

Strengthening Fiscal Transfers in Indonesia Using an Output-Based Approach

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In 2010 the World Bank approved a US\$220 million loan for a Local Government and Decentralization project in Indonesia. The project aims to improve the accountability and reporting of the central government's Specific Purpose Grants (DAK). Piloted in four infrastructure sub-sectors—irrigation, roads, sanitation, and water—the project is the World Bank's first to apply innovative Output-Based Aid (OBA) design principles on a large scale to target improvements in inter-governmental fiscal transfers. Under the project, the DAK grants will work in a similar way to OBA subsidies, which reimburse service providers for independently verified, pre-agreed physical outputs. Up to 81 local governments in five provinces are eligible to take part in this project. This note presents an overview of the project objectives and design.

Since 2001 Indonesia has gone from being one of the most centralized countries in the world in administrative, fiscal, and political terms to one of the most decentralized. Under this process local governments have assumed new responsibilities that were previously covered by the central government, as well as managing new financial resources that have been transferred from the central government or raised within their own localities. Local governments have therefore experienced substantial increases in financial resources, mostly through increased transfers from the central level for delivery of education, health, and basic infrastructure services. Local governments now manage 38 percent of total public expenditure and carry out more than half of all public investment. However, public expenditure reviews show that fiscal decentralization in Indonesia still faces many challenges. These include improving and speeding up spending, and reducing local government dependency on central government transfers.

Specific Purpose Grants (DAK)

The bulk of the intergovernmental transfers to local governments are the General Purpose Grants (Dana Alokasi Umum, DAU) and the Specific Purpose Grants



Photo by Richard Lord

(Dana Alokasi Khusus, DAK). DAU are mainly used to fund salaries and other administrative costs. DAK are allocated to finance specific investment expenditures that are aligned with national priorities and carried out under the jurisdiction of local governments. In 2010, the DAU share of total intergovernmental transfers was 63 percent, while the DAK share was around 7 percent.

There are currently 14 sectors eligible for DAK funds, including four infrastructure sectors—irrigation, roads, sanitation, and water supply—which represent about 21 percent of the total DAK allocation. The amount of the DAK allocation is determined on an annual basis within the national budget. The Ministry of Finance (MoF) allocates the DAK to each sector and within the sectors local governments have the flexibility to determine which activities (sub-projects) they invest in. The Ministry of Public Works (MPW) provides technical guidelines on the implementation, monitoring, and evaluation of the DAK for each infrastructure sector. The MPW's technical guidelines clearly specify the outputs on which the DAK grants can be spent, and these are mostly limited to maintenance, rehabilitation, and the upgrading or improvement of existing infrastructure.

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Application of OBA Principles to Improve the Use of DAK Transfers

The aim is to help local governments improve planning, budgeting, and investment execution, as well as monitoring and verification of results. Two options for project design were assessed: (i) a traditional financing of input-based investment subprojects in a small number of local governments, with disbursements tied to individual expenditures or contracts; and (ii) an output-based approach with disbursements tied to the achievement of pre-agreed outputs within the scope of the DAK expenditure program.

In assessing these options, the project drew important lessons from two core principles that have been applied in the design of output-based aid (OBA) projects funded by the Global Partnership on Output-Based Aid (GPOBA): change in the financing paradigm (from inputs to outputs); and transfer of operational and investment risk (from the funding entity to the entities best positioned to deliver the desired outputs). On this basis, the following advantages of an output-based approach were considered to achieve the project's objective:

- **Increasing transparency** by tying the reimbursement of DAK grants to defined outputs estimated according to agreed reference unit costs.
- **Increasing accountability** by shifting performance risk to local governments and structuring financial incentives, in addition to the DAK allocation, to reward timely and compliant performance in the delivery of agreed outputs.
- **Increasing sustainability of public funding** by linking payment of incentives to local governments to the delivery of sustainable services.
- **Enhancing monitoring of results** since project funds are disbursed against independently verified outputs.
- **Building capacity within Indonesia** to scale up the approach beyond the World Bank project, thereby aligning with the Bank's programmatic engagement strategy in Indonesia.

Project Characteristics

Scope of Financing. The project is a specific investment loan of US\$220 million to be implemented over four years using an output-based approach. The project will reimburse a slice of the existing DAK for infrastructure based on delivery of independently verified physical outputs by selected local governments. Project funds will be used to reimburse the central government for infrastructure expenditures

allocated to the selected local governments, and to reimburse the 10 percent counterpart funding which local governments are required to provide to participate in the DAK program. The project will be piloted in five provinces (Central Kalimantan, East Java, Jambi, North Maluku, and West Sulawesi) and all of their 81 districts. Provinces were selected based on geographic diversity, reporting capacity and performance, and success in delivering outputs financed by their DAK.

Institutional Arrangements. The main actors in the project are the MoF, the MPW, the State Finance and Development Supervisory Board (Badan Pengawasan Keuangan dan Pembangunan, BPKP), the World Bank, and the participating local governments. Figure 1 summarizes the flow of funds and accountability in the project.

Eligible Outputs. Eligible outputs are single sub-projects (Paket Pekerjaan) financed by DAK grants and may include:

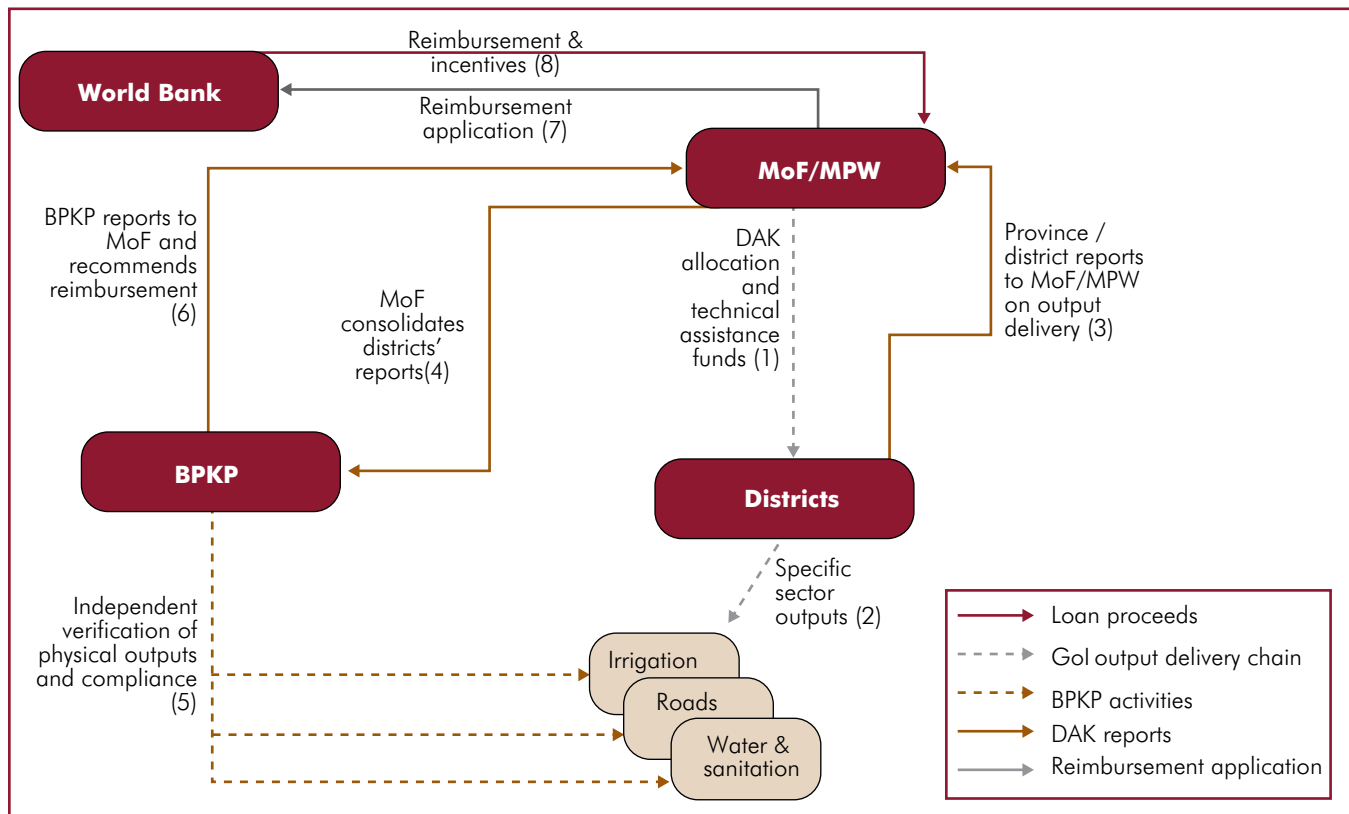
- **Road sub-sector:** Periodic maintenance, improvement, and rehabilitation of provincial, district or city roads and bridges.
- **Irrigation sub-sector:** Improvement, rehabilitation, and development of irrigation networks, including swamp reclamation networks and village irrigation networks.
- **Water sub-sector:** Development of water intake from surface water, water intake from wells, small water treatment plants, water pipe networks, household connections, and public water hydrants.
- **Sanitation sub-sector:** Development of community sanitation facilities, community waste drainage facilities, solid waste facilities, public toilets, and small wastewater treatment plants for households.

Establishment of Unit Costs. Project funds will be disbursed using reference unit costs (RUC) for each of the eligible outputs. The RUC are established by the MPW prior to the start of the DAK cycle at the beginning of the year. They are calculations of provincial aggregates based on actual competitively procured contracts. They also reflect regional variations and take into account the construction cost index and other differences across provinces.

Risk Transfer and Pre-financing of Outputs.

Generally, in OBA projects, the service provider takes on the risk of pre-financing the outputs and the OBA funds reimburse the service provider for the costs incurred on the basis of pre-defined unit costs. The

Figure 1. Flow of Funds and Accountability



entitlement nature of the DAK grants restricts the extent to which operational and investment risks can be fully transferred from the MoF to the local governments. Local governments' capacity to pre-finance the delivery of outputs, a determining incentive for the success of any output-based approach, is also limited, as is the concept of "contracting out" or "delegation" of service provision to local governments within the DAK framework. Under this project, the central government's budget expenditures allocated for the DAK grants will play the pre-financing role. Local governments will use the DAK allocation to contract out the output delivery work to private contractors, following Indonesia's procurement law. The central government, which has pre-financed the outputs, will be ultimately accountable to the World Bank for successful output delivery.

Performance Incentives. The project builds a series of incentives for the MoF and local governments to deliver outputs:

- The risk of non-performance is borne by the central government, as Bank funds will not be disbursed to the central government if a local government is found to be non-compliant. The central government has the power to retain future fiscal

transfers to local governments, however, and this can incentivize the local governments to perform both by delivering outputs on time and by complying with financial and technical reporting.

- Successful delivery of outputs will result in a reward consisting of a portion of the Bank reimbursement to be transferred from the MoF to local governments, representing the required 10 percent counterpart funding of the DAK allocation. This 10 percent counterpart funding will be reimbursed to the local governments as a block grant and will be not earmarked for future infrastructure sector expenditures. It will thus act in a similar way to an OBA subsidy, providing a new kind of incentive to local governments.
- An additional incentive, which makes local government participation in the program attractive and mitigates performance risks, is the technical assistance that the central government will provide to local governments during the project.

Output Verification. The verification of outputs will be conducted by the BPKP, which will compile a list of completed outputs as reported by the local governments and submit it to the MoF by the end of the first quarter of each year. The BPKP will then randomly sample 20 percent of reported outputs in each province and verify

Table 1. Method for Assessing Reimbursement Amounts

Calculation	Definition
STEP 1: Calculate for each local government:	
Value of Potential Reimbursement (VPR)	Sum of the outputs reported by the local governments multiplied by their reference unit costs.
Qualifying Percentage (QP)	Number of outputs in the sample that meet the eligibility criteria, expressed as a share of sampled outputs.
Value of Qualifying Reimbursement (VQR)	QP multiplied by VPR.
STEP 2: Calculate the total for all local governments:	
Value of Total Reimbursement (VTR)	Sum of VQR across all local governments.
STEP 3: Determine World Bank reimbursement:	
Advance Payment (AP)	Sum of the central government's first DAK payments to each local government.
Value of Final Reimbursement (VFR)	VTR – AP
Local Government Reimbursement	10 percent of DAK counterpart funding

the timeliness and accuracy of the financial and technical reports submitted by participating local governments to the MoF and the MPW. The BPKP will work closely with the MPW in verifying the outputs to ensure that the outputs for the specific allocation have been physically achieved and are in compliance with agreed procedures and policies on procurement, financial management, and social and environmental safeguards.

Disbursement Modalities and Conditions. The project will disburse funds using two modalities: (i) advance payment (AP) and (ii) value of final reimbursement (VFR). The project will reimburse both the AP and the VFR values, plus the 10 percent counterpart funding to the infrastructure sector in that year. The World Bank reimbursements will be made based on BPKP's report and recommendation. Table 1 provides a summary of steps for the assessment of the reimbursement amounts that may be claimed by the central government once BPKP has issued the output verification report.

Conclusions

The project, which became effective in January 2011, presents a shift away from financing individual investment sub-projects in a small number of local governments. It focuses instead on improving the government framework within which DAK-funded investments take place. This places the emphasis on achieving results by delivering independently verified outputs in compliance with the government's fiduciary and safeguards laws and regulations. Over time, the project will be expanded through follow-on operations to strengthen downward accountability from local governments to communities, while also improving the efficiency and effectiveness of local government expenditures. Additional design features of OBA, such as targeting the poor, or continued transferring of risk down to the local governments and on to the service providers and contractors, will be explored as part of the World Bank's programmatic engagement with Indonesia on results-based approaches.

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