

**Indonesia's
Decentralization
Policy:
*The Budget
Allocation and Its
Implications for the
Business Environment***

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For further information, please contact SMERU, Phone: 62-21-336336;
Fax: 62-21-330850; E-mail: smeru@smeru.or.id; Web: www.smeru.or.id

Ilyas Saad

The SMERU Research Institute

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ABSTRACT

This paper attempts to answer some questions about the financial capacity of local governments to implement regional autonomy. In the early stages of the implementation of autonomy, financial aspects have been crucial for every kabupaten and kota administration¹. According to Laws No.22, 1999 and No.25, 1999, financial management is an important indicator of local government performance in determining whether they can continue as autonomous entities or should be merged with other neighboring kabupaten or kota.

Some of the related issues to be discussed include: what is the regional budget allocation that each local government is to receive and what is the formula applied by the central government to determine this allocation? Is the allocated budget smaller than the amount received by local governments prior to regional autonomy? Is the allocated budget from the central government less than the amount required for local civil servant salaries and routine bureaucratic and administrative expenses? Why have local governments been so eager to increase local revenues? What is the likely impact of this on the business climate?

Based on the results of field studies conducted by SMERU in twelve kabupaten and kota across nine provinces, it is apparent that in many cases, local governments at the kabupaten and kota level have received an allocation of funds from the central government that exceeds routine expenditures. However, this level of funding is substantially less than the total transferred into the regions (including funds received by central government offices operating at the kabupaten and kota level) during the period before regional autonomy. It is a different matter, however, at the province level where the allocation of funds from the central government is much smaller than their routine expenditures. The size of the budget allocation is one the key reasons given by local bureaucrats to explain why local governments, both at the kabupaten and kota level as well as at the provincial level, have been working hard to increase local revenues by imposing more local taxes and levies.

The negative impact of these levies on the business and investment climate has not been fully captured by recent field studies. Local businessmen have pointed out that most levies have not yet been fully imposed and there is some variation between regions in the degree of their commitment to the creation of these new taxes. But it is widely accepted by local businessmen that all these new levies will create distortions in the market and a high-cost economy in the near future. Some indications of these potential distortions can be already identified and will be discussed in detail in the paper.

If this pattern continues without any amendments by local government or if the central government fails to intervene, another fundamental question arises: will regional autonomy be able to achieve its important goals of improving the quality of public services and increasing the participation of local business in the local economy in the regions throughout Indonesia?

¹ Kabupaten is the Indonesian term for district under province level while Kota is the term applied to municipalities.

I. INTRODUCTION

Introduction of regional autonomy, local governments have gained greater opportunities to provide broader coverage and better public services in their region. At the same time, the central government has lost its power to dictate regional government policies. One of the key elements in this change has been the reform of the intergovernmental fiscal relationship. This involves the decentralization of central government authority over expenditure and revenue to local governments.

The fiscal decentralization policy is intended to increase the efficiency of the provision of regional public services, by allowing a better matching of expenditures with regional needs, priorities, preferences and revenue capabilities. This policy is being implemented following the introduction of Law No.25 issued in 1999.

This paper attempts to answer some questions about the financial capacity of local governments to implement regional autonomy. According to Law No.25/1999, financial issues are an important indicator of local government performance in which may determine whether they will be able to continue as autonomous entities or whether they should be merged with other neighboring *kabupaten* or *kota*.

Some related issues that need to be considered include the following: what is the regional budget allocation that each local government is to receive, and what is the formula applied by the central government to determine this allocation? Is the allocated budget smaller than the amount received by local governments prior to regional autonomy? Is the allocated budget from the central government less than the amount required for local civil servant salaries and routine bureaucratic and administrative expenses? Why have local governments been so eager to increase local revenues? Most importantly, what is the likely impact of these changes on the business climate? The answers to the above questions will be provided by referring to some of the studies SMERU researcher have conducted in nine provinces and 13 *kabupaten* and *kota* during the period between June 2000 to June 2001. Of special importance are the results drawn from the study of six *kabupaten*² that were visited following the implementation of Laws No.22, 1999 and No.25, 1999 that become effective in January 2001.

² They are Kabupaten Bolmong, Deli Serdang, Gorontalo, Karo, Minahasa, and Simalungun.

2. THE LOCAL GOVERNMENT BUDGET PRIOR TO THE IMPLEMENTATION OF FISCAL DECENTRALIZATION

Structures of Local Government Revenues

Before the implementation of decentralization and regional autonomy, there were two types of grants and subsidies allocated by the central government. The first allocation was used for routine expenditure, such as local government civil service salaries as well as for bureaucratic expenditure at the *kabupaten* and *kota* levels of government. The second type of allocation covered funds that are directed for the purpose of investment or government development expenditure.

For routine expenditure purposes, the funds were transferred through subsidies from the central government. This subsidy was the main source of direct income for the *kabupaten* and *kota* as indicated in Table 1, where for the financial year 1999/2000 this contributed about 60% of total *kabupaten* and *kota* revenues.

Table 1
Structure of local Government Revenues Before Decentralization
(FY1999/2000)
(in percentage share)

<i>Kabupaten / kota</i>	Tax & non-tax Revenue sharing	Routine Budget Subsidy	Development Funds	Local Source of Revenues	Others	Total Revenues (billion rp)
1.Banjarmasin *	11.90	52.47	17.82	17.24	0.57	87.3
2.Bolmong	8.71	66.14	22.00	3.16	0.00	72.3
3.Gorontalo	10.10	66.01	21.33	2.55	0.00	94.2
4.Karo	9.75	65.25	15.59	9.41	0.00	75.4
5.Kudus	6.92	61.77	15.77	15.13	0.41	78.7
6.West Lombok	6.61	46.77	32.09	14.48	0.05	101.1
7.Magetan	10.09	70.27	13.71	5.76	0.17	97.3
8.Minahasa	10.96	75.20	11.01	2.83	0.00	139.8
9.Sukabumi *	7.31	51.88	24.10	14.59	2.12	56.9
10.Sanggau	7.34	59.79	30.36	2.03	0.47	86.0
11.Solok	6.66	56.54	33.46	2.96	0.39	90.5
12.Simalungun	12.63	65.14	18.77	3.46	0.00	144.8

Note: *) Kota

Source: SMERU Field Study Results

For investment or development expenditure purposes, the funds were transferred in two different types of subsidies. The first type was in the form of grants that were allocated for specific purposes designed by the central government, such as to build schools and health facilities at the *kabupaten* level. The second type of allocation was

in the forms of block grants that could be used according to the needs of *kabupaten* and *kota* without any intervention from the central government. However, the amount of this type of subsidy was much less than the former. Total funds for investment purposes is only contributing approximately 20% of *kabupaten* and *kota* revenue. In addition to these two kinds of funds transferred, the central government also provided local governments with a share of tax and non-tax revenues that contributed less than 10% of *kabupaten* and *kota* total revenues. The use of these funds was fully controlled by the local government.

The remaining 10% of *kabupaten* and *kota* income was derived from local revenues (PAD) and other insignificant sources. Local revenues are now a much more controversial issue and will be further discussed in section 4.

Central Government Transfers Allocated Through Vertical Government Offices Operating At *Kabupaten/Kota* Level

In the past, the central government transferred money to the regions not only through the local government administration, but also through its “vertical” offices operating in the regions. This funding was commonly known as DIP³ funding (project lists proposed by each office). The amount was much higher than the total revenues received by local government. Table 2 provides average figures of total central government funds allocated to all regions during the 1990s. In terms of percentage of GDP, the total funds allocated to the DIP was 5.2% of GDP. This was considerably higher than the total grants and subsidies allocated for routine and development expenditures which were only 3.5% of GDP.

These funds, however, are no longer transferred under the system of regional autonomy. As a result of the decentralization process, all “vertical” government offices at the *kabupaten* level are automatically becoming part of the local government administration. They have been included in the new organizational structure of regional governments at the *kabupaten* and *kota* level. The budgetary implications of this new positioning these former “vertical” agencies is that both routine and development budgets will be managed by local government. In this case, the local government will use the new block grants for this purpose.

³ DIP is daftar isian proyek, Project list that every financial year financed by central government through technical department. Central office of technical department allocates further to its office operating in *kabupaten* and *kota* level.

Table 2
Transferred Funds to *Kabupaten* and *Kota* Level:
Expressed as a Percentage of GDP
(Average Figures During the 1990s)

Items	Percentage of GDP:
A. Transferred to local government:	3.5%
- For routine budget	(2.2%)
- For development budget	(1.3%)
B. Transferred to central government vertical institutions operating at the district level	5.2%
C. Total (A+B)	8.7%

Source: Raksaka, 2000 (Table 2).

3. DAU (GENERAL ALLOCATION OF FUNDS) GENERAL PURPOSE BLOCK GRANTS IN THE FIRST YEAR OF DECENTRALIZATION (2001)

According to Law No.25, 1999, the allocated funds from the central government are block grants to be used by the local government according to their own priorities. This is contrary to the mechanism applied by the central government prior to the implementation of regional autonomy, where the local government only carried out those programs designed by the central government.

The total amount to be allocated to the regions under regional autonomy is at least 25% of national domestic revenue (after excluding the special share to be returned to resource-rich regions), 90% of this amount is to be allocated to *kabupaten* and *kota*, and the remaining 10% is to be allocated to the provinces. In absolute value terms, the total amount of the block grants for all regions for the FY 2001 is Rp60.5 trillion or equivalent to US\$6.1 million (at an exchange rate of Rp10.000/US\$1).

DAU Funds Compared with the Total Amount Transferred Before Decentralization

The amount of DAU block grants received by the twelve *kabupaten* and *kota* visited by SMERU is displayed in Table 3. Apart from Kabupaten Karo, all other *kabupaten* received a much higher amount of DAU compared to the total funds received in 1999/2000 financial year, the last year before the implementation of regional autonomy. Four *kabupaten*, Bolmong in North Sulawesi, Kudus in Central Java, Magetan in East Java and Sanggau in West Kalimantan, received an increase of more than 100%.

Table 3
DAU Block Grant and Transferred Funds Before Decentralization
(in billions of rupiah)

Kabupaten / Kota	DAU Block Grant	Transferred funds In FY 1999/2000	Increase (%)
1. Banjarmasin *	127.9	72.3	76.9
2. Bolmong	140.8	70.0	101.1
3. Gorontalo	148.6	91.8	61.9
4. Tanah Karo	92.5	68.3	35.4
5. Kudus	175.6	66.8	162.9
6. West Lombok	165.1	86.4	91.1
7. Magetan	208.9	91.7	127.8
8. Minahasa	260.4	135.8	91.8
9. Sukabumi *	81.3	48.6	67.3
10. Sanggau	192.4	84.3	128.2
11. Solok	150.8	87.9	71.6
12. Simalungun	260.3	139.8	86.2

Note: *) Kota

Source: SMERU field survey results .

The Formula Used to Determine DAU Block Grants⁴

The formula applied to determine the amount of the DAU block grants allocated to each region is as follows:

25% of the national budget set aside for block grants X 90% for all Kabupaten and Kota X Weight of each kabupaten and kota

The calculation of the weights for each *kabupaten* or *kota* is based on two main factors: local **needs** and the **local potential** of *kabupaten* or *kota*. **Needs** are represented by variables such as the size of the population, the number of people living below the poverty line, and the total area of physical size the *kabupaten* or *kota*. This is a positive linear relationship where the larger the population, the larger the total number of people living below the poverty line, as well as the greater the area covered, the larger will be the weight for the region and hence the larger the amount of the block grant to be allocated to the particular *kabupaten* or *kota*.

Local potential is depend upon the number and the scale of industrial activities operating in the particular *kabupaten* or *kota*. This relates to the capacity of *kabupaten* or *kota* to raise revenues through taxes and levies from existing economic activities. Consequently, the relationship is negative: the greater a region's potential to create

⁴ Adopted from Mahi (2000) and Keputusan Pemerintah No.181 (2000)

revenue, the smaller the weight for the region and the lower the block grant to be allocated to the particular *kabupaten* or *kota*.

Three possible methods were proposed in the way weight were to be calculated: a) equal weight between the needs and the potential for all regions; b) a greater emphasis on needs, meaning that those variables that determine a region's needs are given greater consideration; or c) a greater emphasis on local potential, where the capacity of a region to raise local revenues is given more consideration. Unfortunately, however, there is no precise information available about which of the three methods was implemented in calculating the first DAU block grant for the 2001 financial year. The data in Table 3 suggests that it is most likely that the central government used the first scenario.

In addition, in allocating the DAU block grants the central government is also considering the following basic principles:

1. Adequacy: the DAU should be able to fulfill adequately the needs of the regions in at least providing standard public services. It must also take into account the demand of the regions that the block grants should not be smaller than what the region received prior to the implementation of regional autonomy.
2. Accountability and transparency: local governments must be accountable to their electorates, not to the central government. Local governments should make the information on funding and expenditure available to the general public. In this matter, the local parliament has a very important role to play.
3. Neutrality and efficiency: the DAU should not create any distortion in the economy that could become a source of inefficiency.

4. LOCAL REVENUES (PAD)

Sources of Local Revenues

There are two main sources of local revenues (PAD). The first is local taxes and the second is levies. Both play an important role, as indicated in Table 4, where 10 out of 13 *kabupaten* and *kota* investigated have received about 90% of their local revenues from these two main sources. Only three *kabupaten* received significant amount of

revenue from other sources, mainly from domestic borrowing and local government asset yields. In many *kabupaten*, the two main sources of local revenues provide relatively equal contributions. However, in the resource-rich and more developed *kabupaten* and *kota*, local taxes are more dominant than levies.

The main sources of local taxes at the *kabupaten* and *kota* level are mostly derived from street lighting tax, entertainment business tax, the use of ground and surface water tax, hotel and restaurant tax, as well as the exploitation and processing of C classification mining activities⁵ tax.

The actual sources of local levies are more variable and each *kabupaten* has its own particular sources. Levies mostly depend on the type of local economic activities and extent of the commitment of the local government in formulating regulations in this area. This is determined by the ability of the local government to identify potential revenues, the freedom they have to impose levies, and the extent of their need to find of additional source of income to finance their routine and development expenditure.

PAD Targets for 2001

During the early phase of the implementation of regional autonomy, local governments tended to be more aggressive in collecting taxes and levies (PAD). Table 5 demonstrates that, apart from Kabupaten Karo, the other five *kabupaten* visited during the early phases of regional autonomy, have targeted PAD for the 2001 FY to a level that is approximately 100% higher than they had achieved in the 1999/2000 FY. To achieved this target, the local government in each of these *kabupaten* has issued a number of local regulations on this subject. Some *kabupaten* have drafted up to 30 new local regulations.

By contrast, Kabupaten Karo has tended to adopt a more moderate policy over the creation new regulations on local taxes and levies. In part this may be a result of the appointment of a new *bupati* (the head of *kabupaten* government) who has experience in business. Due to his background, the new leader is reluctant to impose to many levies. However, it is still too early to conclude that this local government will continue to maintain such as moderate stance. Interviews suggest that other local government officials in Kabupaten Karo are more committed to locating new revenue sources in the near future. For example, the deputy *bupati* pointed out that

Kabupaten Karo has an abundance of agricultural commodities, which have a huge potential as a source of local revenue.

Table 4
Sources of local government revenues, FY1999 and FY2000
(in percentage share)

Kabupaten / Kota	Local Taxes	Local Levies	Contribution from local Government Enterprises	Other Revenues	Total Local Revenues (in mln.Rp)
1.Banjarmasin*	47.3	34.6	1.6	16.5	12,866.0
2.Bolmong	35.2	45.9	4.3	14.5	2,284.6
3.Gorontalo	36.8	51.6	0.5	11.0	2,399.4
4.Tanah Karo	24.3	27.4	-	48.3	7,089.5
5.Kudus	24.7	71.6	1.2	2.6	11,897.8
6.West Lombok	78.0	10.3	4.4	7.3	14,630.5
7.Magetan	21.9	40.9	4.0	33.1	5,609.6
8.Minahasa	74.5	18.2	0.6	6.7	7,403.7
9.Sukabumi*	16.7	80.5	0.8	2.0	7,904.4
10.Sanggau	57.5	26.8	-	15.8	1,746.5
11.Solok	23.9	31.1	5.2	39.8	2,825.1
12.Simalungun	62.3	30.8	-	6.9	5,123.4
13.Deli Serdang	67.8	30.0	-	2.2	12,508.1

Note: * Kota

Source: SMERU field surveys results.

Table 5
Percentage increase in local revenues (PAD) target for 2001
compare with realization in 1999/2000

Kabupaten	Total Local Revenue in 1999/2000	Target local revenue for 2001	Percentage increase (%)	Number of PAD regulations for issued since Jan-2000
1. Bolmong	2,284.6	4,405.6	92.8	21
2. Gorontalo	2,399.4	5,115.1	113.2	32
3. Minahasa	7,403.7	15,877.2	114.4	35
4. Karo	7,089.5	4,007.8	(43.5)	2
5. Simalungun	5,012.0	11,000.0	119.5	32
6. Deli Sedang	12,508.1	24,000.0	91.9	24

Source: SMERU field studies.

⁵ General mining activities that mostly exploited by local people with using simple method.

“Recycled” Regulations on PAD

Before the regional autonomy policy was formulated, the central government issued Law No.18, 1997 regarding those economic activities on which local governments were permitted to impose levies. The main aim of this legislation was reduce the number of local levies in order to reduce the high cost economy in the regions. As a result of this law, hundreds of local regulations were abolished. Consequently, many *kabupaten* faced a significant decrease in their local revenue (PAD).

Since the implementation of regional autonomy, however, local governments have complained about this matter and have lobbied the central government to revise Law No.18, 1997 which severely limits the capacity of local governments to increase their local revenues. The central government responded, and issued Law No.34, 2000. The new law abolished the limitations on the revenue raising capacity of the regions. However, the central government has maintained its authority to review or to abolish local regulations if they are believed to be creating economic distortions.

In practice, senior local governments officials in those *kabupaten* investigated between February and May 2001, had not yet studied the details of Law 34, 2000. Nevertheless, they have adopted the view that the new law gives them full freedom to impose more levies. As a result, each of these local governments have produced new regulations and have also recycled existing regulations on taxes and levies banned under Law No.18, 1977. Kabupaten Simalungun, one of *kabupaten* studied has issued 13 recycled regulations on taxes and levies along with 19 other new regulations during the year 2000 (see Appendix).

Similarly, in Kabupaten Deli Serdang, 18 regulations were recycled in 2000. Officials within the Legal Section at the *Bupati's* Office in Kabupaten Deli Serdang claimed that Law No.18, 1997 can no longer be accepted, as it is not in accordance with the spirit of regional autonomy. As a result, various levies that were banned under Law No.18, 1997 are presently being reinstated. Meanwhile, these officials claim that Law No. 34, 2000 cannot yet be used as a reference point because it has only just been released, and there has not yet been adequate opportunity to study the new law.

Until now, the local governments of Kabupaten Simalungun and Karo are not considering revising any of their local regulations. This will only occur if conflicts are evident between the implemented regulations and Law No. 34, 2000.

Arguments Behind the Increase in Local Revenues and the Issue of New Regulations

Local officials in the five *kabupaten* investigated (Simalungun, Karo, Gorontalo, Bolmong, and Minahasa) give at least six main reasons why their governments are so eager to increasing the level of PAD during the initial implementation of regional autonomy.

1. A relatively large increase in authority also requires a more substantial budget. However, the central government has only allocated 25% of domestic revenues to the regions (all *kabupaten*).
2. The DAU block grants received by the *kabupaten* and *kota* governments are only enough to finance routine expenditure, leaving less than 25 % remaining to finance development expenditure (see Table 6).

Table 6
Percentage increase in routine expenditure and implications
for the development budget for 2001
(in trillions of rupiah)

<i>Kabupaten</i>	Routine Expenditure 1999/2000	Estimated Routine budget For 2001	Percentage Increase (%)	DAU Block Grant for 2001	Remaining for development budget For 2001	
					(Rp)	(%)
1.Bolmong	53.4	111.3	108.4	140.8	29.5	21.0
2.Gorontalo	69.9	128.2	83.4	148.6	20.4	13.7
3.Minahasa	117.7	236.9	101.3	260.4	23.5	9.0
4.Simalungun	99.3	192.0	93.4	260.3	68.3	26.2
6.Karo	56.3	93.6	66.3	92.5	-1.1	-1.2

Source: Field survey results of SMERU

3. The financial capacity of the region is the main factor that will determine the successful implementation of regional autonomy, and consequently *kabupaten* and *kota* governments should increase their local revenues as much as possible (Simalungun).
4. Local revenue is a symbol of independence of the *kabupaten* and *kota* (all *kabupaten*).
5. The Legal Affairs Section of these *kabupaten* is deliberately creating as many local regulations for PAD as possible, in order to capture all available potential resources within the *kabupaten*. Many of these local regulations may be in

conflict with Law No. 34, 2000. If this occurs, then these regulations will be revised following an examination of the contents of Law No.34, or a reprimand from the central government. The local governments believe that these local regulations need to be implemented first so that the implications and effects on the region are apparent. Those local regulations that make a significant financial contribution to the region will be maintained, while those which do not will be abolished. All potential sources of revenue must be explored. Regarding central government sanctions, should these regulations contravene Presidential Decrees, government regulations, or laws, then the local regulations will have to be revised.

6. Every regional office has to compete to find appropriate sources of funds, especially to increase regional revenue. According to the Local Revenue Offices, the allocation from the Regional Budget for the year 2001 for each local government office (*dinas*) will be depend on the amount that each is able to contribute to the Local Treasury.

5. THE IMPACT OF EXCESSIVE LEVIES: PROBABLE TRENDS

Since the new local regulations on taxes and levies have not been fully implemented in those areas, investigated a more detailed study of their impact on the local business climate is not yet possible. However, should these regulations be fully implemented, local business people (farmers and traders) believe that these taxes and levies will have a negative impact on their economic activities. Some of the likely trends are noted below.

- **Increased distribution costs**

The abundant agricultural commodities in each *kabupaten* are mostly perishable goods. Therefore, it is crucial to secure smooth and rapid distribution of these goods to maintain both quality and price at the consumer level. Consequently, farmers and traders make every effort to expedite the delivery of these goods to the buyers, even if they have to pay various taxes and levies during the transport of goods to market. These additional charges add to the distribution costs, and eventually lead to higher prices at the consumer level. The amount of the levies extracted is usually determined by measuring the tonnage of trucks at various weighing stations along main transport routes. Box 1 illustrates the

number of weigh bridges⁶ and the amount of levies paid by a truck driver at each location traveling from Kabupaten Karo, North Sumatra to Jakarta.

Box 1. Fines and levies paid for transporting oranges from Kabupaten Karo to Jakarta

A truck driver who regularly carries oranges from Kabupaten Karo to Jakarta reports that there are at least 16 truck weighing stations and several other levy checkpoints that have to be passed along the route. The table below shows the number and amount of “fines” paid by truck drivers – both for those who comply and those who do not comply with the weight limit at each station.

1. Weighing Station

Province	Number of stations	Amount of fines	Remarks
1. North Sumatra	4	Rp5,000 – 10,000 for each ton of excess weight	Per ton of excess weight
2. Riau	2	Rp60,000, paid by all, irrespective of weight of load.	Fines have to be paid by both compliant and non-compliant vehicles, plus additional road levies: -Rp2,500 (6-ton truck) -Rp3,500 (8-ton truck)
3. Jambi	2	Rp60,000, paid by all trucks	Plus additional road levies: -Rp2,500 (6-ton truck) -Rp3,500 (8-ton truck)
4. South Sumatra	5	Fine of Rp15,000 for each ton of excess weight	In addition to the possibility of receiving a fine, there are also road levies: -Rp2,500 (6-ton truck) -Rp3,500 (8-ton truck)
5. Lampung	3	Fine of Rp15,000 for each ton of excess weight	In addition to the possibility of receiving a fine, there are also road levies: -Rp2,500 (6-ton truck) -Rp3,500 (8-ton truck)

2. Official and non-official levies at Pelabuhan Bakauheuni, Lampung:

Type of levies and charges	Amount	Remarks
-Stamp Fees	Rp3,000	Illegal levies are collected at the Ferry Harbor in Bakauheni
-Fee to raise the barrier	Rp3,000	
-Preman charges	Rp2,000	
-Fees to gain early departure	Rp15,000	To secure priority when there is a long queue
-Quarantine	Rp1,000	Official levy at the Gayam Quarantine Post
-Agricultural produce Levy	Rp7,000	Official levy applied to all types of transport vehicles

It is estimated that the total amount of levies (official and non-official) paid to transport oranges from Kabanjahe to Jakarta ranges from Rp268,500 to Rp1,008,500. Paying the lowest amount would only be possible if the truck complies with its permitted capacity.

Nevertheless, even when trucks comply with the regulations, drivers frequently still have to pay levies. As a result, it is common for truck drivers to prefer to carry loads that exceed the trucks legal capacity.

⁶ The Office of Transport (DLLAJ) have admitted that reopening the weighing stations under the guise of regional autonomy has created a dilemma. Basically, the main function of these stations is to limit the physical damage to the road system (particularly on state and provincial roads), and to check on the origin and destination of the transported goods. However, it is apparent that the weigh bridges will also function as a means of collecting local revenues.

- **Forcing Down Prices at the Farmer or Producer Level**

The wholesalers at the *kabupaten* level interviewed reported that if the burden of levies is too high, they will have to shift some of the burden to the purchase price at the farm gate. Most local farmers fully understand this situation. Therefore, although the various taxes and levies are not directly charged to the farmers, they know that the wholesalers or the middlemen will have to reduce the purchase price of good at the farm gate because of the burden of the levies paid out at the various checkpoints.

In fact, many traders have indicated that they are prepared to make some contribution to the local government as long as the levies are official, are not too numerous, and as long as the total amount is reasonable and manageable. There has to be some doubts regarding the guarantees provided by local government officials obtained during the interviews, who maintain that the amount of the levies has been carefully considered so as not to put too much burden on farmers and consumers. In practice, traders have frequently informed farmers that they have to lower the farm gate prices due the various taxes, levies and other related charges. The local governments have no mechanisms in place to prevent traders or middlemen from shifting the additional costs on to farmers. This situation indicates that the local governments have a short-term perspective and have been partial and one-sided in the policies that they have adopted.

- **Accelerating The High Cost Economy and Social Unrest**

The increasing number of taxes and levies on business activities has spurred a high cost economy even though these taxes, levies, contributions, and other similar charges are not directly related to the production process. However, all such levies should be regarded as elements of expenditure that do directly affect the market price at the various levels of distribution (from middlemen traders, to wholesalers and retailers). Consequently, the market price does not merely reflect the real production cost.

Another potential impact of the application of these taxes is the possibility of social unrest in the form of public disobedience. In the current uncertain social and political climate in Indonesia, any government policy deemed to be detrimental to the interests of the large section of the population for particular groups within the community tends to result in protests or opposition. Such a trend is already becoming apparent. For example, the Association of Palm Oil Producers (GAPKI) in Medan, North Sumatra, is planning to challenge all local regulations that have been applied to their business

activities, including those regulations on Third Party Contributions⁷. On one hand, the reason for the opposition is to prevent a high cost economy in order to safeguard the long-term business sustainability of farmers and entrepreneurs, as well as to maintain the competitiveness of North Sumatra's export commodities. On the other hand, it may also serve as a warning to the local government against the formulation or imposition of unfair taxes or levies on the local business community.

Another indication of opposition is the protest from the Gabion Belawan Association of Fishing Entrepreneurs against various levies imposed on them by the Provincial Government of North Sumatra. The Association believes that most of these levies were "fabricated" since they are not based on the provision of any government services. The members claim that up until now they have never received any services from the local government and are under no obligation to pay the levies (see Box 2).

Box 2. The Fisheries Association of Gabion Belawan (AP2GB): Protests about the local government's taxation policy on marine products

Currently, the fishing communities which are gathered under the umbrella of AP2GB, have become restless. This is due to two reasons: firstly, the production volume of the total fish catch has been steadily declining, and secondly, the implementation of regional autonomy policy has motivated the local government of North Sumatra to take steps to increase regional revenues from fishing. The government's plans are already being realized, with the establishment of the Single Office for Marine Administration (Samsat Kelautan) which will assume responsibility for collecting the various maritime levies that have been applied by the Provincial Government of North Sumatra.

The grievances of the AP2GB members have been expressed at every meeting of the Marine Administration as well as in a number of petitions. In one of the petitions directed to the head of North Sumatra's local assembly, AP2GB addressed the following issues: a) Perda No. 5, 1999 regarding fishing boat docking and mooring levies. This levy is considered thoroughly inappropriate because it is identical to the docking service charges paid to the Perum Prasarana Perikanan Samudera in Belawan. Furthermore, the local government itself has not yet provided any facilities whatsoever for fishing boat docking; (b) Perda No.7, 1999 regarding wholesaler and shopping complex levies. This is also considered to be inappropriate impost, as the local government has not yet established any such location to sell or auction fish. Selling fish at auctions, a common practice in Java, has yet to be introduced in North Sumatra. The recommendation to establish a supervised fish auction as regulated by Perda No. 13, 1987 has now been cancelled because this regulation had been abolished by the Ministry of Internal Affairs; (c) The Office for Marine Administration may be set up but only on the condition that it does not add to the bureaucratic red tape that may impede the fishermen's daily operations.

Another petition which was signed by association members was directed to the Head of the Local Revenue Office and the Head of the Fisheries Office, of the Provincial Government of North Sumatra. The association protested about the sharp rise in the scale of levies on the sale of fish, which have increased by 200%, from Rp25/kg to Rp75/kg. This increase is regarded as too steep and overlooks the fact that until now, the local government has not provided fishermen with any services. For example, in the middle of 1999, when fighting erupted amongst street thugs, no protection was provided for the fishermen. As a result, the fishing wharf at Gabin and 25 fishing boats were destroyed. The association suggested that the rise in levies be limited to 60% or Rp40/ kg.

⁷ Local government requirement for local big scale business activities to pay a certain amount of money as direct contribution to local economic development.

- **Weakening Local Competitiveness and Commodity Exports**

In the long term, if this high cost economy continues, the eventual impact will be to weaken the competitiveness of local export commodities, which have always been the one of the key sources of financial support in this region. In addition, a high cost economy may result in a reduction in local economic activity, as some business leaders are forced to close down or move their business enterprises elsewhere. Early signs of such a trend are becoming apparent. One NGO in Medan, North Sumatra explained that several rattan handcraft businesses in the region, are considering relocating their businesses to other *kabupaten* if local taxes become too burdensome.

- **Main Goal of Autonomy Overlooked: Increasing the Quality of Public Services**

One of the main objectives of the regional autonomy policy is increasing the quality of public services at the *kabupaten* level of government. This can be achieved by simplifying bureaucratic licensing procedures as well as reducing the administrative costs and the time needed to obtain licenses and business permits. Regional autonomy should promote efficiency and economic development at the *kabupaten* level. In reality, however, local governments tend to forget these major objectives. Instead, they are deliberately imposing levies on all economic activities in their regions with the sole aim of increasing PAD to the greatest extent possible.

- **Conflict of Interest Between the Province and *Kabupaten/Kota* Through Overlapping Taxes and Levies**

Under regional autonomy, *kabupaten* and *kota* governments have the key role and greater authority than the provincial governments. As a result, hierarchical relationship between the provinces and the *kabupaten* is no longer in operation. The *kabupaten* governments have used the policy as an opportunity to move away from provincial government influence. On the other hand, the provincial governments are attempting to maintain their power and influence. Consequently, the provinces have also produced many regulations on PAD, many of which duplicate regulation that have also been issued by *kabupaten* and *kota* governments. As a result, there will be many economic activities which will be hit twice by levies with similar content.

6. CONCLUSION AND KEY FINDINGS

Under regional autonomy, the transfer of funds to the local governments is generally larger than the funds that those administration received from the central government prior to the introduction of these reform. However, with the implementation of autonomy, the total budget for routine expenditure for the local government has more than doubled. As a result, not all *kabupaten* and *kota* government have surplus funds for their development budgets. In addition, the size of the DAU block grants are also smaller than the total amount of funds injected into the *kabupaten* in the pre-autonomy era, both through transfer to local government and through the DIP funding to central government “vertical” offices operating at the *kabupaten* level.

This has created new problems at the *kabupaten* level. The financial capacity of local governments is weaker than before, but at the same time they are now required to provide a wider range and a higher quality of public services. Local government have tried to solve the problem by increasing local revenues. However, this tends to produce new distortions and more inefficiency at the *kabupaten* level.

During the regional autonomy era, it is estimated that the number of new taxes and levies will increase significantly. There is a clear indication that local governments have been deliberately exploiting the momentum of regional autonomy to strengthen their financial base in any way they can. Despite public criticism, these local governments have continued to carry out this policy. Many parties are of the opinion that the majority of the taxes and levies that have been introduced have been created simply to collect as much revenue as possible, while disregarding the long-term potential distorting impacts. The extent of local government awareness of the potential impact of such policies remain unclear.

Many entrepreneurs and traders are beginning to complain about the increasing number of levies. If the policy of regional autonomy is only to be exploited as means of providing the regions with legitimate tools to increase the tax burden on the community without the compensation of better public services, the business community will have ample reason to oppose the implementation of regional autonomy. Signs of such opposition towards local government policy are becoming

apparent, as in the case of GAPKI and AP2GB in North Sumatra. If this continues under regional autonomy, the intended goal of providing better public services to improve people's welfare, will remain an empty slogan. Many groups have recently begun to express their concerns that if too much unchecked authority is placed in the hands of regional government, the creative will be encouraged to act arbitrarily. With large funds at their disposal, many fear that this will only lead to the creation of "little kingdoms" in the regions ruled by "little dictators" ⁸.

Many of the above issues are related to local government revenue. However, there are also important problems related to regional expenditure. In this case, *kabupaten* governments have tended to ignore the need to give priority to planning to raise the level of public services. Up until now, for example, the regions still have no scale of priorities for the provision of standard services (except in the provision of permits) to boost the business climate in their area. Many local governments have not decided on the requirements of the development budget in accordance with the services that have to be delivered. The vague and unsatisfactory answer frequently given by senior local officials whenever questions are raised about this issue, is that the local development program will be formulated based on the available budget. Therefore, it is not surprising that local governments are currently focusing all their attention on locating the maximum amount of revenues to increase their development budget. This has been further strengthened by the fact that the DAU received by most regions from the central government is barely sufficient to fund the routine expenditure requirements of the local bureaucracy.

Many of the technical guidelines related to Law 22, 1999 and Law 25, 1999 have not yet been drafted, and consequently some regions have attempted their own interpretation of these two laws, and have then drafted their own local regulations based on their interpretation. The *kabupaten* governments are not concerned that their regulations might contradict with the central government's regulations. For example, in Kabupaten Deli Serdang, the government will continue its plan to form

⁸ Such trend has already become apparent in those regions with abundant natural resources. Local governments in these regions have started to demand a more dominant role in the operation of the state-owned enterprises located in their regions. As the "owners" of the regions, now *kabupaten* governments are asking for a fair share of the profit of these enterprises.

an Office of Land Affairs even though this office has been abolished through Presidential Decree No 895, 2000 that was later reinforced by Presidential Decree No. 10, 2001. However, local officials believe that any law challenged by the central government will have no strong basis because the regional regulation is based on Law No.22, 1999 which occupies a higher authority than a presidential decree in the Indonesian legal system.

Why would the regions dare to take such a step? Are local governments no longer afraid of central government intervention? The most common response from regional officials is that the central government has to be “challenged” by the regions for the following reasons:

1. The central government is reluctant to hand over autonomy to the regions. It is evident that the central government is still interested in managing the regions, particularly concerning those productive sectors of the economy that have been the major sources of government revenue.
2. The central government has been inconsistent in implementing the regional autonomy laws. On one hand, the regions are expected to be self-reliant, but on the other hand the central government has not provided sufficient opportunity for the regions to receive a fair share of the revenues gained from the exploitation of the regions’ own rich natural resources.
3. The amount of the General Allocation of Funds (DAU) provided for the regions is relatively large. However, after covering the wages of the central government employees and considering the increased responsibility for local government services, most of the allocated budget is only sufficient to fund routine local government expenditure.

This situation has boosted local governments’ enthusiasm for increasing local revenue, even though in the long term (consciously or unconsciously) such endeavors will have negative impact on the local business climate.

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APPENDIX

Draft Local Regulations on proposed levies, Kabupaten Simalungun, 2000

No	Title of Draft Local Regulation	Dinas/ Implementing Agency	Status of Levies		Remarks/Status of Draft Regulation
			Under Law No.18, 1997	Approaching /During Regional Autonomy era	
1.	Use of Ground and Surface Water	Mining	Became a tax	Taxed	Being drafted
2.	Third Party Contributions	Regional Treasury	N/A	Taxed	Has been amended
3.	Disturbance Permit (HO)	Regional Treasury	Taxed	Taxed	Has been amended
4.	Hotels and Restaurants Tax	Regional Treasury	Taxed	Taxed	Has been amended
5.	Exploitation of Local Natural Resources Levy	Bina Marga	Taxed	Taxed	Has been amended
6.	Recreation and Sporting Venues Levy	Tourism	Taxed	Taxed	Has been amended
7.	Printing cost of Family Cards, ID cards, and Civil Registration Documents Levy	Civil Registrar	Taxed	Taxed	Has been amended
8.	Worker Welfare Assistance	Manpower	N/A	Taxed	Has been amended
9.	Municipal Waste Disposal/ Sanitation and Parks Levy	Sanitation	Taxed	Taxed	Has been amended
10.	Public Cemeteries and Parks Levy	Sanitation	Taxed	Taxed	Has been amended
11.	Fees for the Registration of Industries and Industrial Assistance	Industry	Abolished	Taxed	Has been amended
12.	Building Construction Levy	Public Works	Taxed	Taxed	Has been amended
13.	Transportation route Levy	Road Transport	Taxed	Taxed	Has been amended
14.	Health Service Levy	Health	Taxed	Taxed	Has been amended
15.	State and Private Plantations Enterprise Contributions to the Governments	Plantations	N/A	Will be reintroduced	Being drafted
16.	Permits for the Supply of Electricity for Privately owned Business and for Public Use	Mining	N/A	Will be reintroduced	Being drafted
17.	Establishment of Local Depot, Fuel Stations	Mining	N/A	Will be reintroduced	Being drafted
18.	General Mining Activities	Mining	N/A	Will be reintroduced	Being drafted
19.	Permits for the Use of Timber on Privately- owned Property	Forestry	N/A	Will be reintroduced	Has been amended
20.	Permits the Use of non-timber Forest Products	Forestry	N/A	Will be reintroduced	Has been amended
21.	Livestock Transport Health Inspection Levy	Livestock	Abolished	Will be reintroduced	Being drafted
22.	Project Bidding Documentation	Public Works	Abolished	Will be reintroduced	Being drafted
23.	Purchased of Privately-owned Heavy Equipment	Public Works	Abolished	Will be reintroduced	Being drafted

Appendix (cont'd.)

No	Titles of Draft Legislation	Dinas / Implementing Agency	Status of Levies		Remarks/Status of draft regulation
			Under Law No.18, 1997	Approaching/ During Regional Autonomy era	
24.	Laboratory Testing Fees	Public Works	Taxed	Will be reintroduced	Being drafted
25.	Periodic Motor Vehicle Inspection Levy in <i>Kabupaten</i> Simalungun levies	Road Transport	Taxed	Will be reintroduced	Being drafted
26.	Rice Milling Enterprises and Rice Hulling Levy	Agriculture	Abolished	Will be reintroduced	Being drafted
27.	Compulsory Business Registration	Trade	Abolished	Will be reintroduced	Being drafted
28.	Origin of Goods Documentation	Trade	N/A	Will be reintroduced	Being drafted
29.	Trading Permit Certificates	Trade	N/A	Will be reintroduced	Being drafted
30.	Warehouse Levy	Trade	N/A	Will be reintroduced	Being drafted
31.	Regulation of Restaurants and Bars	Tourism	Abolished	Will be reintroduced	Being drafted
32.	Regulation of Hotel Businesses under the Bung Melt and Pondok Wisata category	Tourism	Abolished	Will be reintroduced	Being drafted

Note : N/A = information unavailable

Source : Legal Section, Regional Government Secretariat, Kabupaten Simalungun.