

## **BOLSTERING INDONESIA'S URBAN GOVERNMENT FINANCE: LESSONS FROM EXTENDED CRISES**

***Johnny Patta & Pradono***

*Department of Urban & Regional Planning*

*Institute of Technology Bandung*

*LABTEK IXA, Jl. Ganesa 10 Bandung 40132*

*jpatta@pl.itb.ac.id, pradono@pl.itb.ac.id*

### ***Abstract***

*This paper examines the possibility for urban governments in Indonesia to bolster their finance in response to the decline in national government finance due to extended crisis, as well as the policy towards local autonomy & decentralization. Derived from local public finance literature, it is argued that there are at least three approaches viable to be implemented by local government to bolster their finance namely intensive revenue mobilization, engineered efficiency improvements, and expenditure responsibility contraction. We explore the possibility of each approach to be implemented to local government within the context of socio-political setting in Indonesia. Though we haven't come to judge which approach is the best implemented, as it may come to be case & local specific, we note the importance of private role that could be played in all approaches.*

***Keywords:*** *urban government financing, intensive revenue mobilization, engineered efficiency improvements, and expenditure responsibility contraction.*

### **1. INTRODUCTION**

Since mid 1997, Indonesia's government finance has been drastically weakened and gone through a continuous fiscal crisis. The country has been confronted with sharp declines in real revenues, years of uncontrolled budget deficits, enormous public debts, collapsed economy, and obligations to provide large funds for amortizations and interest payments, finance economic restructuring, and finance social programs such as social safety nets. At first, the plummet of the Indonesian currency value in mid 1997 led to the government revenue sharply declined. The crises that confront the government come from all fronts: economic, political, security and social crises, and are proving to be very hard to resolve because of their complexity and interrelatedness. They include enormous public and private debts, the drastic fall of the Indonesian currency value, the drastic fall of foreign and

domestic investments, the drastic fall of GDP growth in 1997 and 1998, large scale capital flights, high inflation rates, swelling unemployment, growing numbers of the poor, ethnic, religious, and interregional conflicts everywhere, conflicts among political elites.

While the country has not yet gotten out of the complex crises, the Indonesian government has had to provide large funds for amortizations and interest payments of its enormous public debts, financing economic restructuring, and funding social programs. These conditions have forced the new government in Indonesia to reexamine its fiscal policy to look for what it can and is supposed to do in order to immediately bolster its finance and achieve a more sustainable public finance in the future. At the same time pressure for reforms has led the national government to launch autonomy & decentralization policy in which there are new types of relationship between national & local government in terms of fiscal ties. The constrained capacity of national government to support local government & the policy towards autonomy means there are potential & constrained as well for local government to manage their finance.

Within this context, this paper intends to find an answer on how to bolster Indonesia's urban government finance. To respond to the question specifically addressed in this paper, the pursuit to such an answer will refer to the models of bolstering urban government finance drawn from the urban finance<sup>1</sup> literature. Even so, since Indonesia confronts government finance issues that go beyond the concerns of the urban finance literature, some adjustments will be made to meet the settings of government finance in Indonesia. Having these conditions, to begin with, this paper will briefly examine the models of bolstering urban government finance drawn from the urban finance literature. Each of these models will then be used in the context of Indonesia's government finance. Given the current performance of Indonesia's economy and the political and social conditions in the country, this paper will then come up with policy recommendations for bolstering Indonesia's urban government finance.

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<sup>1</sup> This paper uses the term "urban public finance" rather than "state and local public finance" merely to emphasize the use of state and local "urban" public finance as opposed to state and local "rural" public finance literature. State and local public finance is a sub-field of public finance concentrated on the study of how urban government fiscal policy and fiscal relation dynamics among urban governments affect the urban economy, and the welfare and the interests of the urban residents. It concerns the consequences of urban government policies to efficiency and equity issues in an "open state-local economy" and spatial dynamics. Competition among urban government units, easiness of resident mobility and business location movement, and interdependent relations among levels of government characterize this "open economy" and spatial dynamics.

## II. MODELS OF BOLSTERING URBAN GOVERNMENT FINANCE

Three primary models of bolstering urban government finance can be drawn from the urban public finance literature. First, which is the most important and common model used, is the model of bolstering urban government finance through intensive revenue mobilization, focusing on finding out effective means for raising additional revenue. Second is the model of bolstering urban government finance through engineered efficiency improvements, concentrating on improving the efficiency and effectiveness of urban government operations, given the currently available resources. Third is the model of bolstering urban government finance through expenditure responsibility contraction, giving way to greater private role and community group initiatives. Whether, in order to bolster its finance, an urban government is supposed to choose and commit itself to a certain model or a combination of the three models above depends on its fiscal capacity<sup>2</sup>, its fiscal choice<sup>3</sup>, its historical fiscal performances<sup>4</sup> and contributing factors that led to such performances.

### 2.1 The Intensive Revenue Mobilization Model

Urban government can bolster its finance through intensive revenue mobilization. An urban government can perform intensive revenue mobilization by utilizing the various resources that are accessible to it while considering the consequences of their utilization. There are a variety of means through which an urban government can utilize these various resources, and there are theories, principles, rules, or criteria that must be considered when a certain means of revenue mobilization is to be used. Some general principles<sup>5</sup> can be used to guide urban government in choosing the means of revenue mobilization. The theory of fiscal federalism, for instance, maintains that the fiscal function of local urban government is mainly allocative function. The allocation theory maintains that public services should be provided and their costs should be shared in line with the preferences of the residents of the benefit regions (Musgrave and Musgrave, 1989: 446). The benefit principle

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<sup>2</sup> The fiscal capacity of jurisdictions  $j$  or  $C_j$  is equal to  $\sum t_n B_{jn}$ , where  $t_n$  is the tax rate for tax item  $i$ , and  $B_{jn}$  is the tax base  $B$  in jurisdiction  $j$  for tax item  $i$  (Musgrave and Musgrave 1989:479).

<sup>3</sup> Urban government deals with three fundamental fiscal choices: the choice of revenue or tax structure, the choice of the level of total spending and thus the total revenue required, and the choice of allocating the total spending among different goods and services demanded by voters (Fisher, 1996).

<sup>4</sup> The achievement level of the jurisdiction with respect to its fiscal position, which is the ratio of fiscal capacity to fiscal need.

<sup>5</sup> For theoretical guidance see for instance, Aronson and Schwartz, 1996, Chapter 4: Local Government Expenditures and Revenues, for practical and empirical explanations see for instance, Davey and Devas, 1996, Chapter 6: Urban Government Finance.

requires the consumers to pay for services in proportion to the benefits that they receive (Davey, 1996:194). The neutrality principle of taxation requires that tax structure be designed with minimum economic distortion, especially to decisions about location, employment, and consumption (Aronson and Schwartz, 1996: 89).

In general, in order to raise additional revenue to fulfill its fiscal needs, an urban government can utilize the various resources that are accessible to it through raising local taxes, increasing its user charges, selling off assets, privatizing urban service provision<sup>6</sup>, increasing the profit shares of local-owned enterprises, borrowing, and asking for more intergovernmental transfers<sup>7</sup> from higher levels of government. Raising local taxes is an appropriate means of revenue mobilization if the revenue increase is to be utilized to finance local public goods whose main beneficiaries are the current local residents and to which the exclusion principle in pricing cannot be applied. Increasing user charges is a suitable means of raising additional revenue if the charged increase is to be used to finance the cost of service provision that benefits the service users to which the exclusion principle in pricing can be applied. In terms of economic efficiency, increasing user charge to finance the full cost of the service provision, both capital and recurrent, is superior to other means of raising additional revenue. Selling off local assets is a proper means of revenue mobilization if the sales revenue is to be used to finance capital rather than routine expenditure (Davey and Devas, 1996). Privatizing local service provision<sup>8</sup> is an appropriate means of revenue mobilization if the privatization money will be used to finance debt service. Increasing the profit share of local-owned enterprise is a reasonable means of revenue mobilization if the profit increase will be used to finance debt service (Musgrave and Musgrave, 1989:562). Borrowing<sup>9</sup> is an

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<sup>6</sup> The transfer -partly or wholly- of the provision of urban services to private firms is usually for the purpose of production efficiency (Fisher, 1996).

<sup>7</sup> The Intergovernmental transfers from higher levels to lower levels of government come as a consequence of multilevel government and multiunit finance as they are commonly discussed in fiscal federalism (King, 1997:Chapter 2, Musgrave and Musgrave, 1989:Chapter 27). They can be in the forms of shared taxes, grants or loans. (Bahl and Linn, 1992, and McMaster 1993).

<sup>8</sup> It is necessary to say that although privatization generates additional revenue due to the transfer of funds from the private buyer to the urban government, it is not the purpose of privatization to merely raise additional revenue (Fisher, 1996).

<sup>9</sup> The rationale behind this intergeneration equity argument is that borrowing or loan finance will benefit and, thus, burden future generations (Musgrave and Musgrave, 1989:553). An urban government that finances its school building by borrowing and amortizing the debt over the length of the assets life provides an equitable pattern of burden distribution (benefit taxation) not only between age group but also between changing groups of residents as the population of the jurisdiction changes in response to in-migration and out-migration (Musgrave and Musgrave, 1989:555). In practice, urban government borrows money for financing public capital projects such as schools and water and sewerage systems, supporting

appropriate means of revenue mobilization if the loan money is to be used to finance capital improvement or long-lasting infrastructure development (Aronson and Schwartz, 1996:88). Asking for more intergovernmental transfers or grants<sup>10</sup> from higher levels of government is a proper means of revenue mobilization if the additional transfers is to be utilized to finance merit goods provision or equalize service levels across jurisdictions (Musgrave and Musgrave, 1989:562).

In addition to the principles above, there are issues that need to be considered when an urban government is about to choose specific means of revenue mobilization. These include equity, technology, production efficiency, administrative, political, legal, and inter-jurisdictional competition issues. For instance, although from the economic efficiency perspective, raising local taxes is perhaps the most appropriate means of raising additional revenue in order to finance a routine budget deficit, short-term borrowing or selling off local assets are often politically preferable and more acceptable (Bahl, 1996:88). Similarly, although increasing user charges is the most efficient means of raising additional revenue in order to finance the full cost of service provision, a more general revenue increase from grants, borrowing, or raising taxes to partly subsidize certain service users are often politically more preferable and acceptable.

## 2.2 The Engineered Efficiency Improvement Model

Besides through intensive revenue mobilization, bolstering urban government finance can also be pursued through engineered efficiency improvements<sup>11</sup>. There are a variety of means through which an urban government can engineer efficiency improvements, and there are consequences<sup>12</sup> that must be considered when a certain means of efficiency improvement is to be engineered in order to bolster urban government finance. An urban government can engineer efficiency improvements through improving the efficiency and effectiveness of its operations. This can be done through productivity improvement programs, better programming, planning

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and subsidizing private activities such as private home mortgages, and providing cash flow for short-term spending (Fisher, 1996:236).

<sup>10</sup> Theoretically, grants are provided for correcting externalities that arise from the structure of sub-national governments, redistributing resources among regions or localities, substituting one tax structure for another, and stabilizing macroeconomic mechanism (Fisher, 1996: 207).

<sup>11</sup> Experiments about how to engineer efficiency movements were interestingly done by Frederick Winslow Taylor at the turn of the twentieth century. His scientific management principles were explained in his publication *The Principles of Scientific Management* (New York: Harper & Brothers, 1915).

<sup>12</sup> Improving productivity, for instance, may significantly push down the total or unit costs of service production, thus helps the budget by saving money. This policy, on the other hand, would be unfavorable to many workers as it eliminates excess or unqualified workers, as well as to politicians whose constituents are especially from the working class.

and budgeting, introducing low-cost methods, reduce interest costs on local debt, cutting-back selected programs, incorporating economies of scale consideration in service provision or delivery, and cost savings promotions using private contractors (Aronson and Schwartz, 1996, McMaster 1991:1, Bahl, 1996:78). Contracting out service provisions to private contractors, through open and competitive biddings, can result in significant savings because private sector is motivated by the desire to minimize costs and to maximize profits. Indeed, in a review of the comparative costs of selected service provisions such as solid-waste collection, electric power, fire protection, airline and bus transportations, postal service, health care, education and social services in the United States, Emanuel Savas (1982:93-111) found that costs were much higher when the provisions of such services were performed directly by municipal governments rather than by private contractors.

An urban government can also improve the efficiency and effectiveness of its operations through creating certain institutional arrangements for different urban service provisions, especially in the metropolitan areas (Stein, 1990). Improving the efficiency and effectiveness of urban government operations can also be pursued by linking budget with program performance, and prioritizing benefit over cost programs. In a situation in which a fiscal crisis tends to emerge, canceling unessential programs, eliminating superfluous activities, and cutting back programs may need to be undertaken to pursue a considerable reduced spending (McMaster, 1991). The model of engineered efficiency improvements is especially important for bolstering urban government finance when the national economy growth slows down or becomes unstable and leads to less transfers or grants to urban governments (Bahl, 1996). National economic instability may create a substantial effect on urban government finances. In this situation, engineered efficiency improvements are really needed to create conducive environment for the success of difficult local revenue mobilization with limited transfers and grants. Spending less and adopting a prudent local fiscal policy are then absolutely necessary to bolster urban government finance in this case.

### **2.3 The Expenditure Responsibility Contraction Model**

In addition to revenue mobilization and engineered efficiency improvements, expenditure responsibility contraction is sometimes needed in order to bolster urban government finance. An urban government can seek to have less expenditure responsibility through several means, such as by allowing private enterprises and community groups to operate and fully finance service provisions that are usually provided and operated by the urban government. Another way is withdrawing from investment-demanding public service provision, such as airports and public television, which indeed can be provided by private sector. The urban government may also need to shift

service provision that creates burdensome expenditure responsibilities to private sector that is willing to run such service provision. It may also need to withdraw from unessential activities that create burdensome expenditure responsibility, such as city celebrations, which indeed can be profitably undertaken by private sectors or community groups through sponsorships. In rare cases, an urban government may encourage certain private enterprises to provide certain local public goods, such as traffic control and streetlights, to the public in their area. In return, the urban government can provide certain legal incentives to those private enterprises. In another rare case, an urban government may even require private businesses to take responsibility for additional service needs that arise due to the presence of their businesses. Aside from seeking to have less expenditure responsibility through allowing private enterprises and community groups to play greater roles in service provisions, an urban government can seek to have less expenditure responsibility by relinquishing a part of its expenditure responsibility –such as in public health, public education, and public museums-- to higher levels of government (Bahl and Linn, 1992). In specific cases, it can seek to have less expenditure responsibility by turning to its neighboring jurisdictions, for instance, by joining its neighboring public school system for the children living in its jurisdiction.

### III. BOLSTERING INDONESIA'S URBAN GOVERNMENT FINANCE

The three models examined above will be used as reference models for the purpose of bolstering the country's urban government finance<sup>13</sup>, although there are differences that need to be taken into account. Country government is concerned with the economic consequences of their fiscal policy to resource allocation, income distribution and economic stabilization, while urban government is concerned with the consequences of its local fiscal policy to efficiency issues in an "open urban economy" and spatial dynamics<sup>14</sup>. For a country's government, the distribution and stabilization effects of its fiscal policy are consequences that must be considered when raising taxes, while for an urban government raising local taxes is focused on revenue-raising objectives, setting aside the allocative and equity objectives (Bahl and Lynn, 1992: 470). The country's government has more flexibility in taxation, charging, and borrowing than does urban government. It can

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<sup>13</sup> In the standard public finance literature, country's government finance is treated as if it is a single level government finance of multiunit fiscal operations (Musgrave and Musgrave, 1989:445).

<sup>14</sup> Ease of resident mobility and business location movement, inter-jurisdictional competition, and interdependent relations among different levels of government characterize this "open economy" and spatial dynamics.

create and impose broad-base taxes, such as national income tax and value-added tax, and broad-base charges such as social security tax and gasoline tax, and flexibly set their rates. More than that, the country's government determines the types and levels of taxes and charges that can be created and imposed by urban government.

While country's government can flexibly engage in both domestic and external borrowing, urban government can engage in borrowing with approval from, and through guidelines set by, the country's government. Then, while urban government engages in borrowing primarily for financing capital expenditures, country's government engages in borrowing mainly for stabilization policy (Musgrave and Musgrave, 1989:561). Unlike the country's government, the urban government has no control over money market conditions under which it can only borrow (Musgrave and Musgrave, 1989:561). Furthermore, country's government can flexibly mobilize revenue through revenue-generating means other than taxation, charging, and borrowing. Privatizing state-owned enterprises, increasing the profit shares of state-owned enterprises, increasing mineral royalties and sales of natural-resource products, and even printing money are among those other means. In contrast, urban government can only mobilize limited revenue from sources other than local taxes, charges, and borrowing when it is allowed in the regulations controlled by the country's government.

### **3.1 Bolstering Urban Government Finance in Indonesia Using the Intensive Revenue Mobilization Model**

With regard to their financial needs and the currently available resources that can be legally accessed by them, intensive revenue mobilization in Indonesia can be pursued through raising urban-related taxes, increasing urban-service charges, borrowing, selling off urban assets, privatizing state and local-owned enterprises, increasing profit shares of urban public-sector enterprises, and increasing mineral royalties and sales of natural-resource products. These means of revenue mobilization fit financing guidelines provided in the urban public finance literature. To contribute in paying amortization and public debt interests – of the debts that were used to finance long-lasting urban infrastructure development, whose main beneficiaries is the current generation of Indonesian urban population and to which the exclusion principle in pricing could not be applied-- raising urban-related taxes is a proper means of raising urban government additional revenue. Following good taxation principles, tax revenue increases for such a purpose is ideally obtained through broad-base non-distorting taxes such as urban income and value added taxes. Furthermore, privatizing state and local-owned enterprises, selling off urban assets, and increasing mineral royalties and sales



of natural-resource products are also suitable means of urban government revenue mobilization for such a purpose.

### **3.1.1 Revenue that can be mobilized and the means of urban government revenue mobilization**

With regard to the magnitude and directions of revenue increase needed by the country's government and the currently available resources that can be legally accessed by the urban governments, intensive revenue mobilization can be pursued through various ways. These include raising urban-related taxes, increasing urban-service charges, borrowing, selling off urban assets, privatizing state and local-owned enterprises, increasing profit shares of urban public-sector enterprises, and increasing mineral royalties and sales of natural-resource products. Aside from the need for pursuing a healthy tax system as the core of sustainable public finance in the long future, at this time, such means of revenue mobilization can be justified and temporarily used.

These means of revenue mobilization fit guidelines provided in the urban public finance literature as discussed earlier. Following a good taxation criterion, tax revenue increased for such a purpose is ideally obtained from broad-base non-distorting taxes such as urban income and value added taxes. Furthermore, privatizing state and local-owned enterprises, selling off urban assets, and increasing mineral royalties and sales of natural-resource products are also suitable means of urban government revenue mobilization for such a purpose.

To contribute in financing economic restructuring that will benefit Indonesia's economy, especially urban private businesses, privatizing state and local-owned enterprises and selling off state and local-owned and publicly held bank and non-bank assets in urban areas are the most suitable means of urban government revenue mobilization. Indeed, not only can privatization drive urban government revenue increase but also Indonesia's economy due to new private investments, economic efficiency promoted by private enterprises, and reinvestment of private profits in diversified business activities. Through privatization, not only can the urban government raise additional revenue--as it can through the selling of state and local-owned and publicly held bank and non-bank assets--, it can also create a conducive environment for the growth of Indonesia's economy, a very important factor in reinforcing various efforts of bolstering Indonesia's urban government finance. In the case of promoting market economy in economic restructuring programs and financing the total costs of the provision of nation-wide urban public services such as electricity and phone, increasing nation-wide urban user charges is a suitable means of raising additional revenue that fits the economic efficiency and benefit principle considerations.

To finance urban development and urban social programs, such as social safety nets for urban poor that are needed by those unable to attain their urban basic needs by themselves, raising urban-related taxes through progressive urban taxation is, from equity consideration, an appropriate means of raising urban government additional revenue. Increasing mineral royalties and sales of natural-resource products, if any, is also an appropriate means of revenue mobilization for such a purpose. In order to finance long-lasting urban infrastructure development and to contribute to efforts for stabilizing Indonesia's economy that will benefit the current and future generation of Indonesian people, borrowing is a reasonable means of revenue mobilization even though it can create inflationary effects and fiscal burden upon future generations (Musgrave and Musgrave, 1989).

### **3.1.2 Factors to be considered**

#### **a. The extent of revenue increase that can be pursued from urban-related taxes**

As mentioned earlier, the performance of the economy significantly affects the magnitude of the revenue increase that can be pursued by urban governments through raising urban-related taxes. Since the performance of Indonesia's economy, after sharply declined in the last few years, tends to decline further, it seems unrealistic to expect the Indonesia's urban governments to immediately raise substantial additional revenue through raising taxes. Under the current circumstances, significantly high urban-related tax rates can cause further disadvantages such as urban capital flights and urban investment relocations. In turn, this will reduce private funds available in the urban market, which are currently very needed by urban private enterprises to make it possible for them to be involved in the economic restructuring process. Thus, although raising the a small rate of broad-base non-distorting taxes such as urban income and value-added taxes is perhaps economically possible, it can cause serious unintended consequences. Raising urban-related value-added tax rate at this time, for instance, can reduce the current volume of urban sales, which can lead to urban job cuts, thus creating more urban unemployment. On the other hand, raising broad-base non-distorting taxes such as value-added tax is perhaps the easiest way of increasing tax revenue that can result substantial additional revenue at this time.

With regard to these possible situations, in the current circumstances, raising additional revenue from urban-related taxes can only be considered to the extent that it can avoid these complications. This can be done, for instance, through intensifying tax collection and improving tax administration. Raising tax-revenue through intensifying tax collections and improving tax administration is promising and it can raise large urban government additional revenue. Through this time, the tax collection rates

and the numbers of registered tax payers are still low, less than 15 percent and about 2 million out of 210 million Indonesian people, respectively (Depkeu, 2003). When the economy gets better, the prospects of raising substantial additional revenue through raising urban-related taxes will also get better.

**b. The extent of revenue increase that can be pursued from urban-service charges**

Increasing charges as long as to cover the full cost of urban infrastructure and service provision, both capital and recurrent, is necessary for promoting economic efficiency. In current practices, the Indonesian government subsidizes charges of most nationwide and local urban services, regardless of the income level of the consumers, such as electricity and telecommunication services. Increasing such charges is thus necessary to eliminate untargeted subsidies.

Nevertheless, with regard to the current political and social conditions in Indonesia, it is not prospective to raise substantial additional revenue to bolster Indonesia's urban government finance through solely increasing urban-service charges. Instead, increasing charges can only be targeted to cover the recurrent costs of the service provision, even though this means bolstering urban government finance through government savings of eliminated certain subsidy. Furthermore, increasing urban-service charges can only be undertaken together with another policy to make sure that urban population who cannot afford such services based on their income can still use the basic minimum of the services. The issue of charging for bolstering Indonesia's urban government finance will also be discussed as reducing subsidy issue in the next section.

**c. The extent of revenue increase that can be pursued from privatization**

Privatization<sup>15</sup> is an important way of revenue mobilization for bolstering Indonesia's urban government finance. It can create not only a substantial fund transfer from the private sector to the government as a result of the

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<sup>15</sup> Privatization is the transfer of industry or business from public ownership or control to private enterprise. Privatization can range in scope from the provision of goods and services based entirely on the free operation of the market to public-private partnerships in which government and the private sector cooperate to provide services or infrastructure. Privatization can mean allowing private enterprises to perform functions that had previously been monopolized by government. It can also mean contracting out the provision or management of public services or facilities to private enterprises. Privatization can include financing public sector programs through the capital market with adequate regulation or measures to ensure that the central government does not bear the risk for this borrowing and allowing private organizations to participate. It can also mean transferring responsibility for providing services from the public to the private sector through the divestiture of state-owned enterprises.

purchase of state and local-owned enterprises but also a conducive urban environment for economic efficiency. This environment is important to reinforce various efforts of bolstering urban government finance and achieving national and local fiscal sustainability, especially as the country decides to move toward the market economy. Privatization can also drive the urban economy due to new urban private investments, market efficiency driven by private capital, and reinvestment of private profits in diversified urban business activities.

Raising substantial additional revenue through privatization is theoretically possible because Indonesia has more than 150 state-owned enterprises that the government wants to privatize<sup>16</sup>, especially as the country decides to move toward market economy. It has been estimated that 850 trillion rupiahs' or about US\$ 85 billion's worth of state-owned enterprises can theoretically be privatized (Tempo, 26th August 2001). These enterprises include a wide variety of urban-based business activities, which can reasonably be taken over by the urban private sector.

The value of the enterprises to be privatized is influenced by the performance of Indonesia's economy and the political and social conditions in the country as well as at the urban local level. The highest possible bid price for the enterprises to be privatized, or the maximum willingness to pay of the private buyer to purchase such enterprises, is usually lower when the country's economy declines because the expected net benefits to be accrued by the private buyer becomes lower. The sale price is also lower when the political and social conditions in the country are unstable and fragile, because the investment risk factor becomes high and the economic environment becomes non-conducive for the private buyer to predict the expected net benefits to be accrued rather than when the political and social conditions are stable and predictable.

Given that the Indonesian economy is slowing down, and the political and social conditions are unstable and fragile, it seems that at this time state and local-owned enterprises in urban Indonesia can only be privatized with very low prices. Nevertheless, since the revenue to be mobilized through

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<sup>16</sup> Many state-owned enterprises that were previously monopolized by the government, such as the public telecommunication and electricity companies, can now be privatized. Traditionally, only private goods and some toll goods, such as parking facilities, garbage collections, cable TV services, toll roads, and sport stadiums can be privatized. Toll goods that are monopolies in nature such as water delivery, telephone line and electricity services can be privatized with price control. Nowadays, thanks to the advent of technology, more and more goods and services that are traditionally monopolies in nature can be provided in a competitive market. All goods and services that can now be provided in a competitive market using the technology available can be privatized. Only conventional pure public goods such as the air people breathe and the sky people see, common-pool goods such as fish in the sea and wild life, and collective goods such as national security, police protection and public information, still can not be privatized.

privatization is needed to contribute in the payment of amortizations and public-debt interests, and privatization can indeed drive the urban economy, which is one of the targets of the country's economic restructuring, raising additional revenue through privatization is needed, and even a must. By privatization, the urban economy will get better, and the prospects of raising substantial additional revenue through further privatization will then improve.

**d. The extent of revenue increase that can be pursued from urban assets sales**

Selling off assets, by its nature, is perhaps the instant way of revenue mobilization for Indonesia's urban governments. This seems even more promising since there are a wide range and a large number of publicly held bank and non-bank assets in urban areas in Indonesia that can be sold off. These assets were acquired by the country due to the emergency credit loaned to domestic private owners of the banks and corporations due to their outstanding private debts. They include thousands of units of assets, tens of banks and hundreds of corporations covering nearly all types of businesses, including electricity, construction, telecommunications, chemical and pharmaceutical, and transportation as well as factories, office and commercial buildings, hotels, and real estates.

The magnitude of the revenue that can be pursued through the selling of urban assets is also affected by the performance of the country's economy and the political and social conditions in the country. When the country's economy declines, the numbers of urban assets that can be sold and the prices at which they can be sold tend to be low, because the expected net benefits of the assets to be accrued by the private buyer becomes lower. With regard to the current economic, political, and social conditions in Indonesia, the numbers of assets that can be sold and the prices at which they can be sold will therefore tend to be low. The magnitude of additional revenue that can be pursued through the selling of the assets will also be low.

Although this is the case at this time, the selling of some publicly held bank and non-bank assets is necessary to mobilize revenue needed to contribute in paying the country's amortizations and public-debt interest, as well as to revitalize the role of the private sector. By returning these assets to the urban private sector, the urban economy will improve and the prospects of raising substantial additional revenue from urban assets sales in the future will become more promising.

**e. The extent of revenue increase that can be pursued from mineral royalties and natural-resource products**

Increasing mineral royalties and the selling of Indonesia's varied natural resources, such as gold, silver, copper, oil, gas, tree crops, and timber, can help generate considerable additional revenue. Raising urban government

additional revenue through this way, if any, is conceptually possible, since most of the current natural-resource-related productions are still lower than their production capacities. However, there are several potential problems or barriers to immediately raising substantial additional revenue through increasing mineral royalties and the selling of natural resource products. Immediately increasing mineral royalties can be difficult and unrealistic, because most contracts with those who currently run the mineral productions are still in effect, even for the next few years. Raising additional revenue through increasing the selling of natural resource products such as oil and gas can be difficult, not only because oil and gas prices can fluctuate and the cost of further exploration of these resources would require a large capital, but also because there has been a collapse in regional demand, especially from Japan, Taiwan, and other South East Asian countries.

**f. The extent of revenue increase that can be pursued from borrowing**

Domestic and foreign borrowing is an important source of urban government revenue. It can be readily accessed by the country's government for stabilization and other macroeconomic purposes, with certain conditionality. Included in the conditionality of the loan agreements are the government obligations to create good governance, eliminate subsidies and monopolies, and provide transparencies in all transactions. Indeed, the foreign loan is given to direct the country's economic restructuring. A loan obtained from the IMF, for instance, can attract the confidence and trust of potential foreign investors and buyers for the success of privatizations and selling of many publicly held urban assets in Indonesia.

However, external borrowing can be the most difficult way of urban government revenue mobilization at this time due to its conditionality. There are strong resentments from those that are negatively affected by the conditionality of the external loan, such as the people whose taxes will increase to help the urban government repay its loans, the people whose subsidies will be eliminated, the businesses that will be disadvantaged from elimination of monopolies, and the corrupt political elites that do not like transparencies.

**3.2 Bolstering Urban Government Finance Using the Engineered Efficiency Improvement Model**

Intensive revenue mobilization is a very important step to be undertaken. Mobilizing revenue aggressively is very important if the urban governments in Indonesia are expected to be able to generate enormous amounts of funds needed, including their contribution to paying amortizations and public-debt interests, financing economic restructuring, and financing urban development and urban social programs. However, doing so without also reducing spending may be inadequate, given the country's ailing financial conditions.

The importance of the contribution of the urban government spending reduction to bolstering Indonesia's urban government finance depends on the magnitude of the spending reduction that can be pursued, with respect to the magnitude of the finance needed as described earlier in the revenue mobilization section. This section will thus focus on assessing the spending decrease that can be pursued by referring to the guidance provided in the urban finance literature.

### **3.2.1 The Efficiency that Can Be Improved**

The Indonesian government can reduce spending by eliminating unnecessary spending due to inefficient and ineffective government operations as reflected in every budget year. The ways of reducing spending that need to be used are related to efforts for improving the efficiency and effectiveness of government operations, as guided by the economic principles, rules, and criteria in the standard public finance literature. From the benefit principle and efficiency considerations, eliminating unnecessary subsidies and eliminating other unnecessary spending such as spending to support the operations of local-owned enterprises are among the ways of spending reduction that can be justified. In terms of Efficiency there is still no clear measurement for the budget spending in many local government. In the era of autonomy.

The autonomy implementation could be seen as one way of engineered efficiency in terms of local financing. In there do exist restructuring of government functions & financing. The changed circumstances mainly after reformation movement in the end of 90s has come to the need of changing the government structure, expected among other to be able to efficiently deliver service to the public.

With the less choice of central government, most of urban government which must depend on the capability of crisis-stricken central government are likely to be disappointed. Therefore raising local resources for local purposes is needed. Autonomy will increase the reliance on local effort and know how. Perhaps what is needed on the evaluation of local budget decisions how to make such decision intelligently. Self-financing policy reduce the drain of local resources to budget certain service that often the direct benefit are only for a relatively small number of citizen. A properly structured urban self-financing will significantly add the total amount of resources available to the public.

More law force on the implementation of provision of public and social facilities (*fasum & fasos*), so that the developer could be responsible in providing streets parks, water, sewerage systems and so on at his own expense. Value creation will increase the rapid rise in property values. This is a potential for tax to finance major part of the needed budget. A rapidly growing cities generally has many potential project Create project that

potential high social productivity so that the benefits to land values may greatly exceed the cost of the projects. Taxation should recover the investment of public agency without exceeding the realizable benefit to any individual landowner from the increased site value of his property (Bird, 1992).

### **3.2.2 The extent of efficiency that can be engineered**

Intensive spending reduction is necessary if the government in Indonesia is expected to be able to save large funds that otherwise would be spent on inefficient and ineffective resource allocation. Subsidies that currently apply to consumer goods such as gasoline and electricity, for instance, mostly benefit those who do not need to be given subsidies, and therefore they need to be eliminated. From the efficient charging system's point of view, eliminating this unnecessary spending can be approached by imposing the marginal cost of service provision to the marginal benefit of service utilization of the service user, in efficient user charges. In the context of bolstering government finance, eliminating unnecessary subsidies is required to reinforce revenue mobilization. In 2001 alone, 66 trillion rupiahs, or about US\$6.6 billion, were used to subsidize petroleum and non-petroleum, such as electricity and telecommunications. If this amount were to be eliminated from government spending, the Indonesian government would have saved quite a large amount of funds.

In addition to eliminating unnecessary subsidies and other unnecessary spending, reducing spending can also be pursued through productivity improvement programs and involving the private sector in service provision in order to save costs and improve productivity and economic efficiency. Further reduction in unnecessary spending, in addition to improving the effectiveness and efficiency of government operations, would then contribute significantly to bolstering Indonesia's government finance. Given the economy and political and social conditions in Indonesia at this time, however, reducing spending is a considerably difficult venture faced with much political and social opposition. Reducing subsidies would save a substantial amount of money, but it requires political support, which is very difficult to obtain in the unstable political environment. The fragile social conditions add to this difficulty—eliminating subsidies could cause uncontrolled rioting all over the country.

### **3.3 Bolstering Government Finance Using Expenditure Responsibility Contraction Model**

In addition to mobilizing revenue and reducing spending, reducing fiscal pressure can also contribute to bolstering government finance. The continuous emergence of fiscal pressure borne by the government, such as additional financing required for the growing needs of the growing



population, can make it difficult for a country's government to focus on the efforts mentioned earlier. Fiscal pressure reduction is therefore required to reinforce efforts from other options of bolstering government finance. The contribution of fiscal pressure reduction to bolstering Indonesia's government finance depends on the magnitude of the fiscal pressure that can be shifted to other parties, with respect to the magnitude of the finance needed as described earlier in the revenue mobilization section. This section will thus focus on assessing the fiscal pressure decrease that can be pursued by referring to the guidance provided in standard public finance literature.

### **3.3.1 Expenditure responsibility that can be contracted**

The Indonesian government can reduce fiscal pressure it bears by shifting some of its expenditure responsibilities to other parties that are indeed capable of taking over these expenditure responsibilities. These shifts can even promote economic efficiency and equity as the country moves toward market economy. The ways of reducing fiscal pressure that can be used are related to efforts for shifting different expenditure responsibilities to different parties as appropriately as possible, as guided by the economic principles, rules, and criteria in the public finance literature. From efficiency considerations, for instance, fiscal pressure that arises from the provision of non-pure public goods and related needs can be more efficiently held by the private sector. Allowing the private sector to fully operate and finance such service provision, e.g., electricity and telecommunication can thus shift this kind of pressure from the government to the private sector. From the optimal fiscal role arrangement among different levels of government, fiscal pressures that arise from the responsibility of public good provision that only benefits local residents can then be shifted to local governments. The fiscal pressure that arises from the running of state-owned enterprises, which often have inadequate financial support, must be shifted to the autonomous enterprises themselves. This way they would have to be more effective and efficient in their operations, and choose runs that can be expected to bring in profits for the enterprises.

### **3.3.2 The extent of expenditure responsibility contraction that can be pursued**

Intensive fiscal pressure reduction is necessary if the government in Indonesia is expected to be able to relieve the fiscal pressure it bears that otherwise would reduce its focus on efforts for bolstering its finance. The growing fiscal pressure that is currently felt by the Indonesian government is to always support non-pure-public good provision, such as additional capacity of electricity provision due to population growth. This fiscal pressure can be shifted to the private sector to fully operate and finance such provision. The growing fiscal pressure that is currently felt by the government to always

support local public good provision, such as local police, can be shifted to the local government, through fiscal decentralization. By doing so, the government can substantially reduce fiscal pressure it bears in the future, and it will be able to devote more time on mobilizing revenue and reducing spending.

Reducing these fiscal pressures, however, is not easy while the country's economy is in crisis and the political and social conditions are unstable and fragile. With the poor performance of Indonesia's economy, the domestic private sector cannot be expected to be involved in taking over these government fiscal pressures, which would actually give them the opportunity to be involved in businesses that are previously run by the government. With unstable and fragile political and social conditions, there is difficulty for the foreign private sector to predict the prospects of investing in the country by taking over some of the government's fiscal pressure. Under current circumstances, fiscal pressure shifts to local governments can also induce those areas with rich resources, such as Aceh, Irian Jaya and Riau, to seek independence from Indonesia, while those areas with little resources will suffer even more from the political instability and social conflicts.

#### **IV. CLOSING REMARKS**

The above discussion though mostly are on the revenue side of any local financing, it doesn't mean that expenditure pattern is not play it role. Promoting development in an efficient and in a fair way perhaps need more attention to expenditure spending. Other consideration is the benefit principle of finance should be always in mind of policy maker.

While the aforementioned means play significant roles in bolstering urban government finance, the position of the private sector plays additional significant roles through its presence in the three models discussed above. It can cause the transfer of funds from the private buyer to the urban government resulting from privatization and asset sales, the adding up of fund savings resulting from contracting out services to private contractors, and the lessening of fiscal pressures as a result of allowing private enterprises to take over. The greater role of private sector can also drive the urban economy due to new private investments, economic efficiency, and reinvestment of private profits in diversified business activities. Thus, not only can an urban government raise additional revenue--as it can through the selling of local-owned assets-, it can also create a conducive environment for urban economic efficiency, a very important factor in reinforcing various efforts of bolstering urban government finance and achieving urban government fiscal sustainability.

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