting.

Nonetheless, the choice to promote expenditure assignment by enlarging IGFTs has resulted in high fiscal dependency of sub-national governments on the central government. On average, the dependency of sub-national governments on IGFTs can be seen from the proportion of IGFTs, which from 2013 to 2018 accounted for between 69 per cent and 72 per cent of total local budget revenues. CG1 admitted that even though there seemed to be many types of tax assigned to sub-national governments,

the potential amount of money that can be collected is insignificant. LG1 added that in this kind of situation, the increase in local own-source revenue would not match the fiscal risk of contributing to a decrease in the IGFTs sub-national governments receive.

Furthermore, even though LG2 admitted this policy would improve sub-national governments' financial management and make them more disciplined in executing their development plans, LG2 and LG13 were unhappy with this policy because the initial implementation in 2017 led to DAU being cut for all sub-national governments. LG2 said that the sub-national government was always forced to complete its budget planning as soon as possible. Failure might cause its DAU transfer to be put on hold. However, with only a few months before the fiscal year ended, suddenly they were told that the central government had cut the DAU allocation due to decreasing *PDN Netto*. LG2 and LG13 argued that all the budget had been allocated, and contracts had been entered into, so how were they supposed to cover the decrease when their own-source revenues were not sufficient?

We also did expansion and intensification of local own-source revenue collection, but you can see the sectors. The sectors given to regencies are small ones. The most popular probably just property tax, while the others even they can increase up to 100 per cent, the amount would probably only 1 billion, from 1 billion, increased 100 per cent to 2 billion is not worthy, not even enough for employees' operational expenditures. You can compare the Regency of Sambas government, from its employees' wealth point of view, among regencies in the Province of West Borneo, you can compare. It is really hard just to increase their wealth a little bit, which eventually affects their performance. (LG1)

We had an allocation of around IDR 70 trillion but then reduced to IDR 60 trillion, which half of it was to pay salaries. It made us confuse. Let me ask you now. We had the allocation at the beginning of the fiscal year, and then we already had programmes scheduled and spend the fund. What is the logical explanation that it was suddenly changed and being reduced? How can we finance our expenses? In terms of fiscal performance, we are urged to accelerate our budget execution, because the central government will hold the next scheduled-transfers if our spending is still low or under the requirement. Meanwhile, we tried to spend it as soon as possible, but suddenly the fund was cut, how should we pay the third-party commitments? Because the cut was only a few months before the fiscal year ended. (LG2)

The central government called it as postponing, but I said it was cutting not postponing. Postponing means the fund still be transferred at the current fiscal year, which means we can still pay all our obligations. However, if it is carried over to the subsequent year, it means our fund has been cut. It will be reallocated in the subsequent

year's budget, like the one in 2017 and later in 2018, calculated to, then, reallocate. The risk is how about the contracts been made when there was no money in our account? Do we have to end it? If we end it, what would be the reason? Is this a third party or sub-national government's negligence? The risk was that it put us, sub-national government, in danger because we have to be responsible for those already-signed contracts. Our experience here, some contractors came very mad to the office and could risk damaging our office. You could imagine if so many contracts unsettled, then how you would lower down the contractors' emotions, which their employees are also chasing them. (LG13)

A year prior, in 2016, the policy was to hold the DAU being transferred to the sub-national governments based on the calculation of the sub-national government's idle money forecasting. LG13 thought the transfer hold irrational because the idle money forecasting method was dubious. The central government forecast that his sub-national government would have idle money by the end of the fiscal year, but the reality was that at the end of the year they did not have sufficient funds even to pay third-party suppliers and contractors. Even though the central government finally transferred the funds, it was too late because it was received on the last day of the fiscal year.

LG13 questioned why the central government's inability to manage its fiscal risk ended up as sub-national governments' fiscal risk. LG13 argued that the central government always taught and warned sub-national governments about making a credible budget, which includes estimating revenue reasonably. However, it was the central government that then failed to implement a credible budget by setting unrealistic revenue targets. The risk is then pushed down to sub-national governments. LG13 argued that sub-national governments are the front-line executives in providing public services to the citizens, so they should not be more burdened with fiscal risk, especially risk that was not of their making.

I need to convey on this occasion, the central government with the Ministry of Finance do not just send APBD [sub-national government's budget] by calculating the percentage. They need to assess the APBD, then conclude, whether with this number of employees' expenditures truly [over cash inventory] or this is simply just to insert expenditures for the employees' needs. Those punishments are sometimes irrational. Punishment of delayed transfers because there is a concern that later the cash inventory will be too high. They do not even know yet whether the cash inventory will be high at the end of the fiscal budget year, they already want to postpone the transfers. Evidently, until the end of the year, there was no more money. Even some payments cannot be made because the delayed transfers were done on 31st December, the last

day of the fiscal year. I think sharing the pain is a fallacious policy because they over-estimate national revenues budget planning. We were taught by our higher institution's leader that estimating revenue must be set to minimum. The achievable target. Nevertheless, the central government made unachievable target, then sub-national governments that must be affected by having the risks on that fallacious policy. I am thinking really simple, why do they over-estimate the national revenue too much if they know they cannot achieve it? We are talking about sub-national government's performance, while that is also part of the central government's performance, where they cannot achieve its revenue target. Hence, why do sub-national governments must bear the risks? (LG13)

7.3.3 Planned DAU Reformulation: Central Government's Assumption vs Sub-National Government Needs

CG9 thought that the central government needed to refine DAU formulation as block grants, which, until recently, formed the highest proportion of IGFTs. CG9 admitted that the sub-national government's dependency on DAU is exceptionally high. Based on the central government evaluation, most of the funds were used to pay local councils' and local civil servants' routine operational expenses, including salaries, leaving minimal opportunity for sub-national governments to create new programs or innovations other than those funded through tied grants.

CG10 argued that the central government could not see any significant outputs and outcomes coming from sub-national governments, especially in managing the utilisation of block grants for almost 20 years. As a consequence, CG10 revealed that the central government intended to revise the DAU allocation formula such that it is based only on public service needs. There will be no more basic allocation in the formula, which was calculated from the sub-national government's salary needs. CG10 argued that the removal of basic allocation from the formula would force sub-national governments to become more efficient with the number of their civil servants. However, CG10 acknowledged that the central government needs to address this carefully because the effect will be massive. Hence, unlike changes to DAK, which have taken immediate effect in practice without waiting for a new law to be promulgated, changes in DAU formulation will not take place until it is adequately notified and explained, discussed, and then stipulated in the new law.

Reacting to this issue, LG2, LG4, LG13 and LG14 discussed their situation concerning local civil servant numbers. LG2 and LG4 said that the salary budget remains high

even though the number of civil servants decreased in the last three years. LG2 added that health and medical workers are now multitasking because they are also assigned to do financial administration tasks, which is complicated and outside their expertise. LG13 and LG14 mentioned a case involving the allocation of doctors by the central government that did not match with the number of health facilities in the region. This forced the sub-national government to make up the deficit and, consequently, burdened their budget to pay those doctors' salaries.

Meanwhile, LG4 and LG13 reported that their sub-national government currently lacks education workers due to a recruitment moratorium and retirement of teachers. LG2 likewise argued that the central government program also affected the sub-national government's number of civil servants. LG2 noted that the recruitment of 'front-line teachers' was driven by the central government, but that sub-national governments are then responsible for paying their salaries.

We have already done three years without recruiting new civil servants. However, if you see current working demand, accrual-based financial reporting, we need to recruit accountants. We have many Community Health Centre, 28 to be precise, and now to administrate the DAK fund named as Health Operational Subsidy, we require nurses to do it, which is so much different knowledge to them. The administration of the fund then will end up as one of the items reported in the Sub-national government Financial Statement. So, how can we get our report good and fair if starting from the lowest unit is not appropriate? We have done no recruitment for three years now, and this year, here, the most retirement comes from teachers and health facilitators. Nevertheless, the government's employee spending is still significant. A few months ago, there were employee transfers, such as front-line teachers, and farming trainers, recruited by the central government but then, in the end, the sub-national government who must pay for their salaries. The central government is smart, they recruited and then told us to pay the salaries. (LG2)

The problem is like this, sir, quite simple. The territorial area of Central Moluccas Regency is huge and archipelagic. We used to have more than 10,000 employees but now decreased to 8000 to provide public service in this huge regency. Even now, we still feel a lack of teachers and paramedics. We do not have enough paramedics just to comply with the minimum service standard. Then, we calculate too that we currently lack teachers. Up to now, some schools only have one or two teachers, and they are non-permanent staff, based on a contract. So, it has to be researched at every sub-national government, especially regarding the number of teachers and paramedics. So, we can know whether the number of salary expenditures equal to the scope of public services that must be provided at the sub-national government. Here, unlike rich regions, we cannot provide performance allowance to our employees, none. (LG13)

7.4 New Approach to Tied Grants and the Rigidity of Its Transfer Mechanism

The increase in total IGFTs has been marked by an increase in tied grants, while the block grants allocation declined. From only 8.4 per cent in 2004, tied grants in 2018 increased to a level of 34.8 per cent of total IGFTs. The increase was caused not only by increasing allocation for *DAK Fisik*, but also by the expansion in types of *DAK Non-Fisik* and the emergence of the Village Fund. The latter is not included in this discussion because it has distinct features which require separate research. Among many kinds of tied grants in the Indonesian IGFTs, *DAK Fisik* has undergone the most notable changes to its allocation method and transfer mechanism.

7.4.1 Changes to Allocation Method Reduce Misallocation of DAK and Improve Focus of Funding

CG6 and CG7 reported that the central government had revised *DAK Fisik* allocation into a proposal-based method. It involves a bottom-up process in allocating tied grants based on each sub-national government's needs, which is the reverse of the previous top-down allocation method. CG7 explained that the intention was to allocate *DAK Fisik* only to sub-national governments that have clear programs reflected in their proposals that align with national priorities.

Moreover, CG7 and CG9 believed this new method could reduce the previous misallocation weakness whereby sub-national governments are allocated DAK funds in sectors where they do not need funding. CG9 mentioned a past example of a municipality that did not have any farming areas but which was given DAK to use in the agriculture sector. LG10 and LG18 mentioned that a few years back, before the proposal-based mechanism, there was a misallocation of DAK. LG18 mentioned the example of the Regency of Nganjuk, which was given DAK for the marine sector despite not having any marine territory in its jurisdiction.

CG7 admitted that it is entirely reasonable if there are concerns among sub-national governments, noting that the proposal-based method is still unable to fulfil all sub-national governments' needs. CG7 stated that this is because there are limited funds; each year the central government receives proposals worth around IDR 500 trillion, but there is only around IDR 60 to 70 trillion available.

Another difference in practice compared to the current fiscal decentralisation law is the division of *DAK Fisik* allocation. CG6 said that the allocation of *DAK Fisik* is currently divided into three types: a regular allocation to fund minimum service standards, an assignment allocation to support national priorities program achievement, and an affirmative allocation to accelerate infrastructure development in underdeveloped regions, border regions and archipelagic regions.

7.4.2 The New Transfer Mechanism

Besides altering the allocation method, CG1 and CG2 mentioned the new government regulation on allocating, transferring and reporting the use of *DAK Fisik*, which is becoming more strict and rigid. The interviews captured several impacts on the implementation of the new policy, especially for sub-national governments.

A. Imposing Reward and Punishment for Sub-national governments' Performance in Utilising DAK Funds

CG1 and CG2 explained that the new transfer mechanism is designed to increase sub-national government performance in regard to planning and executing funded programs. CG1, CG2 and CG7 said that categorising the *DAK Fisik* as tied grants, which means they can only be used for a specific sector and type of output, is not enough for the central government. They need to make sure that the processes are well-planned and that the outputs produced are appropriate and likely to generate good outcomes.

CG3 described DAK as the fund to control sub-national governments. If they could not execute programs correctly and comply with its rigid regulations, then the central government would not give them the money. CG3 explained how, in previous years, DAK implementation could not provide the central government with sufficient data about what outputs sub-national governments had managed to deliver. Moreover, the previous transfer mechanism had allowed an amount of DAK funds to remain unused in the sub-national government's account due to the use of allocation-based transfers instead of output-based transfers.

CG3 explained that the current rigid regulations were the result of the central government's evaluation as tested through the Sub-national governments and Decentralisation Project (P2D2). This was a pilot project, involving selected

provinces, municipalities and regencies, to improve the business process of DAK by awarding fiscal incentives based on DAK output performance. However, CG3 added, two aspects have not been adopted as part of the current DAK regulations. The first is embedding Global Positioning System (GPS) technology into the DAK Web-Based Reporting System, and the second is post-output verification to ensure the output results are appropriate.

CG2 explained that the new *DAK Fisik* regulation aims to apply reward and punishment principles. Sub-national governments will get a reward if they can implement their *DAK Fisik* according to plan and meet each specific period's target, while failure to comply will result in punishment. For example, a sub-national government is expected to complete all its project contracts in the first quarter, so it can assess whether there will be any unused DAK funds. If it can comply with this regulation, then it will be given a chance to re-allocate those unused funds to proposed new projects. However, if it fails to secure all contracts in the first quarter, it cannot re-allocate the funds even if there is a surplus, and it will be calculated as a deduction to the following year's *DAK Fisik* transfers.

As another example, CG2 and CG3 noted that the central government would increase the following year's *DAK Fisik* allocation to a sub-national government that fully utilises the current year's allocated *DAK Fisik*. However, LG17 did not agree with increasing allocations based solely on achievement in optimising the previous year's funds. LG17 said that the central government must also consider the sub-national government's proposal concerning how much it needs for each sector. LG17 pointed to the irrigation agency's experience in his province; the agency was allocated more funds than it sought and consequently was forced to utilise more funds than were needed.

B. Its Rigidity and Short Period of Socialisation Become Costly for Sub-national governments

Despite the agreement that the current DAK regulation is useful for improving sub-national government performance, LG24 said the central government could not just introduce the regulation without being aware of the timeframes and consequences for sub-national government budget planning.

We do not mind the regulation became rigid, but please inform us at the sub-national government's level. Yes, it would improve performance, but unfortunately, the central government communication was awful. We said to the central government's officials that they never communicated or socialised the new regulation. They just stipulated it and let the locals read and interpreted by themselves. If the system is excellent, we will feel motivated, but that was not the case in 2017. (LG24)

LG1, LG2, LG3 and LG4 also recounted their sub-national government's bad experience in 2017. They received a reduction because of their failure to submit fixed individual contracts for their DAK projects by the end of August 2017. According to the regulation, the central government will not transfer the remaining DAK funds in the last quarter of the year to any sub-national government that fails to comply with that specific requirement, even if the projects are fully finished. Hence, their sub-national government needed to manage the balance of the payment using its own resources. LG4 said that they would probably have to re-allocate the following year's budget and cut several programs to cover the debts.

Those three components [DAU, DAK DBH] are crucial to our local development. For example, last year [2017], the DAK fund was cut and affected the local development performance. Sub-national government having that much of cut, we could not cover it. Finally, we had to revise in the middle of the fiscal budget year, you can imagine we depend on 95 per cent on transfers, but then in the middle of the year, it got a revision. So, the Regency of Sambas were cut a dozen per cent. If we want to maintain the development activities, we need to find a solution to cover it, but we do not have the money. So, we had to eliminate several projects. (LG1)

CG7 said that the rigid regulations in utilising DAK funds are meant to discipline the sub-national governments. The central government expected sub-national governments to become more effective in planning projects and to complete their projects promptly. Nevertheless, CG7 realised that this performance-based tied grants mechanism is still new. Hence, sub-national governments need more time to adapt.

Meanwhile, LG15 suggested that the central government should differentiate reporting requirements for transfer purposes between archipelagic and non-archipelagic regions. LG15 noted some difficulties for archipelagic regions in complying with the *DAK Fisik* reporting requirements. LG14 also mentioned the difficulties his sub-national government has faced due to the obligation to utilise an e-catalogue system for medicine procurements.

We are constrained, in the context perhaps we have a different type of area, we are archipelagic sub-national government, sir. We have several roads to do within an area, but the national roads have not even go through the place either, there are still bridge that we need to go pass. Moreover, we do not work only in one big land. There are also others on other islands. Then, we have a supplier, and for example, the technology is not as advanced as in Java, we only have one hot-mix HMB, which means we have to wait. For example, road works at North Seram, really far away 200 kilos, 550 kilos, it is not the same. In Java, each area must have one of the machines. So, with this kind of disbursement stages arrangement, for us, it is a little bit too imposing. We do not have a problem with the procurement tender. Praise to God, we do the planning in the previous year. Here is different from Java, when it rains, it hefty rains, when it tide waves, it is extreme tide waves. Not mentioning DAK project in the mountains area. I have projects that are delayed, sir. When it approached the end of the year, the work became piled up a lot. The supplier that has a hot-mix machine, only one company, and it was broken, so we could not... We had to order another one from Ambon, but from there it was not just simply bring the machine here, they need to get across the strait first, and the machine, it is not small, it is huge. (LG15)

This BOK [Health Operational Subsidy] is for medicine procurements, sir. You can imagine e-catalogue for Community Health Centre that does not have procurement services. The location is far away, some are 6 hours journey, some 12 hours, and some need 5 hours, while they do not have any knowledge of e-catalogue. How would they execute the procurements? Moreover, how can they be timely manner? (LG14)

C. The Technical Guidelines Should Be Asymmetric Not Generalised

Another rigid requirement that constrained sub-national governments is the technical guidelines in utilising DAK. LG1 described a case in 2016 in which the sub-national government was allocated childbirth insurance, but could only utilise 20 per cent of the fund because the technical guidelines stipulated that the fund could only be used for poor people who gave birth at the Community Health Centre located in each sub-district. LG1 explained that the local geographical conditions make it hard for the villagers to travel to the nearest sub-district. Therefore, childbirth was often in a village's Health Unit, which was a subordinate unit of the Community Health Centre. The consequences were that the sub-national government could not utilise the funds and the poor people had to pay for the service. LG2 expressed similar concerns about the mismatch between central government-issued technical guidelines and sub-national governments' needs. Meanwhile, LG3 disclosed that the obligation to use the nationally-provided e-catalogue for all procurements using DAK and the late release of the technical guidelines, are also factors that prevent sub-national governments spending DAK optimally.

Well, how could, the Local Health Agency did not execute the programme because the technical guidelines did not permit it. At one end, the Ministry of Finance wants us to execute as soon as possible, but when we want to execute, the technical guidelines did not include our needs, which made our programme ineligible. (LG2)

Nevertheless, on the other hand, sometimes sub-national government had difficulties in spending DAK because of unanticipated circumstances from the central government. For example, the technical guidelines allow us to buy an operational car, but there was no such item in the e-catalogue. So, how could we spend the fund? Another example, in the education sector, the technical guidelines had only been released at mid-year, and the sub-national government received it two months later. Then, how could we execute the programme and spend it optimally? This sometimes made the trend of spending increase high at the end of the year. So, it was not only the sub-national government performance issue, but there was also the central government's share on the matter. (LG3)

LG24 mentioned another example of spending limited by the technical guidelines. Provinces that are developed have different needs to those which are still underdeveloped. LG24 gave the example of her province needing to provide more advanced Health Community Centres while the technical guidelines only provide for basic medical facilities, which were more compatible with a province like Papua.

LG10 pointed to two cases. The first was in the Municipality of Padang Panjang, where the sub-national government was allocated DAK to rehabilitate junior high school buildings; however, under the technical guidelines, there was no junior high school in the municipality that matched the criteria to be rehabilitated. The second case in that province involved the Local Department of Energy and Mineral Resources. It had a micro hydro-electricity generator project that could not be executed because the technical guidance stipulated that the generator must be handed over to the community. The problem was that the guidance did not mention a specific formal entity in the community. Meanwhile, the sub-national government cannot just grant an asset to a non-formal entity because there are responsibilities as a consequence of owning the asset. The provincial government considered handing over the asset to the regency government, but the technical guidelines stated that the hand-over mechanism was through the grant, which, according to another regulation, the provincial government can only give to a non-government institution.

LG1 and LG24 suggested that the central government should not make a generalised list of items in the technical guidelines. LG1 admitted that the central government is

always asking for suggestions from sub-national governments, but, in the end, it would only make a single technical guideline that was generalised to the situation of sub-national governments.

For DAK, we always restricted to technical guidelines. We did give inputs, every time the technical guidelines were prepared, BAPPEDA was always invited to give inputs at the ministry. We gave relevant inputs, and so do the others, but the technical guidelines of DAK is a generalisation for the whole regions, not specifically made based on each region's condition. For example, *DAK Non-Fisik* for Child Birth Insurance. The payment can be covered if it was done in the Community Health Facility Centre [*Puskesmas*], but it did not apply for Village Health Posts [*Poskesdes*]. It is weird. With our geographical condition, we have hundreds of *Poskesdes*. The technical guidelines should include it. It is still a part of *Puskesmas* networking. Our sub-districts are far away, sir. If one sub-districts consist of one *Puskesmas*, then the distance from villages are far away, they would opt to have birth at *Poskesdes*. In the end, those poor people had to pay sir. I evaluated in 2016, only 20 per cent of the fund was utilised. (LG1)

There were some practical difficulties in the field. The technical guidelines, firstly, for some of the sectors, the establishment came a bit late. Secondly, probably, there were technical guidelines that did not match the sub-national government's geographical condition. Thirdly, its execution mechanism in the technical guidelines does not have clear goals. For example, I was evaluating the budget of the Municipality of Padang Panjang. Its DAK was not executed. Why? Because the activity was for junior high school buildings, meanwhile there were no junior high school buildings that need to rehabilitate. (LG10)

There were *DAK Fisik* used for health equipment, for building's rehabilitation, to build new ones. The colleagues want that the rehabilitation of buildings is not just a simple one, because each sub-national governments have specific conditions, for example, in Papua even the simplest facilities they might not have yet, but for us in Java, probably the simple health facility is already established. We need more advanced. We do not mind being directed. It is safer, but please do not lock the requirement. It would be better if it mentioned that the minimum rehabilitation project should be this way or that way. (LG24)

7.5 Bureaucracy and Central-Minded Law Hamper Local Revenue Collections

CG5 and CG6 said that fiscal dependence is inevitable, so the central government's objective is to reduce it, not to eliminate it. Therefore, the tax ratio has been set as one of the fiscal management performance indicators. Even though the current laws set limitations by creating closed list tax assignments, CG5 and CG11 believed that most

sub-national governments have not reached their full potential in generating local own-source revenues.

CG3 related that the essence of sub-national government tax assignment is to target revenue sources that are not moving, so the government can quickly identify the origin of those revenue sources, and that the beneficiaries of tax payments are the local people. CG6 highlighted the assignment of Urban and Rural sector property taxes (PBB P2)⁴⁸ as an essential central government effort to improve local taxing power. CG6 added that the central government would also plan to further assign the mining, forestry and farming sector property taxes (PBB P3).

However, LG2 mentioned a gap in the current Law No. 28/2009 on Sub-national government Tax and User Charge Fees, which she hoped could be revised as soon as possible.

We have waited for quite long for the central government to revise Law Number 28, especially for Property Ownership Transfer Tax [BPHTB]. The Regent of Sambas has many options to collect it, but since BPHTB was assigned as a local tax and the law said that the minimum taxable transaction was IDR 60 million, we could not get anything. Only large municipalities like Jakarta that can optimise BPHTB assignment because the price of the property at underdeveloped regions were still low. Previously when it was still central government tax, the Central Tax Unit put IDR 10 million and IDR 16 million as the taxable transaction amount. So, it was hilarious when it BPHTB assigned to sub-national governments; the number was increasing because it took large municipalities point of view and then became generalised in the law. (LG2)

LG13 and LG16 said the assignment of property taxes in the Urban and Rural sectors (PBB P2) has not been able to leverage local own-source revenue significantly either. The low price of property in their region results in insignificant property tax collection. Moreover, the operational costs to reach remote areas to make appraisals and tax collections are too high.

Additionally, LG14 identified bureaucratic ‘red tape’, line ministries’ collection in sub-national governments’ potential area of revenues, and the use of the e-catalogue for DAK procurement as factors hampering sub-national government revenue

⁴⁸ Property tax is categorised into five sectors: Urban, Rural, Mining, Forestry and Farm. The Urban and Rural sectors are assigned as local government revenue. Even though the remaining three sectors are shared through IGFTs, they are categorised as central government revenue.

optimisation. LG14 reported that before sub-national governments could collect taxes and charges fees, they must stipulate a relevant sub-national government regulation (*Perda*) as the legal basis and it must be approved by the Minister of Home Affairs and the Minister of Finance. That approval process takes an inordinate amount of time. LG14 revealed that their draft of *Perda* was lodged seven months earlier and remained at the Ministry of Home Affairs with no decision; consequently, they were missing many potential taxes and user fees.

LG14 and LG16 highlighted parking fees at the harbour; these are collected by the Ministry of Transportation, which categorise them as a Non-Tax State Revenue (PNBP). They questioned why the central government collects these fees because, in an archipelagic region like theirs, harbours are critical areas with high potential for their sub-national government to collect infringement fees. They argued that the revenue would create a more significant benefit if the sub-national government collected it.

LG14 also argued that the obligation to use an e-catalogue for DAK procurement reduces local people's chance to benefit from the government's procurement projects, which eventually reduces the sub-national government's potential revenue sharing from income tax.

Now, we already worked hard with the local council, five sub-national government's regulation had been discussed to help boost sub-national government's revenue, like advertisement tax, then parking and environment tax, it has been seven months stayed in the Ministry of Home Affairs and Ministry of Finance. How could this? We were trying to increase local own-source revenue, sir. We had gone through hard work discussing it at the local level, seven months of consultation, went back and forth, spend much money, but the response was yeah later, the minister has not signed it yet. (LG14)

Central Government may collect revenue at the regions, but they should consider the sources, here, transportation, for example, they collect it but never gave us. Meanwhile, it is a significant revenue potential for us, especially the marine sector sir. We have seven PELNI⁴⁹ ports, but the central government takes all. Financial resource, the terminal is taken, parking, low-middle businesses, for marine business licence also, transport every day is collected. What about us? You can imagine, sir,

⁴⁹ PELNI is a state-owned company dealing with sea transportation as its core business.

millions of people go back and forth because three regencies' services are going through our regency. (LG14)

Then, the procurement system, for example, e-catalogue, the supplier companies are not based in this region, directly from Jakarta, which leaves us without any tax revenue. No local tax received, we also do not get the employments. If we at the local region are to be responsible, why don't we give the opportunity to local chemists for the medicine procurement? The money will be spent here anyway. If there are too many margins, the money will only be circulated among the local people again. (LG14)

7.6 Chapter Conclusion

Early fiscal decentralisation practice in Indonesia provided massive fiscal transfers to match the 'big bang' devolution of functions and responsibilities to sub-national government. The choice to focus on expenditure assignment rather than revenue assignment was made simply because sub-national governments needed immediate fiscal support to execute the devolved functions. Moreover, it was a time of transition, when many sub-national governments did not have any experience or qualified human resources to collect and administer local revenues from major sources.

In 2009, the central government classified fees on land and building acquisition rights (BPHTB) and land and building property taxes (PBB) for the Urban and Rural sector as regency and municipality local taxes. This was expected to boost sub-national government revenue. However, the law failed to recognise the extreme regional disparities in Indonesia. The law had set out a tax base that is unrealistic for many sub-national governments.

High fiscal disparity, along with economic and development inequality, was the main factor that convinced the central government to continue its expenditure assignment approach by expanding the types and increasing the amount of IGFTs. The Ministry of Finance, through the Directorate General of Fiscal Balance, is the institution that allocates IGFTs in Indonesia, using a formula-based calculation. There is no room for sub-national governments to negotiate the amount, not even the parliamentary members that represent local constituents.

The new proposal-based DAK allocation mechanism, as explained in Chapter 4, does not necessarily provide a tool for sub-national governments to negotiate with the

central government; it simply provides better knowledge of sub-national governments' priorities and reduces misallocation of DAK funds – which, according to the interviews, often happens due to invalid data being used in the calculation. Proposals from sub-national governments are not taken for granted. They are reviewed by a central government task force that comprises several sectoral line ministries and, obviously, the Ministry of Finance. Moreover, due to limited total allocation of DAK, the Ministry of Finance still uses a calculation formula in determining the sectoral DAK amount for each sub-national government. Therefore, sub-national governments' new role in the DAK allocation process is limited to preparing and submitting the proposal; otherwise they are not included in the process.

The data from 2004 to 2006 show the proportion of block grants over total IGFTs slightly increasing. In 2004, the proportion was 91.6 per cent, and in 2006 it hit 93.1 per cent. Then it began to decrease, from 89.9 per cent in 2007 to the most recent data for 2018, when it accounted for only 65.2 per cent. So, in the early years of fiscal decentralisation the central government provided more block grants, up to 93.1 per cent of total IGFTs compared to just 6.9 per cent for tied grants. Then a trend of declining block grants emerged, down to 65.2 per cent in 2018 compared to 34.8 per cent for tied grants.

Hence, the policy concerning which type of grants to transfer and how to utilise those IGFT funds has changed. The central government concluded that allowing greater discretion did not ultimately produce better outcomes. It considered that most sub-national governments did not perform as well as expected. Scholars and experts may conclude that Indonesia has been successful in the transition to a high level of decentralisation through its 'big bang' approach instead of sequencing the process; however, it seems that it is not enough to reach the level that has been aspired to since the early implementation of decentralisation.

The central government saw the importance of making an immediate transformation in its fiscal decentralisation policy. Several new regulations came into effect without revising Law No. 33/2004. The new policies do suggest that the central government wants sub-national governments to perform well and produce good outcomes. In 2010, the central government introduced the Local Incentives Fund (DID), a kind of performance-based fiscal incentive that aimed to stimulate sub-national governments'

performance. Then, from 2015, the central government delivered more policies to improve fiscal decentralisation outcomes by directing sub-national governments on how and where to allocate and spend their budget. Increases in tied grants allocations, *DAK Fisik* proposal-based allocation, rigid reporting requirements in *DAK Fisik* transfer mechanism, a floating DAU allocation, and even the uncommon practice of ‘earmarking’ block grants, were the policies that it believed would produce good outcomes from sub-national governments.

As we know from the literature, there are two ways of improving outcomes from sub-national governments suggested in the second generation of fiscal federalism theory. The first is the use of performance-based fiscal incentives to stimulate better performance. We have already analysed and discussed the Indonesian experience with introducing DID since 2010 in the previous chapter. The second method is controlling spending and limiting budget flexibility through increased use of tied grants. The Canadian federal government introduced social transfers with an expectation that the provincial governments would have a jointly agreed set of performance indicators with the federal government, especially for health sector performance. As another example, China’s policy to change the central–sub-national government fiscal relations structure involved reinstating central government fiscal power. The central government still allocates an enormous amount of its budget as IGFTs, but it can now drive sub-national governments’ spending through increased tied grants transfers to fund infrastructure and social projects.

Meanwhile, Indonesia’s IGFT policy since 2015 indicates that it intends to be more directive by increasing its use of tied grants. The Indonesian government even created a ‘grey area’ in its block grants, which are supposed to be discretionary funds, by placing some conditionality and classifying them as ‘an earmarked block grant’. It is interesting to see that the Indonesian fiscal decentralisation practice implements both methods.

Looking at the numbers, the increased use of tied grants has not increased the total amount above the block grants component of total IGFTs. In 2018, the proportions of tied grants and block grants were 38.4 per cent and 65.2 per cent of total IGFTs respectively. Nevertheless, if we compare the proportion of IGFTs to total sub-national government revenue, 69.2 per cent sub-national government revenue comprises

IGFTs, of which 45.1 per cent are block grants. Moreover, we should bear in mind that there is a 25 per cent ‘earmarking’ requirement that reduces the 45.1 per cent allocated as block grants. Then, there is also an obligation for sub-national governments to allocate a further 10 per cent of their block grants as additional Village Funds. These facts raise the question of whether applying performance-based grants is still relevant in the context of sub-national governments having limited discretion.

The answer will undoubtedly be ‘no’ if the lack of fiscal discretion affects all sub-national governments. Those proportion numbers are the national average; due to fiscal disparity, there are sub-national governments that have a lower dependency on IGFTs, which means their local own-source revenue is dominant. According to the researcher’s data, in 2017 there were 13 province, regency or municipality governments that had local own-source revenue forming more than 50 per cent of total sub-national government revenue. Dominant local own-source revenue creates a higher level of fiscal space or discretion. Hence, the performance-based grants would still be relevant for this type of sub-national government.

The interview findings provide a sense of perspective on how to approach the fiscal decentralisation system to better acknowledge the high level of fiscal, economic, development, human resources and geographical disparity across 542 sub-national governments. Instead of imposing both methods on all sub-national governments regardless of their circumstances, the central government could adopt an asymmetric approach for different sub-national governments. So, performance-based grants are suited to those that have high fiscal discretion, while the limited flexibility method is optimal for all other sub-national governments. However, the classification could be expanded based on an interesting observation from the results of the *Dana Rakca* Award in late 2017. As previously discussed, this is an award for the three best performers in each cluster. Some provinces and regencies had a high dependency on IGFTs but, surprisingly, managed to beat more-fiscally autonomous sub-national governments to win the award. Therefore, it would seem the level of governance maturity should also be a consideration. The central government should switch the tied grants into block grants without any restrictions for sub-national governments that already demonstrate a high level of maturity.

Furthermore, it is apparent that there are several gaps in practising the limiting-flexibility policy that need to be addressed. First, the central government should consider setting asymmetric reporting requirements and technical guidelines in spending DAK, based on geographical conditions and development needs. Therefore, the assessment criteria to judge how well a sub-national government has performed would be based on each region's characteristics. An interview with a sub-national government official at the Regency of Central Moluccas revealed that it was difficult for them, as an archipelagic region, to comply with the central government's determined timeframe. Second, the central government should also improve its practice in developing operational regulations that will affect sub-national government fiscal management. The central government needs to establish effective communication with sub-national governments, so they can have an up-to-date and in-depth understanding of how the regulation works. Therefore, the central government's introduction of new regulations must give sub-national governments sufficient time to prepare to comply with the regulations.

8

STRUCTURAL ARRANGEMENTS AND TASKS ASSIGNMENT: ANALYSIS AND DISCUSSIONS ON THE EFFORT OF GETTING GOOD OUTCOMES

8.1 Chapter Preview

The ‘big bang’ decentralisation that began in Indonesia in 1998 reversed 32 years of centralised authoritarianism under Soeharto. We need to imagine the euphoria of the people who wanted equal rights in a democracy, equal access to sufficient public services, and development and economic equality at that time. That euphoria has influenced the face of Indonesian decentralisation, which was shown in Law No. 22/1999 on the autonomy of sub-national governments. The law was regarded as imperfect due to the limited length of time available to prepare it, but it has affected intergovernmental relations in Indonesia ever since. The decision to reach out directly to municipalities and regencies, bypassing the provinces, became the central issue each time the central government and national parliament wanted to revise the law – as has happened twice to date, with Law No. 23/2014 the current legal framework.

In between revisions, Indonesian sub-national governments have experienced the impact of each of the laws on sub-national government autonomy on their daily practice while delivering their devolved tasks and responsibilities. Therefore, this research included 24 semi-structured interviews with sub-national government officials, with structural arrangements and task assignments included as interview topics given their essential role in providing the base for the arrangement of IGFTs. The purpose was to assess the differing experiences of sub-national governments under each of the laws, specifically in relation to the effect those evolving arrangements had on sub-national government efforts to deliver good outcomes. This was complemented by 11 semi-structured interviews with central government officials from the Ministry of Finance to assess the impact of laws on sub-national government autonomy on the

design of IGFT policy, especially in regard to optimising sub-national government performance.

Based on the findings, the growing challenges for Indonesia's structural arrangement and task assignments began with the abolition of an explicit hierarchy between provinces and municipalities/regencies in Law No. 22/1999. Since then, the provinces have experienced difficulties in coordinating and establishing synergies with local governments within their respective jurisdictions. The promulgation of the new Law No. 23/2014 brought good news for the provinces, but unfortunately not for the regencies and municipalities. Complications arise which may need to be addressed asymmetrically. Furthermore, due to the term 'concurrent responsibilities' used in the law, the central government needs to work on the clarity of 'who's responsible for what', because there are gaps in the practice that are seen as a burden on sub-national governments. This chapter details the findings from the semi-structured interviews to provide a more in-depth discussion of structural arrangements and task assignment. After discussing Indonesia's fiscal decentralisation policy, specifically performance-based fiscal incentives and IGFTs policies, it is essential to consider the other side of the decentralisation coin — task assignment.

8.2 The Provincial Roles with Regard to Sub-National Governments

The country comparisons have shown us the importance of provinces, or other regional territorial governments, as the second level of decentralised governance. Canada, as a federal country, trusted its provinces or territories, acting as the state in a federal system, to manage and make decisions on development and public service delivery, including for lower-sub-national governments within their jurisdiction. China set up five levels of government, with each accountable to the next higher level. So, in its practice the central government held the provinces accountable for the outcomes produced by their lower-level governments. Spain created a new second-level government in the form of the autonomous communities, although some of these autonomous communities were upgraded single provinces rather than amalgamations of provinces. The Spanish central government placed more emphasis on empowering autonomous communities as pivotal institutions in fostering the success of its decentralisation practice. The intermediate level of governance is not only gradually

given more responsibility by the central government, but also delivers its lower sub-national governments' responsibilities if they cannot perform the tasks.

Meanwhile, the case seems to be different for Indonesian practice. Law No. 22/1999 abolished the hierarchy between province and municipality/regency. Law No. 32/2004 did not provide many changes other than redefining sub-national governments' areas of responsibilities. The current legislation, Law No. 23/2014, calls for more fundamental changes in the way provinces and municipalities or regencies relate. The intention was to empower provinces vis-à-vis municipalities and regencies. However, it still does not reinstate a formal hierarchical relationship.

Based on the interview findings, it turns out that there are different views about the issue of re-establishing provincial authority over municipalities and regencies: whether to explicitly reinstate the hierarchy or to just substantially re-engineer provincial functions and authorities to empower them without establishing a formal hierarchy. Furthermore, aside from the new law, some interviewees made suggestions for managing structural relations between the central government, the provincial governments and municipalities or regencies. Their views spanned the issues of control, efficiency, trust and political party differences.

8.2.1 Do Provinces Matter in Indonesia?

The practice of local autonomy that we see now in Indonesia is a consequence of political pressure. CG5 and CG6 reported that in the early reform era, there was a euphoria about decentralisation, and even demand to switch from a unitary to a federal state. Sub-national governments with enormous natural resources wanted to separate from the nation. To counter this problem, 'the policy was to keep unitary as the formal system with a taste of federalism in the substance'.

The philosophy at that time was a euphoria from highly centralised to become significantly decentralised, from a very authoritarian and become democratic. These euphoria bursts to the surface, which made a demand for federalism, to be honest, totally federal. There was also so many secessionist demands, especially from rich natural resources regions, which was completely overwhelming. Local autonomy was offered to address the situation at that time. The design of local autonomy was made in a way that it could still keep this country in one piece. So, there was more of political aspects that we held our fiscal decentralisation as is now. (CG6)

CG5 admitted that Law No. 22/1999 and its revision, Law No. 32/2004, had an impact on how municipalities and regencies related to their provinces. With no formal hierarchy, they often bypassed the province in consulting on their local budget plans and activities. LG21 added that line ministries likewise sometimes bypass the provinces in delivering their policies and implementing their programs.

The first two laws on Indonesian decentralisation were ‘considered too much’ and had created ‘little kings’, acting as local rulers who could do anything they wanted without considering the broader impact. LG17 said that decentralisation at the beginning of the reform period was a mistake because it gave authority directly to municipalities and regencies instead of strengthening the role of provinces. The consequence was the provinces’ inability to synchronise budget programs among local governments in their jurisdiction.

LG16 and LG17 said that different political party affiliations between the governor and the regents or mayors also triggered a lack of coordination. LG8 stated that in the early years of decentralisation, when the governance hierarchy was established under the law, the role of provinces as the central government representative in the region did not function properly due to the absence of hierarchical relations between provinces and municipalities/regencies. LG8 deplored the pre-reform system where the governor was no longer acknowledged as the head of the region and as a central government representative in the region. Meanwhile, LG6 said that lower-level sub-national governments’ autonomy was excessive: municipalities or regencies never discuss their plans, but come and ask for favours from the province when they have severe problems after implementing those plans.

As a result of that phenomenon, LG8 mentioned how hard it was for the governor to gather the regents and mayors to discuss and align strategic programs for the regions. When the governor holds a meeting, some municipalities and regencies within the governor’s region only send middle-rank officials who cannot directly make crucial decisions. LG17 mentioned that the reason regents and mayors were reluctant to meet and coordinate with the governor was that they came from different political parties.

I think the decentralisation policy at the beginning of the reform period had been mistakenly implemented. Directly to municipalities and regencies. It supposed to strengthen provinces, like the practice in other countries. Nevertheless, because the

political euphoria among us was everyone wanted to become ‘little kings’ at their municipality or regency. Provinces are the ones who should be strengthened, the authorities for – here, gratefully we do not experience it at East Java Province, but if we look at others, it often happened, a regent or mayor who refused to attend meetings with the governor. Because of what? They come from a different political party. However, if we viewed sub-national governments, the programs from the central government up to municipalities and regencies must be harmonised. (LG17)

It really should be at the provincial level. Because in the past, when the 1998 reform era started, local autonomy was meant to become ‘little kings’. Before [the reform era], the role of governor was strong. Now, we need to strengthen its power back to control municipalities and regencies. The autonomy was too much. When they [municipalities and regencies] had problems, then they went to the governor. (LG6)

All this while, the mandate was the governor as the head of the region, as well as the central government’s representative in the region, with the old laws, it did not work out. For example, when the governor held a coordination meeting, even though it was important, some regencies only come with its head of agency, not the regent himself. (LG8)

LG8 and LG10 emphasised the importance of coordination between the province and municipalities or regencies, as it could achieve greater synergy in delivering good outcomes. Moreover, the governor would be aware of mayors’ or regents’ problems so that he could offer appropriate provincial assistance.

Coordination meeting is important so the governor knows what the problems that are burdening municipalities and regencies, what has or has not been achieved, and how could the province provide assistance. If it needs fund resources, perhaps the province and the municipality could financially share a program. (LG8)

The province does not actually have territories. Provincial territories are regencies and municipalities. So, how to make their Middle-Term Development Plan in accordance with the province. Even though the effort has been made, but because they felt they have the autonomy, the budget allocation was not always in line with central and provincial government’s priorities. (LG10)

LG22 mentioned an example of the importance of connecting with the province first, before executing the central government’s agenda in a municipality or regency. In this recent experience, the Ministry of Health tried to intervene directly – via the local government – in a health program to reduce the percentage of children with stunting problems, without coordinating and consulting with the province. As a result, the program was executed by the wrong local government because the ministry was using

out-of-date information. The local government, Nganjuk Regency, did have a problem with stunting levels, but that data was from 2013. Meanwhile, according to the province's most recent data, the intervention should have been directed at Madura Island.

Like I said earlier, about the lousy stunting level at the Regency of Nganjuk, which turns out the central government used the data in 2013. Recent condition, the region with bad stunting level is Madura. Meanwhile, Nganjuk is already good, so why the intervention program came to Nganjuk? This is why [the central government] needs to keep update to the province. It is a must. (LG22)

8.2.2 Substantial Empowerment Instead of Re-establishing Formal Hierarchy

CG2 suggested that it is hard for the central government to control 542 sub-national governments adequately. Hierarchical control needs to be established by revitalising the role of the provinces. Moreover, CG1 understands that the closest government level must provide public services to the people. Still, it has to be arranged efficiently. The central government needs to use provinces as a hub, letting them connect with, direct and control municipalities and regencies, while the central government only directly relates to and controls the provinces.

Yes, I understand that public services should be provided from the lowest sub-national governments. It may even not only from municipalities and regencies but from villages instead. However, the problem is with the structural relationship arrangements. The central government should connect to the provinces, and the municipalities and regencies connect with the provinces. So, the provinces become a hub. I agree that we [the central government] does not have to control too deep. Just the provinces. Then, provinces will control municipalities and regencies. (CG1)

Actually, our decentralisation is too extensive, directly connects with and controls 542 sub-national governments. Too many differences among them, which made it hard to harmonise development programs. I do not care, either make regional institution or stay with provinces. The point is, do not connect directly to all 542 sub-national governments. (CG2)

CG1 and CG2 even suggested that the provinces also be given authority regarding fiscal resources allocation. CG1 argued that if the central government wants to make graduated relationship between tiers of government, it also needs to give provinces the authority to allocate fiscal transfers to municipalities and regencies. Meanwhile, CG2 pointed out an example of the practice of School Operational Subsidy (BOS) transfer

mechanism changes as evidence that an efficient and effective control over sub-national governments is needed. The BOS fund was previously transferred to municipalities and regencies before being sent to schools, but this was changed to direct the funds through provinces and directly went to schools without including municipalities and regencies in the process. The reason for the change was that the previous mechanism was ineffective. There were cases of misuse of the funds, such as funds being kept untransferred in the municipality's or regency's account. So, it was re-routed through the provinces to improve central government control.

The problem now is that municipalities and regencies are controlled by the provinces and also by the central government. Fiscal resources are still from the central government. If we want to make such kind of arrangement, then let the provinces allocate the fiscal transfers for municipalities and regencies. (CG1)

Like BOS, eventually, the transfer mechanism was from provinces directly to schools, without the involvement of municipalities and regencies. Why? Because it was ineffective when previously municipalities and regencies were given the mandate to transfer the fund to schools. There were cases where the fund was being held at municipality's or regency's account. (CG2)

LG16 was not against the idea of re-establishing the hierarchy between the provinces and the municipalities/regencies. However, LG16 emphasised that the hierarchy must be such that the province will always involve municipalities and regencies in making policy, and ask for advice from the mayors or regents. LG16 mentioned as one challenge the fact that the province lacks knowledge about local people's needs.

Moreover, the provinces tend to impose their own programs rather than trying to build synergy with municipalities and regencies. LG14 said the governor is more concerned with the provincial council's aspirations than the voice of municipalities and regencies. LG14 did not mention the potentially disruptive effect of different political party backgrounds on the working relationship between the governor and the mayors or regents, as identified by LG16 and LG17.

The synchronisation between central, provincial, and regency or municipality for example. Between central and regency is quite good. Nevertheless, province, they did not care about us. They only care about the provincial legislature's voices. Meanwhile, the decision about indicators that had to be resolved quickly. We felt burdened by the process. There has to be a limitation that they cannot interfere too deep, such as

deciding on criteria. They could but must be according to certain conditions, otherwise, let it just be our [regency] authority. (LG14)

So, there is still has to be a communication process in the hierarchy. Even though it is provincial authorities, they should still ask for a technical recommendation or something like that. I do not think that is difficult, just so the regent got notice. Thus, the hierarchy between regent and governor to the central government can have mutual respect. (LG16)

In contrast, CG6, CG8 and CG9 considered that the central government should keep the current structural arrangement because municipality and regency governments are closer to the people who receive public services. CG9 believed that the essence of autonomy rests with municipalities and regencies, not provinces. The central government needs to link directly to them. CG6 and CG9 agreed that the role of the provinces needs to be revitalised, but only to act as a coordinator, not an upper layer that will decide public policies for the municipalities and regencies.

Moreover, CG6 and CG8 thought that, ideally, the granting of autonomy should be extended to villages because they are closest to the people. However, in the context of Indonesia – with its more than 75,000 villages – this would be too difficult for the central government to administer. Therefore, the central government decided to assign regencies the role of controlling and evaluating village programs. Since the central government must make sure all sub-national governments perform well, CG6 was not convinced that using the provinces as a hub in relationships with municipalities and regencies would be a good idea.

Well, the provinces are, as you said, need to be more empowered, we strengthen their roles. However, it does not necessarily mean that they will become the layer, which will decide the direction of the municipality's or regency's policies. We still want them to be the coordinator of municipalities and regencies, but not to take away the autonomy authority of municipalities and regencies. We only want to make the provincial roles much clearer, because previously there were concerns about it. They were said as having 'the hat' of the central government, as the representatives in the regions, but they did not have authorities nor the money. That is why Law No. 23 designed to strengthen provinces. However, it does not make the provinces to represent municipalities and regencies. (CG6)

Yeah, well the core place of autonomy is at the regency, isn't it? That is why we transferred directly to them. Then, there is also the reinforcement of governor as the representative of the central government in the region. So, the law is meant more to supervise local governance and to supervise the execution of deconcentration at the

municipality or regency level. Nothing to do with fiscal transfers authority. So, the transfers, other than to the provinces, still go directly to municipalities and regencies. It is simply because the core of fiscal decentralisation is at the municipality or regency level. (CG9)

8.3 Burdening Sub-National Governments to Cover Central Government Responsibilities

The interview findings also captured the imposition of improper responsibilities, in relation to the law about sub-national government, between the national and sub-national governments. The task assignments are not implemented as intended because sub-national governments still have to fund the central government's tasks. LG14 mentioned an issue in the public health sector. Responsibility for providing doctors and medical staff for sub-national government health facilities lies with the central government. However, from 33 first-level health facilities in his municipality, the central government provided doctors for only ten of them. As a consequence, the municipality then tried to cover the remaining cost using their funds, which LG14 argued unfairly burdened their budget. This was not their authority, nor their obligation, but if they do not do it they will not be able to perform well in providing public services in the health sector.

Medical doctors are the task of the central government, providing medical doctors, either those with civil servant status or non-permanent status. Here, we have 33 first-level medical centres, from which only ten are provided with doctors. Then, what should we do? While the people are demanding, saying we, the regency government did not perform. So, we have to hire doctors too, 27 doctors, and pay them with the incentive equal to the central government regulation. You can imagine there is so much money for that. We do receive Health Operational Subsidy, but the fund is to cover services, not the salary and other incentives for the doctors. (LG14)

LG14 drew attention to the awkwardness of the new requirement for sub-national governments to give half of their revenue from the cigarette tax, and almost half of their cigarette excise shared revenue, to fund the central government's national health care program, run by a central government body. LG22 reported that, previously, sub-national governments used the funds to revitalise local health facilities and for preventive public health programs to educate the people. Now, they must also use the fund for medical services that were the central government's responsibility through BPJS. LG14 said that wealthy sub-national governments might not have any problem

coping with this regulation, so if the central government wants to implement it, it needs to do so in an asymmetric way. Meanwhile, LG22 suggested that since the sub-national governments' funds are being used to close the deficit in BPJS because of delayed premium payments by the people, the central government should consider the details concerning where those delayed payments exist. Thus, each sub-national government would only have to cover the delayed premiums of their local people.

I think there is an anomaly with the policy. Now, like cigarette tax, 70 per cent of it was usually used for preventive programs, but why do the central government want us to use it to pay for health insurance [BPJS] contribution arrears. Conceptually it is an anomaly, 75 per cent of the cigarette tax that supposed to be used for public health programs, which is for prevention, now being asked to be used for personal health problems, which is only for curative, not for preventive programs anymore according to facts. I think it is a big mistake, assume that we get 100, but then because of BPJS contribution arrears, we are being asked that 75 per cent of our cigarette tax be used to pay for those arrears. Not based on who and where are those arrears coming from? It should be calculated first, the people from which region that have arrears, not all regions have to cover for the lack of BPJS fund. (LG22)

8.4 Benefits and Challenges of the New Law No. 23/2014

The development of Law No. 23/2014, which aims at strengthening provincial government functions and responsibilities over regencies and municipalities, apparently failed to consider efficiency. The interviews captured several complications arising from the new functional arrangement between provinces and regencies/municipalities.

8.4.1 More Coordinated but Ambiguous

The central government, through Law No. 23/2014, has attempted to make the provincial role more clear and effective. LG8, LG20 and LG22 shared favourable views of Law No. 23/2014. They thought the law could work to bind municipalities and regencies to their provinces. LG20 mentioned that some articles in the law do strengthen provincial authority over municipalities and regencies. LG22 added that those articles had addressed the previous 'little kings' phenomenon and redirected autonomy to the provinces. LG8 and LG20 recounted that while the provincial government where they worked could coordinate with municipalities and regencies

within its jurisdiction before the new law was passed, its effectiveness was greater after the law was established.

With the promulgation of the current Law No. 23, there is a link between municipality's or regency's needs towards the province. Like it or not, the law bound it. DAK proposal has to go through the province first, unlike previous practice that went directly to the central government. So, we do feel that this Law No. 23 make province to have more power over the municipalities and regencies. Even though each of us has the autonomy, but it is a coordinated autonomy between municipality or regency and the province. (LG8)

So, firstly it adds more workload for the province, but the impact is that we have more authority. I think this Law No. 23 is more apparent in terms of division of authority, and the law contains many regulations that placed the province higher than municipality and regency. It means that in every strategic policy decision-making, like planning documents, for example, it must go through the province first, and there will be punishment for those who disobey. Previously, there was coordination [between province and municipality/regency], but less intense. For example, we have never been able to do the municipalities' and regencies' source of revenue mapping, which was supposed to be reported to us, the province. (LG20)

For now, what we feel is that autonomy that was based on Law No. 22 of 1999's emphasis on municipality and regency created 'little kings', but now with Law No. 23, [authority] seems to be retracted to the province. (LG22)

CG1, however, was opposed to this view. CG1 argued that the current substantial empowerment of provinces, without an explicit and formal hierarchy, would only make intergovernmental relations ambiguous. CG1 pointed out that the current structural arrangement in Law No. 23/2014 is an example of ambiguous relations between municipality or regency and province. On the one hand, municipalities and provinces are, legally, still considered equal to provinces, but on the other hand the provinces have an authority that makes them superior to municipalities.

I think the current relationship is still ambiguous. At one side, municipalities and regencies are structurally equal with provinces, but on the other side, provinces are being positioned as if they are higher than municipalities and regencies. (CG1)

8.4.2 Taking Away Municipalities' and Regencies' Functions to Strengthen Provincial Governments' Role Brings Complication

CG2 and CG5 mentioned that Law No. 23/2014 seeks to strengthen the provinces by reclaiming municipalities' and regencies' functions. However, according to CG2, it

has not yet been made clear how it established greater authority of the provinces as coordinator for sub-national governments. LG14 also questioned Law No. 23/2014, which he considered awkward. LG14 drew attention to the contradictory logic whereby, on the one hand, the central government wants to push autonomy lower by empowering villages, while on the other hand it shifted regency and municipal functions and authorities to the province.

Yeah, the fiscal relations cannot be separated from the institutional arrangement, the situation now, it is true that regency and municipality are still structurally equal with province. Even though in [Law No.] 23 mentioned about increasing provincial roles, but in relations to regency and municipality on how province can be a coordinator does not have a clear map yet. (CG2)

Why we empower villages, but took away regency's authorities? This is awkward. We supposed to strengthen the regency, not the province, when we wanted to empower villages. (LG14)

Several findings revealed that this new task assignment also created new challenges, including inefficiency, misalignment of tasks giving rise to problems of accountability, and ensuring adequate power was given to strengthen the provincial government role.

A. Inefficiency Problem and the Absence of Asymmetric Treatment

The new functional arrangement has been criticised for creating inefficiencies. CG1 mentioned that it returns some of the functions and authorities from the municipalities and regencies to the provinces without considering the ease of coordination and consultation, which, in the end, affects public services. LG5 confirmed this when he recounted that road projects in 2017 were delayed in the first period because, according to new regulations stated in Law No. 23/2014, the exploitation of mining and mineral resources requires approval from the province. So, LG5 had to submit the request to the province and wait for approval before the contractor could start using mining and mineral products needed for the road building.

In another example, LG14 highlighted the abolition of municipalities' and regencies' authority at sea to the four-mile limit. The new law transferred that authority to the provincial government. LG14 pointed out that 95 per cent of the local people in his regency live in the foreshore area and are dependent on the sea. The abolition made the regency's government useless for most of the local people. Previous laws already limited their potential source of revenue from the existence of seaports, and now the

current law wholly eliminated it. This is not to mention that the bureaucratic chain to get approval for ships to catch fish gets longer, similar to the road project example mentioned by LG5.

I think not all things become better after the Law No. 23 was promulgated. It is not better in terms of efficiency. For example, the taking of forestry functions, which I think the authorities need to be shared, what becomes province's and what stays at municipalities and regencies. Similar problem with transportation, farmer's trainer, all authorities take over by the province, which made it inefficient. The bureaucracy chain is too long. (CG1)

In the era of autonomy, sub-national governments are encouraged to optimise their local source of revenue. However, our regency, which is archipelagic, has many potential sources of revenue but instead being managed by the central government. Sea transportation port, for example, the central government built the port, but then the charges fees for shops and parking lot, also collected by the central government. It made us, as an archipelagic regency, no longer able to improve revenue to take advantage of our geographical potentials. Moreover, now even more hilarious, the function of the fishery, for example, we are archipelagic regency, our future lies on the sea, but how come all authorities are being pulled out from the regency? Which forced us to apply for approval from the province if our 5 to 10 GT [local-size ships] want to go to the sea to catch fish. (LG14)

LG14 and LG16 suggested an asymmetric approach in assigning functions and authorities between provinces and regencies/municipalities. They thought that the new provincial task assignments have created a lengthy chain of command for archipelagic regions. The consequence is not only time-consuming bureaucracy but also an inefficient use of local budgets. They added that while some provinces are connected to a single mainland area, others are archipelagic which creates a high-cost bureaucratic process for providing public services. They argued that authority and task assignments should be selective, depending on each province's geographical situation. LG14 believed that the lack of coordination between the provinces and their municipalities or regencies should not be the basis for consideration in rearranging several sub-national governments' authorities and tasks to the provinces.

LG16 suggested that the province should not have too many departments. The province should institute a department that consists of the line ministries' representatives in the region, with that department's task being to harmonise and assist sub-national governments with their programs and budget planning. Let the

municipalities and regencies plan and execute programs while the province focuses on providing training, capacity-building and assistance for municipalities and regencies. In this way, municipalities and regencies would not have to send their employees to distant central government training and workshops, or to the central government offices for consultations, which would also help conserve their budget.

LG16 even asked why provinces have local own-source revenue. LG16 reflected that the Law No. 23/2014 tends to strengthen provincial authorities and assert their role as the central government's regional representatives, so that now sub-national governments must consult with the provinces on their activities to. Therefore, LG16 said, the division of local own-source revenue between provinces and regencies is no longer relevant due to the province, in his view, not being a sub-national government anymore.

The province authority, sir, its span of control is too wide for an archipelagic region like us. It is all right but we need to consider the geographical characteristics. Then, secondly, the span of public services is too far, licensing services becomes far; the government's agency also far. Thus, they will have to form new technical units at the regency. Recruiting staff, providing offices, equipment procurements, meanwhile we already have it. Who do you think is closer to the people in suburbs, in villages – it is the regency. You can imagine the province at a far distance, how costly it would be for us. (LG14)

I think the province does not need to have too many departments because the execution is at the regency or municipality level. They do not need many departments, but the province can be the centre for education and training for sub-national government staff. So we do not have to go far away to Jakarta. Imagine, I can only send one person to attend a technical assistance workshop. Instead I can send five people if it is located in the province. So, place the province as the regional centre for education, training, all training centres are provided there. So, we can develop the region. So, the authorities are not blaming each other. (LG16)

Secondly, as I said just now, must provinces have local own-source revenue? That is my concern, if necessary those local taxes should be optimised for regencies and municipalities because I see the province as the representative of the central government. So, everything now the regent must coordinate with the governor. (LG16)

B. The Accountability Issue

Next, the accountability issue: which entity should be held accountable for the tasks that they perform? LG13 took the transfer mechanism of the School Operational

Subsidy (BOS) fund as an example. The fund was previously transferred directly to municipalities and regencies, but this was then changed and it is currently transferred via the provinces; however, the reporting obligation is still embedded in the municipalities' and regencies' financial statement. LG13 revealed how hard it is for them to report on this because they do not know how much and when funding has been transferred by the province to the schools. LG13 criticised this situation as absurd, since municipalities and regencies are held accountable for a program that they do not manage and operate. LG13 questioned the importance of giving many task assignments to the provinces through the new law. LG13 worried that this would eventually burden the municipalities' and regencies' accountability.

School Operational Subsidy [BOS] fund is transferred to the province. The financial reporting at regency and municipality. I think that is hilarious. The money is not us to manage, but if the accountability report went wrong, we got the punishment. We are so stressful in managing that sir. The fund is transferred to the province, but we are the one who has to work. We, here at the regency, forced to be accountable on something that we did not even know when has the fund been transferred. Why cannot just BOS fund transfer to regency and municipality? Do regency and municipality under capacity to transfer the fund to schools account? (LG13)

C. Does Current Addition to the Province Authorities Already Adequate?

The adequacy of the authority returned to the provinces has also been questioned. CG10 said that, if possible, the role of provinces should not be limited to coordination but should also include being indicator-synchronisers and harmonisers. Furthermore, the provinces should be given a greater role in managing, and even distributing, most fiscal resources to municipalities and regencies.

CG1 thought that if the central government wants to reduce the chain of control and create a two-tier hierarchy of sub-national governments, the ability to manage fiscal transfer funds to municipalities and regencies should also be delegated to the provinces. LG8, LG9, LG10 and LG20 also supported this concept. LG8 thought that the province is ready and able to deliver municipalities' and regencies' fiscal transfers. LG8 and LG9 said that this would give greater leverage to the provinces in bargaining with the municipalities and regencies. LG10 believed that it would give more power to the provinces in controlling municipalities' and regencies' budget planning and ensuring their development plans were harmonised with those of the province. LG20 described this as an ideal concept that would shortcut the lengthy chain of command

between the central government and the municipalities or regencies, and it could be used as a tool for the provinces to reward and punish municipalities and regencies.

For me, I agree with that [the simplification of control]. We [the central government] only connect to the province, later the province will connect and control municipalities and regencies. The problem now is that municipalities and regencies are controlled by the province and also by the central government. Sources of funds still coming from the central. If we want to implement that [central to province and province to municipalities/regencies control], all the funds should be from the province too. Afterwards, the funds for municipalities and regencies should be allocated by the province. (CG1)

So, we agree, I mean our provincial government is ready. I mean that transfer mechanism, we already practised it. Revenue sharing from province to municipalities and regencies, which we supervised the regulation, sir. I mean the regulation no more than two working days if the decree has been stipulated. We are like that. So will later, if there are transfer funds that become the rights of municipalities and regencies, it should be regulated how long would the fund be allowed to be kept in the provincial account. With this in practice, the governor can play their role. The governor has a bargaining position. (LG8)

In my opinion, it should be that way [central government transfers to provinces, province transfers to municipalities and regencies], because if the province does not have this kind of authority, we will not be appreciated. Because sir, the continuation of local development, between municipalities or regencies and the provinces, rarely have synergy. The Middle-Term Development Framework of regencies and municipalities often different from the province. With that authority [allocating and transferring IGFTs], the province can control [municipalities and regencies]. (LG9)

I think it would be better. Afterwards, municipalities and regencies funds are taken care of by the province. I honestly want that kind of assignment. Because firstly, we need to cut off the long chain from central to municipality and regency. Secondly, we will be more accurate in calculating our real budget potentials. Thirdly, it can become tools for the province to give reward and punishment. We can have authority to send, postpone, or even abrogate the fund transfers. I think that would be the ideal fiscal policy. (LG20)

However, CG10 added, the fear of disintegration discourages the central government from doing so because the risk of disintegration at the provincial government level is much higher than it is at the municipality and regency level. CG7 said that delegating the distribution of fiscal transfers to provinces is too extreme. There will be resistance from sub-national governments and the parliaments. Moreover, CG5 said that the central government is hesitant to delegate that authority because of concerns over the

capability and integrity of the provinces. CG5 mentioned the case of North Sumatera Province, which kept vehicle tax shared revenue from being transferred to the local governments for three years in a row.

Truly, in terms of the regulator, it should be the province that is given more authority to manage, distribute, most of the fiscal resources. However, perhaps the past experience of Indonesia becoming federal, which had disintegrated the country, had been a nightmare. So, there has not been any courage to do it. That system using province, the risk of disintegration is higher for province than for regency or municipality. (CG10)

I think we are not just discussing IGFTs policy from local autonomy point of view. It also about political economy. What makes it hard to answer the question is that since the beginning, the central government has put a benchmark, which is high-level discretion for sub-national governments. If in the future, we tried to be more provincial centrist, General Allocation Fund (DAU) only to the province, or even let us say we only give Specific Allocation Fund (DAK) to provinces, there will be high resistance from regencies and municipalities, and also from the parliament. (CG7)

There was a discourse to do it [central government only directly relates to provinces], but we are still doubtful, due to so many reports that we received concerning the practice of revenue sharing. You should probably know the province are tend to hold down the transfer. Vehicle Licensing Tax, for example, the Province of North Sumatera has held down municipalities' and regencies' rights to receive the transfers for three consecutive years, which made them have huge debt obligation to its municipalities and regencies. Later on, the province agrees to pay the debt by instalment plan. So did with excise from tobacco, that they were always late in transferring. It means, even only the task to transfer local tax revenue sharing, they cannot do it properly, what would happen if later on they are given the authority to allocate DAU to municipalities and regencies? (CG5)

Furthermore, LG6 was pessimistic about whether provinces are ready to be responsible for allocating immense amounts of money to the municipalities and regencies. LG6 referred to an attempt by the Ministry of Home Affairs in the early years of decentralisation, which used a set of indices to assess provincial readiness for autonomy; this resulted in only one out of 30 being considered ready. LG12 believed that the asymmetric capabilities and the low level of governance maturity among the provinces are the reason the central government still fully controls fiscal transfers.

Nevertheless, LG12 agreed that at some point in the future, subject to the provinces' readiness, it would be good to delegate the authority because the municipalities and

regencies would not have to go so far to ask for assistance or coordination. Meanwhile, CG7 believed that involving the provinces in controlling municipalities' and regencies' plans for their fiscal transfers allocation – such as giving them the authority to review sub-national governments' Specific Allocation Fund for physical projects (*DAK Fisik*) proposal before it is sent to the central government – is a more feasible way of strengthening the provincial role.

There are certainly advantages. The problem is whether the province is ready. There used to be an index to assess the provinces, and from 30 provinces, now is 34, there was only one province considered as ready to implement the autonomy. Obviously, to implement the system, central to provinces, and then provinces will manage the rest, not yet possible. The fund is enormous, I mean do provinces ready yet? If provinces are ready, from the tools, human resources, and there are no longer, or at least low corruption level, that would probably the sign of provincial readiness. (LG6)

The central government still controls all provinces in Indonesia. That is a way to equalise the fiscal decentralisation pattern. If it is now assigned to provinces, there will be strong provinces, but there also be weak provinces who do not even know how to implement it. So, for uniformity until specific timeframes, such as like three or four years later, after the central government can assure all provinces have the equal capacity, I think it would be good to assign provinces so that municipalities and regencies do not have to go far to ask for technical assistance or coordination. (LG12)

So, changing the fiscal decentralisation system in Indonesia, which I think a bit extreme, it is not impossible but hard. Remembering that since the beginning of fiscal decentralisation, we already gave too much discretion. The compromising step, as what we are doing now, we stick with the current concept, we try to improve the allocation and transfer mechanism of IGFTs through a set of control, we assess the performance of regencies and municipalities, we give rewards and punishments, but also, slowly, gradually, we improve provincial roles. The DAK mechanism for example, which there was no provincial role at all. For the current mechanism, we try to endorse more dominant provincial roles at least from two aspects. Firstly, the proposal submission from municipalities and regencies must go through a review process from the province. Thus, before the proposal submitted to the central government, ideally, it must get early screening and evaluation process from the province. Secondly, DAK programs synchronisation before final allocation, the evaluation have also been done by the province. Therefore, it means now the province has more strategic roles in the allocation of DAK. (CG7)

8.5 Chapter Conclusion

Table 8.1. below summarises the findings for this specific theme.

Table 8.1
Structural Arrangements and Task Assignments – Findings Summary

	Central Government	Provincial Governments	Municipalities and Regencies
Intergovernmental structural relations	<ul style="list-style-type: none"> Re-establish hierarchy with two alternatives: explicitly states in the law or implicitly through establishing extra authorities that can show the provinces' superiority to local governments 	<ul style="list-style-type: none"> The new Law No. 23/2014 is sufficient for enabling provinces to bind municipalities and regencies within their jurisdiction 	<ul style="list-style-type: none"> Do not oppose the idea of re-establishing hierarchy between provinces, municipalities and regencies. However, municipalities and regencies must have access to decision-making, instead of being dictated to by the province
How should the central government relate to provinces, municipalities, and regencies?	<ul style="list-style-type: none"> Decentralisation would be more efficient if the central government only relates directly to provincial governments. Municipalities' and regencies' planning, monitoring and evaluation should become a provincial government responsibility 	<ul style="list-style-type: none"> Current intergovernmental relations mean that line ministries often bypass provincial governments when they wanted to implement programs at the municipality or regency level 	<ul style="list-style-type: none"> The central government should still relate directly to the municipalities and regencies because of immature governance at the provincial level, i.e. the governor is more concerned with the provincial council aspiration than the voice of local governments, and different political backgrounds can make disharmony between the governor and the mayors or regents
	<ul style="list-style-type: none"> Central government still needs to relate directly to municipalities and regencies to ensure they are performing well and use the provincial government as a coordinating hub 	<ul style="list-style-type: none"> The provinces would become stronger in acting as the central government's representatives in the regions and controlling municipalities' and regencies' performance if the central government only relates directly to the provinces 	
		<ul style="list-style-type: none"> Line ministries should always coordinate through the provincial government before making policy and implementing programs in municipalities and regencies because the provinces have more reliable and up-to-date data 	

	Central Government	Provincial Governments	Municipalities and Regencies
Managing functions between central, provincial and local governments	<ul style="list-style-type: none"> ▪ Law No. 23/2014 is still ambiguous. Municipality, regency and province are still considered equal in structure, but in practice, the provinces have legal authority that makes them superior to municipalities 	<ul style="list-style-type: none"> ▪ The central government should include fiscal transfer distribution power to the provinces so they can have more bargaining power vis-à-vis municipalities and regencies 	<ul style="list-style-type: none"> ▪ The transfer of some municipalities' and regencies' functions to the provincial government has created difficulties for archipelagic sub-national governments
	<ul style="list-style-type: none"> ▪ Still practically unclear on how taking away some municipalities' and regencies' functions can strengthen provincial governments' role 	<ul style="list-style-type: none"> ▪ The central government burdening provincial governments' budgets for expenditures that were not supposed to be the provinces' responsibilities 	<ul style="list-style-type: none"> ▪ Let the municipalities and regencies execute public service delivery, while the provinces should only focus on providing municipality and regency staff training, technical assistance and capacity-building, so the municipalities and regencies do not have to go to the capital
			<ul style="list-style-type: none"> ▪ The central government is burdening municipality and regency budgets with expenditures that were not supposed to be their responsibilities

Law No. 22/1999, which was later replaced by Law No. 32/2004, has put provincial governments in a puzzling position. The definition of provinces as sub-national governments that also became the central government's representatives in the regions failed to find a firm footing in practice. The early years of decentralisation under those two laws resulted in a loss of control by the central government due to ineffective chains of command caused by the municipalities and regencies bypassing provinces. They went straight to the central government because they did not feel the need to coordinate with the provinces.

Despite this puzzling position, the interviews manage to capture several insights into the importance of provinces in improving Indonesian intergovernmental relations, and what roles the provinces should play. For the central government, provinces need to

become the development planning coordinators in the regions. They are expected to provide the first layer of review and evaluation of regencies' and municipalities' development and budget plans. One interviewee from a regency government offered an additional point of view on how provinces could foster their development. Instead of taking over regencies' and municipalities' functions and authorities to strengthen the provinces, they thought that provinces should be given the capacity to provide training and technical assistance, as this would reduce the cost and increase the uptake of such training and assistance.

Nevertheless, the idea of strengthening provincial roles does not enjoy unanimous support. The interviewees from provinces, and some interviewees from central government, argued that the central government should not only reinstate the formal hierarchy but also create a more simplified intergovernmental relationship, with central government only directly relating with provinces, while the provinces directly relate to regencies and municipalities. This would ease the central government's work in controlling sub-national governments' performance. However, the interviewees from regencies and some interviewees from central government seemed doubtful about that possibility.

Additionally, Law No. 23/2014 has drastically changed the way municipalities and regencies relate to their provinces. Several functions, such as mining and forestry concession licences, and some maritime territorial authority, have been taken from the municipalities and regencies and have become provincial functions. There are also technical regulations, following the new law, that seek to strengthen provincial authority over municipalities and regencies. The law has been presented as the central government's response on positioning the provinces in the practice of decentralisation and regional development.

One interview revealed that the abolition of the 'deconcentration fund'⁵⁰ was a sign that indicated a differentiation between provinces and municipalities/regencies in their status as sub-national governments. Previously, using different terminology, all

⁵⁰ Unlike IGFTs, which are becoming local government's primary source of revenue, the 'deconcentration fund' has not been discussed because it was included in the line ministries' budget. It was not a type of IGFTs but, rather, was basically a central government fund managed by line ministries who wanted to implement programs or activities through local governments. Provinces, municipalities and regencies would only be the executing institutions. They did not have the discretion to plan or decide what kind of programs or activities to undertake.

provinces, municipalities and regencies could receive this ‘deconcentration fund’, but the current law only gives the fund to municipalities and regencies. Therefore, the policy sought to position provinces as the central government’s representative in the face of municipalities and regencies, rather than just another sub-national government that happened to have jurisdiction over certain municipalities and regencies.

Based on the interviews, Law No. 23/2014 creates both benefits and challenges for intergovernmental relations in Indonesia. First, there was a view that it will harmonise and coordinate sub-national government activity. The provincial role has been made more essential, especially in the planning process. The municipalities and regencies have an obligation to have their development planning and areas of priority decision-making reviewed and evaluated at the provincial level. However, the law still does not reinstate a formal hierarchy between provinces, regencies and municipalities, which makes its effect ambiguous — forcing regencies and municipalities to be controlled by the provinces that are formally their equal.

Second, the task assignments regulated in the law bring other complications in practice. The interviews revealed that, first, they are considered inefficient, especially for archipelagic regions where regencies face a greater task in requesting approval from and coordinating with the province due to their geography. The findings suggest the need to create an asymmetric division of functions and task assignments between provinces and regencies/municipalities. Another complication concerns the issue of accountability, with regencies and municipalities held accountable for tasks that have reverted to the provinces. Finally, there is the issue of adequacy, with some interviews revealing the need for the provinces to have authority over the allocation and transfers of IGFT funds to their regencies and municipalities. The assignment of this authority would undoubtedly improve their bargaining position with the regencies and municipalities. However, while the provincial governments feel ready to be given such authority, the central government does not yet have sufficient trust in them. Moreover, interviewees from regencies and municipalities also expressed pessimistic views over what might happen when such authority is given to the provinces.

These findings show how the central government’s intention to create a controlling system over Indonesian decentralisation practice has been burdened by political history and lack of trust. We have read in Chapter 4 that the first law on Indonesian

decentralisation explicitly mentioned the abolition of governmental hierarchy between provinces and municipalities or regencies. Even though subsequent revisions have tried to reclaim provincial power over municipalities and regencies, it has never been explicitly reinstated. So, despite strengthened provincial authorities, the political history has resulted in an ambiguous governance structure. Similar to its navigation of ‘unitary’ and ‘federalist’ approaches to nationhood, Indonesia’s decentralisation seems quite fond of avoiding the titles and getting to the substance.

In terms of intergovernmental relations, the lack of trust goes to all types of sub-national government. First, the lack of trust from central government towards the municipalities and regencies resulted in new task assignments, which sought to increase provincial power not only by adding authority but also by taking several functions and responsibilities away from regencies and municipalities – for example, re-allocating responsibility for mining concession permits to the provinces because the issuing of these permits by municipalities and regencies tended to be uncontrollable and the provinces were often blindsided.

Second, the lack of trust from the central government towards the provinces resulted in changes in direct governmental relations, not only between the central government and the provinces but also between the central government and regencies and municipalities. So, the central government placed its trust in the provinces to control regencies and municipalities, but still does not fully trust the provinces; as a result, the central government still directly relates to all 542 sub-national governments. The interview findings revealed the central government’s hesitance to adopt a graduated structure of decentralisation. The central government is still not convinced that the provinces can coordinate and manage municipalities and regencies under their jurisdictions. The highly dynamic political situation where there is no dominant party – where the person elected as governor, mayor or regent may not come from the winning party at the local level, or the elected governor may come from a different party to the elected mayors or regents – is one reason for this, as is shortfalls in human resources capacity.

This distrust, however, needs to have a stronger basis. A case-by-case assessment would be better than generalising. The *Dana Rakca* Award given to the high performers among sub-national governments is an example of the fact that there are

actually 'champions' among sub-national governments who deserve an increased level of responsibilities. The sub-national governments' ability to demonstrate readiness to take on more crucial responsibilities should be considered as part of an asymmetrical assignment of tasks and responsibilities to sub-national governments, as should the geographical characteristics suggested by several interviewees.

9

CONCLUSION

9.1 Introduction: Research Focus

Fiscal decentralisation theory has been evolving as experience increases and more insights and new concepts are introduced as a result of assessing that experience. Formerly, the conceptual focus was on creating fiscal autonomy for sub-national governments. The basic principle of this was that devolving tasks, authorities and responsibilities to sub-national governments had to be followed by giving fiscal discretion to make decentralisation more meaningful.

The so-called ‘second generation’ of fiscal federalism theory raised a new issue: how to ensure that fiscal autonomy improved outcomes, as was expected by countries practising decentralisation. Two methods for achieving this are giving fiscal incentives through performance-based grants and limiting sub-national governments’ budgetary flexibility through increasing use of tied grants.

Indonesia, known for having a ‘big bang’ decentralisation project, is one of the countries that has kept track of the emerging conceptual perspectives since the beginning of that ambitious project. The first fiscal decentralisation policies were focused on devolving fiscal autonomy to sub-national governments. Laws about IGFTs and revenue assignment for local taxes and charges collection gave fiscal discretion to sub-national governments as far as possible.

From 2010, Indonesia began to implement what the ‘second generation’ theory calls performance-based grants, involving fiscal incentives. In addition, the central government has also increasingly employed the other method for creating good outcomes — tied grants. These new policies, which have not been embedded in the specific laws on Indonesian fiscal decentralisation, raise several interesting questions for research. First, whether performance-based grants encouraged sub-national governments and what challenges arose. Second, how successful has the IGFT transformation — tied grants and block grants — been? Finally, to what extent have

the structural relations between Indonesia's governmental levels been conducive to successful decentralisation?

This thesis set out to answer the following three questions. **First**, has a performance-based grant system, in the form of the Local Incentive Fund (DID), succeeded in encouraging sub-national government performance? Or is it merely a formality because the central government simultaneously chooses to control sub-national government performance by increasing use of tied grants, which limit local-level budget discretion? **Second**, has the transformation of the Indonesian intergovernmental fiscal transfers (IGFTs) policy been able to foster sub-national government performance? **Third**, has the Indonesian structural tasks and responsibilities assignment provided a sound base to support fiscal decentralisation policy in getting good outcomes from sub-national governments?

The research led to the following conclusions in respect to those questions. **First**, the addition of the *Dana Rakca* award into DID has made the fiscal incentives scheme more prestigious and thus more effective. The sub-national governments that had already competed successfully for incentives were enthusiastic about the new performance-based grant arrangements. However, the central government seemed to neglect disadvantaged sub-national governments that could not realistically join the competition. Moreover, the central government only intended the DID scheme as 'lollipops', or incentives to drive good outcomes from sub-national governments. The central government is keener on employing tied grants to ensure good outcomes.

Second, the transformation of the Indonesian intergovernmental fiscal transfer system (IGFTs) since 2015 — which are becoming more directive by increasing tied grants, imposing 'earmark' on block grants, and regulating a 'one size fits all' technical guidance — does not help the more advanced sub-national governments improve their public services because the specification standards are more suited to less developed sub-national governments. Furthermore, the uniform timeframe for finishing the DAK projects disregards geographical diversity as a critical factor in executing the projects.

Third, the central government's effort to revitalise the provinces' functions and authority has created complications. The provinces are being strengthened to become pivotal entities, serving as the central government's representative in the regions as

well as to control regencies and municipalities within their respective jurisdictions. This is being done by re-assigning several regency and municipality functions and authorities to the provinces. However, the shifting of tasks and authority from municipalities and regencies to the provinces has resulted in inefficiencies in decision-making. The central government needs to have proper justification before claiming municipalities, regencies, or provinces are insufficiently competent to perform various tasks and authorities. The central government needs to assess the appropriateness of strengthening provincial roles based on indicators of provincial competence to carry out responsibilities as the central government's eyes and hands in the regions. Otherwise, the central government may need to delegate greater authorities, tasks and responsibilities to local governments, and directly connect to them to ensure good decentralisation outcomes.

9.2 Fiscal Decentralisation and the Performance of Sub-National Governments: Conceptual Evolution and Comparative Practice

Ethnic, cultural and geographical diversity creates different local needs and preferences, which the typically uniform policies of a central government are unlikely to accommodate. Therefore, sub-national governments are needed to bring the policy-makers closer to the people, so that they can better understand those needs and create better policy and service delivery. The conceptual logic of decentralisation provided the reason for countries to put these concepts into practice.

Decentralisation ranges from simple delegation of administrative tasks to full devolution of functions and responsibilities. Whatever the degree, there is a consensus in the literature that devolving tasks, functions and responsibilities is less meaningful without the assignment of commensurate financial resources. Accordingly, the literature also elaborates a specific concept of implementing fiscal decentralisation.

9.2.1 First Generation Theory and Country Experiences

The theory of decentralisation holds that the public would get better service delivery, and regions could develop according to their own priorities, if central government devolved its functions and responsibilities to sub-national governments as the closest entities to the local people and the level of government with the best understanding of

local needs. Therefore, the word ‘autonomy’ became an essential subject to elaborate in the literature of the ‘first generation’ of fiscal federalism theory. In quite different ways, Canada and China provide interesting illustration of these principles at work.

A. Fiscal Autonomy Through Extensive Revenue Assignment: Country Experiences

The ‘first generation’ theory placed great importance on fiscal autonomy as a requirement to ensure the autonomy of sub-national governments. However, there were different views of how to make sub-national governments fiscally autonomous. The first view was that this should be achieved through revenue assignment or localising a significant number of central taxes. This view used the level of sub-national governments’ own-source revenue as a measurement of a country’s fiscal decentralisation. The greater the proportion of own-source of revenue, the higher the degree of fiscal decentralisation.

Canada has a high degree of fiscal decentralisation in terms of the level of own-source revenue available to the provincial governments. This is a result of granting Canadian provinces access to major taxes such as income tax, consumption tax and payroll tax. The provinces have discretion on whether to set their own tax rates, tax credits and regulations or to join the federal government’s tax harmonisation program, under which these are set according to the federal government’s regulations. As a result of its practice of giving extensive fiscal autonomy to sub-national governments, Canada is regarded as the ‘textbook best-practice’ example of fiscal federalism. Even though under the tax harmonisation program the taxes are collected by a federal government agency on behalf of the provincial governments that join the program, the system does not simply share a percentage of tax revenues collected. The Canadian system is more of a tax-on-tax system wherein the federal government agency assesses the tax-payer’s income and then calculates their tax debt based on provincial and federal government tax rates. This system of tax collection is called ‘joint tax occupancy’. However, as a result of the high degree of provincial government access to major taxes, the federal government’s intention to allocate more significant IGFTs — needed to ensure low fiscal capacity sub-national governments can provide equal standard public services — is being held back by the federal government’s reduced fiscal capacity (McLean, 2003). Moreover, increasing IGFTs would leave the federal government facing an unsustainable debt problem (Boadway, 2007). In general, then, there is some point at

which a high level of vertical fiscal autonomy precludes a high level horizontal fiscal equalisation.

In the early years of its fiscal decentralisation, China implemented a similar policy in terms of tax collection. The provinces had the authority to collect most taxes, but, unlike the Canadian practice, they had to share some portion of what they collected with the central government. There were three different arrangements made between 1980 and 1993. From 1980 to 1984, China used the fiscal revenue-sharing system in assigning revenue between the central governments and its provinces. The central government only retained around 20 per cent of collected revenues while the provinces kept the remainder. In 1985, the policy changed and the province's financial capacity became the basis for determining the amount of revenue shared with the central government. This change meant the percentage of shared revenue provided by provinces to the central government varied, with a decreased percentage for poor provinces but an increased percentage for rich provinces.

The system changed again in 1988, when the fiscal contracting system was introduced. The revenue shared between provinces and the central government no longer reflected the percentage of revenue collected; instead, the provincial and central governments entered into contract agreements on the exact amount of revenue that each province had to contribute to the central government. One point of view saw this as creating a guarantee for the central government and, on the other hand, providing a stimulus for the provinces to increase revenues as much as possible, as they retained all revenue exceeding their obligation under the contract. However, the opposing point of view, which led to wholesale change in the system, is that it made the central government weak because it heavily relied on sub-national governments and created mistrust between provinces and the central government.

B. Fiscal Autonomy Using IGFTs: Country Experiences

The second view holds that IGFTs from central government should be the main source of funding for sub-national governments. Arguments like economies of scale, administrative efficiency and the central government's role in redistributing income provide the grounds for this option. The central government needs to be selective in assigning taxes to sub-national governments because some taxes are more cost-efficient if administered and collected by the central government. Furthermore, if

major taxes, such as income tax and VAT, are assigned to sub-national governments, regional disparities will be hard to overcome because the central government will not have sufficient fiscal capacity to address the issue. Therefore, there should be a system of central administration and collection of most taxes, especially major ones, which are then returned via IGFTs to sub-national government. The challenge, however, is to create a fair formulation for redistributing the fiscal resources so as to balance out extreme disparities. Furthermore, the type of IGFTs must grant discretion to sub-national governments in budgeting and expenditure because, otherwise, there is no real fiscal autonomy.

In the second phase of its fiscal decentralisation practice, China chose this option because the central government was weakened by its reliance on provincial government tax collection. Moreover, the fiscal contracting system limited the central government's fiscal capacity. China was experiencing a situation in which its central government was unable to address fiscal disparities and fund basic public services. Therefore, China's central government reclaimed major tax collection — for VAT, stamp tax on security exchange, personal income tax, and company income tax — from the provinces. The transformation represented a '180 degree' change in the policy, whereby the provincial governments became heavily dependent on central government IGFTs. Some researchers have given favourable reviews of the impact of this new fiscal decentralisation policy on the provincial governments' area of development. However, other reviews point out that China's redistribution of fiscal resources through IGFTs could not match the devolved public services responsibilities assigned to its sub-national governments. Moreover, China's IGFTs were considered ineffective in addressing the issues of regional disparities and vital social services funding.

Indonesia, with its 'big bang' decentralisation, also adopted this view of IGFTs as the core fiscal resource for sub-national governments without abandoning the objective of establishing sub-national government fiscal autonomy. In the early days of fiscal decentralisation practice, around 93 per cent of IGFTs were block grants — which certainly provided for sub-national government autonomy. Subsequently, though, the central government began to engage with the issue of sub-national government

performance, which had also been the focus of the ‘second generation’ theory of fiscal federalism.

9.2.2 Second Generation Theory: Assessing the Indonesian Practice

The ‘second generation’ theory went beyond previous discussion of how to establish sub-national government fiscal autonomy to how to encourage sub-national government performance. Establishing fiscal autonomy became the ultimate objective of fiscal decentralisation, but good outcomes are also expected to result from decentralisation. There are two methods suggested in the ‘second generation’ theory. The first is using fiscal incentives to stimulate sub-national government performance. This practice is known in the literature as performance-based fiscal incentives. The theory suggests that the central government determine a set of performance indicators and reward sub-national governments based on their achievements against those indicators.

Fiscal incentives are built into China’s system, but in a particular way. China’s central government set up a fiscal structure that gave automatic direct incentives to its sub-national governments, in that policies supporting market activities would generate higher revenues that would accrue to the provincial governments. It provided strong fiscal incentives because the sub-national governments’ spending options are closely linked with their ability to generate revenue. However, research suggests that this policy only accelerates the growth of fiscal revenues at the provincial level, not for the sub-provincial governments whose revenues in fact decelerate (Martinez et al., 2006d). Moreover, it hinders sub-national governments from achieving optimum performance for other targets, such as the conflict between economic development targets and environmental protections.

Meanwhile, the Indonesian practice of performance-based grants is identical to the one suggested in the theory. The central government provides fiscal incentives for sub-national governments that can bring good outcomes. The ‘good outcomes’ are defined through a set of performance indicators that become the benchmark in assessing sub-national governments.

A. Performance-Based Grants: Assessing Local Incentives Fund (DID)

The Indonesian government's policy was to introduce a fiscal incentive, known as the Local Incentives Fund (DID), to its IGFT policy. The DID is a practical illustration of what the literature calls performance-based grants. The value of the incentives in the first six years of its implementation in 2010 was not huge in comparison to the total IGFT allocation, but it had a simpler set of indicators. Starting in 2015, the central government not only increased the incentives allocation but also 'raised the bar': introducing indicators that were more challenging and required more human resources. Moreover, the central government added an award given directly by the president, called the *Dana Rakca* award, to make the fiscal incentives scheme more prestigious. The sub-national governments that had already competed successfully for incentives were very enthusiastic about the new performance-based grant arrangements.

However, the central government seemed to neglect disadvantaged sub-national governments that could not realistically join the competition. At the beginning of DID implementation, there were only 13 sub-national governments that had unqualified audit evaluation for their financial reports, so the central government broadened the eligibility, recognising a qualified evaluation as a performance threshold to receive guaranteed fiscal incentives. Over the years, the number of sub-national governments receiving an unqualified opinion rose to 378 in 2018. At that stage, the central government believed the requirement was getting too easy to achieve, so decided to raise the performance requirement. There are no longer guaranteed fiscal incentives in return for gaining an unqualified audit opinion; that is used only as an entry requirement to compete for fiscal incentives. As a consequence, the central government has indirectly left the other 164 sub-national governments feeling further behind in seeking fiscal incentives or even the prestigious award, and that, in turn, has diminished their motivation. Therefore, other than making continuous improvement on its assessment indicators, the central government must find a way to acknowledge sub-national governments' achievement according to their level of governance and capacity, so that disadvantaged sub-national governments are inspired to make fresh efforts rather than surrender under their limitations and see the fiscal incentives and awards as unattainable.

Another important finding regarding the practice of DID in Indonesia is the addition of several line ministries' assessment reports as new requirements to obtain DID. Three of the reports — the sub-national governments' Governance Evaluation Report (LPPD) from the Ministry of Home Affairs (MoHA); the sub-national government Planning Assessment (PPD) from National Development Planning Agency (Bappenas); and the Accountability and Performance Report for Government Institutions (LAKIP) from the Ministry of State Employee Empowerment and Bureaucracy Reformation (PANRB) — are substantially similar reports but require different forms. Despite the need for continuous improvement, the previous set of indicators was less burdensome to sub-national governments because it did not require sub-national governments to make a self-assessment report. Sub-national governments would still have to complete those reports, whether they were added as new DID requirements or not, because those reports had been sub-national government obligation long before DID was introduced. So, now is just a matter of adding the money as an incentive by embedding the reports in the DID requirements. This might be a good moment to re-evaluate those reports. Instead of draining sub-national government human resources to complete three substantially similar reports, why cannot the central government line ministries collaborate to simplify them into one report? Or, better still, the line ministries could find another way to assess sub-national governments without burdening them with yearly self-assessment reports.

Furthermore, the findings showed that the Indonesian central government also needs to reconstruct its sub-national government clustering. We can conclude from the findings that the current clustering, which is based on sub-national government status (province, municipality or regency), is too simplistic. The central government is disregarding the fact that within each cluster there are fiscal capacity, human resources capacity and governance maturity gaps between sub-national governments that need to be placed and compete in different groups. Each cluster should have different performance targets based on the sub-national government conditions within each cluster. The clusters' membership should be dynamic, using a kind of promotion and demotion system.

B. Imposing Strict Tied Grants Regulation

The second method identified in the ‘second generation’ theory is limiting sub-national government fiscal flexibility. This is achieved by giving more IGFTs in the form of conditional grants to sub-national governments. Canada’s federal government introduced the Canadian Health Transfer (CHT) and Canadian Social Transfer (CST) with the intention of having a joint set of performance indicators with the provincial governments (Fafard, 2013). However, developing an agreed set of performance indicators is still a challenge due to Canada’s history and political background. China’s central government also tends to allocate more tied grants because the growth of its transfers has outpaced the block grants (Shah & Shen, 2006). The tied grants are mostly used to fund capital infrastructure projects.

The increasing use of tied grants has also been the Indonesian central government’s policy since 2015. The central government view was that the discretion previously given to sub-national governments did not produce the efficiencies or outcomes expected from the sub-national governments. The central government decided that sub-national government spending was wasteful and could not bring about appropriate outcomes and thus needed to be controlled through tied grants. In recent years, Indonesian IGFTs show a trend towards increasing used of tied grants compared to block grants. In 2006, the tied grants reached their lowest level at 6.9 per cent of total IGFTs, but in 2018 the number increased to 34.68 per cent. The highest growth in tied grants, 8.2 per cent, occurred in 2015 when the central government adopted more tied grants as an affirmative policy to control sub-national governments’ spending.

Furthermore, the Indonesian IGFT policy transformation from 2015 was a whole package; it not only involved the amount of money allocated but also specifically included allocation, transfer and reporting mechanisms. The tied grants, DAK, use proposal-based allocations, which is a more bottom-up process instead of the previous top-down mechanism. The purpose of this was to minimise incorrect sectoral allocations that often happened under the previous mechanism.

Nevertheless, there are several problems with the new transfer and reporting mechanisms. First, the ‘one-size-fits-all’ technical guidance does not help more advanced sub-national governments develop more enhanced public services because the specification standards are more suited to less developed sub-national

governments. Second, the uniform timeframe for finishing the DAK projects disregards geographical diversity as a critical factor in executing the projects. Sub-national governments with an archipelagic geography, for example, face greater challenges in moving heavy machinery from one island to another, especially in the high tide season. Third, the central government's policy to control sub-national government spending through tied grants is burdened by excessively-rigid regulation, which has led to some sub-national governments opting for an increase in block grants to increase their discretion and reduce the risk of having their DAK funding cut for non-compliance. The immediate application of the new regulation and lack of socialisation also resulted in different interpretations of the rules and inadequate preparedness among sub-national governments to adapt to the new regulations. This resulted in sub-national government confusion over how to settle the payment for finished projects, with the central government cutting their funding due to inadequate compliance.

In addition to the IGFT transformation, the central government imposed an 'earmark' on block grants, which theoretically should be given with full discretion. The central government required sub-national governments to use at least 25 per cent of its block grants for infrastructure projects. The policy obviously reduces sub-national government fiscal discretion even further.

9.3 Optimising Indonesian Fiscal Decentralisation Practice in Getting Good Outcomes: Introduction of Asymmetric Approach

The Local Incentives Fund (DID) was the means by which the Indonesian central government engaged with the issue of encouraging good outcomes from sub-national governments. The most notable shortcoming in the first six years of DID implementation was the allocation of incentives that were considered too low. A significant increase — from IDR 1.6 trillion to IDR 5 trillion in 2016 — seemed to showcase more serious attention from the central government to optimising this IGFT scheme. Moreover, the *Dana Rakca* Award has added a more prestigious aspect to the DID.

Interestingly, over the same period (i.e. since 2015) the central government has also been trying to take a more directive fiscal decentralisation approach to influencing sub-

national government spending quality. More emphasis has been placed on tied grants with tighter requirements. In addition, it is more evident that the Indonesian central government has been trying to push the limiting-flexibility method in its IGFTs policy, with the central government ‘earmarking’ block grants by adding conditionality to this type of IGFT, which, theoretically speaking, should be classified as discretionary funds.

These policies lead us to ask, what exactly is the focus of the Indonesian central government’s policy strategy in getting good outcomes from the sub-national governments? The ‘second generation’ theory of fiscal federalism acknowledges two methods, which operate in different ways. Performance-based fiscal incentives are suitable where sub-national governments have high discretion, which the central government want to control by giving financial incentives to those sub-national governments that can manage their spending to get optimum outcomes. In contrast, the limiting-flexibility method reduces discretion for sub-national governments because it uses tied grants that can only be used for specific areas and projects.

9.3.1 Asymmetric Approach Could Enable the Two Methods Implemented Together

An interview with a central government official revealed that the central government only wanted to design the DID scheme as ‘lollipops’, or incentives to drive good outcomes from sub-national governments. The central government is more keen on employing tied grants to ensure good outcomes. Therefore, the next question would be whether continuously practising DID is still relevant for low-discretion sub-national governments or whether there is a practical way to implement both methods? Looking at the current practice of Indonesian fiscal decentralisation policy, it seems self-contradictory to continue with both methods at the same time.

However, the research findings suggest that there are reasons, and means, to implement both methods — provided a more nuanced approach is taken. The high diversity in geographical situations, and inequalities in sub-national government fiscal and human resources capacity, have not been tackled in the existing policy approach. A ‘one-size-fits-all’ policy cannot cope with these gaps; a more asymmetric approach is needed.

Performance assessment should not only define kinds of performance and how to measure performance. It should also consider whom to assess, and in which condition or category. As we noted, decentralisation is intended to deal with not only cultural and geographical diversity, but also developmental, economic and fiscal disparity. Moreover, the presence of unequal human resources capacity adds to the argument for a functional and fiscal asymmetric policy approach.

Following the endorsement of second-generation theory principles for ensuring sub-national government performance, there should be improvisation in how to implement it. An asymmetric set of performance management indicators becomes appropriate when there is functional and fiscal asymmetry. It is particularly important when the central government wants to assess a sub-national government to determine whether it can 'graduate' to another level, as suggested by Bahl et al. (2006). Or, even though a central government chooses to implement a permanent duration on its asymmetric approach, the presence of asymmetric performance management would still exist. The central government would need to set different performance indicators based on how much responsibility is given and how much fiscal power sub-national governments have.

The experience of Spain in creating an asymmetric model and approach to its division of functions, responsibilities and fiscal relations could serve as an inspiration. Under a 'fast track' and 'slow track' framework, the central government gave responsibilities differently and gradually to its autonomous communities according to their readiness. In terms of fiscal relations, the asymmetric approach existed in the distinction between 'common regime' and 'charter regime' governments. Despite some criticisms for not devolving sufficient fiscal powers to autonomous communities, especially those in 'common regime', and for weaknesses in its equalisation formula, Spain's asymmetric approach received praise because of its ability to accommodate different levels of preferences and autonomy. Logically, a country tends to decentralise because it wants to acknowledge different public needs among sub-national governments. But these differences are then managed under 'one-size-fits-all' regulations that render some sub-national governments unable to implement the policy. Looking at its success, scholars have suggested that Spain should continue its decentralisation deeper, to the third level of government, in what they call a 'second decentralisation'.

The findings in this research suggest that the Indonesian central government should explore the possibility of implementing an asymmetric fiscal decentralisation policy, starting by categorising sub-national governments based on their fiscal capacity, development level, geographical conditions and the government's leadership maturity in managing the region. Sub-national governments with high fiscal capacity would be given more advanced performance targets than lower capacity governments. Meanwhile, those that have low fiscal capacity would have two options in terms of what types of IGFTs to transfer from the central government. Sub-national governments that already demonstrate ability to exercise good governance practice would receive more block grants and guaranteed discretion in planning and executing their budget. In contrast, those that are still struggling to develop their management and human resources capacity would have more tied grants and have low discretion until they can 'graduate' to the next level. Furthermore, in terms of performance indicators and targets, current DID assessment — obviously with some improvements, as suggested above — could be endorsed for the high-discretion sub-national governments, while those that receive more tied grants could be evaluated using the current rigid DAK mechanism but including development level and geographical conditions as considerations in creating asymmetric mechanisms or tied grant regulations.

9.3.2 Asymmetric Authorities and Responsibilities

Chapters 2 and 8 emphasised the importance of devolving responsibilities and authorities along with appropriate fiscal decentralisation. Therefore, this thesis specifically discusses the findings that relate to the topic of structural arrangements and task assignment in Indonesia. Clarity of relations, tasks, responsibilities and authority assignment between provinces, regencies and municipalities is essential to identify not only expenditure responsibilities, but also roles and boundaries in operating the government, clearly.

Despite their practice of by-passing the constituent units to connect directly with local governments, Canada and Spain's central governments accept provinces or autonomous communities having a strategic role. Similarly, despite some asymmetric authorities given to certain local governments, China also put their provinces as a

pivotal entity in managing their local governments. More local governments within those main units occupy a subordinate position.

After 15 years of decentralisation that created ambiguous roles and relations between provinces and municipalities/regencies, the Indonesian central government began to strengthen the provincial role through the promulgation of Law No. 23/2014. However, the transformation was largely a practical solution and did not touch explicit hierarchical relations. The provinces were given power and authority as if they are superior to municipalities and regencies, but there is no explicit article in the law stating that provinces have a higher position than municipalities and regencies. It has been noted that not all provinces can act on behalf of their municipalities' and regencies' interests. The interviews showed that there are doubts concerning the ability of provincial governments and provincial parliaments to make decisions reflecting the needs of their local governments rather than their own interests. However, similarly to the sub-national governments' asymmetric capabilities issue mentioned earlier, some provinces are considered able to manage and coordinate their local governments quite well.

The central government's effort to revitalise the provinces' functions and authority has created complications. The provinces are being strengthened to become pivotal entities, serving as the central government's representative in the regions as well as to control regencies and municipalities within their respective jurisdictions. This is being done by re-assigning several regency and municipality functions and authorities to the provinces. However, the shifting of tasks and authority from municipalities and regencies to the provinces has resulted in inefficiencies in decision-making. The longer chain of bureaucracy has affected local public services and project management. The difficulty of going through a long chain of command and coordinating with the province is even higher for archipelagic and less developed regencies whose poor infrastructure hampers access to the provincial government's offices.

The ongoing ambiguity of structurally parallel but multilevel authorities of sub-national governments comes from a political history that dates to the beginning of 'big bang' decentralisation, and from the central government's lack of trust. The removal of several tasks and authorities from municipalities and regencies is a sign of lack of trust. On the other hand, that the central government still relates directly to

municipalities and regencies on some issues also shows the lack of trust in provincial governments. Despite recent revision of the law on sub-national government, structural arrangements and task assignments need to be revisited conceptually to provide a better basis for sub-national governments to deliver their tasks and responsibilities.

The existence of the *Dana Rakca* Award has shown that there are provinces that can be trusted to manage municipalities and regencies within their jurisdiction without the central government's intervention. Moreover, it also shows that some municipalities and regencies can be trusted with the revoked tasks and authorities. The central government needs to have proper justification before claiming municipalities, regencies, or provinces are incompetent to perform some tasks and authorities. The central government could consider connecting the performance assessment with adding or reducing tasks and authorities as a consequence of sub-national governments' performance achievements.

In this asymmetric case, those tasks and authorities will depend on the sub-national governments' capacity and maturity. Therefore, the central government needs to make tasks and authorities levelling and the requirements or indicators to grouping sub-national government according to level of capacity. The level of which a group of sub-national governments are entitled to will affect the calculation of IGFTs allocation and the types of discretion embedded on those IGFTs.

In addition, the central government would also need to assess their intention to strengthen provincial roles based on indicators to decide whether a province is competent enough to carry out responsibilities to become the central government's eyes and hands in the regions. Otherwise, the central government may need to delegate greater authorities, tasks and responsibilities to local governments, and directly connect to them to ensure good decentralisation outcomes.

China's asymmetric grants of authority to the provinces of Guangdong and Zhejiang is a good example. Moreover, Guangdong also devolved asymmetric responsibilities to four cities, while Zhejiang gave additional responsibilities to 13 counties that made them equal to their municipality-level of government, which supposed to be hierarchically higher. Another good example is the asymmetric tasks and

responsibilities assignment approach of Spain's central government with its classification of 'fast track' and 'slow track' autonomous communities. These experiences show that the asymmetric approach could become an alternative in getting good outcomes from sub-national governments.

9.4 Prospect and Outlook of Indonesian Intergovernmental Fiscal Relations

Looking back at the data trends on Indonesian IGFTs, there is no doubt as to the central government commitment to decentralisation as its development policy. The budget support kept scaling up from only IDR 33.1 trillion in the year of 2000 to almost IDR 800 trillion in 2018 — equal to around one third of the national budget.

Nevertheless, there are reasons to believe that the Indonesian fiscal decentralisation policy will become a 'centrally-dictated decentralisation'. First, the data show the proportion of block grants declined from 93.1 per cent in 2006 to 65.2 per cent in 2018, compared to 34.8 per cent for tied grants. It may appear that the block grants are still dominant, but the Minister of Finance regulation since 2017 introduced a new era of 'earmarked block grants'. The regulations required sub-national governments to allocate from its block grants the portion of 25 per cent for capital expenditures, 10 per cent for additional Village Fund, 10 per cent for the health sector, and 20 per cent for education.

This 'centrally-dictated decentralisation' would not have emerged had the central government applied an asymmetric approach where groups of sub-national governments would get treatment and privileges to implement the tasks of decentralisation according to their capacity and maturity. It is a situation where the central government acknowledge that there is no single or equal capacity across sub-national governments.

9.5 Further Research

A country's national performance is simply an aggregate of local performance (Faguet, 2005). Hence, the sub-national governments' performance in producing desired decentralisation outcomes is as an essential factor that requires attention from the

central government. Therefore, central government needs to provide adequate systems, policies and regulations to manage its decentralisation practice.

As described in Chapter 4, Indonesia's fiscal decentralisation policies have been very dynamic, especially in terms of IGFT types and regulations. Two types of IGFTs have not been covered in this thesis. First is the most recent addition to IGFTs, the emergence of Village Fund as a consequence of the mandate listed in Law No. 6/2014 on Villages. This is another 'big bang' in Indonesian decentralisation practice. Villages, previously just an administrative government without the power to plan their rural development and budget, suddenly became crucial new actors in Indonesia's decentralisation. The concerns arising from this are more to do with human resources capacity and integrity rather than political issues, as the Head of Village is elected as individual rather than through political party endorsement.

The Village Fund started with only around IDR 9 trillion at the beginning of 2015, which then significantly increased to around IDR 20 trillion in the middle of the same fiscal year. As of 2019, the central government has allocated IDR 70 trillion per year for more than 74,000 villages across the country. The number has not yet been added from municipalities' and regencies' obligation under Article 72 paragraph 1 of Law No. 6/2014, which stipulates that the allocation of Village Fund is to be provided not only from the national budget but also from at least 10 per cent of municipality and regency local taxes and user fees and charges, and at least 10 per cent of municipality and regency block grants received from the central government. These numbers resulted in a 'big bang' of fiscal resources in villages, currently amounting to around IDR 900 million for each village.

The Village Fund policy seems more like an ideological support agenda for the socialist in the parliament, de-bottlenecking governmental budget to provide more support to the villages, which are considered poor and have little opportunity to improve their development. However, such immense fiscal resources for a village can turn into a disaster unless the central government manages to formulate effective regulation. The data from Indonesian Corruption Watch reveal that there were 110 corruption cases involving 139 people regarding the use of Village Fund between 2016 and August 2017. Furthermore, the audit report from the Financial and Development Monitoring Agency (BPKP) indicates that there has been mismanagement in the

utilisation of the Village Fund, which needs better monitoring and assistance from the central government. The audit report raises a red flag, in that the number of incidents of corruption may well be above those cases that have been processed by law enforcement officers.

Further research is called for to determine what has been the result of this massive funding increase — because, as mentioned earlier, this will constitute the aggregate of national development indicators. Furthermore, as much as we know that managing decentralisation outcomes directly at the municipality and regency level is hard, the challenge will be harder with villages which sit at an even lower level of government. The question is, what should the central government's strategy be to control the utilisation of the Village Fund effectively?

The second form of IGFT that is not covered in this thesis is the Special Autonomy Fund. The provinces of Aceh, Papua and West Papua have been receiving extra IGFTs compared to other sub-national governments since 2001. The statutory provisions state that they were to receive the Special Autonomy Fund for 20 years, which means this revenue stream will end soon, in 2021. Therefore, it would be interesting to research the effectiveness of the Special Autonomy Fund in those provinces as an empirical base to modify the provision in case the central government is mandated by future law to continue the Special Autonomy Fund for these provinces. Moreover, it would also be a good opportunity to evaluate the Special Autonomy Fund recently given to the Province of Yogyakarta Special Region.

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Every reasonable efforts has been made to acknowledge the owners of copyright material. I would be pleased to hear from any copyright owner who has been omitted or incorrectly acknowledged.

Appendix 1: Ethics Approval



Office of Research and Development

GPO Box U1987
Perth Western Australia 6846

Telephone +61 8 9266 7883
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Web research.curtin.edu.au

18-Oct-2017

Name: Alan Fenna
Department/School: John Curtin Institute of Public Policy (JCIPP)
Email: A.Fenna@exchange.curtin.edu.au

Dear Alan Fenna

RE: Ethics Office approval
Approval number: HRE2017-0742

Thank you for submitting your application to the Human Research Ethics Office for the project **Getting Good Outcomes from Sub-National Governments: A Case Study on Indonesian Fiscal Decentralisation**.

Your application was reviewed through the Curtin University Low risk review process.

The review outcome is: **Approved**.

Your proposal meets the requirements described in the National Health and Medical Research Council's (NHMRC) *National Statement on Ethical Conduct in Human Research (2007)*.

Approval is granted for a period of one year from 18-Oct-2017 to 17-Oct-2018. Continuation of approval will be granted on an annual basis following submission of an annual report.

Personnel authorised to work on this project:

Name	Role
Hadiana, Ilham	Student
Fenna, Alan	CI
Wilkins, Peter	Supervisor

Approved documents:

Document

Standard conditions of approval

1. Research must be conducted according to the approved proposal
2. Report in a timely manner anything that might warrant review of ethical approval of the project including:

- proposed changes to the approved proposal or conduct of the study
 - unanticipated problems that might affect continued ethical acceptability of the project
 - major deviations from the approved proposal and/or regulatory guidelines
 - serious adverse events
3. Amendments to the proposal must be approved by the Human Research Ethics Office before they are implemented (except where an amendment is undertaken to eliminate an immediate risk to participants)
 4. An annual progress report must be submitted to the Human Research Ethics Office on or before the anniversary of approval and a completion report submitted on completion of the project
 5. Personnel working on this project must be adequately qualified by education, training and experience for their role, or supervised
 6. Personnel must disclose any actual or potential conflicts of interest, including any financial or other interest or affiliation, that bears on this project
 7. Changes to personnel working on this project must be reported to the Human Research Ethics Office
 8. Data and primary materials must be retained and stored in accordance with the [Western Australian University Sector Disposal Authority \(WAUSDA\)](#) and the [Curtin University Research Data and Primary Materials policy](#)
 9. Where practicable, results of the research should be made available to the research participants in a timely and clear manner
 10. Unless prohibited by contractual obligations, results of the research should be disseminated in a manner that will allow public scrutiny; the Human Research Ethics Office must be informed of any constraints on publication
 11. Approval is dependent upon ongoing compliance of the research with the [Australian Code for the Responsible Conduct of Research](#), the [National Statement on Ethical Conduct in Human Research](#), applicable legal requirements, and with Curtin University policies, procedures and governance requirements
 12. The Human Research Ethics Office may conduct audits on a portion of approved projects.

Special Conditions of Approval

None.

This letter constitutes low risk/negligible risk approval only. This project may not proceed until you have met all of the Curtin University research governance requirements.

Should you have any queries regarding consideration of your project, please contact the Ethics Support Officer for your faculty or the Ethics Office at hrec@curtin.edu.au or on 9266 2784.

Yours sincerely



Amy Bowater
Acting Manager, Research Integrity

Appendix 2: Participant Information Statement



Getting Good Outcomes

PARTICIPANT INFORMATION STATEMENT

HREC Project Number:	2017-0742
Project Title:	Getting Good Outcomes from Sub-National Governments: A Case Study on Indonesian Fiscal Decentralisation
Chief Investigator:	Professor Alan Fenna, Researcher at John Curtin Institute of Public Policy, Curtin University
Student researcher:	Ilham Hadiana
Version Number:	2
Version Date:	17/Oct/2017

What is the Project About?

Decentralisation is perceived to be advantageous in meeting local public needs, encouraging better public service delivery, and improving local economic development. As well as involving devolution of governance responsibilities, decentralisation also requires appropriate fiscal relations between central and local governments. Failure in designing the appropriate devolution of responsibilities and its fiscal arrangement might lead to increased disparity among regions, macro-economic instability, high level of corruption, and rent-seeking behaviour from ineffective and inefficient sub-national governments that will eventually burden the national budget.

This research will assess the Indonesian government's fiscal decentralisation policy and evaluate Indonesia's attempt to get better outcomes from implementing a nation-wide program of decentralisation. The research will assess the central government's intentions for the future of Indonesian fiscal decentralisation policy and assess whether fiscal incentive, which has been promoted in literatures, can attract and force local governments to perform well.

This research will provide outcomes both to the Government of Indonesia's policy and existing knowledge of the second generation theory of fiscal federalism in several ways. First, will provide an up-to-date understanding of the complex and ambitious process of decentralization that has been implemented in Indonesia over the last two decades. Secondly, it can provide policy frameworks for the Government of Indonesia's fiscal decentralisation strategy. Thirdly, it will be a useful resource to the recent initiative to substitute the Law Number 33 Year 2004 on central and local government fiscal relations. Fourthly, it will thoroughly analyse what kind of mechanism and indicators used in determining fiscal incentives and give evidence to enrich the literature on whether or not the practice of fiscal incentive attracts and forces local governments to perform well. Finally, the practice of using fiscal incentives in an apparently low-discretion local government's budget is an

Getting Good Outcomes

important topic to examine as it could contribute new knowledge to the second generation theory of fiscal federalism.

The research will collect primary data through semi-structured interviews. The semi-structured interviews will explore the individuals' interpretation to the senses of fiscal decentralisation practice in Indonesia. The semi-structured interviews samples are 30 government officials, which consist of 12 officials at Central Government (Directorate General of Fiscal Balance, Ministry of Finance), and 18 officials at three sub-national governments that represent west region, middle region, and east region of Indonesia. The three sub-national governments are the Province of West Sumatera, the District of Sambas (West Kalimantan Province), and the District of Central Moluccas (Moluccas Province).

Who is doing the Research?

The project is being conducted by Professor John Phillipmore as Chairman, Professor Alan Fema as Chief Investigator, Dr. Peter Wilkins as Co-Supervisor, and Ilham Hadiana as student researcher. The result of this research project will be used by Ilham Hadiana to obtain a Doctor of Philosophy degree at Curtin University and is funded by scholarship grant from Indonesian government through Indonesian Endowment Fund for Education (LPDP) and co-funded by Curtin University. There will be no costs to you and you will be given a souvenir for participating in this project.

Why am I being asked to take part and what will I have to do?

We want to interview several central and local government officials, which duties and responsibilities correlate with intergovernmental fiscal relation's practice in Indonesia. We will ask your opinion involving the implementation of fiscal autonomy and fiscal incentives practice in Indonesia. The interview will take place at a mutually convenient location. The interview will take approximately one hour to complete.

There will be no cost to you for taking part in this research and you will be given a souvenir. We will make a digital audio recording so we can concentrate on what you have to say and not distract ourselves with taking notes. After the interview, we will make a full written copy of the recording.

Are there any benefits' to being in the research project?

There may be no direct benefit to you from participating in this research. However, sometimes people appreciate the opportunity to discuss their opinions. We hope the results of this research will allow us to:

- Provide inputs to improve intergovernmental fiscal policy in Indonesia
- Discover more in-depth opinion from local governments on their policy preferences about intergovernmental fiscal relations in Indonesia
- add to the existing knowledge and literature on the theory of fiscal federalism

Getting Good Outcomes

Are there any risks, side-effects, discomforts or inconveniences from being in the research project?

There are no foreseeable risks from this research project. Apart from giving up your time, we do not expect that there will be any risks or inconveniences associated with taking part in this study. We will provide a souvenir to each participant as our gratitude.

Who will have access to my information?

The information collected in this research will be re-identifiable (coded). This means that the stored information will be re-identifiable which means we will remove identifying information on any data or sample and replace it with a code. Only the research team have access to the code to match your child's name if it is necessary to do so. Any information we collect will be treated as confidential and used only in this project unless otherwise specified. The following people will have access to the information we collect in this research: the research team and, in the event of an audit or investigation, staff from the Curtin University Office of Research and Development

Electronic data will be password-protected and hard copy data (including audio tapes) will be in locked storage. The information we collect in this study will be kept under secure conditions at Curtin University for 7 years after the research has ended and then it will be kept indefinitely. The results of this research may be presented at conferences or published in professional journals. You will not be identified in any results that are published or presented.

Will you tell me the results of the research?

We will write to you at the end of the research (in about 24 months) and let you know the results of the research. Results will not be individual but based on all the information we collect and review as part of the research. The results may also be available through journal publication and or conference proceedings.

Do I have to take part in the research project?

Taking part in a research project is voluntary. It is your choice to take part or not. You do not have to agree if you do not want to. If you decide to take part and then change your mind, that is okay, you can withdraw from the project. You do not have to give us a reason; just tell us that you want to stop. Please let us know you want to stop so we can make sure you are aware of any thing that needs to be done so you can withdraw safely. If you choose not to take part or start and then stop the study, it will not affect your relationship with the University, the Directorate General of Fiscal Balance, staff or colleagues.

If you chose to leave the study we will use any information collected unless you tell us not to.

Getting Good Outcomes

What happens next and who can I contact about the research?

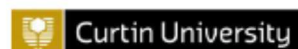
Should you have further enquiries regarding this research project, you can contact Ilham Hadiana, email: ilham.hadiana@postgrad.curtin.edu.au, mobile number +61478106016.

If you decide to take part in this research we will ask you to sign the consent form. By signing it is telling us that you understand what you have read and what has been discussed. Signing the consent indicates that you agree to be in the research project. Please take your time and ask any questions you have before you decide what to do. You will be given a copy of this information and the consent form to keep.

Curtin University Human Research Ethics Committee (HREC) has approved this study (HREC number 2017-0742). Should you wish to discuss the study with someone not directly involved, in particular, any matters concerning the conduct of the study or your rights as a participant, or you wish to make a confidential complaint, you may contact the Ethics Officer on (08) 9266 9223 or the Manager, Research Integrity on (08) 9266 7093 or email hrec@curtin.edu.au.

Appendix 3: Consent Form

Getting Good Outcome



CONSENT FORM

HREC Project Number:	2017-0742
Project Title:	Getting Good Outcome from Sub-National Governments: A Case Study on Indonesian Fiscal Decentralisation
Chief Investigator:	Professor Alan Fenna, Researcher at John Curtin Institute of Public Policy, Curtin University
Student researcher:	Ilham Hadiana
Version Number:	2
Version Date:	17/Oct/2017

- I have read, {or had read to me in my first language – delete if not appropriate}, the information statement version listed above and I understand its contents.
- I believe I understand the purpose, extent and possible risks of my involvement in this project.
- I voluntarily consent to take part in this research project.
- I have had an opportunity to ask questions and I am satisfied with the answers I have received.
- I understand that this project has been approved by Curtin University Human Research Ethics Committee and will be carried out in line with the National Statement on Ethical Conduct in Human Research (2007).
- I understand I will receive a copy of this Information Statement and Consent Form.

Optional Consent

- **Being Audio Recorded:** in this project we would like your permission to let us make a digital audio recording so we can concentrate on what you have to say and not distract ourselves with taking notes
- **Contacted for Future Research:** We would like you to consider allowing us to send you information about future research projects. Once you receive the information it is your choice if you decide to take part or not.
- **Use of information for Future Research:** We would like you to consider letting us share the information we collect during this research with other researchers working in this area.

<input type="checkbox"/> I do	<input type="checkbox"/> I do not	consent to being audio-recorded
<input type="checkbox"/> I do	<input type="checkbox"/> I do not	consent to be contacted about future research projects that are related to this project

<input type="checkbox"/> I do	<input type="checkbox"/> I do not	consent to the storage and use of my information in future ethically-approved research projects related to this project
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Participant Name	
Participant Signature	
Date	

Declaration by researcher: I have supplied an Information Letter and Consent Form to the participant who has signed above, and believe that they understand the purpose, extent and possible risks of their involvement in this project.

Researcher Name	
Researcher Signature	
Date	

Note: All parties signing the Consent Form must date their own signature.

Appendix 4: Semi-Structured Interview Guides and Questions

Introduction

1. Introduce researcher: background.
2. Give and explain the Participant Information Sheet.
3. Tell participant that the interview will be recorded for this research purpose only.
4. Ask the interviewee whether he or she agree to be recorded and sign the Participant Consent Form.
5. A brief summary about the fiscal federalism conceptual framework and this research project

Summary

Indonesia has been experiencing the so called ‘big bang’ decentralisation for over a decade now. Through this period, there have been changes to the decentralisation policy and regulation. Moreover, it is most likely that improvements on the practice of Indonesian fiscal decentralisation will continue to take place in order to achieve the theoretical objectives of decentralisation. However, there are different views on how to formulate and implement a successful fiscal decentralisation policy that can support and stimulate sub-national governments to perform their tasks and responsibilities well. This project seeks to assess how central and regional government officials see the challenges and achievements of Indonesia’s decentralisation program.

Questions

Central Government participants

1. Please tell me your name, position held, and roles in the Directorate General of Fiscal Balance, Ministry of Finance, Republic of Indonesia.
2. (*Explain about the First Generation Theory of Fiscal Federalism*). In your capacity as the policy maker, how do you understand the central government’s approach to fiscal autonomy for sub-national governments? What sources of income do you think are needed by the sub-national governments in achieving fiscal autonomy? Which should be dominant, Local Own Source Revenue (PAD) or Intergovernmental fiscal transfers (IGFTs)?
3. I noted in the Grand Design of Indonesian Fiscal Decentralization document that there was a statement that wanted to push PAD to be more significant, but it was not intended to be the dominant source in the sub-national government’s budget (APBD). If so, then what is the definition of the central government related to sub-national government’s fiscal independency?
4. In the IGFTs’ policy exposures it was mentioned that one of the challenges in managing local finances is the high dependence on IGFTs. Can this be interpreted that when the regions are able to push PAD to be significant, the central transfer funds to the regions will decrease?
5. (*Explain about the Second Generation Theory of Fiscal Federalism*)
 - a. In your capacity as a policymaker, what strategies are used by the central government to ensure that transfers to sub-national governments can actually benefit the people in the regions?

- b. According to you as a policy maker at the national level, what type of transfers to the regions are the most appropriate and beneficial for the region? Unconditional grants or specific for a particular sector? Why is that?
 - c. Does the Balancing Fund formulation directed to be able to encourage sub-national governments to perform better?
 - d. Every year the Central Government always issues regulations relating to the IGFTs transfer's mechanisms. In your opinion, are the requirements imposed for the region so that the allocated Balancing Fund can then be transferred to the regions, have an effect on sub-national government's performance? (*Give examples of DAU and DAK transfer's requirements*)
 - e. There were respondents in the sub-national governments who said that the IGFTs transfer's requirements were increasingly complicated and what even more dangerous was that not all central treasurers in the regions (KPPN) had the same understanding of the existing rules so that they were actually detrimental to the region. How do you respond to this?
6. The Central Government has a policy of transferring Local Incentive Funds (DID) based on the performance of sub-national governments
 - a. What is the rationale for the central government in determining the indicators currently used in assessing sub-national government's performance?
 - b. What causes the DID indicators to change?
 - c. Based on the amount of incentive funds received by the region, do you think this policy is able to encourage sub-national governments to perform better?
 - d. Is there a discourse in the Central Government to separate DID's assessment into several sub-national government's groups based on certain characteristics?
 - e. Since 2018 several version of Ministries/Central Government's Agencies performance assessments are also accommodated as a category for obtaining DID, what was the background of this policy?
 7. In some countries, the fiscal decentralisation hierarchy from the central government is only to the provinces. Then, it is the province that plays a role in coordinating regencies/municipalities in their regions. Law 23/2014 also emerged by strengthening the role of the province. In your capacity as central policy maker, does the central government also plan to strengthen the role of the province by simplifying the hierarchical pattern of central and sub-national governments' fiscal relations?
 8. Is there anything else you would like to say?

Sub-national government participants

1. Please tell me your name, position held, and roles in this Sub-national government's Agency.
2. (*Explain about the First Generation Theory of Fiscal Federalism*). Do you think the fiscal decentralisation policy implemented in Indonesia could further strengthen local fiscal autonomy or vice versa? What sources of income do you think are needed by the sub-national governments in achieving fiscal autonomy? Which should be dominant, Local Own Source Revenue (PAD) or Intergovernmental fiscal transfers (IGFTs)?
3. In the IGFTs' policy exposures it was mentioned that one of the challenges in managing local finances is the high dependence on IGFTs. Based on your

experience, what is the cause of the insignificant PAD? Under achievement of collection in the region or indeed the potential of the tax area currently provided is not possible for the regions to make PAD more significant?

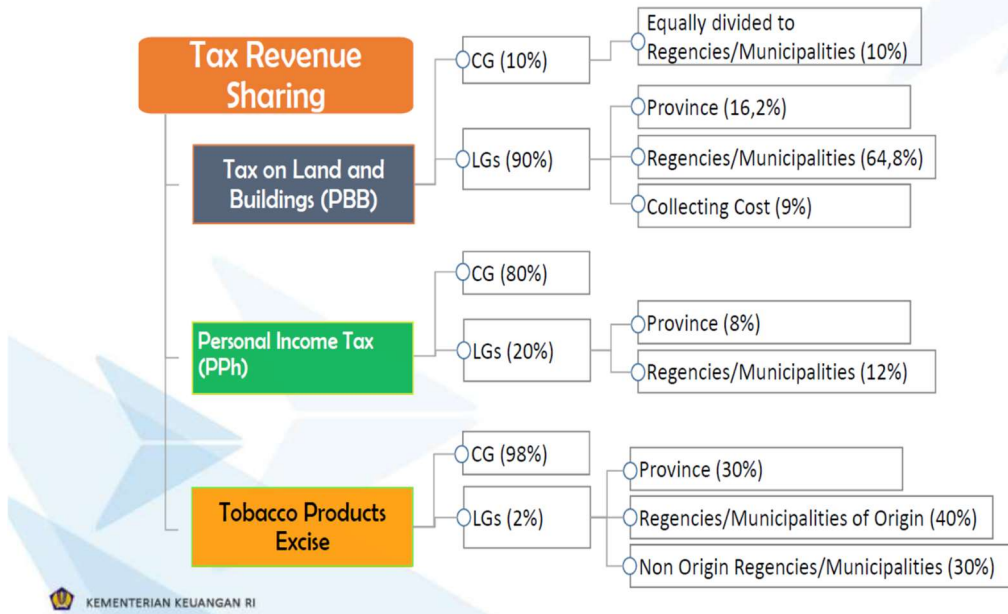
4. In some countries, the fiscal decentralisation hierarchy from the central government is only to the provinces. Then, it is the province that plays a role in coordinating regencies/municipalities in their regions. Law 23/2014 also emerged by strengthening the role of the province. Based on your experience in the region, does the current regulation really seem to strengthen the role of the Province, especially in controlling the performance of regencies/municipalities? Why?
5. From your point of view as a sub-national government official, what type of transfer to the region is the most appropriate and beneficial to encourage sub-national government's performance? Block grants or Specific grants? Why?

(Explain about the Second Generation Theory of Fiscal Federalism)

6. *(Questions about IGFTs)*
 - a. Do you know and understand the Balancing Fund allocation formula?
 - b. In your opinion, does the change in the DAK allocation formulation to a proposal based, able to encourage the sub-national government to perform better?
 - c. Every year the Central Government always issues regulations relating to the IGFTs transfer's mechanisms. In your opinion, are the requirements imposed for the region so that the allocated Balancing Fund can then be transferred to the regions, have an effect on sub-national government's performance? *(Give examples of DAU and DAK transfer's requirements)*
7. *(Questions about DID)*
 - a. Are you aware of DID? What do you think of it?
 - b. Do the DID indicators become the base of sub-national government's performance target?
 - c. Based on the amount of incentive funds received by the region, do you think this policy is able to encourage sub-national governments to perform better?
 - d. Do you think the current DID indicators used to assess are fair, measurable, and acceptable? Why? What kind of indicators would you suggest to add or eliminate?
 - e. Does the Central Government need to separate DID's assessment into several sub-national government's groups based on certain characteristics?
8. 2018 DID performance assessments accommodated Sub-national government's Management Report (LPPD) and Government Institution Performance Accountability Report (LKIP) as categories for obtaining DID incentives
 - a. What is your opinion on these two assessment categories?
 - b. Do the reports burdening sub-national governments or even hampering sub-national government's performance? If yes, in what way (e.g. time consuming, waste of human and financial resources, etc.)?
9. Is there anything else you would like to say?

Appendix 5: Revenue Sharing (DBH) Proportion

Revenue Sharing (DBH): Tax



Revenue Sharing (DBH): Natural Resources

	Type of Natural Resources	Law 33/2004 & Law 23/2014				Law on Special Autonomy	
		CG	Province	Regency/ Municipality As the Origin of Revenue	Other non-Origin Regencies/ Municipalities within the same Province	Aceh	West Papua
1.	Forestry						
	a. IIUPH	20	16	64	-	-	-
	b. PSDH	20	16	32	32	-	-
	c. Reforestation Fund	60	40*	40	-	-	-
2.	General Mining						
	a. Land-rent	20	16	64	-	-	-
	b. Royalty	20	16	32	32	-	-
3.	Fishery	20	-	-	80	-	-
4.	Oil Mining	84,5	3,1	6,2	6,2	70**	70**
5.	Natural Gas Mining	69,5	6,1	12,2	12,2	70**	70**
6.	Geothermal	20	16	32	32	-	-

*Law 23/2014 remove Reforestation Fund from the Origin Source of Revenue to the Province

** Special Autonomy Law that gives Province 70 per cent DBH only applies to Oil and Gas sectors

Appendix 6: The Number of Sub-national governments by Audit Opinion Based on the Supreme Audit Boards (BPK) Evaluation on Their Financial Statement Year 2005 - 2017

	Unqualified Opinion	Qualified Opinion	Disclaimer	Adverse Opinion
2005	14	307	24	13
2006	3	327	105	28
2007	4	283	123	59
2008	13	323	118	31
2009	15	330	106	48
2010	15	330	106	48
2011	35	349	100	8
2012	76	318	80	6
2013	73	311	46	11
2014	162	247	35	5
2015	312	187	30	4
2016	378	141	23	0
2017	411	113	18	0

Appendix 7: Key Points on Types of Intergovernmental Fiscal Transfers (IGFTs) in Indonesia

IGFTs Type	Key Points
Revenue Sharing Fund (DBH)	<ul style="list-style-type: none"> • A type of block grant that consist of tax and natural resources shared revenue • Exception made to the tobacco production excise funds that are earmarked to finance health programs related to the anti-smoking campaign, and re-forestation funds. • The additional 0.5 per cent central government share from oil and gas revenue to finance basic education was also earmarked, but in 2016 the central government abolished the earmarking and classified it as one of the block grants
General Allocation Fund (DAU)	<ul style="list-style-type: none"> • A type of block grant that is given to sub-national governments and used as an equalising grant to reduce horizontal imbalances. • Still the highest proportion of IGFTs despite declining in comparison percentage • Since 2017, together with block grants from DBH become the based of 25% earmarked obligation for sub-national governments to use as general infrastructure expenditure
Specific Allocation Fund (DAK)	<ul style="list-style-type: none"> • A type of conditional or tied grant scheme allocated to finance physical capital investment and limited-period financing of operational and maintenance needs matched with national priorities in several sectors of sub-national government responsibility • The proportion significantly increase since 2015 • Central formula-based allocation changed into Sub-national Governments' proposal-based since 2015

IGFTs Type	Key Points
	<ul style="list-style-type: none"> • Since 2015, consist of Physical and Non-physical DAK. Physical DAK for capital expenditures, while Non-physical to support operational costs in specific sectors
Adjustment Funds	<ul style="list-style-type: none"> • Adjustment Funds was a term used for several types of IGFTs provided as a calculation adjustment from the previous year's allocation of Balance Funds • It also started to become a place for some of the central government's initiatives in the form of affirmative policy for regional development, but then stopped because it was being used by the parliament members for corruption • Since 2015, it has been reclassify as Non-physical DAK that consist of operational subsidy fund for specific sectors
Local Incentive Fund (DID)	<ul style="list-style-type: none"> • A type of IGFTs introduced in 2010 to stimulate sub-national governments' performance by giving financial rewards. • The total amount provided in the state budget from 2010 to 2015 ranged between IDR 1.2 trillion and IDR 1.6 trillion. In 2016 and 2017, it was increased significantly to IDR 5 trillion and IDR 7.5 trillion respectively • Since 2016, introduced <i>Dana Rakca</i> Award. An additional prestigious award from the President but only to top three provinces, top five municipalities, and top ten regencies. The others who do not qualify for the Award are only given the financial rewards
Special Autonomy Funds	<ul style="list-style-type: none"> • Allocated based on Law No. 21/2001 on Special Autonomy for the Province of Papua, Law No. 35/2008 on Special Autonomy for the Province of West Papua, and Law No. 11/2006 on the Governance of Aceh. In 2012, the Province of Yogyakarta Special Region was also given similar funds due to its special status as a region • The laws required those provinces to allocate their Special Autonomy Funds

IGFTs Type	Key Points
	only for specific sectors and programs
Village Funds	<ul style="list-style-type: none"> • The most recent type of IGFT and was implemented as a consequence of the promulgation of Law No. 6/2014 on Villages • The law mandated that all villages be given an amount to support village development and the people's economic empowerment • Institutionally, the village is regarded as a subordinate of regencies, and naturally becomes one of the objects of regencies' budget expenditure programmes. Creation of the Village Fund is meant to re-position the villages as a subject of development that can exercise discretion in planning their expenditure based on each village's unique needs and characteristics