Chapter 9

Issues of Local Government Expenditure after Fiscal decentralization: Experience from Indonesia and South Korea

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Abstract

This chapter aims to discuss about issues of fiscal decentralization in Indonesia and South Korea that explained from the expenditure side. The experience in the two countries confirms that although there are different paths towards fiscal decentralization, there is something in common to learn in the international context. First, that fiscal decentralization must be timely implemented according to the stages of development in terms of political as well as economic institutions. Second, decentralization itself does not guarantee efficiency gains, but sustainable growth and welfare can only be achieved through decentralization policy.

Keyword: Fiscal decentralization, Local Government Expenditure, and decentralization policy

1. Introduction

Decentralization has been a global trend in developed as well as developing countries, starting from the early 1980s and continued to the beginning of the 21st century. In Western Europe, French government under Prime Minister Mitterand and British government under Prime Minister Thatcher started new policies in favor of local autonomy. The USA government under President Reagan initiated the "new federalism" that in effect constituted functional devolution and gave more power to the states. The economic giants of Asia, Japan and China, have also adopted experiments with decentralization, albeit partially. The thrust toward democratization has been a key factor for decentralization in the region.

In the wake of Asian economic crisis in late 1990s, Indonesia has embarked on a radical decentralization together with multi-dimensional reform after the demise of the New Order authoritarian regime. In 1991, South Korean government reintroduced the local autonomy system and, although decentralization system was slightly modified after the 1997 monetary crisis, decentralization policy is still an important discourse in the country. This paper shall discuss a comparison between the two countries in implementing decentralization. The study is focused on the politics of fiscal decentralization for two reasons: first, there is still limited comparative study on fiscal decentralization in Asian countries; second, fiscal decentralization is an area of study that must consider political bargaining while it can be analyzed with objective criteria related to the goal of decentralization, i.e. the improvement of public services.

The classic theory of fiscal decentralization holds that public goods and services can be provided with a greater efficiency and accountability under decentralized environment. First, local governments can be better tailored to the geographical benefit areas of the public goods. Second, local governments are better positioned to recognize local preferences and needs. Third, pressure from inter-jurisdictional competition may motivate local governments to be innovative and accountable to their residents (Oates, 1972). While these arguments may remain valid and applicable for developed countries, the facts in developing countries showed that there are mixed results. This paper would argue that the link between fiscal decentralization and better efficiency and accountability cannot be taken for granted. The explanations on Indonesian and Korean experience with fiscal decentralization shall be discussed from the expenditure side in order to be more focused on how the policy is implemented on the ground.

2. Fiscal Decentralization in Indonesia

Indonesia is a big archipelagic state with 13,667 islands. Its area covers about 4.8 million square kilometer and only 1.9 million square kilometer constitutes lands. In 2007, the population is 235 million. Most of the people (61.7%) are resided in Java island although it constitutes only 7% of the total area. Therefore, geographical condition is one of the fundamental reasons why development in Indonesia must be decentralized.

After the Suharto's authoritarian government was replaced by more democratic government, two laws that reshaped inter-governmental relations were enacted: Law No.22/1999 on the system of local government and Law No.25/1999 on fiscal balance. While in the past central government was entitled to 100% of revenues from natural resources (mainly oil and natural gas), the new law on fiscal balance provided that districts or cities should receive 15% of revenues from oil exploitation and 30% of revenues from natural gas exploitation carried out within their borders. They should receive 80% of the government revenues accruing from mining other than oil and gas, from forestry, and from fisheries within their own borders. The provinces would be entitled much less than that for districts or cities.

The spirit of decentralizing financial responsibility was accommodated in

Law No.25/1999 by the elimination of the subsidy system under *Subsidi Daerah Otonom* (SDO) for paying salaries of sub-national government employees. Rather than the system of centrally-mandated staffing structures in which public servant salaries paid with the SDO, sub-national governments could make their own staffing decisions to achieve administrative efficiency. The law introduced general allocation funds (*Dana Alokasi Umum, DAU*), based on transparent transfer formulas, to be used with full local discretion. At the same time, special allocation funds (*Dana Alokasi Khusus, DAK*) could be made from the central budget to selected regions, based on their special developmental needs. The DAU should amount to at least 25% of central government domestic revenues as stated in the annual budget (APBN). The provinces should retain 10% of this allocation and the remaining 90% should go to the districts or cities. Law No.25/1999 was revised with the enactment of Law 33/2004 with limited changes in terms of subsidy formulas.

During the New Order administration in the past, local budgets in Indonesia were prepared through the so-called "line-item budgeting" method. Financial resources were allocated according to input categories (personnel, material, money, etc.) in the organizational units. This was meant for preventing malfeasance and manipulations. But this method had two main disadvantages: first, there were limited indicators to evaluate budget performance, and second, it was oriented to the inputs while disregarded outputs.[1] When the budgeting system was changed into "performance-based budgeting" together with fiscal decentralization policy, however, other problem emerged. Not only that there is a tremendous lack on the details of expenditure assignments, the capacity of district government officials to create a sound fiscal system is also substantially lacking.[2] This is because capacity building for local human resources on public finance has been neglected during the New Order administration. These shortcomings have bogged down local budgeting system while malfeasance and manipulation continued unchecked.

Contrary to the ideals that fiscal decentralization would create sub-national budgets that are responsive to the local needs, the profile of local budgets after decentralization is in fact less efficient, and therefore has not been able to support economic improvement among the local people. Table 1 shows that the percentage of funds allocated for public investment (development expenditures) are not significant while most of those allocated for official salaries are quite high. In many provincial budgets, development expenditures are much less than official salary expenditures.

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[1] Source from Robert A. Simanjuntak, "Otonomi Daerah Mulai Timbulkan Masalah", *Kompas*, 30 April 2001.

[2] Source from Bambang Brodjonegoro, *Otonomi Daerah dan Kondisi Fiskal Indonesia*, 2000, mimeo. Available at www.perda.or.id. Accessed on 20 February 2002.

In the province of Bengkulu, for example, 38 percent of the budget is allocated for public official salary and only 15.6 percent is allocated for development expenditures. Data from the districts (*kabupaten/kota*) level has indicated that on average the funds that are absorbed for official salaries is at about 50,3 percent while development expenditure (*belanja modal*) is only about 18 percent. [3] Therefore, the idea of creating performance-based budgeting to ensure that public budgets would bolster economic development at the sub-national government has not appropriately achieved.

Table 1: Comparison of Main Expenditures in Provincial Budgets (Million IDR)

No.	Province	Public Official Salary		Development Expenditures (*Belanja Modal*)		Total Expenditures (TE)
		Amount	% of TE	Amount	% of TE	
1	Aceh	870,717	11.4	3,112,053	40.7	7,638,451
2	North Sumatra	709,616	18.5	835,209	21.8	3,833,181
3	West Sumatra	535,612	22.8	581,486	24.8	2,344,232
4	Riau	734,034	17.8	1,389,005	33.7	4,124,904
5	Jambi	400,798	26.6	394,091	26.2	1,504,935
6	South Sumatra	465,132	14.4	942,091	29.2	3,225,412
7	Bengkulu	435,022	38.0	178,558	15.6	1,143,967
8	Lampung	457,642	24.9	266,500	14.5	1,839,829
9	DKI Jakarta	7,586,350	31.2	6,774,979	27.9	24,285,347
10	West Java	1,628,777	17.0	1,131,750	11.8	9,560,557
11	Central Java	1,177,100	20.8	470,443	8.3	5,665,316
12	DI Jogjakarta	357,055	25.6	131,691	9.4	1,394,446
13	East Java	1,483,755	19.0	750,042	9.6	7,826,710
14	West Kalimantan	380,491	22.7	349,866	20.9	1,675,911
15	Central Kalimantan	325,828	16.1	615,772	30.4	2,028,000
16	South Kalimantan	450,512	20.7	585,165	26.9	2,176,862

[3] Direktorat Jenderal BAKD, Ministry of Home Affairs, 2009.

17	East Kalimantan	712,731	11.9	1,719,496	28.8	5,979,388
18	North Sulawesi	355,711	32.5	207,921	19.0	1,093,545
19	Central Sulawesi	320,042	28.9	236,003	21.3	1,105,604
20	South Sulawesi	544,423	22.3	229,646	9.4	2,443,037
21	South-East Sulawesi	341,871	25.9	318,951	24.2	1,320,577
22	Bali	545,181	25.9	281,287	13.4	2,106,051
23	West Nusatenggara	420,714	31.0	176,135	13.0	1,356,772
24	East Nusatenggara	380,989	32.4	188,458	16.0	1,174,630
25	Maluku	311,006	31.9	117,409	12.0	976,322
26	Papua	589,426	11.5	904,527	17.7	5,124,526
27	North Maluku	169,466	20.4	329,769	39.6	832,340
28	Banten	353,760	14.1	716,159	28.5	2,511,267
29	Bangka-Belitung	164,457	14.8	418,548	37.8	1,108,197
30	Gorontalo	173,595	30.8	111,846	19.9	563,308
31	Riau Islands	175,410	9.6	759,487	41.5	1,830,000
32	West Papua	215,981	7.9	895,753	32.9	2,726,150
33	West Sulawesi	98,399	16.2	186,799	30.7	608,616

Source: DJPK, Ministry of Finance, 2010

Fiscal decentralization policy is not supported with improvement in the public budget cycles. The process of allocating budget at the local level is not efficient enough to ensure that all the funds are there when it is needed. The Indonesian fiscal year starts and ends according to yearly calendar, from 1st of January to 31th of December. In reality, however, the funds are actually able to be allocated on May or later. There are various factors why this becomes a pattern. Firstly, when the Ministry of Finance ratifies the national budget (APBN), very limited fund is actually ready to be allocated. Most are based on predicted revenue by the Directorate General of Tax. Therefore, in the first months of the year, even at the central government there is not much fund to be allocated. Secondly, Indonesia is a diverse country in terms of regions and geographical areas. It always takes time when the central government has decided to disbursed funds from the Ministry of Finance to local KPN (*Kantor Perbendaharaan Negara*) in 33 provinces, 389 districts, and 96 cities. Thirdly, there are a lot of procedure for controls and audits that slow down the process of disbursement. Many local governments do not have enough capacity to undertake financial reports. Meanwhile, local government agencies have to satisfy the Bawasda (*Local Supervisory Body*), BPKP and other auditing institutions before they can actually disburse funds.

The fact that many local governments in Indonesia have so much reserve and unspent expenditures substantiate reasons to worry. The number of local governments with budget surpluses has increased steadily. In 2007, for example, it is ironic that while the central government sought standby loans to finance the national budget deficit of about Rp 61.9 trillion, the local government had a combined local budget surplus of over Rp 43 trillion. While many possible explanations can be put forward regarding this phenomena, one thing is certain, that decentralization policy in Indonesia has not been supported by improvement of local capacity in budgeting.

3. Local Political Interest

Irene S. Rubin in her book titled *The Politics of Public Budgeting* (2000) says that the amount and pattern of allocation of the public budget are always be influenced by political interests of the decision makers. She concludes that *"budgets reflect relative proportions of decisions made for local and constituency purposes"*. There are some regulations which make possible for political elites to use public budget. Government Regulation No.5/2009 on Financial Support for Political Parties (*Bantuan Keuangan kepada Parpol*) gives possibilities for allocating funds from the national and local budgets according to the proportion of seats acquired by particular political parties. The political parties must make accountability reports on the use of funds, which then also being audited by the BPK. Nevertheles, the penalties for possible misuse of funds are only administrative. The fund allocation should be stopped but there is no other form of penalty. This loophole would certainly give rooms for politicians and local government elites to use public funds for their own political interests.

For the public funds to be allocated through the local budget (APBD) appropriately, there is an urgent extra effort on the part of the legal and financial authorities. One of the main goals is to ensure that the fund would not be diverted into money politics and all kinds of unproductive activities. Unfortunately, the current trends of Indonesian politics do not lead to more responsible political process.

There have been political reforms to revive the DPRD (*Dewan Perwakilan Rakyat Daerah*, Provincial/Local People Representative Council). While in the past DPRD constituted only as minor elements of the state institutions and the New Order was mostly used the councils as the "rubber stamp" of the government policies, there was a strong swing toward reviving DPRD as the people representatives with all its power for electing and controlling heads of regions (governors, bupatis and mayors). In effect, before Law No.22/1999 on regional administration was revised, it was the DPRD members who would select a pair of candidates for the heads of regions. Critics had asserted that the new DPRD composition and the arrangement for local executive-legislative relations put a high risk for "money politics". [4] Elsewhere, even some legislators at the national level criticized the exaggeration of the oversight function of Indonesian parliaments, which prone to "money politics" and put obstacles on public policy process (Ziegenhain, 2008:145).

Law No.32/2004 revised Law No.22/1999 and removed the DPRD rights to select heads of the regions. Under the new law, the LPJ (*Laporan Pertanggungjawaban*, accountability reports), which previously often misused by DPRD to sack heads of regions, was now considered only as a progress report to the legislatives. As heads of regions are directly elected by the people, the position of executives and legislatives has become more balanced. Nevertheless, the gap between DPRD member as political appointees and their constituencies remain unresolved.

There are some new formats in the Indonesian 2009 elections. For example, the Supreme Court for Constitution (MK, *Mahkamah Konstitusi*) has ruled that the legislative elections would be held according to majority of votes. Therefore, although Indonesian election is still using apportionment system, the parliamentary seats are determined according to the votes instead of the great influence of the party elites as what had been in the past. This provision would certainly force the candidates for legislative members to move more actively to appeal their constituents. They have to work harder, to go down to the people, to prepare campaign with posters, billboards, brochures and other means. While some of the campaigns can be considered as "ethical", there are also some dubious methods such as distribution of *sembako* (basic needs), vote buying, black campaigns, etc. Although all the candidates for legislative members have declared that they would not use dirty campaigns, there always possibilities for money politics.

For the new candidates who have never contested, political funds must be obtained from personal savings, sponsors, and donors. However, for the incumbents, there always possibilities to use funds from the APBN and APBD because of his or her close relations with the local government executives. It should be noted that up to early 2009, there are only one third of the total local governments that

[4] "Mencermati Politik Uang di Tingkat DPRD", *Kompas*, 15 March 1999.

could ratify APBD on time. From the 33 provinces and 491 districts, only 156 APBD could be ratified according to the schedule while the other 162 were still being debated with the DPRD and even some were still in the form of KUA (*Kebijakan Umum Anggaran*, Budget General Policies) and PPAS (*Plafon dan Prioritas Anggaran Sementara*, Tentative Ceilings and Priorities for Budget). It means that when the legislative election was started, there is enough time for the local executives and politicians to get benefits from the APBD so that the stimulus funds were diverted for their political objectives. There are various ways of inserting projects in the local APBD. They could add on the so-called tactical funds (*dana taktis*), emergency funds (*dana tidak terduga*), operational cost for the DPRD secretariat, and other additional posts.

The disturbing fact is that most of the political parties are engaged in "money politics" during the event of elections. As a young democracy, issues on political finance are yet to be regulated appropriately. Unlike in most developed democracies, in Indonesia nearly all of political parties are depended on government budget. This is to say that formally and informally the state gives subsidy to political parties. For the 2004 elections, the Ministry of Home Affairs provided that all registered parties is entitled to a subsidy of Rp 1 billion from the government. For the 2009 elections, Government Regulation No.5/2009 on Financial Subsidy for Political Parties stipulates that political parties that gain seats in the parliament shall be subsidized from the government budget. In addition, there are many ways for the incumbent party to make use of government budget for various purposes that indirectly give benefit for the party.

Data from the Indonesian Corruption Watch revealed that there are various forms of money politics since the direct Pilkada (local elections) was held in all cities and municipalities in 2005. The direct money politics could take the form of cash payment by the "success team" of candidates to certain constituents, cash donation from the candidates to supporting political parties, and "obligatory donation" required by political parties to their functional members and candidates who would run for bupati and mayors. The indirect money politics could take the form of distribution of gifts and door-prizes, distribution of *sembako* (*sembilan bahan pokok*, nine basic needs) to potential constituents, distribution of cements by the candidates in certain electoral areas, etc.

Among local businessmen, it is also important to give donation to the political parties because through these "political investments" they would be able to take returns from the local government in the form of business opportunities, contractual favors, or at least access to information on public projects. Therefore, it is not overstatement to say that that the influence of particular businessman to the performance of local government might be part of the return cost of his "political investment" planted during the Pilkada.[5] This certainly relates to the general impression that the performance of local governments could not be improved or in fact getting worse after the implementation of decentralization policy.

The similar can be said on the performance of political parties. Although democratization has made possible for any political activists to organize a political party that would presumably serve their constituents based on certain platform and ideology, at the end it is mostly the interests of the politicians rather than the constituents that are being accommodated. A survey on the progress of democratization in Indonesia revealed that 81 percent of informants consider the performance of political parties are poor with regard to their task to "reflect vital issues and interests of the people". Majority of the informants also perceive that political parties are vulnerable to money politics and having a tendency to abuse ethnic and religious loyalty to earn public support (Priyono et al, 2007:68).

Under such circumstances, therefore, it is not surprising that public policy process at the local level does not response to the demands of the people at large. When a pair of candidates are elected and run the government, they would always carry the burden at the back because they have to serve political party elites who have helped them to get on their positions. At the same time, businessmen and the political elites who have "invested" their donation to the elected bupati or mayor would always ask for returns during his or her incumbency. The interests of the public are inevitably neglected. Therefore, there are many studies in Indonesian local governance that are titled with the appalling reality that "the people are betrayed" (Collins, 2007). The issue at point is not only concerning with corrupt elites, but also with poor political representation. It should be noted, however, that poor political representation is not exclusively a characteristic of Indonesian politics and democracy. The so-called new democracies around the world seem to be experiencing serious common problem of political representation. This is partly because democracy has been understood only by its ceremonial process instead of the public policy process that reflects day-to-day performance of politics. In order to understand the nature of public budgeting process in at the local level, three cases shall be presented.

As a new district that was only established in 1999, Maluku Tenggara Barat (MTB) in the province of Maluku is still preoccupied by all the provision of infrastructure for administrative functions.

[5] It is a common practice that businessmen' interests are "invested" to many political parties to ensure that whichever the winner they would get the returns. "Pengusaha Penopang Pilar Dana Politik", *Gatra*, 19 February 2009.

Therefore, the local public budget is substantially absorbed to finance the construction of district government (*Pemda*) complex and its necessary supports, including road access, electricity, city parks, etc. At the same time, the budget is also used for political purpose by the executive dominating regime to gain popularity and for personal advantages. Given the fact that government human resource and public control on APBD are considerably low, the possibility for budget misuse in this district is very high. This proved the tendency that remote areas in Indonesia are frequently lagged behind with regards to centralistic system of budgeting. In any case, if the pattern of local budget allocation remains the same, people in MTB would not be able to get the benefit of the stimulus.

The government of Gunungkidul district in the province of Jogjakarta is trying to gain a public trust because its former *bupati* had tarnished its image due to his corrupt behavior. Unfortunately, this effort would not be easy since the misuse of local budget is also pushed by irresponsible attitude in the part of the legislatures (DPRD). Although local government in Gunungkidul is staffed with relatively capable personnel in budgeting, political interests are still dictating the budget in such a way that the basic issue in the district, e.g. water facilities, is not appropriately addressed.

In the city of Pekanbaru, Riau province, more funds from the central government, especially the DBH, has been poured since decentralization. However, as the local government has too much burden to pay salaries and allowances for its public servants, it is much ironical that Pekanbaru is still depended on the central government subsidy. The stimulus package of Rp 23 billion might even considered as too little for the total Pekanbaru budget, which amounted Rp 1.2 trillion. The common tendency of "self-financing" among the DPRD members also occurs in Pekanbaru while funds for more popular program of mitigation infrastructures and *Gentakin* (the anti-poverty programs) are either under-financed or left to the community funds. It is urgently need in Pekanbaru that the government should not only focused on developing the business-friendly environment but also the grass-root programs which would address issues of inequality and poverty among the common people.

4. Fiscal Decentralization in Korea

Republic of Korea (South Korea) has an area of 99,408 square kilometers (km^2) and a population of 48.6 million in 2008. After independence, the Korean government had actually made an experiment with decentralization when an law on local autonomy was enacted. The 1948 act, however was abolished in 1961 when president Park Chung Hee seized power and started a centralistic and state-led economic development. The 24 years of centralization was broken after a massive student protest could topple the government and pushed ideas for national reform including the ratification of a new local autonomy law in 1989. The wave for democratization continued in which district and municipality heads were elected by popular vote since 1995. The public financial system was reshaped after the crisis in late 1990s, in which the state control on financial market was resumed. However, fiscal decentralization policy in Korea was continued by minimizing guidelines on local budget and local debt, upgrading the government accounting system, and accommodating participatory budgeting through citizen monitoring. The most recent institutional reform for local budgeting was the complete rewriting of Local Finance Act in 2006.

In general, local governments in Korea can be categorized as prefectures and municipalities. Prefectures consist of a special metropolitan city (Seoul); six metropolitan cities (Busan, Daegu, Incheon, Gwangju, Daejeon, and Ulsan); and nine provinces (Gangwon, Kyonggi, Chungbuk, Chungnam, Jeonbuk, Jeonnam, Gyeongbuk, Gyeongnam, and Jeju). Prefecture boundaries were determined historically, and populations and areas thus vary greatly from one prefecture to the others. The new Local Autonomy Act divides prefecture functions into two categories: intermediation between the central and municipal governments, and area-wide administration. Prefectures are responsible for matters that affect broad areas within their jurisdiction or for which a single standard needs to be maintained throughout a prefecture.

Table 2: Local Government Expenditure
(Won billion)

Prefecture	1996	1997	1998	1999	2000
Seoul	8,949	9,772	8,796	9,654	10,997
Busan	2,931	3,112	2,936	3,454	3,517
Daegu	2,164	2,701	2,658	2,708	2,444
Incheon	1,900	2,058	2,069	2,378	2,541
Gwangju	1,350	1,581	1,552	1,607	1,608
Daejeon	1,114	1,195	1,190	1,294	1,376
Ulsan	-	976	872	1,099	1,191
Kyonggi	9,959	11,025	11,283	12,349	13,096
Gangwon	3,430	3,893	3,907	4,315	4,309
Chungbuk	2,387	2,684	2,969	2,797	2,862
Chungnam	3,258	3,565	3,782	3,948	4,239
Jeonbuk	3,249	3,620	3,689	3,645	4,022
Jeonnam	3,968	4,754	5,000	5,152	5,826
Gyeongbuk	4,381	4,907	5,745	5,743	5,945

Gyeongnam	5,050	5,018	5,133	5,520	6,039
Jeju	876	1,158	1,120	1,261	1,421
Total	54,965	62,018	62,702	66,924	71,431

Source: Ministry of Government Administration and Home Affairs.

Among many types of intergovernmental transfers in Korea, general-purpose grants called Local Allocation Tax (LAT) are made for equalization across local governments, and are distributed based on the difference between "basic fiscal revenue" and "basic expenditure needs". According to the local budget report published by the Ministry of Public Administration and Security (MOPAS), the total revenue of local governments in 2007 was 112 trillion Won. On average, 65.9 percent of the local revenue comes from own revenue sources, and 42.6 percent from intergovernmental grants.

There are three steps for calculating the LAT. First, the total amount is set at a fixed percentage of Domestic Tax Revenue, this is currently at 19.24 percent. Second, the fiscal gap is calculated based upon the difference between Basic Fiscal Revenue (BFR) and Basic Expenditure Needs (BEN). Third, since the sum of the difference between BFR and BEN is usually greater than the predetermined size of LAT, the difference is scaled down by multiplying an adjustment factor, which is the ratio of the sum of the differences to the predetermined total amount of LAT.

The BFR is calculated as 80 percent of the local tax revenue, and it can be said that it is based on the concept of Representative Tax System. One distinct aspect of local public finance in Korea is the fact that local tax rates are almost uniform across the country, and parliament is often blamed for this, as it sets the standard local tax rates. Nevertheless, it should be noted that the Local Tax Act allows local governments to change, by their own laws, the local tax rates within certain boundaries. Despite the taxing power thus granted to local governments, albeit within a certain range, almost no local governments exercise it. Although the local tax rates are uniform, the per capita local tax revenue varies among local governments since many local tax items, including a surtax on corporate income taxes, are related to business activities. As business activities depend on agglomeration economies, the size of population is the main indicator reflecting economic strength and the fiscal capacity of local governments in Korea.

The BEN is calculated based on 17 expenditure categories. And for each expenditure category, three components are used for calculation: workloads (such as the number of population and local officials), unit costs, and modification factors. A pronounced feature of local expenditure needs in Korea is the emphasis on economies of scale in its calculation.

LAT has been in operation for the past three decades, including in the period of centralization. Before local autonomy policy was actually started in 1995, local government expenditure patterns were determined by the central government. Since then, the system of intergovernmental fiscal relations has barely changed. Therefore, the modification factors presumed to reflect the economies of scale effect have long been embedded in the design of LAT, and its major role has been to financially support rural areas. Modification factors constitute important mechanisms that transform general-purpose grants into regional policy grants.

5. Managing Asymmetric Decentralization

Decentralization is a hard challenge in Korea given the fact that most industrial activities are centered in the capital agglomeration of Seoul. Of the 48.6 millions Korean total population, more than 10.3 millions are resided in the capital area. The usually called capital area (including Seoul, Incheon, and Kyonggi) has the largest population, greatest fiscal capacity, most attractive business environment, and most important roles in shaping local public finance policy. The second largest local government is Busan, the southeastern port city with the population of only 3.7 millions.

Most fiscal variables highlight the dominance of Seoul metropolitan area. Statistics in 2004 shows that the total share of individual income tax revenue was 71% and of corporate income tax was 85%. In contrast, local tax revenues in all the rest of counties accounted for only 12.1% of the total revenues. Most county governments in particular have a limited capacity on their own revenues because of the narrow tax base and the restricted taxing authority. Therefore, under such lopsided fiscal parameters, it is difficult to imagine a full-scale fiscal decentralization as many theories have argued. The transfer of power from the central government to local governments would only enriches a few large cities because of their heavy concentration of population. In other words, given the very fact that decentralization is hampered by economic agglomeration that has been going around the capital area, the best feasible policy alternative is the so-called asymmetric decentralization: giving local governments a menu of public services that can be provided at the local level while retaining most of fiscal power at the central government.

In most countries that are decentralizing financial authorities to the local governments, the national economy is frequently faced with the problem of soft budget constraints. Local governments play "fiscal games" with the central government and ambitiously issue local bonds, expecting that the burden local debt will ultimately fall on the central government. This phenomena of local government debt fallout have in fact occurred in Brazil and Mexico in late 1980s. In Korea, however, the development of local bond market is taking place while the local governments are imposed hard budget constraints. As local governments in Korea are tightly controlled by the central government, the issuance of local bonds does not resulted in serious local debt default. On the contrary, the expansion of local bond market has given local governments more independence and fiscal power.

Local governments have in fact been able to finance local infrastructure projects using local bonds rather than intergovernmental grants.

The Seoul metropolitan government has managed to use foreign debt for financing infrastructures. The SMRTC (Seoul Metropolitan Rapid Transit Corporation) has converted a big portion of its debt (30.6%) into the metro railroad bond. The other OECF loan (22.7%) and the Yankee bond (9.5%) were also managed appropriately. For example, the OECF loan that was borrowed in 1997 at 4.75% interest is expected to be fully retired by 2015. But the Seoul government converted the loan into Samurai bonds in 2002 and, by doing so, is expecting a gain from debt refunding of about 70 billion Won. The local government's effort to improve the debt situation of the SMRTC sends positive signals to the market as credit ratings are fundamentally improved.

Another success story on local government financial capacity building was the provincial government of Daegu. The Daegu government was the most active in taking advantage of the foreign capital market in 1990s. Daegu issued Samurai bonds (5 billion yen) in 1993 and then Yankee bonds ($ 300 million) in 1997 and could manage a deposit of $ 220 million in the Foreign Exchange Bank. It was the financial crisis in 1997 that made the Daegu credit rating collapsed. Nevertheless, Daegu provided a good example how a local government could benefit not only from foreign borrowing but also from exposure to variety of advanced financial services.

On the expenditure side, the Korean Local Autonomy Act stated clearly that local governments are responsible to services that are closely related to the public interests. In general, there are two category of services that should be carried out by local governments, namely: first, purely local public services, and second, national public services that local governments must provide by law. Then, in practice there are at least seven categories of services that must be carried out at the local level as shown in Table 3. Responsibilities for services that are not included in the domain of local governments are also laid out in details. Services under this category are those of:

1) National defense (foreign policy, military defense, administration of justice, and national tax
2) Uniformly provided (monetary policy, financial policy, and trade policy)
3) Managed nationwide (supply control of agriculture, fishery, livestock, and trade)
4) Provided nationwide (national development plans and management of national forests, national rivers, highways, harbors, expressways, and national parks)
5) Subject to uniform standards (labor and survey standards)
6) Coordinated nationwide (postal systems and railways)
7) Related to inspection, testing, research, navigation management, meteorological management, and nuclear engineering

development, which require high technologies.
It appears that functional assignments in Korean government are defined according to the principle of "ultra vires" as opposed to the principle of "general competence".[6]

Table 3: Expenditure Responsibilities of Local Government in South Korea

Category	Subcategory
Local administration	Ordinance, regulation, personnel management, budgeting
Residents' Welfare	Welfare facilities; support for seniors, low-income people and the disabled; public hospitals; garbage collection
Agriculture and Commerce	Irrigation, distribution of agricultural products, forestry, dairy business, small and medium business
Regional Development	City planning, construction and civil engineering, local roads, residential environment, housing, local economy
Education, Culture, etc.	Elementary and junior high schools, libraries, museums, art galleries, stadiums, local culture, and art
Environmental Protection	Water supply, sewage treatment, historic preservation, city parks, supervision of regional rivers, disaster protection, traffic utility systems
Civil Defense and Fire Protection	Management of civil defense system, fire fighting

Source: Local Autonomy Act 1995, Article 9.

Although the Korean government has made it clear that the Local Autonomy Act emphasizes local government independence in providing public services, public service delivery is generally centralized. As explained earlier, because upper- and lower-level local governments differ significantly, particularly metropolitan areas and other local governments, it is difficult to define the power and responsibilities for each local government according to its own capacities. At the same time, even

[6] "Ultra vires" is used for denoting the situation where local governments "vires" (powers, functions) are explicitly listed, and therefore any local government action outside this list would be deemed "ultra vires", i.e. beyond the scope of allowed functions. Under the "general competence" principle, local governments are free to take actions as long as they do not breach provisions in higher-level laws. See, for example, Gabe Ferrazzi, *Legal standing and Models of Local Government Functions in Selected Countries: Implications for Indonesia* (Jakarta: GTZ-SfDM, Depdagri, 2002), p.6.

though the central government claims that the definition of responsibilities in the law is clear, there are still many interpretations in each clause. For example, the provision of "public services that enhance local residents' welfare" can be widely interpreted by each local governments. Therefore, a study accounted that almost 4,000 ordinances, regulations, and laws govern public services; each vaguely defines local, delegated, and mandated services.[7]

The expenditure assignments for local governments are also unclear because pertinent clause in the Local Autonomy Act is vague. Therefore, the central government interprets its responsibilities to its own advantage and many policies are in fact formulated at the central level. Opposition to this centralistic approach is rarely asserted except those from the city agglomeration. In 2002, for example, the Seoul city council of government officials protested against the national audit of local public services by the parliament by arguing that it was out of the central government jurisdiction. Then, the Parliament finally exempted the city government of Seoul from the national audit with the notion that it is purely local services. Such case, however, is rarely occurred and its even more so for the remote local governments. Again, the revenue assignment system for local governments in Korea appears to be depended upon the central government. Even if local governments dare to assert their opposition to the central government, it mostly reflects the asymmetric decentralization. In other words, local governments are not equal as the political and economic resources tend to give advantage to authorities who close to the central government.

The phenomena of asymmetric decentralization are more clearly applied on fiscal matters. In the budget for education, for example, the central government is responsible for local education so that almost 90% of expenditures, including salaries for teachers at the elementary, secondary and high schools. But the education budget is included in the local governments' budget as a special account. In the past, education tax constituted a surtax on many kinds of taxes. In order to give local government more financial responsibility for education, after 2001 the education tax is split into the national and local education taxes. As a result, although at present the local tax appears bigger, its nature as central government tax is not changed. The budget of local governments is enlarged, but it only over-represents their role as service providers while their actual fiscal power remains limited.

In 2004, the National Assembly passed the Special Law for Decentralization. Under Kim Dae-Jung administration, a presidential committee called the Government Reform and Decentralization

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[7] Kim, J.H., *Local Government Finance and Bond Markets in Korea*, Korea Institute of Public Finance, 2004, p.234.

Committee (GRDC) was established to follow through decentralization policy. Yet, despite somewhat impressive transfer of functions in number, more essential planning functions regarding regional development are still severely curtailed by the central government. Financial data on local government appeared to be improved with fiscal decentralization. The local spending comprised 10.2% of the GNP in 1991 and it was increased to 11.4% in 2003. However, the actual shares of local spending was in fact decreased from 55.5% in 1991 to 50.5% in 2003.[8] The plausible explanation is that both central and local spending increased as a percentage of the GNP, but the rate of increase was slightly higher in central government spending.

On the degree of fiscal decentralization in Korea, however, studies generally result in mixed conclusions. Statistical analysis by Kwon (2002), for example, concluded that there is a negative relationship between the level of the central government expenditure and the degree of fiscal decentralization. Even though it is statistically insignificant, the relationship between the level of local government expenditure and the degree of fiscal decentralization is positive. Therefore, it is safe to conclude that local governments appeared to be ready to respond local demands as it is reflected in the level of local expenditure as a result of fiscal decentralization. Yet the empirical data is not convincing. An explanation to this fact is that the Korean central and local governments still do not respond to the citizens' demands although things have been decentralized. This is contrary to the general theory on decentralization. But recently some experts have pointed out to this tendency in developing worlds. Bahl (1999), for instance, argued that political, fiscal and administrative structures in developing countries are organized in such a way that local voter preferences may not be readily revealed into local budget outcomes. In the case of Korea, a study also concludes that centrally determined budgets is undermining participatory budgeting as most of the elements in the budget is non-negotiable and determined by outside forces.[9]

Rather than offering answers, the foregoing explanations have in fact raised more questions on the pattern of fiscal decentralization and local government expenditures in Korea. First, as economic development in Korea is relatively successful and fiscal and administrative structures have been more sophisticated that it can be categorized as a developed country, it is surprising why Bahl's notion on most developing countries is somehow applied in Korea. Second, as resistance towards decentralization

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[8] Korea Statistical Information System 2005, as quoted by Kang Myung-Go, "Globalization of the Economy and Localization of Politics? Restructuring the Development State Via Decentralization in Korea", *Korea Journal*, Vol.46 No.4, Winter 2006, p.101.

[9] Hwang, Y.W., *Citizen Involvement in Budgeting: The Citizen Participatory Budgeting (CPB) Experience in Korea*, mimeo, Chung-Ang University, Seoul, 2005

remains strong that makes asymmetric decentralization more feasible than inter-governmental grants and full-scale inter-governmental fiscal sharing, what would be the role of more resourceful regions like Seoul, Kyonggi and Gyeongnam in the future?

These two questions are particularly relevant to the recent development on the inter-governmental fiscal relations in Korea. In the first half of 2010, local governments' fiscal self-reliance ratio (local taxes plus non-taxes incomes divided by local government budget) is expected to hit its lowest level in two decades with an average of only 52.2 percent. Among the local governments, the tax receipts are generally shrunk while the expenditures are swollen. As revealed by the MOPAS (Ministry of Public Administration and Safety), of the total 246 administrative units, the self-reliance ratio of 143 are ranged between 10 and 30 percent while nine are sunk below 10 percent. According to SERI (Samsung Economic Research Institute), it was because of various reasons, i.e. tax cuts and welfare spending hikes, construction of luxurious office complexes and sponsorship of money-losing events under loose supervision.[10] It appears that Korean government is facing with the dilemma that is commonly applied in decentralization policy. Decentralization can only be effective if capacities of local governments are improved, but such capacities can only be improved if local governments are given decentralized tasks.

6. Conclusion

The experience of fiscal decentralization in Indonesia illustrates a policy that is implemented amid multi-dimensional reform initiatives. In the wake of 1997 economic crisis, Indonesia has been experiencing tumultuous political reform and democratization process with decentralization as the logical consequence. Fiscal decentralization, however, was seen as a part of political instruments rather than a more fundamental and systematic way of ameliorating vertical imbalance and improving public services. Therefore, it can be understood why fiscal decentralization policy in Indonesia has more element of revenue-sharing rather than fiscal sharing. While the policy has relatively been able to address the problem of vertical imbalance, the problem of horizontal imbalance is currently loom large.

The new scheme of inter-governmental fiscal relations have made the general grant (*Dana Alokasi Umum*, DAU) become the main subsidy for provincial and local governments in Indonesia. Yet it is unfortunate that as local governments' discretionary power is substantially increased, more general grant is in fact absorbed for public officials' payrolls. Many local governments are over-staffed that the cost of public bureaucracy is increasingly higher while decentralization policy cannot respond to the

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[10] "*Concerns Mount over Local Government Debts*", available at www.koreaherald.com/national/ Detail.jsp?newsMLId=20100815000279.

need for better quality of public services.

As the political reform in Indonesia remains procedural and has not really touched upon substantive democracy, fiscal decentralization is resulted in various forms of misuse and misappropriation of public funds. Democracy at the local level is revived, but the decentralized authorities are only captured by the elites while the public interests remain unaccommodated. When initiatives for anti-corruption against budget misuses are implemented, however, another dilemma is emerged. As the capacity among local governments is still weak and anti-corruption measures are strengthened, much of the local budget funds are left unspent.

South Korea is a rapidly growing industrial country where national priorities are given to efficient resource allocation and business-friendly environment. As such, although Local Autonomy Act has been put in place, the idea for financing development has always come from the central government. The sub-national government revenues are mainly from the scheme of LAT (Local Allocation Tax), which is made for equalization across local governments, and are distributed based on the difference between "basic fiscal revenue" and "basic expenditure needs". All the decision on LAT is basically determined by the central government.

Fiscal decentralization is even faced a harder challenge in Korea given the fact that most economic activities are centered in the capital agglomeration. Therefore, the feasible policy option at present and in the near future is an asymmetric decentralization, in which more resourceful region such as Seoul, Kyonggi and Gyeongnam are given more political and expenditure discretionary power compared to that of other peripheral regions.

While the local governments' expenditure is largely determined by the central government, there is a distinct feature of fiscal system in Korea as relatively broad opportunities for managing foreign financial resources are given to local government authorities. Although this national policy poses a risk of soft budget constraints as illustrated in the recent decreasing fiscal self-reliance ratio, it is proven to be a good instrument for building the fiscal capacity among local governments, especially in a more globalized financial system in modern time.

The Indonesian and Korean experience appears to take a different path towards fiscal decentralization. Nevertheless, there is something in common in the two countries that we could learn with regards to decentralization policy. First, fiscal decentralization must be timely implemented according to the stages of development in terms of political as well as economic institutions. Second, decentralization itself does not guarantee efficiency gains, but sustainable growth and welfare can only be achieved through decentralization policy. It is also important to hold that decentralization would only be meaningful if it is linked to freedom, prosperous life of the people and better services for all.

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