

**THE POLITICS OF FISCAL DECENTRALISATION IN INDONESIA
A STUDY ON POLICY DEVELOPMENT 1974-2004**

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**UNIVERSITI SAINS MALAYSIA
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WALKING THE TIGHTROPE
THE POLITICS OF FISCAL DECENTRALISATION
IN INDONESIA 1974-2004

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LIST OF ABBREVIATION

ABRI	: Angkatan Bersenjata Republik Indonesia, refers to the military corps (army, navy, air-force) and the police
APKASI	: Asosiasi Pemerintah Kabupaten Seluruh Indonesia, All Indonesian District Government Association
ADEKSI	: Asosiasi DPRD Kota Seluruh Indonesia, All Indonesian City Council Association
ADKASI	: Asosiasi DPRD Kabupaten Seluruh Indonesia, All Indonesian District Council Association
ADO	: Alokasi Devisa Otomatis, allocation of foreign exchange earnings from exports, provided for the provinces
APBD	: Anggaran Pendapatan dan Belanja Daerah, regional/local budget
APBN	: Anggaran Pendapatan dan Belanja Negara, national budget
APEKSI	: Asosiasi Pemerintah Kota Seluruh Indonesia, All Indonesian City Government Association
APPSI	: Asosiasi Pemerintah Provinsi Seluruh Indonesia, All Indonesian Provincial Government Association
Bappeda	: Badan Perencana Pembangunan Daerah, Regional Development Planning Board, established in provinces, districts and cities
Bappenas	: Badan Perencana Pembangunan Nasional, National Development Planning Board
Bimas	: Bimbingan Massal, mass guidance programme for agriculture
BPKM	: Badan Koordinasi Penanaman Modal, Investment Co-ordinating Board
BPS	: Biro Pusat Statistik, Central Bureau of Statistics
Bupati	: Regent, head of district
Camat	: Head of sub-district
CGI	: Consultative Group for Indonesia, forum of donors for Indonesia (after 1992)
CSIS	: Centre for Strategic and International Studies
Daerah	: A unit of local autonomous administration
DAK	: Dana Alokasi Khusus (special allocation / earmarked funds)
Dana Perimbangan	: Lit. Equalisation Funds, the inter-governmental fiscal scheme consists of the Bagi Hasil (Revenue Sharing), the DAU (block grants) and the DAK (specific grants)
Dati I	: Daerah Tingkat I (First Stage Regional Government, province)
Dati II	: Daerah Tingkat II (Second Stage Regional Government, regency/municipality/district)
DAU	: Dana Alokasi Umum (general allocation funds)
Depdagri	: Departemen Dalam Negeri, Minister of Home Affairs
DIK	: Daftar Isian Kegiatan, Activities Proposal Forms, early documents for sectoral projects
Dinas	: Regional agencies, established in the provinces and the districts
DIP	: Daftar Isian Proyek, Project Proposal Lists, mainly for 'sectoral' projects
Dispenda	: Dinas Pendapatan Daerah, Local Revenue Agencies
DPOD	: Dewan Pertimbangan Otonomi Daerah, Local Autonomy Co-ordinating Council
DPR	: Dewan Perwakilan Rakyat (People's Representative Council), lower house of parliament

DPRD	: Dewan Perwakilan Rakyat Daerah, Regional People's Representative Council, established in the provinces and the districts
Dwi-fungsi	: Dual-function
GAM	: Gerakan Aceh Merdeka, Independence Aceh Movement
GBHN	: Garis-garis Besar Haluan Negara (General Orientation of State Policy)
Golkar	: Golongan Karya (Functional Group), the New Order's government party
ICMI	: Ikatan Cendekiawan Muslim Indonesia, the Indonesian Muslim Scholar Association
IGGI	: Inter-Governmental Group on Indonesia, forum of donors for Indonesia
Inpres	: Instruksi Presiden, presidential instruction
Ipeda	: Iuran Pembangunan Daerah, Local Development Fees, property tax levied at the local level
Ireda	: Iuran Rehabilitasi Daerah, Local Rehabilitation Fees, property tax levied at the urban districts
Kabupaten	: regency, district
KAMI	: Kesatuan Aksi Mahasiswa Indonesia, student action groups
Kandep	: Kantor Departemen (Departmental Offices), central government's agencies at the district level
Kanwil	: Kantor Wilayah (Regional Offices), central government's agencies at the provincial level
Kecamatan	: sub-district
Kopkamtib	: Komando Operasi Keamanan dan Ketertiban, Operational Command for Security and Order
Korpri	: Korps Pegawai Republik Indonesia, Indonesian Civil Servants' Association
KPPOD	: Komite Pemantauan Pelaksanaan Otonomi Daerah, Committee for Monitoring Local Autonomy Implementation
Malari	: Malapetaka Limabelas Januari, The 15 January Disaster, the big riots in 15 January 1974
MOF	: Ministry of Finance
MOHA	: Ministry of Home Affairs
MPR	: Majelis Permusyawaratan Rakyat, (People's General Assembly), upper house of parliament
Muhammadiyah	: Moslem association, mainly modernist
NU	: Nahdhatul Ulama, Moslem party / association, mainly traditionalist
OPM	: Organisasi Papua Merdeka (Free Papua Organisation), separatist movement in Irian Jaya (West Papua)
PAD	: Pendapatan Asli Daerah, own regional revenues
PAN	: Partai Amanat Nasional, National Mandate Party, founded by Amien Rais
Pancasila	: The Five Principles of the Indonesian nation state
PBB	: Pajak Bumi dan Bangunan, property tax
PDI	: Partai Demokrasi Indonesia (Indonesian Democratic Party)
PDIP	: Partai Demokrasi Indonesia Perjuangan (Struggle Indonesian Democratic Party), the more popular PDI after reform
Permesta	: Perjuangan Rakyat Semesta, separatist movement in South Sulawesi

PKB	: Partai Kebangkitan Bangsa, National Awakening Party, founded by Abdurrahman Wahid
PKPD	: Perimbangan Keuangan Pusat-Daerah (Financial Balance between Central-Local Governments)
PKI	: Partai Komunis Indonesia, Indonesian Communist Party
PNI	: Partai Nasional Indonesia, Indonesian Nationalist Party
PPN	: Pajak Pertambahan Nilai, value-added tax (VAT)
PPP	: Partai Persatuan Pembangunan (Development Union Party)
PRRI	: Pemerintahan Revolusioner Republik Indonesia, separatist movement in West Sumatera
PUOD	: Pemerintahan Umum dan Otonomi Daerah, Regional Autonomy and General Administration, a division in the MOHA
Repelita	: Rencana Pembangunan Lima Tahun, Five Yearly Development Plan
Retribusi	: Service charges, levies
SDO	: Subsidi Daerah Otonom, Autonomous Regional Subsidy, subsidies given to provinces/districts, mainly for routine expenditures
Siap	: Sisa Anggaran Pembangunan, unspent development budget
TNI	: Tentara Nasional Indonesia, the Indonesian National Military, refers to the military after the reform, consisted of the army, navy and the air force
Wilayah	: A unit of regional/local administration under de-concentration principle

POLITIK DESENTRALISASI FISKAL DI INDONESIA SATU KAJIAN PERUBAHAN DASAR 1974-2004

ABSTRAK

Satu unsur utama dalam usaha Indonesia ke arah demokratisasi ialah perubahan dasar dalam perhubungan fiskal antara kerajaan. Kajian ini meneliti proses pembuatan keputusan tentang dasar desentralisasi fiskal untuk menjelaskan perubahan dan kesinambungan dasar, dengan tumpuan kepada perkembangan-perkembangan dari 1974 hingga 2004. Ini bererti dua fasa: pertama, aturan fiskal yang lebih berpusat dibawah peruntukan perundangan 1974 Kerajaan Orde Baru, dan kedua, aturan yang relatif lebih tersebar di bawah peruntukan perundangan 1999 yang diubahsuai pada tahun 2004.

Perundangan 1974 menyediakan asas peraturan fiskal Orde Baru yang berpusat, serta kawalan ketat ke atas wilayah-wilayah. Walaupun terdapat undang-undang asas yang menggariskan perkongsian hasil antara pusat dan pihak berkuasa tempatan, rejim Orde Baru menggunakan pendapatan daripada hasil minyak untuk membeli ketaatan wilayah-wilayah melalui dua instrumen dasar: dana SDO yang bertujuan untuk membiayai jentera birokrasi tempatan, dan geran Inpres yang digunakan untuk meningkatkan pembangunan ekonomi di wilayah-wilayah. Berakhirnya limpahan hasil minyak, komplikasi pentadbiran, dan pergantungan yang berlebihan telah menyebabkan Kerajaan Orde Baru menimbangkan tindakan desentralisasi.

Krisis ekonomi dan tumbanganya Kerajaan Orde Baru telah mengubah perhubungan fiskal pusat-tempatan. Dengan lulusnya peruntukan perundangan 1999 oleh kerajaan sementara, wilayah-wilayah yang kaya dengan sumber telah berjaya mendapatkan persetujuan perkongsian hasil. Namun pelaksanaan persetujuan ini dan perkembangan-perkembangan terbaru menunjukkan kesinambungan dasar-dasar utama di bawah pentadbiran berpusat. Justeru itu kajian ini menekankan kedua-dua aspek perubahan dan kesinambungan dalam dasar desentralisasi fiskal.

Kajian ini juga menunjukkan empat faktor utama yang berkebarangkalian untuk mempengaruhi masa depan arah dasar desentralisasi fiskal: keupayaan perkongsian hasil untuk memuaskan tuntutan-tuntutan wilayah yang kaya sumber; rundingan politik tentang geran DAU untuk mencapai formula keserataan perkongsian antara wilayah; penyelesaian perselisihan tentang matlamat penggunaan wang; dan perlunya untuk memastikan penyampaian perkhidmatan yang berkesan dan akauntabiliti fiskal di peringkat tempatan.

THE POLITICS OF FISCAL DECENTRALISATION IN INDONESIA

A STUDY ON POLICY DEVELOPMENT 1974 – 2004

ABSTRACT

Policy change in inter-governmental fiscal relations is a crucial part of Indonesia's thrust towards democratisation. This study examines the process of decision-making on fiscal decentralisation policy in order to explain policy changes and continuities. It focuses on developments from 1974 to 2004. This actually consists of two periods: the more centralised fiscal arrangements under the 1974 legislation of the New Order government and the relatively more decentralised arrangements under the 1999 legislation and its modification in 2004.

The 1974 legislation provided the basis for the New Order's centralised fiscal arrangements and tight control over the regions. Although there was a basic law providing for central-local revenue sharing, the New Order used revenue from the oil boom to buy regional acquiescence through two main policy instruments: the SDO funds which were basically aimed at maintaining the local bureaucratic machinery, and the Inpres grants which were used to boost economic development in the regions. The end of the oil boom, administrative complications and regional over-dependence led the New Order government to consider some decentralisation measures.

The economic crisis and subsequent downfall of the New Order government changed central-local fiscal relations. With the 1999 legislation passed by the caretaker government, the resource-rich regions were able to lock in some revenue sharing arrangements. Subsequent implementation and development, however, shows a substantial continuation of the policies under centralised administration. Thus this study highlights both continuity and change in fiscal decentralisation policy.

The study also reveals four main factors that are likely to influence the future course of policy development on fiscal decentralisation: the ability of revenue-sharing to pacify the resource-rich regions, political negotiations on the DAU block grants to achieve a formula-based equalisation among regions, the settlement of disputes over "expenditure assignment" or the purposes for which money is to be used, and the need to ensure effective service delivery and fiscal accountability at the local level.

CHAPTER 1

INTRODUCTION

The subject matter of this study is the process of policy formulation and change with respect to decentralisation in Indonesia during the contemporary period (1974-2004). There are many aspects of decentralisation policy in Indonesia. The study focuses on decentralisation policy on fiscal issues. Fiscal decentralisation is defined as the devolution of fiscal responsibilities from the central government to sub-national levels of government. While the debate on the efficacy of fiscal decentralisation is still on going, there has been much hope that fiscal decentralisation will produce benefits such as enhanced public service delivery, higher economic growth, eradication of poverty, better macroeconomic management, and better governance.

This study is empirical in the sense that it tries to explain the development of fiscal decentralisation policy in Indonesia. The focus is on the process of policy development, or what actually happened, why and how the actions of policy actors produce the decisional output called policy. It is important to bear in mind that policy choices at each stage of development is a resultant of interests and views of national and local political actors.

This chapter consists of five sections that will present the background, rationale, research objectives, theoretical framework and methods that are used in this study. The first section will explain the main issues in fiscal decentralisation that are commonly discussed in the literature. The second section will explain the salient issues in fiscal decentralisation in the Indonesian context. The third section will explain the objective of this study. Then, the remaining two sections will explain the methodology of this study, namely the theoretical framework on policy development and the data collection and analytical approach used in this study.

1.1 Main Issues in Fiscal Decentralisation

The basic idea of fiscal decentralisation is to disperse the burden of development and public service provision as well as financial resources from the central to the sub-national governments that are closer to the citizens. In so doing, the sub-national governments' capacity will be strengthened. According to Bahl & Linn,¹ three general arguments might be given in support of fiscal decentralisation. First, if expenditure mix and tax rates are determined at levels closer to the people, local public services will improve and local residents will be more satisfied with government services. Second, when responsibilities for taxation, financial policies, and services are devolved to local governments, these governments would compete to do the best for the people. In turn, it would create more capable local governments. Third, overall resource mobilisation will be increased because local governments can tax the fast-growing parts of their economic base more effectively than can the central government. In mobilising resources, central government is usually hampered by geographical conditions and span of control. Therefore, when local governments are given more responsibility, resource mobilisation would be better undertaken.

There might be a number of rationale – economic, social, and political – to justify such devolution or decentralisation. The most frequently quoted justifications for decentralising financial functions are to: close the fiscal gap, equalise fiscal capacities among different levels of government, increase effectiveness of central expenditures, and prevent separatist threats. Sub-national governments are frequently faced with fiscal gaps because there are too few revenue sources allocated to local governments. They have to spend beyond their means for development and public services, and they are not making

¹ Roy Bahl and Johannes Linn, *Urban Public Finance in Developing Countries* (New York: Oxford University Press, 1992), p. 386.

effective use of the revenue resources available to them. Fiscal decentralisation is aimed at ameliorating these problems of the fiscal gap. Fiscal decentralisation is also used to promote effective use of government expenditures for public services as the authority to allocate the budget is delegated to sub-national governments that are closer to the people. By possessing budget control, it is expected that they will ensure that expenditure is more effective and more accountable. Also, it is aimed at equalising fiscal capacities among sub-national governments. In many countries, particularly those containing areas with various dominant ethnic groups and unequal resources, fiscal decentralisation has an important political purpose. Richer regions would want independence unless they get – or get to keep – more of the revenue they generate. Therefore, fiscal decentralisation can be instrumental to maintaining the national territory and preventing separatist threats.

Despite the theoretical benefits of fiscal decentralisation, its actual practices raises complex issues about the assignment of fiscal responsibilities to various levels of government. Two basic issues immediately present themselves:² First, on expenditure assignment, what types of spending should be conducted by what levels of government? Next, on revenue assignment, what types of revenue should be raised and what tax rates should be set by what levels of government? Resolving these issues requires answering other questions that they entail. These prominently include the following. How should intergovernmental grants and revenue sharing be used to fill the gap between expenditures and revenues at sub-national levels and to provide the right incentives to sub-national government? Which level is responsible for tax administration and the public expenditure management system? Which level should design and administer further regulations? How should regulations be harmonised across various levels of government? These questions in turn involve many more issues regarding the intergovernmental institutional structures and financial relationships.

² Hamid R. Davoodi, "Fiscal Decentralisation", *IMF Research Bulletin*, 2(2), June 2001.

There is a wide variety of institutional structures and financial relationships between national and sub-national governments among countries in the world. These relationships seem to have little to do with the political structure of the country, whether it is a unitary or a federal system. Intergovernmental relations in federal systems often differ as much among themselves as with unitary countries. Most of the time, constitutional provisions do not entirely reflect the reality in intergovernmental relations.

The literature also discusses methods to decentralise fiscal and financial matters to the lower levels of government. According to Ebel,³ fiscal decentralisation relates to: sorting out roles and responsibilities among governments; intergovernmental transfers; strengthening local revenue systems or defining local service delivery systems; privatising state-owned enterprises (sometimes a local responsibility); and providing a safety net. Islam⁴ argued the need for multiple instruments and requirements in fiscal decentralisation, ranging from equalization grants, local borrowing framework and non-distortionary local taxes to local capacity building and democratic accountability at the local level. These are needed to achieve the various objective of decentralisation policy. In the public finance literature, grants are categorised based on four factors:⁵ the conditions of usage, that is the intended use of grants, whether grants will be used for specific services or for general purposes; the allocation method, whether grants are automatically allocated by a formula or require an application associated with a specific project; the requirement for recipient governments to provide some matching funds to the grants they receive; and the limits on the amount of grants.

³ Robert Ebel, *The Economics of Fiscal Decentralisation* (World Bank paper, 2000).

⁴ Inayatul Islam, *Making Decentralisation Work: Reaping the Rewards and Managing the Risks* (UNSFIR Working Paper, 1999).

⁵ Ronald Fisher, *State and Local Public Finance*, (Chicago: Irwin Publications, 1996), p. 36; Claudia Buentjen, *Fiscal Decentralisation in Indonesia: The Challenge of Designing Institutions* (Jakarta:GTZ-SfDM Project, 1998), p. 22.

With a variety of forms in inter-governmental grants and fiscal relations, there is also a wide array of incentive as well as disincentive effects for the lower levels of government. Depending on their design, matching grants and tax revenue assignments, for example, may spur fiscal effort at sub-national levels, but in doing so produce asymmetrical results that may be viewed as inequitable. Many grants and mandates arise from centrally-determined policy priorities. Thus, they help advance these priorities in a coordinated fashion across the country, but sometimes at the cost of distorting the political and fiscal initiatives of regions and localities that may have divergent priorities. Perhaps, the most important danger is the potential for soft budgets and moral hazard created by transfer systems that do not make revenue-matching or other conditions part of their formulae.⁶

Therefore, assigning transfers and devolving tax administration are inherently problematic. Hedd, for example, has shown the difficulties of simultaneously pursuing the commonly cited objectives of territorial equity, interpersonal equity and local autonomy.⁷ Moreover, sometimes problems arise not only because of conflicting objectives but also because of conflicting approaches and the need to give up some short-term objectives for longer-term ones. For example, there might be a trade-off between macroeconomic stability and public services after fiscal decentralisation.⁸ Again, in many technical issues, the question for fiscal decentralisation policy is how to do it rather than what should be

⁶ Omar Azfar, et al., *Decentralisation, Governance and Public Service: The Impact of Institutional Arrangements* (College Park: University of Maryland, IRIS Paper, 1999), p. 12.

⁷ David Hedd, *Public Expenditure: The Defence and Reform* (Oxford: Martin Robertson, 1983), p. 252.

⁸ Bahl & Linn, *Urban Public Finance in Developing Countries*, p. 470. A macro-economic analysis using Computable General Equilibrium (CGE) model on Indonesia showed a possible positive long-term result for the national economic development yet aggravated regional disparities and deterioration in the delivery of public services in the short-term. See Edi Effendi Tedjakusuma, *Analysis of the Impacts of Fiscal Decentralisation on Regional Development in Indonesia* (Unpublished PhD thesis, Nagoya University, 2000).

done. Most successful fiscal decentralisation efforts exhibit an appropriate matching of methods (as represented by the form of grant schemes, revenue-sharing formulas, and specific local tax assignments) with setting or context (in terms of resources, capacities, infrastructure and local development needs).

Many factors are likely to influence whether or not decentralisation improves the efficiency of resource allocation, promotes service quality and accountability, and reduces corruption in public services. Azfar et al.,⁹ stated that decentralisation works best, indeed may only be meaningful, if there is local democracy, and local democracy works best in socially and economically homogeneous communities. They also stated that the devolution of taxation power can create vertical externalities in terms of tax rates that are too high. What is meant by vertical externalities is the tendency for different levels of government to compete with each other in exploiting the same tax base. However, such competition may result in a higher burden for the tax payers, that is, the ordinary people.

Decentralisation policy will be successful if sub-national government systems are institutionalised enough for creating democratic governance. In spite of theoretical differences between those following more technocratic and more political approaches to decentralisation, most clearly agree that political factors shape the response to decentralisation. Samoff¹⁰ clearly stated that, from the perspective and in terms of the goals of those initiating decentralisation, “decentralisation is effective only when it is compatible with the interests of those expected to implement and defend it”. Again, this is to emphasize the importance of political variables in the process of implementing

⁹ Omar Azfar et al., *Decentralisation, Governance and Public Services: The Impact of Institutional Arrangements* (College Park: University of Maryland, IRIS Paper, 1999), p. 28.

¹⁰ J. Samoff, “Decentralisation: The Politics of Interventionism” in Kent Eaton, “Political Obstacles to Decentralisation: Evidence from Argentina and the Philippines”, *Development and Change* Vol.32, 2001, p. 523.

decentralisation policies and of ensuring that they will result in positive outcomes to the society.

Political variables are at work from the very beginning of particular decentralisation policies. Short-term political calculations can result in the decision to decentralise, and often these decisions are not followed through or are quickly subjected to reversal. In many cases, the policies on inter-governmental fiscal relations swing back and forth between decentralisation and re-centralisation. Politicians may support re-centralisation not only because they come to believe that they were mistaken in their earlier support for decentralisation as a response to systemic problems, but also because electoral and political realities have shifted. Based on a comparative research in Argentina and the Philippines, Eaton¹¹ found that although the speed and scope of the shift toward more decentralised practices is striking, the policy faces enormous political obstacles and can be subject to serious setbacks. Even after the political decision to decentralise has been made, national politicians may be persuaded by deep-seated incentives to preserve centralised control over fiscal policy.

Even in seemingly technical policies such as those in economic and financial areas, contextual and/or political factors will determine importantly the course of policy actions.¹² In developing countries, the results of decentralisation policy are more difficult to predict because of the greater uncertainty in many contextual variables. Regarding fiscal decentralisation policy, there have been many cases in developing countries where more taxing power and expenditure responsibility were given to the local governments, but the goal of the policy could not be attained due to political hurdles at the local level. Bahl and

¹¹ Kent Eaton, *Development and Change*, p. 101.

¹² See, for example, B. Guy Peters & Frans K.M. van Nispen, *Public Policy Instruments: Evaluating the Tools of Public Administration* (Cheltenham: Edward Elgar, 1998), p. 3.

Linn¹³ observed that there are a number of political constraints in developing countries: local councils are often appointed rather than elected and therefore may not be representative of the local population; local taxing powers and responsibilities for expenditure are severely circumscribed; there may be administrative constraints on local governments that prohibit either an increase in taxation or an expansion of public services; and the chief officers who carry out the delivery of services are often appointed by a higher level of government. At the national level, there are also many contextual variables such as the geographical conditions of the country, the administrative system, the size of the population, the nature of the political system, and even the stage of economic and political development that would determine the peoples' demand for decentralisation.

¹³ Bahl and Linn, *Urban Public Finance in Developing Countries*, p. 419.

1.2 Fiscal Decentralisation as an Issue in Indonesia

Being the largest archipelagic state in the world, Indonesia is characterised by geographical and social diversity so that distribution of power and decentralisation are extremely important issues. Aside from sheer size, the country is also one of marked contrasts. Of the 206 million total population in 2000, about 61.9 per cent were living on the small island of Java which represents only 7 per cent of the country's total land area. The other 38.1 per cent of the population were spread unevenly throughout the far greater land areas of Sumatra, Kalimantan, Sulawesi, and Papua (formerly Irian Jaya), the so-called outer islands. In terms of its social fabric, although Javanese are the dominant ethnic group, there are some 300 ethnic groups scattered throughout the country. Together with ethnicity that influences most aspects of Indonesian life, religion is another important factor in the diverse society. Though predominantly Muslim, Indonesia recognizes three other official religions – Christianity, Buddhism and Hinduism – which all play a recognized and often influential role in Indonesian society. It is not surprising, therefore, that many of the tensions and even conflicts have been rooted in this diverse social background.¹⁴

The New Order regime was established after Suharto assumed power with military support in 1969. Under the New Order, Indonesia had a highly centralised administration. All political power resided in Jakarta, and the central government controlled the nation's economic wealth. The ability of the centralised New Order regime to stay in power was basically supported by the following: the unreserved military loyalty to the regime, the systematic de-politicization of nearly all socio-economic institutions, the 1974 enactment

¹⁴ For a comprehensive account of the social diversity in the country, see Colin MacAndrews, *Central and Local Government in Indonesia* (Singapore: Oxford University Press, East Asian Social Science Monographs, 1986).

that gave the central government control over the regions, and the rapid economic development that resulted in better infrastructure and higher economic wealth across the regions.¹⁵ It is undeniable, however, that the New Order approach to development was carried out with much suppression, little political participation, and disregard of provincial and local wishes for greater autonomy. With Suharto out of office, pressures for decentralisation arose immediately.¹⁶ Advocates of decentralisation argued on grounds of both economic efficiency and political expediency, noting the resentment generated in the outer islands against Jakarta's dominance. With the strong call for democratisation and decentralisation in almost all regions in the country, the Habibie government virtually had no choice but to reverse the centripetal tendency that has been in existence for decades.

Movement toward decentralisation was unprecedentedly triggered by the eventual independence of East Timor. Historically, East Timor was a former Portuguese colony while Indonesia's other territories were all under the control of the Netherlands. The Special Province of Aceh and the resource-rich province of Papua are among the provinces with relatively strong secessionist movements. In Aceh, the discovery of mass graves containing bodies apparently of those killed by the Indonesian military in the early 1990s revived secessionist sentiment. On November 1999 as many as one million people gathered in Aceh's provincial capital, Banda Aceh, to call for a referendum on whether to

¹⁵ This thesis generally uses three terms for different tiers of government: 1) central, 2) provincial, and 3) district (which includes rural districts or *kabupaten* and urban districts or *kota*). The lower two tiers will be collectively called "sub-national" or "local" to accord with the generally made central-local distinction. In many Indonesian legal provisions, however, the term *daerah* (region) refers to both provinces and districts, i.e. synonymously with sub-national. The Indonesian literature also uses both these terms. Therefore, to facilitate cross-references, this thesis will also use these two terms interchangeably. It should also be noted that students of federal systems typically speak of state and local governments (municipalities, town councils, etc.), which roughly corresponds with provinces and districts in the Indonesian context. Both *kabupaten* and *kota* are further divided into subdistricts, known as *kecamatan*. Finally each *kecamatan* consists of "villages", which form the lowest level of governments.

¹⁶ Adam A. Schwarz & Jonathan Paris, *The Politics of Post-Suharto Indonesia* (New York: Council on Foreign Relations Press, 1999), p. 3.

stay within Indonesia or become independent. Secessionist and independence movements were also revived in Papua where the Free Papua Organisation (*Organisasi Papua Merdeka*: OPM) started to conduct its activities publicly. Papua is considerably rich in natural resources such as copper, gold and oil, but development there has lagged behind other regions. Resentment was growing, and the local community was demanding a larger share of the wealth extracted from the province.

All these challenges were confronted by Habibie when he became president in May 1998. Since Indonesians had been under a repressive regime for a long time, the experiment with political liberalisation under Habibie created enormous uncertainty. A democratic Indonesia committed to open markets and regional stability was the hope of many Indonesians and many of Indonesia's friends abroad. But there were no guarantees that Indonesia would turn out this way. No one could say that regional tensions would not spiral out of control, turning Indonesia into an Asian version of strife-torn Yugoslavia.¹⁷ No one could say whether the military would agree to a lower political profile, or that continuing civil unrest would not lead to a return to authoritarianism.

With East Timor and Aceh, the central government could have made people there feel they were being treated fairly as Indonesians if it had sincerely tried to understand the situation and demonstrate that by deeds. By doing so, the central government could have eased resentment and tempered the secessionist movements. Unfortunately, what Jakarta did, conspicuously under the Suharto administration, was to intimidate revolting regions or residents by armed force when necessary, and force them to obey its will. Instead of lessening resentment, the policy stimulated hatred among the residents in the outer-island regions, which led to the outbursts in 1998 when the military was in retreat.

¹⁷ Adam A. Schwartz, *A Nation in Waiting: Indonesia's Search for Stability* (New South Wales: Allen & Unwin, 1999), p. 419.

Therefore, the decentralisation policy has high political stakes. Unless the central government pursues decentralisation skilfully and carefully, Indonesian territorial integrity is at risk. To some extent, Indonesia is engaged in a race against itself. It must install and then consolidate a democratic process while fending off a range of threats. The Indonesian central government can no longer procrastinate with respect to the policy time-frame for decentralisation. This is especially true given the increasing demands for regional autonomy at present and in the foreseeable future.

Decentralisation in Indonesia took a big step forward during Habibie's presidency with the enactment of Law No. 22 of 1999 on Regional Government Administration and Law No. 25 of 1999 on Balanced Budget between Central and Regional Governments. Significant changes were introduced with these two laws. There are two concepts of region in sub-national administration in Indonesia: *daerah*, a unit for presumably local autonomous administration, and *wilayah*, an administrative unit for central government functions. In the previous regional government administration, *daerahs* refer to first-level regions (provinces) and second-level regions (districts/cities), while *wilayahs* consist of provinces, district/cities and sub-districts. In the *wilayah* concept, district/cities were made subordinate to provinces and sub-districts to districts/cities. Under Law No. 22 of 1999, *daerahs* were provinces and districts/cities as before, but *wilayahs* were limited to provinces only. The district/city governments were no longer directly responsible to the provincial government while the provincial governments were put in charge solely of inter-district/city matters. As this study is aimed at explaining political decentralisation or devolution of powers among different levels of governments, it focuses more on the concept of *daerah* rather than *wilayah*.

The most important provision in Law No. 22 of 1999 was that the provincial and local legislatures were given more political powers. Before that, heads of sub-national governments – governors of the provinces, *bupati* (regent) of the rural districts, and

walikota (mayor) of the urban districts – were practically appointed by the President through the Ministry of Home Affairs while the sub-national parliaments only had the right to propose the candidates. Under Law No. 22 of 1999, the heads of regions were elected by the DPRD (*Dewan Perwakilan Rakyat Daerah*, sub-national parliaments) and made accountable to the regional and local constituents. The law opened the way for central-provincial-district government relationship to undergo a major change.¹⁸

Enacted almost simultaneously with Law No. 22 of 1999 on regional government administration, Law No. 25 of 1999 was specifically intended to eliminate dissatisfaction in rich natural resource provinces. The law provided for considerable fiscal decentralisation. It stipulates that local governments' fiscal revenues are to be composed of local revenue, balancing fund (*dana perimbangan*), loans, and other revenues. The legislation permits inter alia the development of own-tax sources for local governments, although it does not specify these. The balancing fund is sub-categorised into four: the local portion of revenue from natural resources (especially oil and gas mining and forestry); the local portion from property tax (*Pajak Bumi dan Bangunan*: land and building tax); a general allocation fund (*Dana Alokasi Umum / DAU*); and a special allocation fund (*Dana Alokasi Khusus / DAK*). These will be explained in detail later.

The new fiscal decentralisation policy created an immediate concern, that is inter-regional inequality. In general, Indonesian provinces can be classified into five groups: the densely populated Java, Bali and Lampung in southern Sumatra; the four resource-rich provinces of Papua, East Kalimantan, Riau and Aceh; isolated provinces (the two Nusatenggaras); five 'settled' provinces off Java; and another five sparsely settled

¹⁸ Yuri Sato, *Indonesian Entering New Era: Abdurrahman Wahid Government and Its Challenge* (Chiba: Institute of Developing Economics, IDE-JETRO, 2000), p. 40.

provinces.¹⁹ The 1999 legislation's provision on revenue sharing will definitely benefit the resource-rich provinces, but will not mean anything and even result in a loss for the poorer provinces. This is because oil and gas production are very unevenly distributed across the regions. A statistical projection by the Indonesian Ministry of Finance revealed that the policy will only provide benefits to three provinces where can be found large deposits of oil and natural gas deposits, namely Aceh, Riau and Kalimantan Timur, while it will certainly imply loss for a majority of other provinces.²⁰ Unfortunately, the scheme for revenue sharing had to be passed to pacify the resource-rich regions. Political realities made some form of fiscal decentralisation, e.g. revenue sharing and local taxes, inevitable.

This study covers the contemporary period until 2004 when the 1999 laws were revised. This revision effected a compromise between the central, provincial and district governments on some decentralisation measures. In line with the constitutional amendment in 2002 that envisioned direct elections of the national as well as sub-national leaders, it was necessary to revise Law No. 22 of 1999, particularly its stipulation that the heads of regions were to be selected by the DPRD. Also, this law was considered as having created confusion and administrative disorder because of the removal of hierarchical relationships between the provincial and the district governments. Therefore, in order to address these two issues, Law No. 22 of 1999 was revised with the enactment of Law No. 32 of 2004 on regional administration.

At the same time, Law No. 25 of 1999 was also revised with the enactment of Law No. 33 of 2004 on fiscal balance between central and regional governments. Along with the stipulation for restoring hierarchical relationships between the provincial and the district

¹⁹ Hall Hill, *Intra-Country Regional Disparities* (Singapore: The Second Asian Development Forum, 2000).

²⁰ Ministry of Finance, "Revenue Capacities of Provincial Government in FY 1999/2000", as quoted in Ehtisham Ahmad & Bert Hoffman, *Indonesia: Decentralisation – Opportunities and Risks* (World Bank paper, June 1999), p. 15.

governments, Law No. 33 of 2004 gives a higher proportion of block-grant allocation to the provincial governments. This law also provides better formulas for determining the financial allotment to the sub-national governments. It is likely that this law will be the main guideline for implementing fiscal decentralisation policy in the foreseeable future.

The year of 2004 may also be viewed as marking an end to the turbulence of Indonesia's political transition after the fall of Suharto's New Order regime. This is the year when the first direct presidential election was conducted smoothly and peacefully. Susilo Bambang Yudhoyono was elected as the new president with a landslide victory. The two revised laws on decentralisation policy were signed by the newly inaugurated Susilo, who will then be responsible for implementing the policy accordingly.

1.3 Research Objective

The main objective of the study is to explain how particular policies of fiscal decentralisation have been formulated, implemented and subsequently changed. The main factors that influence the course of policy development in fiscal decentralisation are political in nature. As such, the political interactions among the policy makers at the central, provincial and local governments and other stakeholders form the focus of this study.

In terms of the timeframe, this research covers the period between 1974 and 2004. The study focuses on three important episodes of policy development on decentralisation during this period. The examination of each episode includes the prior or intervening developments that lead to it and shape its outcomes. The first culminates in the enactment of Law No. 5 of 1974 on the Regional Administration System during the New Order regime under president Suharto.

The second culminates in the enactment of Law No. 22 of 1999 on Regional Government Administration and Law No. 25 of 1999 on the Balanced Budget between Central and Regional Governments. Compared to the 1974 laws, these two laws substantially changed the pattern of relationships between the central, provincial and district/city governments and constituted a major progress in terms of fiscal decentralisation. Finally, the third episode culminates in the enactment of Law No. 32 and Law No. 33 of 2004. These laws contain some compromises between the central government and sub-national governments.

There have been many studies on decentralisation in Indonesia. Some examine the political aspects of decentralisation and how the relationships between the national

government and the sub-national governments are settled.²¹ Others focus more on economic, administrative or technical aspects of decentralisation, such as the resource potential of sub-national governments, how the central government deals with issues of inequalities among sub-national governments, the sub-national governments' capability to undertake decentralised public services, and how the sub-national governments manage their revenues or enhance the tax assignments.²² However, there are few studies on the linkages between macro political issues and fiscal issues in decentralisation. The study is therefore aimed at filling this research gap. The other reason for choosing fiscal decentralisation as the focus of study is that the issue will most probably continue to be the major concern in developing Indonesia. As the preceding section makes clear, the distribution of fiscal resources is the most important bone of contention between the national and sub-national governments in Indonesia.

The theoretical question to be answered is: How can the policy on fiscal decentralisation and its changes be satisfactorily explained? This is taken up in the next section.

²¹ See, for example, William R. Liddle, *Ethnicity, Party and National Integration: An Indonesian Case Study* (New Haven: Yale University Press, 1970); Audrey R. Kahin, *Regional Dynamics of the Indonesian Revolution: Unity from Diversity* (Honolulu: University of Hawaii Press, 1985); Nazaruddin Sjamsuddin, *The Politics of Unrest* (Singapore: ISEAS, 1994).

²² Colin MacAndrews, *Central and Local Government in Indonesia* (Singapore: Oxford University Press, East Asian Social Science Monographs, 1986); Goeritno Mangkoesoebroto, *Tax Incidence in a Developing Country: The Case of Indonesia* (Unpublished Ph.D Thesis, Boulder: University of Colorado, 1987); Roy Bahl & Johannes Linn, *Urban Public Finance in Developing Countries* (New York: Oxford University Press, 1992); Hall Hill, *Intra-Country Regional Disparities*, (Singapore: The Second Asian Development Forum, 2000).

1.4 Policy Development: The Theoretical Framework

This study follows the common definition of public policy as “a proposed course of action of a person, group, or government within a given environment providing obstacles and opportunities which the policy was proposed to utilize and overcome in an effort to reach a goal or realize an objective or a purpose”.²³ Public policy does not only deal with individual or segmented interests, but it deals more with common objectives, public interests, or citizens at large. The proposed course of action that constitutes policy is then implemented through subsequent decisions and actions. Public policy is also defined comprehensively as the sum of government activities, whether acting directly or through agents, as those actions have an influence on the lives of citizens.²⁴ Such a definition would include what is called policy implementation.

The common approach of understanding how a policy is made is to identify a certain sequence of steps such as inquiry of problem, identification of goals, design and evaluation of alternatives and the choice of decision.²⁵ This way of looking at policy making is useful for imposing initial order or structure on a complex process. But it risks viewing policy making as though it was mechanistic and controlled by one governing mind, which is clearly not the case in real life. It does not adequately capture the complexity of the policy process and the different ways in which policies emerge. As Lindblom²⁶ has stated, sometimes policies spring from new opportunities, not from problems. Sometimes policies

²³ Carl Friedrich, *An Introduction to Political Theory: Twelve Lectures at Harvard* (Boston: Harvard University Press, 1967).

²⁴ Guy B. Peters, *American Public Policy: Promise and Performance* (New Jersey: Chatham House Publishers, Inc., 1996), p. 4.

²⁵ Austin Ranney, *Political Science and Public Policy* (Chicago: Markham Publishing Company, 1968), p. 7.

²⁶ Charles E. Lindblom, *The Policy-Making Process* (New Jersey: Prentice-Hall Inc., 1968), p. 4.

are not decided upon but nevertheless happen. No one would say that the British government in India planned mass starvation in Bengal during World War II. Yet the government did not bring adequate grain into the famine area, as it could have. In an important sense, then, tolerating starvation in Bengal was established as a government policy, without anyone explicitly deciding on it. Incapability and inaction might, by themselves, constitute a policy. In other words, deciding not to act is also a policy decision. This is in line with a straightforward definition that “public policy is whatever governments choose to do or not to do”.²⁷

The framework used in this study consists of two essential parts. First, like all policies, the policy on fiscal decentralisation is the result of an interminable process of political decision-making episodes. Second, these decisions result from the actions and reactions of policy actors. To explain these decisions, it is important to examine these actions of policy actors – actions that reflect their interests and their perception on available alternatives and possibilities for attaining their interests.

It is obvious that there is a close relationship between politics and policy. Politics can be defined simply as the activity by which an issue of public concern is agitated or settled at various levels of government. Policy is thus the outcome of the political process.²⁸ People engage in political activity – voting, electioneering, communicating with public officials, holding office – because they hope to affect public policy in some way. The study of politics, by and large, can be viewed as the study of the various factors which, directly and indirectly, affect public policy making. As long as the conflicts remain private, no political process would need to be initiated. Conflicts become political only when a

²⁷ Thomas R. Dye, *Understanding Public Policy*, (New York: Prentice-Hall, 1981), p. 1.

²⁸ Marian D. Irish, & James W. Prothro, *The Politics of American Democracy* (New York: Englewood Cliffs, 1962), p.16; James E. Anderson, *Politics and the Economy* (Boston: Little, Brown and Company, 1966), p. 49; Michael Hill, *The Policy Process in the Modern State* (London: Prentice Hall, 1997), p. 8.

public policy is at stake and an attempt is made to involve wider publics in its settlement. As for decentralisation policy, Smoke²⁹ notes that efforts at decentralisation have been politicised in many developing countries. Decentralisation policy concerns administrative or technical matters but it is a prominent instrument for coping with political problems and for achieving political goals.

Given the many political factors working on policies on fiscal decentralisation, it is not surprising that fiscal intergovernmental relationships move back and forth between decentralisation and centralisation. Movement toward more decentralised practices may be striking in a particular stage, but the policy might soon encounter political as well as technical obstacles and can be subject to serious setbacks. This accords with most theoretical explanations of public policy making that the policy process will never come to a final decision and that the “policy process is not one process but a series of sub-processes”.³⁰ There are always good and bad effects in centralisation as well as in decentralisation. Thus, analysts who emphasize decentralisation often also point to the necessity to retain centralisation in particular issues. Some have even tried to map out the advantages of both centralisation and decentralisation policies.³¹ It is therefore not surprising that the history of decentralisation policy in many developing countries is characterised by frequent swings of the pendulum between central and regional governments.

Therefore, this study is based on the following important propositions:

²⁹ Paul Smoke, *Reforming Regional Government in Developing Countries* (Morocco: HIID Conference on Economic Policy Reform in Developing Countries, 1988).

³⁰ Jeremy J. Richardson & A.G. Jordan (eds.), *Governing Under Pressure: The Policy Process in a Post-Parliamentary Democracy* (Oxford: Martin Robertson, 1979), p. 153.

³¹ Katalin Pallai, *The Framework of Decentralisation* (World Bank Paper, 2001). See also Kuldeep Mathur, “Administrative Decentralisation in Asia” in Shabbir Cheema, & Dennis A. Rondinelli (eds.), *Decentralisation and Development: Policy Implementation in Developing Countries*, (Beverly Hills: Sage Publications, 1983), p. 64.

- a. Fiscal decentralisation affects the interests of multiple parties or groups in the country at both national and sub-national levels.
- b. Since each group has different interests while fiscal decentralisation affects those interests differently, the policy tends to create gains for a particular group at the expense of the others.
- c. Like other public policies, a formulated policy on fiscal decentralisation is a tentative compromise among groups of actors and reflects varying degrees of accommodation of the interests of contending actors.
- d. The balance between fiscal centralisation and decentralisation is subject to continual shifts. Once settled, a given policy or resolution is not permanent but is subject to change. Some actors or groups would agitate for change and this agitation reflects: 1) how actors see their interests in the light of experience or even their re-evaluation and re-ordering of the multiple interests with changing conditions; 2) the relative power position and relations among actors; and 3) perceptions of new opportunities to agitate for change or more favourable policy settlement.

Fiscal decentralisation policy involves more than just two actors. Thus while the focus is on the interaction between the central government and sub-national authorities, attention should also be given to ideas and influences coming from other organisations within the national and regional government system. This is clear from Allison's model of bureaucratic politics,³² in which governmental action is understood as the political resultant of bargaining among multiple actors. The positions of players, parochial priorities and perceptions, interests, stakes and stands, rules of the game, and power are among the essential elements to be analysed. The term 'central-local government interactions' can be

³² Graham T. Allison, *Essence of Decision: Explaining the Cuban Missile Crisis* (Boston: Little & Brown and Company, 1971).

misleading if it encourages a narrow focus on the interaction between central departments and local authorities. In practice, a range of other organisations cut across the relationship, including the regional authority associations, professional organisations, party institutions, quasi-governmental organisations and trade unions,³³ are usually involved in the policy process.

Policy formulation is a difficult game to play because any number of people can and do play, and there are few rules.³⁴ At one time or another, almost every kind of policy actor could be involved in formulating policy proposals. Several actors, however, are especially important in formulating policies. A classic model of the policy formulation process is formulated by Anderson.³⁵ He explains that public policies constitute the product of interactions among legislature, executive, administrative agencies and judiciary. In the process, they are influenced by other external groups of political parties and interest groups and the citizens at large. The model focuses on what Lindblom³⁶ calls “the proximate policy makers”, which consists of the president, legislators, judges, and interest groups. Aside from the official policy makers, there are also many unofficial actors who might have significant influence in policy formulation. Political parties and candidates are not as good in promulgating solutions to problems as they are in identifying problems and presenting lofty ambitions for society. Expertise begins to play a large role, given that the success or failure of a policy will depend to some degree on its technical feasibility as well as its political acceptability. Thus various parties with relevant expertise are able to

³³ Gerry Stoker, *The Politics of Local Government* (Hampshire: MacMillan Education Ltd., 1988), p. 136.

³⁴ Peters, *American Public Policy*, p. 59.

³⁵ Anderson, *Politics and the Economy*, p. 53.

³⁶ Lindblom, *The Policy-Making Process*, p. 71.

influence policy formulation, such as think tanks, shadow cabinets, technocrats, professionals, or policy analysts.

The role of experts and professionals as well as interest groups and individual citizens has increased as a result of the intensification of social interactions.³⁷ There are more actors with various values who come in and influence modern public policy and the tendency toward a policy 'polyarchy'³⁸ is almost inevitable. These values are pursued through existing institutions or individual actions. The growing importance of pluralistic decision making systems and the more complicated relationships among parties, bureaucracy and interest groups in policy formulation have been found in many developed countries, such as Norway, Japan, Sweden, the Netherlands and Britain.³⁹ The direct influence of various interest groups and the tendency toward pluralistic decision making in developed countries may not occur to the same extent in developing countries. However, pressure groups outside the government or the so-called extra-administrative institutions are also common in most developing countries.⁴⁰ In Indonesia, it has been predicted even during the authoritarian New Order administration that greater social confidence will lead to a more pluralistic and organised sharing of power and communication among various levels of Indonesian society.⁴¹ Interest groups have played an increasing role in the public

³⁷ David G. Garson, *Handbook of Political Science Methods* (Boston: Holbrook Press Inc., 1971), p. 23.

³⁸ Wayne Parsons, *Public Policy: An Introduction to the Theory and Practice of Policy Analysis* (Cheltenham, Edward Elgar, 1995), p. 253.

³⁹ Richardson & Jordan (eds.), *Governing Under Pressure*, p. 169.

⁴⁰ See for example, Ishwar Dayal et al., *Dynamics of Formulating Policy in Government of India* (Delhi: Concept Publishing Company, 1976), p. 25.

⁴¹ Gary E. Hansen, "Bureaucratic Linkages and Policy-Making in Indonesia: BIMAS Revisited" in Karl D. Jackson & Lucian W. Pye, *Political Power and Communications in Indonesia* (Berkeley: University of California Press, 1978), p. 342.

policy process, especially with the onset of *reformasi* and greater openness following the economic crisis in 1998.⁴²

Most public policies also have multiple objectives. A major issue in policy decision making is how much of one objective is to be achieved in relation to others.⁴³ The objective of a policy in employment, for example, is to achieve full employment without causing inflation, endangering the nation's trade abroad or creating further environmental deterioration. Likewise, the objective of policy in fiscal decentralisation is to strengthen the regional governments' capacity, to improve public services and to maintain democratic governance, while at the same time it has to avoid separatism, inter-regional imbalances, unfair competition, and so on. It is also important to bear in mind that problems of conflicting objectives are not only faced by government actors but also those outside the government. The behaviours of other non-government actors, their demands, and their actions to influence the government will reflect multiple objectives. In fact, the problems of multiple objectives are faced by all actors in varying degrees.

Another important element for understanding policy-making process is the circumstances in which policy elites make decisions. Grindle and Thomas⁴⁴ identify two typical kinds of circumstances, perceived crisis (macro-politics) and politics-as-usual (micro-politics). Macro-political concerns, most prevalent under crisis situations, mean that policy elites pay particular attention to a policy problem which affect the legitimacy of the regime they serve, longer-term political and economic goals, major definitions of 'the national interest', class alignments, and the overall survival of the regime. On the other

⁴² Arief Budiman et al. (eds.), *Reformasi: Crisis and Change in Indonesia* (Clayton: Monash Asia Institute, 1999).

⁴³ Charles W. Anderson, *Statecraft: An Introduction to Political Choice and Judgment* (New York: John Wiley & Sons, 1977), p. 9.

⁴⁴ Merilee S. Grindle & John W. Thomas, *Public Choices and Policy Change: The Political-Economy of Reform in Developing Countries* (Baltimore: John Hopkins University Press, 1991), p. 105.