Sub-National Performance Incentives in the Intergovernmental Framework

Current Practice and Options for Reform in Indonesia

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Decentralization Support Facility

Introduction

Interest in incentives in the context of Indonesian decentralization abounds at the moment. On the donor side, multilateral agencies, including the World Bank and Asian Development Bank, regularly stress the importance of getting incentives right in their research reports and operational documents related to sub-national lending activities. Bilateral agencies have taken up the refrain too. The government of Australia, for example, has recently issued a white paper that emphasizes the importance of incentives in encouraging better sub-national performance. They are planning to use performance incentives as a central feature in the design of a new local government support project. The Government of Indonesia has also expressed interest in developing a stronger system of incentives for the intergovernmental framework. This paper is intended to provide a framework for the government to explore the desirability of and options for furthering such incentives.

The need for national performance incentives in a decentralized system may not seem immediately obvious. A common but rather limited view of decentralization portrays local government autonomy as an absolute right enshrined in constitutional provisions, decentralization laws or other enabling regulations. This is usually interpreted to mean that the role of the central government in a decentralized system is largely to develop appropriate intergovernmental structures, systems and procedures. If the decentralization framework is structured properly, e.g., assigns appropriate expenditure and revenue functions to local governments, establishes fiscal discipline and a hard budget constraint, makes provisions for redressing inter-jurisdictional fiscal disparities, etc., local government behavior is supposed to be primarily driven at the local level by sub-national elections.

A more complete view of decentralization is that it is always necessary to find an appropriate balance between important national goals and local autonomy. In most decentralized countries, central and/or regional governments substantially regulate or attempt to influence local government fiscal behavior in a variety of ways so as to support the attainment of legitimate national priorities. Moreover, it is clear that the theoretical benefits of decentralization can only be realized if local governments have adequate systems, capacity and incentives to behave in a responsible manner and can be held accountable to their constituents. Capacity and accountability are not built rapidly or easily, and local elections are a blunt and inadequate instrument to stimulate local accountability, particularly in environments where civil society is weak and inclusive collective decision making is neither well understood nor well established.

In this broader, more dynamic view, decentralization requires a capable central government that can properly develop and enforce appropriate intergovernmental mechanisms, support the enhancement of local government capacity, and help to promote a climate for improved local

governance. Reform should be seen as a lengthy process that requires substantial, often complex changes in government systems and operating environments, as well as modifications in the behavior of all major actors—central government officials, local governments, and citizens. Under such circumstances, central incentives for local government performance can play an important role in furthering national development priorities, in promoting the adoption of decentralization reforms to systems and procedures and in stimulating behavioral changes intended to further the major goals of decentralization.

This paper provides background for the Government of Indonesia as it considers if and how to introduce more robust local government performance incentives into the intergovernmental fiscal framework. The next section briefly examines the forces that have driven the recent national wave of interest in improving local government performance. This is followed by a review of the relatively limited set of local government performance incentives currently in force in Indonesia. The fourth section provides a conceptual overview of how to think about the possible expansion of local government incentive programs, outlining the potential role(s) of such programs in general and the key issues involved in designing and implementing them. The fifth section tentatively considers a number of options for additional local government incentives in Indonesia that the central government may wish to consider pursuing. The paper concludes with an outline of next steps for moving forward with the possible development of more purposeful and meaningful performance incentives in Indonesia's intergovernmental fiscal framework.

The Case for Improving Local Government Behavior

There is widespread discontent among central government bureaucrats and international agency officials with the manner in which sub-national governments use their fiscal resources. Three sets of facts illustrate the reasons for the general dissatisfaction with sub-national fiscal performance. The first relates to a lack of spending, the second concerns inefficient spending, and the third is associated with the apparent low quality of social and infrastructure services.

Sub-national governments have under-spent the resources at their disposal and have accumulated large reserves. Prior to the start of decentralization, sub-national governments held just over Rp. 7 trillion in reserve funds. Between the beginning of 2001 and the end of 2006, sub-national reserve funds expanded by an order of magnitude, reaching just under Rp 70 trillion. Reserves grew at an annual rate of 45 percent during the indicated period. At the time of this writing, sub-national reserves stood at about Rp 108 trillion. This amount represents about 3 percent of estimated GDP for 2006. An accumulation of reserves of this magnitude is probably excessive and, as such, represents a significant forgone opportunity to increase spending to support service delivery and economic development.¹ Figure 1 provides the details of the accumulation of sub-national bank deposits, a reasonable proxy for reserve funds.

¹ Of course sub-national governments should keep some funds in reserve to smooth expenditures in the short-term (in the context of the business cycle) and the long-term (in order to address the eventual decline in some natural resource revenues). Determining precisely how much sub-national governments should hold in reserve is not a question that is easily answered. Some analytical work is currently underway to examine actual reserve fund needs.

The spending that sub-national governments have carried out has been arguably inefficient. Sub-national government expenditure on administration, for example, is very high. In 2004, provinces and kabupaten/kota spent 32 percent of their combined budgets on administrative activities. Best practices from more developed countries suggest that a figure of around 5 percent should be sufficient to cover administrative needs.² By contrast sub-national governments spent only 29 percent of their budgets on education, just 17 percent on infrastructure, and only 7 percent on health. See Table 1 for the details.

Table 1: Sub-National Government Spending (2004)

	Province		Kabupaten/Kota		Consolidated	
	Rp (Bn)	Percent	Rp (Bn)	Percent	Rp (Bn)	Percent
Administration	12,327	38.0	35,529	29.9	47,856	31.6
Agriculture	1,823	5.6	4,201	3.5	6,024	4.0
Education	3,815	11.8	39,805	33.5	43,620	28.8
Health	3,000	9.3	8,108	6.8	11,108	7.3
Infrastructure	8,321	25.7	17,147	14.4	25,468	16.8
Mining	195	0.6	74	0.1	269	0.2
Trade	479	1.5	681	0.6	1,160	0.8
Labor	426	1.3	452	0.4	878	0.6
Environment	619	1.9	1,233	1.0	1,852	1.2
Other	1,399	4.3	11,728	9.9	13,127	8.7
Total	32,404	100	118,958	100	151,362	100

The delivery of key types of sub-national social and infrastructure services appears weak. The examples of education and water services illustrate the general problem.

² For example, in 2001, state and local governments in the United States spent 3.1 percent and 4.6 percent on administration, respectively (United States Census Bureau Statistical Abstract of United States, 2004-2005).

Despite some progress in school enrollments³, significant concerns exist about the quality of public education in Indonesia. Indonesian students ranked just 34th out of 45 in the Third International Mathematics Science Study (TIMSS), carried out in 2003. Indonesian junior secondary school students achieved especially poor outcomes in key areas such as problem-solving. In the Program for International Student Assessment (PISA), also implemented in 2003, Indonesia ranked last out of 40 countries, in both mathematics and language exams. Moreover, on a scale from zero (lowest) to six (highest), over 50 percent of students did not reach level one in mathematics. And only 31 percent of students could accomplish more than the most basic reading tasks. These performance outcomes in Indonesia were lower than those in other countries, even after accounting for household socio-economic status (World Bank, 2007).

Household access to and the quality of water services in Indonesia are among the lowest in East Asia. Provision of piped water services by local water enterprises (PDAMs) is deficient and deteriorating. The percentage of the urban population served by PDAM piped water in 2002 (the latest year for which reliable data exist) was just 33 percent, declining from 40 percent in 1997. Relatively few PDAM offer 24 hour service. The incidence of unaccounted water is high, reaching nearly 50 percent. No PDAM in the country offers water of drinking quality and very few PDAMs treat water at all with appropriate dosages of standard chemicals.

The three sets of outcomes just described together provide a strong rationale for the discontent with the status quo alluded to previously. The current zeal for incentives in Indonesia probably stems at least in part from the overall lack of satisfaction with sub-national government behavior. That is, many argue that the poor performance is a direct function of the lack of proper incentives in the fiscal system. It is often claimed that, if only Indonesians could get the incentives right many of the outcomes would be improved.

Current Local Government Performance Incentives in Indonesia

This section reviews incentives—some intended and others unintended, some productive and others perverse—currently operating in the Indonesian system of intergovernmental fiscal relations. Many of these relate in some way to sub-national government expenditure and revenue behavior. A profile of sub-national spending for 2004 is presented in Table 1 above, while Table 2 below provides a snapshot of sub-national revenues for the same year.

Table 2: Sub-National Government Revenue (2004)

	Province		Kabupaten/Kota		Consolidated	
	Rp (Bn)	Percent	Rp (Bn)	Percent	Rp (Bn)	Percent
Own-Source Revenue	22,696	49.3	10,131	8.3	32,827	19.5
Shared Tax Revenue	8,759	19.0	13,706	11.2	22,465	13.4
Shared Non-Tax Revenue	2,833	6.2	8,773	7.2	11,606	6.9
DAU	8,217	17.9	75,794	62.1	84,011	50.0
DAK	13	0.0	3,661	3.0	3,674	2.2
Other	3,483	7.6	10,055	8.2	13,538	8.1
Total	46,001	100	122,120	100	168,121	100

³The net enrollment rate in primary school rose from 72 percent in 1975 to 93 percent in 2005. Net enrollment rates also increased for junior and senior secondary school, from 17 percent for both in 1975 to 65 percent and 42 percent for junior and senior secondary, respectively, in 2005 (World Bank, 2007).

Several incentive mechanisms are present in the intergovernmental fiscal system. Examples from all types of fiscal transfers—shared tax revenue, shared non-tax revenue, DAU and DAK are detailed below.

Shared Tax Revenue: Property Tax

Performance incentives have been integrated into the system of property tax transfers to the regions, albeit in a rather minor way. The property tax is a central tax in Indonesia, although local governments assist with collections. The bulk of property tax revenue is shared with the regions. The center returns 64.8 percent and 16.2 percent of total property tax receipts to kabupaten/kota and provinces (by derivation), respectively. The center (initially) keeps 10 percent of the total for itself and in addition charges nine percent for administration. The center subsequently allocates its 10 percent share to local governments; 6.5 percent is distributed in lump sum payments across all places and 3.5 percent is allocated to local governments as a function of their achievement of the previous year's (urban and rural) property tax revenue target.

No data exist with which to judge the effect of the property tax incentives described above. Many suspect that the mechanism is not even implemented, at least not regularly. In any case, the impact, if any, could not be very considerable, given that only 3.5 percent of property tax revenues are subject to the incentives. In 2006, this amounted to about Rp 550 billion or about 0.33 percent of total sub-national revenue budgets (and about 0.02 percent of GDP). Another salient feature of the incentive scheme is that responsibility for property tax collection is shared between deconcentrated Ministry of Finance tax offices and local governments. As such attainment of targets depends in part on central government performance as well as that of kabupaten/kota. This surely further weakens the incentive structure.

Shared Non-Tax Revenue: Oil and Gas

The Ministry of Finance has attempted to encourage natural resource rich regions to spend more of their resources on education. Starting in 2009, relevant sub-national governments will be awarded an additional 0.5 percent share of state oil and gas revenues. At that time, sub-national shares will rise to 15.5 percent and 30.5 percent of total domestic oil and gas revenues. According to law (UU 33/04), recipient sub-nationals must spend the additional 0.5 percent on education. Neither the law nor attendant regulations mention how this mandate will be monitored by the central government nor what sanctions will be applied should the mandate not be followed. As such, it is difficult to see how this particular spending incentive will have any real impact.

DAU

Incentives have also played some role in the allocation of the general purpose grant (DAU). The DAU is the most important source of funds for sub-national governments. It makes up approximately one half of total sub-national revenues and nearly two-thirds of local government budgets. The pool of finance for the DAU is 26 percent of (planned) net domestic revenues. In 2008 the DAU reached nearly Rp 179 trillion (4.8 percent of GDP). From the total pool of

finance, a portion sufficient to cover the entire regional wage bill is hived off and allocated to the regions as a function of their respective salary needs. The remainder of the DAU pool is distributed across regions according a fiscal equalization formula. Recently, about 50 percent of the DAU was allocated to fund sub-national civil servant wages.

The stated rationale (in Law 32/04) for covering sub-national salary payments from the DAU is to ease the local fiscal planning burden associated with the regular transfer of staff among regions or between the center and regional governments. Most analysts have argued that from the local perspective, however, the DAU allocation scheme serves as a disincentive to rationalizing sub-national civil service employment. Why would sub-national governments bother firing excess staff as long as the center is paying their salaries? Any disincentive that does exist, however, is somewhat diluted by the fact that regions do not have complete control over the hiring and firing of their civil servants. Much of this authority is reserved by agencies of the central government. The easiest way for regions to rationalize their stock of personnel is through attrition, a mechanism of rather limited scope.

The disincentive effects are further complicated by the fact if a region were to cut staff it would receive more funds for non-staff spending. (That is, as the regional wage bill declines, the portion of the pool of finance reserved for staff payments decreases and that for non-staff spending increases; thus any region with a positive fiscal gap would receive more in equalization funds.) Looked at from this perspective one could argue that the DAU allocation scheme offers a spending incentive for reformist regions—i.e. those less interested in building up staffing levels and more interested in service delivery and economic development. Of course the reduction in funds for a region depleting the number of its civil servants would far exceed the increase in non-wage funds it would receive in compensation. And all regions would receive some additional equalization funds whether they cut their staff rosters or not. These features weaken reformers' incentives. All things considered, therefore, the DAU allocation scheme probably does serve as some disincentive to reducing excess personnel at the sub-national level. Unfortunately this is impossible to rigorously test and quantify given the dearth of data.

Another incentive that was embedded in the DAU allocation system concerns the treatment of own-source revenues in the equalization formula. The latter is based on the difference between estimated expenditure needs and fiscal capacity. Expenditure needs are derived from a set proxies (population, area, a cost index, etc.) and fiscal capacity is based on a region's other revenues (i.e. besides those from the DAU and also the special purpose grant—DAK—which is not included in the formulation). Potential rather than actual own-source revenues are used in estimating fiscal capacity, whereas actual revenues are used for all other sources. The former are determined via a simple regression model that specifies revenues as a function of gross regional domestic product (a proxy for the local tax base); a region's potential own-source revenue is its own-source revenue, as predicted from the estimated model.

The intent of the formulation was to encourage regions to increase their own-source revenues, in the context of the overwhelming importance of transfers. That is, it was hoped that regions would strive to be “above the potential revenue line” so that they would be able to “keep” some portion of their own-source revenues alongside DAU allocations. The argument was that the

incentive would be helpful in guarding against the common outcome of declining local tax effort and local revenues in the face of large and/or increasing intergovernmental transfers.

As it turns out, the empirical evidence shows that growing central-local transfers are associated with rising own-source revenues in Indonesia. It is doubtful, however, that this result is a consequence of the scheme outlined just above. The idea was never understood by regional government officials, in the first instance, and the feature has in any case recently been eliminated from the DAU allocation methodology. A more likely explanation is that increased transfers lead to increased reserve funds, which in turn lead to increased interest earnings, a form of own-source revenue. Recent analysis (Lewis and Suharnoko, 2006) suggests that increased interest earnings on unspent balances may explain up to half of the increase in own-source revenues in the post-decentralization period.⁴

Scant other evidence exists on the impact of the intergovernmental transfer scheme on local fiscal outcomes. Lewis (2005) shows that increasing transfers lead to fairly predictable increases in local government spending and savings and that rich local governments (i.e. those with substantial natural resource revenues) spend less and save more of transfer increases at the margin than non-rich local governments. The study also shows that increases in transfers lead to increased local own-source revenues (as mentioned above) for both rich and non-rich regions. Another study (Lewis 2006) demonstrates that increasing transfers to local governments are associated with reduced cost efficiency in local tax administration. More empirical analysis of the relevant issues would be useful.

DAK

The DAK is a matching grant designed, according to current law, to encourage capital spending in poor (or otherwise specially designated) regions. The matching component is set at a minimum of 10 percent of the center's contribution. In the event, the local share has not deviated from the minimum amount set out in law.

During the initial years of decentralization, the DAK was insignificant, making up less than Rp 1 trillion during 2001 and 2002. But by fiscal year 2008 the DAK had grown to Rp 21.2 trillion. The DAK currently makes up only around 3 percent of total local government revenue. While still relatively small, it is likely that the DAK will become even more important in years to come. This is especially true if the Ministry of Finance and Bappenas succeed in re-channeling central deconcentrated spending on decentralized tasks through the DAK as planned and required by Law 33/04.

Beyond increasing the size of the DAK, however, the government seems to have no unified agenda for the grant. It is not clear for example the extent to which the DAK is to be used to promote expenditure in key sectors, to address poverty, to correct for benefit spillovers, and/or to

⁴ Between 1999/00 (the last full fiscal year before decentralization) and 2004, 46 percent of the increase in own-source revenues is accounted for by interest earnings on bank deposits. In addition, about 20 percent of the increase was derived from the electricity sales tax (administered by PLN) and another 20 percent was from "other" user charges (mostly newly created charges). Finally, about 10 percent of the absolute increase in own-source revenues was from puskesmas health fees (Lewis and Suharnoko, 2006).

assist in the achievement of minimum standards. All of these goals have been mentioned at one time or another by various central officials. Nor does the central government monitor the use and impact of the grant.

In this policy environment, a particular concern is that the grant will become fragmented across many sectors and uses (in the same way as the old INPRES grants were). This has already started to happen to a certain extent. The sectoral coverage of the DAK in the initial years of operation was limited to education, health, roads, irrigation, and government office buildings (for newly created local governments). But by 2008 coverage had expanded to 11 sectors: education, health, roads, irrigation, potable water, fisheries, agriculture, environment, population, forestry, and local government office buildings. In addition, by 2008, all local governments in the country (451) received at least some DAK. A major reason behind the increasing sectoral and geographic fragmentation of the DAK is that allocation procedures appear to have been captured to a large extent by DPR.

The Overall Status of Incentives

As indicated by the above discussion, the Indonesian experience with attempts to structure performance incentives into the intergovernmental fiscal system has been rather ad-hoc. This lack of a systematic approach is not unexpected in Indonesia given the multiple central agencies involved, some degree of policy fragmentation within individual agencies, and the lack of overall coordination. One government agency sometimes out-maneuvers another, as occurred, for example, with the adoption of the requirement that the DAU cover the sub-national wage bill. (The Ministry of Home Affairs insisted on this principle, overriding the objectives of the Ministry of Finance). On other occasions a single central agency works in a non-strategic manner, as is the case with many of the incentives created by the Ministry of Finance.

In addition to concerns about the limited and fragmented adoption of incentives, lax or partial implementation of those that exist would appear to be the rule rather than the exception. Use of property tax and own-source revenue incentives, for example, has been irregular and inconsistent. Equally noteworthy, the effects of incentives have been poorly monitored and studied, as is the case with the DAK especially. Where information is available, the impacts seem to have been limited or uneven, and in some cases unintended or perverse. The potential power of incentives, however, is illustrated by a recent (partial) withholding of DAU transfers to regions that did not comply with budget reporting requirements. The noncompliant local governments almost immediately conformed to the relevant regulations, suggesting the kind of positive impact that incentives may have if designed correctly and enforced.

Opportunities for Expanding the Use of Incentives

Although their use to date has been limited and/or of questionable impact, there are many current or pending national policies that might benefit from local government performance incentives. *Mandates* are one important class of policies used in the intergovernmental framework in Indonesia. Local governments, for example, are subject to substantial mandates in the education sector. A constitutional provision requires that 20 percent of local government spending be allocated to education, and a recent law (UU 20/03) specifies that this mandatory figure is

exclusive of school personnel expenses. Similarly, with a view to improving the targeting of local government expenditures, the Ministry of Home Affairs (MoHA) is leading the development of mandatory minimum service standards for an array of core sub-national service delivery functions. This approach has been codified in a recent government regulation (PP 65/05). Unfortunately, it is not even clear how or by whom education mandates and minimum service standards will be monitored, much less whether and how the central government might provide specific incentives for local governments to follow them.

Other important central government policies related to local government fiscal behavior could be classified as behavioral *restrictions*. These occur, for example, in the form of upper limits on the rates applied for local own-source revenues or restrictions placed on levels of local government debt. In the case of rate limits, it is not clear how seriously they are monitored and enforced, or if and how current fiscal incentives play a role in stimulating compliance. (There is also, however, no reason to believe that local governments would want or need to violate them given the magnitude of intergovernmental transfers). With respect to debt limits, local government borrowing is not presently excessive, but probably not because of strict enforcement of limits. Local governments have limited access to borrowing, in part because loan repayment is poor, with a 2004 arrears rate of 48 percent. The Ministry of Finance has access to a strong repayment incentive in the form of a sanction that allows interception revenue sharing funds, but there has been a reluctance to use this mechanism to enforce compliance.

An Overview of the Objectives and Design of Local Government Incentives

Given the serious concerns about local government performance in Indonesia raised above and the limited and uneven use of incentives to improve the situation, there may be potential opportunities for the government to develop and apply incentive mechanisms more broadly, more creatively and more effectively. Such incentives could play the role not only of promoting the adoption of reforms and the enforcement of mandates, but also of creating more efficient and citizen-responsive fiscal behavior.

This section provides a simple framework for thinking about the possible roles, design and implementation of more carefully conceived local government performance incentives than presently exist in Indonesia. First, it reviews the possible broad target purposes of local government incentives. Second, it considers some of the potential specific objectives that might be pursued within this broader set of purposes. Third, it outlines a range of key issues that must typically be considered in designing an incentives program. Fourth, it provides an overview of major issues and challenges involved in measuring performance. Finally, it notes various types of institutional responsibility that must be defined for designing and implementing a performance incentive system.

Broad Target Purposes

There are many purposes to which local government incentives could be put by the central government, ranging from the more limited goal of facilitating the adoption and performance of very specific system and procedural reform programs to the broader goal of promoting larger development and policy objectives. The use of performance-based incentives for local

governments in developing countries has been relatively limited, so there is not much experience to draw on.⁵

Adoption of System Reforms

Basic performance incentive efforts sometimes target simple reform adoption, and many of these have focused mainly on the development of some limited aspect(s) of the basic intergovernmental fiscal, administrative and legal system and its operating procedures. Such technical reforms are generally seen as contributing to improved governance and accountability through more efficient and transparent public sector conduct. Some accountability reforms may go beyond the basic elements of the system by trying to facilitate more direct engagement with citizens, e.g. through the adoption of participatory approaches or other citizen consultation and feedback mechanisms.

Fiscal, Economic and Social Performance Targets

Beyond the adoption of basic system and process reforms, incentives can be used to stimulate improved fiscal behavior/aggregate budget performance, more or better local government service delivery, and enhanced own-source revenue generation. These targets can be pursued in a variety of ways outlined below. Incentives can also be provided to facilitate behavior that is intended to support other priority public sector goals and policies. These can be broad and multi-faceted, such as poverty reduction, or more limited, such as pollution control or other environmental friendly behavior.

Innovation

Central governments can use performance incentives to encourage local governments to try new ways of doing business. Examples include the adoption of new types of efficiency enhancing technology, the use of public-private partnerships in undertaking local government functions, the pursuit of joint initiatives with other local governments (inter-jurisdictional cooperation), or efforts that create linkages with community driven development (CDD) activities. These types of initiatives would be appropriate when there are proven benefits from pursuing them, or when the government wishes to create an environment conducive to experimentation with alternative mechanisms to see if such benefits materialize.

Focal Objectives

Within the broader set of target purposes outlined above, the specific focal objectives of a local government incentive system can range from simple adoption of various types of decentralization reforms to a range of improved development outcomes. Incentives could be provided for complex or multiple objectives from the start or there could be a progression in the evolution of incentives over time from very basic to more demanding.

⁵ A good review of the conceptual literature on performance incentives and of the application of related mechanisms in developing countries, including in the local government sphere, is provided in Zinnes (forthcoming).

Simple Reform Certification

In the most straightforward case, the incentive program could simply acknowledge that a particular local government has started to use systems and procedures required under a revised intergovernmental framework. This in effect constitutes a certification that specific measures have been undertaken without reference to how well this has been done. Certification can occur for technical reforms, such as new record keeping systems, new planning and budgeting procedures, financial management and reporting requirements, etc.; legislative reforms, such as the passage by the local assembly of new regulations for revenue enforcement or public-private partnerships; or for the use of somewhat “softer” types of governance reforms, such as the adoption of citizen consultation mechanisms or the opening of a citizen complaints bureau.

Reform Adoption Performance

A step beyond providing incentives for the simple adoption of technical reforms or governance processes is to reward sub-nationals with regard to the extent or technical quality of such reforms. Such performance measurement might focus, for example, on whether budgets and financial reports are prepared in a timely manner, how well actual revenues and expenditures correspond to local budget estimates, whether priorities identified in local development plans are actually funded, if and how often new regulations actually applied, how frequently citizen consultation exercises occur and the extent of participation in them, etc. Such measures do not necessarily say anything about the impact of the new behavior, but they do indicate some movement beyond the pro forma adoption of reforms.

Aggregate or Specific Fiscal Performance

The central government may also wish to provide incentives for local governments to alter their aggregate fiscal behavior or the level/and or composition of their expenditures and revenues. Local governments may, for example, be running large deficits, running large surpluses and holding substantial idle balances, or assuming excessive levels of debt. On the expenditure side, they may be spending what is considered to be an excessive share of their budget on administrative expenses or debt service, or spending too small a share of their budget to social services targeted by a national poverty strategy or to capital investment in areas where infrastructure levels are documented to be insufficient to meet economic or social objectives.

There may also be particular legal spending mandates on which the government wants to create incentives for local government compliance. With respect to revenues, there may be concerns that own-source revenues in the aggregate account for too low a share of total local revenues or that local governments are not raising as much funds as they could from a particular local revenue source. Incentives can be devised to help to stimulate changes in these or other similar fiscal management or budgetary behavioral patterns.

Inputs, Outputs, or Outcomes

Regarding service delivery side, local governments may be excessively or inadequately using key inputs or significantly under- or overspending relative to input or cost standards in a

particular service sector. For example, teacher-student ratios or class sizes may be very high or very low, or expenditures per kilometer of road may be well below or well above national or provincial averages. In such cases, incentives could be used to try to push local governments to adjust the inputs they use or modify the costs they incur for units of particular inputs. There may, of course, sometimes be good reasons for atypical behavior, such as the locally specific need for special technologies or unavoidable spatial cost variations, and these would need to be taken into account in defining the levels for which incentives would be provided.

Rather than motivate local governments to spend more or less on a particular service, or to increase or decrease specific inputs, or reduce unit costs of service delivery, the central government may wish to provide incentives for certain output levels defined, for example, by the relevant sectoral ministry, a national development or a poverty reduction strategy. Examples would include targeting increases in student enrollment ratios, the number of liters of water produced per local government resident, the number of kilometers of road, etc. In many cases it would be possible and desirable to specify some measure of quality, such as water or roads meeting a certain standard. It would even be possible to target incentives to improvements in outcomes that measure something beyond the direct production of a public service, such as improvements in the literacy level, reductions in morbidity and mortality, etc.

Although any of these focal objectives could be pursued through a local government incentives program, it is clear that they become progressively more difficult to achieve and/or measure as they move from simple reform measures to better outcomes. Certifying the adoption of a new budgeting procedure, for example, can occur rather quickly compared to increasing literacy rates, and the pro forma use of new citizen consultation mechanisms is much easier to document than the effect of such mechanisms on the quality of such local government interactions with their constituents and their eventual impacts.

Key Incentive Design Issues

Beyond the basic decisions about the focal objectives of a local government incentives program, several major design decisions commonly need to be made. Key issues include the degree of flexibility in the program; whether to use absolute or relative performance standards; if incentives should be positive, negative or both, if rewards/penalties should be financial, non-financial or both; whether financial incentives should flow through new or existing mechanisms; what is an appropriate performance period; whether to support capacity building; how to ensure transparency; and whether it is necessary to pilot the incentives before general adoption.

Degree of Flexibility in Targets

The degree of flexibility of the program has implications both for the nature of targets and incentives and how they are decided on. At one extreme, an incentive program can define fixed broad expectations of all target entities, such that each local government would be rewarded for its performance in adopting a particular technical reform, increasing the collection of a particular revenue source, improving a clearly defined aspect of the delivery of a particular service, etc. A less restrictive design would allow local governments to choose from a menu of possible reforms or improvements within or across reform areas and/or revenue-sources and/or service sectors.

The most flexible type of design would be open-ended and allow local governments to play the dominant role in selecting a specific reform or set of reforms. Obviously, this spectrum of options involves different levels of central government direction and local government discretion.

Absolute versus Relative Standards

Another important design feature is the nature of standards on which performance will be evaluated. The most restrictive option is the requirement of absolute standards, such that any participating local government must meet exactly the same requirement for a particular behavior being promoted—whether adoption of a particular budgeting reform or attainment of a particular level of revenue generation or service delivery. Given the common diversity of local governments in many countries, absolute standards may be neither practical nor desirable, except perhaps for simple compliance-style reforms, such as adopting a new reporting format or meeting a certain reporting deadline. There could, however, be absolute standards for different groups of local governments, where the classification depends on central government identification of a set of characteristics that are expected to determine local governments' need and ability to meet particular standards. It would also be possible to give local governments a say in defining a specific set of reforms or target performance indicators that they believe they can meet over a particular performance period, in effect leading to some individualization of targets over a specific time period, even if eventual requirements are standardized.

Positive versus Negative Incentives

Another set of design decisions has to do with the nature of the incentives, which can be positive and/or negative. Positive incentives would reward local government compliance or performance with a particular target reform or behavior. Failure to comply or perform to standard could simply result in the lack of a reward, or there could be penalties involved.

Financial or Non-financial

Penalties and rewards can be tangible or financial, such as technical assistance or funding, or non-financial, such as good or bad publicity. Whatever decision is made on this, the consequences of performance must be something that matters to local governments. If they do not need more resources or care about being publicly sanctioned, then the incentives will have no effect. Both penalties and rewards can be fixed, such as a 20 percent increase/decrease for meeting/failing to meet compliance or performance standards, or they can be graduated to correspond to the extent to which performance exceeds or lags some specified target level. If penalties and rewards are financial, the source, level and regularity (one-time, for a specified period, or recurring) of funds needs to be identified. The source of funds can be, for example, the central government budget, or a share of sub-national government revenues, or external donor grants or loans.

Use of Existing or Creation of New Mechanisms

Financial resources can be allocated through existing programs, such as unconditional or conditional transfer programs, or special funds can be set up, with or without special management arrangements separate from existing government departmental procedures. If the funds are channeled through an existing arrangement, they can be determined either as a proportion of currently allocated resources (that will become subject to new performance conditions under the program) or they can represent an addition to current funding levels.

Performance Period

A fundamental design issue relevant for a local government performance incentives system is defining the performance period. Making this decision requires consideration both of how frequently performance measurement is needed in order to stimulate better local government performance. Some simple aspects of compliance or performance may be changed over the course of a single annual budget cycle, while others would be expected to take longer to realize or to measure the effects of (depending on exactly what aspect of performance is being measured). If the evaluation process is at least to some extent based on secondary data (see below), the performance period may be dependent on how frequently these data are collected and how soon after collection they are made available.

Capacity Building and Technical Assistance

A common concern with performance incentive programs in developing country environments is if and how they incorporate capacity building and technical assistance. On the one extreme, centrally prescribed general training and technical assistance can be required of a local government based on a pre-program assessment of capacity, and a local government would have to accept this as a condition for participation in the incentives program. At the other extreme, any capacity building or technical assistance required to meet the conditions of the performance incentive program would be entirely the responsibility of the local government. In between these two extremes are a variety of options. Capacity building and technical assistance might be provided in a targeted way based on what is expected to be needed for a local government to meet specific performance indicators at a particular point in time. Alternatively, the central government might make resources available for an eligible local government to try to meet its capacity building and technical assistance however it sees fit. In this latter case, there would have to be an ex-post assessment of how these resources were used, particularly if the local government does not meet its performance targets.

Transparency

The design of a local government performance incentives program, however it is structured, will need to meet basic transparency requirements. This means that there should be clarity on the rules and processes to be followed in implementing the program, and this information will need to be readily available to local governments. The results of the compliance/performance evaluation should also be open, and local governments should have the right to appeal if they believe, for example, that the information used in their evaluation is inaccurate or if the

evaluation procedures as stated were incorrectly applied. If a broad goal of the performance incentives program is improving accountability, then the results of the evaluation process should also be public information so that residents of a local government will be better able to judge how their local officials are performing and how this compares to other local governments.

Piloting or Mainstreaming

Finally, it will be necessary to decide whether the performance incentives program needs to be piloted or if it can be immediately mainstreamed into intergovernmental relations. In theory, the more complicated and innovative the mechanism, the more likely it would need to be tested and adjusted before being scaled up for use with all local governments. A constraint in this regard is however that it is difficult to pilot locally what would eventually become national programs. A related issue is if and how the program will be sustained, which depends on its purpose, the source and reliability of funding, and the institutional arrangements required to keep it going.

Measuring Compliance/Performance

A number of decisions need to be made with respect to measuring compliance or performance for an incentive program. These include whether the measure(s) used should be subjective, objective or mixed; how to select an indicator that accurately measures the appropriate dimension(s) of performance; and how to secure the required data, recognizing the potential advantages and disadvantages of various possible sources.

Subjective, Objective or Mixed

One of the greatest challenges involved in designing a performance incentive program is how to measure performance. An initial decision that needs to be made is whether the performance indicators used in the process will be objective, subjective, or some combination of the two. Generally speaking, objective measures are preferable because they are likely to be easier to measure, verify and to interpret, and they are more amenable to a process that will be repeated. The data required to construct objective indicators, however, may not be available or may be unreliable. In addition, some aspects of performance may be difficult to measure in an objective way. For example, the performance of participatory governance mechanisms is sometimes measured in terms of the number of people or percentage of an eligible population that actually participates. In such cases, more subjective measures may need to be used. For example, local governments can be rated comparatively or relatively on a scale, e.g. from strongest performance (great improvement) to weakest performance (no improvement), by a panel of people with appropriate knowledge.

Such ratings, of course should not be fully subjective—there must be clear guidelines for what the different ratings mean and a well defined process for preparing the ratings that minimizes overt biases or opportunities for manipulation by either those conducting the ratings or local government officials. In some cases, it may be useful to develop a composite index based on multiple indicators to capture, for example, both the extent to which a new reform has been used (objective measure) and the degree to which it has made a difference in how local government decisions are made (subjective measure).

Choosing an Appropriate/Accurate Measure

There are often many challenges involved in measuring performance, even in the case of objective measures. A central concern is that an indicator needs to be chosen so as to accurately represent a desired result in evaluating local government performance. In some cases, this is relatively clear, while in others it is not. Increases in revenue yields from a particular source, for example, can be considered to represent improved local revenue performance (although the source of the increase and whether deliberate local government behavior was responsible for it may not be evident from such a measure). Increases in local expenditures on a particular service, in contrast, need not mean that services have actually improved; in fact, spending increases may prove to be wasteful.

Sources of Data

The sources of data used to measure performance are clearly important. If existing data sources are considered appropriate and reliable, it is obviously preferable to use them rather than mount a new data collection effort, but this is not always feasible. And sometimes existing data sources may not be accessible to the agency that needs to use them, or they may not be collected and updated on a regular basis, and there may be changes in the way the data items are defined or collected over time that complicate their use in a periodic evaluation process. In addition, sometimes desired data may cover different units of analysis, e.g., cost or expenditure data may be local government specific whereas some types of outcome data may only be available at the provincial level, or two data sets may cover different time periods. Such discrepancies must be understood and dealt with to the extent possible in the construction of performance indicators.

Institutional Responsibility

Undertaking a local government performance incentives effort requires a number of decisions about assigning institutional responsibilities for the various tasks involved—design of the system and specific incentive instruments and indicators; collection and verification of data required to prepare the indicators; creation of the indicators and preparation of evaluation reports based on them; implementation and enforcement of incentives based on indicators; review, evaluation and revision (as necessary) of the incentive system and process. While the overall process will require direction and oversight from a lead agency, some aspects of the process might be delegated to other agencies or contracted to nongovernmental actors. In early stages, the work might be done by a separate entity funded by international agencies, although this should only be done if there is clarity about how and in which government entity the process would be institutionalized.

Considering New Local Government Performance Incentives in Indonesia

As noted above, the government is considering if and how it might be beneficial to further the use of incentives for improved local government performance in Indonesia. A number of areas of opportunity in which the adoption of incentives could be productive were also identified. If the government wishes to proceed with an expansion of local government incentives, there are many potential options that cover the range of possibilities outlined in the above overview.

Before providing a few concrete examples of new incentive mechanisms, this section outlines some of the considerations and challenges involved in moving forward in the Indonesia context.

Challenges

There are a number of nontrivial challenges to developing local government performance incentives in Indonesia, but they are certainly surmountable. One important challenge is that it might be considered rather late in the decentralization process to begin using some of the simpler types of performance incentives outlined above, particularly those related to the adoption and effective use of reforms to local government systems and procedures. On the one hand, one could argue that many local governments have not fully adopted many of the basic system and procedural reforms that they are supposed to be using under decentralization or have not used them well. Ideally, however, such incentives are used at initial stages of decentralization and applied throughout the process of implementing reforms designed to get the basic intergovernmental institutional and managerial infrastructure in place.⁶ At this point, there are reasons to doubt the value of using such incentives on their own in Indonesia. First and foremost, this style of reform does not directly address the dominant concerns about local government performance. These squarely focus on persistent major inadequacies in service delivery even after several years of a decentralization reform that generated high expectations of results. Given this situation, incentives for simple adoption of reforms seem unlikely to be of much interest to the central government or to local government constituents. In addition, the incentives would likely have to be great to induce local governments to change the behavior they have adopted since decentralization began, and the incentives may have to function for a long time get institutionalize and sustain the system reforms.

Also of considerable concern is the central institutional fragmentation among agencies that have a role to play in decentralization and local government development, as highlighted above in the discussion of current local government incentives in Indonesia. If different central agencies develop an ad hoc collection of incentives, some of them may work at cross purposes, some may be dependent on the adoption of others that do not materialize, and the overall set of incentives might confuse local governments about priority reforms and overwhelm their ability to respond to multiple incentives.

Another potentially daunting challenge is the constraint placed on the value of financial incentives in Indonesia by the size and growth rate of fiscal surpluses being accumulated by local governments, as documented above. A local government that is not spending the resources it already has available is unlikely to respond to financial incentives intended to alter its fiscal behavior. This situation does not, however, undermine the potential value of finding some way to create incentives for different behavior. Indeed, it is highly likely that at least a number of (if not most) local governments with substantial accumulated surpluses are not providing an adequate level and quality of key local services or otherwise behaving in the type of responsible and accountable manner that is required for the theoretical benefits of decentralization to be realized.

⁶ Most such documented experiences to date, many of which are discussed in Steffensen (2005), have been in countries in the early stages of the decentralization process or from the initial introduction of a new type of intergovernmental reform.

It is in principle possible to consider using negative incentives to improve on the idle resource situation by, for example, penalizing repeated large surpluses in local governments that are not meeting certain performance standards. At present, however, data on surpluses (based on BI commercial bank account information) are being made available only as provincial aggregates. It would be reasonable for the Ministry of Finance to request access to individual local government data given the importance of this information for assessing performance. Basing incentives on changes in bank account balances, however, would almost surely lead to local governments finding other places to keep their surplus resources. Ultimately, only a local government budgeting system that reports annual surpluses and where they are kept reliably would meet the data requirement for this type of broad incentive mechanism.

Finally, a particularly vexing issue concerns the potential moral hazard of transferring additional funds to inefficiently operating local governments. It is well known that, in general, Indonesian sub-national governments use the funds that they do manage to spend (as opposed to save) inefficiently in delivering services with which they have been charged (Lewis, forthcoming). And it is probably safe to conclude that all sub-national governments could be operating at least somewhat more efficiently than they are now. Under such circumstances, the provision of additional funds to any sub-national government as an incentive for having achieved some desired outcome (i.e. that they could have realized with more proficient use of resources in the first instance) risks rewarding inefficient behavior, at least implicitly. In theory some sub-nationals may be operating “efficiently enough” and therefore arguably more deserving of additional incentive funds. But identifying sufficiently efficient performers is not easily done in any rigorous way. This makes it difficult to avoid sending mixed signals in attempting to operationalize a system of performance incentives in the intergovernmental framework.

Despite these various challenges and concerns, there are ways to make progress in creating performance incentives for local governments in Indonesia. These may be broadly classified as those focused on aggregate fiscal behavior and those focused on specific purposes or sectors.

Incentives focused on Aggregate Behavior

A number of aspects of aggregate local government fiscal behavior—budget surplus/deficit, borrowing behavior, balance between recurrent and capital expenditures, significance of own-source revenues, etc—may merit incentive attention by the government. Some of these, as noted above are already influenced, whether intentionally or not, by central regulations and actions, such as the structure of local government taxes and the allocation of the DAU. If, for example, data on local government surpluses could be reliably secured, the reduction of idle surpluses could be made a condition for the disbursement of some portion of DAU allocations. Although some observers would object to placing restrictions or incentives on a general (unconditional) transfer in a decentralized system, a case can in fact be made to do this. There has already been some behavior-influencing use of the DAU, such as the above-described Ministry of Finance withholding of DAU disbursements from local governments that had not submitted required budget reports.

More importantly, a strong argument can be made that the central government has an obligation in a decentralized system to help ensure the responsible and accountable use of local government

resources, especially in a country where downward accountability is still only weakly developed. Such an approach is being used, for example, with Kenya's Local Authority Transfer Fund, where a substantial percentage of formula allocated entitlements from this general revenue sharing program can be held back by the Ministry of Finance if certain reform conditions are not met by local governments. It would be similarly possible, technically speaking, for the Indonesian government to withhold a portion of formula-determined DAU allocations unless certain reform or performance targets were met. Although this could provide a powerful incentive for improved local government performance, it seems unlikely to be politically feasible at the present time.

More broadly, the discussion of the DAU above highlighted some weak or problematic incentives created by various aspects of the DAU formula and the way that variables used in its calculation are defined. Although this is again rather politically sensitive, it would seem worthwhile at the very least to conduct more systematic study of the effects of the DAU and to consider options for reforming it in a way that would create incentives for improved local government performance. Perhaps with a more grounded and more public debate about the effects of the present system, it may become more politically feasible to introduce changes over time in the incentives it creates.

There may also be other worthwhile incentives focused on specific problematic aspects of a local government's overall fiscal behavior. For example, it would be possible for the central government to provide local governments experiencing poor revenue collection performance with dedicated positive incentives for improving yields, or to penalize local governments with substantial or growing debt arrears (especially if they are not making an effort to cooperate with ongoing debt restructuring efforts). Consultation with the Ministry of Finance would undoubtedly reveal more ideas.

Incentives focused on Particular Purposes or Sectors

Given the potential problems associated with immediately focusing on some of the most important aspects of overall local government fiscal behavior and the structure of the DAU, another option would be to pursue incentives for changes in particular types of behavior. As argued above, focusing on simple reform adoption does not seem likely to gain much traction at the present time. A more strategic step-by-step incentive process that starts with basic reform adoption may still be considered appropriate to develop local governance in a number of carefully identified weaker local governments in Indonesia. Such an approach is in fact being considered by an Ausaid performance incentives project that is under development. For most other local governments, however, efforts to enhance performance should likely focus directly on creating incentives for more targeted aspects of improved fiscal performance and priority public services.

The logical way to target performance in particular service sectors is through the use of conditional transfers. These are commonly used throughout the world to create incentives for the performance of local government service delivery functions that are central to major national

policy objectives.⁷ After a fairly slow start, Indonesia's nascent conditional transfer mechanism, the DAK, has been rapidly growing in recent years, and it seems poised to continue on an upward trajectory. Unfortunately the DAK, which is by law supposed to be designed and managed by the Ministry of Finance and relevant sectoral ministries, has been substantially captured by the DPR, and it seems unlikely that it could be meaningfully used for the purpose of creating strong local government performance incentives. This suggests that the hibah mechanism, which is a highly flexible way to get grants from any source (government or donor) to local governments and does not suffer from the possible concerns noted about the DAK, might be the best resource channel for creating local government incentives.

If the initial target of performance incentives is to be service delivery, then a choice must be made about which sector(s) to work in. Many services under local government control in Indonesia would benefit from improved performance. Drawing broadly on the above discussion of incentive design issues, tentatively sketched examples of how performance incentives might be considered in the education and water sectors are provided below.

Education

Given the above-noted mandate on educational spending and the failure of many local governments to meet it, this would appear to be an appropriate sector in which to introduce a performance incentive that would support implementation of the mandate. In order to proceed, it will be necessary to consider many of the various design issues outlined above—targeting inputs or outputs, using objective or subjective indicators, focusing on absolute or relative behavior, etc. Many ways of proceeding could be considered, but as a start, it would seem prudent to focus on some aspect(s) of outputs or outcomes, such as enrollment rates, attendance rates or test scores. Focusing on inputs seems likely to be less effective, as there is inadequate information about the relationship between inputs and ultimately desired outputs, and it is clear intuitively and from international experience that increasing input levels need not lead to improved results. In a sector like education for which some relevant data are available, there is also a strong case for using objective rather than subjective indicators.

It should be feasible to develop a simple indicator to identify educational performance in local governments. Since local governments in Indonesia are rather different and operate at various levels of performance, absolute standards would not be sensible; instead, performance could be measured relative to a base over a period of time to be determined. A local government that attains a particular level of improvement could be awarded additional resources to spend on education, or there could be a series or progressively more generous incentives offered for attaining either specific levels of a series of indicators ordered in importance or increasingly higher levels of the same indicator(s). A key design concern is how to ensure simplicity and transparency—it should be clear to the local governments and their constituents (from the rules and processes of the incentive program) what is being rewarded and how. It would be possible to consider providing technical assistance and capacity building to some local governments identified as deserving of it, or the target levels of performance could simply be adjusted to reflect different expectations based on different characteristics of local governments. The system

⁷ Broad reviews of various forms of intergovernmental transfers, including conditional, are provided, for example, by Bahl (2000), Bird and Smart (2002), and Schroeder and Smoke (2003)

would, of course, be simpler if attaining the performance targets were left to the local governments, but even in these cases separate special assistance programs might be designed for the weakest local governments that are likely to experience difficulties in making adequate progress on their own.

Water

Another high profile sector and also a major sub-national focus of the World Bank Infrastructure Policy Development Loan (IDPL) is the water sector. In some ways water is more complicated than education because this basic service is largely provided through local government water enterprises (PDAMs) rather than directly by local governments. The PDAMs have various and evolving relationships with local governments. At present they are generally subject to a nontrivial degree of local government influence over service levels, service coverage, tariff increases, etc., and they are largely dependent on local governments for access to loans and grants provided by the central government. At least some of the better performing water enterprises are likely to enjoy a greater independence from local governments after in-process legislation is completed and passed. It seems likely, however, that weaker PDAMs will, at least for some period of time, maintain a dependent relationship with local governments, so a performance incentive targeted at local governments could potentially be effective. Taking this type of approach does assume, however, that local governments have sufficient influence over PDAMs to influence their behavior and that financial resources used to create incentives for improved performance would actually be passed by the local governments to the PDAMs.

As with education, it would be necessary to consider many of the various design issues outlined above. Input targets seem even less appropriate in water than they are in education since the targets would have to vary widely by water source, distance from the consumption point, and other factors that would be expected to affect technology needs. Some might argue for targeting one of the most recognized water sector issues with great implications for service sustainability—cost recovery performance. It may be more effective, however, to focus on other, more easily attainable aspects of performance that could improve the prospects for cost recovery over time. These would include, for example, reductions in water loss/leakage or increases in the number of connections. As in the case for education, there are some data available in the water sector that could be used to create objective indicators, which would be preferred to subjective indicators.

Many of the other design issues raised about the education sector also apply to the water sector. Following the same logic about variations in local government characteristics and current service delivery performance levels, relative standards would be more appropriate than absolute standards in evaluating performance and determining financial reward levels. Progressively improved behavior would be required for future incentive funding. The issues covered above regarding simplicity and transparency are equally applicable to the water sector, and consideration would have to be given to whether it is best to entirely leave the question of how to attain the performance standards to local governments or if some technical assistance or resources for securing it would should be provided to those local governments and PDAMs with lower levels of capacity.

Thinking Beyond Illustrative Sector Examples

The education and water performance incentive initiatives briefly outlined here need not be seen as concrete proposals—in fact more careful consideration would have to be given to these ideas in order to determine whether they are likely to be feasible and productive, as well as if they are appropriate starting points for a new government incentives effort. Instead, these sectoral proposals are simply meant to provide illustrations of how to think about developing performance incentives in Indonesia. There are strategic elements to these proposals, such as the focus on a key public service sector for which there is already a powerful national mandate (education) or the link to a sector that the government is required to act on as part of a policy lending agreement (water), and the proposed use of the hibah instead of the DAK. Some suggestions have also been made about the possible effective design of the incentive systems—targeting outputs rather than inputs, using objective rather than subjective indicators, adopting relative rather than absolute performance standards, etc. But these particular ideas should really be considered after a fuller review of options and in the context of a broader set of proposals in multiple sectors. Specific design details and institutional responsibilities for various aspects of the effort would have to be carefully worked out by policy makers through consultation with fiscal incentive and education/water sector experts and various interested parties.

Next Steps

A number of steps would be required to move forward with a local government performance incentives program.

- First and foremost, the interest of key government actors, principally the Ministry of Finance and Bappenas would have to be confirmed, as would any already determined preferences for adopting a particular approach.
- Second, if a general interest in the basic idea is confirmed, broader consultation may be required in order to gather support and suggestions for the initiative, particularly if the cooperation of other agencies would be required for the incentives to work.
- Third, a general target or targets would have to be selected and some decisions made about the basic structure of the program. Would the incentives be on aggregate fiscal behavior or limited aspects fiscal behavior or specific service delivery sectors? Will the incentives be for reform adoption, performance or both? Will the incentive mechanism be provided for inputs, outputs or outcomes?

Once these basic determinations are made, additional research specific to the agreed target would have to be undertaken. Thus, for example, if a decision is made to develop performance incentives in education, it would be necessary to look at of present education sector reports and government and donor initiatives in Indonesia that might provide ideas on how to proceed, as well as to take stock of relevant sources of data that may be available. It would also be useful to take a closer look at international experiences with local government performance incentives in the particular target sector.