Transfers to Improve Performance

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Indonesia’s decentralization is one of the great global development success stories...

...but key challenges remain

- Expanding access in lagging regions
- Financing urbanization
- Improving service quality
- Strengthening accountability for the quality of spending

Changes in service access over changes in government spending per capita, 2008-2017

Note: Average access is a simple average of five sectoral indicators access. The sectoral access indicators themselves are composites of multiple indicators, as described in footnote 11. The change in government spending is GDP-deflated. Source: Susenas and SIKD data, World Bank staff calculations.
Managing Horizontal Fiscal Disparities
Ensuring similar standards of service delivery remains a challenge...

District average junior secondary school (SMP) national (UN) exam scores, 2017

Note: Orange indicates districts with exam scores lower than the average (52.8), and Blue are districts with scores higher than the average.
Source: Ministry of Education; World Bank staff calculations.
...in part because differences in transfers drive differences in district spending capacity

The General Allocation Grant (DAU) has strong features. It:

- Is based on gap between fiscal needs and capacity
- Accounts for major cost drivers
- Is transparent
- Supported national unity when designed

...but it:

- Underfinances per client expenditure needs in populous districts
- Incentivizes overstaffing

Median total revenue per capita, by district population quintile FY2018

Note: District revenue data uses 2018 realization data; population data uses 2015 data from SUPAS Source: COFIS; World Bank staff estimates based on SIKE-MoFdata.
The current transfer system ... 

• Underfinances urban areas with high population growth which face pressing service and infrastructure financing needs and...

• Leads to inequities within urbanizing areas

**Differences in total per capita revenues across districts**

**PANEL A.** Real growth rate of total average per capita revenue (%) from 2010 to 2016, Kab/Kota level

0 150 300

| Group with above average population growth from 2009 to 2016 |
| Group with below average population growth from 2009 to 2016 |

**PANEL B.** Per capita revenue gap between small urban kota and large surrounding kabupaten (example) (IDR million per capita)

| 0 | 4 | 8 |

Kota Mojokerto, Jawa Timur
Kab Mojokerto, Jawa Timur

Source: World Bank staff estimates.
There are opportunities to better target the Special Allocations Grant (DAK Fisik) to national priorities and to districts with the greatest needs.

Correlation between DAK per capita allocation and lagging sectoral needs indicators, 2015-18

Note: The figure represents the correlation between DAK Allocation at time T and the district’s “need” (as measured by sectoral outcomes) at time T-2, as two-year lagged data are the primary figure by which need can be measured and assessed. For simplicity, this figure shows that absolute values of correlation coefficients. The signs of the correlation coefficient depend on the indicator. For example, for the percentage of the population with water access, the correlation is negative, meaning that districts with less access receive higher transfers. For poverty, in contrast, the correlation is positive. Source: World Bank calculations, based on DAK allocation (DJ PK) and Susenas data.
Recommendations for Managing Horizontal Fiscal Disparities

Allocate per client
Rebalance the design of Indonesia’s fiscal equalization formula toward a per-client basis, with a view to ensuring sufficient financing for a minimal service standard across its territory. Abolish the basic allocation.

Offer a Package Deal
Design a politically viable transitional strategy that limits revenue losses for net losers. Offer a “package deal” to losing regions, for example through a DAK for lagging regions with infrastructure gaps.

Better target DAK
Improve the proposal-based allocation mechanism for the DAK, by making allocations more predictable, and better targeting those districts with the greatest needs.
Improving Efficiency of Subnational Spending
Districts have significant spending responsibility ...

Share of general government expenditure by level of government (%), 2016

<table>
<thead>
<tr>
<th>Category</th>
<th>District</th>
<th>Province</th>
<th>Central</th>
</tr>
</thead>
<tbody>
<tr>
<td>General Administration</td>
<td>49%</td>
<td>5%</td>
<td>24%</td>
</tr>
<tr>
<td>Housing and public facilities</td>
<td>28%</td>
<td>71%</td>
<td>5%</td>
</tr>
<tr>
<td>Health</td>
<td>33%</td>
<td>14%</td>
<td>6%</td>
</tr>
<tr>
<td>Education</td>
<td>38%</td>
<td>56%</td>
<td>56%</td>
</tr>
<tr>
<td>Social Protection</td>
<td>92%</td>
<td>6%</td>
<td>92%</td>
</tr>
<tr>
<td>Infrastructure</td>
<td>38%</td>
<td>15%</td>
<td>48%</td>
</tr>
</tbody>
</table>

Note: General administration mostly comprises salaries, including teachers' salaries. BOS (education) spending may be classified as general administration expenditure for some SGs. Most spending on housing comprises housing subsidies, which are centrally managed. JKN (National Health Insurance) subsidies or PBI is classified as Health spending—not Social Protection.

Source: World Bank staff estimates based on data from DG Fiscal Balance, MoF.
... with limited accountability for results, top-down...

Because most transfers are “discretionary”, i.e. not earmarked and linked to results.

Composition of district government revenue (real terms), 2018

- **DAU: General Allocation Transfer**: 45%
- **DAK: Special Allocation Transfer**: 14%
- **DBH: Revenue Sharing**: 7%
- **PAD: Own-source Revenue**: 15%
- **Other**: 19%

**Discretionary**: 86%

Note: “Other” revenues include grants; emergency funds; revenue sharing from province/other districts; adjustment and special autonomy funds; and financial assistance from other provinces and districts. 2018 is budgeted data. DAK = Dana Alokasi Khusus; DAU = Dana Alokasi Umum; DBH = Dana Bagi Hasil (tax & non-tax); PAD = SNG own-source revenues. Source: COFIS (World Bank staff estimates based on SIKD-MoF data).
...and limited accountability for results, bottom-up,...

because of a weak local “fiscal contract”...

Share of Own SNG Spending in total Government Expenditures

From **3%** in 2001 to **13%** in 2018

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**Indonesia’s SNG expenditure and own-source revenue shares in international comparison, 2015-16**

Note: Federal countries are in red and unitary countries in black. The classification of countries as “federal” is based on OECD data (OECD/UNU, 2018a and 2018b). Both axes are truncated at 60 percent, omitting countries outside this range (e.g., China). Countries for which relevant data were unavailable are omitted.

Source: IMF Fiscal Decentralization Database; OECD Consolidated Fiscal Database for Mexico.
Challenges with Subnational Fiscal Data

Comparing apples with apples:
How much does district A spend per student on non-junior secondary education, compared to district B?

Mapping expenditures to services (e.g. by level of delivery)
How does district A compare to district B in education performance, relative to their respective expenditures?

... and because citizens lack reliable and comparable performance data (fiscal and output data)
Recommendation: Strengthen Accountability

- Further increase the share of earmarked transfers with a view to enhancing the GoI’s ability to provide direct funding for national priority programs

- Carefully experiment with performance-oriented transfers

- Strengthen the local ‘fiscal contract’. Incentivize districts to exert more revenue effort, by measuring fiscal capacity based on potential, rather than actual own-source revenues

- Provide citizens with better performance information for assessing local government performance, including by revising the subnational chart of accounts (PP BAS)
Recommendation:
Move toward an asymmetric design of the fiscal transfer system

- Adjust the share of unearmarked (DAU) and earmarked (DAK) financing based on performance

- **Scale up the Hibah** to innovate and to finance emerging needs, such as filling the “missing middle” of mid-sized urban infrastructure

- **Use a DAK for lagging regions** as an instrument for bringing infrastructure up to a minimal standard in districts with a low capital stock

- **Introduce a performance-framework for the successor of OTSUS.** Set performance expectations, monitor progress, support and reward improvements
Beyond this PER: Improving Efficiency of Subnational Spending may, among others, require...

- Reforming the subnational civil service, by potentially giving better performing SNGs greater autonomy to decide how many staff to hire and with which skills
- Creating a more enabling central regulatory environment for SNGs, in particular for public financial management
- Improving SNG financial accountability through more performance-oriented audits
Thank you