Implementing Decentralization: Lessons from Experiences in Indonesia

Kadjatmiko

In Indonesia, centralizing government authority used to be considered a way of preserving national unity, promoting economic growth and maintaining national stability. For more than 30 years, Indonesia enjoyed growth and political stability because authority was centralized. Economic growth was based on centralized authority even though Indonesia is an archipelagic country comprising various cultures, ethnic minorities and diverse communities. Highly centralized public sector decision-making, however, reduces accountability, retards the development of public infrastructure, adversely affects rates of return on public sector projects and constrains the development of local institutions.

Between 1945 and 2001, during the era of centralized government, at least three systems of financial transfers were in operation. First, from 1945 to 1956, the national government provided government subsidies to ensure local governments’ ability to finance their planned budgets. By 1956 the national government had issued Law No 32/1956, with the concept of an intergovernmental transfer formula. The government introduced revenue sharing so that local governments received a percentage of government tax revenues. In 1972 the so-called subsidy for autonomous regions (SAR) was implemented, which implied that salaries of local government civil servants were covered by the national government. Over 60 per cent of the SAR was allocated to provincial governments, with the remainder allocated to the districts. Local governments also received President’s Instruction transfers, which covered local development activities.

Before 1998, Indonesia was probably considered the most centralized country in the world, in that the authority to determine most aspects of national policy was held by central government. The revenue and expenditure systems were fairly centralized, and central government collected almost 95 per cent of national
revenue, allocating 87 per cent of that for expenditure and transferring the remaining 13 per cent to local governments as grants and subsidies. National revenue was derived from taxes (59.2 per cent), national resources (23 per cent) and aid (17.8 per cent), and funds to provincial governments, at the first level, came from a tax share, general purpose grants (GPGs) and development grants. Revenue for regency governments, as the second level, came from first-level (provincial) government, local taxes, routine expenditure transfers (under the SAR) and development expenditure transfers as President’s Instructions. Central government fully supported the costs of local government employees under the SAR scheme. For this reason, the SAR is classified as a specific purpose or conditional grant, with no discretion at the local government level, to support routine activities.

To support local development activities, the central government allocated President’s Instruction funds, which have the important objective of reducing regional disparities. These are transferred as specific purpose grants (SPGs) as well as SAR (for example for basic education) and as block grants (for example for provincial development).

In the Reform (Reformasi) Era, beginning in 1998, Indonesia implemented a policy of regional autonomy. The policy was embodied in Laws No 22/1999 and No 25/1999 and fully implemented in 2001. Laws No 22/1999 and No 25/1999 provide a new framework for a relationship between local governments (districts and provinces) and the central government. These laws devolved all authority to the local governments except for authority for national defence, monetary affairs, justice, development planning and religion.

Implementing regulations were passed to support Law No 33/2004 as an amendment of Law No 25/1999. In accordance with this amendment, Government Regulation No 104/2000 was revised as Government Regulation No 55/2005 on fiscal balancing. This regulation was intended to devolve functions to the regions. Such a design works well only if the central government budget is healthy, however, and unfortunately this is not the case in Indonesia. With a huge national debt, coupled with economic and social crises, funding for decentralization was limited.

By providing only very limited funding, the central government expects that local governments will eventually adjust their expenditures accordingly. The ‘money follows functions’ rule is not being applied by the central government in the distribution of funding. Instead, it may be inferred from the budgetary situation that it is more a case of ‘functions follow money’, especially at the local (district and municipality) level. With limited local funding and transfers, it is expected that local governments will not be able to support all the functions delegated to them. This problem is coupled with the fact that the functions assigned to local governments have never been clearly defined. It is better, therefore, to refer to this local situation as ‘functions (only) follow (the availability of) money’.

Two laws on special autonomy were also enacted in 2001. These two laws – the Law on Special Autonomy for Aceh and the Law on Special Autonomy for Papua
were passed as a result of local aspirations and the rather atypical needs to solve the problems of vertical imbalance. The laws made ‘the asymmetric treatment’ of sub-national government legally acceptable. That is, Papua was given 70 per cent of revenue-sharing rates for oil and gas and also receives special grants equal to 2 per cent of the national GPG transfer. Both Aceh and Papua provinces receive 15 per cent of oil revenues and 30 per cent of natural gas revenues plus an additional 55 per cent of oil revenues and 40 per cent of natural gas revenues because of their special autonomous status (total shares for both provinces being 70 per cent: 15 + 55 per cent and 30 + 40 per cent of oil and natural gas revenues respectively); these funds are included in the state budget as shared revenue, not as funds for special autonomy.

Decentralization began in Indonesia after more than three decades of a centralized system. Indonesia’s large population and vast archipelago, along with the aspirations of districts and provinces, required a new, more decentralized system. Decentralization began, in fact, with a spirited declaration by the Reformasi movement without the benefit of adequate time for planning and preparation.

The decentralization of government in Indonesia was conducted quickly, by devolving to local government the authority for everything except the five functions mentioned earlier – functions considered to have nationwide impact. Decentralization, in turn, encourages the regions to establish more local governments to deliver better public services. As shown in Table 10.1, as a result of decentralization, the number of provinces has grown by 10 per cent, and the number of districts or cities has grown by more than 25 per cent.

ASSIGNMENT OF EXPENDITURE

The national government has responsibility for national public services, defence, security, international affairs, monetary policy, legislation, transfers and subsidies to persons and businesses, fiscal policy coordination, regional equity, redistribution, and the preservation of internal common markets; local governments have authority and oversight devolved to them as described above. Local services are assigned to local governments. Where responsibilities are shared, the role of each level of government must be clarified.

The economic issues involved in the financing of provincial and local governments deserve and demand separate attention for three reasons:

1. the provincial and local governments are now a substantial part of Indonesia’s economy, accounting for approximately 5.94 per cent of gross domestic product and representing about one third of total consolidated government expenditures;

2. the major services provided by government that most affect citizens on a day-to-day basis – ranging from basic education, health and transportation to social
<table>
<thead>
<tr>
<th>No</th>
<th>Revenue type</th>
<th>Before decentralization</th>
<th>After decentralization</th>
<th>Balance to other Districts</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Central</td>
<td>Provinces</td>
<td>Districts</td>
</tr>
<tr>
<td>1.</td>
<td>Property tax</td>
<td>10</td>
<td>16.2</td>
<td>64.8</td>
</tr>
<tr>
<td>2.</td>
<td>Property Rights Transfer</td>
<td>20</td>
<td>16</td>
<td>64</td>
</tr>
<tr>
<td></td>
<td>Tax</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3.</td>
<td>Personal Income Tax</td>
<td>100</td>
<td>–</td>
<td>–</td>
</tr>
<tr>
<td>4.</td>
<td>Forestry: IHH</td>
<td>55</td>
<td>30</td>
<td>15</td>
</tr>
<tr>
<td>5.</td>
<td>Forestry: PSDH</td>
<td>55</td>
<td>30</td>
<td>15</td>
</tr>
<tr>
<td>6.</td>
<td>General Mining: Land rent</td>
<td>20</td>
<td>16</td>
<td>64</td>
</tr>
<tr>
<td>7.</td>
<td>General Mining: Royalties</td>
<td>20</td>
<td>16</td>
<td>64</td>
</tr>
<tr>
<td>8.</td>
<td>Fishery</td>
<td>100</td>
<td>–</td>
<td>–</td>
</tr>
<tr>
<td>9.</td>
<td>Oil</td>
<td>100</td>
<td>–</td>
<td>–</td>
</tr>
<tr>
<td>10.</td>
<td>Gas</td>
<td>100</td>
<td>–</td>
<td>–</td>
</tr>
<tr>
<td>11.</td>
<td>Reforestation Fund</td>
<td>100</td>
<td>–</td>
<td>–</td>
</tr>
<tr>
<td>12.</td>
<td>Geothermal</td>
<td>100</td>
<td>–</td>
<td>–</td>
</tr>
</tbody>
</table>

Source: Law No 33 of 2004
services and public safety – are dominated by provincial and local governments; and

3 because of the diversity of provincial and local governments and the magnitude and mix of revenues and expenditures, many economic and fiscal issues are substantially different for provincial and local governments than for the central government.

Under the expenditure approach, functions are first designated as the clear responsibility of one level of government. Thus functions such as primary education, local general hospitals, clean water and refuse collection would be assigned to local governments as having primarily local impacts and being within the local management capacity. Specialist secondary schools, regional specialist hospitals, and river and water resources management would be assigned to the provincial level as having substantial inter-regional impacts. Religious affairs and justice would be reserved as central government functions, requiring uniform policies with nationwide impact. Once the assignment of functions is agreed upon, the allocations of financing sources between levels and amongst the regional governments at each level are tailored accordingly.

**Assignment of Revenue**

According to Law No 25/1999, local governments (provincial and district or municipal) are encouraged to increase their own revenues from various sources, such as local taxes and charges, profits from locally owned enterprises, and other eligible local revenues. However, the current scheme still provides only a small proportion of local revenue compared with total national revenue. The central government still controls the major revenue from important sources – income taxes, value-added taxes and others – whereas local governments have only weak local taxation power.

**Intergovernmental Transfers**

Districts and cities have essentially become responsible for all public services that the central and provincial governments do not deliver in these areas: public works, health, education and culture, communications, industry and trade, capital investment, environment, land, and cooperatives and labour. A third of the national budgetary expenditure is transferred to local budgets, mostly as block grants. Almost 26 per cent of national revenues are transferred to regions through the general purpose grant mechanism. The management of two million national civil servants has also been transferred to the regions.

After Laws No 22/1999 and No 25/1999 were enacted, decentralization evolved gradually. Consequently, as a result of widespread calls for clearer decentralization
and popular pressure to maintain the pace of development through more rapid growth of services, the government and parliament revised Laws No 22/1999 and No 25/1999 by enacting Law No 32/2004 on Local Government and Law No 33/2004 on Fiscal Balancing between Central Governmental and the Regions.

The amendments to Laws No 32 and No 33 of 2004 were intended to improve the implementation of decentralization. Indonesia’s fiscal decentralization is supposed to increase the efficiency of national allocation by devolving authority from central government to the sub-national level. The devolution of authority was also intended to meet regional aspirations, improve the fiscal structure, and mobilize regional and national revenues. Laws No 32/2004 and No 33/2004 are intended to meet the ‘finance follows function’ principle. Based on this principle, the balancing fund is designed to ensure that each local government can deliver mandatory public services using its fiscal capacity. Since the Indonesian decentralization process is intended to ensure equity, there should be fair treatment for each local government to close the gap between needs and capacity. It is very important to ensure that all Indonesians are provided with the same minimum basic services by their local governments. However, allocating the same amount of money to each local government will not mean fair treatment, since local governments have a variety of different needs and capacities. The allocation has to be designed so that every local government can at least bridge the gap between its minimum needs and its maximum fiscal capacity.

Under Law No 33/2004, local governments control important revenue resources (taxes on hotels and restaurants, royalties, entertainment, advertising, parking, street lighting, and selected mining), the provinces control more important resources (motor vehicle registration, transfer and fuel taxes and water-user fees), and the central government manages the most important and productive sources (local personal income, property rights transfers and other shared revenues). According to the law, regions receive decentralization funds, deconcentration funds and co-administered tasks. ‘Decentralization’ means the transfer of the authority of the government to an autonomous region to regulate and administer governmental affairs in the region under the Unitary State of the Republic of Indonesia. The transfer is followed by a fund transfer, called the decentralization fund, to regional budgets. ‘Deconcentration’ means the delegation of governmental authority to the provincial governments. ‘Co-administered tasks’ refer to assignments from the government to a region and/or village or other entities with the obligation to report and account for the implementation of the assignment to the government. Deconcentrated and co-administered tasks are funded by the national budget through line ministries.

Intergovernmental fiscal transfers play a critical role in public finance in both unitary and federal decentralized countries. In the case of decentralization reforms, the design and implementation of transfers have significant impacts on the potential efficiency and equity of basic public service provision. Indonesia’s 2001 decentralization process illustrates the implementation of significant
reforms in changing to an intergovernmental fiscal system. Almost overnight, local governments were effectively put in charge of almost a third of consolidated government expenditures (Hofman et al., 2006), whereas their ‘regional own revenues’ (Pendapatan Asli Daerah, PAD) were able to finance only approximately seven per cent of their expenditures. To deliver public services closer to the point of use, local government tends to expand. At present, local government sources of revenues are PAD, balancing funds and other income. Since the enactment of Law No 25/1999 local governments have had the power to raise local taxes and user fees, although under devolution they can raise local taxes only up to 3.5 per cent of national taxes. Balancing funds are derived from revenue sharing and general purpose and specific purpose grant transfers.

Revenue sharing is intended to respond to regional aspirations for increased access to and control over revenues, strengthen regional ability to mobilize revenue, and address vertical fiscal imbalance. Revenues consist of taxes and ‘non-taxes’ (income from natural resources). According to Law No 25/1999, the revenue is shared according to origin – that is, by producer region. The balancing funds transfer system is intended to address vertical imbalances between levels of government (revenue sharing and general purpose grants), equalize local government fiscal capacities, encourage local expenditure on national development priorities, promote the attainment of minimum services and standards, and stimulate revenue mobilization.

**Revenue Sharing**

Revenue sharing is intended to respond to local pressures, stimulate local participation in national revenue mobilization and address vertical fiscal imbalance. Sources of revenue to be shared include natural resources (forestry, general mining, fisheries, oil, gas and geothermal energy) and taxes (property taxes, property rights transfer taxes and personal income taxes).

Nevertheless, many regions remain unhappy with the revenue-sharing mechanism and believe that they do not receive fair shares. Revenue sharing is also intended to alleviate vertical imbalance, thereby reducing local government budget deficits; however, revenue-sharing systems potentially create horizontal imbalance between regions, depending on their natural resource wealth and other factors.

Sharing of natural resource revenues is considered an inappropriate instrument for fiscal decentralization because natural resources are usually unevenly distributed, and this can induce higher horizontal fiscal imbalances across regions. Of course, natural resource revenue sharing may be justified as a tool to improve vertical fiscal imbalances. However, in general, its negative impact on equitable revenue allocations is much bigger than its positive effect on the vertical fiscal imbalances. It is for this reason that sharing of natural resource revenues is not adopted in many countries (Sidik, 2003).
GENERAL PURPOSE GRANTS

According to Law No 33/2004, general purpose grants (GPGs) should act as an equalization measure. Furthermore, GPGs should be sufficient to close the gap between minimum needs and maximum possible fiscal capacity. Consequently, each local government receives a different level of allocation, according to its needs and capacities. The variation in needs may arise from differences in the size of the population or area, geography, and people’s welfare; the variation in fiscal capacities may come from differences in tax revenue, non-tax revenue and PAD. The GPG is also used to reduce horizontal imbalances resulting from revenue sharing across regions. It addresses vertical fiscal imbalance between levels of government. The grant equalizes regional government fiscal capacities in order to deliver services and stimulate revenue mobilization. It is also intended to respond to regional aspirations for greater access to and control over revenues. Moreover, the amount of the grant is determined by fiscal gap analysis – determining fiscal needs minus fiscal capacity – which means that the formula recognizes the fiscal capacities (capabilities) of regional governments to finance their expenditures. Regions with lower fiscal capacity receive more in GPG, and vice versa.

Districts and cities are allocated 90 per cent of GPG funding, and the remaining 10 per cent is allocated to the provinces. These grants are intended to address problems related to both vertical and horizontal fiscal imbalances. The formula adapts the equalization principle and considers measures of both expenditure needs and fiscal capacities. Expenditure needs are derived from an analysis of population size, area, consumer price index, human development index and gross regional domestic per capita product; the fiscal capacity is derived from PAD and revenue sharing. The grants account for an average 64 per cent of total district revenues.

The GPG acts like an equalization mechanism, but there is a balancing factor, known as ‘hold harmless’. This means that local governments that received large transfers in the past will not receive less. GPGs were first allocated in 2001 (see Table 10.2); only 20 per cent of the grant was then allocated, by means of a formula, and this was based on the ‘hold harmless’ principle in relation to the previous year’s subsidy for autonomous regions and President’s Instruction transfers. In 2002 the formula-based allocation increased to 40 per cent; the remainder was allocated on the basis of lump-sum ‘hold harmless’ factors. The lump sum implies that a minimum amount was equally distributed across regions. Only 10 per cent of total GPG was allocated through the lump-sum mechanism in 2002. Fifty per cent was allocated through the ‘hold harmless’ policy, which meant that no region received less than in 2001. In 2003, 2004 and 2005 the GPG was essentially allocated along similar principles, although the formula-based share was increased and figures were updated to account for the increase in the number of regions. New ‘hold harmless’ conditions have superseded the 2001 ‘hold harmless’ conditions. Simulations were always made using the previous year’s local government figures.
Indonesia will implement the ‘hold harmless’ concept until 2007, such that no local government receives a lower grant than it received in 2005 (according to the GPG formulation, regions may receive a lower or higher grant than in the previous year; however, equalization funds are allocated to regions receiving lower grants). The formula used to calculate GPGs is given in Annex 10.1.

**Specific Purpose Grants**

Initially, the specific purpose grant (SPG) had two components: the reforestation specific purpose grant, which was a mechanism for intergovernmental sharing of proceeds from forest exploitation, and the regular specific purpose grant. The reforestation SPG was first allocated in 2001, and both SPGs were allocated in 2003 (see Table 10.3). By 2006 the reforestation specific fund had become a revenue-sharing mechanism, which meant that in 2006 the allocation of SPGs was for non-reforestation purposes only.

The reforestation SPG is allocated on the basis of the 40 per cent share of reforestation funds that were allocated to regions at the provincial level. The SPG is allocated annually according to the national budget to help certain regions finance special activities that are purely regional affairs. The government establishes several criteria when allocating SPGs: general criteria, special criteria and technical criteria.

The general criteria are established with due regard to the financial capacity of the region, and the special criteria apply to the prevailing laws, regulations and characteristics of the region. Technical criteria are established by the line ministries. A region receiving an SPG must provide matching funds of at least 10 per cent to establish a regional commitment to the investment.

Special criteria are established by using dummy variables to assess whether regions meet the criteria and conditions as stated in the decentralization law.

In 2003 specific activities funded by non-reforestation SPGs were primary health, primary education, infrastructure and local government. In 2006 these expanded to include primary health, primary education, infrastructure (roads,
bridges, irrigation and clean water), fisheries infrastructure, agriculture, local government infrastructure and the environment.

Of the total government expenditure of Rp 647.7 trillion, SPG 2006 transfers were Rp 11.56 trillion, or only 5.2 per cent of total local expenditure (transferred funds) or 1.7 per cent of government expenditure. Yet SPGs remain an important mechanism for maintaining the delivery of public services. The formula used to calculate SPGs is given in Annex 10.2.

### Table 10.3 Specific purpose grant (SPG) allocation (Rp trillion)

<table>
<thead>
<tr>
<th>Sectors</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
</tr>
</thead>
<tbody>
<tr>
<td>Primary Education</td>
<td>625.00</td>
<td>652.60</td>
<td>1221.00</td>
<td>2,919,525.00</td>
</tr>
<tr>
<td>Primary Health</td>
<td>375.00</td>
<td>456.18</td>
<td>620.00</td>
<td>2,406,795.00</td>
</tr>
<tr>
<td>Infrastructure – Roads</td>
<td>842.50</td>
<td>839.05</td>
<td>945.00</td>
<td>2,575,705.00</td>
</tr>
<tr>
<td>Infrastructure – Irrigation</td>
<td>338.50</td>
<td>357.20</td>
<td>384.50</td>
<td>627,675.00</td>
</tr>
<tr>
<td>Infrastructure – Clean Water</td>
<td>0.00</td>
<td>0.00</td>
<td>170.00</td>
<td>1,094,875.00</td>
</tr>
<tr>
<td>Local Government Infrastructure</td>
<td>88.00</td>
<td>228.00</td>
<td>148.00</td>
<td>438,675.00</td>
</tr>
<tr>
<td>Fishery Infrastructure</td>
<td>0.00</td>
<td>305.47</td>
<td>322.00</td>
<td>775,675.00</td>
</tr>
<tr>
<td>Agriculture</td>
<td>0.00</td>
<td>0.00</td>
<td>170.00</td>
<td>1,094,875.00</td>
</tr>
<tr>
<td>Environment</td>
<td>0.00</td>
<td>0.00</td>
<td>0.00</td>
<td>112,875.00</td>
</tr>
<tr>
<td>Total</td>
<td>2269.00</td>
<td>2838.50</td>
<td>4014.00</td>
<td>11,559,800.00</td>
</tr>
</tbody>
</table>

Source: State Budget legislation 2001–2005

### Problems and Challenges

The mismatch between grants transferred and functions devolved to the regions is caused mainly by the rather simplified transfer formulas, which do not accommodate complicated functions. The unclear responsibilities of the devolved functions has also tended to create an overlapping funding, that is through the fiscal balancing mechanism (intergovernmental fiscal transfers) or through the line ministries fund (deconcentration fund). The contribution of PAD to local revenue was low because most local governments had been assigned only limited devolved revenue. Local governments mistakenly assumed that central government would pay local civil servants because local civil servants’ salaries were computed in the GPG formulation. This, of course, gave them an incentive to increase spending on personnel at the cost of other priorities.

The devolution of authority was followed by the devolution of expenditure responsibilities, as regulated in the decentralization laws. Although they still deliver national public service priorities, local governments may not be able to afford such
responsibilities because of the limited funds they receive, both shared and through GPGs. The only possible mechanism is the SPG, which covers national priorities. However, some in central government believe that it is not right to achieve national objectives through this mechanism if it could be achieved through the de-concentration mechanism. The issue of whether to provide financing through specific grants or through the de-concentration mechanism has been widely disputed. Government Regulation No 55/2005 implied that the de-concentration fund should be gradually transferred to the SPG; however, the dispute persists because line ministries still see some local functions as national functions.

The decentralization legislation devolves authority for governance for all issues except international policy, defence and security, judicial and monetary affairs, and religion. Legislation relating to line ministries, however, still covers aspects of governance not included in those exceptions. Line ministries continue to control significant line expenditures (for example for capital and development) in devolved sectors, such as basic education, health and infrastructure. At least 25 laws regulating line ministries contradict the laws on decentralization. Law No 33/2004, for example, implies that de-concentration (line ministries) and jointly administered tasks that are funded as part of the line ministries' budgets and utilized to administer regions will gradually be transferred to SPGs, but the prevailing law relating to line ministries states the opposite.

Law No 33/2004 implies that the 'hold harmless' policy for allocating GPGs will be discontinued beginning in 2008, so the possibility exists that some regions will receive less GPG than in 2005 – or none at all. The idea of this regulation is to make the allocation formula more just and fair.

Fluctuation in national revenues will in turn affect the transfer of funding to the regions; that is, fluctuation in national revenues will result in fluctuation in transfers. This must encourage both central and local governments to increase their revenues.

There are issues of transparency in allocating the transfers. The law on decentralization implies that there are formulas for allocating GPGs and SPGs, along the lines of the revenue-sharing systems, but protests continue about the level of funds. Many still believe that the formulas are being manipulated through lobbying at the central government level and in the legislature. Furthermore, the regions do not consider the GPGs and SPGs to be fairly allocated.

Differences between national and local objectives create disputes over SPG allocations in particular. To receive their allocations, the regions are obliged to utilize the funds according to national objectives; however, some regions maintain that their local objectives do not match the national objectives. These differing objectives could mean that the funds transferred might not be available for use. For example, a region may receive an SPG to finance the primary education sector, with the guideline that the funds must be used to rehabilitate classrooms, while the local government actually may need to build more schools; consequently the money could not be used and there would be no point in making this transfer.
The GPGs allocated at least 25.5 per cent of net domestic revenue, and this will increase to 26 per cent by 2007. The regions contend that this percentage is far too small compared with their total needs. Although local governments are encouraged to increase their PADs, the Association of Local Governments recommends that the transfer to local governments be at least 40 per cent to fund the devolved functions.

Clearly, decentralization has brought complexities and confusion for Indonesia, along with the desired greater local autonomy.

REFERENCES

Ministry of Finance (2002) General Purposes Grant, Concept, Burden and its Prospect, Ministry of Finance, Republic of Indonesia, Jakarta

ANNEX: FORMULAS USED TO CALCULATE GPGs AND SPGs

GPGs

\[ GPG = \text{total wages of local civil servants} + \text{fiscal gap (FG)} \quad (1)* \]
\[ FG = \text{fiscal needs} - \text{fiscal capacity} \quad (2) \]
Fiscal needs (FN) are derived as follows:

\[ FN = \text{Abe} (\alpha_1 \text{IP} + \alpha_2 \text{IAr} + \alpha_3 \text{IAr} + \alpha_4 \text{HDI} + \alpha_5 \text{GRDP}) \quad (3) \]

where:

Abe = average of total local budget expenditure
IP = population index
IAR = area index
CPI = construction price index
HDI = human development index
GRDP = gross regional domestic product
\( \alpha_1, \alpha_2, \text{etc.} \) = coefficients.

The coefficients \( \alpha_1, \alpha_2, \alpha_3, \alpha_4, \text{and} \alpha_5 \) in Equation 3 are distributed by ‘best equalization’, according to the Coefficient of Variation utilizing the Williamson Indexation.

Fiscal capacity (FC) is derived as follows:

\[ FC = \text{PAD} + \text{RSNa} + \text{RST} \quad (4) \]

where:

PAD = ‘regional own revenue’
RSNa = revenue sharing of natural resources
RST = revenue sharing of taxes.

**SPGs**

General criteria represent regional fiscal capability and imply regional capacity to cover the development expenditure. Thus the SPG is meant to finance the development of the regions, especially those sectors relating to national objectives.

\[ \text{RFC} = \text{general revenue from local budget} - \text{civil service expenditure} \quad (5)^* \]

and

\[ \text{General revenue} = \text{PAD} + \text{GPG} + \text{RS} \quad (6) \]
where:

RFC = regional fiscal capability
PAD = ‘regional own revenue’
RS = revenue sharing.

Note: *Law No 33/2004.