
Understand Fiscal Decentralization and the Potential Moral Hazard in Indonesia

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ABSTRACT

Fiscal decentralization as a product form of political economy policy is a determinant of a country's economic growth. However, the implementation of these policies is considered vulnerable due to a lack of transparency and accountability, so that abuse of authority at the local government level often occurs which causes moral hazard and triggers fiscal policy inefficiencies. We describe the search related to fiscal decentralization through this research and how the potential for moral hazard can occur in Indonesia. This type of research is a literature study using a descriptive qualitative approach. The data collected is in the form of results from literature reviews, journals, books, newspapers, and documentation that are considered relevant. After reviewing, criticizing, and synthesizing representative literature in such a way, we are able to find several facts indicating that fiscal decentralization can be a solution to overcome economic inequality, on the other hand it can also be utilized by various parties for personal gain. With various polarizations built by the authorities, moral hazard has the potential to occur at any time.

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Introduction

A well-planned, programmed and implemented decentralization results in increased fairness, transparency, accountability, effectiveness and efficiency of the bureaucracy, good public services, accelerating regional development and reducing poverty rates (Fatoni, 2020; Sutrisno, 2017). That's the sound of the promise of a system called decentralization. The big bang of fiscal decentralization took place in 2001 with the aim of removing the autocratic and unnecessary centralized part of power. Decentralization tends to be considered as being able to strengthen the economic base of the Unitary State of the Republic of Indonesia through empowering and strengthening autonomous regions, as well as being able to accelerate the process of economic recovery after every global recession (Hastuti, 2018; Supeno & Ansari, 2022).

Nationally, the regional economic development priorities contained in the Regional Medium and Long Term Development Plan documents are improving the quality of education, health, people's purchasing power, self-sufficiency in food, energy and clean water, improving the performance of apparatus, regional infrastructure, capacity to handle disasters and maintaining quality. environment, village development, culture and tourist destinations. This is all about political economy.

Before the state decentralized the economy and politics through regional autonomy, many deviations occurred (Wiryawan & Otchia, 2022). One deviation is moral hazard. Conceptually, when the central government and local governments have conflicting goals, this can cause moral hazard (Schweizer & Renn, 2019). But if a country is decentralized then moral hazard doesn't occur? not necessarily. Many empirical

studies state that with decentralization, control over corruption will be better. However, this does not mean that with decentralization, corruption will be eliminated by itself. An interesting phenomenon found by Suprayitno (2011) is that with decentralization, corruption in the center, which is very large, will decrease. However, on the contrary, corruption in small areas (petty corruption) will increase, such as the decentralization concept carried out in India, Bangladesh, Ivory Coast, and Ghana. This fact is also corroborated by Setiyono (2017) which reveal that decentralization can have ambiguous consequences: on the one hand it allows regions to have more authority so that they are flexible and responsive in carrying out public services, but on the other hand, it also causes officials to have more opportunities for corruption. Corruption by elected officials and public employees can be a major source of public dissatisfaction with local government. When officials corrupt money from the Regional Revenue and Expenditure Budget (APBD), or solicit money from individuals or companies that do business with or are regulated by local governments, there will be an increase in government costs, regulations that are not implemented, and in general reduce the quality of government administration. Finally, corruption destroys the hope of good public services as a goal of decentralization itself.

Moral hazard in the government sector is also not a rare thing, this situation is very likely to arise from the relationship between the government and companies that is more enduring than the government and the community. Jaya (2021) has also emphasized that oligarchic politics in the regions is prone to moral hazard, especially when there is information asymmetry in public control. As previously stated, Afrimayosi (2020) also in his study explained the dangers of a government that does not maintain accountability, he looks at this problem by using agency theory. The occurrence of a lack of information obtained by the public is a contractual problem of making and implementing public policies (Hartanto, 2013; Mueller, 2020). Academically, agency theory does focus on the problem of information asymmetry which then has the potential to cause moral hazard because each region is given authority by the central government to explore the financial resources it has to finance needs in its region. This tends to have a negative impact in the form of opportunistic behavior. Opportunistic behavior is the behavior or actions of a person who deviates from existing regulations to fulfill all his desires (Silvestrovich et al., 2023; Siva & Gajendran, 2023; Sularso et al., 2014). Information asymmetry between local government and the community opens up space for opportunistic behavior in the budget preparation process (Afrimayosi, 2020). Moreover, if the policies of the central and local governments are contradictory.

Conflicting economic development goals between the central government and local governments can also create moral hazard problems (Estache et al., 2016; Zhang et al., 2022). According to Setiyono (2017), this model of corruption is seen as if it is not an act of corruption because it is covered by a legal regional regulation (PERDA). In fact, in terms of the substance of the regulations, there are many deviations, both from higher regulations and from other normative aspects such as a sense of justice, general decency, or convention. Because it is protected in the form of regulations, this type of corruption is often referred to as legalized corruption or legalized corruption.

Political economy decentralization means the transfer of authority or economic policies from the center to the regions, this concept is defined as functional decentralization (Rodríguez-Pose & Muštra, 2022; Tselios & Rodríguez-Pose, 2022). More than that, with decentralization, the authority to manage finances which was originally centralized in the central government has shifted to local governments. Thus, the authority of the regional government both functionally and financially will become much larger, including authority in the economic sector. However, during the two decades of implementing decentralization, regional economic inequality in Indonesia is still unclear (Aritenang & Chandramidi, 2022), especially in the eastern part of Indonesia (Lamba et al., 2019).

Based on the phenomena described above, the purpose of this study is to seek to further examine several important matters, including: what is the role of fiscal decentralization, how is moral hazard developing, and how far is the commitment to fiscal decentralization in suppressing and minimizing the potential for moral hazard to occur in Indonesia.

Research Methods

This research method uses descriptive qualitative analysis in relation to fiscal decentralization which is carried out using library research. This research was conducted with the aim of knowing conceptually and factually how the role of fiscal decentralization is, how to handle the developing moral hazard, and the extent to which the commitment to implementing decentralization has suppressed and minimized the potential for moral hazard to occur in Indonesia.

In this research, the activities of reviewing, criticizing, and synthesizing representative literature on a particular topic were carried out in an integrated manner, so that a new framework or perspective on related topics could be produced (Torraco, 2005). The time of this research was held in January 2023. The type of data in this research is secondary data which can be obtained through various sources such as material in the form of books, articles from journals, research results, and other sources considered relevant to discussion on fiscal decentralization and moral hazard.

Results and Discussion

The Role of Fiscal Decentralization

According to Wickens (2008), so far every country has considered its economic model, in which one economic agent makes each decision: consumption, saving, leisure, employment, investment and capital accumulation. The alternative interpretation he gives for a country's economic model is that central planners make public policies so that everyone in the economy can make decisions or make choices in an equal and equal position. In this interpretation, Wickens emphasizes that it can be applied to all aspects of the economy, except in the context of market structure because all these decisions must be automatically coordinated through the government.

We started our discussion of economic decentralization by looking at its effectiveness and efficiency in the private and public sectors. The government, in this case the central and regional governments, have a more important role than the private sector in making economic decentralization effective. In Indonesia, in the beginning there was Law Number 33 of 2004 concerning Financial Balance between the Central and Regional Governments which stated that the General Allocation Fund (DAU) is a fund originating from APBN revenues allocated with the aim of equal distribution of financial capacity among regions to fund regional needs in the context of implementing decentralization. However, the regulation was revoked and replaced with Law Number 1 of 2022 concerning Financial Relations between the Central Government and Regional Governments which is substantially similar to the previous regulation in the context of decentralization.

With regard to DAU, Nuradhawati (2019) in her study argued that DAU, which is in the form of block grant, is the main mechanism for fiscal transfers to regional governments, marking the end of central control over regional budgets and decision-making. The role of regional decentralization is certainly very helpful in realizing a democratic system, especially in the economic sector. However, the mentality of government officials, both central and regional, has not undergone any fundamental changes, because the changes in the system are not accompanied by strengthening the quality of human resources that support the new government system (Nuradhawati, 2019). So, does fiscal decentralization have a significant effect on economic growth in their respective regions, particularly in efforts to alleviate poverty?

Wibowo & Oktivalerina (2022) try to answer the above questions through their latest research using data from 476 regencies/cities in Indonesia in the 2010-2018 period. His research yielded several important findings: First, there is a negative and significant relationship between fiscal decentralization and poverty reduction nationally. Second, the impact of fiscal decentralization on poverty is not significant for the Eastern Region of Indonesia (KTI), partly due to the more varied regional conditions compared to the Western Region of Indonesia (KBI). Third, socio-economic factors such as limited infrastructure, population density, and unemployment have a crucial role in poverty reduction programs. Other research also shows the role of central government transfers to regional governments such as village funds as one of the manifestations of fiscal decentralization. Village fund transfers channeled by the central government to regional governments are expected to indirectly improve the standard of living of rural communities, who make up the majority of the poor population in Indonesia (Kharisma et al., 2020).

The findings above are certainly based on various factors, one of which is due to the limitations of local governments in interpreting the concept of decentralization, so that the implementation of decentralization has not been optimal. Fiscal decentralization in Indonesia still leads to the spending/expenditure side with funding sources that are still very dependent on Transfer Funds to the regions (Wibowo & Oktivalerina, 2022). In addition, data from the Ministry of Finance Republic of Indonesia (2021) also reports a number of important matters, including: (1) The utilization of TKDD is not yet optimal, it is known that 64,8% of the DAU for personnel expenditures and capital expenditures depend on DAK; (2) The local tax ratio is low, even though the trend of previous PDRD recipients is increasing. However, since the COVID-19 pandemic it has decreased by 1,2%; (3) The structure of the quality of spending is not optimal, it is known that programs and activities are not yet focused on reaching 29.623 programs and 263.135 activities, personnel spending reaches 32,4% of the APBD and regional infrastructure spending is only 11,5%; (4) The use of alternative financing is limited,

it can be seen from the PPP that is not optimal, regional loans are only 0,049% of GDP; and (5) central regional fiscal synergy is also not optimal or in other words there is a mismatch between central and regional programs.

Transfer funds for local governments have been allocated in the state budget for more than two decades. Along with its development, the types and amounts of transfer funds have improved and increased, especially since the implementation of fiscal decentralization in 2001. The development of transfer funds can be seen in Figure 1 below:

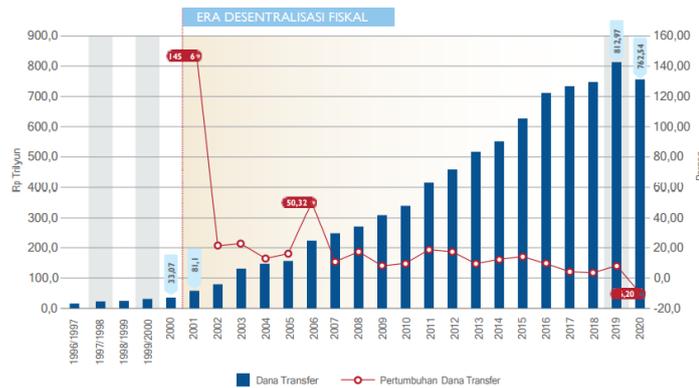


Figure 1. Development of Transfer Funds in 1996-2020

Source: Ministry of Finance Republic of Indonesia (2021)

Figure 1 above shows the exponential increase in Transfer Funds at the start of the implementation of fiscal decentralization until the COVID-19 pandemic hit. It can be seen that in 2001 there was a very high amount of transfer funds amounting to 145,06% from IDR 33,07 trillion in 2000 to IDR 81,05 trillion in 2001. The amount of transfer funds before 2001 was still very small with an average of IDR 24,77 trillion (1996-2000). In the two decades of implementing fiscal decentralization, the amount of transfer funds increased significantly from IDR 81,05 trillion in 2001 to IDR 812,97 trillion in 2019 and decreased slightly in 2020 to IDR 762,54 trillion.

Based on the data above, the conclusion that can be drawn is that the role of decentralization is quite large. Nevertheless, the resulting impact is less able to overcome the socio-economic problems of the community in certain areas. This conclusion is not much different from the study produced by Siburian (2021) using empirical data in Indonesia, the results of his study show that there is a link between fiscal decentralization and regional disparities. Hariani RS (2018) also tries to emphasize that there should be independent oversight and stricter policies on transfer mechanisms to the regions. According to him, the money follow function principle that has been applied so far proves that transfers to the regions are not in line with the decentralization agenda as they should be. As many as 31 government affairs or 70% were handed over to the regions, while in terms of the proportion of the budget transferred it was still around 30% (Hariani RS, 2018). In fact, previous studies have shown the role and contribution of the decentralization system in reducing the disparities that have existed between regions (Kim & Samudro, 2017; Sidig, 2018; Sudhipongpracha & Wongpredee, 2017; Talitha et al., 2019). However, interesting and recent findings also show different things, where increased fiscal decentralization actually increases inequality and even corruption (Fatoni, 2020; Maria et al., 2019; Puspasari & Suwardi, 2016; Syarif & Saleh, 2017; Utami, 2018). Therefore, we also explored and found a number of facts which also show that the implementation of fiscal decentralization tends not to be carried out conceptually and has even become a means for interested parties to abuse their authority to the detriment of the state.

To take a closer look, agency theory is quite able to help us reach this fact, because it creates positive things in the form of decentralized budget efficiency. However, this agency theory is often considered to have negative things in the form of opportunistic behavior (Siswati, 2019). He also added that opportunistic behavior is behavior that tries to achieve what it wants by all means even illegally, because it can cause principal-agent relationships that occur in a contract eventually leading to adverse selection (hiding information) and moral hazard (abuse of authority).

Moral Hazard

In this section, we share the main points about moral hazard, which occur in the private and government sectors. The rate of economic growth of a country is of course triggered and accelerated by regions in a country. The role of companies and communities in supporting a country's economy is very significant, so it is important that we highlight the moral hazard that often occurs in the private sector.

The global financial crisis that hit the world in 2008 was triggered by moral hazard behavior from actors in banking companies (Basri, 2018). At that time public trust in banks continued to decline and withdrawals of public funds from banks increased. Moral hazard arises because of the separation between company managers and agents. The owner cannot directly observe the policies carried out by management (Rahmawati, 2018). In addition, according to Tian (2007), the main cause of moral hazard actions is efforts that affect the level of production of agents but also create disutility for agents. Similar to the moral hazard that exists in companies, in the public sector it is also possible for non-compliance to cause moral hazard to occur (Simanjuntak, 2005; Yuhertiana et al., 2015). Moral hazard actions can be found through findings of non-compliance in audit reports (Pamungkas et al., 2019), or with terms that are often referred to as fraud. In Indonesia, there are a number of studies which suggest that there are quite a number of non-compliance findings in local government audit reports, especially during the implementation of the decentralization system. The Association of Certified Fraud Examiners (ACFE) Indonesia Chapter 2019 study revealed fraud with the most cases, where the highest losses reached more than 373 billion. Furthermore, the perpetrators (fraudsters) of corruption are State Civil Servants (ASN) who work in local government agencies (Tarjo et al., 2022).

Decentralization does not necessarily guarantee better results, because there are several factors that can sometimes be generated such as waste, corruption and inefficiency (Baltaci & Yilmaz, 2006). However, the greater the authority and financial capacity possessed by local governments after decentralization, it can also be stated that the quality of good services has also increased. This condition will occur with the assumption that public and administrative policies owned by local governments are well organized. Regional government policies and APBD must work integrally to overcome economic problems, because they are a driving factor for high or low levels of economic growth that occurs in the regions (Hikmah & Sugiharti, 2022). This good system certainly occurs when there is law enforcement or the rules of the game are well organized. That way, agents in the regions show good quality as well. This good quality can be indicated by the existence of law enforcement, the existence of accountability procedures that can reduce or even eliminate abuse of authority. This is very important for all levels of government to know as parties who are directly or indirectly responsible to the community, because the source of funds used by the government in running the government actually also comes from the community (Fatoni, 2020).

When these conditions are met, the implementation of regional autonomy will realize a better division of labor among the regions so that work in providing services and providing public goods as well as carrying out development expenditures will be better because the work carried out is in accordance with local needs and capabilities, and in the end corruption can be minimized. Moreover, local governments are often vulnerable to fraud risks and are considered to be less transparent in accessing information (Tarjo et al., 2022).

Kyriacou & Sagalés (2008) argue that decentralization can improve the quality of governance in various ways. First, with decentralization, it becomes easier for local governments to obtain information about their constituents, so that local governments can provide more satisfaction to their people in providing public services and carrying out regional requests. Second, local residents more easily receive information about the activities carried out by the local government (PEMDA), thus it is easier for constituents to control so that it is also easy to provide rewards and punishments to local governments while directing the course of government to be better. Third, when the fiscal is decentralized by establishing flexible and competitive authorities, it is hoped that local governments will be able to provide public goods more efficiently or more responsively to demand and at lower costs and also create lower levels of corruption in the regions.

Fiscal Decentralization in Minimizing Potential Moral Hazard

Moral hazard occurs when there is an abuse of authority from the public interest for personal gain. Misuse for personal gain is officially defined when employees accept, promise or accept bribes. It is also abused when employees actively offer to accept bribes to carry out policies and processes in the interests of competitive advantage and economic advantage. Moral hazard is much more pronounced when the compensation given to members depends on the team rather than the productivity of the members themselves. Empirical evidence found that when a team is compensated as a team, the social processes that occur tend to result in moral hazard problems. Another problem hindering the goals of implementing decentralization is the lack of institutional

oversight and scrutiny at the local level. These limitations create opportunities for government officials to exploit the budget for personal gain (Alfada, 2019).

Nevertheless, through decentralization, the phenomenon of moral hazard and corruption cases can be reduced as long as the oversight function can run optimally. The more centralized government authority is, the more centralized the power will be, and this can result in a tendency to commit corruption. With decentralization, corruption has decreased. On the other hand, there are many empirical studies which show that the more decentralized the *marginal propensity to accept bribery* increases, the more corruption grows when decentralization takes place (Alfada, 2019; Maria et al., 2019). If the local government has greater capacity constraints than the central government or has an inaccurate system of reporting and accounting, or has contributed to a system of government that is less open and has less criticism from its opposition, then decentralization tends to make corruption more rampant. In this condition, there is far less corruption at the center than the level of corruption that has increased in local government. The facts shown in Alfada (2019) are actually very worrying, where Indonesia consistently scores low on the Corruption Perceptions Index (CPI).

According to Pradipto (2009), the source of corruption is caused by various things: First, there is information asymmetry so that it is exploited by opportunistic behavior by carrying out moral hazard and adverse selection. Second, the lack of incentives to enforce the law results in a weak rule of law. Consciously or not, such immoral acts certainly have a negative impact on the economic growth of a region. The agendas that are expected to eradicate poverty and overcome inequalities will eventually become increasingly difficult to achieve. That is why we are trying to emphasize that the implementation of fiscal decentralization must receive great attention from all elements and the community also needs to make this issue a discourse in preventing acts of corruption through very strict supervision. One of the important things that can be done by the public and can be widely educated is accounting skills. Another factor that often escapes our attention is how to understand the relationship between accounting systems such as financial reporting in the public sector and corruption discourse. In practice, weak accounting and financial reporting systems can undermine monitoring incentives and thereby reduce the benefits of decentralization in fighting corruption (Changwony & Paterson, 2019).

Several past studies have also tried to convince us to believe in the implementation of decentralization and view it as a preventive measure and a strategy for mitigating moral hazard. Radically, the study of Miao et al. (2021) further traces the relationship between moral hazard that occurs in the management of natural disasters caused by abuse of authority through the fiscal decentralization program. In his research, he hopes that fiscal decentralization will be able to overcome such disasters through more solutive budgetary political policies. Not much different from previous studies, Estache et al. (2016) attempted to investigate public policies made by the central and local governments whose goals conflicted with regard to water pollution control. His research considers that conflicting government policies are a moral hazard problem that must be overcome by optimizing coordination between the central and local governments through decentralization. In addition, the study Martinez-Vazquez et al. (2017) is more focused on the distribution of taxes from the central and regional government budgets which are considered complicated and cause moral hazard problems at various levels of government. Departing from this problem, the study concluded that to overcome the problem of sharing budgetary taxes between the central and regional governments, fiscal decentralization to political institutions and public policies should be reformed, designed and implemented better. Moreover, because the role of tax is present as a contributor to state revenue in Indonesia which is considered very important in the life of the state, especially in financing national development expenditures (Adikur & Imran, 2022).

The studies described above tend to be optimistic and even believe in the implementation of fiscal decentralization which is considered capable of dealing with moral hazard issues, and Indonesia is no exception. Nevertheless, case studies in Indonesia have focused more on the impact of fiscal decentralization on corruption cases, there have been few studies highlighting its impact on moral hazard specifically on the abuse of authority.

Conclusion

In order to avoid the problems described above, the function of the legislature must be corrected as soon as possible. Decentralization policies can be a double edged knife, can be both beneficial and detrimental. It has been described in the background and based on the findings of previous researchers that the role of state administrators, in this case the central and regional governments, greatly determines the effectiveness and efficiency of decentralization policies. Therefore, in our opinion, it is deemed necessary to have fiscal

decentralization through stricter political economy policies. Supervision and control must be strengthened by continuing to provide intensive assistance.

The most important and unforgettable of course is education in these areas. More education is also needed for the population in order to eradicate corruption or prevent moral hazard actions. Although not significant, the resulting coefficient shows that the greater the number of literate residents, the more they can make efforts to supervise the running of the regional government thereby not only boosting the economy of a region, but can also suppress efforts to commit corruption, because corruption itself is not only caused by a system that is not good is also supported by values that are born from a culture that is not good.

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