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Linking expenditure assignments and intergovernmental grants in Indonesia

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1. Introduction

Indonesia is currently in the process of evaluating and revising the decentralization legislation and the progress made during the first stage of its “big bang” decentralization reforms. This first wave of decentralization reform was implemented without major interruptions in service delivery as had been feared by some. However, initial and partial field evidence suggests that the long-term viability of service delivery may now be threatened in some local governments and in some sectors. In particular, there is a danger that the proliferation of obligatory functions and minimum service standards that far outstrip available resources will undermine functioning and credibility of local government units (LGUs). To forestall this possibility, and address other shortcomings in the decentralization framework, the Government of Indonesia (GOI) is in the process of reviewing and refining its system of intergovernmental relations.

A key component of the governmental review and fine-tuning of the decentralization framework is the clarification of the assignment of expenditure responsibilities under Law 22/1999 on regional government (Law 22), and ensuring consistency between this law and other relevant legislation.¹² The current emphasis in the review of Law 22 in this respect is the formulation of Obligatory Functions (OF) of local governments and their related Minimum Service Standards (MSS).³ However, one of the key “big picture” questions which appears to be largely overlooked is how to assure that the funding provided to local governments, through the provisions in Law 25/1999 (*Law On The Fiscal Balance Between The Central Government And The Regions*) and other legislation,⁴ is consistent with the responsibilities, and the associated MSS, that are assigned to the local government level through a revised Law 22 and other relevant legislation/regulation.

In response to the government’s reform agenda, and as part of the USAID-GOI agreement regarding the project’s support work, the current technical study proposes a “legislative bridge” that will assure consistency between Law 22 (or its amended form) that defines the functional responsibilities of local governments on one hand, and Law 25/1999 (Law 25), that defines the various funding mechanisms for local governments on the other hand.

It is important to emphasize that establishing a linkage between these two laws will require more than a technical solution and procedures. It will require an institutional

¹ In the decentralization literature, a distinction is generally made between central government (i.e., a national or federal government), regional governments (such state or provincial governments) and local governments (such as county/district governments or municipalities). In Indonesia’s decentralization lexicon, Kabupaten and Kota (Regencies and Cities) are often referred to as “regional” governments. However, consistent with the decentralization literature, this technical note refers to this level of government in Indonesia as the local government level unless otherwise noted.

² Among other purposes, the review of Law 22 is meant to assure consistency between the law and the law’s implementing regulations, some of which will also need to be changed to be consistent with the substantive changes made to the framework of decentralization in the amended law. At the same time, the review of Law 22 is meant to assure greater clarity on the devolved assignment of local government services, since various sectoral laws often continue to dictate the centralized provision of local government services for many responsibilities which were assigned to the local government level by Law 22 and its follow-up Government Regulation 25/2000. A review of the problems with Law 22 on functional assignment is presented by Ferrazzi. 2002. *Obligatory Functions and Minimum Service Standards: A Preliminary Review of the Indonesian Approach*. GTZ-SfDM.

³ For additional information, see: Donor MSS Working Group. 2002. *Local Government Obligatory Functions And Minimum Service Standards: A Proposal For Conceptual Development And Implementation*. June 4: Jakarta.

⁴ In particular, Law 34/2000, the framework for local own-source revenue collections.

meeting of minds, notably between the Ministry of Home Affairs (MOHA) and the Ministry of Finance (MOF).

It is our hope that an open discussion of the alternative policy approaches needed to build a bridge between Law 22 and Law 25 might prompt policy makers and stakeholders to take a fresh look at some of Indonesia's decentralization challenges, in particular what role OF/MSS should play in this system and their fundamental nature. The main challenge is to assure that OF/MSS adopted are consistent with prospective resources available to fulfill them and therefore, that the decentralized systems gets closer to achieving optimum delivery of services within the available revenue "envelope".

2. The current lack of linkage between Laws 22 and 25 and how it may be aggravated by the introduction of OF/MSS

The decentralization reforms that were enacted in Indonesia in 1999 and implemented in 2001 were fundamentally built on two laws: Law 22, which includes a general assignment of functional responsibilities for all levels of government, and Law 25, which provides local governments with shared revenues, including a larger share of natural resource revenues, general-purpose transfers, , and own revenue sources.

Law 22 was the first to be drafted of the two and is constructed as the overall framework law, thus also encompassing the broad features of financial relations between the center and the local governments. These are treated in Chapter VIII (articles 78-86). Article 80(4) calls for the introduction of a law to provide the details of the broad provisions on financial relations set out in Law 22. Accordingly, Law 25 makes reference to Law 22 in its preamble. From this legal construction, it is reasonable to expect that Law 25 would have borne out the principles and directions on financial relations set out in Law 22, and that these then would be closely aligned with the expenditure assignment found in Law 22. This logic unfortunately is not found in fact, for several reasons:

- a) Law 22 presents a broad assignment of expenditures for a number of sectors⁵ that provides a higher degree of discretion to the local government level but little specific guidance on the obligatory functions that local governments must perform.
- b) The connection between this assignment and the financial relations, in particular revenue assignments and transfers, are not clear in Law 22 itself, particularly on the issue of obligatory functions.
- c) Law 22 is followed by a clarification of obligatory functions by the formulation of minimum service standards in Government Regulation 25/2000 that fails to correct many of the problems of Law 22/1999 and certainly fails to clarify the assignment of functions' connection to financial relations.
- d) The institutional division of responsibilities for intergovernmental relations issues between MOHA and MOF makes consistent bridging from Law 22 to Law 25 very challenging. In general, MOHA has the lead in the implementation and revision of Law 22 and in guidance and supervision of local governments, while MOF has a similar lead with respect to Law 25 and regulation of fiscal arrangements with local governments, but guidance on financial management and other important aspects of central-local financial relations is uneasily shared between these two ministries.⁶

As Indonesia is now seeking to fine-tune and consolidate the progress made in the rapid decentralization reforms begun in 1999, it has become increasingly apparent that the current decentralization framework lacks a systematic linkage between Law 22 (expenditure assignments) and Law 25 (revenue allocation mechanisms). The opportunity to make a tighter linkage between the two basic decentralization laws is now available as MOHA attempts to clarify the assignment of expenditure responsibilities between the different levels of government and ponders the clarification of OF/MSS, as part of its review of Law 22.

⁵ Certain sectors, such as defense and religion, are reserved exclusively for the central government, with the residual powers allocated to local governments and certain sectors, such as education and health, specifically assigned to them.

⁶ For instance, MOHA oversees the implementation of Law 34/2000 on what new taxes can be introduced by local governments.

Currently there is no mechanism or process to assure that the level of funding provided to the local level will be “adequate” to deliver the local public services expected to be specified as obligatory functions and operationalized through their respective MSS. Reaching vertical balance in a decentralized system is always a challenge, as international experience indicates; functions and revenues are provided to local government in different combinations and with varying relationships between these two building blocks of local fiscal autonomy. Some countries address this challenge of achieving vertical fiscal balance by providing local governments with autonomous revenue sources and some clarity on expenditure functions. Local governments can then, for example, increase or decrease the tax rates of some significant taxes to raise adequate revenues for their stipulated expenditure responsibilities. There is often some ambiguity around which expenditure responsibilities must be carried out or which have national priority⁷. Thus even when local governments are given revenue autonomy, vertical imbalances are likely to occur but their extent is subject to debate.

Other countries choose not to provide local revenue autonomy, and rely on alternative mechanisms to reach vertical balance at the local level. For instance, vertical fiscal imbalances could be avoided by not defining in any concrete way the expenditure responsibilities of local governments or leaving quite open, that is subject to the availability of resources, the level at which concrete physical expenditure norms could be fulfilled. In essence, these approaches mean that local expenditure choices are made at the level and quality that available local resources allow in accordance with local priorities.⁸ This has been largely the experience of most transition countries in Central Europe and the former Soviet Union and it is also a common practice in Latin America.

The “revenue first” approach, with little follow-up on expenditure assignment, avoids vertical imbalances by definition, but this construction potentially can make it difficult for the national government to realize national interests and priorities through local government service delivery. For this reason, some countries choose to set specific service obligations for local government and expected performance levels for these

⁷ See Ferrazzi G. (2002). *Legal Standing and Models of Local Government Functions in Selected Countries: Implications for Indonesia*, SfDM Report.

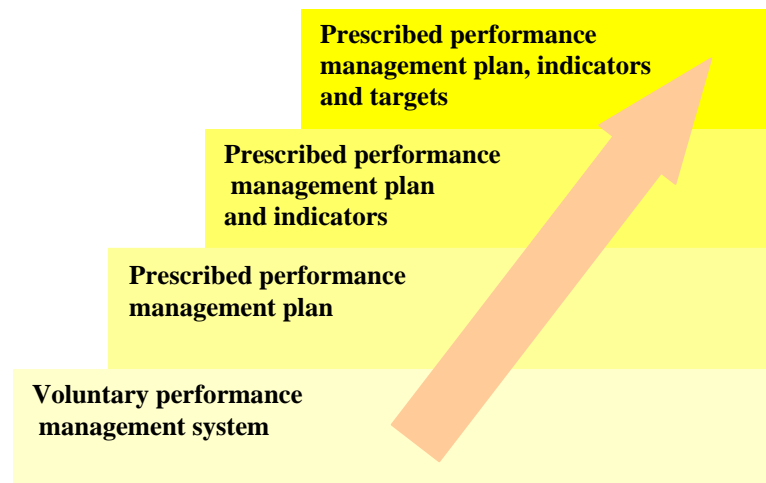
⁸ Alternatively, vertical balance could be achieved by financing specific local government functions by conditional grants. Of course, this approach would limit the degree of local budgetary autonomy and would run counter to Law 22 in Indonesia.

services. A “traditional” system of minimum service standards (MSS) provides local governments with a set of input, output, and outcome-type standards to be achieved in the delivery of local government services.

The degree of prescription and enforcement of these performance levels or standards varies by country. As Figure 1 indicates, several approaches to prescription can be found. It is not uncommon to find performance management systems that are both of a voluntary nature (driven by local accountability mechanisms) and a prescribed nature (imposed by higher level government).

The challenge in a fully prescriptive system (the top of the ladder in Figure 1) such as the one being considered in Indonesia by MOHA lies in matching these prescriptions with available finances. This matching is particularly challenging when local government has not been provided with significant autonomous revenue sources and must rely on intergovernmental conditional grants, which may or may not be well-designed, to meet the prescribed performance levels for services that it is obligated to deliver.

Figure 1: Ladder of Prescription for Local Government Performance



Source: Ferrazzi (2003). Minimum Service Standards In Indonesia: Searching For A Model (mimeograph)

The current lack of connectivity between Laws 22 and 25 may be aggravated if a revised Law 22 were to define local expenditure needs through the introduction of obligatory functions of local government (operationalized through minimum service

standards) and fail to assure the affordability of these obligatory functions under Law 25 and related legislation/regulation⁹. This could lead to a number of intergovernmental difficulties, with the worst case scenario being a serious vertical fiscal imbalance leading to unfunded mandates, significant distortions in national and local allocations, and intense inter-agency and intergovernmental conflict.

Vertical fiscal imbalance would be more likely to occur if “local expenditure needs” were to be defined outside the national budget process, as is the case with the “ad hoc” definition of MSS by line ministries and other central government agencies. There may be other complications and negative results from these policies beyond a vertical imbalance. If the expenditure norms or budget standards set fail to assure that local governments can afford the responsibilities assigned to them, then this would falsely raise the expectation that local governments could actually deliver the unrealistically high levels of service. This would likely result in general disappointment in the decentralization process among voters and encouragement for local governments to pass the blame for substandard local service delivery to the central government for not providing “adequate” resources. In turn, the “failure” of local governments to deliver could be used as an excuse for re-centralization measures across the system.

The likelihood of the above difficulties coming to pass is very real if recent events are any indication. The Ministry of Health has recently issued a ministerial decree that it deems binding on local government, covering a long list of obligatory health services to be provided by local governments, with their respective MSS. These MSS have yet to be properly costed; in fact, the Ministry is still involved in designing the costing methodology. A cursory examination of the list would suggest that many local governments will face great difficulties in financing these services at the levels expected and that, indeed, the nation as a whole cannot afford them at the current time. MOHA, for its own part, has not been able to coordinate the introduction of these MSS in the health sector in any process that would take into account other anticipated claims on national and local resources from impending OF/MSS in other sectors. Confusion and conflict surely lie ahead, with worse repercussions, if OF/MSS are not properly

⁹ For instance Law 34/2000 prescribing allowed own revenue sources.

conceived and implemented through a revised law 22, and then properly linked to financing provisions in Law 25¹⁰.

A visual representation of the impending lack of connectivity between Law 22 and Law 25 as exacerbated by poorly conceived OF/MSS is provided by Figure 2. The figure consists of four panels that represent the four main policy decisions that take place as part of the current process of allocating local government resources in Indonesia. The diagram highlights the current lack of a bridge or structural link between Laws 22 and 25 and how this may worsen by the adoption of MSS defined in an *ad hoc* manner.

- The top panel in Figure 2 illustrates the fact that the resource envelope available for the local government level is the cumulative result of a series of policy decisions made at the national level – either implicitly or explicitly - by the President, Cabinet and MOF as part of the national budget process. First, the resource envelope available to the public sector in a country is determined by the tax system and the public sector’s ability and willingness to borrow for public spending. Second, under the current approach, Law 25 is the most important legislation in defining the resource envelope for the local government level. After all, Law 25 defines the revenue sharing arrangements between the different levels of government and the size of intergovernmental grants (e.g., the pool for the general allocation fund, the “DAU”, is defined as at least 25% of total domestic revenues. In addition, Law 25 provides the framework for local own-source revenue authority, elaborated in Law 34/2000. One additional funding mechanism, , which falls outside the context defined by Law 25, lies in the sometimes recurrent but mainly capital resources which flow to the provincial and district/city government levels through, and at the discretion of, sector ministries (“deconcentration” funds)¹¹.

¹⁰ Or a revised version of Law 25. This law also is plagued with its own shortcomings and may be revised. As is argued at a later point in the paper, if both laws are to be revised, their revision should be connected process wise and in substance.

¹¹ These funds, to the extent that they are meant for development activities that fall under the responsibility of local government, contradict the principles and legal stipulations underlying Indonesia’s decentralization reform.

- A second and added element in the intergovernmental resource allocation process in Indonesia is the envisioned clarification of obligatory local government responsibilities and the quantification of the expenditure needs related to their associated MSS. As indicated above, currently the level of expenditure needs of local governments is poorly defined, owing largely to the large “residual” architecture with which local responsibilities are defined and the faulty formulations of Law 22 with respect to the service delivery obligations of districts and cities. In order to address this problem, MOHA has embarked on a process of defining the criteria for determining the obligatory functions of the district/city (and lately of provincial) governments (Panel 2) and the related MSS (referred to in Indonesia by the acronym SPM for “Standar Pelayanan Minimal”).¹² An extensive process known as the “model-building exercise” was undertaken with support from international donors, involving numerous stakeholders including MOHA, two key line ministries (health and education), local government officials, and the MOF, with the ultimate objective of defining MSS and assessing the likely impact of committing to these standards in view of technical capacity and financial realities in Indonesia.

The exploratory work conducted by this team was initially intended to yield lists of obligatory functions and MSS purely for discussion purposes. The lists of OF/MSS were not intended to be automatically enshrined in law or placed in regulations as they were being fashioned. The lists were expected to be further piloted through a planning/implementation cycle in selected districts/cities, again with the assistance of donors.¹³ It is apparent that this “understanding” reached in the initial stages is now being breached by the Ministry of Health, with its recent decree, and may be breached by a number of other ministries in a destructive race to attract national budgetary resources.¹⁴ The “tragedy of the commons” (which,

¹² In reality MOHA has provided general guidelines for the process and the sectoral ministries are responsible for defining the actual OF and MSS. It is not entirely clear, whether the MSS are supposed to be set only for OF, as argued by part of the donor community, or whether they can be set for any function as the sectoral ministry chooses.

¹³ This piloting exercise covers 8 districts/cities in four provinces, and is supported financially by ADB and executed on the donor side by RTI-GTZ. It began in April 2003 and will proceed for 18 months.

¹⁴ The comment may not be entirely fair to the Ministry of Health, which on many accounts has on the whole taken its decentralization responsibilities more seriously than other ministries. The “understanding”

refers to the phenomenon of the overgrazing of communal pastures) may soon be played out on the share of the national resource pool that is set aside for the local government level, unless the process is returned to its exploratory/piloting track, giving room for consultation, learning, and a proper design and introduction that place firm financial discipline on the development of OF/MSS.

The affordability question is central to the exploratory and piloting exercises. At this stage it is apparent that the degree of attention and ability to anticipate the financial implications of MSS varies widely among local governments and among sectoral agencies¹⁵. A number of both conceptual and practical issues must be addressed to assure financial affordability.

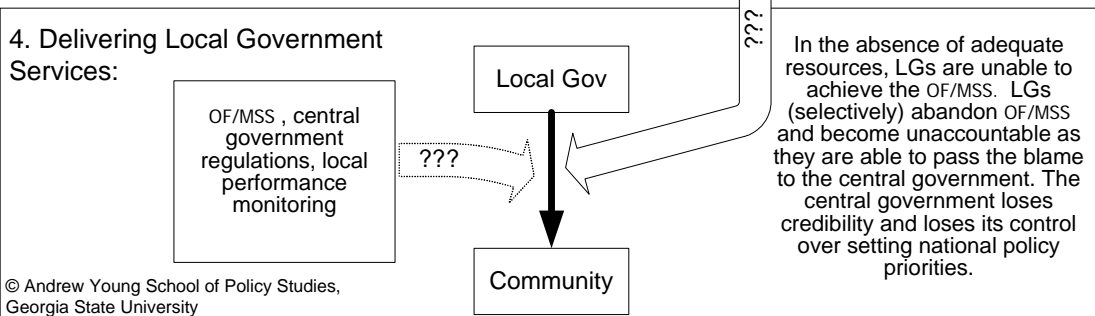
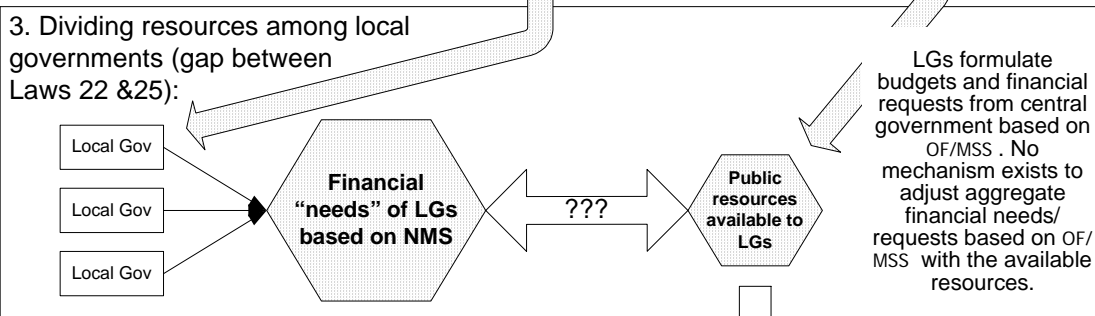
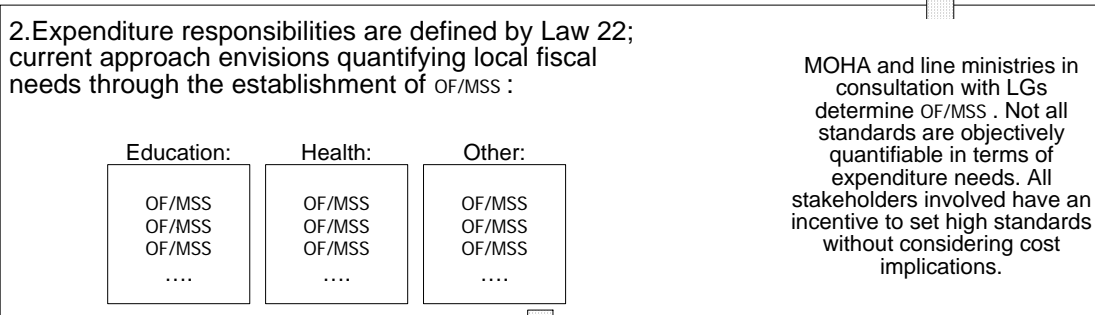
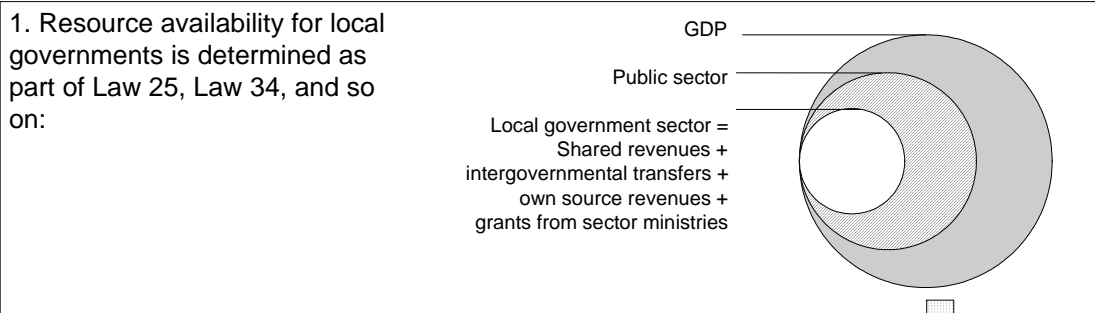
The OF and MSS drawn up so far generally reflect a range of functions and levels of service delivery that fail to take into account what is affordable. According to the 2002 MOHA policy circular¹⁶, OF and their MSS are meant to be derived from commitments made nationally and internationally, especially in the areas of health and education. In contrast, some draft OF/MSS reflect a “wish-list” approach to service delivery by including a long list of “desirable” service delivery standards, rather than truly establishing minimum acceptable standards for service delivery. While some of the intervention levels being discussed are obviously rooted in international empirical findings that encompass technically efficient and cost-effective delivery of government services (for instance, a minimum standard in education based on the teacher-pupil ratio), this is no assurance that the service is affordable at the desired level at a local or national scale in Indonesia. Hence there is a need to recognize the legitimacy of policy/legal commitment made toward national and international goals (with their

of what the ministries were supposed to accomplish may not have been complete. It must also be noted that most ministries had already promulgated some MSS and were being asked to reconsider their policies, which we may have added to the confusion.

¹⁵ This view has been gained in part through discussions with staff members of the ADB funded TA-3967 that is supporting the piloting effort.

¹⁶ Ministry of Home Affairs (2002). Pelaksanaan Kewenangan Wajib dan Standar Pelayanan Minimal (SPM) Se-Indonesia (Implementation of Obligatory Functions and Minimum Service Standards throughout Indonesia), Circular 100/757/OTDA issued July 8 by the Director General for Regional Autonomy on behalf of the Minister.

Figure 2
A Schematic Representation of the Impending Gap Between Available Local Resources (Law 25) and Expenditure Assignments (Law 22)



strong base of professional expertise) but at the same time balance these in the near term with expectations of affordability.

In the policy framework that is currently taking shape in Indonesia, most stakeholders involved in defining MSS have an incentive to set many obligatory functions and high standards. This is seen as a way for sectoral agencies (at national or local level) to attract a larger slice of the budget, as well as for all parts of the bureaucracy to justify their continued existence. For their parts, MOHA and local governments may hope to advance the overall level of funding for the delivery of local government services by supporting high service levels.¹⁷ On the other hand, as the model building exercise reveals, some local voices argue that MSS are an intrusion on local autonomy, and should thus be limited in their number and stringency. Undoubtedly, some local heads, and councilors, will prefer MSS that are within grasp, making their achievement more likely.¹⁸ This is particularly the case for embattled local heads seeking an easier ride by the local councils and constituents on the occasion of their annual accountability reports¹⁹. Also wary of too many MSS is MOF, in this case because of its obvious concern with affordability.

The balancing of the above considerations can only come about if a coordinated (cross-sectoral) analysis and policy prioritization process is undertaken, with the requisite phased introduction of MSS in line with affordability. Unfortunately, such an approach does not seem to be favored by the government, despite repeated alerts from some donor agencies that such an approach is absolutely necessary to avoid a messy outcome.

- The third phase in the resource allocation process clearly reveals the schism or bottleneck between Law 22 and Law 25 under a possible resource allocation approach driven by a poorly conceived MSS system (Panel 3). Given the

¹⁷ Based on feedback that we received during discussions in July 2003, local government officials were asked how high they felt standards should be set as part of the model building exercise, but it does not appear that local government officials were asked how high they felt minimum standards should be set given the current availability of resources.

¹⁸ It must be noted that some LGUs may already meet higher standards than what is being proposed, but no firm information is available.

¹⁹ This is valid for the current election system; the pressure may ease on local heads if they are directly elected in the future.

- incentives provided in the formulation of MSS, local budget “needs” quite likely would structurally exceed government resources made available from the various sources under Law 25. However, should local governments formulate their budget requirements based on MSS, no systematic process has yet been formulated to assure vertical fiscal balance to assure that the aggregate financial “needs” of local governments (based on MSS) fit within the resources available for the local government sector. While the elaborated/improved OF/MSS policy of the government has yet to be congealed in law or regulation, it does not appear that sufficient discussion and concrete research, estimation, or costing methodologies development are yet underway to construct a robust financial component of the OF/MSS policy. The discussion that must take place should include how equalization grants (DAU) are allocated to better enable individual local governments to cover their expenditure responsibilities as quantified by the MSS.
- The final stage of the local government resource allocation process is the actual delivery of local government services (Panel 4). If the original local government budgets are formulated without the assurance of affordability, many local governments may be unable to achieve the service delivery standards set forth in the MSS, particularly because an ad-hoc sectoral approach will fail to bring about a properly phased and flexible approach. In the wake of missed service delivery targets, local governments would likely point to the central government’s failure to transfer sufficient funds, in an effort to escape accountability for this failure. In turn, the central government loses credibility and diminishes its control over setting national policy priorities. The entire decentralization effort would be called into question and political frustration at the central and local levels would likely rise.

3. Linking expenditure assignments and intergovernmental grants in Indonesia: Building a bridge between Law 22 and Law 25

The previous section highlights challenges and possible pitfalls faced by the government in shaping its OF/MSS policy in relation to the local governments’ resource requirements. Making a strong link between expenditure assignments and revenue

allocations in Indonesia requires that the funding mechanism for local governments, in particular the system of intergovernmental grants (most importantly the DAU), be specifically linked to the functional responsibilities assigned to the local level, in order to assure that governments will have the resources needed to provide the expected services. That is, there is a need to assure vertical fiscal balance to prevent the creation of unfunded mandates. This will require bridging the assignment of expenditure responsibilities, as formulated in general terms in the local government law (Law 22 or its successor) and specifically in other legal products that set out MSS, with the distribution of local public resources as defined in Law 25 (and associated legislation and regulations).

One way to establish a link between the expenditure responsibilities assigned to the local government level (OF and MSS) and the intergovernmental grant system (including the DAU) on the revenue side is to make sure that both the quantification of the minimum service levels to be achieved by local governments and the calculation of local expenditure needs in the DAU computation are closely tied to the same measure of minimum expenditure requirements. This can be achieved by defining MSS as the level of local expenditure needs required to achieve a certain performance level in delivering local government services. This could be done by framing the traditionally defined minimum service levels in financial terms in relation to the corresponding client base. For instance, rather than defining MSS for education as a series of input, output, or outcome standards, the MSS for education could be determined as a (cost-adjusted) per-student expenditure norm. The DAU computation would thus take into account the ability of local governments to finance expenditure needs by comparing their local expenditure requirements tied to MSS to their level of fiscal capacity (including own revenues, revenue sharing, and other transfers).²⁰

Assuring that “local expenditure needs” in grant funding levels are connected to MSS and driven directly by the number of clients for local government services is preferable to defining these indirectly through the number of inputs used to provide a range of services whose ranking in terms of priorities and “enforcement” is largely

²⁰ Depending on how the MSS are defined, some transition DAK type funds may be needed to complement overall local funding coming from own revenues, revenue sharing and the DAU.

undefined. However, it will not be a trivial task to take the variety of input, output and outcome measures that represent the current proposals for the MSS and reduce these to standard expenditure needs that are defined in per-client financial terms. Yet this is key to placing MSS in the national DAU formula and in realizing MSS through local budget allocations.²¹

Reducing (or perhaps, recasting) MSS to be defined as the minimum expenditure required to achieve a certain level of service delivery should not be taken to mean that the expenditure norm in turn will necessarily become prescriptive for local governments. These expenditure needs are ideally used only for computational purposes in the DAU, and can become rough guides for local governments in making their own allocations. If these expenditures were used in a prescriptive fashion – in defiance of Law 22 - the DAU and the system of intergovernmental finance would essentially be transformed from an unconditional grant to a series of conditional or sectoral grants.

The current system is intended to allow local governments to respond to local communities' needs in a creative and flexible manner within the framework of an MSS-based system. For instance, a local government facing low primary school enrollment rates due to high levels of local illiteracy and poverty might respond very differently to this policy challenge (for instance, by emphasizing adult education and “food-for-education” type programs) compared to a district which is facing low enrollment due to low population density and transportation problems (which, for instance, might require smaller schools and smaller class sizes). Providing local governments with such flexibility in delivering local government services in order to meet the needs of local communities lies at the core of achieving the benefits of decentralization. On the other hand, over-regulating the way in which local government services should be supplied, whether through prescriptive expenditure needs or excessive and overly rigorous MSS, paradoxically may stand in the way of a renewed focus on improved local service delivery. This example illustrates well the need to carefully design an OF/MSS system for Indonesia, if one is to be instituted.

²¹ In some cases a significant investment of additional resources over time will be required to achieve the certain level of service delivery prescribed nationwide. This may require some phasing in over time to ensure affordability.

Some countries avoid the challenges of performance based budgeting approaches that are tied to MSS by adopting a system where the local government sectoral allocation is devised in a “top-down” manner which fails to link up to the cost of delivering local government services. Under this approach, the national government -through a priority setting process that cuts across sectors (generally through Cabinet discussions)- determines sectoral resource envelopes that take into account a local government component. These envelopes may be further subdivided into programmatic envelopes of national and local government expenditures. The local government programmatic allocations are then divided by the aggregate number of clients served, generating an expenditure norm that is used as a means of computing an equalizing grant for the local governments. In this sense, the allocation is sometimes referred to as “needs-based”, although its relationship to actual local expenditure needs (as determined by some accepted level or standard of service) is not known or not considered. The sectoral or programmatic envelopes for the local government sector can be prescriptive, forcing local government to spend according to these envelopes, or they can be made indicative, merely becoming guidelines that are helpful to the local governments in setting their own budget allocations. The latter is often preferred in the context of a decentralized system, giving local government discretion in its service delivery choices that meet local preferences. The approach described here does not explicitly use MSS in the budgeting process, but MSS may nevertheless enter into the equation at later stages in ways that may not be well connected with local financing. The advantage of this approach is the relative simplicity of the process, both in terms of decisions and data requirements.

However, the top down approach described above may have serious shortcoming as well. The sectoral/programmatic trade-offs made at cabinet level do not necessarily have a clear connection to real service needs.²² Thus the process tends to increase the budget of most existing programs and sectors through “political rules” or an on incremental basis, for instance, in a somewhat equal fashion as additional resources are found. These rules tend to lock in allocation distortions in the sense that some cherished

²² An important question is how are the priorities identified and quantified. In countries like Ukraine and Latvia these priorities are based on political decisions for marginal changes (increases and decreases) to last year’s allocations. Conceptually, these priorities may be determined through some estimate of service standards to which the government is committed to achieving. Some older and more established decentralized systems, such as those in Denmark and Japan, fit better this latter approach.

national goals (such as the commitment to Millenium Development Goals) are not operationalized in terms of specific minimum levels of service delivery expected of national or local government. The risk is that while priority- setting does take place, the policy choices made are not necessarily evidence-based, in the sense that they may not represent “costed” responses to concrete local needs and national commitments to service delivery. Rather, the budget formulation process could potentially result in an opaque practice where incremental resources are provided to sectors and programs that are subjectively felt to be “needed” to achieve better outcomes. In developing country contexts, political affiliations of cabinet members and legislative allies often play a particularly dominant role in such priority setting.²³

The attempt, such as is being contemplated in Indonesia, to inject transparency and rationality in the national and local government sector allocation process is to be encouraged. However, it is essential to avoid some major pitfalls. Figure 3 presents a possible approach to funding local government services that allows the bridging of Law 22 with Law 25. It consists of four panels that represent the four stages of decision-making that parallel to a large extent those followed in the allocation of formula-based block grants to local governments. The figure helps us visualize how a consistent and integrated approach to the assignment of expenditure responsibilities in Law 22 with the allocation of resources under Law 25 may work to assure the affordability of expenditure responsibilities assigned to the local government level:

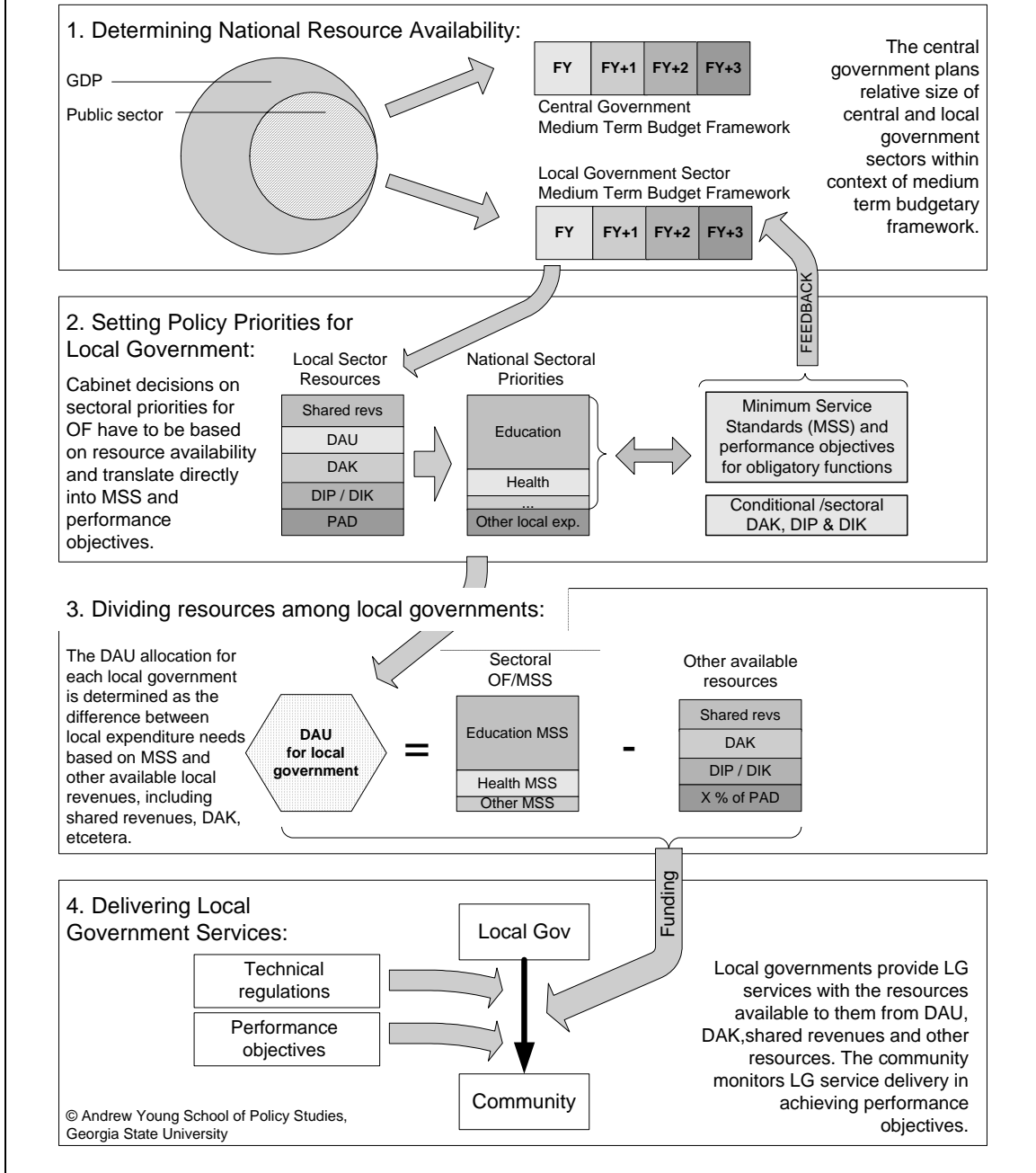
- Similar to the current budget process, the first policy choice that is made in the local resource allocation process is the determination of the pool of resources that is available for local government activities at the beginning of the annual budget formulation process (Panel 1 of Figure 3). In a unitary system of government, the decisions on the level of national tax effort and how to allocate public resources among different levels of government are the decisions made by the state (Parliament together with the executive). The advantage of this top-down approach is the explicit recognition that public resources – and by extension, public resources available to the local government level - are always scarce. This

²³ This is not necessarily bad if all these officials are elected democratically.

- principle should be carried through the following steps of the system of intergovernmental fiscal relations. An “innovation” of the proposed process is the explicit recognition that the local government sector should be closely integrated in to the medium term expenditure framework, as Indonesia moves to introduce a multiyear budget framework within the context of Law 17/2003. The strategic planning framework for local governments will be significantly improved by incorporating multi-year projections for the system of intergovernmental grants as well as revenue forecasts for local (shared and own) revenues into the national multi-year budget process
- The second step in the local government resource allocation process is the determination of national policy priorities within the local government sector (Panel 2). Again, it is clearly within the purview of the national government – especially in a unitary country - to determine the relative policy importance or priority of the local government functions.²⁴ As such, it is appropriate for the central government (typically at Cabinet level) to identify expenditure priorities for the local government sector within the resources available to the entire local government sector as a whole. Local government associations could become part of the annual process of identifying aggregate expenditure priorities for the entire local government level. By explicitly determining the (indicative) sectoral resource envelopes within the applicable resource constraints in advance, the mechanism constrains sector ministries and local governments from demanding unachievably high MSS with the hope of receiving a greater share of public resources.

²⁴ However, as already pointed out, the international experience is quite diverse on this point. There are unitary countries that allow significant discretion to local government to determine their own expenditure priorities in practice. See, for example, the discussion in the appendix for the new decentralized system in Ukraine.

Figure 3
Proposing a Sound Mechanism to Bridge the Gap Between Available Local Resources (Law 25) and Expenditure Assignments (Law 22)



Since MSS in this case are to be defined as per-client or per capita expenditure norms, there is a one-to-one correspondence between sectoral budget envelopes and the formulation of sectoral MSS. As a result, the formulation of national sectoral priorities would be legitimated in law through their connection to obligatory functions and the MSS. Yet whereas in the current system there is an impending gap between functional responsibilities and resources available at the local government level, under the proposed system the sum of all sectoral resource envelopes would not be allowed to exceed the resources expected to be available to the local government level in the medium term budget framework. This approach would protect local governments from unfunded mandates imposed by different sector ministries, each of which hold the expectation that local governments should fund *their* sectoral priorities from general local resources, while ignoring the financial implications of mandates imposed on local governments by other sector ministries.

The careful interlinkage of the national medium term budget framework for the local government level and the client-based MSS also provides the executive branch with some measure of protection against possible politicking by the legislature, as any political attempt by DPR to increase any specific MSS would have to result in a corresponding decrease in another MSS, or in an overall increase in the resources made available to the local government level.

Sectoral performance targets would be carefully defined within the context of the MSS to establish a direct link between the allocation of resources based on MSS for obligatory local government functions and national policy objectives, such as the Millenium Development Goals. The local performance targets may outstrip somewhat the resources available in the budget envelope for the local government level in the upcoming budget year, but the aim should be to make the performance targets reachable within the medium term. The sectoral performance targets being pursued in the context of the MSS could become fully feasible in the mid-term by seeking reallocations within the local sector (from expenditures that are not on obligatory local government functions to those that are), reallocating resources between areas, reducing waste (e.g. corruption), forging more efficient

- delivery approaches (e.g. private sector partnerships), and increases in national and local revenues through better collection and general upward trend in the gross national product.
- For the imminent budget year, the proposed approach would establish a direct link between the obligatory functions and minimum service standards based on Law 22 and the level of DAU allocations defined pursuant to Law 25. The DAU allocation for each local government unit, as identified in the third panel of Figure 3, would be determined as the difference between, on one hand, the sum of a local government expenditure needs as defined by the MSS, and on the other hand, the total revenues available from other available sources (including shared revenues, DAK, and so on). In determining the fiscal capacity of local governments to fund OF/MSS, the central government is forced to explicitly recognize that some own local resources (and potentially some shared revenues) should be set aside for the local government to fund local government administration and other (non-obligatory) local functions.

While the expenditure levels associated with the MSS would be used for computational purposes for the DAU grants, the funding mechanism would only *suggest* that these resources be used for sectoral purposes – without mandating this.²⁵ Even so, the proposed funding approach assures that all local governments should be able to achieve the minimum sectoral expenditure levels associated with MSS. As such, DAU local allocations are an essential part of the hard budget constraints within which local government must make their allocations. It should be made clear that local governments must pursue the performance targets associated with the MSS within their own revenues, shared revenues, and the DAU allocations. Additional financial assistance (conditional grants) would only be for very special cases that are well justified.

- The fourth stage of allocating local resources using MSS based on client-driven expenditure norms involves the local governments setting their own local priorities, using the expenditure norms defined by the MSS as a rough guide as to

²⁵ As noted earlier, a mandatory approach would transform part, if not all, of the funding mechanism from an unconditional funding scheme to a sectoral or conditional funding mechanism.

the expenditures they may need to make to achieve the national policy objectives pursued by the central government.²⁶ However, local governments would have budgetary autonomy, without any envelope restrictions, as long as the performance targets associated with the MSS are achieved. For most local governments, if the performance targets are set properly, this intrusion into local service delivery functions would not be significant since well-performing local governments would tend to exceed the national targets. If local governments lag in the pursuit of their performance targets, they will at least have discretion as to how, and at what pace (over the prescribed time frame) to achieve them. In addition, the local governments will be the recipient of capacity building efforts of the national government, possibly including some special funding in the form of conditional grants if the DAU cannot be reconfigured adequately in the short term, there is concrete evidence of a shortfall, and the cases can be well justified.

For the above approach to work, a fine balancing act must be played out where national performance targets are determined in such a way that they are likely to be not fully achievable by most local governments, in order to encourage greater efforts in resource mobilization and efficiencies, but also not to be so far in excess of immediate affordability as to result in low performance over the mid-term and call into question the entire enterprise (making it thus unenforceable). For this reason, the formulation of the performance objectives associated with MSS must be carefully considered. Some guidelines for setting the MSS include the following: There should be as few as possible performance measures and the MSS performance measures must have achievement targets (milestones) that are multi-year, allowing local governments a measure of flexibility in their fulfillment. In other words, a prescriptive approach to MSS is more likely to be made workable if it is embedded in a longer term perspective and accompanied by flexibility and appropriate national level support to the local government level (see Box 1).

²⁶ In this respect it is unfortunate that the noble commitment of the state to primary education is framed in the constitution as an obligation to spend 20% of the budget on education. This form of prescription, if overdone, can introduce rigidities in national and local budgeting that work against the achievement of desired service goals.

The challenge in working with the described approach to MSS is to develop appropriate performance targets that are achievable within the resources available to local governments using the client-based expenditure norms. For instance, as a starting point, the minimum service standard (e.g., the indicative expenditure norm) for primary education could be determined as the indicative resource sectoral envelope for education (as determined by Cabinet) divided by the number of enrolled pupils. This expenditure norm could further be adjusted based on regional cost differences or some other readily recognized local differential needs or “relativities” (or “disabilities” to use the Australian term). Local data will obviously be needed to compute the expenditure needs of each local government based on MSS. Additionally, even with comparable strategies and activities, the cost at the margin of achieving certain MSS-related policy outcomes at various points in the achievement level can change. For example, the additional cost of increasing the enrollment rate at the margin from 66% to 76% is likely to be higher than the average (per-student) cost of educating 66% of all school-aged children. Hopefully, these are technical considerations that can be overcome.

The government of Indonesia must decide if it has the determination to see through a properly coordinated approach to MSS along the lines suggested in the above proposal. Considerable discipline will be needed to prevent sector ministries from undermining the system by preemptively “going at it alone”, as some already appear to be doing. If the political will cannot be forged to properly coordinate the introduction of a well-designed system of affordable MSS, then it is best to avoid the “prescriptive” aspect of the system of minimum service standards, by barring Ministries from setting their obligatory functions and mandatory MSS as they see fit, disconnected from any aggregate local or national budgeting process.

If a coordinated approach to MSS cannot be worked out at the central government level, local governments should be made to understand that whatever MSS are “imposed” by sector ministries should be seen more in the way of long term visions for the sectors, to be pursued by the local governments to the extent that they see fit until the gap between local government functions and local government finances can be institutionally bridged. This system could be anywhere but in the top rung of the ladder of prescription shown in Figure 1. This fall-back position is by its very nature sure to avoid vertical

Box 1
Prescription with flexibility and affordability:
illustration of a minimum service standard in the education sector

The government of Indonesia has committed itself to the Millenium Development Goal of full accessibility to primary education by 2015. This MDG is enshrined in constitutional provisions and in the sectoral law on education. The MSS is built into the description of this right; all Indonesians throughout Indonesia have a right to receive nine years of primary education. Indonesia is still a fair ways from achieving this goal, with the enrollment rate currently at about 66%, and progress is uneven across local governments.²⁷

It may be reasonable then for Indonesia to break down this MSS into stages (milestones), say 75% in 2003-2006, 85% in 2007-2010 and full enrollment in 2011-2015. These milestones would need to recognize that the likely shortcomings in enrollment are not evenly distributed across local governments. It would be also important to undertake a clear analysis of the causes for the lack of access to education in different localities so that the policies adopted can be more effective in increasing school enrollments.

In deciding on this staged approach and the degree to which achieving certain policy milestones would be affordable in the medium term, the national government would need to take into account other claims on national resources, particularly other MSS in key sectors. The proposed reliance on client-driven MSS would provide a realistic framework for setting the medium-term performance milestones in education and other areas, by providing verification that local governments will in fact have adequate financing from their general sources of revenue, including the DAU transfers, to achieve these goals.

It is important to note that this approach would provide some discretion within the time frame of each stage (the progress need not be linear), and the local governments are allowed to pursue the MSS in their own way. For example, some will use the hook of better qualified teachers to attract students. Others will note a lag in female students and ensure that there are proper washroom facilities and parent education to spur enrollment. Others will seek to lighten the cost of attendance. The appropriate solutions would become clearer from the previous analysis of the causes of the lack of access to basic education in different local governments.

²⁷ Estimate by Lewis, Blane D. (2003). Minimum Service Delivery Standards for Decentralized Education Functions: Fiscal Needs, Financing Options, and Policy Implications, Research Triangle Institute International, Draft

fiscal imbalances simply because it does not require local governments to deliver any minimum level of basic services. This obviously has other disadvantages, some alluded to earlier. In particular, this approach does not ensure that particular national priorities and commitments are met. Thus, for this fall-back approach to work, it would be essential to develop strong links between the local governments and their constituencies and rely on all other possible means of direct horizontal accountability. Current conditions and practices do not allow much optimism in this area.

4. Implications for the reform of Law 22 (re-defining expenditure assignments)

According to MoHA, sufficient learning has taken place to set an overall architecture for OF/MSS. The broad features of the new architecture should be set within a revised Law 22/1999. It appears that the tight legal redrafting schedule has limited the necessary reflection and consultation. The time and effort dedicated to this effort are too low in relation to the technical challenges involved and the need to secure both understanding and political support for actions that could be easily misunderstood as an effort of the central government to re-centralize power for its own sake.

Recent statements by MoHA officials who have belatedly recognized the financial linkages needed in setting OF/MSS suggests that they have only absorbed part of the lessons learned elsewhere. There is the possibility that MoHA along with the sectoral ministries prefer to let the annual budget process at national and local level become the battleground for sorting out which OF/MSS will get priority, rather than settling on a more limited but affordable set of MSS which would be applicable for all local governments after a proper consultative process.

The imposition of minimum standards that are ultimately not enforceable because local governments are simply not able to afford them would end up reducing the credibility of the decentralization process overall. The introduction of minimum standards that are not affordable can also cause disruptions in service delivery. These results would be contrary to the objectives which policy makers have for introducing the MSSs.

An important decision needs to be made regarding the use of minimum expenditure standards versus or complemented by a system of MSS. In case the GOI continues the current course of introducing a “traditional” system of MSS (which provides local governments with a set of input, output, and outcome-standards to be achieved in the delivery of local government services), and in anticipation of a window of opportunity for commenting and improving on any draft revision of Law 22/199, we put forward the following basic principles which should govern the design of the OF/MSS component of the law:

1. A broad “general competency” formulation of local functions may be workable, but this must be accompanied by clear statements of what obligations local governments have toward national objectives and priorities and international commitments regarding basic public service delivery.
2. These obligations of local governments in relation to public services need to be reasonably clear and ideally embedded in law.
3. The obligations of local governments need to be balanced with the principle of local discretion to allow for creativity and efficiency in the discharge of public services.
4. The process for setting minimum service standards for local obligations regarding service delivery should ensure that the following considerations are met:
 - a. the MSS are determined in a process of wide consultation with affected stakeholders
 - b. all information including data bases is available to enable the tracking of the required performance
 - c. the short to mid-term financial implications of the MSS for the national and local levels of government have been adequately addressed.
 - d. a proper phasing, taking into account differing base conditions across local governments, is used within sectors and between sectors to ensure that priority OF/MSS are feasible in view of budget and capacity constraints.
5. The budget affordability of the OF/MSS system must be a priority in its design. The financing principles for supporting the implementation of OF/MSS must be

set in the law governing general central-local relations, with their elaboration being continued within a separate law on local finances. These principles should include:

- a. OF/MSS, being the core of local service delivery, ought to be financed to the largest possible extent from own revenue sources to encourage local accountability and pressure from below in meeting national and local standards.
- b. Expenditure needs related to OF/MSS must be reflected in the calculation of the general allocation grant (DAU) where equalization is necessary
- c. As a transition to properly restructured own revenues and properly configured DAU, a temporary conditional grant mechanism may be warranted to close the gap for some local governments.

5. Implications for the implementation of Law 25 (reform of the DAU)

The proposed linking of Laws 22 and Law 25 through the adoption of per capita minimum expenditure needs require a change in the provisions of Law 25 regarding the computation of the DAU. A detailed overview of the current workings of the DAU exceeds the scope of the current technical note.²⁸ However, it is clear that the most important implication of the proposed bridging methodology is that the computation of expenditure needs in the DAU formula would be now conducted on the basis of the minimum expenditure requirements as opposed to the expenditure needs index built with four variables that is being used currently.

Table 1 provides a step-by-step description of how the allocation of the DAU might be modified by using a client-based expenditure norm approach, as illustrated earlier in Figure 3. Similar steps would apply if, first, a OF/MSS approach were adopted,

²⁸ A detailed description of the DAU mechanism is provided by: Bambang Brodjonegoro and Jorge Martinez-Vazquez. An Analysis of Indonesia's Transfer System: Recent Performance and Future Prospects. In: James Alm, Jorge Martinez-Vazquez and Sri Mulyani Indrawati (eds) *Decentralization and the Rebuilding of Indonesia*: Edward Elgar (forthcoming). ISP Working Paper Number 02-13. Andrew Young School of Policy Studies, Georgia State University; and Blane Lewis. 2003. Revenue Sharing and Grant-making in Indonesia: The First Two Years Of Fiscal Decentralization. In: Paul Smoke (ed) *Intergovernmental Transfers in Asia*: Manila: ADB.

and second, the quantification of the MSS were used in the computation of expenditures needs for the DAU. We need to mention that the figures mentioned in Table 1 are just meant to be illustrative.

Table 1 Step-by- step description of allocating the DAU using a client-based expenditure norm approach	
Step	Description
1.	<p>The first step in computing local expenditure needs as part of the DAU formula would be to determine the resource availability for the local government sector as a whole. For instance, the government may seek to set aside Rs. 120.0 trillion for government services delivered at the subnational level. This resource envelope would include shared revenues, DAU and DAK, and also the forecast for the aggregate fiscal capacity of the local government level to generate own source revenues. The overall resource envelope would also possibly include any grants received by the local governments from sector ministries.</p>
2.	<p>As part of the regular national budget formulation process, the President and Cabinet (and at some point with the participation of the local government associations) could decide the size of sectoral resource envelopes, which would finance or made available to the different functional expenditure categories in the local budgets (either on an indicative or notional basis, or on a mandatory basis).</p> <p>For instance, local education could initially be assigned a relative weight of 27 % of the total local government level's resource envelope, which would correspond to a sectoral resource envelope for education of Rp. 32.4 trillion. For the first few years, these sectoral resource envelopes could be determined based on (relative) historical expenditure patterns. After the first few years, inter-sectoral shifts would be part of range of possibilities in the national budget process (once the MSS system is well understood). The advantage of this top-down approach is that the shares of expenditure or sectoral resource envelopes could be modified to reflect the change in priorities for expenditures reached by the central government jointly with the associations of local governments.</p> <p>The performance targets or milestones that could be achieved within the available sectoral resource envelopes would be derived from the costing of the potential sectoral performance targets for the time period in question. The necessary cost for achieving a given performance standard would be arrived at by convention, settling on an accepted combination of capital and recurrent cost that is part of a plausible results chain leading to the desired</p>

	<p>output or outcome (which are the form in which MSS are largely expected to be set). Obviously, the performance targets associated with MSS should be set at a realistic level, so that they are actually achievable and affordable for local governments.</p>
<p>3.</p>	<p>Ideally, each sector’s indicative resource envelope will coincide with the cost of delivering the specific obligatory service in accordance with the minimum performance targets that the central government hopes to achieve. However, a horizontal assignment mechanism will be needed to translate the indicative sectoral resource envelope into specific local government needs.</p> <p>The most basic approach to computing a minimum expenditure norm for local governments is to assure that every client receives the same expenditure level; for instance, every local government might be required to spend Rp. 60,000 per school-aged child receiving primary education. The accepted per-client norm relying on the national-level computations could be further adjusted for local cost differences to achieve a more accurate cost-figure for MSS. Hence, rather than computing local expenditure needs strictly based on the number of clients, a “normalized client” could be defined by multiplying the number of clients in each locality with a normalized cost index. Thus, a local government where it is twice as costly to deliver local government services would have twice as many “normalized clients” as actual clients. Nonetheless, this methodology assures that the resources never exceed the initial resource constraint.</p> <p>Once the per capita minimum expenditure standards are defined for each obligatory function in the local budgets, they can be used with at least two purposes. First, they can be used to estimate the expenditure needs of local governments in the DAU computations. Thus, the total expenditure need for each local government, for example kabupaten i, would then be computed, for example, as the sum education need$_i$ + health need$_i$ + other needs$_i$. Note that to this point, the minimum expenditure standards are just notional devices used for budgetary computations.</p>
<p>4.</p>	<p>The DAU grant to each locality should equal local expenditure needs (estimated using the minimum expenditure standards rather than the four-variable weighted index currently used) minus local fiscal capacity. It is important that the computation of fiscal capacity include all sources of revenue for local governments taken into consideration in the definition of the resource envelope for all local governments.</p>

The approach outlined in Table 1 has many features in common with the process currently followed, and virtually the entire proposed methodology is consistent with Law 25 and its implementing regulations. The major challenge with the proposed approach would be to change the regulatory frameworks for the budget process to allow the identification of the sector and sub-sector funding envelopes for all the major expenditure categories (obligatory functions) at the local government level. If the minimum expenditure standards are made mandatory at the program and sub-program level, this may face opposition from the local governments as they would be quite restricted in their budget choices. At the same time, line ministries are likely to favor mandatory minimum expenditure standards, as these would assure that local governments would at least provide a minimum level of funding for their sector.

Depending on how the performance targets under a more traditional MSS approach are formulated, local governments may feel less restricted under the MSS regime. The MSS approach may be made more palatable to local governments by:

- allowing for the meaningful participation of local government associations in the determination of MSS and the derivation of the minimum expenditure standards,
- allowing flexibility in pursuing MSS and focusing on supporting the local governments rather than applying sanctions, particularly in the early stages.

It is important to note that within our proposal the DAU would remain an unconditional grant scheme. But clearly there will be a tradeoff between the autonomy provided by the unconditional grant and the central government's desire to assure that local resources are spent in accordance with the context of national regulations and policy priorities; hence the MSS system.

6. Conclusion

Indonesia is exploring a concept of OF/MSS and is about to enshrine the basic architecture in a revised Law 22/1999, the framework law establishing central-local relations. These explorations have not sufficiently examined or resolved the issues of affordability, technical capacity, and political acceptability. International practice

suggests that there is a real danger that unfunded mandates will arise if GOI embarks on a prescriptive approach that is bereft of linkages between obligatory functions and local finances. The inability of local governments to comply with an unrealistic and unaffordable system of OF/MSS will erode the credibility of local and central government officials and quite likely seriously set back the decentralization efforts started over two years ago.

A variety of guidance and support approaches are possible to ensure that local governments take into account national priorities. The central government could impose minimum expenditure requirements; performance standards associated with a traditional MSSs could be imposed; or voluntary compliance systems might be introduced (often aided by incentives provided by conditional matching grants) that bank on public accountability. These options have been tried in many countries, singly or in combination, with varying success. It is not yet possible to conclude that there is a “best practice” for this aim, but some pitfalls to avoid are known. Indonesia needs to construct its homemade concept with an eye to what has been learned elsewhere, and to make its choice with a full awareness of the governance requisites implied.

The most important message of this report is that there is a need to bridge Law 22/1999, however amended, on expenditure assignments (encompassing MSS) with Law 25/1999, on revenue assignments and transfers. A fundamental step for this bridging is to compute expenditure needs in the DAU on the basis of minimum expenditure standards that are tied to quantified MSS. The report describes the top down envelope setting that is the basis for some countries’ approach to minimum service expenditure standards. Recognizing that Indonesia is committed to a system that is based on MSS, in this report we have focused our efforts on describing how this minimum expenditure standards approach can be adapted to meet the needs of an MSS focused system.

Whatever choice is made, a careful, participatory design is warranted, and a phased approach where all can learn and adjust incrementally is advisable. Improving local government performance and accountability is a long term process.

The issues reviewed in this report will, no doubt, require further analysis and study, but ultimately political factors will decide where Indonesia’s decentralized system puts itself on the continuum of local budgetary autonomy and central government control.

APPENDIX

Measuring local expenditure needs and minimum service standards:

What can be learned from international experiences?

Indonesia is certainly not the only country struggling to align its assignment of expenditure responsibilities with the availability of fiscal resources at the subnational level. The concern over vertical fiscal balance is raised in different ways in different countries. For instance, this policy issue pops up in the United States in the form of a policy debate on unfunded mandates. In some other countries, particularly in some developing and transition countries, the policy debate is more similar to Indonesia in the sense that it is seeking to relate the financing of local government services to certain service norms or national minimum standards of service delivery. But, besides the issue of vertical balance, the central government may be concerned that some services get delivered in a certain way and that some national priorities are achieved.

What has the experience in this regard been in other countries, and what can Indonesia learn from these countries' experiences? In this appendix we look at how two transitional countries, Ukraine and Latvia, have introduced useful innovations into the concept and measurement of local expenditure needs in their system of intergovernmental fiscal relations. We also take a look at how Tanzania and South Africa have addressed the linkage between the intergovernmental grant system and the need to provide local governments with guidance and direction on the service level that is expected from them. These we think provide useful perspectives for the definition and possible use of minimum expenditure standards and MSS in Indonesia.

In this appendix we briefly describe how these four countries, all of which have gone through an intensive period of decentralization reform, have dealt with the measurement of expenditure needs and how they are using the concept of minimum services standards in their respective systems of decentralized finance.

Latvia

As in the case of Indonesia, Latvia's equalization grant system seeks to equalize the difference between some measure of revenue capacity and some measure of expenditure needs.²⁹

Each local government's level of expenditure need is determined by first establishing the total resource envelope for the local government level (known as "total local government necessity"). This latter envelope is determined through negotiations between the central and local government authorities each year. The local governments are represented by the local government associations. As described in greater detail below, this total pool of local resources is subsequently apportioned among local government units in order to arrive at a locality's "notional" expenditure need. The measure of fiscal capacity used as part of the formula is based on the forecasts for three local taxes: the local government's share of the personal income tax, the real estate tax, and the property tax. Latvia's equalization is somewhat peculiar in the fact that part of the Equalization Funding is funded from the national budget, while additional funding is provided from "fraternal" contributions from the well-off local governments.³⁰

Although there are many similarities between the Indonesian and Latvian intergovernmental grants systems, a particular point of interest for the potential reform of Indonesia's system is how Latvia's equalization mechanism determines each local government's level of expenditure needs. The first step in the computation for the expenditure "need" for each local government starts with the estimation of the "total resource need" of local governments. As stated in the Law on Equalization, the "local government total financial need" is determined in negotiations between the central government and the Union of Local Governments on the basis of: (1) the anticipated total local government financial needs for the next year, without an explicit definition of

²⁹ There are three different types of local governments in Latvia: republican cities, rayons or district-like regions, and pagasts or municipalities. In actuality, the equalization formula equalizes simultaneously, but at different levels, all three different types of governments through slightly different formulas.

³⁰ Contributions into the equalization fund come from those local governments for which forecasted revenues exceed their notional expenditure needs by more than 10 percent. The contribution to the fund is 45 percent of the "surplus" or positive difference between forecasted revenue and notional expenditures in excess of 10 percent. Actual distributions from the fund go to the local governments with forecasted revenues less than notional expenditures. Local governments with forecasted revenues less than 100 percent of their notional expenditures receive a transfer which fills 100 percent of this "fiscal gap".

service standards, (2) the macroeconomic forecast,(3) any re-assignment of expenditure responsibilities between the local and central governments, and (4) policy priorities defined for the upcoming year.

The notional level of expenditure needs for each local government is subsequently computed as the product of the total resource envelope for the local government level multiplied by an “index of relative financial necessity” or “index of relative expenditure need” for the respective local government. The computation of the relative index of financial necessity is the weighted average of six criteria: (1) relative population of each local government; (2) number of children ages 0-6; (3) number of children ages 7-18; (4) population above retirement age; (5) number of children in orphanages; and (6) number of elderly in retirement homes. Each of these allocation factors either implicitly or explicitly represents groups of clients for local public services. The last two criteria were added to the other four in the reform of 1998. The reason for this reform was to allow for a more equalizing distribution of resources across local governments. Unlike the rest of the criteria, the last two criteria can be influenced by the behavior of local governments. Note that all of these are some kind of proxies for actual need differences but none relate directly to service standards.

A final policy decision which needs to be made is the determination of the relative weights for each of the allocation factors used in Latvia’s formula. Article 9 of the Law on Equalization states that the weights should be calculated taking into account: (a) local government budget figures for a two-year period prior to the preparation year, and (b) the state budget priorities for the budget year. During the initial year that the equalization formula was introduced, the relative weights were derived based on actual expenditures for the previous budget year. For instance, the relative weight for the population factor was computed as the ratio of expenditures on general services (all but education and welfare) to total expenditure. In order to determine the relative weight for child-care services, the respective allocation factor (children under 6 years) was weighted by the ratio of expenditure on kindergarten to total expenditures. Similarly, local educational expenditure (for which demand was measured by youth aged 7 to 18) was weighted by a ratio of local educational expenditures to total expenditures. Finally, social welfare expenditure (which predominantly provides local services for the elderly) was assigned a

weight equal to the ratio of expenditures on social welfare to total expenditures. In practice, the largest weight (close to 40 percent) falls on the population factor.

*South Africa*³¹

Also similar to Indonesia, South Africa has a unitary system, where most transfers are made directly from the central government to provinces and to local governments.³² The “equitable share” is the most important transfer of resources to the sub-national governments in this country³³. The equitable share is a block unconditional grant distributed to provinces and local governments on the basis of a redistributive formula that accounts for demographic and economic development profiles of each sub-national government. The factors contained in the formula are weighted in line with expenditure patterns in order to provide an assessment of relative need or demand for services.

The municipal basic services (S) grant, is the main component of the equitable share transfer. In fact, the largest portion of the equitable share payments to local governments is allocated through this channel. The objective of this grant is to ensure the access of all low-income households to basic municipal services, in all municipalities across the country (Department of Constitutional Development, 1999). This is basically a block grant that is equal to the estimated costs of providing ‘basic services’ to all residents living in poor households.

The S grant to each municipal jurisdiction is calculated taking into account the following factors in a formula: (1) an estimate of the annual per capita cost of providing basic public services; (2) the number of residents living in poverty within the municipality. For the first factor, the per capita costs of basic electricity, water, refuse,

³¹ This information was mainly drawn from the Intergovernmental Fiscal Review 2000 of National Treasury, Republic of South Africa and Andrew Reschovsky (2003), “Intergovernmental Transfers: The Equitable Share.” In Roy Bahl and Paul Smoke (eds.) *Intergovernmental Fiscal Reform In South Africa*. Edward Elgar. More recently, provincial governments have started providing some transfers to municipalities

³² The relative importance of transfers as a revenue source is more marked for the provincial governments, which have far less own-source revenues compared to the more self-sufficient local governments (municipalities)

³³ The “equitable share” refers to some fair portion of nationally raised revenues as mandated in the Constitution.

and sanitation services were accounted and a monetary amount was determined.³⁴ For the second factor, the income as reported on the 1996 census was used to estimate the number of poor people living in each municipality. In fiscal year 2000/2001, persons were defined as being poor if they lived in households with total household income less than R800 per month.

Research conducted by the agency responsible for the census in South Africa and the World Bank found that relying on money income results in a substantial underestimation of the economic resources available to households and consequently this measurement overestimates the rate of poverty in South Africa (Statistics South Africa, 2000). Moreover, they concluded that the overestimation of poverty differs systematically by place of residence, being higher in rural areas of former homelands than in formal urban areas. Thus, for 2001/2002 fiscal year, the national government decided to use data on household expenditures to better measure household income and consequently more accurately determine the number of poor people in each municipality.

The two factors explained above are adjusted in the formula using two parameters. The first, is a phase-in parameter, which is designed to allow for the differences in service provision between rural and urban settings. Thereby, for rural municipalities this parameter was fixed at 0.1 for the 1998–1999 fiscal year, and was set to be annually increased by 0.15. For the same fiscal year, in urban municipalities the phase-in parameter was fixed at 0.6 and was set to be annually increased by 0.1. In addition, because rural municipalities require a longer period of time to achieve a level of basic service provision comparable to urban areas, their S grants were phased in over a seven-year period and urban jurisdictions' were phased in over a five-year period.

In fiscal year 2001–2002, the number of municipalities fell from more than 800 to approximately 240 as a reflection of the new municipal boundaries established by the Municipal Demarcation Board. Many of the new municipal governments could no longer be classified as being either pure 'urban' or 'rural'. As a consequence, the value of the phase-in parameter for each municipality was calculated as a population-weighted average of rural and urban shares of the total population of each municipality. For the

³⁴ R252 annual per capita or R86 per month, per household under the assumption of 4.1 persons per household. This is a cost-estimate made several years ago by the Development Bank of South Africa

2002–2003 S grant allocations, the value of the rural phase-in parameter was 0.55 and the value of the urban one was 0.9.

The second parameter works as a budget-adjustment mechanism, which tweaks the size of the grants to the available budget for this purpose. The current national budget allocation for the S grant is below the amount of money necessary to provide municipalities with R86 per month for each poor household. To reflect these budgetary constraints, the budget adjustment parameter, is set at less than one. Finally, it is important to point out that despite the fact that the central government encourages municipalities to use the S grant as a mean to subsidize the consumption of basic municipal services to poor households, the S grant is ultimately an unconditional transfer. As such, local governments finally decide by themselves how to use these resources. Constitutionally, there is no provision tying the use of this grant to the provision of any specific public service.³⁵

Tanzania

Although Tanzania's economic, social and institutional setting is very different from Indonesia in many respects, Tanzania is currently going through a process of local government finance reform that bears many similarities to the decentralization process in Indonesia, and therefore there may be some mutual lessons to be learned. In 1999, as part of ongoing local government reforms that were started in the 1980s, Tanzania enacted a local government budget formulation process based on national minimum service standards (NMS). Since local governments in Tanzania have limited own-source revenues, most local government services (notably local education, health care, water supply, road maintenance and agricultural extension) are fully funded by conditional sectoral grants from the central government. The distribution of each of the sectoral grants is (notionally, at least) driven by sectoral national minimum service standards.

Similar to the MSSs currently being developed in Indonesia, the NMS used in Tanzania more often than not reflected lofty policy goals rather than affordable and objective measures of local demand for public services. For instance, one of the leading

³⁵ However, ministries have set MSS (water provision for instance) but the follow-up in terms of resources and enforcement is unclear.

minimum standards for local education suggests that local governments have to prepare their budgets based on a student-teacher ratio of 40:1. Although achievement of this norm is a worthwhile sectoral policy objective, this standard is currently achieved by only the most developed urban local governments. Achievement of this standard across all local governments would require the hiring of tens of thousands of additional teachers, and the allocation of millions of dollars of additional resources beyond the current funds allocated to the education sector and to local governments. Nonetheless, all local governments were instructed to draw up their budgets in correspondence with these norms. Of course, since these “minimum standards” were not defined in such a way that assured their affordability, the end-result was that the local budget plans reflected an unaffordable basket of local public services. Among other reasons for the lack of success we can identify a failure to set multi-year targets toward the achievement of the MSSs in consultation with the local governments and the failure to take into account the issue of affordability over the targeted time period.

Although local budget plans had to be formulated and prepared in accordance with the NMS approach, the computation of local expenditure needs based on NMS was unconnected to the distribution of central-local grants in Tanzania as Tanzania’s system of local government allocations relied exclusively on *ad hoc* (discretionary, negotiated) sectoral grants.³⁶ However, since the aggregate resources to fund local services at NMS were unavailable, local governments were subsequently asked to significantly reduce their budgets in a negotiated process during the final stages of the budget formulation cycle. This negotiated reduction of local budgets failed to assure resource adequacy (compared to the unaffordable NMS standards) and introduced inefficiencies, inequity, lack of transparency, lack of local accountability, disillusionment with decentralization, and the potential for significant corruption and bribes. Tanzania here walked the same road that many transitional countries in Central and Eastern Europe had walked when the budgets were built around hundreds of norms.

³⁶ In this respect the situation in Indonesia is quite different, since Indonesia already has a formula-based grants scheme in place. However, the key problem - notably the lack of correspondence between expenditure assignments and the funding made available through the grant system - is the same in Tanzania and Indonesia.

Recognizing the failure of the NMS framework of national minimum service standards, the Government of Tanzania reversed its position in 2002 and made a policy decision to replace the system of NMS with a formula-driven block grant scheme based on client-based expenditure norms. Formula-driven block grants based on expenditure norms are scheduled to be formulated by December 1, 2003, and expected to be introduced by next fiscal year (starting on July 1, 2004) for the education sector and the health sectors, which constitute over three-quarters of local government spending. For instance, primary education resources are to be distributed in accordance with the number of enrolled students, while health care resources will be allocated in proportion to the demand for health services.³⁷ Simultaneously, the detailed and unaffordable NMS will be removed from the local government budget guidelines and replaced with simpler and feasible grant conditions, such as a requirement that local governments have to pass through at least 90 percent of the education grant directly to the school level

Although in some ways Indonesia's system of intergovernmental fiscal relations is more advanced than Tanzania's (for instance, through the existence of a formula-based DAU in Indonesia), Tanzania may still offer some useful lessons for Indonesia in other aspects of decentralization reform. Tanzania has recently experienced the systemic failures that result from a disconnect between "minimum standards"-based expenditure assignments on one hand, and local government allocations (transfers) on the other hand. Tanzania has been moving expeditiously to replace its system of NMS and to introduce a formula-based grant system using client-based expenditure norms (in line with what is being proposed in this technical study), to bridge the divide between expenditure assignments and the allocation of local government resources.

*Ukraine*³⁸

With the 2001 reforms in Ukraine, local governments are no longer hierarchically subordinated to local governments and the Ministry of Finance now computes

³⁷ The actual formulas should be finalized by December 1, 2003. The health care formula takes into account population (70%), population in poverty (10%), larger distances in rural areas (10%), and under-five mortality (10%).

³⁸ This part of the report is drawn from Martinez-Vazquez, Jorge; and Zeikate, Signe. "Ukraine: Assessment of the implementation of the New Formula Based Inter-Governmental Transfer System". August 2002

equalization transfers separately for the local governments and the municipalities. The new equalization transfers are formula-driven and computed on the basis of the fiscal gap for each local government: the difference between expenditure needs and revenue capacity.

The new equalization transfers system in Ukraine has a number of positive features. Noteworthy is that the new expenditure norms are “client-based” as opposed to the traditional soviet-era type of “input-based” expenditure norms. These latter norms had never been implemented because they were financially unfeasible. In addition, rather than transfers based on the cost for supporting infrastructure (i.e: number of schools, number of hospitals, number of beds per hospital, etc, for each local government), the new transfers are based on needs of the population served.

For estimating expenditure needs, the new formula uses client-based expenditure norms for the main categories of expenditures in the local government budgets, including administration, health, education, social protection, and culture and sports.

The methodology for determining unified norms of per capita expenditures for each major service starts with the central government setting the envelope or overall amount of expenditures for local governments that will be used for the calculation in the following year. Next, the total amount of local expenditures is divided into separate aggregate expenditure functions such as education, health, and so on. Each function is subsequently subdivided into expenditure sub-functions (i.e: primary education, secondary education).

The process so far determines the notional amounts of what would be spent on the aggregate expenditure at the local level for each of the sub-functions. The next step consists of arriving at a basic expenditure norm for each main functional expenditure category by dividing the notional amounts by the objective criterion or number of clients (population, or number of students and so on.) Once the basic per client norms are derived, these may be adjusted for differences in the costs of provision and for other regional, location, environmental and social factors that affect local governments’ expenditure needs.