

THE ROLE OF THE STATE IN THE CASE OF INDONESIA LOCAL TAX REFORM

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ABSTRAKSI

Negara merupakan jaringan yang menghubungkan antara masyarakat (principal) dengan pihak-pihak yang mereka pilih sebagai wakil mereka (agent). Dengan posisi ini, pemerintah merupakan pihak yang dominan dalam menentukan dan menegakkan peraturan dalam negara tersebut (the rule of the game). Berdasarkan teori agensi, negara memiliki peran sebagai nexus dari kontrak yang terjalin di dalam sistem pemerintahan. Karena informasi yang tersedia tidak simetris, maka seringkali terdapat potensi bagi pemerintah untuk melakukan aktivitas oportunistik. Berdasarkan konsep mengenai desentralisasi fiskal, kekuatan fiskal pemerintah daerah terletak pada kemampuan mereka untuk mengelola pajak dan pengeluaran. Pajak sendiri merupakan aspek terpenting untuk mengevaluasi kekuatan fiskal suatu pemerintahan. Terkait dengan berjalannya otonomi daerah, pemerintah daerah juga harus memiliki kemampuan untuk memperoleh pendapatan. Salah satu elemen penting dalam mengukur derajat otonomi suatu daerah adalah kemampuan suatu daerah untuk menarik pajak dari masyarakatnya. Namun demikian, hingga saat ini rata-rata penerimaan pajak di seluruh daerah di Indonesia masih relatif kecil. Oleh karena itu reformasi pajak perlu dilakukan untuk meningkatkan penerimaan pajak pemerintah sekaligus menghindari terjadinya eksploitasi berlebih yang merugikan kepentingan principal.

Kata kunci: The role of the state, tax reform, fiscal decentralization.

Many economists have argued that the role of a state is an important feature in developing and industrial countries (Alston, 1996, World Development Report, 1997 and 2002). State is understood as a network of relational principal-agents contracts between the constituents (the principal) and their representatives (agents) or state can be understood as a nexus of long-term relational contracts between individual. In democratic government there are two stages of principal-agent relationship. In the first stage, voters are the principals and political actors (individuals,

parties, and elected officials) are the agents. Meanwhile, in the second stage, elected politicians or government actors, legislatures, or judiciaries are principals and the public bureaucrats are the agents (Burki & Perry, 1998: 122). However, many researchers have paid little attention to examine the relationship between role of the state and tax reform.

Many economists argue that state is a dominant player in making and enforcing of the rule of the game. State in agency theory can be conceived as a nexus of contracts both internally with central government, province government and local government and externally, with local legislature, local government and local private sector.

¹ This paper is a part of my thesis at Monash University, under supervised by Marika Vicziany and Associate Robert Rice.

Furthermore, the choice of contracts will depend on the cost of transaction and information and subject to behavioural assumption, i.e. bounded rationality and opportunism (Williamson, 1975). However, since information is asymmetrically distributed, principal-agent relationship can give rise to adverse selection (hidden information) and moral hazard (hidden action). Therefore, state as a key player can potentially act as opportunistic behaviour.

A simple neoclassical theory of the state can be used to explain the relationship between theory of the state and public finance (see also Jaya, 2004). There are two general types of explanation for the state exists: a contract theory and a predatory or exploitation theory. North (1991: 21) argues that a contract theory of the state based on the theorem of exchange in which the state plays the role of wealth maximiser for society. The contract theory approach offers an explanation for the development of efficient property rights that would promote economic growth or wealth. Meanwhile, the predatory theory of the state considers the state to be the agency of a group or class; its function, to extract income from the rest of the constituents in the interest of that group or class. The predatory state would specify a set of property rights that maximise the revenue of the group in power, regardless of its impact on the wealth of the society as a whole (North, 1991:22). Therefore this paper will use New Institutional Economics of the State to examine Indonesia local tax pre and post reform of Law No.34/2000 on Regional Taxes.

TAX SYSTEM IN THE GLOBAL CONTEXT

Based on the concept of fiscal decentralisation, local fiscal power is the power of local governments to make their own decisions about taxations and expenditures - that is the degree to which regional governments have independent control over

their budgets (Burki *et al.*, 1999; and Mahi, 2003; Shah *et al.*, 1994; Ter-Minassian, 1997). Some scholars argue that to evaluate local fiscal power one needs to study the four pillars of a fiscally decentralised system: tax or revenue assignment, expenditure assignment, intergovernmental transfers, and local government borrowing (Ebel & Yilmaz, 2002; Martinez & Vasquez, 2002; Shah, *et al.*, 1994; Shah *et al.*, 2004). The examples cited here are based on papers that appeared in *Fiscal Federalism in Theory and Practice* edited by Teresa Ter-Minassian (1997). Ter-Minassian provides a good overview of federal fiscalism as it works in various developed and underdeveloped countries.

Tax assignment is the most important aspect to evaluate local fiscal power (Noregaard in Ter-Minassian, 1997). Ebel & Yilmaz (2002) assert that tax assignment is the allocation of tax responsibilities among multiple tiers of government. Musgrave (1983: 2-19) points out that "there are seven principles in tax assignment, i.e. (1) progressive redistributive tax should be centralised, taxes suitable for economic stabilisation should be centralised; (2) unequal tax bases between jurisdictions should be centralised; (3) taxes on mobile factors of production should be centralised; (4) residence-based taxes, such as excise, should be levied by states; (5) taxes on completely immobile factors should be levied by local authorities; and (6) benefit taxes and user charges can be levied appropriately by all levels".

Some scholars use tax evaluation criteria to assess local fiscal power. Devas (1989) and Davey (1996) argue that from an administrative point of view there are six criteria for judging the appropriateness of tax assignment. These are adequacy and elasticity, equity, administrative feasibility, political acceptability, economic efficiency, and suitability as local taxes. Similarly, Ebel & Yilmaz (2002) argue that from an economic point of view, the tax base (mobile/immobile), tax rate

(regressive/progressive), and the economic scale are the criteria for success in determining revenue assignment.

The tax assignment system in the United States provided something of a model for the Indonesian reforms, although those reforms have not gone far enough along the American track. Stotsky & Sunley in Ter-Minassian (1997: 343-359) note that the United States has a decentralised tax administration with each federal, state, and local government having its own tax administration to collect the taxes it imposes. They also note that decentralisation gives each government maximum fiscal independence and control over the base and rates of its taxes. Property tax is usually collected and administered by state governments. Ter-Minassian (1997) also describes another US tax arrangement that runs parallel to the one just described. This is called piggyback system of taxation where, for instance, the federal government collects income tax and then gives a fixed 10 percent of that yield to local government. This piggyback or overlapping system seemed to inspire legal drafter of the Indonesian income tax law as stipulated in Law No. 17 of 2000. Despite this, local governments in Indonesia still have only a minimal role in controlling and administering the district tax base and tax rates.

Japan's tax assignment system also presents an interesting example for Indonesian officials to think about. Mihaljek in Ter-Minassian (1997: 250-285) notes that local taxes are the greatest source of district revenue in Japan: about 35 percent, which is about three times the proportion of local taxes in the case of Indonesian districts. However, despite this the tax base and tax rates cannot be determined by local governments in Japan. At the same time, local governments do have some flexibility with certain taxes, provided that these are approved either formally or informally by the central Japanese government. What Indonesia can learn from this is

how to structure the tax system in a manner that gives local governments the capacity to raise a greater proportion of total revenue from local taxes. And as the Japanese case shows, this can be done in a way that is flexible and involves the central government as a monitor and ultimate authority.

Australia's decentralised system is another example that Indonesia might look to for a better understanding of the workings of a modern fiscal system in the context of a democratic society. Craig in Ter-Minassian (1997: 175) describes how the Commonwealth Government controls the four major high-yielding taxes: personal income tax, customs and excise duties, company income tax, and sales tax. It left only low-yielding smaller revenue sources for state and municipal governments. For example, state governments control and administer property taxes which contribute almost 56 percent of state government revenue. Ter-Minassian (1997: 9) also points out that Australia espouses the principal of complete separation of the tax base for different levels of government. In Indonesia, by contrast, the central government has dominated the tax system by monopolising all the high-yielding tax sources including the property tax. This has resulted in a large vertical fiscal imbalance (Shah *et al.*, 1994).

In Australia there are also annual meetings of the state Premiers with the Prime Minister to discuss the fiscal formula used to allocate centrally-collected taxes back to the state governments. This provides the state governments with the chance to plead their case for altering the formula on a regular basis. Although the formula has been relatively stable in recent years, the annual process of consultation is an important part of Australian democracy. It also avoids the impression that the federal government controls all the fiscal resources of Australia without taking into account the opinions of state governments. The Premiers take the annual review very seriously and employ a

team of lawyers to present their views. For example, the State Government of Victoria retains a team of about 100 tax lawyers who work on the presentation of the Victorian case throughout the year so that at the annual meeting the state of Victoria can put the strongest possible argument for an increase in centrally-collected states to the state of Victoria (Dixon, May 2003). The Australian experience could well hold lessons for the Indonesian government when it comes to establishing a fiscal dialogue between central and local governments in a manner that promotes consultation and transparency.

In contrast to Australia, Japan and the US, the Indian tax system is one that is marginally better than the Indonesian but it does not hold powerful lessons. Hemming, *et al.* in Ter-Minassian (1997: 527-539) argue that tax assignment in India is based to a significant extent on the relative efficiency of the central and state governments in collecting taxes. Thus all central taxes are collected by the central tax authority and all state taxes by state tax authorities. As in Indonesia, the lower level governments have been assigned taxes from relatively immobile tax bases while the central government takes the highest yielding taxes. Thus New Delhi collects 100 percent of income tax, profit tax, excise duties and import duties. The state governments collect 95 percent of sale taxes and 75 percent of other taxes. However, after applying the revenue sharing formula, 72 percent of income taxes and 45 percent of excise duties are distributed to the state governments (Hemming *et al.*, 1997: 531). This appears to be much more generous than the Indonesian case where less than 25 percent of centrally collected revenues are redistributed beyond Jakarta. Despite these apparently favourable equations, the Indian tax system remains in serious difficulty as the persistent fiscal deficits at the state and central levels demonstrate. Underlying what seems to be a good system, is the failure of all governments to tax the rich peasants. This has proven to be

politically too sensitive for any party to make into an election agenda. For all these reasons, the Indian example is not illuminating for Indonesia.

Tax assignment in Argentina provides another example of a model that could be useful for Indonesia, at least in demonstrating how to increase locally generated revenues. Schwartz & Liuksila in Ter-Minassian (1997: 388-423) argue that the Argentinean federal government collects the main taxes such as income tax, value added tax (VAT), excise taxes, foreign trade taxes, liquid fuel and energy taxes, gross assets tax, social security taxes, and a number of minor levies. Provincial and municipal governments collect real estate tax, automobile tax, road taxes & the provincial turnover tax. Schwartz and Liuksila note that in the Argentinean case provincial tax collection represents about 45 percent of total provincial government revenue. This is much higher than in Indonesia because Indonesian provincial and district governments cannot levy their own property and turnover taxes.

Overall, the experience of tax assignment in both developed and developing countries provides three important questions for the present paper on Indonesia. Who actually collects and administers the taxes and levies? Who determines the tax base and the rate of taxes? Should the central government continue to dominate the revenue system?

INDONESIA TAX SYSTEM: PRE REFORM LAW NO.34/2000 AND POST REFORM LAW NO.34/2000

One of the crucial elements in measuring the degree of regional autonomy is the power of regional governments to tax their population (Simanjuntak, 2002: 1). The larger the proportion of locally generated revenue, the more authority the local *Kabupaten* government can have. However, the majority of scholars working on this issue confirm that the role of locally generated revenue has been

very small in Indonesia for a long time. There is another way in verifying the power of the central government, i.e. through its control over the collection and distribution of tax and non-tax revenues.

PRE REFORM

Shah *et al.* (1994: 41) confirms that the collection of taxes was highly centralised because Jakarta insisted that the central government should control the most productive sources of revenue. Table 1 confirms his analysis but also takes that analysis one step further by including information about non-tax revenues. For the rest of this chapter, the analysis of the power of Jakarta is based on both of these sources of financial power: tax and non-tax revenue. To my knowledge, no scholar working on Indonesia until now has generated an analysis that seeks to summarise the total revenue powers of the central state.

Table 1 shows that oil and gas revenues (the main form of non-tax income), income taxes, property taxes, value-added taxes and taxes from international trade were all collected by Jakarta and retained by the central government as part of the central budget (Table 1). Table 1 also shows that central government decided what the tax base was going to be, the specific rate of taxation and the administration of tax and non-tax revenue collection. Even in the case of other revenue, rents from mines and royalties from forest for example, Jakarta retained the bulk of taxes collected: 65 and 55 percent respectively.

After Jakarta, it was the provincial governments that benefited most and the *Kabupaten* district and municipal governments the least. For example, Table 1 shows that in the case of forestry licenses and mining royalties the provincial government received 56 percent of the total revenues collected by the central government and that a mere 14 percent went to district governments. In these

two cases, the central government retained the minor share of revenues raised, yet still local government received hardly anything. Moreover, as we show in the next section the actual revenue yield from these two sources was relatively small compared with the large revenue earners. District governments only received the lion's share of total revenues in a single instance, the land and building tax where 64.8 percent went to district governments compared to 16.2 percent to provincial government and the 19 percent that was retained by the central government.

Table 2 compares the share that the various levels of government had in the total revenue collection system of Indonesia. The Table provides powerful evidence for the argument that Indonesia suffered from massive vertical revenue imbalances in the pre reform tax era in 1990/1991: the central government collected 95 percent of the consolidated domestic revenue of Indonesia compared with just over three percent by the provincial governments and a mere one percent by district and municipal governments.

The actual yields of these revenues also confirm the argument that the centre had a virtual monopoly over the revenue system of Indonesia because it controlled all high yielding tax sources and left only low yielding, smaller revenue sources for the provincial and *Kabupaten* governments. In the period 1990-1991 and 1997-1998 some shifts in the importance of certain revenue sources did manifest themselves. For example, during the early 1990s non-tax receipts from oil and gas resources constituted the single largest source of revenue in Jakarta (42 percent of total revenues) and 100 percent of this revenue remained in the hands of central government. By the late 1990s, however, revenue from income taxes had doubled to 36 percent of all national revenues and the yield from gas and oil resources had fallen to some 16 percent of the total. This paper is not concerned with the

changing nature of Indonesian revenues in the pre reform era, so at this stage there is no obvious answer to the question of why these shifts were taking place. Rather the point of this analysis is to show how during the 1990s, despite the shifting nature of domestic revenue, the central government of Indonesia continued to control both tax and non-tax

sources of government income and how that control was ensured by central dominance over all high yielding revenue sources. Another way of verifying this central dominance is to look more closely at the capacity of *Kabupaten* governments to generate new revenue from *Kabupaten* sources.

Table 1. Tax Assignment and Revenue Sharing in Indonesia, Pre Reform 34/2000

Revenue	Responsibility			Distribution of Revenues		
	Base	Rate	Adm	Centre	Province	District
CENTRAL GOVT TAXES						
Income taxes	C	C	C	100.0	0.0	0.0
Value-added taxes	C	C	C	100.0	0.0	0.0
Import duties	C	C	C	100.0	0.0	0.0
Excise	C	C	C	100.0	0.0	0.0
Export tax	C	C	C	100.0	0.0	0.0
NATURAL RESOURCES						
Oil and gas receipts	C	C	C	100.00	0.0	0.0
Land and building tax	C	C	C	19.00	16.2	64.9
Forestry royalties	C	C	C	55.00	30.0	15.0
Forestry licenses	C	C	C	30.00	56.0	14.0
Mining land rents	C	C	C	65.00	19.0	16.0
Mining royalties	C	C	C	30.00	56.0	14.0
DATI I OR PROVINCIAL TAX						
Motor vehicles registration and transfer taxes	C,P	C,P	P	0.0	100.0	0.0
DATI II OR DISTRICT AND MUNICIPAL TAXES						
Hotel and restaurant tax	C	C	L	0.0	0.0	100.0
Entertainment taxes	C,P	C,P,L	L	0.0	0.0	100.0
Street lighting taxes	C,P,L	C,P,L	L	0.0	0.0	100.0
Advertisement taxes	C,P	C,P,L	L	0.0	0.0	100.0
Bus. registration tax	C,P	C,P,L	L	0.0	0.0	100.0
Radio tax	C,P	C,P,L	L	0.0	0.0	100.0
Slaughter house tax	C,P	C,P,L	L	0.0	0.0	100.0
Other district taxes and charges	C,P	C,P,L	L	0.0	0.0	100.0

Notes:

C = Central government

P = Provincial Government (*Dati I*)

L = District Government (*Dati II*)

Base = The tax base is the population obliged to pay the tax according to the law.

Rate = The rate is the level of taxation

Adm = The administrative system for collecting the tax.

Source: Shah *et al.* (1994: 42)

Table 2. Value and Proportion of Taxes Collected by various Levels of Government from Various Tax Bases in 1990/1991 compared with 1997/1998 in Trillion Rupiah

Level of Government	Total Value of Taxes Collected in 1990/1991*	Percentage of	Total Value of Taxes Collected in 1997/1998**	Percentage of
I. Central Government	39.3	95.3	87.7	93.5
I.A. Tax				
a. Income Tax	6.7	16.3	29.1	31.0
b. Value Added Tax	7.4	18.0	24.6	26.2
c. Import Duty	2.4	6.0	3.3	3.5
d. Excise Duties	1.9	4.6	4.4	4.7
e. Export Tax	0.04	0.1	0.1	0.1
f. Property Tax	0.8	0.6	2.5	2.7
g. Other Taxes	0.2	2.0	0.6	0.7
I.B. Non Tax Receipt (natural resources)				
a. Oil and Gas Receipts	17.7	42.6	14.9	15.8
b. Others	2.1	5.1	8.2	8.8
II. Province (<i>Dati I</i>)	1.4	3.4	4.1	4.4
a. Vehicles Tax	0.9	2.4	3.0	3.2
b. Charges	0.3	0.5	0.5	0.5
c. Others	0.2	0.3	0.6	0.7
III. Local (<i>Dati II</i>)	0.5	1.3	1.7	1.9
a. Taxes	0.1	0.3	0.6	0.7
b. Charges	0.3	0.7	0.8	0.9
c. Others	0.1	0.3	0.3	0.3
Total Tax and Charges: I+II+III	41.2	100	93.5	100

Source: * Shah *et al.* (1994: 43) and ** Simanjuntak (2002)

From the viewpoint of good local governance, decentralisation reforms may be more far reaching. However, the public sector as an interlocking set of institutions cannot be re-engineered at will over a short period (Dick, 2000). Indeed, the problem of accountability and transparent budget at the local level could also be compounded by possible abuses of power and corruption. Legislature and judiciary at the local level are considered too weak to prevent local bureaucracy from such (Brojonegoro & Asanuma, 2000).

Indeed, there are several deviations and corruption over the management of local revenue (Jaya *et al.*, 2000). For examples are

tax officer and tax payer collusion, no administration order in tax collection, target determining in tax revenue manipulated, illegal collection and corruption, collusion and nepotism especially on part of the profit local enterprise (BUMD). Moreover, there was collusion between local government executive and local legislative on local budget ratification, we called this "*Pertemuan setengah kamar*" (budget compromise between Bupati/Major with head of legislative).

AFTER REFORM

Table 3 shows that the central government controlled the whole revenue system even if it

did not collect the revenues because they determined the tax base, the rate of taxes and tax administration.

The second and third sections of Table 4 show the revenues that were raised by provincial, district and municipal governments. Clearly, the power of Jakarta was ensured by the restricted capacity of all *Kabupaten* governments to raise their own revenue as this Table demonstrates. The restriction arose in the first instance from the lack of taxable items. For example motor vehicle registration, transfer taxes on vehicles registration and transfer title taxes on vehicles were the only locally generated source of

revenue controlled by provincial governments. District and municipal government had a wider range of tax sources that they could draw on but the total yield from these was very small as we shall see shortly. Table 4 shows that locally generated revenue at the district and provincial levels remained small in proportion to centrally generated revenue largely because it was confined to a limited range of economic activity. Almost 95 percent of the total revenue of Indonesia in 2002 was raised and collected by the Central Government and only three percent by the provincial government and about two per cent by the *Kabupaten* or district governments.

Table 3. Tax Assignment and Revenue Sharing Arrangements/Formula in Indonesia: A Comparison of the Pre and Post Reform Years: 1993 and 2000

Item	Central government		Provincial Government		Resources Producing District Government		Other District Govt in the same province		All District Govt in Indonesia	
	1993	2000	1993	2000	1993	2000	1993	2000	1993	2000
Tax and Non Tax and Sharing										
Income	100	80	0	8						12
Value added	100	100	0	0						
Import duties	100	100	0	0						
Export	100	100	0	0						
Excise	100	100	0	0						
Land and building*	19	20*	16.2	16					64.8	64
Property Tax**	19	19**	16.2	16.2					64.8	64.8
Natural Resource revenue sharing										
Oil	100	85	-	3		6		6		
LNG	100	70	-	6		12		12		
Mining: Land rent	65	20	19.0	16		64		0	16	
Mining: royalty	30	20	56	16		32		32	14	
Forestry: land rent	55	20	30	16		64		0	15	
Forestry: provision	30	20	56	16		32		32	14	
Fishery	-	20				80				

Note * 20 percent distributed equally to all districts, ** 10 percent distributed to districts and 9 percent for tax collection
Source: Shah *et al.*, 1994, Law 25/1999 and Government Regulation 104/2000

Table 4. The Total Value of All Revenue Collected by Various Levels of Government from Various Sources and Tax Bases in the Calendar Year 2002 (in Trillion Rupiah)

Level of Government	Total Value of Revenue Collected in 2002	Percentage of revenue from each source relative to total revenue in 2002
I. Central Government	301.6	94.9
I.A. Taxes		
a. Income Tax non Oil and Gas Receipts	88.8	27.9
b. Income Tax oil and gas	15.7	4.9
c. Value Added Tax	70.1	22.1
d. Import Duty	12.2	3.8
e. Excise Duties	22.4	7.1
f. Export Tax	0.3	0.1
g. Property Tax	8.1	2.6
h. Other Tax	1.9	0.6
I.B. Non-Tax Receipts		
i. Oil revenues	44.0	13.8
j. Natural gas	14.5	4.6
k. Mining	1.3	0.4
l. Forestry	3.0	0.9
m. Fishery	0.3	0.1
n. Non natural resources	19.0	6.0
II. Provincial	9.6	3.0
a. Vehicles Tax	8.6	2.7
b. Charges	0.6	0.2
c. Others	0.4	0.1
III. District	6.7	2.1
a. Taxes	2.3	0.7
b. Charges	2.2	0.7
C. Others	2.2	0.7
Total Taxes and Charges: I+II+III	317.9	100
All the percentages in cols. 3 and 5 are calculated as proportions of 100 % at the bottom of this table		

Source: Calculated from Central Bureau of Statistics, Government of Indonesia, *Statistical Year Book of Indonesia*, (2002: 417) and Central Bureau of Statistics, Government of Indonesia, *Financial Statistics of District/Municipality Government* (2002: 4)

However, in-depth interviews in these three *Kabupatens*: Sleman, Badung, and Kupang, confirm that local perceptions of the new reforms law 34/2000 have been viewed both positively and negatively. On the negative side is the perception that *Kabupaten*

governments have become “more revenue hungry” by issuing a plethora of regional taxes and charges. Some other scholars have also supported this finding. Hofman & Kaiser (2002) wrote that *Kabupaten* governments after becoming revenue hungry introduced

nuisance and predatory local taxes. (The World Bank, 2003) The World Bank found in 2003 that more than 2000 regulations on *Kabupaten* taxes and charges have conflicted with Law 34. Taxes on the movement of goods from one *Kabupaten* to another were of great concern to the central government because of their adverse effect on the economy, by causing fewer realisations of economics of specialisation and increased allocative inefficiency. Therefore we can argue that transfer of fiscal power has not been followed by a transfer of monitoring accountability, resulting in a transfer of abuse fiscal power.

POLICY ISSUES IN LOCAL TAX REFORM

The New Institutional Economics is an important analytical tool to analyze a state transformation. The new reforming institutions in local tax will determine the non-price incentives for the behaviour of individuals and organisations, particularly, in public administration and they can solve information and enforcement problems (agency problem). However, when the state agency behaves in predatory manner and rules of the game are unstable and changing, it is difficult to define appropriately incentives and to monitor devices in fiscal contracts between principal and agents. The choice of fiscal contracts will depend on the transaction cost. When information is asymmetrically distributed, principal-agent relationship can give rise to adverse selection (hidden information) and moral hazard (hidden action) such as cheating, shirking, opportunism and problems of agency. As a result, these conditions create high transaction cost. In fact, in the context of the behaviour of State agencies, potential corruption, collusion and nepotism are evidence of organisational dysfunction, stemming from weakness in the institutional framework.

The analysis in this paper has revealed a major contradiction in the reforms introduced in 1999: despite political and administrative decentralisation, district governments remain financially weak. They have limited fiscal power. Despite a great expansion in the number of local taxes and cesses, the revenue yielding capacity of local grants is relatively small. The result is that the central Indonesian government continues to control the highest yielding taxes and as a result remains the dominant fiscal authority in the land. This characteristic of the new revenue system needs further qualification. The revenue collecting capacity of the district governments is weak and they received the smaller share of total centrally collected revenues. Nevertheless, at the same time their decision making power over what the centrally allocated funds spent are used for has increased significantly. In particular, it is up to the *Kabupaten* governments to decide on the allocation between routine and development projects and what proportion of the local budgets can be allocated to increasing or decreasing the number of civil servants attached to its offices. Paradoxically, this local flexibility has also opened the doors to further corruption and nepotism at the district level.

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