The Dynamics of Fiscal Decentralization in Development Financing in Indonesia

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Abstract. Indonesia's fiscal decentralization framework has evolved substantially since the 1998 *Reformasi* era; however, its capacity to ensure equitable and sustainable development remains debatable. This study analyzes the intricate dynamics of fiscal decentralization within Indonesia's development financing system using a mixed-method approach that integrates policy analysis and regional case studies. Findings indicate persistent structural challenges: (1) dependence on central government transfers despite formal autonomy, (2) enduring vertical and horizontal fiscal imbalances, and (3) limited institutional capacity at subnational levels. The analysis identifies three core paradoxes—formal autonomy versus practical dependence, abundant fiscal resources versus weak absorption capacity, and policy innovation versus limited implementation capability. Comparative insights from Sumedang Regency and North Sulawesi Province illustrate how local political–economic contexts influence decentralization outcomes. The *Village Fund (Dana Desa)* program exemplifies both progress and pitfalls, emphasizing the role of targeted technical assistance in improving local governance. To strengthen fiscal decentralization, four policy reforms are proposed: rationalizing conditional transfers, broadening progressive local revenue bases, institutionalizing tiered capacity development, and establishing intergovernmental fiscal councils. These strategies reflect Indonesia's archipelagic diversity while offering relevant lessons for other developing decentralized systems.

Keywords: fiscal decentralization, development financing, intergovernmental transfers, local governance

1 Introduction

Indonesia's governance system experienced a profound transformation following the 1998 Reformasi movement, which initiated a broad shift toward decentralization through the enactment of Law No. 22 of 1999 on Regional Governance[1]. This legislation laid the foundation for redistributing administrative and political authority from the central government to regional administrations. Over time, the regulatory framework has undergone several revisions aimed at improving coordination, accountability, and local autonomy. These successive adjustments ultimately culminated in the establishment of Law No. 23 of 2014 on Regional Government, which refines the principles of decentralization to better align with contemporary governance challenges and promote more balanced regional development across Indonesia.

ICAS 2024, November 12, Bandung, Indonesia

DOI 10.4108/eai.12-11-2024.2358553

The decentralization process marks a major shift in Indonesia's system of governance, characterized by the transfer of significant administrative and financial responsibilities to local governments. This transformation represents a clear departure from the centralized model that dominated the country's political structure since independence[2]. The reform was guided by three key objectives: reducing regional disparities in development, improving the quality and accessibility of public services, and promoting broader participation in local democratic processes. Through this approach, Indonesia sought to create a more responsive and inclusive governance framework capable of addressing diverse local needs while fostering equitable national growth.

Structurally, Indonesia's decentralization has been carried out through the delegation of authority across three levels of local government: provincial, regency, and municipal administrations. This arrangement involves both administrative and financial responsibilities. While the central government continues to oversee national priorities—such as macroeconomic stability, defense, and foreign affairs—regional governments are entrusted with managing essential sectors, including education, healthcare, infrastructure, and basic public services. This division of authority is intended to ensure that local governments have the flexibility to address community needs more effectively while maintaining coherence with national policy objectives. By empowering regional administrations, Indonesia aims to enhance service delivery, promote equitable development, and strengthen accountability at the local level within a unified national framework[3].

Indonesia's system of governance is organized into a three-tiered structure that clearly defines the distribution of governmental authority and responsibilities. At the top level, the central government functions as the primary policymaker, responsible for setting national priorities and maintaining overall policy coherence. The provincial governments operate as regional coordinators, facilitating alignment between national directives and local implementation while overseeing inter-district cooperation. Meanwhile, the regency and municipal governments serve as the main providers of public services, directly addressing the needs of local communities. This hierarchical arrangement is designed to promote efficiency, accountability, and responsiveness across all levels of government, ensuring that national development goals are effectively realized through coordinated local action.

This multi-tiered system is intended to fulfill two main objectives: first, to ensure a more balanced distribution of development resources through structured and coordinated financing across government levels; and second, to improve the quality and effectiveness of public services by allowing local governments to design and implement programs that reflect the specific needs and conditions of their communities. Through this arrangement, Indonesia seeks to promote both equity in regional development and greater responsiveness in public service delivery.

The central government implements fiscal decentralization by allocating financial resources to regional administrations through several key mechanisms, including the General Allocation Fund (DAU), Special Allocation Fund (DAK), and Revenue Sharing Fund (DBH). These financial transfers are designed to reduce fiscal disparities between regions and ensure that all local governments have adequate funding to provide essential public services. By distributing resources in this manner, the policy aims to promote equitable development, strengthen regional financial capacity, and support consistent service delivery across Indonesia's diverse regions[4], [5].

Local governments are granted the authority to manage their own administrative and financial affairs, including the allocation of resources for development programs. However, this autonomy is accompanied by clear accountability measures designed to ensure that public funds are used effectively, efficiently, and in accordance with established regulations. These mechanisms aim to promote transparency, prevent misuse of resources, and strengthen public trust in local governance [6].

Despite more than two decades of fiscal decentralization, a persistent research gap remains in understanding how Indonesia's intergovernmental transfer system affects local fiscal autonomy and development equity. While extensive fiscal transfers have been introduced to reduce regional disparities, the extent to which these mechanisms foster sustainable self-reliance at the local level remains unclear.

The central government channels sub-national transfers to mitigate both vertical and horizontal fiscal imbalances, aiming to equalize fiscal capacity and ensure uniform public service standards across the country[7]. Fiscal decentralization is thus intended to strengthen local decision-making and improve the alignment of spending with regional development priorities. The General Allocation Fund (DAU)—the largest component of intergovernmental transfers—addresses fiscal gaps through a formula that considers population size, poverty rates, and geographic conditions[4], [7]. The Special Allocation Fund (DAK) functions as a performance-based instrument supporting priority sectors such as education, health, and infrastructure, rewarding regions that demonstrate improved governance and service delivery[4], [8]. Meanwhile, the Revenue Sharing Fund (DBH) redistributes national revenues to sub-national governments to enhance local fiscal capacity, reduce dependency, and promote greater fiscal autonomy[5], [7].

However, empirical evidence shows that while fiscal decentralization has improved resource targeting and service delivery in some regions, it has not substantially reduced dependency on central transfers. This persistent reliance limits local capacity for revenue generation and weakens fiscal sustainability. To address these challenges, this study recommends revising transfer formulas to strengthen incentives for own-source revenue mobilization, enhancing fiscal transparency and performance monitoring, and expanding local taxation authority to achieve a more balanced and self-sufficient fiscal system.

2 Methods

This study adopts a qualitative research approach through a policy study framework, employing documentary analysis as its primary methodological tool [8]. This approach was selected for its capacity to uncover nuanced meanings, contextual factors, and historical developments in examining the dynamics of fiscal decentralization within Indonesia's development financing system. The analysis draws on two main categories of data sources: primary and secondary materials. Primary data consists of academic papers and official legislative records related to key decentralization laws, specifically Law No. 22/1999 on Regional Governance, Law No. 23/2014 on Local Government, and Law No. 1/2022 on Central-Regional Financial Relations. Secondary data encompasses official government documents from relevant institutions, including fiscal reports from the Ministry of Finance, development planning documents from Bappenas (National Development Planning Agency), and World Bank country reports. Additionally, the study incorporates scholarly literature such as peer-reviewed journal articles, academic textbooks, and relevant doctoral dissertations to provide comprehensive theoretical and empirical context. The documentary analysis method enables systematic examination of policy evolution while maintaining rigorous academic standards through source triangulation and contextual interpretation.

3 Result and Discussion

3.1 Policy Innovation in Fiscal Decentralization

In recent years, the Indonesian government has implemented significant reforms to enhance the effectiveness of its multi-level governance framework and development financing allocation. The enactment of Law No. 1/2022 on Central-Regional Financial Relations, introduced a novel fiscal decentralization framework designed to improve transparency and accountability in intergovernmental transfers. This legislative reform has additionally expanded local financing instruments by incorporating municipal bonds and sukuk (Islamic bonds) as viable options for infrastructure development financing [9], [10].

The government has implemented measures to align national fiscal policy with local development priorities. These measures include: (1) synchronization of national and local development planning, (2) adoption of evidence-based decision making, and (3) enhanced intergovernmental coordination mechanisms [11].

The Village Fund Program (Dana Desa) represents a recent policy initiative designed to empower rural communities through direct fiscal transfers to villages for development projects. While the program has demonstrably improved rural infrastructure and public services, its effectiveness has been constrained by institutional capacity limitations and governance challenges [12].

3.2 Case Study: Regional Experiences in Development Financing

Case studies on the dynamics of fiscal decentralization in indonesia's development financing in Sumedang Regency in West Java exemplifies the challenges of pseudo-decentralization, where local governments remain heavily dependent on central government transfers despite formal devolution of authority. While the regency has achieved some developmental successes, these accomplishments largely stem from effective political lobbying rather than genuine fiscal autonomy [13].

North Sulawesi Province presents a case study of fiscal decentralization's impact on regional economic development. The province has demonstrated progress in optimizing local revenue generation and capital expenditure, yet its financial self-sufficiency remains constrained by limited managerial capacity and persistent reliance on central government transfers [8].

The Village Fund Program (Dana Desa) underscores the critical role of institutional capacity in development financing. Despite substantial resource allocations to rural areas, program effectiveness has been hampered by weak governance structures and technical expertise deficiencies at the village level [12].

4 Conclusion and Recommendation

This analysis reveals that the dynamics of fiscal decentralization in development financing present both significant challenges and untapped potential. The key challenges include: (1) the complexity of intergovernmental transfer systems, (2) limited local tax autonomy, (3) fiscal capacity disparities across regions, and (4) weak institutional capacity at subnational levels.

4.1 Recommendations

a. The central government should simplify the intergovernmental transfer system to enhance transparency and reduce inefficiencies. This could be achieved through consolidation of transfer programs and the establishment of clearer allocation criteria.
b. Local governments should be granted greater authority to levy taxes and generate own-source revenues. This empowerment should be accompanied by capacity-building programs to improve local tax administration and fiscal management.
c. Substantial investments are needed to enhance local institutional capacity, including comprehensive training programs for local officials and the development of robust monitoring and evaluation systems.
d. The central government must facilitate better coordination across government tiers to ensure alignment of development priorities and effective resource allocation. This requires establishing formal mechanisms for vertical and horizontal policy dialogue.

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