

**Managing Development Assistance to Improve
Fiscal Decentralization in Indonesia¹**

Heru Subiyantoro

Secretary of the Directorate General of Fiscal Balance

Ministry of Finance, Indonesia

E-mail: herusubiyantoro@depkeu.go.id

ABSTRACT

Empirical evidence and argument is presented concerning the benefits of multi-donor facilities as a mode of development assistance within the field of decentralisation in Indonesia. Principal benefits include the quality and relevance of support provided, combined with significant economies of scale for donor partners and for government. Most important of all, however, is the fact that assistance provided under such facilities is genuinely government-led, making the multi-donor facility a preferred mode of aid delivery and management for the Government of Indonesia. Future success will hinge on the willingness of all development partners to participate constructively in such facilities; to exercise patience as well as commitment in order to give them sufficient time to work; and to be prepared to advance incrementally in ways that are not always in the precise direction or at a pace that conform neatly to individual or institutional predilections.

¹ Based partly on a paper presented by the first author at the School of Political Science and Economics - Waseda University, Tokyo, in conjunction with the 8th International Conference of Japan Economic Policy Association; National University Finance and Management Center; Tokyo; Nov. 28-29, 2009. I am grateful to Prof. Dr. Yasumi Matsumoto of Waseda University for inviting me to speak at the conference and to Peter Blunt for his extensive comments on earlier drafts of this paper. The opinions expressed in this paper are solely those of its author.

Managing Development Assistance to Improve Fiscal Decentralization in Indonesia²

1. Introduction and Context

Indonesia's 238 million people make it the world's fourth-most populous nation (after China, India and the United States). The island of Java is one of the most densely populated areas in the world, with more than 130 million people living in an area the size of Greece. Indonesia includes numerous related but distinct cultural and linguistic groups. Since independence, Indonesian (a form of Malay and official national language) is the language of most written communication, education, government, and business. Many local ethnic languages are the first language of most Indonesians and still important. There are over 300 ethnic groups in Indonesia.³ Indonesia is the largest archipelago in the world, covering an area that measures about 2,000 kilometres from north to south and more than 5,000 kilometres from east to west, and it is divided into three time zones.

Governance and development. Indonesia's growing status as a stable and strong democratic country with a healthy and robust economy is widely recognized in the international community of nations. In the last few years, considerable progress has been made by government in relation to macroeconomic management, governance reform and development performance generally, and in relation to the political objectives of decentralisation. However, progress on certain development indicators (such as maternal mortality) has been slower than might be expected. This co-exists with survey reports of citizen satisfaction with service delivery (the 'service delivery paradox'), suggesting that greater attention needs to be given to demand side reform for decentralisation. The aim would be to create a virtuous cycle for service delivery. This would comprise the creation of heightened expectations and awareness of rights and obligations among citizens – and hence demand for improved service delivery – combined with continued supply side support that promotes (among other things) the allocation of well managed incentives to local governments for service provision.

During 2009, some of the more visible and significant events associated with governance have arisen from questions surrounding the so-called Corruption Eradication Commission

² Based partly on a paper presented by the first author at the School of Political Science and Economics - Waseda University, Tokyo, in conjunction with the 8th International Conference of Japan Economic Policy Association; National University Finance and Management Center; Tokyo; Nov. 28-29, 2009. I am grateful to Prof. Dr. Yasumi Matsumoto of Waseda University for inviting me to speak at the conference and to Peter Blunt for his extensive comments on earlier drafts of this paper. The opinions expressed in this paper are solely those of its author.

³ http://en.wikipedia.org/wiki/Demographics_of_Indonesia; accessed Oct. 20, 2009.

(KPK) scandal. Allegations that government prosecutors and senior police had conspired to frame KPK investigators (for taking bribes) and tape recordings of conversations that seemed to support the allegations, cast a pall over some of the most important institutions of governance in the country. The governance implications arising from allegations surrounding the government bailout of Bank Century are equally grave.

These events posed a serious test to the new government and, according to some analysts, threatened investor confidence. Nevertheless, the fact that open discussion of the issues involved took place in the media, and a number of public demonstrations were allowed to proceed, signifies enduring strength of other significant governance institutions.

One year after the global economic and financial crisis, Indonesia's economy has recovered to near pre-crisis growth rates. Domestic and global risk remains significant however. The main risks in the global economic environment are likely to be associated with the withdrawal or exhaustion of various monetary and fiscal stimulus measures. On the domestic front, 'recent domestic political developments have begun to raise questions about the timing and depth of future economic reforms'.⁴

Looking to the future: The achievements of the past decade augur well for the future - in relation to sustainable human development (education, health, and living standards), physical infrastructure, and economic development. If the solid foundations of political and macroeconomic stability that have been laid can be built upon, then in the coming decade Indonesia has the potential to become a socially just and cohesive society with a dynamic and competitive economy - in short, an inclusive middle income country.

The main challenges to achieving such ends lie in: accelerating the rate of poverty reduction and reducing the vulnerability of relatively large sections of the population to slipping-in to poverty; employment creation, particularly in higher value-added, non-agricultural jobs; improving water and sanitation, health and education service delivery, particularly at the local level; stemming environmental degradation and natural resource depletion; improving physical infrastructure; strengthening the investment climate; and, as a means to addressing all of these challenges, continuing to reinforce and protect the institutions of effective, efficient and clean governance.

Priorities of the new government. Short-term priorities specified by the new government address the issues identified above, including accelerating improvements in health and education service delivery, and improvements to fiscal decentralisation.

⁴ Source: *Indonesia Economic Quarterly: Back on Track*. World Bank, Jakarta, December 2009.

2. Fiscal Decentralisation

Regional autonomy and fiscal decentralization in Indonesia have been in place for approximately eight years. The general goals of Indonesia's fiscal decentralization program are to improve national and regional government efficiency; to improve the overall fiscal structure of government, including an increase in regional and therefore national revenue mobilization; to enhance accountability, increase transparency, and expand constituent participation in decision-making at regional level; to mitigate fiscal disparities among regional governments and to ensure the delivery of basic public services to citizens across the country; to improve and safeguard the social welfare of Indonesians; and to support macroeconomic stability.⁵

3. Progress and Constraints

Apart from the generally favourable survey reports mentioned above, there are now sufficient signals on the ground, and in the public discourse, to suggest that decentralization is not delivering what had been hoped for, particularly in terms of social development and poverty reduction. The democratic wave of the last decade has brought political changes, but improvements in the lives of ordinary people have not been as evident.⁶ As mentioned above, rates of maternal mortality and under-five infant malnutrition remain unusually high for a lower middle income country. Progress has also been slow in relation to the provision of access to clean water and sanitation.

There are of course many reasons for this. Among them, poor policy management means that the opportunities for concrete changes are not taken up. Urgent issues remain unaddressed (e.g., civil service reform); good policies remain unimplemented (e.g. shifting funding away from central funding/mechanism for functions that are devolved to regional government); or good policies are poorly implemented as they become central operational policies and concrete action (e.g., minimum service standards). This underperformance in policy making and implementation delays the hoped for achievement of better services and empowered and accountable local actors.⁷

4. Ways Forward

The need for a roadmap is recognised by both Indonesian policy makers and by development partners, and progress towards such ends is being made. A Grand Strategy for Decentralization has been under development since 2006, and Bappenas (The Economic Planning Agency) has

⁵ Machfud Sidik and Kadjatmiko (2004); p. 137.

⁶ USAID-DRSP (2009): Stock Taking on Indonesia's Recent Decentralization Reforms: Main Report.

⁷ USAID-DRSP (2009): Stock Taking on Indonesia's Recent Decentralization Reforms: Main Report.

initiated the National Plan for Fiscal Decentralization (NAPFD). The Ministry of Finance completed an initial draft of the Grand Design for Fiscal Decentralization in 2009, and the Ministry of Home Affairs' is working on a Grand Design for Local Autonomy.

In the last three years, there has also been encouraging cross-ministerial discussion of decentralization policies among the three main central agencies involved with decentralisation: Bappenas, Ministry of Home Affairs, and Ministry of Finance. At the ministerial level, the Regional Autonomy Advisory Council, *DPOD* has been established; and this is supported by an informal association called "*Paguyuban Otonomi Daerah*" Local Autonomy Association, comprising Echelon I officials from the above three related ministries.

5. Making the Best Use of Development Resources: Multi-donor Facilities

But it is also important for the government to consider how best to marshal all of the development resources available to it. Towards this end, over the last three years, the Government of Indonesia (GoI) and its development partners have established a multi-donor aid delivery mechanism, the Decentralization Support Facility (DSF). The structure and decision-making procedures for the DSF make the facility genuinely government-led. The GoI has a strong preference for this aid modality.

The principal purpose of the DSF is to support the decentralization agenda of the Government of Indonesia. Within the field of decentralisation, the DSF attempts to satisfy its purpose by fulfilling three roles, which are designed to help the GOI to improve:

- Policy development and implementation, as this pertains to the demand for and supply of local public services; and hence the promotion of local government (downward) accountability to citizens, and local government (upward) accountability to central government.
- Governance capacity for decentralisation, at both central and sub-national levels.
- The harmonization, alignment, efficiency and effectiveness of development assistance.

Structural components and responsibilities: The DSF is made up of three structural components:

- A *Steering Committee* (SC) comprising senior (Echelon 1 level) representatives of the Ministry of Finance, the Ministry of Home Affairs, and the National Development Planning Agency, and the heads of nine international development partners. This entity is responsible for the strategic management of the DSF and for determining work program priorities and the roles that the DSF as a whole shall play.

- A **Management Committee**⁸ (MC) that is responsible for overseeing the operations of the DSF Executive and approving its work program.
- The **DSF Executive**, concerning whose job it is, first, to assist government with the design, procurement, and management of projects financed by the DSF, and with the realisation of aid effectiveness objectives; second, to promote informed debate and action of decentralisation and aid effectiveness issues among the decentralisation development community; and third, to provide secretariat support to the SC and MC. The *World Bank* serves as trustee and administrator of the funds contributed by donors, and it staffs and manages the DSF Executive.

6. Fiscal Decentralisation Improvement

Examples of activities designed to improve different aspects of fiscal decentralisation that have the support of the DSF include those set out below.

6.1 Intergovernmental Transfers

Here DSF support has helped government to analyse and understand different performance incentives that might be introduced into the grants system; to explore the circumstances suited to different options; and to outline the steps to be taken in their introduction. Among other things, this work informed discussions concerning improvements of performance in the water sector associated with a World Bank infrastructure development policy loan.

Under this activity, work was also done on the possibilities of using revenue-sharing intercepts as sanctions for poor performance at the sub-national level, including the identification of ‘debilitation thresholds’ or ‘intercept space’ (the point at which the withholding of shared revenues would prevent basic service delivery or functioning of the local government in question).

6.2 Sub-national Borrowing

DSF support in this area has addressed four issues: (1) debt restructuring; (2) a Jakarta (DKI) bond; (3) fiscal insolvency; and (4) a Bandung bond.

Debt restructuring. From 2006, the DSF has been working with the Ministry of Finance on the management of non-performing loans and the possibilities for debt restructuring. This involved a comprehensive review of existing legislation, including: (a) Ministry of Finance regulation (PMK) 120/08 on the settlement of state credits to local government-owned

⁸ The author is currently co-chair of the DSF Management Committee.

enterprises; (b) PMK 153/08 on the settlement of state credits to local governments; and (c) PMK 129/08 on the intercept mechanism. The support has also analysed the latest local government/PDAM loan portfolio status, which in turn has given new impetus to internal Ministry of Finance discussions concerning debt restructuring.

DKI (Jakarta) bond. DSF has helped the Ministry of Finance with much of the background analysis and preparatory work for the issuance of such a bond, which would be the first municipal bond to be issued in Indonesia. Such analysis has included debt servicing capability. Staff training and development needs have also been identified. In addition, the support has helped government to assess a long list of mainly infrastructure projects that might be financed in this way, and to draw up a short list for approval by the Governor of Jakarta. In the short term, future activities will focus mainly on the preparation of documentation required by PMK 147/2006 - for presentation to local government legislatures (DPRD) and the Ministry of Finance as a basis for seeking approval to proceed with bond issuance.

Fiscal insolvency. Among other things, this joint work has entailed a review of those aspects of the Indonesian Civil Code pertaining to debtors and creditors and bankruptcy or insolvency. Similar reviews were conducted of legislation governing public companies and (national and regional) state-owned enterprises, as well as government implementing regulations, principally those derived from Laws 32 and 33/2004, which have a bearing on regional government insolvency and other forms of financial crisis. One important finding has been that Law 37/2004 cannot be applied to regional government insolvency because of conflicts between this law and other legislation on decentralization and state finances. However, it was also found that if applied properly existing government regulations (PP) 54/2005 and 56/2005 are likely to be sufficient to prevent regional financial crises, at least those arising from excessive borrowing. It is likely that the next steps will involve support for the drafting of legislation for the establishment by the Ministry of Finance of an emergency fund for dealing with financial crises, including qualification or access criteria for those in need of bailout.

Bandung bond. This work began in March 2009. To date, a detailed road map has been produced that sets out the steps that will need to be taken in order for Kota Bandung to be able to make use of such a financial instrument. The activity has also assessed the borrowing or debt servicing capacity of Kota Bandung. The next steps will involve the setting up of a team to prepare for the issuance of a Bandung municipal bond. This work has been the catalyst for broader engagement between cities in Indonesia and the World Bank.

6.3 Sub-national Surpluses and Reserves

Surpluses. This work examines issues surrounding sub-national governments' deficits, surpluses, and reserves. Empirical analyses of regional government surpluses (based on data from 27 provinces and 220 districts and cities) have found that increases in bank deposits are due primarily to: (a) problems of (too little) budget execution or spending; (b) underestimations of own-source revenues and revenue-sharing proceeds; (c) risk aversion (to bank deposits and away from anything else) caused by the government's anticorruption drive; and (d) a lack of knowledge concerning alternative forms of investments for surplus cash. Recommendations included: removing unnecessary restrictions to budget execution; raising awareness of alternative forms of investment; increasing transparency by making information on regional government surpluses publicly available; and providing incentives for regional development banks to invest part of these surplus deposits in projects that contribute to regional development.

Investment. Findings on the composition of sub-national government investment included:

- Regional governments have invested substantial sums in fixed assets (notably in roads, canals, buildings and other structures). However, regional governments do not depreciate their fixed assets, meaning that government accounts overstate the service potential of such assets.
- Most investments in financial assets consist of equity participation in regional government enterprises that do not invest in public service delivery.

Recommendations included initiating discussions with the accounting profession in order to improve the relevance of regional government financial reports – to be done by changing accounting standards so that such reports classify investments by function (such as health, environment, or public services) and sectors (such as roads, education or irrigation). Central government agencies currently do this. Likewise, it was recommended that discussions commence with the Audit Board of the Republic of Indonesia with a view to encouraging depreciation of fixed assets by regional governments and discouraging regional government investment in assets unrelated to public infrastructure services.

7. Advantages of Multi-donor Facilities

The examples given above exemplify the quality and relevance of donor-assisted genuinely government-led activity that can be produced by a multi-donor facility. Many other examples could be given that pertain to the interests of the other two government members of the DSF – the Ministry of Home Affairs and Bappenas.

The main arguments in favour of maintaining a government-led multi-donor facility like the DSF include: first, and most importantly, the DSF is genuinely ‘government led’, that is, government decides the uses to which DSF funds are put. The role of the DSF Executive and, to some extent, the DSF governance structure has been to help government refine and develop its ideas; to help government consider the most appropriate means for executing and implementing them; and to expedite the processes surrounding execution and implementation over which it has some measure of control.

Though not-straightforward and therefore time-consuming, a significant proportion of DSF-funded activity is executed by government. That is, grants to government are made that give it complete control over financial management and procurement and rely on its own fiduciary safeguards. The DSF Executive, which is administered by the World Bank, provides help with this where it is needed and requested, and monitors and reports on activities during implementation. This is entirely consistent with the stature of an emerging middle income country whose presence is increasingly recognised on the global stage.

Second, there are significant and widely known economies of scale and other efficiencies associated with such facilities. These arise primarily from the fact that all aspects of the project cycle are managed through a single governance structure, making for significant efficiencies for both government and development partners.

None of the benefits inherent in the first two arguments outlined above is easily realisable – or, perhaps, realisable at all - from stand-alone bilateral projects of assistance.

Third, all of the international declarations and commitments on aid effectiveness (Rome, Paris, Accra, and Jakarta etc.) signed by development partners over the last ten years or so recognise the benefits of multi-donor arrangements and advocate strongly that they be employed, particularly in governance and development circumstances such as those that – increasingly – prevail in Indonesia.

The path ahead will not be an easy one, however. Like all development work, future success will require ingenuity, commitment, integrity, perseverance, energy, enthusiasm, collaboration, transparency, trust, and humility - but perhaps above all, patience. This is a daunting list of desirable attributes to which to aspire. And, as with any cooperative endeavour, challenge and complexity increase with the number and diversity of partners involved. Building within the DSF as a whole a culture that possesses these qualities will therefore be far from straightforward and will take considerable time. The purpose of the DSF is clearly a worthy one, but in order to achieve it, all DSF constituents will need to contribute constructively to building these foundations for success and be prepared to advance incrementally in ways that are not

always in the precise direction or at a pace that conform neatly to individual or institutional predilections.

REFERENCES

- Cox, Kevin R. and Andrew Mair.** 1988. "Locality and Community in the Politics of Local Economic Development," *Annals of the Association of American Geographers*, Vol. 78, No. 2 pp. 307-325.
Stable URL: <http://www.jstor.org/stable/2563810>. Accessed: 05/09/2009.
- Haider, Donald H.** 1981. "Balancing the Federal Budget: The Intergovernmental Casualty and Opportunity", *Publius*, Vol. 11, No. 3/4, The State of American Federalism, pp. 21-38; Stable URL: <http://www.jstor.org/stable/3329896>. Accessed: 15/09/2009.
- Hedge, David M.** 1983. "Fiscal Dependency and the State Budget Process", *The Journal of Politics*, Vol. 45, No. 1, pp. 198-208.
Stable URL: <http://www.jstor.org/stable/2130331>. Accessed: 05/09/2009.
- Marlow, Michael L.** 1988. "Fiscal Decentralization and Government Size", *Public Choice*, Vol. 56, No. 3, pp. 259-269.
Stable URL: <http://www.jstor.org/stable/30024865>. Accessed: 05/09/2009.
- Martinez-Vazquez, Jorge and Bob Searle** (eds.) 2007. *Fiscal Equalization: Challenges in the Design of Intergovernmental Transfers*, Springer, New York.
- Methé, David T. and James L. Perry.** 1980. "The Impacts of Collective Bargaining on Local Government Services: A Review of Research", *Public Administration Review*, Vol. 40, No. 4 pp. 359-371.
Stable URL: <http://www.jstor.org/stable/3110262>. Accessed: 28/08/2009.
- Sharpe, L. J.** 1980. "Is There a Fiscal Crisis in Western European Local Government?", *International Political Science Review / Revue internationale de science politique*, Vol. 1, No. 2, Recent Changes in Urban Politics: National-Local Linkages pp. 203-226;
Stable URL: <http://www.jstor.org/stable/1600993>. Accessed: 28/08/2009.