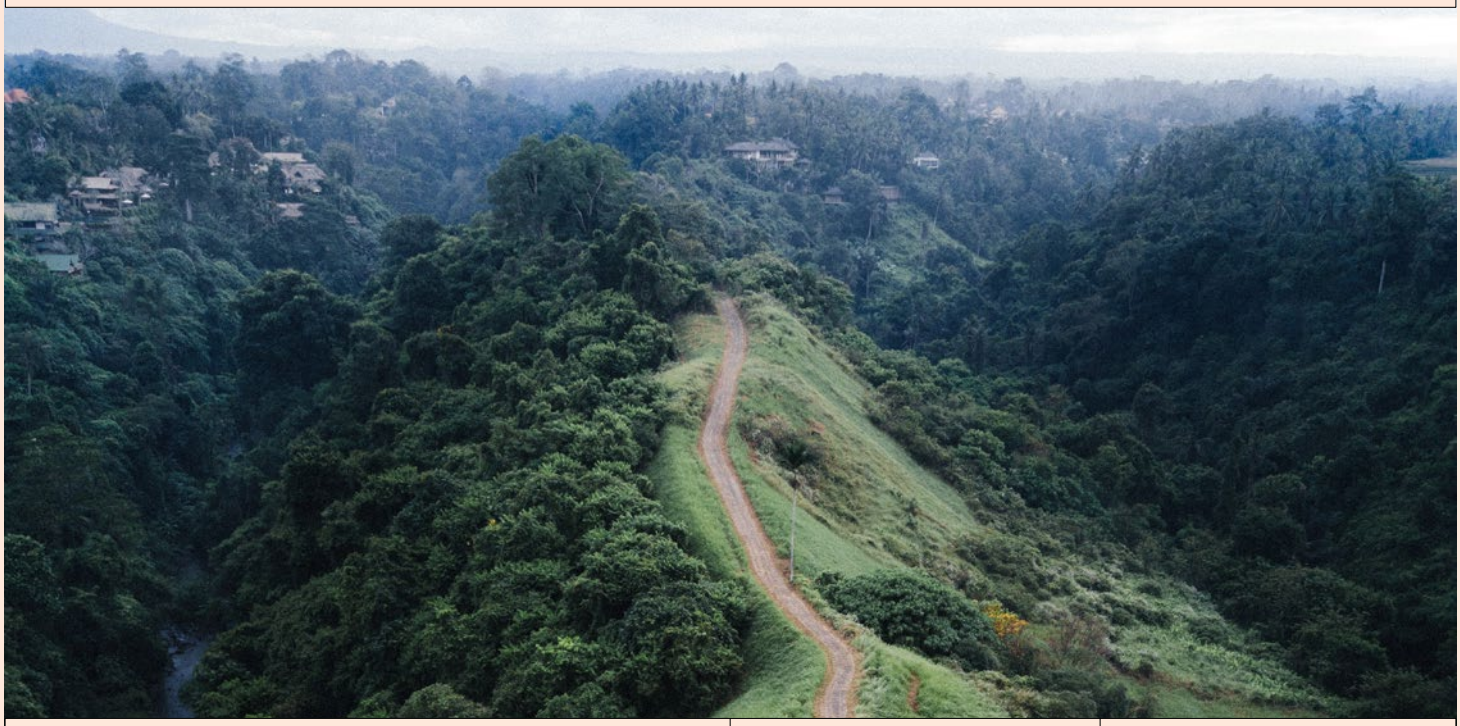
CHAPTER

3

Reforming *the* Intergovernmental Fiscal Transfer System *for* Better Services



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Key Policy Messages

The GoI should seize the opportunity of the ongoing revision of Law No. 33/2004 for a fundamental review of its intergovernmental financing system, with a view to strengthening its results orientation. The GoI could in particular consider the following guiding principles:

A

Measure fiscal capacity in the DAU fiscal gap formula based on potential, rather than actual, own-source revenues to to incentivize districts to exert more tax effort for collecting property and sales taxes (such as Hotel and Restaurant Taxes), and to address Indonesia's persistent vertical imbalance;

B

Move the design of Indonesia's fiscal equalization formula toward a per-client basis, with a view to ensuring sufficient financing for a minimal standard of service delivery across its territory; at the same time, abolish the basic allocation in the DAU to reduce perverse overstaffing incentives. To be politically viable, this will require a transitional strategy that limits revenue losses for net losers;

C

Move toward an asymmetric design of the fiscal transfer system, in a way that grants more autonomy to better performing districts;

D

Redesign the DAK Afirmasi as an instrument for bringing infrastructure up to a minimal standard in districts with a low capital stock;

E

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

F

Reform Otsus arrangements performance expectations, provide support for improvement, monitor progress, and reward performance.

G

Scale up the *Hibah* with a view to filling the "missing middle" of mid-sized urban infrastructure;

H

Improve the proposal-based allocation mechanism for the DAK, by making allocations more predictable, and better targeting those districts with the greatest needs; and

I

Carefully experiment with performance-oriented transfers, with a view to strengthening top-down accountability for results.

Further key reading

The World Bank. 2017. World Development Report 2017: Governance and the Law, The World Bank, Washington, DC. https://www.worldbank.org/en/publication/wdr2017

The World Bank. 2017. Indonesia Economic Quarterly. Decentralization that Delivers, The World Bank, Washington, DC. https://www.worldbank.org/en/country/indonesia/publication/indonesia-economic-quarterly-december-2017

Lewis, Blane D, and Paul Smoke. 2017. "Intergovernmental fiscal transfers and local incentives and responses: the case of Indonesia." Fiscal Studies 38 (1):111-139.

3.1

Introduction

Indonesia's decentralization is in many respects one of the great global development success stories. The world's fourth-largest country, its largest majority Muslim nation, and one of the most geographically and culturally diverse large countries, has successfully transformed into a vibrant democracy and simultaneously decentralized power to over 500 subnational governments (SNGs).

Almost two decades on, Indonesia has much to be proud of. Threats of disintegration, which loomed large at the start of the 21st century, have subsided. Despite lingering concerns about local corruption, a new breed of developmental local leaders is emerging and succeeding in parlaying their achievements in delivery for their citizens into personal political success, paving the way for others to emulate them. Driven by a highly engineered central planning system, Indonesia has achieved commendable success in expanding access to basic services across the length and breadth of this extraordinarily geographically diverse country. Values of regional equality are hardwired into its bureaucratic culture and systems at a most fundamental level.

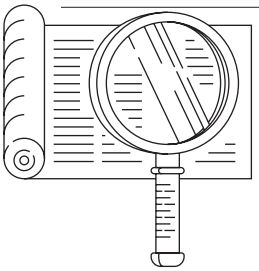
However, while most citizens today have access to basic services, improving their quality remains a major challenge, as noted throughout the preceding chapters. As Indonesia's SNGs bear most responsibility for delivering services to citizens, the question of how to improve the quality of basic service delivery is primarily one of local governance and of central-local relations. Between 2001 and 2017, provinces and districts were responsible for about half of total general government expenditures, compared with merely 23 percent pre-decentralization (1994-2000).[90] Indonesia's SNGs––provinces (*provinsi*), cities (*kota*), districts (*kabupaten*), and villages (*kelurahan/desa*)––deliver most services that shape the opportunities in life for their citizens. Cities and districts manage primary and junior high school education, basic health care, and local water, and road and sanitation infrastructure, among others. While there is a widespread sense that SNGs are not using their resources as effectively as they could be, finding effective entry points for reforms has been challenging.

Indonesia's rapid development and urbanization since it passed its major decentralization laws in 2004 through Laws No. 23/2004 and No. 33/2004 also confront it with new challenges. As Indonesia modernizes and becomes more urbanized in its most populous regions, the persistent development challenges in its rural periphery grow starker. New challenges in urban areas are emerging that threaten not just the quality of life, but Indonesia's productive potential. The funding packages that accompanied the political settlement for Eastern and Western periphery provinces have not translated into those regions catching up to the extent that was anticipated 20 years ago. **The 'last mile' of improving service quality, expanding access in remote and lagging regions, creating conditions for inclusive growth, and improving meaningful accountability will likely be the toughest.** These challenges will require Indonesia to dig more deeply to uproot the path-dependent bureaucratic norms that persist from the New Order system, take a leap of faith to embrace new norms of public management that many countries adopted more than 30 years ago, and think more pragmatically about the model of governance that best fits the country's means as a lower middle-income country. It is an opportune time to rethink the one-size-fits-all model of configuring decentralization and seek out new models that are more agile and better suited to the different challenges faced by regions in different parts of the country.

Recognizing these challenges, the Government of Indonesia (GoI) is embarking on significant reforms of its intergovernmental fiscal system. The Ministry of Finance (MoF) is currently revising Law No. 33/2004 and, in particular, the design of the General Allocation Grant (*Dana Alokasi Umum*, DAU), the centerpiece of its intergovernmental fiscal system. The Ministry of Home Affairs (MoHA) and the MoF are working jointly on harmonizing subnational budget classifications and Charts of Accounts (Government Regulation (PP) No. 12/2019, MoHA regulation (Permendagri)

90 Between 1994 and 2000, central government spending on average amounted to 77 percent of expenditures, provincial spending to 9 percent and district spending to 14 percent. In contrast, between 2001 and 2017, the equivalent shares were 49, 11 and 14 percent, respectively.

"Recognizing it is only one piece of the puzzle for improving service delivery results, this chapter focuses on the question how the GoI can reform its intergovernmental transfer system"



No. 90/2019 and G.R. on subnational Chart of Accounts PP *Bagan Akun Standar* or BAS. These reforms are essential to enabling subnational governments to make better spending decisions for service delivery. They will also enable benchmarking of subnational spending efficiency. Several agencies, including the Ministries of Education and Health, are piloting more performance-oriented designs of specific purpose grants, with a view to strengthening SNG accountability for results.

Improving subnational service delivery, however, ultimately requires strengthening the accountability of local leaders to their citizens—and reforming intergovernmental transfers alone will have only limited impact. Indonesia's choice to largely decentralize service delivery responsibility inherently limits the central government's ability to influence results. It is ultimately the accountability of local elected leaders to their citizens that needs to drive them to provide better services, but this is often challenging in practice. Local elite capture and clientelism can undermine service provision to the poor (Mansuri and Rao 2012). For Indonesia, there are promising signs that some local leaders are rewarded at the ballot box for improving service delivery. But there is also evidence that incumbent office holders have an advantage, because they can use their control over public money to raise their popularity. Rather than providing public goods to the poor, their best strategy for winning may be to target transfers (Gonschorek 2018) or private goods to critical constituents (patronage), such as jobs to teachers (Pierskalla and Sacks 2016).

Besides reforming the transfer system, the central government should hence focus on strengthening bottom-up accountability of local leaders through the ballot box, in particular by:[91]

1. Providing local voters with credible information about their SNG's performance. In Brazil, for example, disclosure of municipality audit results prior to elections significantly reduced the likelihood of corrupt public officials getting re-elected (Ferraz and Finan 2007), and that the media—local radio stations in this case—played a key role in reducing information asymmetries. In Indonesia, with its vibrant NGO sector and (relatively) free media, such transparency has the potential to increase the chances of developmental leaders winning office. The GoI should therefore more proactively empower citizens by making SNG fiscal and performance information public, for example by publishing a dashboard that benchmarks district health indicators, as currently planned by the Ministry of Health. To credibly compare and benchmark district spending efficiency, standardizing district spending information though a subnational Chart of Accounts will be critical (see Data Spotlight).

2. In the medium term, better balancing districts' revenue autonomy with their spending responsibilities would strengthen the local "fiscal social contract". There is a strong (theoretical) argument for "tax bargaining", i.e., that "local residents are more likely to hold officials accountable if local public services are financed to a significant extent from locally imposed taxes and charges as opposed to central government transfers" (Bird 2011). There is some emerging evidence in support of this argument: again, in Brazil, Gadenne (2016) finds that increasing the share of SNG tax revenues leads to a larger increase in local public health and education services than correspondingly large increases in transfers. Rigorous evidence in support of the "tax bargaining" argument is only just emerging and stronger reliance on local taxes certainly needs to be weighed against other considerations, in particular equity. Nevertheless, given the current imbalance between district spending and revenues (Figure 3.4), the GoI should make increasing local tax autonomy and effort––for example, by giving districts more discretion over the property tax rate––a key consideration for its National Medium-Term Development Plan 2020-2024 (RPJMN).

Furthermore, reforming other aspects of central-local relations will shape critical complements to reforming the transfer system. It will be critical for the GoI to address the many coordination problems between and within levels of government that have surfaced in this report. These coordination challenges are the price for a decentralized service delivery model and become exacerbated in the context of urbanization. Other important potential complementary reform areas are: (i) civil service reform, and potentially delegating greater autonomy to SNGs to manage their establishment, pay setting and recruitment; (ii) creating a more enabling central regulatory environment for SNGs, in particular for public financial management; (iii) improving SNG financial accountability through a better audit function; and (iv) strengthening judicial enforcement, as a complement to reforms within the executive.

Recognizing it is only one piece of the puzzle for improving service delivery results, this chapter focuses on the question how the GoI can reform its intergovernmental transfer system. Reforming transfers is perhaps the central government's most direct means of influencing subnational service delivery results. As noted above, the GoI could first seek to correct longstanding (vertical) imbalances between SNGs' spending and revenue autonomy. Second, it can review the horizontal distribution of transfers across local governments, with a view to addressing persistent regional disparities in service access and quality. Third, it can optimize the design of transfers with a view to encouraging more efficient and effective local spending. This chapter will address these three issues in turn, focusing on districts as the level of government that bears the most responsibility for service delivery.

91 The "levers" for influencing service delivery discussed here are by no means exhaustive. Other important potential levels comprise (i) civil service reform, and potentially delegating greater autonomy to SNGs for managing their establishment, pay setting and recruitment; (ii) creating a more enabling central regulatory environment, in particular for public financial management; (iii) improving SNG financial accountability through a better audit function; and (iv) strengthening judicial enforcement, as a complement to reforms within the executive.

3.2

History *of* Intergovernmental Fiscal Relations & Vertical Balance

Since 1999, Indonesia's system of intergovernmental finance has been marked by a fundamental imbalance between SNG spending and revenue autonomy. While SNGs, in particular districts, have major spending responsibilities and autonomy over the allocation of resources, they have very limited autonomy and capacity to raise own-source revenues (to finance the services they provide). In 2018, districts spent 32 percent of general government expenditures, but their own-source revenues only represented 5 percent of total government revenues.

Districts have significant spending responsibility and autonomy. In line with their responsibility to deliver all major basic services, districts are responsible for the lion's share of expenditures for education, health, infrastructure, etc. (Figure 3.1). They also have wide-ranging autonomy to decide on what to spend the majority of their resources. As Figure 3.2 shows, districts have discretion[92] over about 85 percent of their revenues (all bars except the DAK), despite their high reliance on transfers.

The main reason for districts' spending autonomy is that Indonesia's intergovernmental financing system heavily relies on a General Allocation Grant for fiscal equalization, Dana Alokasi Umum (DAU). Current regulations mandate that the DAU pool should amount to at least 26 percent of total net domestic revenues, with 90 percent of the pool transferred to districts and only 10 percent to provinces. Consequently, since 2001, DAU transfers have consistently made up the majority of districts' revenues, and over 60 percent in 2018 (Figure 3.2).[93]

Indonesia initially opted against strong reliance on earmarked[94] sectoral grants, but this has gradually changed since 2003. Earmarked grants, typically an instrument for central governments to steer subnational spending to central priorities, played little or no role in early decentralization. Since its inception in 2003, however, Indonesia's most important earmarked grant, *Dana Alokasi Khusus* (DAK),[95] has gradually grown in importance (Figure 3.2) for SNGs. Box 3.1 summarizes the evolution of the DAK from 2003 until 2015. Starting in 2016, DAK financing doubled compared with the previous year because the GoI re-classified various vertical programs (i.e., programs run by central government) that provide additional recurrent cost financing of service delivery, such as school and health operational assistance (BOS and BOK, respectively) into a so-called "DAK *Non-Fisik*" for recurrent expenditures.[96]

92 Discretionary revenues are here defined as such that are largely unearmarked to specific spending purposes or tied to other forms of conditionality (performance, etc.). SNGs are hence large free to spend these revenues according to their priorities, with "no or few strings attached".

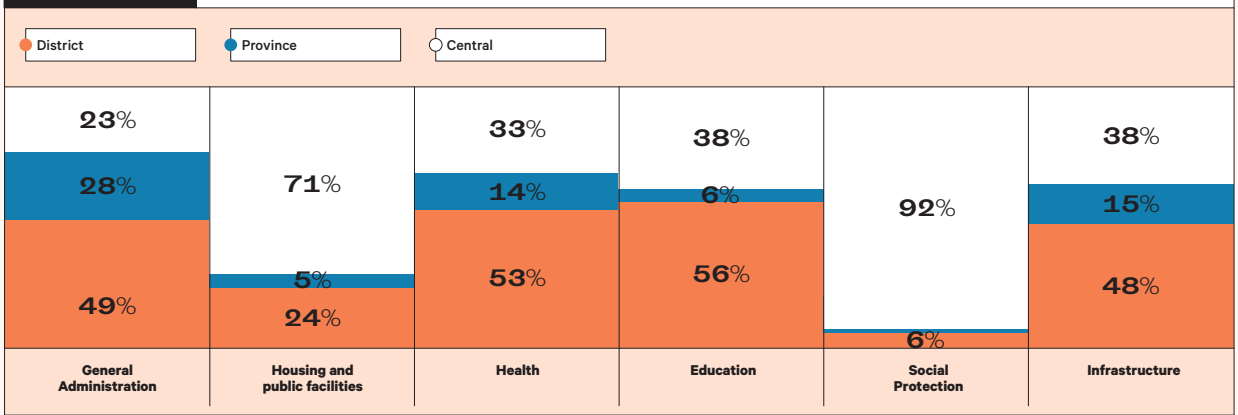
93 Besides the DAU, districts also have discretion over their own-source revenues, the Dana Bagi Hasil and other revenues, totaling 85 percent.

94 An earmarked grant is a grant that is given under the condition that it can only be used for a specific purpose.

95 The DAK (supports SNG capital and recurrent expenditures in a range of sectors. It comprises the DAK Fisik, which co-finances capital investment and the DAK non-Fisik, which co-finances recurrent expenditures. In addition, in recent years, the Dana Desa has grown in importance as a transfer to villages from the national government and from district governments (Alokasi Dana Desa), introduced in the context of Indonesia's 2014 Village Law.

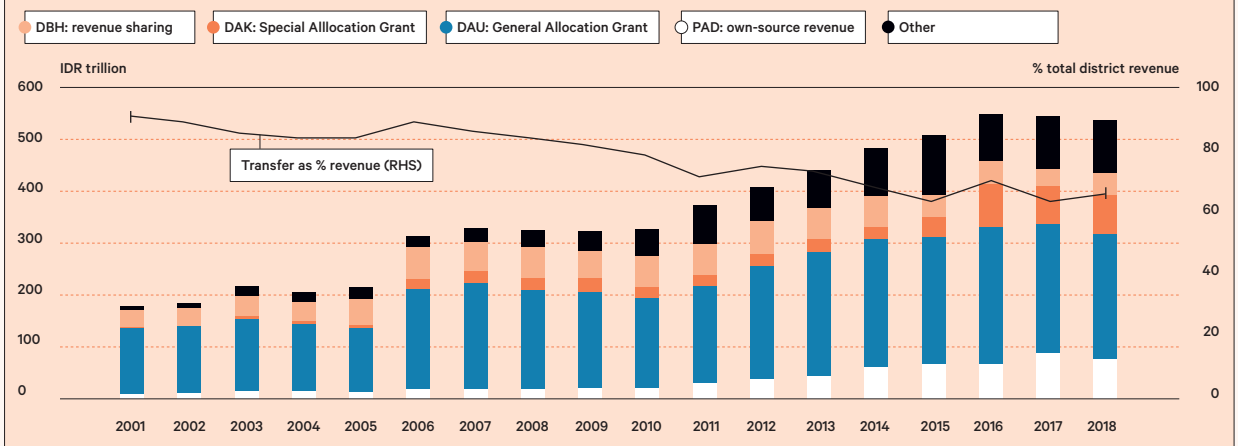
96 This new category is also used to channel funds previously managed as deconcentration funds.

FIGURE 3.1 Share of general government expenditure by level of government (%), 2016



Note: General administration mostly comprises salaries, including teacher salaries. BOS (education) spending may be classified as general administration expenditure for some SNGs. 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.

FIGURE 3.2 Composition of district government revenue (real terms), 2001-18



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).

BOX 3.1. The evolution of the DAK, 2003-15

The DAK was originally introduced in 2003[97] as an *earmarked grant*, intended to fund specific national priorities under the responsibility of districts and cities, to support the achievement of minimum service standards (MSS) and to address spillovers between local governments. It was designed as a *matching grant*, with central government matching SNG allocations tenfold. In 2016, this matching requirement was abolished.

Until 2015, the DAK was allocated to eligible SNGs based on a formula, from a fixed pool defined in the annual budget. Eligibility was based on: (i) general criteria (*kriteria umum*), reflecting SNGs' fiscal capacity; (ii) criteria designed to target specific localities (*kriteria khusus*) identified by law;[98] and (iii) sectoral technical criteria (*kriteria teknis*), such as the size of the irrigated area, for the DAK irrigation. In a second step, the amount allocated to each eligible SNG was determined by a formula that combined fiscal, special and technical criteria.

Over time, the DAK has become increasingly fragmented: in 2003, it only covered five sectors, while by 2014 it covered 19 sectors. This fragmentation has been associated with a significant shift in the sectoral allocation of the DAK: originally it is was primarily a capital grant, but the weight of infrastructure declined from about half to one-quarter of DAK allocations, as new sectors were added. Besides roads, education and health have remained the largest regular DAK recipients (with about 30 and 10 percent, respectively, in 2015).

Despite growth in DAK earmarked grants, the central government's ability to steer district spending to national priorities remains limited. By 2018, the DAK allocation had grown nearly fivefold in real terms since 2014 and represents about 26 percent of the total intergovernmental fiscal transfer to provinces and districts. Yet, it still only represented about 15 percent of district revenues in 2018, relatively little compared with the weight of earmarked grants in many other countries. This limits the center's ability to steer district spending. In some sectors, such as health, the center's ability to steer spending is further limited by demand-side financing mechanisms: social health insurance funds, for example (JKN), are the single most important financing source for primary health care and flow directly to primary community health-care facilities (*Puskesmas*).

97 DAK operations actually began in 2001. However, for the first two years, it focused solely on reforestation, with funding based on reforestation levies (*dana reboisasi*).

98 These localities comprise SNGs in Papua and West Papua and regions identified as: (i) lagging, (ii) in border, and (iii) coastal areas. Among the later three, only a subset of SNGs would be eligible for the DAK based on their rank on indexes that weight their needs and fiscal capacity.

Indonesia's centrally managed civil service is perhaps the single biggest constraint to SNG spending autonomy. As a legacy of the pre-decentralization era, civil servants working for SNGs remain part of the central civil service (*Aparatur Sipil Negara*, ASN). While entry exams for selecting candidates for civil service positions are centrally conducted, for example for teachers, SNGs do have significant influence over which candidates they recruit and over managing their careers. But SNG influence over other critical human resource decisions is very limited. They need to seek central government approval for changes in their number of civil service positions and have no control over base pay setting and career regimes, with a view to attracting better talent. Especially in education and health, where the lion's share of spending is consumed by the salaries of teachers, doctors and nurses, this limits SNGs' autonomy in managing service delivery.

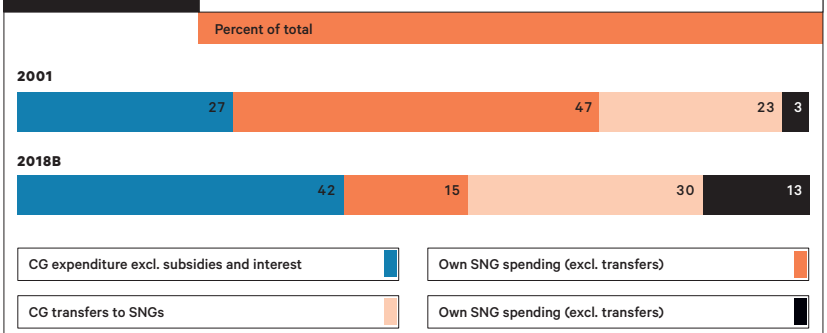
In addition, SNGs continue to have limited autonomy and capacity for raising own-source revenues. About a decade ago, the GoI significantly increased district autonomy in raising own-source revenues with the passing of Law No. 28/2009 on Local Government Taxes and Retributions. The law authorized districts to expand local tax and user fees (*retribusi*), increasing their discretion for setting their own tax and fee rates. Its centerpiece was the devolution of property taxes to districts, including both recurrent (PBB P2) and property transfer taxes (BPHTB). Property taxes have since become the most important source of district own-source revenues, representing 41 percent in 2017.[99] These reforms contributed to significant growth of own-source revenues, to about one-third of SNG expenditures by 2018, compared with only one-seventh in 2001 (Figure 3.3). Despite this, compliance with local tax has been poor, largely due to limited administrative enforcement capacity, local tax-to-GDP ratios have not grown and SNG dependency on transfers remains high. As of 2018, districts depended on transfers for an average of 78 percent of their revenues, while for villages it was about 94 percent.

Indonesia's imbalance between SNG spending and revenue autonomy is accentuated in international comparison. Indonesia is on par with federal countries in terms of the decentralization of spending responsibility but lags far behind them and resembles unitary countries in terms of SNG revenue authority. At about 38 percent of general government spending, SNG expenditures in Indonesia are comparable to those of large federal countries (such as Brazil, Germany, Australia) and to unitary countries with highly decentralized spending responsibilities (such as Peru and Finland) (Figure 3.4). But Indonesia lags far behind these "peers" in terms of its SNGs' own-source revenues, which represented only 13.5 percent of general government revenues in 2016.

A striking feature of Indonesia's intergovernmental system is the weak role of provinces. In 2018, provinces were only responsible for 12 percent of total spending compared with 32 percent for districts. Provinces have some responsibility, in particular for regional infrastructure, but otherwise primarily play the role of regional representatives of the central government, in charge of coordinating districts. While this weakness is partially by design for historical reasons (Box 3.2), it exacerbates intergovernmental coordination challenges, especially as the number of districts has nearly doubled since decentralization, from 298 in 1996 to 514 today.[100]

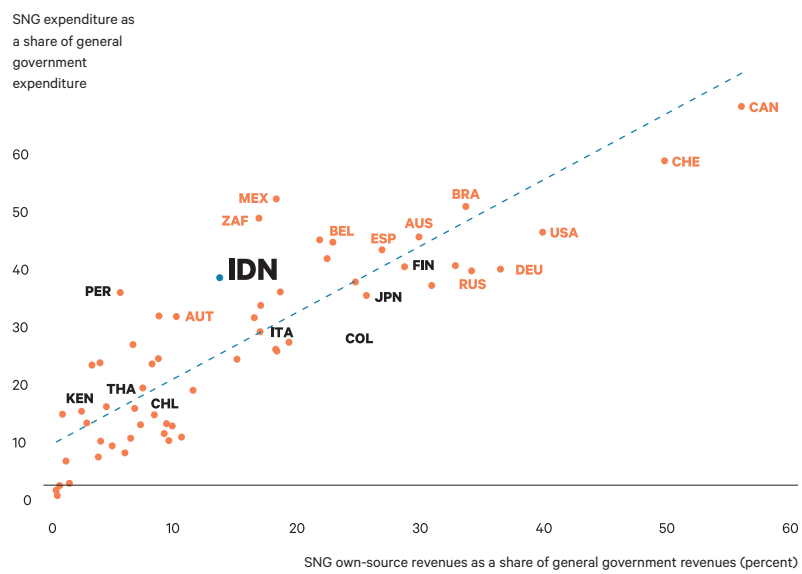
Overall, the vertical (im)balance in Indonesia's intergovernmental financing system has remained relatively stable since 1999, despite the above-mentioned noteworthy reforms. SNGs' expenditure responsibilities grew from only 20.2 percent of total government expenditures in 2001, to 31.5 percent in 2018. As Figure 3.2 shows, non-earmarked transfers, in particular the DAU, continue to shape the lion's share of SNG revenues, with own-source revenues playing only a limited role. With Law No. 33/2004,[101] the major legal foundation for Indonesia's transfer system has remained unchanged.

FIGURE 3.3. Composition of total government expenditures, 2001 and 2018



Note: The figure reports expenditure outturn data for 2001 and budget data for 2018 .
Source: Ministry of Finance, COFIS database, staff calculations

FIGURE 3.4. 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/UCLG, 2019a and 2019b). 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.

99 Other major district own-source revenues are traffic taxes and selected sales taxes (for hotels, restaurants, and entertainment).

100 Districts have incentives to split, among others as a means of increasing their transfers, given the "per district" allocation of the DAU. These figures include the 6 administrative units that make up DKI Jakarta.

101 Law No. 33/2004 replaced the original Law No. 25/1999 on Intergovernmental fiscal Relations.

BOX 3.2. **The role of provinces in Indonesia**[102]

Prior to the 1999 decentralization reforms in Indonesia, both provinces and districts served a dual function. First, they served as local representatives of the central government. Local heads coordinated with the deconcentrated vertical units of central agencies—the so-called *kantor wilayah* at provincial level, *kantor departemen* at district/city level. Second, they had limited "autonomous" functions as local governments. Pre-decentralization, the public administration system was dominated by the former deconcentrated structures, with limited autonomous functions. Provinces were the most powerful tier of local government.

Indonesia's decentralization,[103] however, fundamentally altered this structure. It emphasized the delegation of power to the sub-provincial level, to *kabupaten* and *kota*. Sub-provincial regents (*bupati*) and mayors (*wali*) became entirely focused on their "autonomous" roles. Provincial governors, in contrast, continued to serve in both autonomous functions (*daerah otonom*) and as local representatives of the central government, reporting vertically through the Minister of Home Affairs (MoHA) as before.[104] In fact, the role of provincial governors became increasingly focused on representing the central government (*Gubernur Sebagai Wakil Pemerintah Pusat*, or GWPP). Subsequent legal changes in 2004 and 2014 on the political and administrative aspects of decentralization (Law No. 23/2014)[105] aimed to reduce the perceived excessive autonomy of regional government and to create greater vertical integration and synergy. In practical terms, they have added more weight to the role of the governor as a representative of the central government or GWPP, and recapturing bupati/wali under a direct command for certain general government functions (*urusan pemerintahan umum*).

Today, provinces' GWPP tasks are wide ranging, with large implications for the district/city governments as they seek to discharge their functions. Some key functions of the GWPP include: (i) support and supervision of the discharge of autonomous functions and assistance tasks (including public services) of the district/city governments; (ii) approval of draft district/city government regulations pertaining to the medium-term plan, annual plan, spatial plan, and annual budget; and (iii) recommendations for the Special Allocation Fund (DAK) for district/city governments. In principle, these tasks give a great deal of responsibility, and leverage, to the governor (as GWPP) in relation to district/city governments.

This potential, however, has yet to be realized, primarily due to unfinished efforts to clarify organizational issues and funding. To this end, in July 2018, the GoI adopted Government Regulation No. 33/2018 concerning the Implementation of Tasks and Authority of the Governor as Representative of the Central Government. The regulation confirmed the ongoing practice: GWPP functions are funded from the national budget (APBN) and funds are channeled to the governor through the MoHA. Governors must report to the MoHA and other ministries on these expenditures, and their performance on these functions is evaluated foremost by the MoHA. However, a significant lack of clarity remains regarding the organizational structures for executing these functions at the provincial level.

102 This box draws heavily, in part verbatim, on an informal note by Gabe Ferrazzi, entitled "Deconcentration Channel in Support of Minimum Service Standard Systems".

103 Law No. 22/1999 and Law No. 25/1999.

104 One potential motive for weakening provinces may have been to avoid political unrest, as provinces historically were the locus of such unrest. Under the administration of President Abdurrahman Wahid "Certainly many at the center felt that pushing more resources to sub-provincial governments would weaken the appeal of secession by provinces" [Marks 2009:43-4, cited in Booth (2011)].

105 Law No. 23/2014 replaced the original Law No. 22/1999.

3.3

Managing Horizontal Fiscal Disparities

The centerpiece of Indonesia's intergovernmental financing system––the General Allocation Grant (DAU)––is well designed in several ways. The DAU formula[106] measures districts' fiscal needs based on a transparent formula that accounts for major cost drivers, including population, the surface area of the district (to account for diseconomies of scale), a human development index and a cost adjustment factor.[107] It seeks to finance the gap between districts' fiscal needs and their fiscal capacity by using a fiscal gap formula. When the DAU formula was originally designed, after the fall of Suharto and in the context of decentralization, the DAU played an important role in holding together Indonesia's diverse regions; by allocating resources according to districts' fiscal needs rather than population, it targeted high per capita revenues to lagging regions, such as Papua and Kalimantan. In addition to DAU and DAK, two regions benefit from additional special autonomy funding (Otsus). At decentralization in 2001, special autonomy arrangements were introduced for the province of Papua (extended to West Papua when the province split in 2003). These arrangements gave the provincial governments a stronger role and provided for additional funding. The province of Aceh was incorporated into these arrangements in 2006. Both arrangements are time-limited, with Papua and West Papua due to graduate from Otsus in 2021.

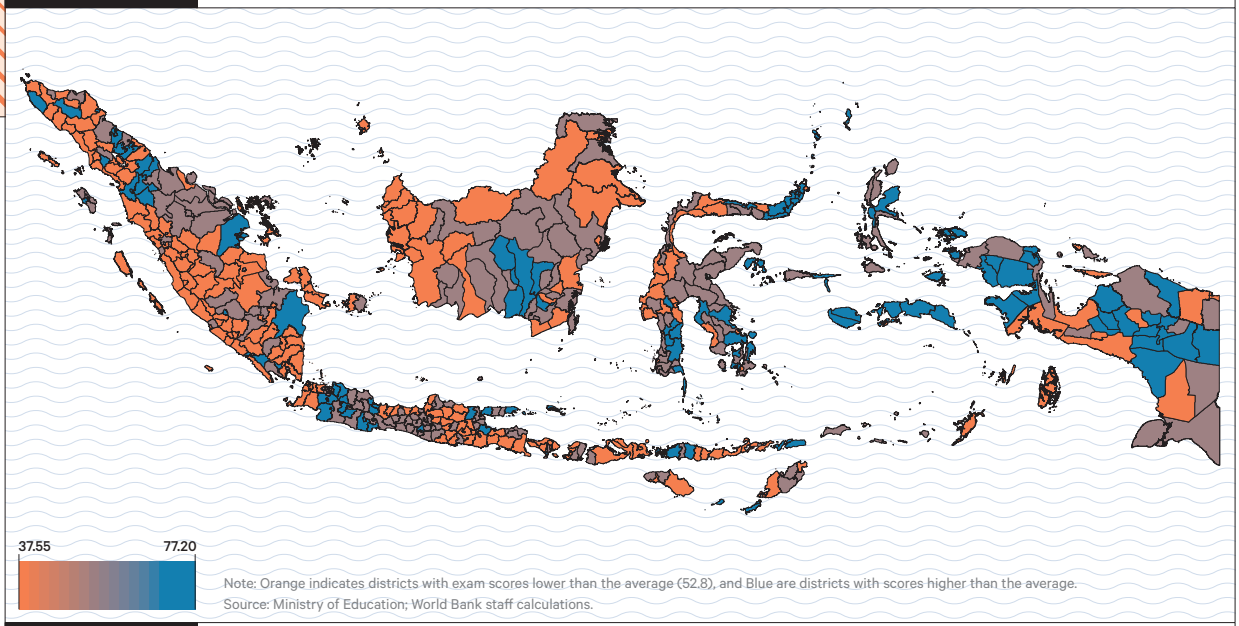
However, Indonesia today still faces major challenges in ensuring a similar minimal standard of service delivery across its territory, as highlighted throughout this report. For example, there are major differences in learning outcomes both across and within regions (Figure 3.5). To illustrate, in 2017, average junior secondary school (SMP) national exam scores in parts of northern Sumatra (Kabupaten Padanglawas Utara, 73.2) were more than twice as high than in parts of Aceh (Kabupaten Bireuen, 29.4).

Vast differences in district per capita spending for delivering the respective service could in part explain these different outcomes. In the case of education, in 2016, district per student expenditures differed by a factor of 400, ranging from about IDR 31,000 per student (in Kabupaten Aceh Tenggara, Aceh) to IDR 13 million per student (in Kabupaten Tambrauw, West Papua). Preliminary econometric analysis suggests

106 The current DAU formula comprises two elements, each constituting about half of the total DAU transfer, on average: (i) the "basic allocation", which depends on the number of civil servants employed by the district; and (ii) the "fiscal gap formula", which accounts for the gap between a district's fiscal needs and its fiscal capacity, here defined as the district's potential ability to raise own source revenues.

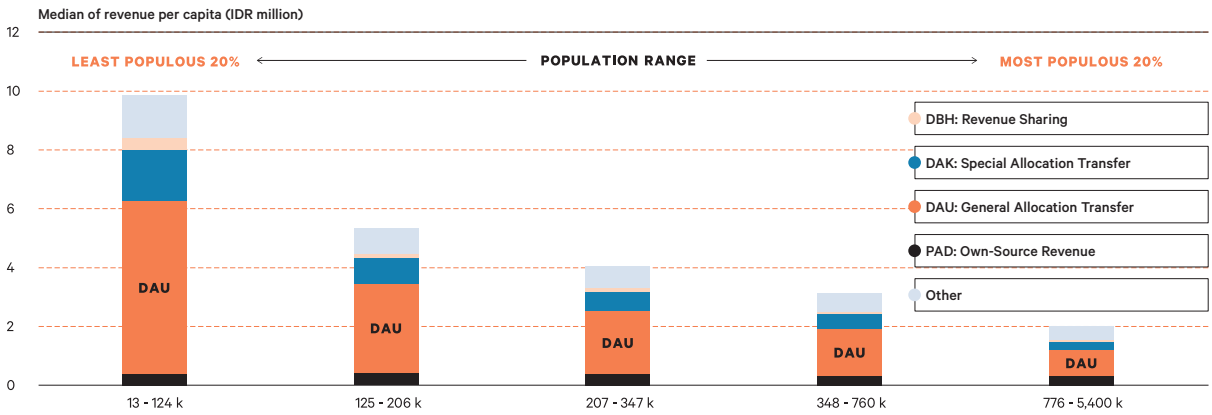
107 *Indeks Kemahalan Konstruksi* or IKK.

FIGURE 3.5 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.

FIGURE 3.6. Median total revenue per capita, by district population quintile FY2018



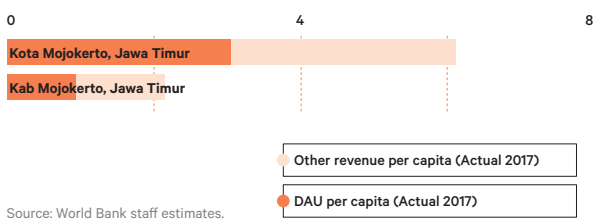
Note: District revenue data uses 2018 realization data; population data uses 2015 data from SUPAS
Source: COFIS; World Bank staff estimates based on SIKD-MoF data.

FIGURE 3.7.

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

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



Source: World Bank staff estimates.

that higher per capita education spending is associated with better learning outcomes.

Differences in per capita spending for service delivery are, in turn, partly driven by large differences in intergovernmental transfers across Indonesia's districts. For example, discrepancies in education expenditures are at least in part explained by discrepancies in total transfers. In 2018, districts in the 20 percent least populous percentile received about five times more revenue per citizen than those in the 20 percent most populous percentile. As Figure 3.6 shows, the DAU and the DAK drive much of this difference, as these transfers constitute the largest sources of revenue most SNGs, across population quintiles. The transfers of special autonomy funding (classified as 'other' in Figure 6) also contribute to the higher per capita revenues received by districts in the first quintile, but DAU and DAK are more important.

The current transfer system produces a few particularly noteworthy fiscal disparities. First, urbanizing areas face pressing service and infrastructure financing needs, but the current transfer system underfinances them. As one indication, total per capita revenues in districts with above-average population growth increased far more slowly between 2009 and 2016 than in districts with below-average population growth (Figure 3.7, panel A). Second, some urban *kota* with small populations (such as Kota Mojokerto, Figure 3.7, panel B) receive much higher total per capita revenues than far more populous surrounding or neighboring *kabupaten* (such as Kab. Mojokerto), even though they may have similar per capita expenditure needs.

More generally, transfers are also far from proportional to the number of people who lack access to basic services (as a measure of unmet service delivery needs). On average, as the number of people without access to basic services doubles in a district, its total transfers only grow by less than one-third (Figure 3.8).

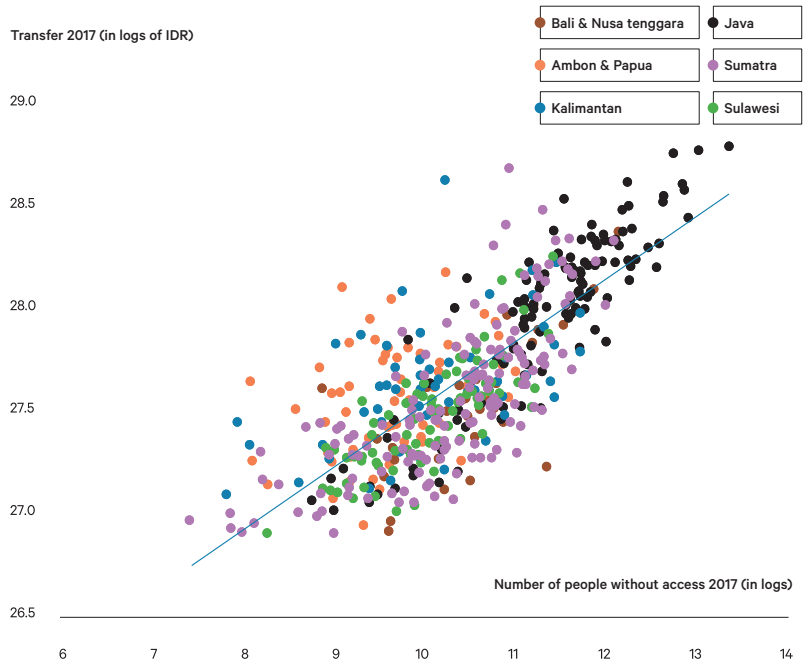
This raises the question of how Indonesia can revise its intergovernmental transfer system with a view to ensuring a minimum standard of service delivery across all districts. Moving toward a transfer allocation that assumes similar expenditure needs by person, not by place, certainly has to be part of the answer, with adjustments for regional variation in demand and unit costs (Box 3.3).

In revising the design of both the DAU and the DAK, Indonesia will need to strike a fine balance between different—and in part competing—objectives. Reallocating spending to more populous districts will need to be balanced with the diseconomies of scale in thinly populated regions and the need to create economic opportunities and improve basic services in lagging regions. The GoI will need to finance both the costs of current service provision and the infrastructure catch-up needs of lagging regions. With a view to enhancing bottom-up accountability and spending efficiency (see following section), the GoI may wish to incentivize own-source revenue collection. And it may grant well-performing especially urban districts, such as Jakarta and Surabaya, significant spending autonomy, while holding poor performers more tightly to account for how they spend. The ongoing revision of Law No. 33/2004 provides an opportunity for the GoI to fundamentally redesign its intergovernmental financing system with a view to better balancing these objectives.

Besides ensuring minimal service standards, a key factor that calls for reforming the current DAU design is that it creates incentives for SNGs to overspend on personnel. The reason is that the so-called "basic allocation" (*Alokasi Dasar*) ties the DAU to the number of civil servants employed by the respective district. Whereas the "basic allocation" was originally established to ensure that districts could afford their wage bills, it unintentionally created incentives for districts to overspend on wages, and to underspend on capital.[108] In principle, the Ministry of Administrative and Bureaucratic Reform (MoABR) controls the establishment centrally and can hence contain wage bill growth. But, de facto, politically influential *bupati* and *wali* (mayors) may well be able to negotiate their way to inefficiently large workforces. While this provides a strong case for abolishing the basic allocation, this can only be done as part of a broader DAU reform. If done in isolation, it would exacerbate, not reduce, inequalities in per capita transfers across districts, as preliminary simulation results in Figure 3.9 clearly show, leading to losses in particular in densely populated districts, especially in Java.

Furthermore, the DAU is currently not well-targeted toward poor districts—with a view to compensating for lack of economic opportunities—or toward districts with diseconomies of scale. In 2017, the DAU was only weakly targeted toward poorer districts, even though a human development index, closely correlated with district income, is an important factor in the formula (Figure 3.10, panel A). Similarly, differences in districts' surface area only explain 1.13 percent of the variance in 2017 DAU transfers (Figure 3.10, panel B).

FIGURE 3.8 Number of people without access to basic services and total per capita transfers, FY2017



Note: Both axes are in natural logs. The number of people without access to basic services in each district is defined as a simple average of the number of people that lack access to the following services: (i) enrolment in junior high school; (ii) enrolment in senior high school; (iii) access to protected water; (iv) access to protected sanitation; and (v) births attended by a skilled health worker; n = 501; R2 = 0.38; 4 outliers removed.
Source: Susenas and SIKD data, World Bank staff calculations.

BOX 3.3. Population as the central driver of SNG expenditure needs

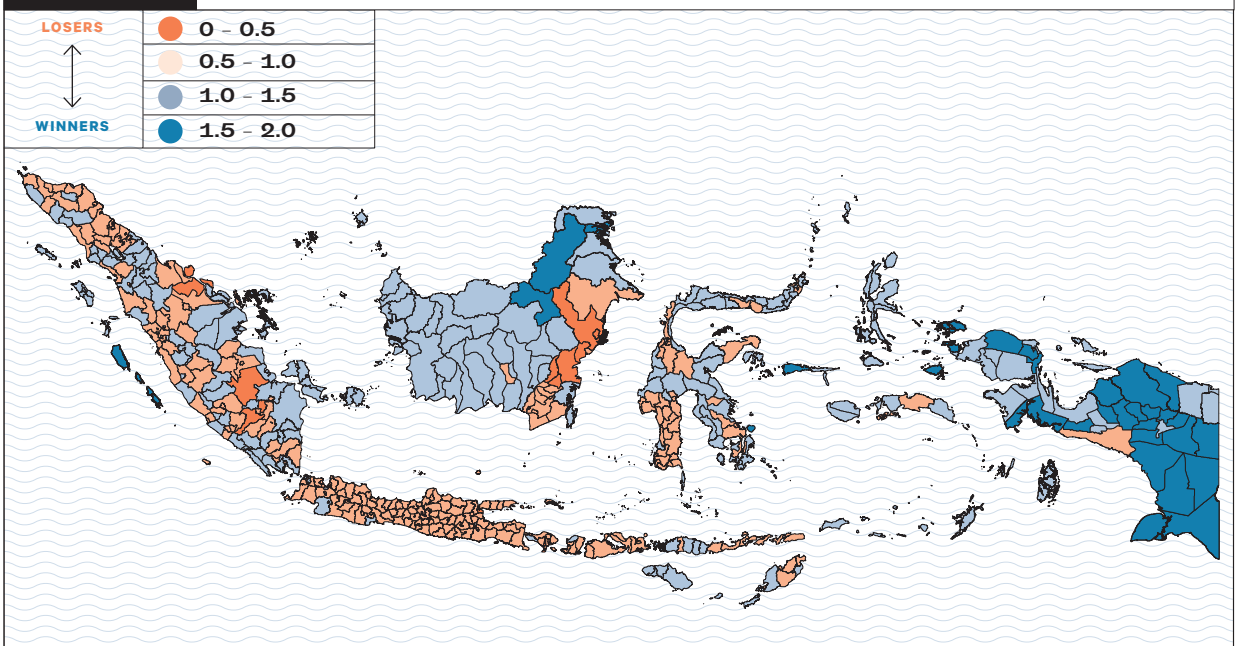
Countries estimate SNG expenditure needs in a variety of ways, ranging from using lagged expenditure values to regression-based expenditure systems. The method chosen is largely shaped by history, politics, and also the limits of data availability. As Boex and Martinez-Vazquez (2007, 9) note, "individual residents/voters are the ultimate clients of local government services", and hence "many countries use population as an important factor in arriving at expenditure needs. In some countries it is the sole factor in the allocation formula". A population-based approach is preferable to equalizing transfers by region, which can lead to severe discrepancies in per capita revenues.

Furthermore, fiscal needs are generally driven by (a) variation in per capita demand for service delivery, depending among others on demographic factors, and by (b) variation in unit costs for delivering a standard package of services. Besides population, fiscal needs estimates hence ought to take into account relevant predictors of demand and unit costs. Many countries, including Indonesia (for the DAU), use a weighted index of relative needs for this purpose. While such approaches are, in principle, technically sound, in practice they run the risk that political pressures can influence the choice and weighting of factors, resulting in an allocation of transfers that poorly reflects needs.

Source: World Bank compilation, based on Boex and Martinez-Vazquez (2007).

108 In a hypothetical example, if a district faced a choice between hiring additional teachers and investing in better school management, it might favor the former as the costs would partially be covered by an increased "basic" DAU allocation. This is manifest in the high share of DAU transfers that districts devote to personnel spending: between 2001 and 2009, out of every IDR 100 transferred, districts spend IDR 40 on personal (Lewis and Smoke 2017). By contrast, districts only spent IDR 15 out of every IDR 100 in shared taxes on personnel, and only IDR 3 out of every IDR 100 in shared non-taxes. However, it is important to note that there are also practical reasons for districts to heavily use DAU for personnel spending: DAU is a relatively stable source of funding, and reliably transferred at the beginning of each fiscal year, and hence well suited for covering the monthly payroll.

FIGURE 3.9 Winners and losers of abolishing the basic allocation



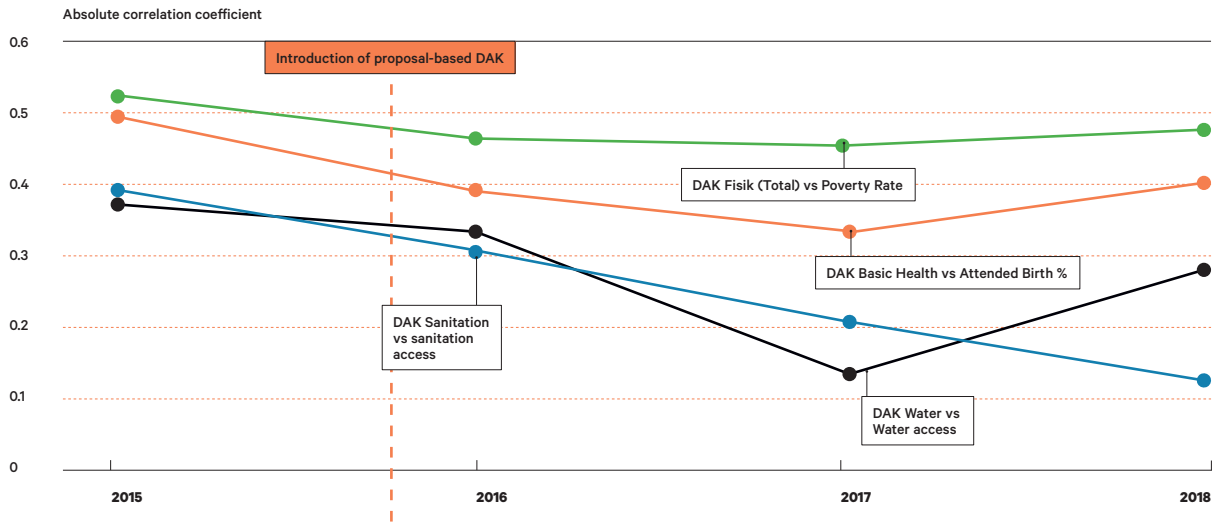
Note: Districts in orange lose and districts in blue gain from abolishing the basic allocation
Source: World Bank simulation.

With regards to the DAK *Fisik*, President Joko Widodo's administration's recent reforms have aimed to better target it to meet SNGs' 'true' needs, especially for infrastructure investments. To this end, since 2016, the GoI requires SNGs to submit proposals for specific investment projects that they seek funding for, replacing the previous formula ('proposal-based' DAK). Other changes in the DAK include the introduction of a new Affirmative DAK (DAK *Afirmasi*), allocated to 196 disadvantaged and/or border areas with low fiscal capacity,[109] and of a DAK *Penugasan*, a category of DAK *Fisik* that the central government allocates based on specific criteria.

However, these reforms have had limited impact on focusing DAK spending on national priorities or in targeting SNGs with the greatest needs. First, prior to the reform, the DAK's increasing fragmentation has made it less effective in supporting SNGs in achieving national priorities. Not only has the number of sectors funded by the DAK grown rapidly (see Box 3.1), diluting its focus on national priorities, even within sectors DAK allocations often do not reflect national priorities. For example, in the health sector, allocations to referral services have roughly doubled between 2016 and 2017, even though the National Health Strategy calls for increasing funding to basic health services. Second, initial evidence suggests that the

109 The DAK Afirmasi covers three infrastructure sectors: Water and sanitation, irrigation, Village/rural road and transportation, although the DAK Afirmasi sectors vary from year to year.

FIGURE 3.10. 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 (DJPK) and Susenas data.

proposal-based approach to allocating the DAK *Fisik*, introduced in 2016, has reduced its responsiveness to needs, contrary to the GoI's intentions. As Figure 3.10 shows, DAK allocations to districts in 2016-18 were less correlated with district needs than in 2015, as measured by indicators of access to services, especially for water supply and sanitation.[110] One reason may be that low-capacity districts are less capable of preparing eligible proposals. The proposal-based approach has also made allocations more volatile, making it difficult for SNGs to plan multi-year investments. The MoF has tried to give districts greater budget certainty by providing early notification of which *projects* will be funded, even if it cannot provide projections of proposed *allocations* before Parliament has voted on them.

The proposal-based DAK has also posed significant implementation challenges that undermine effective targeting based on needs. In 2017, for example, late finalization of the eligible expenditure menus left SNGs with only one month to prepare and submit their proposals, likely undermining their quality. In 2017, three-quarters of submitted proposals were rejected, exacerbating unproductive transaction costs for SNGs. Assessing how relevant the proposals are for national and subnational priorities has been difficult, because SNGs submit proposals for broadly defined programs. Which proposals were funded and why has not been very transparent, and Bappenas and DG Fiscal Balance are still working on developing standard evaluation procedures. The submission of all proposals through the KRISNA information system in 2018 could be a key step toward increasing transparency.

Reform of special autonomy funding could play an important role in addressing inefficiencies in targeting, inefficiencies in spending and pervasive infrastructure gaps in lagging regions. After 18 years of providing additional funds to the Papua region, the benefits of this investment are not clear. Recent analysis by the MoF suggests the outcomes have not been as expected.[111] The Otsus arrangements are scheduled to expire in 2021, presenting an immediate opportunity for trying a new approach to lagging regions. Such a new approach could draw on experience of targeting lagging regions in other parts of the world. The European Union places a very high priority on lagging regions.[112] A potential approach could involve: (i) greater conditionality on transfers (either tied to specific investments, or to the achievement of agreed results); coupled with (ii) evidence-based identification of needs that differentiates the challenges faced by districts within the region; (iii) institutional arrangements that promote inclusion, transparency and citizen engagement; (iv) independent monitoring of implementation; and (v) proactive but demand-driven capacity support. Identifying a fair approach to crowding in districts' own funding will be key to ensuring investments are both efficient and sustainable.

110 For example, South Sumatra was the fifth-largest rice producer, but it was the fourth-smallest recipient of the DAK Irrigation (no 31 of 34 provinces) (see Water Resources Management chapter).

111 https://bit.ly/2HvKIiO; Widodo, B. T., 2019. Evaluasi Dinamis Dampak Fiskal Otonomi Khusus terdehap Efidiensi Layanan Publik Dan Pertumbuhan Ekonomi di Provinsi Papua, Papua Barat dan Aceh Tahun 2011-2017. Kaijan Ekonomi Keuangan Volume 3(1) see also on Aceh: Butarbutar, I.R., D. Hediyana, Sutarto, Analisis Pelaksanaan Dana Otonomi Khusus Provinsi Aceh dan Dampaknya terhadap Pertumbuhan Ekonomi.

112 See the new EU Cohesion Policy outlined at https://ec.europa.eu/regional_policy/en/2021_2027/

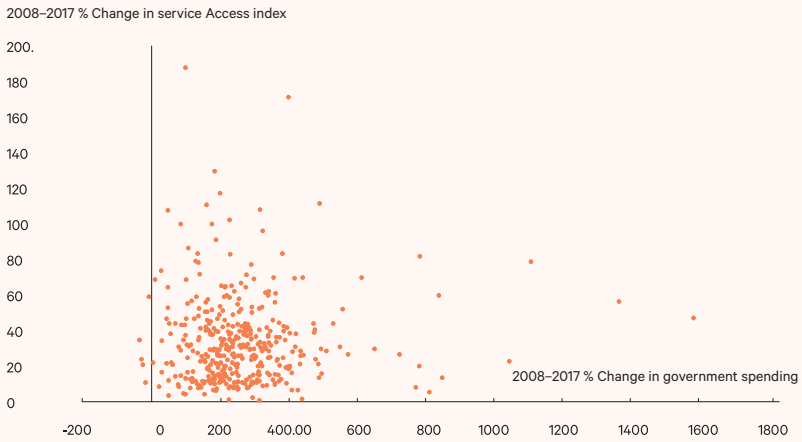
3·4 Improving Efficiency *of* Subnational Spending

Ensuring that SNGs use public money efficiently to deliver services remains a major challenge for Indonesia. One indication for this is that access to basic services, while much improved since decentralization, has not kept pace with growth in local spending. Whereas real per capita spending increased significantly between 1994 and 2017, by 258 percent on average, "access to basic services"[113] on average only increased by 33 percent. At the district level, the increase in spending was not clearly associated with better access. The simple correlation between changes in total local spending per capita and changes in access to services at the district level between 2008 and 2017 is therefore weak (Figure 3.12).

Intergovernmental transfers could play an important indirect role in strengthening both bottom-up and top-down accountability for results. As noted, there is significant potential for districts to exert more effort for collecting own-source revenues already under their authority, especially for property taxes. In 2017, Indonesia only collected about 0.12 percent of GDP in local recurrent property taxes, far less than comparator countries. Anecdotal evidence suggests that this is because compliance rates are very low in most districts. For district sales taxes, Figure 3.13 estimates the variance in enforcement and compliance, using district service GDP as a proxy for the tax base. It suggests that many districts collect far less of these taxes than possible. Hence, incentivizing districts to exert at least "average" revenue effort has significant potential for strengthening the local "fiscal social contracts".

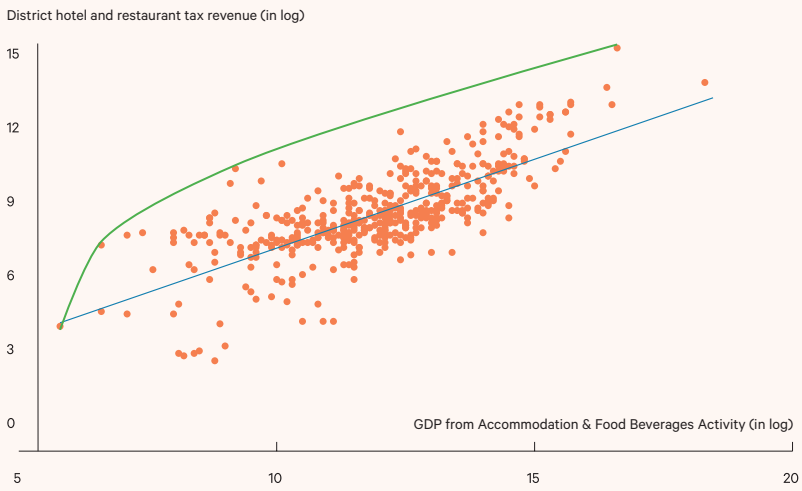
However, currently the DAU fiscal gap formula does not incentivize districts to exert more revenue effort. The DAU formula currently measures districts' fiscal capacity based on actual,[114] rather than potential, revenues. As districts can expect transfers to at least partially compensate for low own-source revenues, they may have little incentives to redouble revenue collection efforts—an argument already made in 2002 (Brodjonegoro). It is important to note, however, that available evidence does not corroborate this argument that transfers "crowd out" own-source revenue efforts in Indonesia. On the contrary, using fiscal data until 2009, Lewis and Smoke (2017) find that rising DAU transfers were associated with increases in own-source revenues. While further research is needed, simply dropping actual own-source revenues from the fiscal capacity component of the DAU formula or moving toward a measure of potential own-source revenue could be options for strengthening own-revenue collection efforts by districts.

FIGURE 3.11 Changes in service access over changes in government spending per capita, 2008-17



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.

FIGURE 3.12 District service tax revenues and service sector GDP, 2012



Note: The horizontal axis shows the log of GDP from Accommodation & Food Beverages Activity. The vertical axis shows the log of Hotel Tax and Restaurant Tax Revenue. The red line represents how much tax revenue a district would collect, given its GDP level, if it exerted average revenue effort. The green line represents the "possibility frontier", as indicated by those districts with the highest revenue at a given GDP level.
Source: BPS and MoF-SIKD data; World Bank staff calculations.

Furthermore, the GoI could be tempted to use earmarked transfers to hold SNGs more tightly to account for the results they financed. Although earmarked transfers—the DAK, the *Hibah* and the DID—have gained in importance, these remain mostly conditioned on inputs,[115] rather than on performance.[116] Attempting to strengthen the top-down accountability of local leaders for results is particularly tempting, as strengthening bottom-up accountability is a challenging long-term effort that requires building SNGs' own-revenue raising capacity and altering deeply rooted patterns of local elite capture and clientelism.

Nonetheless, both international and Indonesia's experience caution that performance-based earmarked transfers are far from a silver bullet, and that the devil is in the detail of getting incentives right. Indonesia itself only has limited experience with performance-oriented transfers. For infrastructure, as an output-based earmarked grant, the water *Hibah* reimburses selected participating SNGs for water connections to poor households, and has been evaluated as successful (Box 3.4).[117] In 2017, the GoI introduced limited performance conditions

113 As a simple aggregate measure of "average access to basic services", the average of five indicators that reflect access to locally provided basic services is used: (i) net enrolment rate for junior high school; (ii) net enrolment rate for senior high school; (iii) access to protected water; (iv) access to protected sanitation; and (v) proportion of births attended by a skilled health worker. An average score of 100 means that all households in the relevant district have access to protected water and sanitation, all births were attended by a skilled worker, and everyone in the relevant age groups are enrolled in junior or secondary school; a score of 0 means that no households have access to protected water or sanitation, no births were attended by a skilled worker, and no child in the relevant age groups are enrolled in junior or secondary school.

114 The current fiscal capacity measure of the DAU fiscal gap formula sums own-source revenues, revenues from tax sharing and natural resource revenues.

115 "Input-oriented transfers" are here (loosely) defined as transfers that condition financing on SNGs spending needs and behaviors, such as the gap between spending needs and fiscal capacity or SNGs' ability to fully spend their past budget allocation (absorption rate).

116 "Performance-oriented transfers" are here (loosely) defined as transfers that condition financing on results produced by SNGs, with results comprising process and quality improvements, as well as service delivery output and outcome measures. "Input-oriented transfers", by contrast, focus on inputs, such as co-financing, absorptive capacity, or sound PFM. Transfers can combine both aspects and they are hence not mutually exclusive.

117 Between 2014 and 2016, SNGs connected more than 600,000 new households and received almost IDR 1.4 trillion through *Hibah* reimbursements. The MoF's Regional Incentive Fund (Dana Insentif Daerah, DID) combines input, process, output and outcome indicators, but has little fiscal weight and lacks focus.

BOX 3.4. **Successful precedents for performance-based infrastructure grants in Indonesia**

Key precedents for performance-based transfers in Indonesia include the Water *Hibah* and the Local Government and Decentralization Project (P2D2). Success factors in both cases included that outputs were independently verified (for P2D2: by the GoI's internal auditors, BPKP). A key feature of the *Hibah* is the division of labor between the relevant line ministry and the MoF. The line ministry, which understands the technical area, is responsible for supervision and for ensuring that achievement of outputs is independently verified, which then triggers the disbursement by MoF.

Source: World Bank compilation.

for the DAK *Fisik*, for example by rewarding districts for past compliance with reporting requirements in the DAK allocation, and by conditioning disbursement of DAK *Fisik* tranches during the fiscal year on evidence that a minimal share of the contracted amount has been paid to the contractor. Tying the DAK more strongly to the independent verification of outputs is a promising direction of reform.

Indonesia's recent efforts to move toward performance-based financing of selected recurrent expenditures highlight the inherent challenges with getting the details right. In education, the GoI has recently introduced a performance-element in the BOS, the BOS *Kinerja*. In line with good practice, BOS KINERJA rewards districts for both improvements in test scores and in school characteristics (such as teacher attendance). However, the transfer is currently tied to far too many school characteristics, some of which are hard to measure, diluting clear signals that could trigger behavioral change. As noted in the Education Chapter, it will be crucial to invest in monitoring and evaluation (M&E) arrangements to evaluate if the current design has the desired performance effects. Similarly, efforts to make the *Bantuan Operasional Kesehatan* (BOK) for health more performance-oriented have highlighted the inherent data challenges. While coverage data, such as the share of pregnant women delivering at health facilities, are systematically available, this is not the case for data on the quality of maternal and child health care. This makes it challenging to design a performance-transfer that incentivizes quality of care improvements, a critical goal for Indonesia. More generally, performance incentives will only work if they build on reliable and independently vetted service delivery data, whereas in Indonesia major concerns over the reliability of administrative data prevail.

CONCLUSION:

Key Policy Messages

3.5

Overall, the GoI should seize the opportunity of the ongoing revision of Law No. 33/2004 for a fundamental review of its intergovernmental financing system, with a view to strengthening its results-orientation. The above analysis suggests that the GoI could consider the following guiding principles:

1 Vertical Balance

Better align districts' revenue autonomy and effort with their spending responsibility, in the medium term. This would serve to correct the deep-seated vertical imbalance in Indonesia's intergovernmental financing systems and to strengthen the accountability of local leaders to their citizens. An important first step to this end could be to incentivize districts to exert more tax effort for collecting property and sales taxes (such as Hotel and Restaurant Taxes). This could be achieved by measuring fiscal capacity based on potential revenue estimates, or simply by removing own-source revenues from the fiscal capacity component of the fiscal-gaps formula.

2 Horizontal Balance

Move the design of Indonesia's fiscal equalization formula toward a per-client basis, with a view to ensuring sufficient financing for a minimal standard of service delivery across its territory. One promising approach could be to estimate fiscal needs based on proxies of sectoral service delivery needs, such as in South Africa. For example, for education, districts could receive an allocation per school-aged child, for health an allocation per capita, etc. These per-client allocations could be adjusted to account for regional differences in unit costs, driven inter alia by diseconomies of scale.

Develop a (transition) strategy that holds the net losers of this change––especially large and thinly populated districts––harmless or limits their losses (Box 3.5). This will be critical for making the transition to a new fiscal formula politically viable.

Redesign the DAK Afirmasi as an instrument for bringing infrastructure up to a minimal standard in districts with a low capital stock. This could be one promising way of holding net losers of the DAU reform harmless for their losses, while at the same time strengthening their accountability for bringing their infrastructure stock within a defined percentage of national averages.

Further increase the share of earmarked transfers to enhance the GoI's ability to provide direct funding for national priority programs. Specifically, the GoI could transform the DAK *Penugasan* into a "DAK for National Priority Programs". This DAK would focus on a small number of the GoI's top strategic priorities. Rather than limiting financing to a menu of eligible project types, the DAK *Penugasan* could "follow programs".[118] Financing could then be directed to those projects most suited to reaching the respective program's objectives. A DAK *Penugasan* for tourism development, for example, could focus on those infrastructure investments deemed most critical to tourism development in a region. Such a DAK could also be allocated for multiple years, to enable medium-term planning and increase predictability.[119]

BOX 3.5.

Guiding principles for a transition strategy to a per capita formula for general transfers (DAU)

International experience suggests the GoI should consider the following critical factors in designing a transition strategy to a per capita DAU formula:

1. **Ensure that fiscal needs are estimated realistically and reliably**. This means both making the right assumptions about the cost drivers of expenditure needs and investing in reliably measuring them (such as population and local unit costs, see Box 3.3). It may also help to differentiate unit costs between urban and rural areas. For example, the per capita costs of securing water access will typically be higher in urban than in rural areas.
2. **Smoothen revenues for losing localities through fixed-term complementary funding**. This requires identifying SNGs with the biggest revenue losses and designing a mechanism for providing them with complementary funding for a fixed period. Managing the transition requires a medium- to long-term time horizon, as the example of Spain illustrates. Until 1986, Spain relied "lagged expenditure values" for determining transfers to its regions, perpetuating regional inequalities in service provision, among other shortcomings. In 1986, the Spanish government decided to transition toward a on allocation based on a weighted index, with most weight on population. However, a transitional "hold harmless provision" ensured that no region would see a decline in revenues and accounted for a significant share of SNG revenues for many years (López-Laborda, Martinez-Vazquez, and Monasterio 2006).
3. **Utilize transition funding pools[120] to also encourage better spending.** For example, losing districts could be compensated from a structural fund that aims to fill critical infrastructure gaps.
4. **Develop a medium-term political communication strategy for building and sustaining reform support.** As a first step, government should focus on advocating for the reform and on building public support, even if reform adoption and implementation will likely not be feasible within a single legislative period.

Scale up the *Hibah* to fill the "missing middle" of mid-sized urban infrastructure. Building on its success as a performance-oriented transfer, the GoI could use the *Hibah* to structure a suite of national urban grant programs that match local resources. Financed through the Regional Infrastructure Development Fund (RIDF), these programs could target: (i) slum upgrading and affordable housing; (ii) urban solid waste management; (iii) urban flood risk management; (iv) urban transport; and (v) urban water supply and sanitation. The *Hibah* is well-suited for this purpose because (a) it encourages SNG ownership of the assets built and healthy competition among SNGs for funding; (b) it can flexibly be used for projects of all sizes; (c) it uses a strong joint line-MDA and MoF oversight mechanism; and (d) using grants as the principal source of long-term finance for basic infrastructure in small and poor municipalities (and as additional finance for growing municipalities), reflecting good international practice.

Better integrate the DAK and other conditional transfers with the local budget process. DAK policies are currently unpredictable,[121] undermining good planning and budgeting of DAK at the local level. The central government could improve this by committing DAK to national priority programs over the medium term instead of on an annual basis only. Furthermore, it could involve Parliament (*Dewan Perwakilan Rakyat*, DPR) in prioritizing DAK types and in agreeing on early ceilings for key DAK.

Improve the proposal-based allocation mechanism for the DAK by making allocations more predictable and by better targeting districts with the greatest needs. Predictability could be enhanced by introducing indicative (per-district and per-sector) multi-annual funding ceilings. Such funding ceilings would also help prevent districts from spending extra time on proposals that stand little chance of being funded.

3

Efficiency

Abolish the basic allocation in the DAU to reduce perverse overstaffing incentives.

Move toward an asymmetric design of the fiscal transfer system in a way that grants more autonomy to better performing districts. For example, well-performing (in terms of spending efficiency) district governments could be financed largely through unconditional transfers (the DAU), whereas poor performers could be more tightly centrally managed through conditional transfers.

Carefully experiment with performance-oriented transfers with the goal of strengthening top-down accountability for results. The GoI should carefully pilot and evaluate performance-oriented transfers, before scaling them up.

118 In 2016, President Jokowi announced a new approach to linking the plan to the budget under the catch phrase "money follow program, not money follow function" which mandated a stronger link between resource allocation and government priorities, rather than resources being allocated to the administrative structures of government (functions).

119 This DAK could be implemented in three ways: (i) by assigning DAK to support specific national priorities in the annual work plan (RKP); (ii) by specifying the policy objectives of the DAK in the line ministry technical guidelines; and (iii) by requiring local governments to develop plans to implement the national priorities and demonstrate the link between their planned inputs and the objective of the national policy. This would build on the proposal-based approach initiated in 2016.

120 Transition funding pools are temporary funding arrangements that serve to top up formula-based transfers for SNGs that lose revenues in the transition to a new fiscal formula. Their primary purpose hence is to help smoothen the fiscal impact of the transition for these SNGs.

121 Different DAKs appear and disappear in the national budget from one year to the next and the technical guidelines (juknis) change each year.