Institutionalising Hibah Grants in Indonesia

Discussion Paper

TECHNICAL REPORT

SMEC

Australian AID

Indonesia Infrastructure Initiative

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Maurice Gervais

Jakarta, August 2010

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ACRONYMS

APBN	National budget
APBD	Regional budget
Bappenas	National Planning Agency
DAK	Dana Alikasi Khusus – Special Grant
DAU	Dana Alokasi Umum – General allocation grant
DBH	Dana Bagi Hasil – Revenue sharing grant
Dana Penyeimbang	Transitional grant
DJPK	Directorate General of Fiscal Balance
DEKON/TP	Funding for deconcentration and co-administration functions
DPR	House of Representatives
DSF	Decentralisation support facility
GDP	Gross Domestic Product
GoI	Government of Indonesia
GR	Government regulation
Hibah	Capital grant
IDR	Indonesian Rupiah
IFF	Infrastructure Finance Fund
IGF	Infrastructure Guarantee Fund
Kabupaten	District
Kanwils	Sector ministry branch offices in the regions
K/K	Kabupaten/Kota
KMK	Ministry of Finance decree
Kota	City
MoF	Ministry of Finance
MoHA	Ministry of Home Affairs
MTEF	Medium-Term Expenditure Framework
MRT	Mass Rapid Transit
NGO	Non-governmental organisations
Pemakaran	The process of the creation of new regions
Peta kapasitas fiscal	Fiscal capacity indicator
PPI	Public private investment
RPJM	National development plan
RPJMD	Regional development plan
SOE	State Owned Enterprises
SOP	Standard operating procedures

EXECUTIVE SUMMARY

Indonesia's infrastructure challenges are very significant. The country needs to rehabilitate/build its economic infrastructure at a pace that overcomes decades of maintenance neglect, reduces the backlog of public infrastructure assets in poorly provided regions, improves the provision of public services in all regions and improves the competitiveness of the economy at home and abroad.

1. The infrastructure challenge. Since about 2004, the infrastructure challenge has prominently figured as a top GoI strategic priority. This priority has been maintained as a key objective of the 2009-2014 RPJM. Funding targets are very significant: - about IDR 1,429 trillions, an average 5 percent of GDP during the current plan period. About IDR 511 trillion is to come from the national budget. This target is achievable since the GoI already allocates about IDR 110 trillion to public investment, including about 28 trillion to regional governments through *DAK* and *ad hoc* capital grants. Also, Indonesia's improving sovereign debt rating is quite favorable and there are prospects that its sovereign bond rating will reach investment grade in the near future. This bodes well for an accelerated infrastructure improvement program since the country has the potential to mobilise the additional funding required at reasonable cost.

Indonesia has developed a comprehensive strategy to overcome the negative sentiment that has caused PPI funding to plummet in the wake of the Asian crisis. This effort is paying off and, although the level of investment has yet to be restored to pre-Asian crisis levels, significant progress is being made to strengthen pro-investor policies and market PPI projects.

The GoI is now phasing out a moratorium on regional government borrowing, actively promoting access to domestic capital markets by selected, credit-worthy regional governments, establishing the institutional framework for a domestic municipal bond market and revising national regulations for on-lending and on-granting (*Hibah Daerah* capital grants) of GoI funds to the regions.

The Jakarta Commitment has also set the stage for a better alignment of GoI and donors policies as well as for using the GoI's reformed budget management system as a vehicle for channeling funds to the regions and accounting for results.

But much has yet to be done to accelerate infrastructure development in the regions. "Big Bang" decentralised governance is recent. Capacities in the regions to undertake significant infrastructure initiatives remain constrained. The regulatory framework restricts initiatives: Indonesia has yet to institutionalise a multi-year budget framework that would support large investments in the regions. Multi-year contracting is not allowed, unless waivered by the Minister of Finance. The crack-down on corruption, while necessary, has induced risk-aversion by public officials and project managers, which contributes to slow down public investment effort. The relationships between the GOI and the regions remains very much top-down with the GoI seeking to direct investment priorities by the regions. The government has recently acknowledged that complex procurement requirements may have stifled investment spending and is poised to simplify and improve the regulation to adjust it to the skills set available in the center and in the regions.

2. Indonesia's conditional grant system. Regional governments depend excessively on GoI transfers to finance public services and investment. Regional taxes provide less than 16 percent of total regional revenues, with significant differences occurring among provinces (42 percent), cities (12 percent), and districts (6 percent). The overall transfer system has yet to achieve its full equalisation potential, as required by the constitution. And there are major differences between per capita revenues in resource-rich regencies, which are the major beneficiaries of *DBH* funding and highly populated, resource-poor ones, which depend mainly on *DAU* grants.

2.1 Unconditional grants. Indonesia's main grant, the *DAU* – which accounts for 70 percent of total official transfers - provides general funding to the regions and also aims at reducing horizontal fiscal imbalances. But its equalisation propensity has been eroded from the start because of transitional factors. With transitional elements accounting for more than 50 percent of the pool of DAU resources, the equalisation propensity of this grant is significantly mitigated.

The second largest grant, *DBH (Dana Bagi Hasil*) provides for the sharing of certain revenues, most importantly, derived from the extraction of oil and gas. – mineral extraction resource rent, tax and non-tax revenues on oil and gas extraction, forestry and fisheries taxation, payroll taxes and taxes on property and property transfers. This grant accounts for about 25 percent of total transfers. Because it rewards resource-rich regions, this grant is basically dis-equalising.

2.2 Conditional matching grants – the DAK. Indonesia's only official conditional matching grant, the *DAK* (Dana Alokasi Khusus) was introduced in 2003, with a small pool of funds covering 5 sectors and allocated to about 350 kabupaten/kota. In 2010, *DAK* grants had increased tenfold but average nominal grants only doubled in size and, in real terms, remained at the same level as in 2003. The reason is the increasing fragmentation of *DAK* grants caused by a three-fold increase in sectors eligible for funding and sharply rising numbers of beneficiary regions.

2.3 DEKON/TP funding. GoI sector ministries have provided additional funding for regional government functions under the heading of *DEKON/TP* funding. This type of funding is admitted under the Fiscal Balance Law, but it is designed to finance deconcentrated and co-administration functions delegated by the GoI for implementation by the regions. Under this heading, a new type of grant has emerged consisting of cash support or *ad hoc* investment initiatives. In some policy areas – education, health, community services – the extra funding provides support for national programs linked to the achievement of Indonesia's MDG goals. Recognising that *ad hoc* grants of this type contributes to soften budget constraints, the Fiscal Balance Law requires that DEKON/TP funding which finances regional government functions be converted into *DAK* grants. While progress has been achieved, new investment initiatives crop up occasionally. As well, generous APBN funding of routine expenditures, notably in the education and health sectors has yet to be converted into official grants, in part because a MoF decree that restricts the use of *DAK* grants to funding physical activities.

2.4 Substitution effect. There is evidence that generous supplementary finance provided through *DAKs* and *DEKON/TP* funding has induced a "substitution effect", meaning a shifting of fiscal resources away from assisted sectors and activities. This appears to have happened to a significant degree in the education sector.

3. Institutionalising an effective capital grant system. In light of this background, efforts to institutionalise an effective *Hibah* capital grant system will be a major challenge:

- Without exception, funding for the regions has always been decided in a top-down fashion – Inpres grants before decentralisation, formula-based grants since then and *ad hoc DEKON/TP* funding. Adopting a grant system which is more demand-driven will be a major paradigm shift and will be difficult to accept by central government ministries and agencies.
- The regions have come to expect that they are entitled to GoI capital grant support, with few conditions attached and little counterpart funding provided.
- There is little appetite in the regions to borrow for their investment needs.
- The political economy of allocating investment grants has become more challenging. The recent "push" by the DPR and the DPD to influence grant allocations through "aspiration funding" shows that there is little appetite among political actors in the centre for a formula-based system which reduces the scope for discretionary decision-making.
- On the other hand, the regions prefer a transparent formula-based approach which provides more predictability in the access of fiscal resources and more transparency in allocations.
- There is little experience in the GoI in managing a full demand-driven grant system. Hibah grants are a recent innovation and the capacity needed to support an effective capital grant system in the GoI has yet to be developed.

3.1 The conceptual framework. The body of fiscal decentralisation theory regarding grants mostly focuses on the design of equalisation grants and neglects capital grants as an area of research. International practices in the use of capital grants in OECD and developing countries alike presents a large variety of practices, all of which are very specific to country situations. While this may not be very helpful since none of the practices may usefully be imported in Indonesia, some of the features of significant country cases provide useful insights for the design of an adapted capital grant system in Indonesia.

One reason which explains the difficulties to find good models is that most decentralised countries have three tiers of government – central, provincial and cities/districts. Transfers usually transit through provinces/states, which then reallocate resources to local governments. Under such arrangements, the national government wholesales grants to states/provinces, which then retail allocations to cities and districts. Using such a layered approach is not feasible in Indonesia, where the relationship between the center and cities/district is direct.

Another significant difference is that most states and local governments borrow to fund their investment needs, which reduces the need for capital grants. In the USA and Canada, the market determines the volume and conditions under which regional governments may access borrowed funds. Because of this, effective capital grant systems are quite rare and cater to very special needs.

From a comprehensive review of theory and country cases we have derived three possible models for a centrally managed capital grants system:

- A formula-based approach that can be used for all or for specific categories of regional investments. South Africa is currently introducing such a grant system to fund capital investments which targeted to achieve constitutionally mandates public service objectives.
- A categorical block grant approach, where categories of investments are targeted and some choice is left to sub-national governments on what initiatives will be undertaken within the allowed categories. The UK's formula-based grant aimed at funding affordable housing represents an advanced model of such a grant. The USA and Canada have are leading the effort to progress from project funding to categorical block grants.
- A project-by-project demand driven system, where investment proposals are submitted for funding by provinces/states or, in some cases, by the central government. A well documented example of such a grant is Australia's 'Black Spot' road safety program which has limited funding available and is fully competitive.

All three approaches have strengths and weaknesses and their application in both OECD has been uneven and, in some cases, have encountered problems. The bottom line is that there are no "perfect solutions" that Indonesia could import and adapt from other country experiences.

3.2 Eligibility and pre-qualification. How the grant system deals with the issue of access to grant funding is critical to the success of any of the systems proposed above. The failed experience of the DAK to focus funding in resource-poor regions that highly depend on DAKs to fund their investment programs provides an object lesson on the pitfalls to avoid in designing a fiscal capacity indicator. The DAK eligibility formula was basically flawed at the outset. It included two factors which mutually offset each other in ranking the regions' access to DAK funds. It also sought to exclude access in a country where the political system emphasises inclusiveness. Not surprisingly the political economy of DAK allocations has resulted in providing access to all regional governments, irrespective of their fiscal endowments. And this result risks to be carried over to Hibah, if a better approach fails to be developed.

Even if a robust debt capacity indicator could be developed, its use in determining eligibility for capital grants will remain a politically charged issue simply because all regions believe that they are now entitled to a share of the grant 'pie'. There are two basic options that should be considered:

- Use the fiscal capacity indicator to 'draw a line in the sand', so to speak, and, as a result, select those regions which will be eligible for grant funds. This will surely challenge the political economy of grant allocations, particularly if a project-by-project, demand-driven system is adopted.
- Allow all regions to access the grant facility but use the fiscal capacity indicator to benchmark their contribution to total project costs - the differential counterpart funding approach, which is allowed under the DAK grant system but has yet to be used. Under this approach, resource-rich regions would receive a much reduced share of grant funds as a share of total project costs, with the difference being made up by their own contribution as well as by loans provided by the GoI through its on-lending facility.

3.3 Dealing with the substitution effect and the use of matching funding. The substitution effect presents a key risk factor in the context of a conditional grant system since it undermines 'additionality'. There is very little that can be done to offset the substitution effect except to use matching requirements creatively to ensure that expenditure effort by the regions in targeted activities are maintained in part or in total.

In a demand-driven, project-by-project capital grant system, the substitution effect may not be a major issue, to the extent that the funding provided will target specific investments which the regions would be unable to undertake with their own funding. If a formula-based system is adopted, then a more aggressive use of counterpart funding may be required. And, whatever the choice of systems, if resource-rich regions are allowed to access grant funding, then a more creative approach towards requiring counterpart contributions by the regions may be warranted to ration grant funding to resource-rich regions.

3.4 Big projects and the constraints posed by the annual fiscal cycle. The current annual fiscal cycle does not provide much scope for undertaking significant investment projects that may require several years to be completed. Under the DAK system, all GoI funding needs to be consumed in one year.

Hibah capital grants are targeted to new investments, which need to be planned in advance of the budgeting cycle and may require several years to be completed. Understandably, the regions will be reluctant to undertake multi-year investments under an arrangement where the central government's firm commitment to provide funding lapses at the end of each fiscal year and the funding available cannot be rolled over to the following fiscal year.

3.5 The way forward – options for an effective hibah grant model. So far, a firm decision on the key features of the Hibah system has yet to be confirmed. This report advocates the adoption of a two-track system for Hibah:

- The use of a formula-based, categorical block grant approach to allocate the bulk of Hibah grant support to the regions. This would target district and municipal infrastructure which is standardised as to content and costs.
- A project-by-project approach for very large, complex, investments that cannot be accommodated within the block grant approach. This would include major urban investments – such as large urban transit systems, regional watershed management initiatives, and the like, which are very specific as to content and costs and require complex financial backing. This type of approach would also be used to manage donor-funded activities, both Hibah grants and donor on-lending operations.

The proposed two-track system would then allow to minimise capacity building needs while recognising the need for a project-by-project for large, complex investments. The system will also require the development of robust fiscal capacity indicator to be used to benchmark regional government counterpart funding requirements. The indicator will be used as a benchmark to reserve capital grants for resource-poor regions or to benchmark counterpart funding requirements.

4. Capacity building needs. Capacity building needs in both the central government and the regions are very different depending on the system which is adopted.

4.1 Current status and immediate requirements. After more than six months of effort, a number of components of a future Hibah grant system have been developed, notably, a detailed SOP which covers contracting, fund channeling and, to a lesser degree, monitoring. However, the SOP has yet to develop the front end of the system, the practice of allocating grant awards and integrating funding support in the APBN. This will be a major activity in the immediate future, as decisions are made on the Hibah grant model. Significant effort will also be made to improve the amended draft government regulation (GR 57) and harmonise the regulation concerned with on-lending (GR 54). Follow up work will be focused on developing the engineering of the system, through support provided to draft a ministerial decree on Hibah. As well, an effort will be made to develop an effective fiscal capacity indicator, to be introduced in 2011.

Should the GoI firm up a decision regarding a formula-based approach, much effort will be required to conceptualise, develop and test options for an allocation formula. This is a critical requirement and cannot be done expeditiously. Getting the formula wrong had significant fiscal as well as political economy implications as illustrated by the experience over the last ten years in Indonesia. And, where there are no optimal solutions available, second-best solutions may allow breathing space for improving on results over the medium-term.

4.2 Medium-term capacity building needs. Once clarity has been achieved regarding the major options, it will then become possible to scope out the main areas where capacity building support will be needed, assess organisational and human development requirements and conceptualise the IT system required to manage the transactions and documents needed to institutionalise Hibah.

CHAPTER 1: THE INFRASTRUCTURE INVESTMENT CHALLENGE

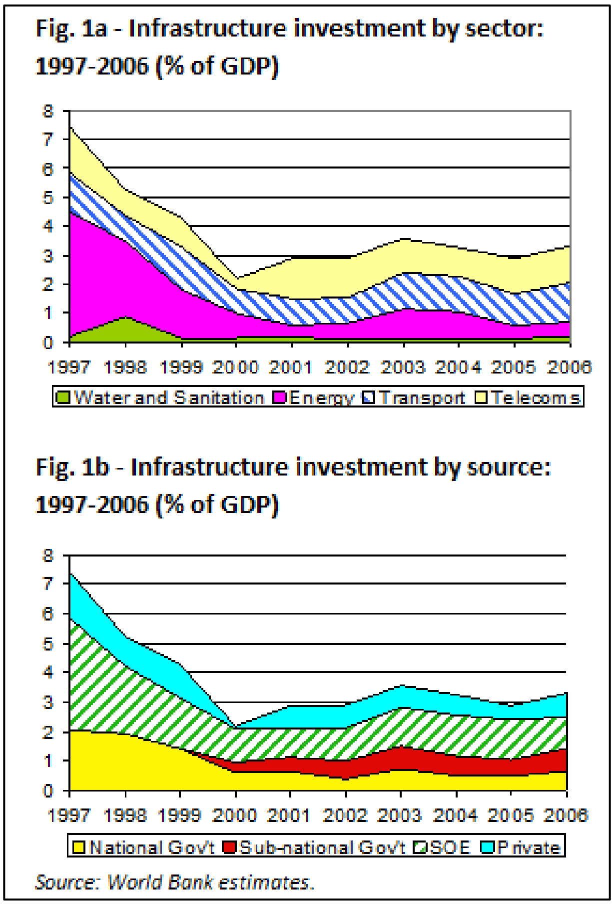
This chapter reviews key issues regarding Indonesia's infrastructure challenge during the next five years. The objective is to highlight the GOI's infrastructure investment strategies in light of developments in infrastructure finance since the crisis of the late 1990s, recent developments, roles of the various stakeholders and the constraints faced by the GOI and regional governments to participate and fund infrastructure development.

1.1 THE CHALLENGE – ACCELERATING INFRASTRUCTURE INVESTMENT

The infrastructure development challenge in Indonesia is very significant. Indonesia's needs to build infrastructure at a pace that: (a) overcomes decades of neglect of maintenance of the stock of public assets, at all levels of government; (b) reduces the backlog of public infrastructure assets in poorly provided regions; (c) reduces the high cost of production and exports; and, (e) improves the provision of public services in all regions.

Figure 1 - Infrastructure Investment by Sector: 1997-2006

(% of GDP)



The impact of the Asian crisis of the mid-90s. The country has yet to recover from a significant decline in investment effort since the onset of the fiscal crisis of 1997/98, as illustrated in **Figures 1a and 1b**. Prior to the crisis, investment in infrastructure had reached about 7% of GDP. The economic crisis of 1997/98 provoked a sharp downturn in infrastructure investment which fell to 2% of GDP in 2000. All key infrastructure sub-sectors (energy, telecommunications, transport, water and sanitation) were affected by the crisis, with the most severe contraction occurring in the energy sector.

Furthermore, investment in the water and sanitation sectors, which had received much support from the IFIs, virtually collapsed from 1 percent of GDP in 1998 to nil in 1999, with little progress achieved thereafter. Since 2000, the overall level of investment has progressively recovered but has yet to reach pre-crisis levels. Comprehensive figures are only available to 2006 and show investment recovering to about 3.5 percent of GDP, half the pre-crisis levels.

Since 2000, the most dynamic surge in investment has taken place in telecommunications, following the liberalisation of the cellular phone industry and the surge in demand for internet services. Next-in-line is a recovery of investment in transport, notably roads and bridges, likely spurred by investment activities in the regions and number of large projects funded by the GOI. Investment in toll roads has been gridlocked, notably because of difficulties experienced in acquiring land and rising land prices. Mainly for this reason, a number of contracts awarded to toll road operators have failed to be implemented.

Figure 2 - Infrastructure Investment by Source: 1997-2006

Fig. 2a PPI investment (USD billions)

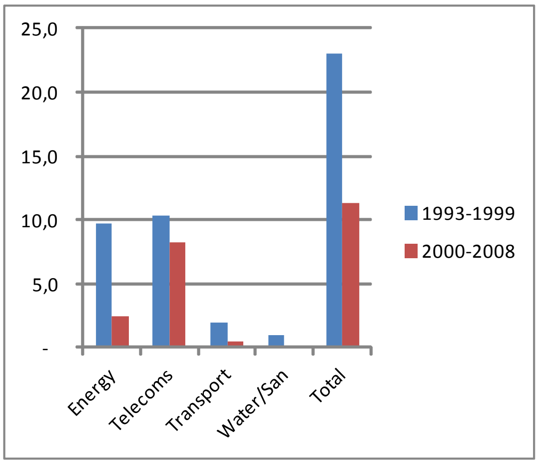
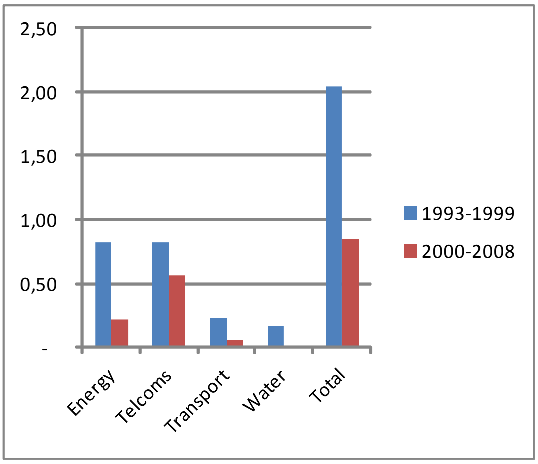


Fig. 2b. PPI investment - percent of GDP



Source: World Bank PPI database

Private investment in infrastructure (**Fig. 2a and 2b)** virtually declined to zero between 1997 and 2000 and has been slowly recovering ever since, with investment concentrated in telecommunications. Investment by SOEs, notably in energy, fell significantly, from 4 to about 1 percent of GDP and has since been recovering. The share of investment funded by the GOI dropped 50 percent between 1997 and 2000, from 2 percent to less than 1 percent of GDP. In 2006, GOI's share had not increased significantly from its low in 2000, in spite of improvements in the fiscal position. However, since the GOI has, since 2001, been funding most investment in the regions through general and conditional transfers consolidated government investment has been maintained to about 1 to 1.5 percent of GDP since 2000.

1.2 PUBLIC FINANCES AND INFRASTRUCTURE INVESTMENT

1.2.1 Goi Fiscal Constraints

Till about 2005, the GOI's key objective was to achieve fiscal consolidation – reducing the debt overhang resulting from the cost of recapitalising the banking sector and reducing inflation to manageable levels. During this period, "Big Bang" decentralisation was initiated, resulting in the allocation of significant fiscal resources to regional governments through formula-based transfers. Efforts to reduce general subsidies were undertaken, partly offset by the need to provide temporary relief to the poor to dampen the effect of reducing subsidies. Since 2005, significant fiscal resources were also allocated to establish and improve a number of social protection programs aimed at improving access to the poor of essential public services (education and health) as well as providing investment resources to empower local communities. In spite of efforts to reduce subsidies, rising commodity prices (oil, food) have obliged the GOI to maintain subsidies at a high level – more than IDR 100 trillion in 2010. Buoyant oil prices have a negative result on the GoI's fiscal space, owing to formula-based *DBH* grants and general fuel subsidies.[1]

Table 1: Composition of GOI Expenditure 2010

Table 1: Composition of GOI Expenditures : 2010	% of Exp.	% GDP
Non-discretionary:	**79,2**	**13,9**
Personnel and pensions	15,3	2,7
O&M, materials, BLUs	10,2	1,8
Interest on Debt	11,0	1,9
Subsidies	22,4	3,9
DAU, BDH, D. Otsus transfers	20,3	3,6
Discretionary	**11,2**	**2,0**
of which:		
GOI investments	7,8	1,4
DAK and Hibah	2,7	0,5
Adjustment regional transfers	0,7	0,1
Total	**100,0**	**15,9**

Source: MoF

Table 1 shows the composition of GOI expenditures in 2010, classified into non-discretionary and discretionary expenditures. Non-discretionary expenditure items reflect major inertia: the difficulty of adjusting the size and composition of the civil service owing to existing civil service rules; entitlements such as general subsidies that are difficult to phase out; interest on the public debt that cannot be trimmed without endangering the country's credit-worthiness and its access to capital markets; and, legally enabled formula-based transfers to the regions that are linked to revenues. An important conclusion emerges: out of a budget of IDR 1,189 trillion, 86 percent consists of

[1] See World Bank Policy Research Working by 4718 Cut Dian R.D. Agustina Javier Arze del Granado, Tim Bulman, Wolfgang Fengler, Mohamad Ikhsan: "Black Hole or Black Gold?, The Impact of Oil and Gas Prices on Indonesia's Public Finances", September 2008.

programs that are non-discretionary, i.e., where the GOI is locked into expenditure patterns that are not amenable to changes in the short-term. The remaining 12 percent includes investments by the GOI as well as capital grants to the regions (DAK and Hibah) and transitional transfers (*Dana Penyeimbang)* which is a fund that allows transitional adjustments required to implement the GOI's regional government transfer policies (such as phasing out "hold harmless" allocations).

While the above rigidities constrain the ability of the GoI to shift resources for additional investment, the funding objective totaling IDR 511 trillion over five years is achievable: total investment funding, including *DAK* grants in 2010 amount to IDR 110 trillion. Accelerated GDP growth and continued effort to reform the tax system will likely improve the situation. And, Indonesia's capacity to mobilise additional funding in domestic and international capital markets at reasonable terms is adequate, with the prospect that the country's sovereign debt ratings will reach investment grade in the near future. Thus, the supply of funds needed to support a program of increased on-lending and on-granting of fiscal resources to the regions does not appear to constitute a major obstacle. The major problem lies elsewhere: significant absorptive capacity constraints, much of it self-imposed by complex regulations and budget processes and significant underfunding of resources available for investment in resource-poor regions.

1.2.2 Regional Government Finances[2]

Regional governments also face significant constraints in financing investments. **Fig.3** summarises expenditure patterns in Kabupaten/Kota during the first five years of decentralised governance – 2001 to 2005.[3]

[2] Comprehensive information on regional government finances, including detailed breakdowns of expenditures by functions is not generally available. The MoF directorate charged with collecting the data which manages the *SIKD* system is swamped with masses of data, mostly in paper form and much of the data of dubious quality, in light of the few regions that receive a *BPK* stamp of approval. Since 2003, when *Pemendagri* 29/2009, came into effect, the accounting classification of functions were changed. Further changes were promulgated under *Kempmendagri* 13/2006, the current accounting standard. The difficulties encountered by *SIKD* to reconcile those changes coupled with difficulties experienced by the regions to adapt to those changes has resulted in data series that are difficult to reconcile over time and, because of the mass of the data that cannot be treated electronically by *SIDK,* cannot be used for analytical purposes. In effect, with the exception of an effort made by the World Bank to collect relevant data for analysis, as part of its 2007 Public Expenditure Review, there is no other comprehensive information available on regional finances since 2005, except for the tons of paper reports that threaten to collapse the building in which they are stored.

[3] Detailed functional breakdowns of regional expenditures are not available after 2005.

Notable features are:

- The share of investment in total expenditures has increased slowly by 5 percent in five years.
- The share of wages in routine expenditures declined slightly in 2002 and 2003, only to increase again to 71 percent in 2005.
- The share of investment in social sectors declined – 34 to 18 percent. Investment in administrative buildings and equipment rose from 19 to 30 percent, driven by mostly by *Pemakaran.*[4]
- Infrastructure investment also increased its share by 5 percent in 2005, compared to 2001, most likely focused in maintaining and rehabilitating roads, bridges and irrigation systems rather than new additions to the capital stock.
- Investment in support of directly productive activity (agricultural extension services, in particular) dropped in importance – from a share of 10 percent to 5 percent over the same period.

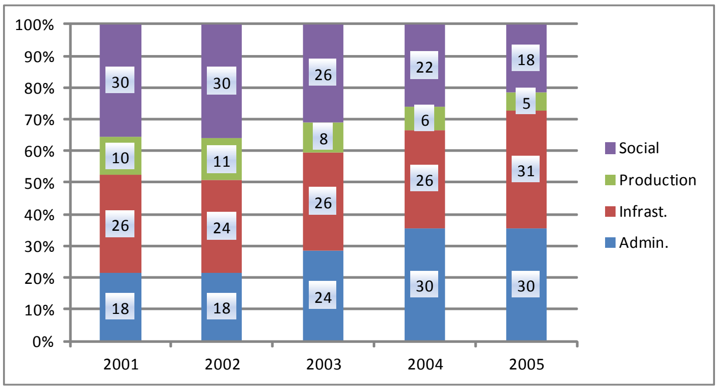
Figure 3 - Expenditure Patterns in K/Ks: 2001-2005 (Percentages)

Fig. 3. Expenditure Patterns in K/Ks: 2001-2005

(Percentages)

Aggregate indicators	2001	2002	2003	2004	2005
Development/Total Exp.	31%	35%	37%	33%	37%
Personnel/Routine	73%	68%	69%	72%	71%
Administrative/Development	18%	18%	24%	30%	30%

Development expenditure patterns (Percent of total devt. spending)



Source: World Bank Indonesia 2007 Public Expenditure Review

Data on regional government investments after 2005 have been compiled and analysed in a report produced by the Decentralisation Support Facility (DSF) for the Ministry of Finance.[5] The report does not provide data by regional government

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[4] According to the Minister of Home Affairs, 225 new autonomous regions have been created since the initiation of decentralized governance in 2001 and there are 50 others waiting to be approved by the DPR.

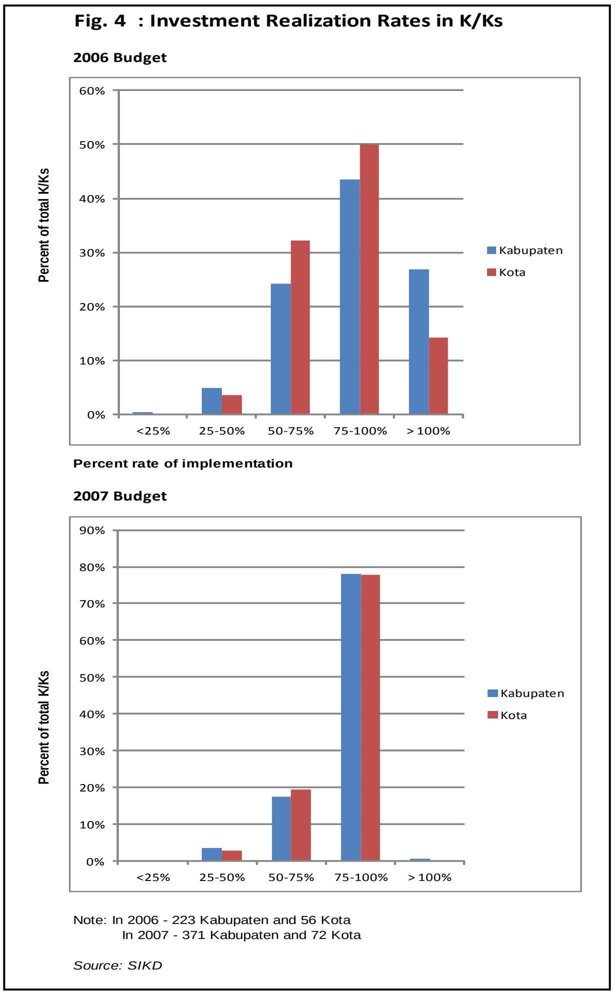
[5] Andre Oosterman, *"Regional Government Investment in Public Infrastructure in Indonesia"*, Decentralization Support Facility, June 2009.

function but it breaks down the data by type of investment (land, buildings, roads, bridges, irrigation networks and financial investments). The report provides evidence of a surge in regional investment which occurred in 2006 and, to a lesser extent, in 2007, in the wake of a sharp rise in transfers (DAU and Dana Bagi Hasil), as well as rapidly increased DAK funding. However, this increased investment effort may not have been sustained in 2008 and 2009, as the level of grant funding stabilised in nominal terms and declined in real terms. One interesting conclusion of the DSF report is: best performing regions invest more in fixed infrastructure assets while lesser performing regions invest more in equipment, including vehicles, office equipment, computers and the like.

1.2.3 Absorption of regional investment budgets

The rate of completion of investment programs in the regions has consistently been less than planned amounts. The latest comprehensive data available for 2006 and 2007 shows a deteriorating trend (85 percent in 2006 and 79% in 2007). This may be attributed to the following factors: in 2006, regencies planned investments in light of past levels of income, including DAK grants, although DAU funding available in 2006 rose dramatically. In 2007, planned investments were much more ambitious, reflecting higher anticipated levels of revenues and significant budget surpluses acquired in 2006. Overall, the track record for the completion of investments is quite remarkable, and appears to exceed the performance of the GoI. A review of APBD budgets in 2006 and 2009 shows that planned investments as a percentage of total expenditures peaked in 2007 (31 percent), declining to 27 percent in 2009. **Figure 4** also shows that the percentage of K/Ks realising 75%

Figure 4 - Investment Realization Rates in K/Ks



of their budget plans increased significantly, as shown by the concentration of regions achieving 75 percent or more of their budget plans.

While there may be a number of reasons for underacheiving investment targets, the most important appears to be the late start of budget implementation in the regions owing to a complicated budget process, coupled with the late announcement by the GOI of firm commitments regarding the allocation of the various grants. In particular, the introduction of new rules for the preparation of budgets in 2007 under Permendagri 13/2006 added at least one additional month needed for the final approval of budgets. Budget preparation rules were then simplified under Permendagri 59/2007, which may have contributed to improve the situation.

1.2.4 Constraints resulting from the absence of a multi-annual planning and budget cycle

The current annual budgeting cycle coupled with constraints placed on multi-year contracting, places severe constraints on the regions' incentives to plan ahead. It also forces the regions to absorb all investment resources provided by the GOI in a single fiscal year, although the regions may retain surplus funding for further use. This limits the size of the capital transfers provided by the GOI through DAK grants, to small investments that can be implemented in a short time frame, which, in turns leads to the fragmentation of the capital grant system.

The GOI is moving towards the introduction of an MTEF framework for the central government that will be implemented in 2011. It is expected that the system will be generalised for all departments in the GOI. In 2012, the GoI intends to introduce a multi-year budget planning framework for transfers. If coupled with a relaxation of constraints regarding multi-year contracting, this will facilitate the introduction of multi-year capital grants in the GOI. The framework will cover a four year cycle. As well, MoHA will soon be issuing a decree which will regulate planning and its links to budgeting. The new framework will introduce MTEF in the regions, but planning period will be five years instead of four years in the GOI. The five-year cycle is required since it must coincide with the duration of the *RPJMD*, which is subject to be approved by regional legislatures, unlike the *RPJM* in the GOI, which is a Presidential plan. How the regional system works and what flexibility will be allowed, notably to introduce unplanned projects and activities, will be critical to the operation of a demand-driven capital grant system. This issue needs to clarified by MoF and Bappenas, before final approval of the regulation by the Minister of Home Affairs.

1.3 GOVERNMENT STRATEGY FOR RAISING INFRASTRUCTURE INVESTMENT: 2010 TO 2014

1.3.1 A comprehensive strategy

Since 2005, the GOI's has evolved a comprehensive strategy to strengthen the country's infrastructure.[6] In the central government and the regions, efforts have been made to market infrastructure projects to domestic and foreign investors, through international conferences in 2005 and 2006. A fast track program to increase energy production capacity was successfully launched and a second phase program is being initiated, which will, among other objectives, seek to accelerate to develop clean geothermal sources of electricity production. Significant investments have been undertaken in the transport sector, including, re-launching the MRT project in DKI Jakarta. A strategy is being developed to overcome obstacles to investing in urban water and sanitation initiatives, gridlocked because of the debt arrears problem. New initiatives are being undertaken to overcome the backlog in the treatment of wastewater and rural/urban sanitation facilities. Solid waste management issues are also being addressed.

Investment targets for the 2010-2014 period are ambitious – equivalent to about 5 % of GDP, or some IDR 1,429 trillion. IDR 511 trillion would come from the state budget and 401 trillion, from the private sector.[7] Private sector investment in infrastructure would thus represent about 1% of GDP over the next five years. Assuming that SOEs contribute an additional 0.5% of GDP, this then means that consolidated GOI and regional government investment would require funding of about 3.5% of GDP, to achieve the target.

Total consolidated government investment in 2010 amounts to about 1 percent of GDP for the GOI and about 1.5 percent of GDP for the regions. But this figure covers all public investments, including administrative infrastructure and investments in the social sectors. Assuming that of this total about 75 percent represents infrastructure investment, the investment effort by all governments combined would stand at about 2 percent of GDP, leaving a gap of about 1.5 percent of GDP in 2010. This additional level of effort should be achievable.

The key elements of the GOI's strategy are:

- Accelerating private sector investment in infrastructure
- Facilitating borrowing by credit-worthy regions to finance their own infrastructure needs
- Ensuring an improved alignment between donor funding and government infrastructure investment policies

[6] See Appendix 1 for a more comprehensive discussion of infrastructure investment strategies.
[7] Figures are quoted from the Jakarta Post: *"PII will get WB financial backing to guarantee projects"*, May 12th, 2010.

- Rationalising expenditure programs in the GOI by reforming the discretionary grant system (DAK and Hibah grants, rationalising DEKON/TP funding)
- Inducing greater participation by the regions in infrastructure investment

1.3.2 Accelerating private sector investment in infrastructure

The level of PPP investment in USDs and as a percent of GDP, has not yet recovered to levels achieved prior to the end 1990 economic and fiscal crisis. The GOI is developing an effective agenda for attracting private investment. Elements of this agenda include:

- Expanding the positive list of eligible sectors
- Introducing "one-stop-shop" processes to simplify and accelerate business licensing
- Reducing obstacles to land acquisition by the GOI and by private operators, through improvements in regulations and the establishment of a land bank approach to purchase land well in advance of investment activities
- Cancelling old contracts with private investors for toll road construction which remain unexecuted, agreed prior to the 1997/98 Asian crisis,. This will create space for new operators
- Improving costs recovery by enforcing a national policy of economic water tariffs in the regions and phasing out electricity subsidies for the middle class and medium-to-large corporations within two years
- Reducing constraints regarding bidding processes for PPI projects (such as the recent revision of Perpres 67/2005) to allow the GOI to conclude contracts with private operators where there are less than three bidders for a project
- Creating an Indonesian Infrastructure Fund Facility (IFF) and an Indonesian Guarantee Fund (IGF), which will help to provide for the participation of GOI funding in PPI projects and guarantee large PPP projects against excessive risk
- Improving the preparation of PPP projects that will be offered to private sector bidders

These measures all contribute to improve the policy and institutional setting for private sector participation in infrastructure investment at all levels of governments. Attracting private investors to help finance income-generating investment in the regions is one element of a total funding approach.

1.3.3 Borrowing by regional governments

Reducing the dependence by the regions on government capital grants by allowing regions to borrow for their investment needs constitutes another component of GoI's public strategy. The strategy consists of reducing the reliance by the regions on GoI capital grants (both DAK and Hibah) over time by encouraging them to undertake responsible borrowing. The borrowing strategy includes a revival of the on-lending mechanism for regions that are unable to access domestic capital markets directly, with a selective effort to graduate credit-worthy regions for market access. The GOI is also establishing a municipal bond market. The framework whereby the GOI on-lends funds acquired from donors and sovereign debt undertakings is being improved, through an amendment of GR 54/2005. Ultimately, as regions improve their capacity to borrow for their investment needs, the number of regions that depend on capital grants should be reduced. This will then allow the GOI to concentrate the scarce grant resources in resource-poor regions.

An interesting recent development is a decision by three state banks to provide loans to water supply units (PDAMs) for the development of urban water systems. Loans are expected to be provided to PDAMs that pre-qualify on a case-by-case basis. Pre-qualification requirements include the settlement of debt arrears with the GOI. The GoI has committed to subsidise loan conditions and guarantee the loans.

1.3.4 The Jakarta Commitment

In January 2009, an agreement was reached - the Jakarta Commitment – to which all donors subscribed. An important element of the GOI's funding strategy is to improve the alignment of donor funding policies with the GOI's development strategies and priorities. As well, the GOI is encouraging donors to make their funding more "fungible", less tied to specific projects and more flexible in terms of funding priorities and regional government support. The ultimate objective is that donors adjust their funding in line with the improved planning, budgeting, budget implementation, accounting, reporting and auditing systems, all of which are being reformed under Laws 17/2003, Law 1/2004 and Law 15/2004.

While the result may not substantially increase the amount of funding made available to Indonesia (lending ceilings in the IFIs restrict the scope for expanded lending to Indonesia), the Jakarta Commitment does place the GOI in the 'driver's seat' with respect to the targeting of donor support, the integration of donor programs in the transfer system, and the use of GOI and regional budget institutions to manage much donor funding. A number of bilateral (AusAid, for instance) and international organisations – all IFIs and the EU – are now adjusting their policies in alignment with the Jakarta Commitment and providing financial support as "fungible" program assistance.

The institutional underpinnings of on-lending and on-granting arrangements are being revised through the revision of GR 2/2005, which regulates the integration of donor funds into the national budget, GR 54/2005, which regulates on-lending and GR 57/2005, which regulates the channeling of donor grant funding through *Hibah.*

1.3.5 Making capital grants and on-lending more responsive to regional priorities

The GOI is moving forward to re-design both on-granting (*Hibah)* and on-lending systems to better reflect the need for responsive funding of infrastructure development in the regions. Both are components of Indonesia's intergovernmental fiscal arrangements, regulated under the Fiscal Balance Law of 2004 but their further development had been delayed for a number of reasons since decentralised governance was initiated. Capital grant funding was deemed adequate after DAK grants were introduced in 2003 and rapidly increased in volume thereafter. With the GOI moving to regain fiscal sustainability in the wake of the Asian crisis, it was considered prudent to impose a moratorium on regional government borrowing. The moratorium is now being phased out, reflecting the need for a more pro-active stance by the regions to strengthen regional infrastructure. The revival of *Hibah* capital grants and on-lending represents an effort by the GOI to introduce a more responsive, demand-driven approach to helping the regions fund their infrastructure needs. It also recognises that many regions are not credit-worthy enough to access funds from a domestic municipal bond market, which itself remains underdeveloped.

How this new approach is designed at the outset and becomes embedded in the medium-term is critical to supplementing a supply-driven, top-down transfer system with one that responds to regional needs for infrastructure funding. A well conceived and implemented capital grants system also constitutes an important development for the donors, which have endorsed the Jakarta Commitment but are hamstrung in supporting infrastructure development in the regions through the DAK grant system.

1.4 SUMMARY

Indonesia faces major financing issues in its efforts to conserve and improve its economic infrastructure. Compared to neighboring countries, Indonesia's infrastructure is inadequate and affects the country's competitiveness at home and abroad. Within the regions, the provision of public services is inferior in volume and quality relative to what would be expected of a rapidly growing middle income country.

Efforts are now being made to overcome a severe backlog in infrastructure investment, in part, caused by the Asian Crisis of the mid-1990s, and its impact on fiscal sustainability and private sector incentives. But the capacity of the country's public finances, both national and regional, to respond to the infrastructure challenge is constrained by expenditure patterns which are difficult to modify in the near term. And, even if the funds can be found, the capacity to absorb available funding is constrained by complex regulations and the and weak implementation capacity in the regions.

Private sector incentives for PPP programs have been affected by the Asian crisis and recent economic downturns in the global economy. Nonetheless, over the medium-term, Indonesia's performance in weathering the recent crisis together with efforts to accelerate GDP have contributed to boost investor confidence. Accordingly, the GoI is developing an ambitious infrastructure consolidation and expansion strategy, which includes measures to improve incentives for private sector investment, allocate a larger share of increasing revenues for investment to public sector infrastructure and improve the intergovernmental fiscal arrangements for a more responsive provision of capital grants and loans, which is important to elicit greater participation by the Indonesia's 550 regions in addressing the infrastructure challenge.

CHAPTER 2: INDONESIA'S CONDITIONAL TRANSFER SYSTEM

In this chapter, we discuss Indonesia's conditional grant system, both formal (*DAKs*) and informal (*DEKON/TP* or APBN funding). As opposed to unconditional grants, conditional grants provide additional financial support to the regions for specific purposes linked to their assigned functions, with the objectives being specified by the Government. We include DEKON/TP funding in this category of grants even though it is not a 'grant' as defined in Indonesia.

The objective of this review is to: first, state key principles that should guide the use of conditional grants, in a system dominated by unconditional transfers; assess the performance of the grant system in light of Indonesia's constitutional requirements of fairness and equity; and, review existing problems in the conditional grant system that should be taken into account when designing the Hibah grant system, which is meant to be demand-driven.

2.1 KEY PRINCIPLES TO GUIDE THE DESIGN OF CONDITIONAL TRANSFERS

Providing subnational governments additional funding through conditional grants in a system which is dominated by unconditional grants is difficult since it may induce adverse spending patterns. The rationale for additional support needs to be justified by the need to improve spending patterns to meet national policies and priorities, given that regional spending patterns that reflect "regional aspirations" may not adequately be aligned to national policies. Using this criteria the literature on fiscal decentralisation provides three main reasons for central government intervention:

- Achieving minimum service standards
- Addressing fiscal externalities (spillover effects)
- Containing incentives for fiscally-induced internal migrations of labor and capital

2.1.1 Achieving minimum service standards

If the central government imposes a policy of minimum service standards, it then has the obligation to target funding to regions which cannot meet these standards on their own – i.e., resource-poor regions. But the required standards may be difficult to achieve immediately by most regions in Indonesia. One approach to resolve this problem may be to establish a moving average standard, for public services where outcomes are measurable (national exam results, incidence of health problems which may vary by regions) and help the regions which are below standard on a declining basis over a relatively extended period of time.

2.1.2 Compensating for under-spending resulting from benefit-cost spillover effects and low economies of scale

When powers to allocate resources are devolved to the regions, significant public service provision gaps may take place because regional governments seek to serve their constituents rather than those residing in neighboring communities. As a result, regional authorities may seek to deny benefits of services provided in their jurisdictions to residents residing in other jurisdictions. The result is under-spending of services which would otherwise 'spill over' to non-residents. Limiting spending on these services may also have a negative effect on economies of scale – i.e., investments by the regions which only target residents may not be optimal in size to secure the benefits derived from larger investments in infrastructure characterised by economies of scale – regional water supply and sanitation units. The result is higher unit costs which may not be recovered from poor consumers which are unable to afford the full cost of the services provided.

2.1.3 Reducing incentives for fiscally-induced internal migrations

Regional disparities in the provision of public services may induce migrations of capital and labor from regions where services are inadequate to those where services are much better – i.e., where differences in fiscal benefits are significant. Strengthening services in regions where service provision is poor – i.e., reducing regional disparities in public services - may help to moderate migrations, which deprive regions of the capital and labor needed to improve their economies, while overwhelming regions with better services, such as Indonesia's large cities.

2.1.4 Inadequacies of formula-based systems and of capital markets

Where intergovernmental fiscal arrangements include one or several large unconditional grants, providing additional support for capital investments may also be justified on the following basis:

- Formula-based systems which characterise unconditional grants may not be able to take into account 'lumpy' capital investment. Additional support may be required in the form of project capital grants which provide support for large projects.
- Regions may not be able to borrow to finance their capital investment needs owing to a number of factors – constraints on borrowing imposed by the Government, low credit-worthiness which makes borrowing too expensive and/or not available at all, low development of municipal bond markets. In such a case the Government needs to step in with capital development loans (for regions that can service debt extended by the GOI) or grants (for regions that have little scope to service debts).

Both cases provide the main justification for a project-by-project, demand-driven capital grant system.

2.1.5 Possible negative incentives

Capital grant support programs may, however, produce significant negative incentive effects:

- When linking conditional grant support to achieving national priorities, there may be a bias created in the centre in favor of investments as opposed to providing support for routine expenditures. Getting the input mix right is critical in sectors such as education and health services - books are as important to achieving good education outcomes as are new school buildings. Correcting for this bias requires that decisions on the input mix be shared between the regions and central government agencies. This then militates in favor of a grant system that includes both routine and investment support – a block grant approach - where the input mix is based on local knowledge rather than decisions made by the centre. In sectors where service provision is more capital intensive – economic infrastructure - this bias has less consequences.
- Generous funding of capital investments by the central government may lead the regions to shift their own expenditure effort to unassisted sectors and come to rely on government capital grants for all of their investment needs.

2.2 KEY FEATURES OF INDONESIA'S TRANSFER SYSTEM

2.2.1 Dominance of unconditional transfers

As in many developing countries, Indonesia's intergovernmental is characterised by huge vertical fiscal gaps. In Indonesia, the average varies from Provinces, where regional taxes account for about 42 percent of total income, cities – 12 percent, and rural districts – 6 percent. **Table 2,** shows the low reliance on own revenues according to the four fiscal capacity classes of MoF's fiscal capacity indicator (Peta Kapasitas Fiskal - PF). While the share of regional revenues, notably in cities, may improve in the future as the GoI implements the revised law on regional revenues (UU 28/2009), vertical fiscal gaps will continue to be quite large and, as a result, reliance on GoI transfers will continue to be important.

Table 2; Local Revenues/Total Revenues: 2009 APBD

Table 2: Local revenues/Total Revenues : 2009 APBD

PF Class	Kabupaten		Kota		Provinces	
	Number Regions	Taxes/ Tot Rev.	Number Regions	Taxes/ Tot Rev.	Number Regions	Taxes/ Tot Rev.
1	197	6.4%	18	12.4%	7	62.7%
2	86	5.4%	35	13.5%	16	32.1%
3	45	4.7%	19	10.5%	3	18.5%
4 a 1/	56	7.1%	19	8.7%	6	37.9%
4 b 2/						53.9%
Total 3/	384	6.2%	91	11.8%	32	41.5%

Note:
1/ 4a does not include DKI Jakarta
2/ 4b DKI Jakarta
3/ Not including DKI Jakarta

Source: SIKD

Unconditional grants dominate the transfer system, accounting for 93 percent of total official grants. This type of transfer is unconditional, in the sense that the GOI cannot direct the allocation of transferred funds in regional government budgets.

The main grant is the *Dana Alokasi Umum (DAU*), which is based on a formula which seeks to fund the gap between fiscal capacity and expenditure needs as well as achieve a measure of horizontal equalisattion. It accounts for about 70 percent of total official transfers. The *Dana Bagi Hasil (DBH),* is a revenue-sharing grant which seeks to return to each originating regions part of the taxes collected by the GOI on the exploitation of natural resources (oil, gas, forestry and fisheries), on payrolls and properties. *DBH* transfers account for about 25 percent of total official transfers. *DBH* transfers do not seek to equalise fiscal capacity: they in fact contribute to dis-equalise the transfer system.

The only official conditional capital grant, i.e., where the GOI allocates funds to reflect national priorities is the *Dana Alokasi Khusus (DAK).* This grant provides investment funding to the regions and represents about 7 percent of total grants. Since *DAKs* were initiated in 2003, support has been concentrates in education, health and infrastructure, notably district roads. But, in most other sectors covered by *DAK* grants, allocations have been significantly fragmented. A focused assessment of the *DAK* grant system is undertaken in **Part 2.3** of this chapter.

2.2.2 Fairness and equity of the official grant system

Article 18 A of the Constitution establishes the principle of fairness and equity as the main guidance for intergovernmental fiscal relations: "*The relationship in finances, public services, utilisation of natural resources and other resources between the central government and the regional governments shall be regulated and executed fairly and equitably based on the laws."* As interpreted by a legal expert (see **Attachment 2)**, this requires that the *intergovernmental* **fiscal system as a whole be fair and equitable**, even though elements of the transfer system may not meet this requirement. This requirement may not have been met since the *DAU* formula has not been fully applied, *DBH* grants are inherently dis-equalising and allocations of *DAK* grants are not focused in regions that need additional financial support.

A rough analysis of inter-regional equity is provided in **Fig.5.** It shows that by making population the main determinant of grant allocations the scope for improving equalisation is quite substantial.[8] The chart presents a simple Lorenz curve of Indonesia's main transfers (DAU, DBH and *DAK*) mapped against population. The horizontal axis represents shares of fiscal transfers for 411 kabupaten/kota and the

[8] For a more comprehensive review of this issues, see World Bank 2007 – Indonesia Public Expenditure Review: "*Spending for Development, Making the Most of Indonesia's New Opportunities*", February, 2007.

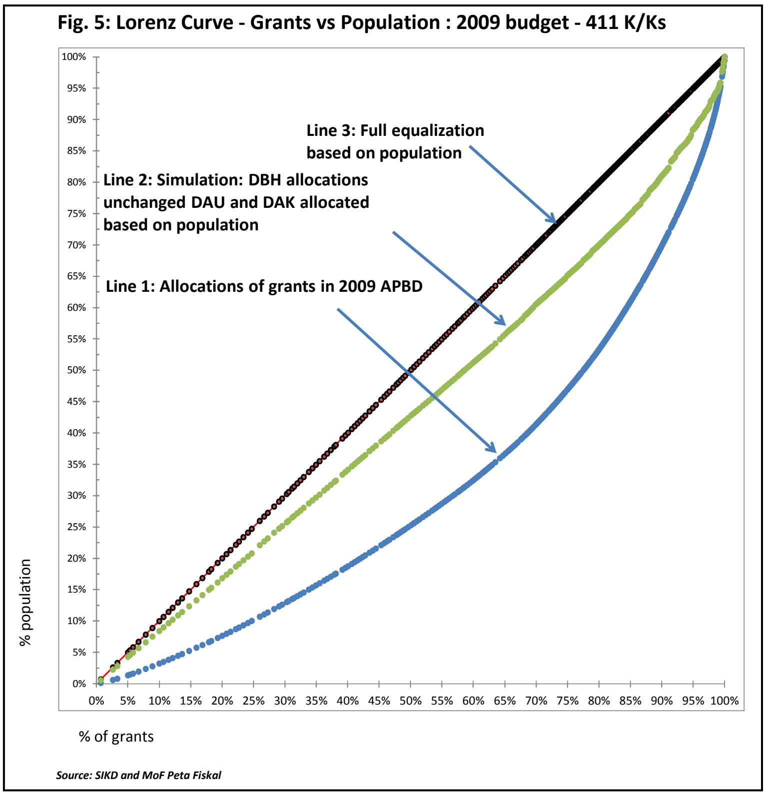
vertical axis indicates shares of population in the regions. Each curve (Line 1 in blue, Line 2 in green and Line 3 in red) represents three different allocations of total grants measured against population:

- Line 1 represents the actual allocation in 2009 regional budgets
- Line 2 is a simulation which maintains the allocation of DBH intact but re-allocates DAU and *DAK* in line with population
- Line 3 represents full alignment of transfer allocation with respect to population

The main results are:

- The current allocations are significantly dis-equalising when benchmarked against population but,
- Allocations of *DBH* grants may not be the main dis-equalising factor. Line 2 shows that by making population the main driver of allocations for *DAU* and *DAK* grants, leaving *DBH* allocations unchanged, the gap between Line 1 and Line 2 would be substantially reduced. This means that improvements in the *DAU* would have a much more significant impact on equalisation than would the re-allocation of *DBH* funding.

Figure 5 - Lorenz Curve - Grants vs Population: 2009 Budget - 411 K/Ks



2.3 *DAK* GRANT LEGACY – EXCESSIVE FRAGMENTATION

Over the years, DAK grant funding has become excessively fragmented, owing to difficulties experiences in focusing grants in resource-poor regions and in a limited number of high priority activities. The main result is excessive fragmentation of a relatively small pool of fiscal resources. *DAK* grant fragmentation is illustrated in **Fig. 6**, which shows that patterns of allocations have remained nearly identical from 2003 to 2010 despite the more than tenfold increase in funding.

2.3.1 Fragmentation across regions

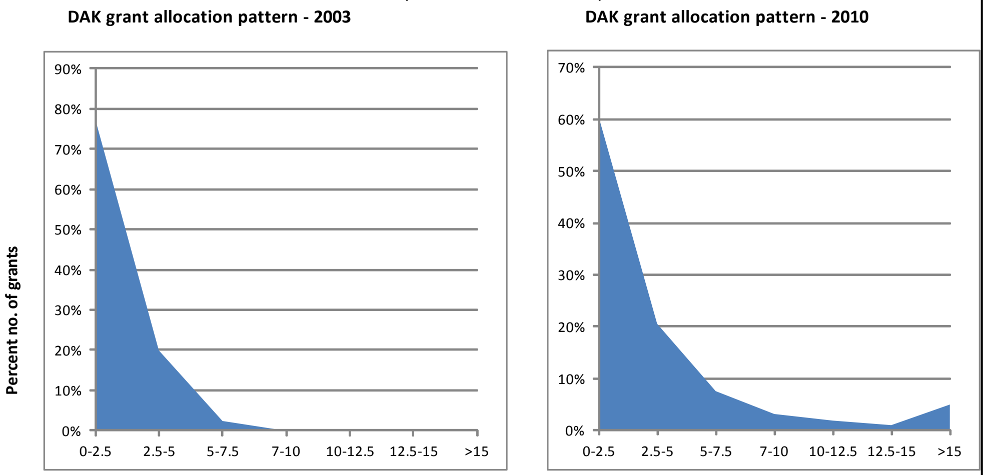
Using conditional grant funding to offset the weak equalisation effects of the DAU and DBH, while possible, has not been done so far. Rather, *DAK* funding has likely contributed to a worsening of **fairness and equity.** All regions now feel entitled to a share of the *DAK* grant pool of funds. Furthermore, the number of sectors in which *DAK* grant funds provide support has expanded, from 5 in 2003 to 15 in 2010.

A key reason for this result is that *DAK* allocations have been based on **eligibility** rather than **fairness**. Selecting regions on the basis of eligibility means that some regions will be excluded. Given the political economy of intergovernmental fiscal arrangements in Indonesia, designing a formula-based system which ranks regions by order of eligibility is difficult to achieve. The formula used to determine eligibility has two elements: fiscal capacity and special needs. The special needs criteria over-rides the fiscal capacity argument, allowing resource-rich regions to access *DAK* grants. This criteria which is legally defined and regulated, has been expanded to such a degree that all regions may now argue that they are 'special'. As well, regions which enjoy **Special Autonomy** (Aceh, Papua) have automatic access to *DAK* grants. In effect, the special needs criteria nullifies fiscal capacity as a determinant of eligibility. As a result, all regions, except very few, receive DAK grants, whether or not they need the extra funding. **Pemakaran** has exacerbated the problem of focusing grants in needy regions: the number of regencies which now receive DAK grants has increased by 39 percent in 7 years.

Figure 6 - DAK Grant Allocation Patterns: 2003 and 2010

Fig. 6: DAK Grant Allocation Patterns: 2003 and 2010

(IDR billions and units)



Characteristics of DAK Grants in 2003

Total Value DAKS	1.922
Total number DAK grants	980
No of sectors	5
Average size of grant (IDR bio)	2,0
No of KKs recipients	354

Characteristics of DAK Grants in 2010

Total Value DAKS	20.304
Total number DAK grants	5.179
No of sectors	15
Average size of grant (IDR bio)	3,9
No of KKs recipients	490

Source: SIKD

Although Law 33 allows to vary counterpart funding requirements above the minimum requirement of 10 percent, the GoI has not used this to ration DAK funding. In a formula-based system, this constitutes as tool to concentrate funds in resource-poor regions. The minimum 10 percent requirement has become a maximum, allowing all regions to access DAK funding with minimum matching funding requirements. As well, the system for ensuring that counterpart funding is provided is relatively weak, since DAK grants are provided in advance of expenditures by the regions: the GoI has little means to ensure that the regions contribute their share of funding after the fact, except to intercept DAU funding in the following year. Intercepting DAU funding has proven to be difficult to implement wherever it is allowed. But, using differential counterpart funding benchmarked by an appropriate fiscal capacity indicator would be feasible as a means to introduce fairness as a principle for the allocation of conditional funding.

2.3.2 Fragmentation across sectors

The sectors and sub-sectors covered by *DAK* grants have expanded from 5 in 2003 to 15 in 2010. Education has increased its share of total DAK grant funding significantly, a result of a well focused program aimed at rehabilitating some 500 thousand primary schools coupled with a push towards increasing GoI education funding to meet constitutional spending requirements. All other sectors initially funded in 2003 have lost their share of DAK funding. Infrastructure's share has declined significantly.

Table 3: Investment Analysis in K/Ks by Peta Fiskal Class:2009 APBD

Table 3: Investment analysis in K/Ks by Peta Fiskal class : 2009 APBD

PF Class	PF Index	Numbers K/K (units)	Av. Pop. ('000)	Inv/Tot Exp (percent)	Inv/capita (IDR '000)	DAK/Inv. (percent)	Deficit/Exp (percent)	DAU/Tot Rev (percent)
PF Class 1	.00 to .50	188	771	20%	189	40%	-7%	68%
PF Class 2	.50 to 1.00	104	372	28%	464	27%	-11%	59%
PF Class 3	1.00 to 1.50	42	217	32%	901	22%	-15%	54%
PF Class 4	> 1.50	78	194	39%	1.691	14%	-22%	36%
Total		412	504	27%	381	27%	-12%	59%

Note: Total K/Ks reporting budget estimates in 2009 = 500

Sources: MoF and BPS for population estimates in 2007.

A key reason for fragmentation among sectors is pressure exerted by sector ministries to continue to fund activities in the regions, after losing direct control over Inpres grant funds. In many ways this is the result of a lack of specification of the meaning 'national priorities' in the fiscal balance law which directs the use of DAK grants. The vagueness of this criteria has allowed all sector ministries to claim a share of the DAK pool of grant funds for their sector.

Fragmentation across sectors was further exacerbated by the requirement to rationalise DEKON/TP funding (further discussed in **Section 2.4)**. This is required under Article 108 of the revised Fiscal Balance Law which requires that all DEKON/TP funding which support regional government functions be shifted to the DAK mechanism. The process of rationalisation has been ongoing for a number of years and in 2008, some IDR 4 trillion of *ad hoc* investments were converted into DAKs. But sector ministries have been able to include the corresponding sector in the list of those sectors which benefit from DAK grant support. This has contributed to expanding to expand the list of sectors covered by DAK grant funding.

2.3.3 Dependence by resource-poor regions on the GoI for investment funding support

Although the regions are investing significant amounts of their own money, the capacity to invest on their own and to leverage their own savings to mobilise GOI funding through *Hibah* grants and on-lending support varies significantly, depending on their fiscal position. This is show in **Table 4**, which reviews the investment profile of 412 cities and districts on the basis of the 2009 APBD and MoF's fiscal capacity indicator to classify the regions by income groups. For the purpose of this analysis, we have split the lowest group, PF Class 1, into two sub-groups (a and b), since there are significant differences between both. While the estimate of investments is based on planned amounts, which may distort the results, it does show that many regions have the potential to spend more than their current revenues, as shown by the significant deficits (11% for PF 2, 15% for PF 3 and 22% for PF4), financed by fiscal surpluses carried over from previous years. By comparison, resource-poor regions are significantly hampered by fiscal constraints, have lower reserves, depend highly on DAU funding and excessively rely on *DAK* grants to invest (four times more than resource-rich regions). Their responsibilities for providing regional services is much higher than in resource-rich regions, given their high average numbers of residents.

Table 4: DAK Grant Funding in K/Ks by Peta Fiskal Class: 2009 APBD

Table 4: DAK grant funding in K/Ks by Peta Fiskal class : 2009 APBD

PF Class	PF Index	Numbers (units)	Av. Pop. ('000)	DAU/T Rev (percent)	Inv/Tot Exp (percent)	Inv/capita (IDR '000)	DAK/Inv. (percent)	Deficit/Exp (percent)
PF Class 1 a	.00 to .25	100	998,1	70%	17%	143	44%	-6%
PF Class 1 b	.25 to .50	88	513,2	64%	23%	292	37%	-8%
PF Class 2	.50 to 1.00	104	371,6	59%	28%	464	27%	-11%
PF Class 3	1.00 to 1.50	42	217,2	54%	32%	901	22%	-15%
PF Class 4	> 1.50	78	193,6	36%	39%	1.691	14%	-22%
Total		412	504,5	59%	27%	381	27%	-12%

Simulation:		Scenario 1	Scenario 2
PF Class 1 a	.00 to .25	9,2	32,0
PF Class 1 b	.25 to .50	2,7	7,8
Total		11,9	39,8

Note:
Scenario 1: Additional funding (IDR trillion) needed to bring investment levels calculated as a percent of total expenditures to the level of regions in PF class 2.
Scenario 2: Additional funding (IDR trillion) needed to bring investment levels calculated as per capita investments to the level of regions in PF class 2.
Total K/Ks reporting budget estimates in 2009 = 500

Sources: MoF and BPS for population estimates in 2007.

To illustrate the investment gap, we have calculated the amounts of supplementary finance that would be required annually to raise investment levels of Class 1 regions to levels achieved by Class 2 regions using two scenarios: Scenario 1, which would equalise investment as a proportion of total expenditures. The requirement would be an average IDR 12 trillion per year; and, Scenario 2, which would equalise per capita investment. Achieving this would require about IDR 40 trillion of additional funding. Even if this were possible, it would still leave the 188 regions in PF Class 1 far behind the other regions with respect to total investment effort. To make matters worse, half of the 88 regions left out of the analysis because of the absence of population figures (not available since most of these regions were recently created) belong to the lowest fiscal capacity class.

The conclusion is obvious: regions under PF Class 1 are so strapped for fiscal resources that they are likely to be unable to raise their investment effort to higher levels as well as to preserve existing infrastructure assets without additional help. The implications for a capital grants strategy are: most capital grant support should be reserved for the poorest regions to help them preserve existing assets and strengthen their asset base to meet the basic needs of their residents. All other regions should receive GOI support through its on-lending facility and the richest ones should be encouraged to finance their infrastructure needs through the domestic capital market. Adopting this eligibility policy would be fully consistent with the fairness and equity requirements of the constitution.

2.4 DEKON/TP FUNDING

While the *DAK* is the only “official conditional grant” recognised in the Fiscal Balance Law, the law also provides for funding of national government functions which are delegated to the regions as agents of the national government: de-concentration (*DEKON)* and co-administration funds (*TP* or *TugasPembantuan). DEKON/TP* funds are budgeted in central ministry budgets. DEKON is then managed by Provinces on behalf of the GoI. *TP* funds are provided directly to the regions and are used to facilitate activities such as the provision of services to manage national elections.

However, owing to a generous interpretation of the nature of this funding support, sector agencies have budgeted significant resources to support regional investments and other programs which, in fact, provide additional funding for regional government functions. Funding is provided directly to ‘vertical institutions’ – sector agencies, service provision units such as schools and hospitals – either as *ad hoc* investments or routine expenditure support – BOS and Jamkesmas funding. While much of this funding may be justified – notably to achieve minimum service standards and to reduce barriers of access to the poor and near-poor – this unofficial transfer system by-passes regional government budget processes and muddles accountability by the regions. Furthermore, allocations do not take into account the fiscal capacity of each region and, as a result, likely contributes to further dis-equalisation. Providing such support to all regions, irrespective of their fiscal position places the GOI into an awkward position where it is assuming most of the cost of the services being provided, notably in the education sector.

Table 5: APBN Funding of Regional Governments Function: 2005-2010 (IDR Trillion)

Table 5: APBN Funding of Regional Governments Functions: 2005-2010 (IDR trillion)

	2005	2006	2007	2008	2009	2010
Community development 1/	0.6	1.2	2.4	2.1	3.1	3.2
Individual public health services 2/	2.1	4.8	8.1	8.8	9.5	11.0
Pre primary Education	0.3	0.3	0.4	0.5	0.6	1.1
Primary Education 3/	12.3	22.8	22.5	24.6	37.1	31.6
Secondary Education 3/	4.0	4.7	4.1	3.8	7.4	5.6
Total	19.2	33.9	37.6	39.8	57.8	52.5
Notes:						
Ratio of APBN funding relative to DAK grants	4.8	2.9	2.2	1.9	2.5	2.6

1/ Mostly PNPM
2/ Mostly Jamkesmas
3/ Mostly BOS

Source: MoF

DEKON/TP funding is quite substantial. The main programs are shown in **Table 4.** The amount of funding provided is significant and represents twice the amount of *DAK* funding in most years since 2005.

Recognising that the emergence of DEKON/TP funding is not consistent with the Fiscal Balance Law, the law instructs the GoI to rationalise this type of funding by converting programs funded by DEKON/TP into DAK grants. The effort to do so has been ongoing for several years and has focused mainly on shifting under the DAK most *ad hoc* investments – about IDR 4 trillion of investments were shifted to the DAK in 2008. In part, this process of rationalisation accounts for the expansion of the number of sectors to which DAK funds are allocated. Shifting under the DAK of programs that provided routine expenditure has not occurred, partly because DAK funding does not allow for expenditures other than investments.

2.5 TOWARDS A MORE EFFECTIVE, SUPPLY-DRIVEN DAK GRANT SYSTEM

Much criticism, including this paper, has arisen in recent years about the effectiveness of the DAK and there is a consensus that the system needs to be changed.[9] In line with evolving good practices, notably in the USA where specific grants have been replaced with categorical block grants, the DAK grant system should be made more flexible so as to allow for adjustments that reflect the specific needs of policies being pursued by the GoI. Categorical block grants (see **Section 3.2.1.** of this paper which deals with this) recognise that the regions are better positioned than the centre in allocating conditional grant funding in detail. Different sector have different needs and the grants should be adjusted to reflect these needs. For instance, in the education and health sectors, the support provided needs to take into account the specific situation of each regional government and the input mix – routine versus capital expenditures – needs to be adjusted accordingly. Getting the input mix right is much more difficult in these sectors particularly since the provision of materials, supplies, books, pharmaceuticals, and the like is as important to effective service provision as the buildings in which the services are provided. The approach to providing grants in capital intensive sectors needs to recognise that many regions which are not provided adequate resources through the DAU need additional support to preserve existing assets as well as to build new ones. However, under current practices, the GoI segments DAK allocations by sub-sector – roads, water supply, sanitation, wastewater treatment – under the assumption that each regional government's asset conservation needs can be benchmarked on the basis of information on existing assets. It fails to recognise that priorities for asset conservation may be different from the allocations of the DAK and, in fact, that allocating resources may result in maintenance programs that are not needed. The regions are best positioned to identify areas where funds should be concentrated. Regions should be given more flexibility to allocate asset conservation funds. A block grant which would provide resource-poor regions with a minimum amount of asset conservation funds in a predictable manner would likely be a more effective approach to stabilising the state of infrastructure assets. The construction of new assets could then be supported by demand-driven loans and grants.

Enabling the conversion of DAK grant funding into block grants which cater to both routine expenditure support as well as investment would only require a reconsideration of a MoF decree which restricts the use of DAKs to investments. This approach is overly restrictive. Neither the Fiscal Balance Law nor GR 55/2005 specify that funding is restricted to investments. This restriction has impeded the rationalisation of DEKON/TP funding: much of direct APBN funding for the regions

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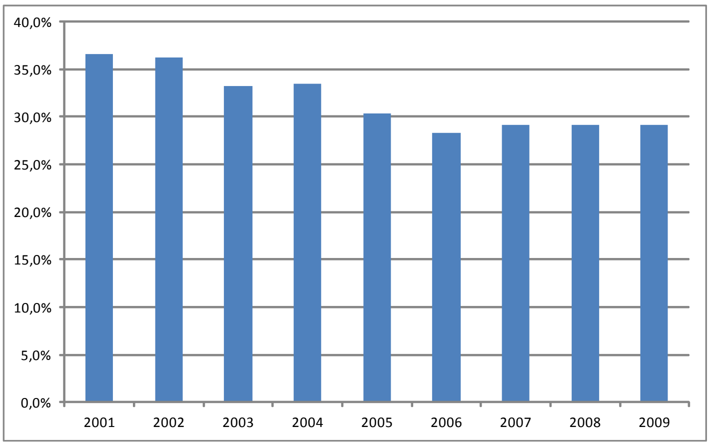
[9] Two recent studies have been produced under Bappenas sponsorship: SMERU, "The Specific Allocation Fund (DAK): Mechanism and Uses", January 2008 available in both English and Bahasa Indonesia, and Maurice Gervais, "*Options for Improving DAK Grants",* Discussion Paper, ADB TA 4984 – INO Project, September 2009. Further analytical work is currently being undertaken under an ADB TA Program, LGFGR.

takes the form of routine expenditures (BOS and Jamkesmas, notably), which accounts for more than twice the funding provided under the DAK.

Figure 7- Share of Education Spending in Total Expenditure of K/Ks-2001-2009

Fig 7: Share of Education Spending in Total Expenditures of K/Ks - 2001-2009



Notes:
In 2001-2002: DAK funding not yet introduced
In 2003-2004: DAK funding but not yet BOS support
From 2006: Large increase in DAK grants + full BOS funding

Source: World Bank Estimates

Given the weaknesses of the DAK, should the solution be to get rid of it and make conditional grant support more demand-driven? This report supports the need to maintain an effective tool for focused intervention by the help regions achieve minimum service standards in selected services (notably, education and health), overcome externalities and mitigate fiscally-induced internal migrations. The funding provided should be focused in a few critical services (education, health, infrastructure conservation, environmental issues) and aimed at improving the operation of existing services, while allowing regions to make choices on the detailed allocation of funds provided as categorical block grants. Major capital investments would then be handled by demand-driven loans and grants (*Hibah),* aimed at expanding the availability of infrastructure assets needed to improve the reach of public services and supporting the growth of the economy.

2.6 THE SUBSTITUTION EFFECT

One of the key problems regarding the design and use of conditional grants is the negative effect it may have on regional expenditure patterns – the so-called substitution effect. This negative effect is well documented in theory but difficult to identify in practice. It occurs when expenditures that would normally be included in regional government budgets receive additional external support. This may lead the regions to use the grant for purposes other than intended or to shift their own expenditure effort to non-assisted services. Understanding substitution is critical to the effective design of grant instruments. In Indonesia, identifying if conditional grants have induced a substitution effect in regional spending patterns is difficult to document. But, there appears to have taken place a strong substitution effect in the education sector over the past nine years. Figure 7 provides the results of an analysis of the available data. It shows a clear reduction in expenditure effort as a percentage of total expenditures in the regions, during periods when additional GOI support (DAK and BOS funding) was introduced. This reduced effort may have been motivated by the need of the regions to reduce their own effort to adjust to the constitutional requirement that each level of government spend 20 percent of their expenditures in education. In the GOI, the required expenditure effort has not yet been achieved while it has been exceeded in the regions. Whatever the reasons, there is nonetheless clear evidence of a substitution effect at play.

Does it really matter if the regions shift their expenditure effort to other activities? There is little doubt of the need for improvements in education funding. However, the GOI needs to guard against assuming a large share of the financial burden of funding basic education services in the regions, without a strong commitment by the regions to do their share of the heavy lifting. Without such a commitment, the GOI is *de facto* re-assuming control over basic education – which is a key function of the regions. It also provides an example that could be applied in other sectors, such as the maintenance and improvement of basic regional infrastructure assets, as the GOI steps in to strengthen funding in this priority area. What appears to be happening in education could then be replicated in other sectors, which would then undermine the credibility and the robustness of the whole transfer system as well as the hard budget constraint under which regional governments should be operating.

2.7 SUMMARY

Indonesia's conditional transfer system is a work in progress. The constitution requires that the overall transfer system be *fair and equitable,* although individual transfers may not be required to meet the criteria. The transfer system has the tools needed to achieve the constitutional requirements but the effectiveness of the total system to do so has been constrained.

- The introduction of transitional elements in the *DAU* has dampened its equalisation potential
- Efforts to restrict eligibility for *DAK* grants for resource-poor regions have not been very successful
- *DEKON/TP* funding is allocated to regions irrespective of their fiscal needs
- The commodity boom of 2006 and 2007 has allowed resource-rich regions that are the main beneficiaries of *DBH* grants to accumulate significant fiscal surpluses that have remained underutilised
- A rough assessment of the total system's propensity to meet this criteria shows that improvements would be required. The GoI is currently preparing a revision of the Fiscal Balance Law and it is expected that the DAU will be improved.

The introduction of demand-driven capital grants and loans will be a significant challenge, given the legacy of a transfer system that needs to be improved and the fact that Indonesia has little experience in managing a funding system in which regional governments initiate the process of requesting GOI assistance.

CHAPTER 3: MODEL FOR A HIBAH CAPITAL GRANT SYSTEM

3.1 INTRODUCTION

Institutionalising a demand-driven capital grant system will be a major challenge. The key elements of the challenge are:

- With the exception of mega projects, funding for the regions has always been decided in a top-down fashion – Inpres grants before decentralisation, formula-based grants since then and *ad hoc DEKON/TP* funding. Adopting a grant system which is more demand-driven will be a major paradigm shift and will be difficult to accept by central government ministries and agencies.
- The regions have come to believe and expect that they are entitled to GoI grant support, with few conditions attached and little counterpart funding provided.
- There is little appetite in the regions to borrow for their investment needs. Resource-rich regions, which have accumulated significant fiscal surpluses appear willing to draw down reserves to invest on their own but still expect the GoI to provide grants, even though they are credit-worthy.
- The political economy of allocating investment grants has become more challenging. Lobbying for additional funding has been a feature of DAK grant allocations. The recent "push" by the DPR and the DPD to influence grant allocations through "aspiration funding" has made the desire for more political voice in allocations more evident and systematic. There is little appetite among political actors in the centre for a formula-based system which reduces the scope for discretionary decision-making.
- As recently emphasised in regional consultations for the amendment of the Fiscal Balance Law, the regions prefer a transparent formula-based approach which provides more predictability in the access of fiscal resources and more transparency in allocations.
- There is little experience in the GoI in managing a full demand-driven grant system. 2010 is the first year in which *Hibah* capital grants are being provided, and, with the exception of the MRT project, all other grant funds have been provided by donors - 85 performance contracts in water supply, health and education. The central decision-making process is slow, in the absence of a firm institutional framework for expediting approvals by the GoI.
- Switching to a demand-driven grant system will also present difficulties in synchronising grant allocations with the preparation of the national budget. As well, the national budget does not easily facilitate output-based grants since the rules for allocating budgets and appropriating funds are still based on line-item budgeting, which obliges to track the use of funds through the purchase of inputs. The budgeting system does not allow to roll over unused funds at the end of the fiscal year.

- Monitoring of project outputs will eventually require changes in PFM regional accounting and reporting regulations, which, at present, do not allow to drill down to the activity level.
- The current single-year budget management system does not allow to commit public resources over several years, which would be required to support large investment initiatives that require to be implemented over a number of years. This constrains incentives in the regions to undertake significant investments.
- Most of all, there is potentially massive pent-up demand for investment grants and the GoI will need to develop a demand-management policy to channel demand in areas of intervention that the GoI is willing to support with capital grants and in poor regions which need the extra support.
- The additional supply of grant funds will likely require additional sovereign debt. In effect, the GOI will be borrowing on behalf of the regions which are not credit worthy. And, since sustainable borrowing depends on sustained capacity to service debts, the GOI has a stake in ensuring that the grants that are awarded contribute to buoyant GDP growth and generate the tax revenues and user charges needed to service the debt. This, in effect, means that the GoI will be retaining the right to decide which project and regions receive grant awards, even though the allocation of grants will be driven by regional demand.

For all these reasons, the introduction of an effective demand-driven capita grants system will require a 'deep thinking' process, to flesh out the main amendments required to be operated in the current institutional framework and the operation of government agencies, both central and regional, and then introduce the new system stage by stage, as capcity develops and adjustments to the system are operated as experience is gained.

3.2 CONCEPTUAL FRAMEWORK - THEORY

In identifying a workable grant model, it is useful to consult the relevant writings on such models as well as review a number of applications in both OECD and developing countries. The body of fiscal decentralisation theory regarding grants mostly focuses on the design of equalisation grants and neglects capital grants as an area of research. International practices in the use of capital grants in OECD and developing countries alike presents a large variety of practices, all of which are very specific to country situations. While this may not be very helpful since none of the practices may usefully be imported in Indonesia, some of the features of the various country cases provide useful insights for the design of an adapted capital grant system in Indonesia.

One reason which explains the difficulties to find good models is that most decentralised countries have three tiers of government – central, provincial and cities/districts. Transfers usually transit through provinces/states, which then reallocate resources to local governments. And they are better positioned to do so since they a closer to the 'action'. Thus, the center wholesales grants and the states perform the retailing functions. States also regulate the borrowing practices of local governments, in many cases, providing them with loans. With such arrangements, the grant management system is layered, with broad-based management being the responsibility of the center and states assuming detailed management responsibilities.

Indonesia presents a unique decentralised governance system, in the sense that there is no hierarchical relationship between provinces and cities/districts, except in DKI Jakarta. Thus relationships between the center and local governments are direct, obliging the government to micro-manage the capital grant and loan systems. The number of local governments is quite substantial and is rising rapidly – on average, a new regional government is being created every 15 days. But the detailed knowledge required to target investment resources to the regions is spotty. And the detailed, unbiased, data that would need to be collected to design effective and focused grants is scarce not available and, if so, is not regularly updated. As a result, formula-based transfers (the DAU and DAK) provide for 'rough justice' rather than an accurate representation of resource needs. So far, this has been a workable arrangement, since most grants are formula-driven. But should the Hibah capital grant system be designed as fully demand-driven system, the prospects of setting into place the management systems required to retail capital grants to the regions and to ensure that grant allocation decisions remain untainted by 'back-room' lobbying deals is remote. The capacity building requirements would be significant and would need to include, at the very least, the creation of a dedicated grants management agency, under MoF leadership.

Another significant difference is that most states and local governments borrow to fund their investment needs. In the USA and Canada, the market determines the volume and conditions under which regional governments may access borrowed funds. Because of this, effective capital grant systems are quite rare and cater to very special needs. Notable examples are: Australia's demand driven 'Black Spot' program which aims to improve road safety; the UK's formula-based low cost housing program; and, Canada's 'Build Canada for the 21st Century' program. South Africa has been effecting a transition from a project-based, demand-driven capital grant system to a full formula-based system which is limited to specific areas of intervention which are mandated by the constitution.

From a comprehensive review of theory and country cases we have derived three possible models that provide a conceptual framework for a centrally managed capital grants system:

- A formula-based approach that can be used for all or for specific categories of regional investments. South Africa is currently introducing such a grant system to fund capital investments which targeted to achieve constitutionally mandates public service objectives.
- A categorical block grant approach, where categories of investments are targeted and some choice is left to sub-national governments on what initiatives will be undertaken within the allowed categories. The UK's formula-based grant, aimed at funding affordable housing represents an advanced model of such a grant. The USA and Canada have are leading the effort to progress from project funding to

categorical block grants. Indonesia's health sector DAK grant is evolving towards a formula-based block grant.

- A project-by-project demand driven system, where investment proposals are submitted for funding by provinces/states or, in some cases, by the central government. A well documented example of such a grant is Australia's 'Black Spot' road safety program which has limited funding available and is fully competitive.

All three approaches have strengths and weaknesses and their application in both OECD has been uneven and, in some cases, have encountered problems. The bottom line is that there are no "perfect solutions" that Indonesia could import and adapt from other country experiences. The main features of these three approaches are outlined in **Box 1**.

Box 1: Conditional Capital Grant Design – Basic Options

Grant design	Characteristics	Flexibility	Administration
Fully formula-based capital grants	Grant allocations determined by a formula using a common benchmark – such as the net value of stock of assets after depreciation. May be matching or non-matching, depending on the objective. May be designed to take into account regional disparities since extent of disparities will be revealed by baseline estimates of asset values. Cannot easily account for asset quality. Requires good accounting system and transparent assets valuations. Example: Experience underway in South Africa.	Maximum flexibility of use of grant funds by grantee.	Easiest to manage by the centre. Once acceptable formula is agreed, allocations are automatic and can be made fair, if formula takes into regional disparity gaps. No need for grant awards system since this awards provided through formula. Monitoring done through financial / performance and verified through audits.
Categorical block grant, based on formula.	Grant conditions determined in line with areas of support which the grantor is willing to finance, usually benchmarked on assessment of physical assets. Usually matching funding required. Does not take into account regional disparities. Fair formula difficult to design. Example: UK grants for pro-poor housing, Build Canada Initiative.	Regions obliged to use grants according to prescribed categories. Constraints placed on the use of funds. May allow for roll over of funds between fiscal years.	Formula more difficult to design since it requires recent data on physical assets. Monitoring more complex since data on realisations are specific to each category of activities supported by grants and monitoring system may impose heavy burden on regions.

Grant design	Characteristics	Flexibility	Administration
Demand-driven project grant	Grant allocations made for specific projects proposed by regional governments. Competitive system. Usually used for large projects. Grants targeted for objectives that grantor is willing to support. Example: USA categorical grant system, Australia 'Black Spot' program for road safety.	Regions initiate project proposals in line with areas of intervention decided by the grantor. Poor regions may be non-competitive owing to capacity constraints. This type of grant most responsive to regional needs.	Most demanding system: Requires strong grant administration by the central government, including transparent grant award system. Decisions on awards may be contested.

3.2.1 Comprehensive formula-based systems

Comprehensive formula-based systems are designed to provide fungible resources to sub-national governments to meet all or a broad category of their investment needs. This may be considered the 'Holy Grail' of capital grant systems and the approach is similar to that of equalisation grants. If successfully developed in Indonesia, it could be the best possible option, allowing the GoI to wholesale capital grant support as well as on-lending to resource-poor regions, providing them broad options to exercise choice over investment priorities and allowing them to do all of the 'heavy lifting' while remaining accountable to local legislatures for detailed results and to the national government for broad outcomes.

Key reasons for considering this type of grant is the recognition that sub-national governments are best informed about the infrastructure needs of their economies and public services. As well, in a country that values inclusiveness and equity, a competitive grant system may bias allocations in favor of regions that are better equipped to develop well-argued, competitive, capital grant proposals. A formula-based system ensures that all regional governments are treated fairly and may also be designed to ensure that resources availability remains contingent on performance. It is also more likely to be transparent, to the extent that it reduces the scope for discretionary decision-making and lobbying at the center. The great merit of a formula-based system is to provide predictability of fund access to regional governments and transparency in the allocation of resources among regions, allowing regions to plan ahead and to have confidence that they will be treated fairly in the allocation of grant funds.

Some less desirable characteristics include reduced control by central authorities regarding the use of investment funds, which makes it difficult to align national development objectives with regional investment priorities and, thus, create undue reluctance by central planning authorities to relax controls over regional government investments. A formula-based approach also makes it more difficult to monitor the use of funds – which may pose legal problems to the national legislature which still requires line item budgeting. Switching from input controls (which is a key feature of DAK grants) to output monitoring also requires strong evaluation capacities on behalf of the GoI which may not be readily available. Another weakness is that a formula-based system cannot cater to the need for large, lumpy investments, the requirement to differentiate urban and rural public investment needs and providing additional investment funding to close regional investment gaps.

The key problem is designing an effective and well adapted formula that is well aligned with the policies which drive the capital grant system. A formula that allocates investment resources to increase capital assets needs to be based on dynamic benchmarks, rather than those that represent an existing situation. And acceptance by all parties requires that the formulas be simple and logically robust in order to allow stakeholders to understand and to endorse the system.

The need for a common benchmark covering all asset types is a key requirement if the capital grant system is broadly reflect aggregate investment needs and allow regions to exercise choice. Otherwise, benchmarks for allocating will continue to be benchmarked on physical indicators that cannot be aggregated. The best way to develop a common benchmark is to use accounting information on the amortised values of physical assets of each region, which information should be derived from audited regional balance sheets. This is feasible in most OECD countries which have adopted international public sector accounting standards (IPSAS) but may be beyond reach in Indonesia: the national accounting standards based on IPSAS, while promulgated, have yet to be fully adopted and implemented by the GoI and the regions. Thus, while not achievable in the short-and medium-term, the data needed to use asset valuations in the longer term may become available. Therefore, the approach towards developing a formula-based approach should take this eventuality into account.

There is a unique working model developed for South Africa which may provide useful information on how this could be done in Indonesia. A review of the South Africa model should be undertaken[10] as a long-term option for the development of a comprehensive, formula-based approach. As well, a feasibility study should be carried out to assess whether or not the data requirements may be feasibly met over the medium term.

[10] See Petchey, Jeffrey and MacDonald, Garry, "*Financing Capital Expenditures through Grants"* in *"Intergovernmental Fiscal Transfers"*, edited by Shah, Anwar and Boadway, Robin, World Bank, 2007.

3.2.2 Categorical formula-driven block grants

Categorical formula-driven block grants are designed to provide resources to sub-national governments for specific categories of investments which the central government is willing to support. They provide a middle way between a fully formula-based system which leaves most decisions on the use of resources to the regions and a demand-driven system, which is competitive and where the best project gets the money. Many capital grant system in OECD countries take the form of categorical block grants. The USA and Canada are in the forefront of converting project grants into block grants.

Categorical block grants may be specific, in that the grantor specifies the investment types for which grant funding is provided – roads, bridges, water supply systems, schools and the like – or more generic, such as municipal/district infrastructure, which allows more scope for choice by the regions. The 'Build Canada Program' for municipal infrastructure represents such an initiative. Conditionality regarding the application of funds by the regions is more precise than general formula-based grants, requiring more detailed design and monitoring. Regional governments are, however, given substantial discretion in the choice of specific investments, within the approved categories.

In Indonesia, the health sector DAK grant is slowly evolving towards becoming a categorical block grant, in that the emphasis has been switched from the procurement of types of equipment to the implementations of various types of investments – basic health units, reference hospital care to accommodate the Jamkesmas initiative, aligned to clearly enunciated policies. Similar approaches could be adopted for generic types of investments such as – rural, urban, water transportation; urban, rural water supply, sanitation and wastewater treatment; primary, secondary and tertiary irrigation networks, and the like.

A formula-based categorical block grant would appear to be more feasible in Indonesia than a fully-developed formula-based grant, since the development of a common benchmark requires less data and could possibly be achieved by using proxy indicators coupled with the exploitation of existing data available through the financial reporting system. A feasibility study would need to be undertaken to assess information requirements and availability of data. Further development of such a system could be fostered by pre-conditioning access to grant funds to improved reporting of balance sheets and asset valuations, coupled with the requirement to register newly developed assets in balance sheets.

3.2.3 Project-by-project, demand-driven capital grant

Given the scarcity of fiscal resources that the GOI is able to make available to regions, a project-by-project, demand-driven grant system allows to focus grant funds in large projects, which require more intense scrutiny than is the case for smaller investment initiatives undertaken by the regions. Under this approach, the best project gets the money and regions compete against each other to secure the available finance. A project-by-project approach allows to overcome a key weakness of formula-based systems in that formulas cannot accommodate large, 'lumpy' projects.

Nonetheless, in a country such as Indonesia where there are many regional governments competing for funds, a project-by-project approach may:

- Overwhelm the capacity of the central government to manage the system which obliges the center to retail investment resources to a large number of regional governments.
- Lead to unwarranted tensions among regions, since many regions will be unable to compete for a share of the available funding or will be denied grant funding.
- Make decisions on allocations less transparent and predictable, since decision-making regarding the allocation of grants will be discretionary and will be exposed to lobbying. The key requirement of the institutionalisation of a transparent and contestable grants award mechanism, able to make timely decision to meet the requirement of the GoI's annual budget cycle, may not be met.
- Discriminate against resource-poor regions which do not have the capacity to formulate well-argued grant requests.

A project-by-project system may also be swamped by massive demand originating from the regions, which requires the central government to be very specific on the type of projects that will be eligible for awards as well as the regions which will be eligible to access grant funds. Policy development and prioritisation of effort are key to an effective demand management strategy. But constraining demand also reduces the scope for regional choice, dampens ownership, reduces willingness to contribute counterpart funding and increases the risks of 'substitution'.

3.3 CONCEPTUAL FRAMEWORK – GOOD INTERNATIONAL PRACTICES

One reason why there is no comprehensive body of theoretical literature on capital grants is that, in public sector management, theory is usually derived from empirical studies of country practices. Such a review is disappointing. There are few, if any, outstanding examples of good, sound and effective capital grants systems that could be adopted and adjusted to Indonesia's practices and political environment. In most cases, the central government provides block grants to provinces/states and leaves them the care to distribute capital grants to communities. States/provinces are able to more effectively manage a capital grant system since they are much closer the 'action' and can better assess needs, enforce conditions and monitor results. Indonesia is unique in that the central government's relations with cities/districts is direct buts its ability to assess needs and monitor results is 'remote'- the GOI cannot possibly acquire all of the data needed to allow for the targeting of capital grant funds and the large number of grants awarded to the regions cannot adequately be monitored. Dependence on the regions to provide the information needed to benchmark grants exposes the system to manipulation by sub-national governments.

Another key feature which characterises the infrastructure funding in mature federations, particularly in the USA and Canada is that most states and local governments secure investment funds through capital markets. Where municipalities are not allowed to borrow directly, provinces and states, not the central government, borrow on their behalf and provide grant and loan funds to the district and cities.[11]

3.3.1 Canada

Canada has recently (2007) initiated a seven-year infrastructure initiative – the 'Build Canada for the 21th Century' program which has a number of features that could be useful to Indonesia. From the policy standpoint, this program is well focused regarding the areas of intervention and the approach to contracting for outputs and outcomes uses a multi-year frame agreements between the federal government and provinces. The federal government also provides funding directly to communities, by-passing the provinces, which is unusual in a federal system. Capital grants in communities are funded through a tax rebate arrangement – the Federal Government returns to the communities the VAT and taxes on fuels collected in the communities, to provide them predictable resources to fund the investments that the regions want to carry out, from a list of project types, specified by the program. Applications for grant funds by the communities are simple and are managed through the internet. Grant awards to communities are managed by agencies on contract with the federal government and their performance is evaluated annually on the basis of standardised performance criteria. Co-financing requirements by provinces and communities are quite high: 50 percent for public sector initiatives, 75 percent for projects owned and operated by the private sector.

3.3.2 The USA

Unlike most federations, the USA does not have an equalisation grant to provide general funding to states and local communities. Rather, it has a system that provides some 2,700 types of grants to regions, states, local governments, research agencies, the private sector, NGOs and individuals. The system is competitive and well developed and provides a good example of how a competitive system is managed. But the US system is extremely fragmented, which is not recommended as a good practice. Over the years, the USA has introduced more flexibility in its conditional grant system by converting project-specific grants into block grants, leaving grantees more flexibility

[11] See an interesting paper written by Sri Mulyani Indrawati and James Alm, "*Decentralization and local government borrowing in Indonesia",* in *"Reforming Intergovernmental Fiscal Relations and Rebuilding Indonesia"*, edited by James Alm, Jorge Martinez-Vasques and Sri Mulyani Indrawati, 2004. The study maps out borrowing practices

in the use of grant funds. The system may accessed by all users and the general public through a single web interface – www.cfda.gov – and thus provides a one-stop entry point for all grant applications and grant awards.

3.3.3 France

France has a long-standing experience in national and regional planning and its experience in decentralised governance is recent. Prior to decentralised governance until 2007, the central government institutionalised a system of plan-contracts (*Contrats-Plans Etat-Regions),* which provided capital grant assistance to economic regions – France has 22 regions and four overseas departments – with each region covering one or several provinces. The *contrat-plan* approach first aimed at harmonising and funding regional development plans on the basis of a development contract. Since 2007, the approach was amended to a more flexible project-based approach, based on a typology of projects eligible for central government funding. The French model could be of interest to Indonesia in light of the difficulties in attempting to integrate national and regional planning as a basis for agreeing strategies for the provision of capital grant support. The fact that this effort was shelved after many years of effort provides a useful lesson on the difficulties inherent in trying to harmonise national and regional plans. If used in Indonesia, the GoI would be required to review more than 500 regional plans year-by-year, prior to making allocation decisions, which is clearly unfeasible.

3.3.4 South Africa

South Africa is moving away from a project-by-project, demand-driven grant system, to a formula-based system which is better adapted to the constitutional requirement to equalise the quality of certain services targeted by the constitution. A key reason for shelving its demand-driven system was the uneven capacity, among regions, to prepare well argued grant proposals.[12]

3.3.5 Summary of theory and good practices

The lessons to be learned from theory and the various country practices could be quite valuable for Indonesia. The various grant models allow to make strategic choices among the various approaches as well as to prepare the way to evolve towards optimal solutions. Country cases provide element of good practices that could be embedded in

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[12] See Petchey, Jeffrey and MacDonald, Garry, "*Financing Capital Expenditures through Grants"* in *"Intergovernmental Fiscal Transfers"*, edited by Shah, Anwar and Boadway, Robin, World Bank, 2007.

Indonesia's grant system, in efforts to design a responsive grant system which leads to the forging of partnerships between central and regional authorities. Such partnerships critically depend on fostering ownership of investments by the regions, which heightens their willingness to co-finance projects, offsets 'substitution effects' and provides for longer-term sustainability, including willingness by regions to allocate O&M funding to conserve assets. Partnerships can then be translated into real contracts for performance, in which each partner, including the central government, undertake firm commitments to realise contracts [13].

3.4 ADDRESSING KEY OPERATIONAL ISSUES

Key operational issues that can be identified without further research are:

- Eligibility and pre-qualification
- Linking grant awards to the budget cycle and MTEF
- Output contracting

3.4.1 Eligibility and pre-qualification

How the grant system deals with the issue of access to grant funding is critical to the success of an effective capital grant system. The failed experience of the DAK to focus funding in resource-poor regions provides an object lesson on the pitfalls to avoid in designing a fiscal capacity indicator.

There is little doubt that resource-poor regions need capital grant support to, at the very least, keep up with needs and, optimistically, reduce regional disparities in the provision of basic services (as discussed in **Section 2.3.2.** of **Chapter 2)**. Since Hibah aims at providing grants to regions that cannot reasonably be expected to use loans and municipal bonds to finance their investment needs, then the eligibility formula should only be based on debt carrying capacity. It should also include all regional spending capacity, meaning that fiscal reserves, current level of indebtedness, arrears on debt payments, and annual revenues should all be considered. This is a major requirement which may not be met by all regions owing to deliberate or inability by the regions to provide the audited financial information required to establish an index.

Even if a robust debt capacity indicator can be developed, its use in determining eligibility for capital grants, as opposed to loans, will remain a politically charged issue

[13] There is an emerging body of literature which deals with inter-governmental contracting. A comprehensive assessment has recently been carried out by the OCED. See, OECD, "*Linking Regions and Central Governments – Contracts for Regional Development*", 2007

simply because all regions believe that they are now entitled to a share of the grant 'pie'. There are two basic options that should be considered:

- Use the fiscal capacity indicator to 'draw a line in the sand', so to speak, and, as a result, select those regions which will be eligible for grant funds. This will surely challenge the political economy of grant allocations, particularly if a project-by-project, demand-driven system is adopted.
- Allow all regions to access the grant facility but use the fiscal capacity indicator to benchmark their contribution to total project costs. Under this approach, resource-rich regions would receive a much reduced share of grant funds as a share of total project costs, with the difference being made up by their own contribution as well as by loans provided by the GoI through its on-lending facility. Regions that have accumulated arrears on debts owed to the GoI would not be eligible to receive loans. This approach may be much more feasible, given the political economy of grant allocations and the constitutional requirements of fairness and equity. This option does not seek to exclude regions. It is inclusive but requires resource-rich regions to carry a fair share of investment costs using their own resources and with loans provided by the GoI.

The above approach suggests that pre-qualification requirements should be set to allow access to access to grant funds and to maintain access to grant funds on a year-to-year basis. The objective of a pre-qualification system is to manage the 'free rider' problem – poorly performing regions that access scarce grant funds, thus discouraging performance by other competitors for funds.

Prequalification requirements could be:

- Provision by the regions of audited information regarding all of its current spending capacity, including fiscal reserves. Failure to do so would automatically disqualify the regions from accessing capital grants. The GoI would provide templates to all regional governments of the data to be provided.
- Comprehensive data on their debt load, including payment arrears on official debts and on supplier credits.
- Satisfactory audit ratings of regional accounts by BPK. In this respect MoF would reach an agreement with BPK on audit rating thresholds, which could be accommodating at first but would become more rigorous as the Hibah system become entrenched. The research and development unit of BPK would also help develop typical action programs required to meet future audit requirements. Agreements with the regions on such action programs would be embedded in Hibah output contracts.
- Proof of performance regarding the implementation of Hibah-funded activities and satisfactory audits of these activities. Proof of satisfactory performance should be a requirement to allow eligible regions to maintain access to Hibah grants on a year-to-year basis.

It should to be noted that this last requirement may be difficult to achieve because of the absence of development in regional PFM regulations (Permendagri 13/2006 and 59/2007) of accounting and performance report that drills down to the activity level. An interim solution for DAK grants has been developed by BPK, which could be adapted for Hibah-funded activities. Ultimately, the accounting system will need to be improved to allow regular reporting at the activity level. Another constraint is technical reporting, which is important to assess whether or not contracted outputs have been produced. Currently, compliance by the regions in providing performance reports for DAK grants is very low – from 15 to 20 percent. The main reason is that the reporting requirements are different from sector-to-sector since they are specified by the sector ministries and have not be harmonised in common standard. Depending on the solution adopted for Hibah grants (general formula-based system, categorical block grant, project-based grants) the technical reporting requirements will be quite different – from generic to project-specific reports. Much effort will be needed to develop a feasible and achievable reporting system for Hibah, if this grant system is to meet the requirements of a performance-based grant. A possible solution to technical monitoring may be developed by the World Bank, in connection with its new initiative in support of DAK infrastructure funding.

3.4.2 Linking grant awards to the budget and MTEF

The current annual fiscal cycle does not provide much scope for undertaking significant investment projects that may require several years to be completed. Under the DAK system, all GoI funding needs to be consumed in one year. Since DAK grant funds are disbursed *ex ante,* i.e., in anticipation of the completion of investment initiatives, the funding provided in the latter part of the year may not be used and, as a result, residual funds will be retained in each region's consolidated treasury accounts. As a result, DAK funding becomes fully fungible and, in the following fiscal year, may be allocated to non-targeted activities. And, even if investment programs are completed, the annual fiscal cycle biases the use of funds to the procurement of equipment and away from undertaking infrastructure sector improvements.

In a demand-driven approach, the GoI should not allocate grant funds among sectors (as is done for DAK grants) until the grant awards process has been completed. Otherwise, a demand-driven approach will not work since GoI allocation policies will have reduced the scope for allocation decisions to be driven by regional priorities. Final decision on allocations in the APBN which are driven by regional demand must await the completion of the grant awards process. **Box 2** illustrates the problems that arise in linking grant awards and the annual APBN preparation cycle.

Resolving the problem posed by the annual project cycle does not, however, help to support multi-annual funding commitments by the GoI that are required to support large investment initiatives that may require several years to be completed. Hibah capital grants are targeted to new investments, which need to be planned in advance of the budgeting cycle and may require several years to be completed. Under Hibah, regions are fully exposed to funding new initiatives, since the provision of grants by the central government occurs after expenditures have been incurred, i.e., funding is provided *ex post.* Understandably, the regions will be reluctant to undertake multi-year investments under an arrangement where the central government's firm commitment to provide funding lapses at the end of each fiscal year and the funding available cannot be rolled over to the following fiscal year.

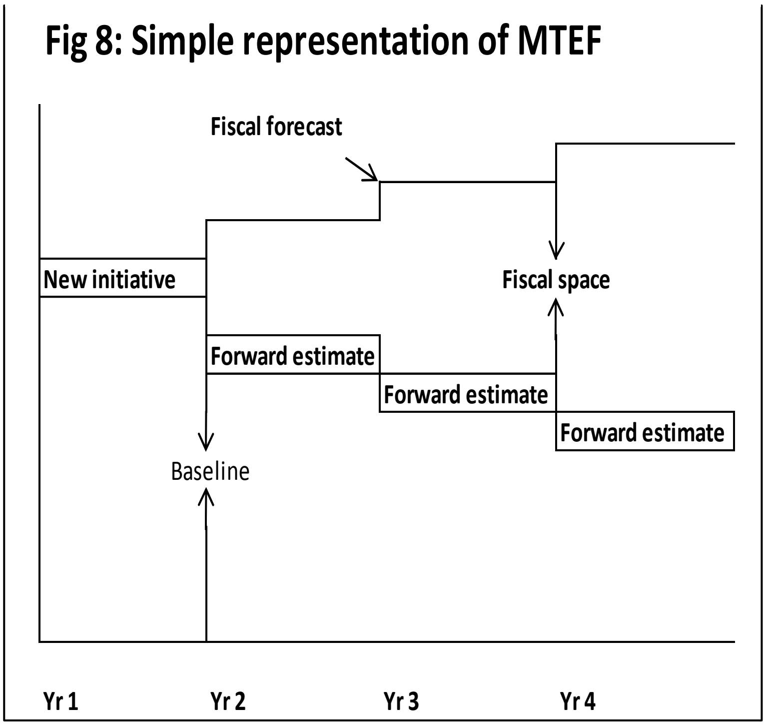
Box 2: GOI annual budget cycle and implications for budgeting Hibah grants and on-lending

Date	Steps in the budget cycle	Steps for budgeting *Hibah*
January – May	Indicative expenditure ceilings are set for each ministry and agency. This initiates the budget preparation cycle.	An indicative ceiling would need to be set for total Hibah and on-lending funding requirements planned to be implemented during the fiscal year for which the budget is being prepared. The indicative ceiling needs be set "en block", meaning that the available funding would remain unallocated among sectors and sub-sectors, to allow scope for choice by the regions on new initiatives.
May	Consultations with the DPR indicative spending ceilings are firmed up and borrowing policies are established.	Since much of the additional finance needed to support Hibah and on-lending will come from sovereign debt, the borrowing policy will determine the size of the grant and on-lending pool of resources for the following year. To guide regions in the preparation of grant proposals and ensure that each region disciplines its proposals in light of fiscal realities, MoF would need to disaggregate this grant pool into indicative sub-ceilings for all eligible regions and provide this information to the regions for planning purposes.
May to mid-July	Budget users prepare their budgets based on ceilings approved by the DPR. Additional spending proposals are possible. Budget allocations must be confirmed prior to the issuance of the *Nota Keuangan* which occurs end July.	For Hibah and on-lending, this means that preliminary decisions regarding grant and loan awards would need to be taken and confirmed before the issuance of the Nota Keuangan. A deadline for the submission of grant and loan requests needs to be set to allow for the review of proposals and decisions on awards. Grant proposals that do not meet this deadline but that meet standards would be retained in the project pipeline for further consideration. All other would be returned to the regions.

Date	Steps in the budget cycle	Steps for budgeting *Hibah*
August – October	After the President's budget speech in mid-August, all budget users prepare their budget proposals in detail. At end October, the budget law is promulgated.	During this period, there may be further scope for introducing additional grant and loan awards in the budget before it becomes law, should the budget ceilings be changed. This means that a reserve list of grant and loan awards would need to be ready to be inserted into the list of approved awards.
Mid-November	The Minister of Finance issues ministerial decrees confirming all transfers.	Hibah grant and loan awards are confirmed, allowing the regions to finalise their budget plans and to initiate the implementation of projects.
Mid-year budget revision	The GOI reviews and revises the budget.	Additional grant and loan awards are possible at this stage.

Within Hibah a solution to this problem is available: the GoI is able to commit financial support over several years without having to marshal the resources when the commitment is made. Actual funding is only required when the expenditures incurred by the regions need to be partly or totally reimbursed by the GoI. And, only the funding expected to be disbursed in a particular fiscal year needs to be budgeted in APBN. Fiscal resources may also be mobilised 'just-in-time' by the GoI, reducing the prospect of the accumulation of unspent resources, which need to be rolled-over. To institutionalise this approach, multi-year funding commitments may need to be anchored in an MTEF and linked to the GoI's fiscal sustainability strategy. Indonesia

Figure 8: Simple Representation of MTEF



will soon be introducing a Medium-Term Expenditure Framework (MTEF) in the central government in 2011.

A simple representation of an MTEF framework is shown in **Fig. 10**. An effective MTEF aims at managing the budget process by imposing a strong fiscal discipline on the budget while allowing budget users to compete for scarce budget resources over the medium-term. The competition is meant to assure that only the best budget proposals are taken into account, through a rigorous screening process. The fiscal space is the difference between conservative revenue forecasts, minus debt obligations, and the "baseline", the sum of all programs to which the government has committed in the past. Budget users proposing new initiatives may try to find savings in their existing programs to help fund new initiatives which they propose for approval. Once new initiatives are approved, the initiatives become forward estimates (basically future budget estimates). These estimates have priority claims over future allocations, but they are not fully protected against budget cuts, which may take place if the government's fiscal position deteriorates or if spending policies change. Therefore, an MTEF framework provides budget users "predictability" but not "certainty" in the funding of forward estimates that have been approved.

An MTEF for *Hibah* would look like **Fig. 10.** The fiscal forecast becomes the total pool of grant funds allocated in the APBN, which provides a firm ceiling for planning purposes. But only in Year 1 is this funding guaranteed in the budget and is integrated in the annual budget law. New initiatives are grant proposals made by the regions. All new initiatives approved as grant awards take up the fiscal space available for Year 1, so that no other proposals are allowed for the budget year. Provided that the projects are implemented as planned, they also have prior claims to resources over all new initiatives approved in following years, till projects are completed. In Year 2, the total grant pool may increase, creating more space for new initiatives. As well, projects planned in previous years will have been completed, which provides additional fiscal space for new initiatives (grant proposals by the regions).

MTEF is therefore well adapted to a *Hibah* capital grant system since it allows to award grants for big projects that need to be implemented over several years and to anchor multi-year commitments. What the system requires however is accurate spending forecasts, to ensure that each year's spending forecasts are budgeted accurately and, therefore, do not require adjustments during any fiscal year.

The adoption of a GOI MTEF system for the management of multi-year funding commitments by the centre has significant implication for budgeting practices in the regions since co-financing commitments in the regions may also need to be extended over several years. Fortunately, MoHA is in the process of finalising a Permendagri on regional planning and budgeting which includes MTEF. An urgent consultation would be required to ensure that the new system meets the minimum requirements of a demand-driven grant system.

3.4.3 Output contracting

This form of contracting between governments represents a major innovation in Indonesia. The usual form of agreement is a Memorandum of Understanding (MOU), which is usually non-binding legally and, in any case, is usually used to specify intentions rather than firm commitments to deliver results.

In an effort to secure firm commitments from the regions, including enhanced counterpart funding, the Ministry of Education to cement DAK funding commitments with the regions through the use of voluntary MOUs. The effort was partly successful but did encounter some resistance by a number of regions – mostly, resource-rich regions, which provides indications on the difficulties ahead in the institutionalisation of Hibah out contracts, which are much more binding. Nonetheless, prospects for using output contracts as a requirement to providing Hibah grants may be better to the extent that the contracts also bind the GoI to commit the promised funding. Since Hibah grants are gifts and, therefore, do not represent a funding obligation by the GoI, output contracts may, in fact be more feasible than MOUs.

Making output contracts work, however, may present a number of problems. First, specifying outputs is not easy: it requires technical as well as legal expertise. Second, the grantor (the GoI or its delegate) needs to be able to monitor the delivery of outputs, which will raise the transaction costs of the grant system. Third, legal enforcement of contracts in a court of law may not be feasible or practical: commercial litigation usually is required because of a breakdown of the relationship between litigants, which is not possible when litigants are governments which rely on each other to provide public services. An emerging body of best practices regarding contracting among levels of government suggests that, at best, contracts should be considered 'relational contracts' which assume that the relationship cannot be severed and that the only option available is to resolve disputes through third-party binding arbitration.

Different types of contracts may also be required for a formula-based grant system, where outputs (investment initiatives) cannot be specified in advance of contract agreements. A possible solution would be multi-year frame agreements, which would help define the scope for choice by the regions in making decisions, the conditions under which the regions would remain eligible from year-to-year for grant funding, the system through which funds are channeled to regions, monitoring and reporting requirements, at all other general conditions needed to regulate contractual relations. Much work would need to be done to develop such an approach, prior to introducing such contracts in the regions.

3.5 SUMMARY - THE WAY FORWARD – OPTIONS FOR AN EFFECTIVE HIBAH GRANT MODEL

This report advocates the adoption of a two-track system for Hibah:

- The use of a formula-based, categorical block grant approach to allocate the bulk of Hibah grant support to the regions. This would target district and municipal infrastructure which is standardised as to content and costs.
- A project-by-project approach for very large, complex, investments that cannot be accommodated within the block grant approach. This would include major urban investments – such as large urban transit systems, regional watershed management initiatives, and the like, which are very specific as to content and costs and require complex financial backing. This type of approach would also be used to manage donor-funded activities, both Hibah grants and donor on-lending operations.

The proposed two-track system would then allow to minimise capacity building needs while recognising the need for a project-by-project for large, complex investments.

The system will also require the development of robust fiscal capacity indicator to be used to benchmark regional government counterpart funding requirements. The indicator will be used as a benchmark to reserve capital grants for resource-poor regions or to benchmark counterpart funding requirements.

CHAPTER 4: CAPACITY BUILDING NEEDS

4.1 INTRODUCTION

The model for the *Hibah* grant system in Chapter 3 is designed to meet the requirements of a policy which covers basic economic infrastructure needs of the regions for new investment initiatives allocated primarily to regions which are unable to borrow to finance their investment needs.

Grant support requirements for large investments (or large programs, which cover the needs of several regions) would be fully demand-driven, meaning that the regions would be required to apply for grant funding in competition with other regions. All other investment support provided by the GoI would be based on an appropriate formula, that would allow substantial choice by the regions on grant-funded investment initiatives. For practical reasosn, the formula-based approach could, at first, be based on categories of investments that the GoI would be willing to support but the funding would be provided as block grants, leaving the regions considerable discretion regarding investment priorities. A demand-driven, large project approach coupled with a formula-driven block grant approach for city and district investments, both possibly restricted to economic infrastructure would contribute to reduce the complexity and the transaction costs of the *Hibah* grant system.

To better manage the political economy of *Hibah* grants (large project and conservation funds) the GoI would refrain from using a fiscal capacity benchmark to restrict access (eligibility) to resource-poor regions. Rather, the GoI would evolve a differential counterpart funding approach, benchmarked on an appropriate fiscal capacity indicator which would quantify a regions borrowing capacity. The approach suggested in this paper is an appeal to the **fairness principle,** enunciated in the constitution, rather than the **elibility approach,** adopted under *DAK.* Therefore, all regions would be allowed to access a share of the pool of capital grants but would have to contribute a fair share of co-financing.

Should the GoI firm up a decision regarding a formula-based approach, much effort will be required to conceptualise, develop and test options for an allocation formula. This is a critical requirement and cannot be done expeditiously. Getting the formula wrong had significant fiscal as well as political economy implications as illustrated by the experience over the last ten years in Indonesia. And, where there are no optimal solutions available, second-best solutions may allow breathing space for improving on results over the medium-term.

Hibah also introduces a completely new innovation in Indonesia: output-based performance contracts between the GoI and each region. Individual output-based contracts would be required for grant awards made for individual projects. This means that funding would be provided to the regions based on proof that outputs specified in each contract have been delivered. A multi-year output contract (frame agreement) would be designed to manage block grants. But this approach is relatively new in

Indonesia as well as in most developing countries, where funding is provided on the basis of proof of purchase of inputs. Output-based contracts will likely be applied progressively as Indonesia develops models for output contracting which will be different depending on the services provided by the regions – it is relatively easy to define outputs for piped water services but much more difficult to do so for roads. Considerable analytical work, modeling and piloting will need to be carried out before generic requirements are defined for each project type. Support will need to be provided to set principles, develop and pilot models and help define robust standards for such contracts

4.2 PROGRESSIVE CAPACITY BUILDING STRATEGY

The GOI could initiate the operation of a "Big Project" facility in 2011 by focusing, at first, on projects financed by donors. This would then provide an opportunity for piloting a demand-driven "Big Project" facility funded by APBN, in a manner that makes demand management feasible. All other small infrastructure grants would continue to be managed under the *DAK*.

During 2010, the enabling ministerial regulations would be designed to allow for the management of the "Big Project Fund". In 2011, regulations would then be drafted to enable the management of the infrastructure, categorical block grant investment fund.

The capacity building strategy would also include the design and development of an effective grants system handbook for distribution among the regions and teaching institutions. The handbook would be designed as a "live document", to be amended and improved as the grant system evolves. The handbook would be posted on MoF's web-site for downloading by all users and the general public. It would also be made available in hard copy to all regional governments.

The handbook would also constitute the basis for the design of short courses to be made available to teaching institutions under a network developed by MoF.

4.3 CAPACITY BUILDING OBJECTIVES IN 2010

Assuming that the demand-driven capital grant system, as described in Chapter 3, is agreed by the GOI, capacity building support in 2010 would focus on:

- A review by MoF of the options for a demand driven capital grants system, including the policy framework required to focus grant resources and the integration of the *Hibah* grant decision-making process into the budget cycle.
- Resolving all remaining legal framework issues regarding the finalisation of revised GRs 54 and 57, to ensure that the legal framework supports the proposed model.

- Revising KMK 168/169 to, at the very least, enable the operationalisation of the grant system in 2011 and, possibly, 2012.
- Revising the SOP to enable the GOI to provide specific directives to the regions and map out the business processes required to allow MoF to manage the grant system. This would include a section of the SOP that would establish the operating procedures to be followed by partners in sector ministries that are required to provide inputs regarding grant award decisions. As part of the SOP review, assess the implications of the *Hibah* grant system regarding the management of funds originating from sources other than APBN (bilateral and multilateral donors, private sector, NGOs, other regions).
- Developing initial standards for regional grant proposals for 2011, including the preparation of project typology templates and check-lists.
- Carrying out an assessment of medium-term capacity building needs, in particular, focusing on an option to set up a dedicated grant/loan management agency. This activity would then allow to develop a medium-term capacity building plan for the management of *Hibah* grants.
- Addressing immediate IT support requirements (data management, web-based interface system) to support MoF's data management requirements in 2011. Follow-up work would then be needed to develop the technical standards for a fully integrated IT solution that would link to MoF's IT system for budget and treasury management.

Support for 2010 would also include a focused study tour with the objective to review best practices used by a country model to provide insights on how effective, demand-driven grant systems are managed. This would help sharpen MoF's understanding of some of the approaches used to manage demand-driven capital grants systems.

Once the Hibah system has been defined, an effort would also need to be made to develop a medium-term capacity building plan for MoF, including the need to scale up the staff and, possibly, develop the organisation design to match the grant administrations of Hibah. The organisational development plan would also require a thorough identification of the IT tools needed to support grant administration requirements, including the development of an interactive web-site to enable MoF to manage relationships and transactions with regional governments at arms-length. The plan would also develop an option for institutionalising a dedicated agency able to cater to the micro-management of Hibah on behalf of the MoF.

4.4 CAPACITY BUILDING NEEDS AFTER 2010

Beyond 2010, medium-term capacity building requirements would include:

- Further development of the SOP as decisions are made on the full development of a comprehensive capital grants system, described in Chapter 3.

- Preparation of a capital grants handbook that would, among other features, include the SOP, models of the types of projects that would be acceptable for grant funding, guidance for the preparation of grant proposals, standard bidding documents, check lists needed to carry out technical audits by supervisors, and standard reporting formats including project completion reports.
- The full roll-out of the IT tools needed to fully operationalise the capital grant system.

4.5 SUMMARY

Assessing capacity building needs for a demand-driven capital grant system is a major exercise, given that Indonesia has little experience in this type of grant system. All grant systems in Indonesia, past and present, have been designed by the centre and allocations among the regions have been defined either using formulas defined by the central government (*DAU, DBH* grants) or in line with GoI policies (*DAK and DEKON/TP).*

Although a demand-driven grant system will allow regions to affect allocation policies, the GoI has an interest to ensure that the capital grant system allows to concentrate resources in significant infrastructure development as well as in favor of those resource-poor regions that do not have the resources to undertake investments on their own or, because of their weak fiscal position.

Grant management systems also need to ensure that the investments that are financed by GoI grants meet minimum standard guidelines: since the GoI must borrow the funds needed to support the capital grant system. This means that the regions that request grant funding must meet quality standards to be eligible for grant awards. This then requires them to prepare grant proposals that compete against proposals by other regions to access the limited grant funding that will be available on an annual basis. To allow for a **fair** competition among regions, the GoI may need to set into place a funding mechanism (project preparation and supervision facility) to help resource-poor regions prepare viable grant proposals.

While a formula-based grant system may reduce the grant administration burden in the GoI, it will introduce different management requirements, including the assessment of continued eligibility of the regions for grant assistance. These needs cannot adequately be assessed till the system has been defined.

An approach to the development of a multi-year pipeline of projects and budgeting system (MTEF) needs to be developed that will help smooth out the flow of work needed to develop viable project proposals and ensure that funding commitments is safeguarded for projects that need several years to be implemented (MTEF).

As the system develops and becomes entrenched, the GoI may need to equip itself with an effective grant management agency that would carry out much of the detailed work needed to support an effective demand-driven capital grant system.

ANNEXES

ANNEXE 1: THE GOVERNMENT'S INFRASTRUCTURE AGENDA[14]

Electricity

1. **With electricity demand growing at over 6% per year over the past decade, and very little system expansion during this period, the system now has an inadequate reserve margin.** Blackouts are occurring across the country. PLN has installed capacity of about 24,000 MW. Since early 2006, the Government has been pursuing a "crash" program to procure 10,000 MW of coal-fired power plants to be operated by PLN, the Government-owned utility. Around 3,600 MW of capacity are expected to be commissioned by the end of 2010, with the remainder of the crash program expected to be delivered by 2012. Simultaneously, PLN has pursued additional private investment in electricity, with IPPs expected to make an increasing contribution to capacity after 2012.

2. **The task of raising finance for the new investment is made very difficult by the fact that electricity tariffs have not been increased since 2003, when the average tariff was brought to the pre-crisis level of 6.8 cents/kWh.** Because of higher oil prices, and the significance of oil in PLN's fuel mix, the fuel cost alone now exceeds the average tariff. To ensure PLN's financial sustainability the Government provides a "Public Service Obligation" (PSO) subsidy, which covers the difference between PLN's costs and the regulated tariffs for different consumer categories. The GOI is proceeding with a significant increase in rates for high level consumers in mid-2010.

3. **One of the reasons for the current high cost of subsidies is reliance on expensive diesel to meet a significant proportion of base load, in addition to its normal role of satisfying peak demand.** Most of the currently planned capacity expansion is coal-fired power plants, which will result in significant reductions in the cost of meeting base load. The Government is also considering connecting natural gas to existing plants which currently burn diesel, and for developing geothermal power projects (10 geothermal projects are now scheduled to be offered to private investors).

4. **The Government has recently reorganised PLN and appointed a new Board of Directors.** One of the changes is to re-establish a planning unit, which will improve the orderly development of investment projects and help the government forecast

[14] This section is based on the Indonesia: Second Infrastructure Development Policy Loan (Report No. 46328-ID) document and ongoing preparatory work for the proposed Third Infrastructure Development Policy Loan.

the fiscal burden of PLN's subsidies. The planning unit was fragmented in preparation for reforms that would have moved Indonesia to an unbundled competitive market. These reforms were disallowed by the Constitutional Court in 2004, disrupting the reform momentum: it remains the root cause of many of the sector's current problems. Another element of the recent restructuring is a move to regional business units. PLN's costs vary widely by region, and it is anticipated that this restructuring will facilitate the development of responses to region-specific problems.

Roads

5. **The first priority in any road network is maintenance of the existing network.** In 2006, the national road network of 34,628 km included 81% in good or fair condition, 10% in poor condition, and 9% in bad condition. The Ministry of Public Works' Directorate General of Highways aims to have no roads left in poor or bad condition by 2010, an objective which will be largely determined by budget availability. The Ministry of Public Works received a substantial budget increase in 2008. To provide a more systematic link between funding and sectoral performance targets, the Government is working towards a medium-term expenditure framework and performance-based budgeting. The Ministry of Public Works is keen to act as a pilot ministry for these initiatives.

6. **The development of an expressways network, including toll-roads is a national priority.** Development of an expressway network would provide an important boost to economic growth. The National Road Network Master Plan calls for the creation of 2,885 km of toll-road expressways, of which 676 km are already operational.

7. **The Government is seeking private investment to expand the toll-roads network**. The Indonesian Toll Road Authority, BPJT, was established in 2005 with regulatory powers and the responsibility to prepare projects for private investment. Concession agreements have been signed for 805 km in 22 sections of toll-roads. Fourteen of these agreements were signed prior to 1997, and because of difficulties in land acquisition have languished, unable to achieve financial close. Over the past two years, the Government has taken measures to address the land acquisition problems and to terminate projects that are still unable to achieve financial close. The Government has also tendered several new "batches" of toll-roads in recent years, and these are in various stages of preparation.

8. **Institutional capacity in the roads sector needs enhancement. Heavy vehicle overloading is prevalent, and road safety is poor.** Road works are often expensive and low quality, and collusion between contractors is a problem. The World Bank is assisting the Ministry of Public Works and Ministry of Transport with a pilot road safety program, and pilot testing performance-based contracts for road maintenance, including vehicle loading control.

Piped Water

9. **Approximately 18% of the population, or about 40 million people, currently have access to piped water.** An extra 10 million household piped water connections would roughly double the number of people with access to piped water, and would cost in the order of US$1 billion. Merely providing connections is not sufficient, however. Additional investment is needed to ensure bulk water supply, and to improve water utility (PDAM) operations, to ensure that water is reliably available through the existing and any new connections.

10. **The Ministry of Public Works has ambitious national goals for expanding water access, but these goals can be contrasted with low levels of sectoral investment, the sub-national government responsibility for actually delivering water and sanitation services, and poor operational and management performance of PDAMs.** Sector investment has declined from an average of US$400 million in 1990s to under US$45 million in 2005, and is about one tenth of what is needed to achieve the 2015 Millennium Development Goals.

11. **In the absence of long-term local financing, donor support could provide the loans necessary to underpin new investments.** But not a single donor loan to the sector has been approved in the past decade. A significant obstacle to the flow of funds has been Ministry of Finance regulations that prevent donor financing to PDAMs which have debt arrears, or which are owned by local governments (PEMDA) that have debt arrears.

12. **Since 2008, the problems of debt arrears of local governments (PEMDA) and their water utilities (PDAM) is being addressed.** A scheme has been developed for the rapid restructuring of debt arrears, which will remove current legal barriers to necessary financing. The new scheme will reschedule principal arrears and write off all penalties or interest arrears on PDAM and PEMDA debt, subject to a limited set of conditions, including submission of audited accounts, raising tariffs to cover basic costs, and in some cases a commitment to invest an amount corresponding to the amount of debt arrears being written off. In the event that a PDAM or PEMDA again falls into arrears, the new arrangements permit the Ministry of Finance to intercept fiscal transfers which would normally be made to the relevant PEMDA.

13. **Over the past year, BPPSPAM, a water sector advisory body, has assessed the managerial, technical, and financial performance of 306 out of 335 PDAMs, and published the results on its website.** Using criteria such as operating ratio, debt-equity ratio, customer structure, number of employees per 1000 customers, water losses and operating hours, the PDAMs have been classified into three categories: (i) healthy – 79 (26%); (ii) less healthy – 114 (37%), and sick – 113 (37%). The mapping will be updated every year to exert pressure on PDAMs to improve performance.

14. **Following on from the Water Resources Law 7/2004 and Government Regulation 16/2005 on Water Supply, which eliminated the need for local parliamentary approval of water tariff increases, Regulation 23/2006 on drinking water tariff**

policy was issued by the Ministry of Home Affairs. This regulation introduced the principle of cost recovery and reduced the number of customer categories. Most PDAMs classified as healthy have benefited from tariff increases. Based on BPPSPAM's ranking, the Ministry of Public Works has sent letters to about 50 large PDAMs in the lower categories to adjust their tariffs to reach a cost recovery level of Rp. 3,500 per cubic meter.

15. **The Ministry of Public Works is providing technical assistance to PDAMs categorised as unhealthy (ie less healthy and sick), to assess their performance and draw up business plans.** Business plans are also required as part of the debt restructuring process. As part of the investments identified in the budget plans, the Ministry also provides capital improvements in the headwork, intake or treatment facilities, while PDAMs fund improvements in the distribution systems.

16. **Finally, the Government is examining ways to provide positive incentives to sub-national governments to improve the delivery of water and sanitation services.** Conditional fiscal transfers are being considered by the Ministry of Finance. Consultants have been mobilised using Dutch trust funds, and are working with the Ministry of Finance and Ministry of Public Works to develop the incentive scheme, as well as identifying other ways of encouraging financial flows into the sector.

Public-Private Partnerships

17. **The Government is pursuing PPP transactions in all infrastructure sectors, including toll roads, power plants, natural gas pipelines, rail, ports, bulk water plants, airports, and telecommunications projects.** Modest results are beginning to show. Some short sections of toll-roads and small bulk water treatment plants have commenced operation. Construction has commenced on over US$ 2 billion of new PPP projects, including power plants, toll-roads, and water treatment plants.

18. **Slow progress has generally been the result of poor project preparation, with inadequate background analysis undertaken prior to tendering, resulting in unrealistic expectations by tendering agencies.** Over the past year the Government has strengthened the project preparation process, and has placed greater reliance on external advisers. An electricity plant in central Java is being prepared with the assistance of an IFC advisory mandate. The ADB has mobilised a PPP project development facility, funded by a US$ 26.5 million loan, and a US$ 7.56 million grant provided by the Netherlands. The facility is currently providing support to 20 national and sub-national PPP projects, including toll-roads, ferry terminals, bulk water supply systems, railways, an airport, and a telecommunications project. The emphasis of current support is on improving the quality of feasibility studies prior to bidding.

19. **Till recently, the Ministry of Finance was only authorised to provide guarantees or direct financial support for PPPs which comply with Perpres 67.** This regulation required three bids received in a competitive tendering process. Given the infancy

of Indonesia's PPP program, the requirement of three bids has proven to be a practical barrier to projects for which government support may be economically justified. Recognising this constraint, Perpres 67 has now been amended and now authorises negotiations with successful bidders in cases where fewer than three bidis s are received. This would open the way for the provision of Government support to a wider range of transactions.

20. **The Government is also taking measures to address land acquisition issues which have blocked private toll-road development.** A revolving land fund was established by the Ministry of Public Works in January 2007. The fund finances land acquisition for toll-roads, and is reimbursed by the concessionaire when land acquisition is completed. The fund has been accessed by eight toll-road concessionaires, of which six have now commenced construction, and one toll-road section is already operational.

21. **Fourteen toll-road concession contracts were awarded prior to the financial crisis in 1997, and have not moved to financial close, in part because of escalation in the cost of land acquisition since initial contract award.** The Government has developed a "land-capping" scheme, under which the concessionaires will pay 110% of the land costs initially envisaged, with the Government to pay for the remaining land acquisition costs. The Government funds available for this scheme are capped at Rp. 4.9 trillion. The criteria for allocation of these funds to particular concessionaires are described in the discussion of IDPL 2 triggers. Transactions that do not move to financial close after accessing the land-capping funds will be terminated.

22. **Finally, the Government is developing institutions to support infrastructure financing.** In addition to establishing an Indonesian Infrastructure Finance Facility (IIFF), the GOI is preparing a framework to institutionalise an Indonesian Infrastructure Guarantee Fund (IIGF) to ensure the availability of government funds to honor guarantees given to private infrastructure projects. The IIGF will be a single window for appraising infrastructure PPP subprojects requiring GOI guarantees. The IIGF will support the qualified subprojects by providing subproject sponsors and lenders with adequate protection against specific subproject risks. Qualified subprojects passing the IGF's appraisal criteria will receive guarantees backstopped by a suitable combination of: (a) IGF's own balance sheet, (b) the GOI balance sheet, and (c) the WB credit and guarantee assistance to IGF.

Land Acquisition

23. **Land acquisition is a frequent source of delays in infrastructure projects across all sectors.** A Land Working Group has been established to review issues associated with the process of land acquisition, with a view to removing impediments to timely land acquisition for infrastructure development. The Working Group is

chaired by the President of the National Land Agency (BPN), and includes members drawn from the Coordinating Ministry of Economic Affairs, BAPPENAS, Ministry of Public Works, and the Ministry of Home Affairs.

24. **Two sub-committees have been established, dealing with "land banking" (in effect, the process of zoning land or purchasing land well in advance of potential projects) and "land acquisition".** The sub-committee on land acquisition has proceeded over the course of the year to identify the major practical issues encountered in land acquisition, and is preparing an action plan to address these issues.

25. **The World Bank is preparing trust-funded technical assistance that will go beyond the sub-committee's** identification **of issues, and assist in the design of pilot activities, such as a demonstration of revised approaches to land valuation.**

Managing Environmental Impacts

26. **The Government's annual work plan includes the environmental actions to be addressed in each budget cycle.** Some of the items mentioned include development of debt for nature swaps, reducing environmental pollution, reducing smoke and haze from forest and land fires, rehabilitation of forests and degraded lands, conservation of natural resources, improving environmental management through the spatial planning process, and developing environmental data and information. The Bank is supporting initiatives to improve solid waste management and to improve environmental impact assessment and management under the IDPLs.

27. **The Government recognises the problems of solid waste (open dumping, open burning, and mismanagement) as an increasing pollution problem and a threat to public health.** Only about half of Indonesia's solid waste is actually collected, 15-20% is properly disposed, and less than 2% is treated (recycled or composted). About 85% of small cities and more than 50% of medium cities dispose of their waste in open dumps. The new Municipal Waste Management Law, enacted in early 2008, aims to reduce the generation of solid waste by encouraging communities to "reduce, reuse, recycle", and improve the handling of solid waste, through improved separation of types of waste and processing prior to final treatment.

28. **Indonesia has decentralised responsibility for environmental impact assessments, known in Indonesia as AMDAL.** All 33 provincial governments and 55% of kabupaten/kota governments have AMDAL agencies. The Ministry of Environment has undertaken two surveys of the quality of environmental assessments performed by these agencies. While quality is improving, the most recent survey still found that 21% of assessments were poor quality. The Ministry is undertaking measures to improve the quality of the work performed by these agencies, including through the licensing of AMDAL commissions, the certification of

commission members and trainers, and the establishment of an AMDAL training center.

29. **The Government is also preparing revisions to the AMDAL law.** These revisions include sanctions for agencies that issue development permits without a necessary environmental impact assessment. The potential sanctions include revocation of the permit, and criminal prosecution of the responsible person. The revisions also aim to strengthen public consultation in the AMDAL process, providing for the possibility of representation of the public by technical experts.

Ministry of Public Works Governance Issues

30. **The Ministry of Public Works (MPW) accounts for a considerable part of the national government's public infrastructure investment program, including US$2 billion per year delivered through the Directorate General of Highways.** Measures to improve governance in MPW include improvements along the length of the project cycle from planning and design through payments and audit.

31. ***Planning and contracting form:*** The Government is moving towards a Medium Term Expenditure Framework, with MPW one of six government agencies selected to pilot the reforms. The reforms will help, among other matters, to improve and guarantee the level of resources dedicated to maintenance. In addition, the government is planning to pilot performance-based contracting for maintenance, which should improve the efficiency of the maintenance process.

32. ***Oversight:*** The Government is piloting a system of contract oversight that relies on contracted engineering firms acting as responsible agents rather than in an advisory capacity. In the new arrangements, the engineer specified in FIDIC contracts as the overseer is clearly specified by MPW to be the contracted engineering firm, rather than MPW officials. The system provides considerably greater authority and responsibility for successful project delivery to the engineering firm.

33. **Transparency and Disclosure:** The Ministry of Public Works website (*www.pu.go.id*) provides a high standard of information disclosure, exceeding the information availability of most public works ministries in developing countries. The website includes the Ministry's budget, planned roads and other works, the results of all tenders including winners and losers and bid prices, audit reports, and the quarterly financial reports for all World Bank projects (the last is not required by the World Bank).

34. **Procurement:** One international benchmark suggests general levels of integrity and transparency in public procurement in Indonesia are comparatively strong,[15] but this contrasts with Transparency International's assessment of general levels of corruption, which ranks Indonesia as 143rd of 179 countries. Certainly a number of issues and potential problems remain – many of which are being addressed by MPW. In particular, collusion and the related issue of fake bid securities remain a significant problem in road projects in Indonesia, affecting recent donor-funded projects. Not least for this reason, the MPW has moved to strengthen procurement systems and procurement support.

35. **To support the procurement process, MPW has introduced an advanced e-procurement system**. The system handled 4,000 contracts last year. It currently allows publication of advertisements of projects, availability of bidding documents on line for free download, online clarifications and queries and notification of contract awards on line. All Directorate General of Highways (DGH) national roads contracts in all regions and all value of contracts are processed through the system. To date MPW has been constrained in allowing submission of bids on-line due to the lack of digital signature legislation. However this has been recently enacted and DGH will move to full e-procurement in the near future. A team from MIT is currently analysing the impact of the move to e-procurement. Early indications are that the change has resulted in a significant increase in the number of people obtaining bidding documents, but it is less clear that there has been a significant increase in the number of bids made.

36. **To support the multitude of procurement committees in MPW and improve the quality and promptness of their reviews, DGH is establishing a Procurement team staffed, funded and mandated to provide support to procurement committees in terms of advice, capacity building, review and streamlining of procurement procedures and promotion of standardised bidding documents.** AusAID is providing technical assistance in the establishment of the Procurement Team. DGH is also receiving financing from donors aimed at supporting different tasks related to the reform of public procurement on the national, ministerial and local levels. Particularly aimed at bidder collusion, on some projects the Government has piloted a system which allows for no prequalification, which keeps confidential the list of bidders who obtained bidding documents and which avoids physical pre-bid meetings.

37. **The Ministry is participating in a World Bank study of ways to improve competition in the road construction industry.** The study will include a survey of public works officials, local state-owned and private construction companies, leading potential international bidders, contractors, consultants, material suppliers, and industry associations, aimed at identifying the barriers to entry into the industry, and industry perceptions of the causes and effects of corruption. The

[15] OECD/DAC procurement benchmarking of Pillar IV covering integrity and transparency of procurement scored Indonesia at 69 percent.

study will also include a workshop with all stakeholders aimed at identifying reform recommendations.

38. ***Audit****:* The MPW Inspector General (IG) has a broad set of priorities set by management covering the minimisation of leakage, improved quality of public works and support for good practice in project management. The IG has recognised the need to move towards systematic risk assessment, develop a manual for technical audits and expand training. AusAID and the World Bank are working together to provide technical assistance in the implementation of its reform action plan.

ANNEXE 2: OPINION – CONSTITUTIONAL ASPECTS OF GRANT SYSTEM

1. Introduction

The broad objective of this opinion is to determine the scope of the legal obligations pertaining to 'regional grants' having specific regard to Articles 1(28) and 45 of *Law 33 of 2004 Fiscal Balance Between the Central Government and the Regional Governments* (Law 33) and Government Regulation 57 of 2005 (PP 57).

Law 33 is the primary statute that sets out the several funding mechanisms and administrative requirements regulating intergovernmental fiscal transfers between the Government of Indonesia (GOI) and regional governments. Law 33 and all relevant subordinate legislation, however, are subject to Article 18A of the *Constitution of Indonesia*, 1948 (as amended). Article 18A (2) contains a legal duty or obligation that intergovernmental relations relating to finances be carried out in a manner that is governed by an 'express standard of conduct' based on 'fairness and equity'. This legal standard of conduct governs both the substantive composition of the laws as well as administration of what constitutes the intergovernmental fiscal transfer system being implemented in Indonesia.[16]

The more specific objective of this opinion is to analyse the scope and depth of Article 18A (2) to determine how the operation of the 'fairness and equity' obligation can be expected to govern the design and administration of an output-based (also known as a conditional) grants scheme pursuant to any revision/amendment of PP 57 or Ministerial Regulation drafted pursuant to PP 57.[17]

The specific questions addressed in this advice are:

1) What is the broad conceptual and legal character of the 'equity' obligation contained in Article 18A?
2) How is Article 18A likely to be interpreted by the Constitutional Court within the context of Law 33?

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[16] The notion of 'legal duty' is central to this advice. A legal duty arises by operation of law. It is a statement or expression, also known as an obligation that requires a particular party or parties to act, or forbear to act, according to a particular standard of conduct. Failure to act in a manner consistent with the obligation results in a breach of that obligation. Hacker, P.M.S. (1973). "Sanction Theories of Duty," in A.W.B. Simpson, ed. ***Oxford Essays in Jurisprudence: 2nd Ser.*** Oxford: Clarendon Press.

[17] Output-based grants are a form of intergovernmental transfer instrument that are also referred to in the literature as performance-based and/or conditional instruments. Conditional transfers may specify requirements that must be either present or achieved before the grant recipient is eligible to receive the grant. Alternatively, conditional grants may specify requirements in the form of performance milestones that must be achieved to be entitled to funding maintenance over time. *See:* Shah, (2006) A "Intergovernmental Fiscal Transfers" *World Bank Policy Research Paper* No. 4039.

3) How does the Article 18A equity obligation influence the design and drafting of substantive provisions regulating the:
    a. form,
    b. access to, and
    c. distribution of 'regional grants' within any subordinate legislation created under the authority of PP 57?
4) How does a demand driven, specific-purpose, output-based fiscal transfer instrument differ from the *DAK* as contained in Law 33 of 2004.

2. The Legal Concept of Equity: Social or Fiscal?

Article 18A (2) of the Constitution provides that:

> The relationship in finances, public services, utilisation of natural resources and other resources between the central government and the regional governments shall be regulated and executed fairly and equitably based on the laws.[18]

The *subject matter* of Article 18A (2) concerns the 'relationship' between the GoI and the regional governments pertaining to finances, public services and natural resource management. Article 18A (2) imposes a *legal duty* upon the GoI and regional governments to carry-out affairs relating to this subject matter conforming to a specific *standard of conduct*. The standard of conduct is expressly stated in the substantive requirement that relations concerning this subject matter be regulated and executed 'fairly and equitably'.

Under Article 18A (2), the 'fairly and equitably' standard applies to the composition of laws relating to finances as well as to the *administration and effects* of those laws. Determining how this standard is to be applied requires some explanation. Both the words 'fairly and equitably' are legal 'terms of art' that carry with them specific connotations, especially applied in the context of public law and finance.[19] In

[18] It should be noted that there are several different versions of Article 18A (2) that vary depending upon the translation. The version cited above is that version used by the Decentralization Support Facility (DSF), an Indonesian Government-led multi-donor trust fund whose principal purpose is to support the decentralization agenda of the Government of Indonesia. The DSF is managed by a committee structure comprising senior representatives of the Ministry of Finance, the Ministry of Home Affairs, the National Development Planning Agency, and nine international development partners.

[19] A legal term of art is a word or phrase that have precise and fixed meanings when applied in a legal context. The legal meaning of a word that is a term of art will differ from the lay meaning of the same word. Haigh, Rupert *Legal English* Cavendish Press: London, 2004.

particular, equity is a word that has many different legal meanings.[20] As a consequence, the appropriate meaning of equity to be applied under a given circumstance is derived from the context in which the word is used.

Equity, in its broadest sense, is defined as “what is fair and just”. At law “what is fair and just” does not necessarily mean equal (although under certain circumstances it may mean equal). It is the relationship between fairness, on the one hand, and inequality, on the other, that is central to understanding how the concept of equity is applied in a public administrative context. Equity, as a public administrative law standard, permits a departure from equality where the notion of ‘fairness’ justifies such a departure. The primacy of fairness over equality is central to the broad notion of ‘social equity’ and its related, but narrower, concept of ‘fiscal equity’.[21] As will be described below, social equity is a legal concept; fiscal equity is a policy concept. This critical distinction between the two concepts has a subtle but important implication in respect of the jurisdiction of the Constitutional Court to engage in judicial review.

2.1 Social Equity as a Principle of Law

The legal notion of social equity is closely associated with the writings of John Rawls in western philosophy (although corresponding notions are found throughout eastern philosophical thought).[22] Rawlsian conceptions of society, justice and fairness provide a broad conception of equity. Rawls based his theory of ‘justice as fairness’ (as opposed to equality) on two principles. His first principle describes equality in terms of an assignment of rights and duties among diverse social actors. His second principle explains how social and economic inequalities are ***just*** only if distributive imbalances result in compensating benefits for everyone, and in particular for the least advantaged members of society.[23]

The idea that justice and equity necessitates an examination of the distribution of gains and losses, and can justify (non-equal) compensatory action, is well recognised as an embedded legal concept underlying public planning and administration within modern

[20] Newman, James “The Place and Function of Equity in the Structure of Law” *16 Hastings L.J. 401* 1964-1965.

[21] Social equity analysis emphasizing the distribution of resources and legal analysis emphasizing equal protection may lead to differing views. *See: San Antonio Independent School District v. Rodriguez*, 411 U.S. 1 [1973], in which the US Supreme Court determined that social equity is not an express or implied constitutional right under the US Constitution. In the absence of an express social equity provision in legislation, equal protection takes constitutional priority over social equity. By contrast, under Article 18A (2) of the Indonesia Constitutional, social equity is an express and embedded right.

[22] Van Dung, Nguyen (2007) “Eastern Religions- Reforms and Renovations” *Religious Studies Review* 1(3) pp. 69-79 at 76.

[23] Rawls, John *A Theory of Justice*, Cambridge, MA. 1971.

states.[24] Whereas Indonesia has constitutionally entrenched an explicit social equity principle in the form of Article 18A, social equity is a constitutional implication that has been read into the constitutions of most developed countries. Although abstract theories of distributive justice are intellectually challenging and often ambiguous, western courts have developed general and functional legal theories of social justice and social equity that are routinely applied in a public administrative context. At law, the concept of social equity has become embedded in a body of principles that seek to either balance or distribute 'burdens and benefits' on a bases that are 'fair' although not necessarily equal.

Social equity as a justification for non-equal treatment must be distinguished from the concept of 'equal justice' before the law (analogous to equal protection clauses elsewhere in the world) contained in Article 27 of the Constitution. Article 27 applies only to natural persons, not to State or local governments (See: decision of the Constitutional Court in the *South Sulawesi Case*, No. 070/PUU-II/2004). The equal justice obligation, such as that contained in Article 27, is a non-discrimination clause ensuring every citizen is treated equally by public authorities (in relation to access to, and the administration of justice and other government funded services). By contrast, social equity as a justification for non-equal treatment by public authorities is a principle recognised in Indonesian law. In the *South Sulawesi Case,* the majority of the Constitutional Court applied an equitable concept of 'justice' to justify differential treatment of provinces. In its decision, the Court stated that:

> …justice does not mean that all legal subjects are treated in the same manner regardless of the circumstances of each party. In fact, justice should apply the principle of proportionality, which means treating similar things the same way and treating different things differently. The circumstances of each principle province and newly created province are not always the same, therefore it is appropriate not to treat them in the same way either… uniform treatment of inherently different things will cause injustice.

The Constitutional Court's reasoning conforms to that of US Constitutional scholar, Laurance Tribe. Tribe uses the term *equality* to denote two distinct legal principles. On one hand is *equality of treatment* (also known as equal protection), the ideal embodied in the US Constitution as "equal justice under the law." It is reserved for limited situations, such as voting, in which every person must be granted identical privileges or rights. On the other hand, he describes the *right to treatment as an equal,* a principle of American legal tradition that is not tied to any particular Constitutional language but has a foundation in common law. It says that the state must treat each individual with equal *regard* as a person, no matter what his or her particular interests may be, and

[24] Frederickson, George "Public Administration and Social Equity" *Public Administration Review,* 50(2) 1990, pp. 228-237

acknowledges that the conditions or outcomes of treatment may vary from case to case.[25]

2.2 Fiscal Equity as a Policy Concept

Whereas the concept of social equity is recognised by the courts in many countries as a fundamental *principle of law* that governs the ordering of a broad array of social relations, the concept of fiscal equity is not a legal principle. Instead, fiscal equity (as derived from the legal concept of social equity) is a concept used to guide the development of public policy grounded in the disciplines of economics and public administration.[26]

In the public economic and public administration literatures, the concept of fiscal equity is frequently discussed in terms of a theoretical justification for public policies that distribute resources unequally. In his landmark paper, Buchanan identifies the political dimension of the fiscal equalisation question stating that when “the interstate differences in fiscal capacity can be traced through to their ultimate impact upon individuals, and a policy objective formulated in inter-personal terms, it would seem that greater support could be marshalled for interstate fiscal equalisation.” In an equally influential paper examining the theoretical underpinnings of fiscal transfer arrangements, Le Grand notes that unequal policy choices can be justified when applied to correct fiscal imbalances between regions stating “fiscal disparities between local authorities are considered inequitable if they arise from factors that are largely or entirely beyond a local authority's control.”[27]

Even though the two concepts may seem inter-changeable, there is a subtle difference between social and fiscal equity. Social equity is a legal principle; fiscal equity is an economic policy used to achieve social equity. Although the distinction may appear to be one of semantics, the difference becomes apparent in light of an analysis of the jurisdiction of the Constitutional Court as discussed below.

3. Social Equity, Fiscal Transfers and the Constitutional Court

Given the decision of the Constitutional Court in the *South Sulawesi Case*, a strong argument can be made that Article 18A (2) contains an express legal duty that intergovernmental relations be conducted using a social equity standard rather than an

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[25] Tribe, L. *American Constitutional Law* (2nd ed.). Mineola, NY: Foundation Press. 1988.

[26] Buchanan, J. M. "Federalism and Fiscal Equity" *American Economic Review*, 40 (4) 1952 pp. 583-99.

[27] LeGrand, Julian, “Fiscal Equity and Central Government Grants to Local Authorities” *The Economic Journal* 85 (339) 1975, pp. 531-547

equal justice/protection non-discrimination standard. The question arises as to how the Constitutional Court (MK) could be expected to apply the concept of social equity in the context of Law 33 and its subordinate legislation? For example, does Article 18A (2) require that ***each*** 'fiscal transfer mechanism' contained in or authorised under Law 33 satisfy the fairness and equity requirement (i.e., must each of the DAU, DBH, *DAK* and capital grants must satisfy the fairness and equity principle in their own right)? Or, does Article 18A allow for an interpretation that, in combination, ***all*** fiscal balance mechanisms contained in Law 33 operate as a whole system of interacting instruments satisfy the justice and equity requirement?

This question has implications affecting the design of the Indonesian intergovernmental fiscal transfer system. If a broader interpretation is permissible, individual instruments may be designed in a manner to target specific goals and objectives. Although in isolation, each instrument/mechanism may lead to an inequitable distribution (within the meaning of social equity), if the inequitable outcomes under individual instruments balance each other out, is the 'spirit' of the fairness and equity standard satisfied?

This question is answered in two steps. The first step requires an examination of the MK's jurisdiction. The second step requires an examination of Article 2(3) of Law 33.

3.1 The Review Jurisdiction of the Constitutional Court

Article 24C of the Constitution (as amended) sets out the review jurisdiction of the Constitutional Court (MK). Article 24C grants the MK the power to make binding decisions in the review of the constitutionality of statutes. Since its creation in 2002, the jurisdiction most frequently exercised by the MK has been reviewing the constitutionality of statutes to determine whether legislation enacted by the DPR is consistent with the principles contained in the Constitution. Since its inception, Court has garnered a reputation as being competent, diligent and impartial in the exercise of its jurisdiction.[28]

Four relatively recent decisions relating to Article 33 of the Constitution shed light on the approach the MK could be expected to take in relation to any constitutional challenge arising under Article 18A. All four Article 33 decisions relate to questions having important economic policy implications for Indonesia- just as an Article 18A challenge would.

The questions that arose under the Article 33 cases relate to the interpretation of key terms used in Article 33 that were ambiguous in their interpretation. The leading case on this issue is the *KPK [Corruption Eradication Commission] Law case* (KPKC 2003). In it, the MK majority made the following statement:

[28] KPKLC **(KPK Law Case) (2003) MK Decision No. 006/2003**, reviewing **Law No**. 30 of 2002 on the Corruption Eradication Commission, Constitutional Court, Jakarta.

> When performing material review, the MK must differentiate between [different types of] legislation … If the constitution's provisions and spirit [require] a statute to contain **detail to achieve a particular aim**, but the statute takes a different or contrary direction, then the statute will go against the constitution's provision and spirit. The MK then has jurisdiction to declare that statute to conflict with the constitution and to declare that the statute has no binding legal force [emphasis in original] (KPKC 2003: 94–5).

More importantly, for the purposes of this analysis, the Court went on to explain that if the Constitution establishes an end to be achieved by legislation, but not the means to achieve it (as in the circumstances of Article 18A (2)), then the Court should not evaluate the means the legislature chooses to achieve that end, nor the effectiveness of those means.

> … if the constitution has underlined that the statute must contain the **means** to achieve a purpose, that is, it chooses an instrumental policy, law makers (the DPR and the president) can choose between a number of alternatives. Whichever alternative the law makers choose will be valid, provided that it remains within the **corridor** stipulated by the constitution. The MK does not have jurisdiction to review the instrumental policy chosen by law makers.
>
> … In a democratic country in which the people are represented through elections, it is presumed that the people's will is represented by the people's representative institutions. Upon this premise, one can syllogistically … conclude that the people's aspirations are represented by elected people's representative institutions.
>
> Instrumental policy also relates to the **effectiveness** of a statute; that is, the extent to which the **means** chosen by law makers has successfully achieved the purposes mandated by the Constitution. The MK's jurisdiction does not extend to evaluating a statute's effectiveness. This does not mean that a statute's effectiveness cannot be reviewed [at all]. It can be reviewed at any time by law makers through *legislative review* [emphasis in original] (KPKC, 95).

The implications of this decision for the regulation and administration of fiscal transfer arrangements are significant. Article 18A (2) provides the means (i.e., the instrumental policy being social equity standard), but it does not specify how that policy is to be achieved. This absence of prescription in Article 18A (2) opens the possibility for a much greater flexibility in the design and implementation of fiscal transfer system as well as the interaction between different components of the system.

3.2 Article 2(3) of Law 33 and the 'Spirit' of the Fiscal Transfer System

The notion that intergovernmental fiscal transfer arrangements in Indonesia should be perceived as a 'system' rather than a collection of individual components is reinforced by Article 2 (3) of Law 33 which states that:

> Fiscal Balance between the Government and the Regional Government is a comprehensive system in the funding of Decentralisation, Deconcentration and Co-Administered Tasks.

The importance of this statement is that, in light of the findings in the *KPK Case*, so long as the fiscal transfer system articulated in Law 33 satisfies the social equity standard under 18A, there is no requirement that the separate components of the system must satisfy the equity obligation in their own right. The disconnect between 'system' and 'mechanism' legally and constitutionally occurs in that Article 18A is not prescriptive. As such, Article 18A (2) allows legislators to deviate from the 'equality standard' contained in Article 24C of the Constitution and leaves it open to law makers to choose the policy means by which the policy objectives underlying Law 33 are to be achieved. The KPK case makes it clear that so long as the Law 33 fiscal policy objectives are framed within the Article 18A (2) social equity corridor, a broad range of fiscal policy choices and instruments can be used. Furthermore, so long as the means chosen remains within the 'corridor' (any directed instrument and process) required by the constitution, the MK does not have the jurisdiction to review that policy choice or the effectiveness of that choice.

4. Law 33 of 2004, Subordinate Legislation and the Design of a Regulation Governing Regional Grants Under PP 57

The implications of the *KPK case* for the policy choices underlying the substantive composition of a grants scheme pursuant to Article 6 of PP 57 are considerable. The critical passage contained in the judgement of the MK in the *KPK case* pertaining to the design of policy instruments pursuant to a statute states that:

> …if the constitution has underlined that the statute must contain the **means** to achieve a purpose, that is, it chooses an instrumental policy, law makers (the DPR and the president) can choose between a number of alternatives. Whichever alternative the law makers choose will be valid, provided that it remains within the **corridor** stipulated by the constitution. The MK does not have jurisdiction to review the instrumental policy chosen by law makers.

The 'corridor' (as described in the KPK case) as applied in the context of the fiscal transfer system originates with Article 45 of Law 33. Article 45 authorises the creation of Government Regulations regulating procedures pertaining to the giving and receiving of 'grants' (within the meaning of that word used in the context of Article 2 (28) of Law 33). The relevant government regulation authorised by Article 45 of Law 33 is PP 57 which, in turn, states that: "further provisions concerning the procedures for the distribution of grant shall be regulated in the Regulation of the Minister of Finance".

Although the delegation chain is clear, neither the Law 33 nor PP 57 delegation is prescriptive. As a consequence, the drafters of any Ministerial Regulation pursuant to Article 6 of PP 57 have a very wide discretion in determining the method by which the 'grant' is to be distributed provided that it is directed towards achieving the constitutionally mandated statutory purpose of achieving social equity. This broad discretion falls entirely to the Minister of Finance. He/she may choose whatever instrumental approach is deemed appropriate. The only obligation attaching to the Minister is that the method and means of distribution must be transparently articulated in the form of a formal Ministerial Regulation.

4.1 Fiscal Equity and the Design of Fiscal Policy Instruments

A second aspect of the *KPK case* that informs the design of subordinate legislation under Law 33 is the MK's reference to the relationship between *'the means'* a statute is constitutionally required to use to *'achieve a purpose'* and the *'instrumental policy'* chosen to achieve that purpose.

The distinction between 'means, purpose and policy', although made in a slightly imprecise way, provides an analytical framework that distinguishes between the underlying legal principles that must be embedded within a statutory scheme to achieve a constitutional purpose, on the one hand, and the policy choices and instruments that can be used to achieve those purposes, on the other.

The purpose of Article 18A (2) of the Constitution is to entrench the principle of distributive fairness.[29] The means directed towards achieving this purpose that is provided in Article 18A is the social equity standard. The social equity standard, however, is a broad one that can be applied in many different policy contexts. In the case of 'financial relations', social equity is achieved through the implementation of instruments directed towards achieving the policy objective underlying Law 33, which is fiscal equity.

How the policy objective of fiscal equity is implemented in the substantive instruments that comprise Law 33 (in conjunction with how those instruments are administered) is a question that the MK has said it will leave open to law makers. In short, as long as the social equity obligation is embedded in the overall fabric of the statutory scheme, the instruments and mechanisms chosen by the GOI to achieve this legal obligation (and their effectiveness) are not open to constitutional challenge. For example, if in light of

[29] The inclusion of an express social equity obligation in Article 18A(2) by drafters could have been a response to its absence in the US and western Constitutions (which were drafted at a time pre-dating the more recent concept of social equity).

the Article 18A social equity obligation, Law 33 were drafted in a manner that its substantive instruments were contrary to the 'spirit' of the obligation (say, by using an 'equality' rather than 'fairness' standard), the MK would deem Law 33 as unconstitutional, and therefore, contrary to the spirit of the Constitution.

Fiscal equity is the GOI policy objective underlying Law 33. It is a policy objective that is consistent with the broader Article 18A legal obligation of social equity. How Law 33 achieves its policy objective of achieving fiscal equity, according to the MK decision, is a discretion that falls to the GOI. The effect of this declaration is that the GOI has a lot of latitude in fashioning the individual regulatory instruments that comprise Law 33.

4.2 The Design of a Regional Grants Scheme Pursuant to PP 57 and Ministerial Regulations 168 & 169

Given the latitude the GOI has in determining the composition of instruments directed towards achieving its policy objective of fiscal equity, and given the absence of prescription contained in Article 45 of Law 33, the Minister of Finance has a wide discretion in determining the substantive content of a Ministerial Regulation pursuant to Article 6 of PP 57 and Regulation 168.

The Minister can choose whatever approach they deem fit as long as the operation and administration of the scheme chosen contributes, or can be justified on the grounds of achieving the overall policy objective of fiscal equity. Therefore, the Minister's discretionary scope of authority is broad enough to encompass:

i) Establishing the form that a policy scheme takes; i.e., a grant

ii) Establishing restrictions on access and eligibility to the capital grant based upon fiscal equity considerations

iii) Establishing conditions and requirements that must be satisfied by grant recipients

If the Minister chooses, as a matter of policy, to implement the capital grant scheme in the form of an instrument that is distributed on fully discretionary grounds and, the receipt of which is to be subject to some set of eligibility or performance conditions, the MK is unlikely to strike the scheme down as unconstitutional provided that the Regulation can be shown to contribute to, and further, the overall policy objective of achieving fiscal equity. The fact that some regions may not be eligible/entitled to receive the grant can be fully justified on the 'fairness' as opposed to 'equal' standard that is embedded within the concept of fiscal equity through the legal obligation of 'social equity'.[30]

[30] For an interesting article examining the relationship between social equity policy objectives and instrument design, see Collins, B. and B.J Gerber "Taken for Granted? Managing for Social Equity in Grant Programs" *Public Administration Review* 68(6) 1128 – 1141 (2008).

5. Comparative Analysis of *DAK* and Demand Driven Fiscal Transfer Instruments

In this section, a comparative analysis of two fiscal transfer instruments is undertaken. The first instrument is the already existing *DAK*. The *DAK* is designed to be a supply-driven or 'top-down' fiscal transfer instrument that is intended to fill funding 'gaps' that may arise as a result of the operation of the general fiscal transfer arrangements pursuant to the DAU. In essence, this means that the GoI has primary responsibility to identify the funding gaps and address those gaps through *DAK* authorised funding arrangements.

By contrast, a demand driven fiscal transfer instrument is designed on the basis of regional authorities being primarily responsible for identifying funding needs that have not be fulfilled by either the DAU or *DAK* instruments. The benefit in allowing regional authorities to specify funding requests is that local decision-makers are able to exercise greater autonomy in identifying funding priorities thereby targeting funding based on locally, rather than centrally, determined needs.

The Regulatory Structure of the *DAK*

The regulatory structure of the *DAK* is specified in Articles 39 and 40 of Law 33 of 2004. Article 39 identifies and attaches the 'special' status to the *DAK* by limiting its allocation to 'certain' regions as a 'special fund'. Article 40 sets the broad eligibility for *DAK* funding in setting the process criteria that:[31]

> (1) The Government shall establish criteria for *DAK*, including general criteria, special criteria and technical criteria.
>
> (2) General criteria referred to in paragraph (1) shall be established with due regard to the financial capacity of the region in APBD.
>
> (3) Special criteria referred to paragraph (1) shall be established with due regard to the prevailing laws and regulations and the characteristics of the region.
>
> (4) Technical criteria referred to in paragraph (1) shall be established by the state ministry/technical department.

Article 40 is supplemented by *Government Regulation (PP) No. 55 of 2005 Regarding Balancing Funds* (Government Regulation (PP) No. 55).[32] Government Regulation (PP)

[31] See also Article 41 of Law 33 which provides that: (1) All regions receiving DAK shall provide Matching Funds in an amount of at least 10% (ten percent) of DAK allocation; (2) Matching Funds referred to in paragraph (1) shall be budgeted in APBD; (3) A region with a certain fiscal capacity shall not be required to provide Matching Funds.

[32] See Article 42 of Law 33 which provides that: 'further provisions on DAK shall be established by Government Regulations.'

No. 55 is significant in that it allocates the responsibility of administering functions relating to the financial management of the *DAK* the Minister of Finance. More significantly, Article 54 (3) of Government Regulation (PP) No. 55 provides insight into the mechanics of how the fund is to be calculated and allocated:

> Besaran alokasi *DAK* masing-masing daerah sebagaimana dimaksud pada ayat (1) huruf b ditentukan dengan perhitungan indeks berdasarkan kriteria umum, kriteria khusus, dan kriteria teknis.
>
> [the *DAK* grant referred to in paragraph (1) (of Article 54) is determined with the calculation of an index was based on the general criterion, the special criterion, and the technical criterion.]

The crude English translation of Article 54(3) of Government Regulation (PP) 55, 2005 refers to the method of allocation of the *DAK* as being based on the calculation of an index (or formula) derived from the general, special and technical criteria referred to in Article 40 of Law 33, 2004. The construction, calculation and administration of the allocation formula are the substantive core of the regulatory arrangement and, accordingly, warrants special attention. It is important to note that the administrative authority to construct and apply the formula in the course of *DAK* allocation falls within the scope of responsibility of the Ministry of Finance with the input and assistance of other relevant Ministries. Government Regulation (PP) No. 55/2005 provides a general procedural roadmap indicating which relevant Government ministries are expected to contribute required statistical information to enable the Ministry of Finance to apply the formula constructed to guide *DAK* allocation.

In brief, the *DAK* can be characterised as a:

- Supply driven (in that funding allocations are made by the GoI rather than regional authorities, *see* Section 40 of Law 33)
- Specific-purpose (in that the *DAK* is an instrument designed to fill funding gaps for special needs purposes that arise as a consequence of insufficient targeting inherent in more general fiscal transfer arrangements under the DAU
- Formula-based transfer (where the method of allocation is determined by a funding calculation based on an algorithmic or technical formula)

Based on other international experience, a supply-driven, specific-purpose, formula-based transfer is an unusual instrument design. According to some researchers, it is likely to be sub-optimal owing to the absence of accountability and incentive measures built into the instrument design. The accountability deficiency arises because of the absence of 'conditionality' provisions giving risk to weaker accountability for expenditure (as discussed in greater detail below). There are concerns that formula-based method of funding distribution are inefficient resulting in an underutilisation of resources.

Demand Driven, Specific-Purpose, Conditional/Output-Based Transfers

According to Shah, formula-based, specific-purpose fiscal transfer instruments are relatively rare. A general criticism of supply driven formula-based transfers is that they induce regional authorities to underutilise their own tax base and lack inherent accountability mechanisms.[33] In addition, formula based transfers that are unconditional tend to be regarded as an inefficient allocation of resources that are hampered by a lack of accountability. By contrast, there is significant research indicating that specific-purpose transfer arrangements should be designed using demand driven, output-based selection and allocation criteria. As discussed above in the previous sections, there is no legal impediment barring the design and implementation of a special-purpose fiscal transfer instrument that would operate on the basis of demand driven, conditional/output-based design characteristics.

According to the literature examining international best practice in the determination and design of fiscal transfer instruments, a strong argument can be made that demand driven instruments are superior to supply driven instruments (such as the *DAK*) when used for general transfer ‘gap-filling’ policy purposes. A demand driven instrument is one where funding needs and priorities are initially determined by local authorities. The logic in delegating authority and responsibility to local authorities to identify local funding priorities is because local authorities will be more knowledgeable of local conditions and needs. In addition, the creation of a demand driven specific-purpose fiscal transfer instrument respects the principal of regional autonomy that is an entrenched constitutional principle (Article 22A).

Output-based transfers that link grant finance with service delivery (also referred to as performance) requirements place conditions on the results to be achieved while providing full flexibility in the design of programs and associated spending levels to achieve those objectives. Output-based as opposed to outcome-based specific purpose grant design is preferable, especially where local authorities are the public managers responsible for project management. Grant funding conditions placed on outputs as opposed to outcomes links funding to project milestones and criteria that fall more closely within the public managers’ scope of influence. Grant conditionality, if appropriately incorporated in instrument design, therefore, serves as both an incentive and accountability mechanism.

At present, the *DAK* has none of these best practice characteristics.

6. Summary and Conclusion

This advice contains several major findings.

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[33] For further discussion see Shah, fn.1, in which he discusses how conditional grants contain inherent incentive and accountability mechanisms that general, formula-based transfer instruments often lack.

The first major finding is that the social equity obligation embedded in Article 18A of the Constitution implies that 'justice and equity' need not equate to equality. Therefore, the design of instruments relating to 'fiscal relations' need not result in an equal distribution of funding. The policy of fiscal equity, which equates to the legal obligation of social equity, justifies an unequal distribution of funds between the regions. The social equity obligation opens the door to justifying, on legal grounds, exclusion of some regions in being eligible to gain access to certain funding sources designed to achieve the policy of fiscal equity.

The second major finding is that the GOI is granted a very broad discretion in its policy choice of instrumental arrangements directed towards achieving constitutional obligations. In the case of implementing fiscal transfer policies within the scope of Article 18A of the Constitution, the MK will not review the instrumental means chosen as long as the 'spirit' of the policy instrument chosen remains within the 'corridor' or is consistent with the broader means (in this case the social equity standard) constitutionally imposed to achieve that purpose.

Given the lack of prescription contained in Article 45 of Law 33 and Article 6 of PP 57, the GOI has chosen to delegate the determination of the instrumental form of grants to the Minister of Finance. In the case of grants, the Minister is granted a very wide discretion in fashioning the detail of the 'policy instrument'. This discretion is limited only by the requirement that the instrument must be designed to contribute to achieving the overall policy objective of Law 33 which is fiscal equity, which in turn, is governed by the constitutional obligation of achieving social equity in financial relations.

A final finding flows from a comparative analysis of different alternatives in the design of specific-purpose fiscal transfer instruments. The existing 'supply-driven' *DAK* instrument is compared to a proposed 'demand-driven' instrument. Not only is there no constitutional or statutory impediment to implementing a demand driven instrument, research indicates that best practice in specific-purpose instrument design points to fiscal transfer arrangements that specific-purpose funding arrangements that are demand driven and conditional (output or performance based) are optimal due to their inherent incentive and accountability characteristics.

ANNEXE 3: *DAK* ELIGIBILITY FORMULA

Step 1: The determination whether a district/city is eligible to receive the *DAK* under the general criteria provisions of Law No. 33 is derived from Net Fiscal Index (NFI) NFI<1.

Step 2: If a district/city does not fulfill the general criteria; whether the city/district falls within a special autonomy region (districts/cities within the Provinces of Aceh and Papua). If yes, the district/city is eligible to receive the *DAK*.

Step 3: If a district/city is not under the territory of the provinces of Aceh or Papua, it may qualify for *DAK* funding under the specific criteria provisions. A city/district that satisfies the specific criteria requirements include coastal and offshore areas, areas bordering a foreign country, remote areas, and areas prone to floods and landslides, and food shortages. The specific criteria characteristics of such a city/district is calculated and reflected by the Regional Characteristic Index (RCI).

Step 4: Combine NFI and RCI to generate a composite Fiscal and Regional Index (FRI).

Step 5: If a district/city has an FRI calculation less than 1, then the respective district/city is automatically eligible to receive *DAK* (although, initially based on Step 1, is not eligible to receive *DAK*). Conversely, if the respective district/city has FRI greater than 1, then it will not be eligible to receive *DAK*.

Step 6: Districts/cities that are eligible to receive *DAK* are districts/cities that fulfill Step 1 (where NFI<1); or fulfill Step 2 (districts/cities under the territories of the provinces of Aceh or Papua, no matter their NFI>1 or NFI<1); or fulfill Step 5 where their FRI < 1.

Step 7: For all districts/cities which are eligible based on Step 6, the calculation FRI = f(NFI,RCI) must be made.

Step 8: A weight of region (WR) calculation is made by multiplying the local FRI and Construction Cost Index (CCI).

Step 9: For all eligible districts/cities, a Technical Index (TI) is calculated for each sector that will be given *DAK*.

Step 10: A calculation of the Technical Weight (TW) is conducted by multiplying the Technical Index (TI) and Construction Cost Index (CCI).

Step 11: The determination of *DAK* weight is derived from the result of addition of Weight of Region (WR) and Technical Index (TI).

Step 12: The Weight of *DAK* determines the amount of each individual district/city's *DAK*.

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