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Republic of Indonesia: Preparing the Second Local Government Finance and Governance Reform Program (Financed by the Japan Special Fund)

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Asian Development Bank



ADB

**ADB – INO. TA 7010 – Preparing the
Second Local Government Finance and
Governance Reform Program**

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Abbreviations

ADB	–	Asian Development Bank
APBN	–	national budget
APBD	–	regional budget
BAKD	–	Regional Finance Analysis Office
Bappenas	–	National Development Planning Agency
CG	–	Central Government
DAK	–	specific purpose grant
DAU	–	general equalization grant
DBH	–	revenue sharing transfer
Dekominfo	–	Department of Communications and Information
DG	–	Director General
DG OTDA	–	Director General of Regional Autonomy
DPR	–	National Parliament
EA	–	Executing Agency
EAP	–	External Advisory Panel
GOI	–	Government of Indonesia
GR	–	Government Regulation
IA	–	Implementing Agency
LG	–	Local Government
LGFR	–	local government finance and governance reform
MOE	–	Ministry of Environment
MOF	–	Ministry of Finance
MOHA	–	Ministry of Home Affairs
MSS	–	minimum service standards
MTEF	–	medium term expenditure framework
NAPFD	–	National Action Plan for Fiscal Decentralization
NSPC	–	Norms, standards, procedures and criteria
PG	–	Provincial Government
RG	–	Regional Government
SIKD	–	system for consolidating regional financial information
TA	–	technical assistance

Contents

Abbreviations	<i>i</i>
Executive / Knowledge Summary	1
1. Introduction	2
2. TOR Requirements	4
3. Progress in Relation to Proposed TA Impact and Outcome	7
3.1 Progress – Proposed TA Impact.....	7
3.2 Progress – Proposed TA Outcomes	8
4. Overview of Progress in Relation to Planned TA Outputs	9
5. Progress in Relation to Output 1 – Stocktake of Progress with LGFGR 1 and Update NAPFD	11
5.1 Output Objectives and Work Undertaken	11
5.2 Summary of Review Findings	11
5.2.1 Review of Progress with LGFGR 1 and Links to LGFGR 2	11
5.2.2 Updating Progress to Date in Implementing the NAPFD	12
5.3 Issues and Lessons	13
6. Progress in Relation to Output 2 – Prepare LGFGR 2 Policy Matrix and Supporting Documentation	15
6.1 Output Objectives and Work Undertaken	15
6.2 Summary of Output Documentation	15
6.3 Issues and Lessons	16
7. Progress in Relation to Output 3 – Review of Proliferation of Regional Governments	17
7.1 Output Objectives and Work Undertaken	17
7.2 Summary of Report Findings	17
7.3 Issues and Lessons	20
8. Progress in Relation to Output 4 – Mapping of Inconsistencies Between Sector and Decentralization Laws and Regulations	21
8.1 Output Objectives and Work Undertaken	21
8.2 Summary of Report Findings	21
8.2.1 DeKominfo Study.....	21
8.2.2 MOE Study	23

8.2.3	Some Common Findings of Both Studies.....	25
8.3	Issues and Lessons.....	27
9.	<i>Progress in Relation to Output 5 – Strategy for Devolving the Land and Buildings Tax</i>	28
9.1	Output Objectives and Work Undertaken	28
9.2	Summary of Report Findings	28
9.2.1	Situation Analysis	28
9.2.2	Principal Recommendations.....	31
9.3	Issues and Lessons.....	34
10.	<i>Progress in Relation to Output 6 – Analysis of Deconcentration Expenditures in the Regions</i>	35
10.1	Output Objectives and Work Undertaken	35
10.2	Summary of Report Findings.....	35
10.3	Issues and Lessons.....	37
11.	<i>Personnel, Administration and Budget.....</i>	38
11.1	Personnel Recruitment and Management	38
11.2	Administrative Arrangements.....	39
11.3	Budget Management	39
12.	<i>Summary of Lessons Learned.....</i>	41
12.1	LGFR 1 and NAPFD	41
12.2	Development of Policy Matrix	41
12.3	Fragmentation of RGs	41
12.4	Consistency of Sector and Decentralization Laws and Regulations	42
12.5	Devolution of the Property Tax	42
12.6	Analysis of Deconcentration Expenditures	43
12.7	Personnel, Administration and Budget Matters.....	43
13.	<i>Conclusions.....</i>	44
	<i>Annex 1 – List of Consultants by Output.....</i>	45
	<i>Annex 2 – List of Major Reports Prepared.....</i>	46
	<i>Annex 3 – LGFR 2 Policy Matrix</i>	47
	<i>Annex 4 – List of Equipment Procured Under TA 7010.....</i>	56

Executive / Knowledge Summary

The work of ADB TA 7010 was principally focused on the preparation of the LGFGR 2 program and related program loan. This work mainly involved (i) support to reviewing progress under LGFGR 1 and the GOIs, National Action Plan for Fiscal Decentralization (NAPFD); (ii) preparation of a medium term policy matrix; and (iii) preparation of studies aimed at strengthening policies and practices in 4 important areas of fiscal decentralization, namely – (a) fragmentation of Regional Governments (RGs); (b) inconsistency between sector and decentralization laws and regulations; (c) devolution of the property tax; and (d) deconcentrated Central Government (CG) expenditures in the regions.

In relation to the impact, outcomes and outputs originally set for it the TA assesses that it was in overall terms quite successful, though this view needs to be tested by independent evaluations of the ADB and the EA and IAs in the GOI.

The intended longer term impact was for the program to facilitate more transparent, efficient, equitable and effective management and use of public resources for regional development. Policies and processes developed by both TA 7010 and the LGFGR 2 program have been firmly focused on the longer term impact targets and should over time make strong contributions to their attainment.

The work of TA 7010 has been assessed as very positive in relation to the originally intended outcomes. Mapping of progress under LGFGR 1 and a stocktake of NAPFD progress occurred satisfactorily and a policy matrix for LGFGR 2 (Subprograms 1 and 2) was prepared and agreed by ADB and GOI. All agreed policy actions and legal reforms were completed in time for the LGFGR 2 program loan to be approved and disbursed in December 2008. A detailed policy framework for Subprogram 2 covering the period 2009 to 2011 is also in place.

All required outputs have been delivered in less elapsed time than was originally designed and within the unit costs provided for in the budget. Questions of quality of TA outputs are more difficult to come to assess, involving broader issues, including: (i) effectiveness of engagement; (ii) the extent of GOI take-up in policies and practices; and (iii) the extent to which GOI systems, institutional and human capacities have been strengthened. Assessment of the quality of TA outputs has been assisted by an External Advisory Panel and strong internal peer review processes. Nevertheless, quality needs where possible to be independently assessed by the ADB, the EA and IAs of the different output components. The TAs own assessment has been that quality of the main outputs produced has been sound and the team takes heart from the conclusion that the main outcomes sought for the TA were fully and quite successfully achieved.

The policy matrix developed was broad and comprehensive and involved very many policy actions beyond the 4 technical output areas on which much of the TA work was focused. While the TA did support completion and verification of many policy actions beyond its 4 core output areas, it is clear that the majority of actions completed under Subprogram 1 of LGFGR 2 (from 2006 to 2008) were completed independently by many different Government Officials, the strong involvement of whom must be applauded and seen as an important plus for the LGFGR 2 program moving forward.

1. Introduction

This represents the final report (the report) for Asian Development Bank (ADB) Technical Assistance (TA), number ADB – INO. TA 7010 – Preparing the Second Local Government Finance and Governance Reform Program (LGFGR 2) – (hereinafter referred to as the TA). In a snapshot the core objective of the TA was to support preparation of a large second program of fiscal decentralization reforms in Indonesia.

The TA was originally approved by the ADB in December 2007, with finance provided by the Japan Special Fund. The TA was designed to run for an elapsed period of 12 months commencing in January 2008. All TA consultants were recruited on an individual basis with no firm involved. Some initial delays were experienced in reaching agreement between ADB and the Executing Agency (EA) in the Ministry of Finance (MOF) and initial recruitment of the Fiscal Decentralization Adviser / Team Leader (the Team Leader) did not occur until March 2008 at which time only one other consultant had been appointed (the TA Administrator). Other consultants were progressively identified and recruited between April and June 2008 with a full team not in place until around July 2008. Most work of the TA had been concluded by December / January 2008 though work on a small number of finalization matters occurred until late February at which time the TA office closed down with the final tripartite meeting planned for late March 2009. Given the time taken with initial recruitment the effective elapsed time of the TA was around 8 to 9 months and most program preparation work was completed in a period of approximately six months.

This final report has been prepared by the Team Leader of the TA. While it aims to take into account known views of key stakeholders (including the ADB, the EA and the various Implementing Agencies [IA] it nevertheless mainly represents the views of the TA management team. The TA team would encourage the ADB and EA to conduct their own independent evaluation of TA performance through the planned final tri partite meeting and using other evaluation techniques, following which this report could be revised if found necessary.

The main objective of this report is to summarize results, achievements and failings of the TA by recording in summary form what work was undertaken and making comparisons with the anticipated impacts, outcomes and outputs contained in the original TA Report of December 2007. As set out in more detail in the following sections and the conclusion of this report, the TA overall is rated as being quite successful in relation to the original objectives set for it.

The remaining chapters of this report cover the following matters:

- Chapter 2 summarizes the requirements set out in the initial terms of reference (TOR) as adjusted for changes agreed in the inception report;
- Chapter 3 assesses progress in relation to the originally proposed TA impacts and outcomes;
- Chapter 4 provides an overview of progress in relation to planned TA outputs

- Chapters 5 to 10 (inclusive) assess progress in relation to the 6 outputs that TA was required to produce;
- Chapter 11 addresses matters relating to personnel, administration and budget;
- Chapter 12 provides a summary of lessons learned;
- Chapter 13 draws brief conclusions on the performance of the TA; and
- There are 4 annexes which cover: (i) a list of consultants; (ii) a list of major reports prepared; (iii) the LGFGR 2 policy matrix which was developed and agreed; and (iv) a list of assets procured and handed over to GOI.

2. TOR Requirements

The fundamental purpose of the TA was to support the GOI and ADB to prepare a second program of assistance (including a second program loan) supporting fiscal decentralization reform and strengthening in Indonesia. During the 2006 Country Programming Mission the GOI had reaffirmed commitments given in relation to the first program (LGFGR 1) to proceed to a second program and loan and sought ADB TA to support: (i) a review of policy progress and updating of the National Action Plan for Fiscal Decentralization (NAPFD); (ii) the preparation of an agreed set of policy actions for implementation under LGFGR 2; and (iii) to support completion of agreed policy actions.

In preparing the TA design paper significant attention was given to ongoing activities under the NAPFD as well as to other important policy matters identified in a joint GOI and ADB scoping study undertaken in March 2007. From a broad range of possible work options the work of the TA was eventually agreed to cover 6 main output areas as set out below. Two of these work areas went to the heart of the preparation role and involved: (i) support to stocktaking progress with the NAPFD; and (ii) development of the LGFGR 2 policy matrix. The policy matrix eventually developed was very broad and quite comprehensive in nature and involved very many policy actions beyond the 4 technical output areas on which most of the TA technical work was focused. While the TA did support completion of a number of policy matrix areas beyond its 4 core professional output areas it is clear that the majority of actions completed under Subprogram 1 of LGFGR 2 (over the period 2006 to 2008) were completed independently by Government Officials, the strong involvement of whom is seen as an important plus for the program moving forward.

Subsequent chapters review in some detail progress in relation to anticipated TA (i) impacts; (ii) outcomes; and (iii) outputs. In brief summary form the main expectations here were:

- The intended impact of the longer term program is more transparent, efficient, equitable; and effective management and use of public resources for regional development;
- The intended outcome of the TA was the adoption of policy changes / reforms with regard to Local Government (LG)¹ finance and governance reforms so facilitating the timely processing of LGFGR 2;
- Six main output areas and objectives were set out for the TA as follows:
 - (i) Stocktake progress under LGFGR 1 and update the NAPFD;
 - (ii) Support GOI and ADB to prepare the policy actions matrix for LGFGR 2;

¹ Throughout this report the term Regional Government refers to Provincial Governments plus Local Governments (Kabupaten and Kota) combined. The term Local Government refers to Kabupaten and Kota combined.

- (iii) Assist to prepare a “Grand Strategy” for addressing the proliferation of new RG Governments;
- (iv) Support development of consistency between sector and decentralization laws and regulations;
- (v) Study options and develop strategy for decentralizing the property tax; and
- (vi) Undertake analysis to support the transfer of Central Government (CG) deconcentration funds to DAK.

In terms of implementation arrangements the EA for the TA was named as the MOF Directorate General of Fiscal Balance through the Office of the Secretary to the Director General. Implementing Agencies (IAs) were appointed for the core output areas and involved different Directorates in MOF, the Ministry of Home Affairs (MOHA); and Bappenas. Some 14 months of international consultants and 33 months of domestic consultants was provided for (see Annex 2 for the list of consultants finally appointed).

Following a brief inception phase an inception report was prepared in March 2008 and was eventually endorsed by ADB and GOI. The inception report mainly took the required impacts, outcomes and outputs from the TA report as givens and focused on methodology and plans for achieving them. However, the following (more important) inception recommendations were made and accepted:

- For activity 3 that the TA’s output be confined to submission to MOHA, MOF and Bappenas of input to a Draft Grand Strategy Paper during 2008;
- For activity 6 that the TA’s output now focus on completing the Decon / DAK data analysis and recommendations paper in 2008 with the recommendations to be taken up for consideration in the 2010 budget;
- For activities 4 (consistency of sector laws and regulations) and 6 (analysis of decon to DAK data) that the two pilot ministries / sectors be the same ones for each study (at a later stage this recommendation was revised with: (i) the consistency of laws studies being basen on communications / information and the environment; and (ii) the deconcentration analysis being based on education and the environment;
- The initial 7 months of consulting time provided for a single Domestic Fiscal Decentralization Policy Expert and Project Administrator be split into two positions, one for a Domestic Fiscal Decentralization Expert for two (2) months and one for a Domestic Project Administrator for five (5) months;
- Two new short term international positions of Fiscal Decentralization Adviser were provided for to support early completion of the LGFGR 2 stocktake, NAPFD update and preparation of a draft policy matrix. One of these positions was for 0.5 months and the other for 1.5 months; and

- That international consulting resources of 2 months be switched from the position for an International Expert in Analysis of Decon / DAK data to the 2 new positions supporting the stocktake of LGFGR 1 / update of NAPFD / preparation of policy matrix (eventually around 1.5 months of additional time was found for an International Consultant to support the deconcentration analysis work).

3. Progress in Relation to Proposed TA Impact and Outcome

3.1 Progress – Proposed TA Impact

According to the initial TA design the intended impact relates more to the broad LGFGR Program rather than simply to the TA itself. In terms of impact the design states”the longer term program leads to more transparent, efficient, equitable; and effective management and use of public resources for regional development”.

The main performance targets specified to measure performance in relation to impact were:

- Improved horizontal and vertical equity in intergovernmental financing arrangements; and
- A higher percentage of revenues in local income.

The linking of impact to the broader program rather than to the TA itself was perhaps in part recognition that impacts typically take a long time to eventuate with results likely to be difficult to measure within the 12 month time frame of most TAs. This is certainly the case here and raises issues of how practical and useful such long term impact goals are for short term TAs which are not linked to ongoing support.

In the policy and process sense it could be strongly argued that the majority of the policy actions agreed under the LGFGR 2 policy matrix (Subprograms 1 and 2) will over time make important contributions to transparency, efficiency, equity and effective management and uses of public resources for regional development.

It is equally clear in the policy and process senses that all output components of TA 7010 and the majority of proposed actions under the LGFGR 2 policy matrix (Subprograms 1 and 2) will over time make important contributions to improved horizontal and vertical equity in intergovernmental financing arrangements (particularly work in relation to the DAU, the DAK, deconcentrated expenditures; and shared revenues).

It is also clear that if work undertaken in TA 7010 to devolve the property tax to RGs eventually comes to fruition then this will certainly result in a significant growth in the share of own source revenues.

In the short term of a year of the TA it is difficult to unreservedly demonstrate improved performance. Indeed 2008 / 2009 realization data on vertical and horizontal balance and own source revenues is not likely to be available until at least 2011 given lags in RG fiscal data in Indonesia. Furthermore, even if the data does continue to trend favorably in these areas it will be difficult to discern the extent to which this has been caused by the current program and TA alone vis a vis other factors.

Notwithstanding the complexities it can nevertheless be concluded that policy and processes of both the TA and the program have been firmly addressed to the longer

term impact objectives and targets set and should over time make strong long term contributions to their attainment.

3.2 Progress – Proposed TA Outcomes

According to the initial TA design the intended outcomes of the TA “will be the policy changes / reforms that the Government agrees to make with regard to LG finance and governance reforms so facilitating the timely processing of LGFGR 2”.

The main performance targets specified to measure performance in relation to outcomes were:

- Well prepared evaluation of progress under LGFGR 1, NAPFD stocktaking; and updated policy matrix;
- Agreement on policy reform areas for program loan under LGFGR 2; and
- All agreed policy actions and legal reforms completed and program loan processed.

Results of TA 7010 work are unambiguously positive in relation to the originally intended outcomes. As documented in chapters 5 and 6 of this report progress under LGFGR 1 and a stocktake of the NAPFD occurred satisfactorily and a policy matrix for LGFGR 2 (Subprograms 1 and 2) was prepared and agreed by ADB and GOI. All agreed policy actions and legal reforms were completed in time for the LGFGR 2 program loan to be approved in early December 2008 with program funding of US \$ 350 million for Subprogram 1 drawn down in late December 2008. A detailed policy framework for Subprogram 2 covering the period 2009 to 2011 is also in place.

4. Overview of Progress in Relation to Planned TA Outputs

The overview of progress in relation to planned TA outputs (as per the original design document) is provided in Figure 4.1. More details on performance in relation to the 6 planned outputs is provided in the following 6 chapters of this report (chapters 5 to 10 inclusive). To some extent the following six chapters explain the factors behind the ratings given in Figure 4.1, particularly with regard to the quality of outputs.

There are commonly 4 main tests applied in relation to the delivery of outputs, namely:

- Quantity;
- Quality;
- Timeliness; and
- Unit Cost.

In the overview sense it seems unambiguous that the required quantity of outputs have been delivered in less elapsed time than was originally designed and within the unit costs provided for in the budget.

Questions of quality of TA outputs are more difficult to come to grips with typically involving not only issues of whether pieces of technical work have been completed and reports produced. Broader issues include: (i) the effectiveness of engagement with Government counterparts; (ii) the extent to which Government policies and practices are improved as a result of the technical work undertaken; and (iii) the extent to which Government systems, institutional and human capacities have been strengthened.

Matters of quality of the outputs of the TA are to some extent assessed by the TA team in the 6 following chapters, especially in relation to the performance indicators for individual outputs as set out in the original TA design. Assessment of the quality of TA outputs has been assisted by the TA having an External Advisory Panel (EAP) to assess and advise on major outputs as well as a management structure that highlighted the importance of internal peer review prior to release of key outputs to the GOI and ADB. Notwithstanding these processes quality needs to be assessed from the eye of the beholder, in this case particularly the ADB, the EA and IAs of the different output components. The TA encourages the ADB, the EA and IAs to make their own assessments of quality, the results of which could be incorporated in a revised version of this report if found appropriate.

In relation to quality the TA team does take much heart from the unambiguous conclusion reached in chapter 3 that the main outcomes sought for the TA were quite successfully achieved. It is unlikely that the outcomes would have been so successfully achieved without reasonable quality having been achieved with regard to the main outputs.

Figure 4.1: TA Assessment of Performance in Relation to Delivery of 6 Core Outputs

Output	Quantity ²	Quality ³	Timeliness ⁴	Unit Cost ⁵
1. Stocktake progress under LGFGR 1 and update the NAPFD	Excellent	Satisfactory	Excellent	Excellent
2. Support preparation of policy actions matrix for LGFGR 2	Excellent	Excellent	Excellent	Excellent
3. Assist prepare a “Grand Strategy” addressing proliferation of RGs	Excellent	Satisfactory	Satisfactory	Excellent
4. Support consistency between sector and decentralization laws / regulations	Satisfactory	Satisfactory	Unsatisfactory	Excellent
5. Study options and develop strategy for decentralizing the property tax	Excellent	Excellent	Satisfactory	Excellent
6. Analysis of CG deconcentration expenditures / switches to DAK	Excellent	Satisfactory	Excellent	Excellent

Color Code:

Excellent	Excellent
Satisfactory	Satisfactory
Unsatisfactory	Unsatisfactory

² Quantity is mainly assessed in terms of delivery of required reports and workshops

³ Quality is based on qualitative self assessment with main considerations for each output spelt out in chapters 5 to 10 respectively

⁴ Timeliness is assessed in terms of time frames set in the inception report

⁵ Unit costs are assessed in terms of inputs planned and actually used and bearing in mind the overall TA operated within budget

5. Progress in Relation to Output 1 – Stocktake of Progress with LGFGR 1 and Update NAPFD

5.1 Output Objectives and Work Undertaken

This output required a stocktake of progress under LGFGR 1 and an update of progress in implementing the NAPFD policy matrix. In terms of performance targets and indicators the main expected output was to be a policy paper. Most of the work under this output was completed by Bp Khoirunurofik with support of the Team Leader. Bappenas was the IA. Results of the work were presented in two locations as follows:

- Progress with LGFGR 1 and particularly its linkages to LGFGR 2 were reported and
- A detailed updated NAPFD matrix showing progress to date was presented in a separate report, entitled, ADB TA 7010, *Review of Progress in Implementing the National Action Plan for Fiscal Decentralization, 2005-2009*, November 2008.

Brief summaries of these two pieces of work appear in 5.2.

5.2 Summary of Review Findings

5.2.1 Review of Progress with LGFGR 1 and Links to LGFGR 2

In developing LGFGR 2 the details of and lessons from LGFGR 1 were closely considered with LGFGR 1 and LGFGR 2 integrally linked in terms of proposed impacts, outcomes and involving a consistent evolution of outputs (as depicted in Figure 5.1). Comparing the two programs: (i) output areas 1, Coordination and Planning; and 2, Regional Administration are equivalent in both; (ii) In LGFGR 1 intergovernmental financing, RG revenue policy and debt management were all contained in one output area 3, whereas under LGFGR 2 these are now split into three distinct areas, 3, 4 and 5; and (iii) in LGFGR 1 planning, budgeting and financial management and FMIS development were split into two components, 4 and 5 whereas in LGFGR 2 they are combined into one output group, namely 6.

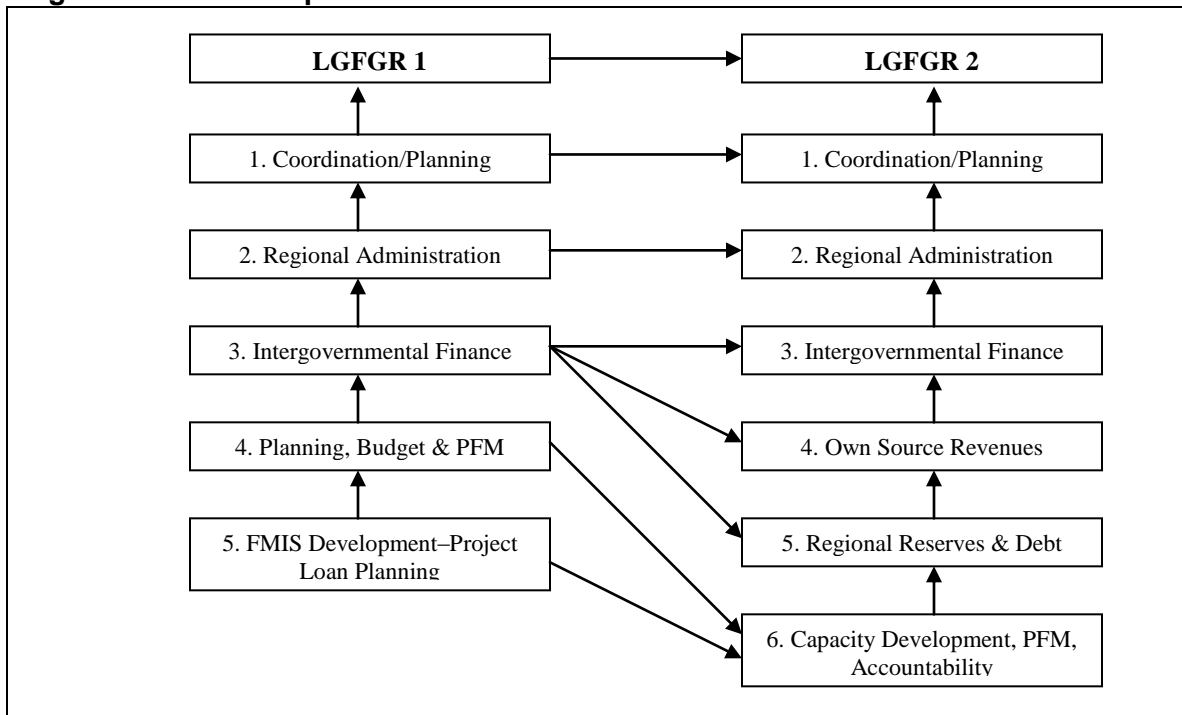
LGFGR 1 covered the period from 2003 to 2005. The RRP for LGFGR 1 envisaged a medium term approach to LGFGR development with at least 2 further medium term program loans to follow the first single tranche release of \$ 300 million made in December 2005. The RRP for LGFGR 1 provided for some 14 indicative actions likely to be pursued under a second phase of LGFGR 1. Mapping undertaken indicated 13 of the 14 indicative actions were provided for in the LGFGR 2 policy matrix. The only exclusion relates to the development of regulations to deal with bankruptcies of RGs which was not considered high enough priority by GOI to include in LGFGR 2. The significant number of policy actions eventually included under LGFGR 2 goes well beyond levels envisaged at the time of preparing LGFGR 1.

The most important action which binds the two programs is the NAPFD which is central to the selection of well sequenced related actions under both programs. Mapping of links between LGFGR 1 and LGFGR 2 actions indicates there has been no significant

broadening of effort between LGFGR 1 and LGFGR 2. Rather there has been a significant deepening of the GOI reform effort. While proposed actions under Subprograms 1 and 2 of LGFGR 2 deepen the LGFGR 1 reform efforts in multiple ways the general direction of deepening is as follows:

- (i) LGFGR 1 finalized higher level laws and regulations and commenced initial work on institutional strengthening and capacity building;
- (ii) LGFGR 2 (Subprogram 1) moves much nearer to finalization of the regulatory regime and intensification of key policy reforms, while deepening efforts at institutional strengthening and capacity building; and
- (iii) LGFGR 2 (Subprogram 2) will move to a near settled regulatory regime with implementation of currently defined reforms while further deepening efforts at institutional strengthening and capacity building.

Figure 5.1: Core Output Areas of LGFGR 1 and LGFGR 2



5.2.2 Updating Progress to Date in Implementing the NAPFD

This study focused on a detailed action by action review of proposed actions under the NAPFD with a stocktaking of progress to date and provision of assessments on policies and approaches to move forward with fuller implementation over time. The bulk of the

report is set out in matrix form with additional columns to the original NAPFD to indicate progress and to set out issues in relation to implementation.

The review of NAPFD progress followed its 8 core components, namely: (i) to finalize administrative regulations; (ii) to ensure adequate funding to meet all assignment obligations; (iii) to achieve more rational and effective public spending to improve the quality of services; (iv) to increase local own revenues by improving capacities; (v) to improve horizontal and vertical balance through more effective inter-governmental fiscal transfers; (vi) to improve fiscal fiduciary responsibilities to increase the effectiveness, stability and accountability of regional financial management; (vii) to build local and national capacities in financial management, monitoring and evaluation; and (viii) to strengthen DPOD's role in decentralization coordination and implementation.

The methodology for this update involved: (i) an extensive review of laws and regulations; (ii) interviews with key informants; and (iii) the conduct of 2 ADB TA 7010 workshops (in April and August 2008) involving key CG stakeholders.

The review of NAPFD progress to September 2008 revealed that 73 % of proposed actions (57 actions) had either been completed or had made substantial progress (compared to 78 actions which were initially planned in the NAPFD from 2005 to 2009). The assessment emphasized Government efforts to start and produce tangible results notwithstanding that for some actions work continues such as matters still being under consideration by DPR and or DPOD working groups. Very detailed summary tables and a comprehensive matrix are provided in the report charting actual actions and remaining issues.

The current version of NAPFD is due to conclude its term in 2009. At this stage it is anticipated that a follow up NAPFD covering the period 2010 to 2014 will be prepared. This is an agreed action under Subprogram 2 of LGFGR 2. The follow up NAPFD will be able to remove the significant number of actions completed to date under the first phase of NAPFD, while allowing for continuation of ongoing items and the inclusion of new items, including those contained in the policy matrix for Subprogram 2 of LGFGR 2.

5.3 Issues and Lessons

With regard to policy actions under LGFGR programs 1 and 2 there are no significant issues, with quite smooth integration being achieved between LGFGR 1 and 2. However, there are significant issues for the GOI and ADB deriving from slow progress in implementing the related investment loan approved in December 2005 under LGFGR 1. Such problems were beyond the scope of work or resources of ADB TA 7010 but it may be possible to address them under the proposed piggy back TA to commence in mid 2009.

With regard to the NAPFD, while there are numerous detailed issues involved in the completion of particular planned actions under NAPFD, there appeared to be continued strong interest on the part of GOI in using the NAPFD as a planning and monitoring device and there are not major issues with regard to its fundamental ongoing role. Following the completion of the review report on NAPFD progress there were some within GOI who expressed disappointment that the review was mainly of a backward looking monitoring nature and did not provide significant guidance on the proposed

rewrite of NAPFD for the next phase 2010 to 2014. An attempt has been made to address these concerns by providing significant resources under the proposed piggy back TA to commence in mid 2009 to support preparation of the updated NAPFD 2010 to 2014.

Briefly lessons learned under this output have been:

- Continuity between programs is useful and is supported by continuity in personnel at all levels, including key stakeholders in GOI, ADB staff and TA resources. The design of LGFGR 2 with 2 sub programs covering an extended medium term period of 6 years is likely to be supportive of medium term continuity and consistency; and
- The NAPFD has proved a useful medium term guide for both the GOI and DPs, but will need continuing work and effort from all stakeholders, particularly if the NAPFD is to become the universally accepted plan to harmonize efforts in fiscal decentralization reform. The updating of NAPFD if possible should lead to a clear medium term roadmap for fiscal decentralization which all stakeholders are willing to support. This will require enhanced efforts on the part of DPs to better harmonize their efforts in the field of fiscal decentralization reform and strengthening.

6. Progress in Relation to Output 2 – Prepare LGFGR 2 Policy Matrix and Supporting Documentation

6.1 Output Objectives and Work Undertaken

The objectives in the initial TA design were to finalize a LGFGR 2 policy matrix, including negotiation and agreement between GOI and ADB. The Inception Report and individual consultant TORs also highlighted the importance of provision of support to preparation of key program loan documents, and the collection of evidence in relation to completion of agreed actions under Subprogram 1 of LGFGR 2. Most of the work under this output was completed by the Team Leader but with considerable support at different times from: Bp Khoirunurofik; Andre Oosterman and Professor Jorge Martinez. Work on the GOI side was led by the EA in MOF.

The main work undertaken by the TA involved: (i) initial situation review of reform efforts and preparation of working papers on possible content of the policy matrix; (ii) review of progress in implementing LGFGR 1 and the NAPFD (as per output 1 above); (iii) preparation of an early draft of the policy matrix which was discussed in an April 2008 workshop of key stakeholders; (iv) individual and small group meetings with key stakeholders; (v) provision of further revisions and updates to the draft policy matrix during the Fact Finding and Appraisal Missions and in preparation for the Negotiations; (vi) provision of written supporting documentation; and (vii) collection of evidence files in relation to completed actions under Subprogram 1.

6.2 Summary of Output Documentation

The finally completed and agreed policy matrix is included as Annex 3 to this report. The RRP document and its key appendices are referred to in Annex 2 which lists major documents prepared and are available on a CD of key materials prepared (or supported) by the TA. Important features of the policy matrix prepared include:

- It covers 2 periods over a medium term framework (Subprogram 1 covers the period 2006 to 2008 while subprogram 2 covers the period 2009 to 2011);
- The approach is quite comprehensive covering 6 core components: (i) program management and coordination; (ii) regional autonomy and local governance; (iii) intergovernmental fiscal system; (iv) own source revenues; (v) regional reserves and debts; and (vi) capacity development, public financial management and accountability;
- Under each Subprogram there are a total of around 55 required actions for each with smaller numbers highlighted as core actions prior to Board for Subprogram 1 (19 highlighted) and proposed triggers for LGFGR 2 (15 highlighted);
- There is a close relationship between LGFGR 1, including future actions anticipated there and Subprograms 1 and 2 of LGFGR 2. Most proposed actions under Subprogram 2 relate to completing actions commenced in Subprogram 1 and in some cases prior to this under LGFGR 1.

6.3 Issues and Lessons

Broadly speaking the development of the policy matrix and related documentation went smoothly and there are no major issues of conflict or difficulty to raise.

In terms of lessons learned under this output the following can be briefly recorded:

- The existence of a GOI accepted medium term framework for policy actions (the NAPFD) greatly assisted the development of the LGFGR 2 policy matrix;
- It will be important that the planned update of NAPFD 2010 to 2014 take into account proposed actions under Subprogram 2 of LGFGR 2 (2009 to 2011) and vice versa Subprogram 2 needs to be responsive to the content of the new NAPFD; and
- Broad consultation, strong leadership on the GOI side and reasoned flexibility on the part of the ADB Staff Team Leader all contributed to the emergence of broad consensus on what was practical and feasible, but meaningful at this point in time.

7. Progress in Relation to Output 3 – Review of Proliferation of Regional Governments

7.1 *Output Objectives and Work Undertaken*

The main stated objective of the TA design here was to prepare a review study for MOHA and the DPR addressing the recent proliferation of new RGs and issues relating to the optimal number of RGs so as to assist them to prepare a grand strategy paper. The work was to support proposed new regulations on: (i) the formation of RGs; and (ii) evaluation of the performance of RGs. During the inception phase it was agreed that the TA's output be confined to submission to MOHA, MOF and Bappenas of input to a Draft Grand Strategy Paper rather than actual preparation of such a paper or draft regulations (which were not to be imminently considered by the Government).

Work under this output was completed by two consultants: (i) Dr. Handry Imansyah; and (ii) Professor Jorge Martinez. The main methods adopted were: (i) significant consultation particularly at CG level; (ii) development of a major data base on financial management and service delivery indicators for Provinces and LGs; (iii) regression and other statistical analysis on attributes and performance of different types of RGs; and (iv) a workshop was held to review preliminary findings.

7.2 *Summary of Report Findings*

The main goals of this report were to examine the nature and causes of the on-going process of fragmentation of sub-national governments (*pemekaran*) and to offer guidance and advice to the GOI on the design of the "Grand Strategy for *Pemekaran*." The focus of the report is on LGs as opposed to PGs because the most difficult issues confronted by the Government of Indonesia are at the local level.

Lower production efficiency of systems operating with a large number of smaller sub-national governments is expected because their small size may cause the loss of economies of scale and economies of scope. A loss in efficiency is also expected because with more fragmentation larger amounts of resources will be utilized just in the administration of the sub-national governments as opposed to using those resources to improve the delivery of public services.

On the other hand, it is also generally recognized that there are advantages to the relative smaller sizes of sub-national governments from the perspective of allocational efficiency. That is, relatively smaller sub-national governments may be more responsive and accountable to residents, so that the available resources are better used to cover their needs and preferences.

The theory and best practice of sub-national government optimal size is to find the right balance between those two principles of efficiency: efficient scale of production and delivery of services and efficiency in representation, responsiveness and accountability.

Indonesia has been undergoing a significant increase in the number of sub-national governments, especially at the LG level. Because decentralization is a fairly new phenomenon in Indonesia and because the process of creation of new LGs and PGs

has been quite rapid in just several years, there is still a lot of confusion surrounding the process and there are many questions about the nature (causes and motivations), consequences and effects, and therefore the overall desirability of this process.

Previous empirical studies (which are reported on in detail) tend to agree on several major determinants of the *pemekaran* process. First, sparsely populated regions, those with larger land areas and larger populations, as well as those with more heterogeneous populations are more likely to undergo *pemekaran*. These findings assume “other things are constant” though in reality other things are not always constant. For example, Java with densely populated regions and with a large population has not experienced a high incidence of *pemekaran*. Among other things, Java has a quite homogenous population and enjoys a better infrastructure system, which helps solve the span of control problem with relatively better access to public services. Java therefore demonstrates a lower desire to undergo *pemekaran* as a solution to a variety of problems. These are important empirical findings that say that the process of new LG creation in Indonesia responds to a large extent to the same economic fundamentals that are predicted by public finance theory and trends as observed in other countries around the world.

Second, we also find with some earlier studies a role, perhaps weaker in statistical terms, for fiscal incentives being a determinant of *pemekaran*. These fiscal incentives effects when present vary with the type of transfer (revenue sharing, DAU, DAK) with revenue sharing, particularly in relation to natural resources, being particularly important.

Third, the political drive behind *pemekaran* may be there but it is not as noticeable in statistical terms as economic fundamentals (for example, land area or population) or even fiscal incentives. An interesting finding is that other factors such as historical conflicts and demand for autonomy do not seem to play a robustly significant role, after other factors are taken into account, in explaining the incidence of *pemekaran*. These findings are in contrast with the common (untested) wisdom regarding *pemekaran*.

Taking into account existing limitations on methodologies that can be used, available data, and duration of time periods, the studies own findings and the past available empirical evidence on the impact of *pemekaran* on LG performance for public service delivery is mixed. Although some negative aspects and problems are present from fragmentation, there are some other positive factors, such as the fast response of *pemekaran* districts to improve some basic public services and infrastructure, which give pause to come up with generalized conclusions. In truth, the evidence is still developing and clearly more work is needed to understand what is really happening. However, the evidence available so far provides the basis for a cautious note on the speed and extent of further *pemekaran*. We should also say that many other evaluations of *pemekaran* in the national press and by popular commentators have been less than scientific and should in many cases be discounted.

The analysis in this report should allow us to better understand the nature and outcomes of *pemekaran*. Although there are multiple causes behind *pemekaran*, there is robust evidence that this process in Indonesia responds to the same basic determinants that have worked in other places and are predicted in basic public finance theory. That in a way is reassuring; on average, it appears there are good positive reasons behind *pemekaran* in Indonesia. However, we also find that *pemekaran* has been responsive to perverse negative incentives coming from the structuring of the transfer system (DAU and DAK) and revenue sharing from natural resources. These issues need to be

addressed and, in particular, the DAU and DAK need to be reformed to get rid of any remaining incentives to the fragmentation of local government units.

Regarding the impact of *pemekaran*, particularly on service delivery performance, the report strives to review available data and to produce new evidence on whether the LGs that have undergone *pemekaran* have suffered in public service performance vis-à-vis the originating LGs. We find that the evidence is also mixed here; in some cases performance has improved (as in the case of education) while in others it has deteriorated (as in the case of health).

The report also finds that the degree of sub-national government fragmentation in Indonesia is much less than in many other countries, and quite importantly, that the average size of *Kabupaten / Kota* in Indonesia is large enough to take advantage of any possible economies of scale found in the empirical literature on public finance. This does not mean that there are not any problems in Indonesia - there are clearly some problems because at least some LGs may already be too small and because the process of fragmentation cannot continue unabated without coherent policy and administrative frameworks.

The report also takes a careful look at the “legislated” and “factual” processes that have been followed in Indonesia for the creation of new LGs, the criteria that new LGs must meet, the best international practice in these matters; and what policy and procedural changes should be made to the Indonesian processes. There has been legitimate concern about “*process*.” Even though there have been regulations a common feeling is that past and current regulations lack a “grand strategy” for this issue. That is, even though the current regulated process for going about the creation or amalgamation of LGs and PGs can be debated and improved upon, the most serious problem from this perspective is the lack of a strategy for where the country should go on this important matter (this is sometimes put in terms of a question: what is the explicit set of criteria that could be used in the process to get closer to or move in the direction of the “optimal number of LGs and PGs for Indonesia?”). In reality it is very unlikely that there is such a thing as a universal “optimal size” for local and provincial units. The optimal size is likely to differ quite significantly by the type of service or public good that has been assigned to the LGs and PGs. In addition geographical and settlement patterns that naturally existed in the past in a far flung archipelago cannot be avoided.

Unless we are willing to settle for one single criterion for *pemekaran* decisions (which we should not be), such as population size, a fixed ideal number will not be the right policy to follow. For example if we accept the international empirical evidence that most economies of scale are reached at a population size of 100,000 residents, then given that the average population size of all *kabupaten / kota* in Indonesia is 500,000, the “ideal” number would be about 2,500 *kabupaten / kota* in Indonesia, or approximately five times the number that now is in place. But, of course, we do not believe that this would be the right approach. Instead, the Government policy toward *pemekaran* should be based on seeing that the right processes as stated in a strong law is followed and that the core criteria as also stated in the law are met in each case.

The main recommendations for creating the basis of a “grand strategy” for *pemekaran* are twofold:

First, the DPR needs to follow regular procedures for *pemekaran*. Achieving this goal will require incorporating the approved processes and requirements for *pemekaran* into a law approved by the DPR, as opposed to having them in a Government Regulation (GR) as is now the case. Although this will not be easy to accomplish (as the DPR has been very active in using informal processes outside of the provisions in the current GR), it is the most realistic solution; otherwise it will not be possible to just simply eliminate the role of DPR as legislator in the *pemekaran* process. Having the process and requirements in a law will guarantee that the requirements for technical and administrative aspects for *pemekaran* are applied consistently and that no short cut is used for the process.

Second, the criteria for *pemekaran* now in GR 78 / 2007 will need to be rationalized and simplified. The report goes into the options here in some detail and eventually recommends the incorporation of 4 basic core criteria regarding: (i) minimum population scale; (ii) representation and accountability; (iii) financial and fiscal capacity and sustainability; and (iv) administrative capacity. Other criteria may be added, such as territorial continuity and security and border considerations, but these additions should be minimal.

The formulation of a “grand strategy” for *pemekaran* should also consider the development of other instruments that have proved successful in the international experience for dealing with the problem of fragmentation at the sub-national level including: (i) the introduction of incentives to encourage the voluntary amalgamation of LGs; (ii) the redesign of expenditure assignments by developing the role of PGs for those services with significant economies of scale and externalities across LGs; (iii) the promotion of different forms of cooperation among LGs in the provision of local public services; (iv) the creation of special service districts (for example for water or transportation where economies of scale are particularly important); and (v) the privatization of some services.

7.3 Issues and Lessons

Issues underlying the *pemekaran* debate are amongst the most complex and difficult that any government confronts. They involve geographic, political and financial / economic elements. A complex array of stakeholders within the GOI (MOHA, MOF, Bappenas, Office of President), as well as the DPR and its Commissions and many external DPs (ADB, USAID, UNDP, World Bank, DSF) have been involved in the development of strategy for some years now and not surprisingly a clear consensus on the content of a grand strategy paper is still in all likelihood some time off.

One important lesson that emerges from this exercise is that significant patience and enduring on the ground consultation and involvement is needed if DP efforts are to make a significant contribution to the nature of the final grand strategy paper developed. Short one off interventions of the nature provided by this ADB TA input do provide the opportunity to inject fresh (and at times conflicting) information to the ongoing debate. However, without a sustained on the ground presence it will be difficult to develop a consensus amongst the at times unwieldy stakeholders. Hopefully, the current report and workshop have added some fresh ideas to knowledge and the policy debate but without a sustained ongoing contribution in close coordination with other DPs it remains to be seen the extent to which strategic recommendations will be taken up by GOI.

8. Progress in Relation to Output 4 – Mapping of Inconsistencies Between Sector and Decentralization Laws and Regulations

8.1 Output Objectives and Work Undertaken

Objectives in the initial TA design required the preparation of a mapping and advisory paper to review inconsistencies between sector laws and regulations and the decentralization laws and regulations (especially those relating to the assignment of functions between different levels of Government). The studies were to be based on 2 pilot ministries which were eventually decided to be: (i) the Ministry of the Environment (MOE); and (ii) the Department of Communications and Information (DeKominfo).

Work under this output was completed by two consultants: (i) Dr. Professor Rusadi Kantaprawira (MOE study); and (ii) Dr. Wihana Kirana Handry Imansyah (DeKominfo study). The main methods adopted were: (i) significant consultation particularly at CG level but also in selected RGs; (ii) detailed review and mapping of relevant laws and regulations; (iii) case studies; and (iv) a workshop was held to review preliminary findings for the DeKominfo study while a workshop is still to be held (possibly in March 2009) in relation to the MOE study. Two separate study reports were produced one for MOE and one for DeKominfo. While technical conclusions for both were naturally different there were also some common conclusions as reported in 8.2.3

8.2 Summary of Report Findings

8.2.1 DeKominfo Study

The study aimed to address wide concerns that inconsistencies may exist in the assignment of functions to different levels of Government as between the decentralization regulatory regime (particularly GR 38 / 2007 on assignment of functions and sector laws and regulations). The report focuses on a review and analysis of the consistency or otherwise of the two sets of legal instruments based on a case study of the communications and information function. The methodology used focused on a detailed mapping of the main communications and information laws and regulations in relation to GR 38 / 2007. Detailed legal mapping was supplemented by interviews in DeKominfo, MOHA, in one Province (Yogyakarta); and in one LG (Kabupaten Sleman). A national workshop was also conducted to discuss preliminary results of the study.

The report reviewed general concepts on the assignment of functions between different levels of Government with a brief outline of theoretical considerations supplemented by international examples in approach from the USA, Japan and Australia. These are contrasted with different institutional and legal framework conditions applying in Indonesia. While the aim is for clarity in assignments between levels of Government as highlighted in the theory, the practical experience suggests major challenges remain if Indonesia is to achieve this ideal situation.

A review is provided of the major laws and regulations which deal with the assignment of functions between different levels of Government in Indonesia. Law 5 / 1974 on Decentralization operated for much of the pre decentralization era up to 1999 and

involved heavily centralist and deconcentrated approaches to the assignment of functions. Understanding this New Order period is important as many of the laws and regulations relating to communications and information date back to that period. Laws 22 / 1999 and its successor Law 32 / 2004 set out administrative and functional assignment arrangements for the new decentralization era which commenced from the 1999 law. GR 38 / 2007 provides the detail to the principles set out in Law 32 / 2004 and both of these documents are reviewed in detail, including the outlining of some identified differences and inconsistencies between the two instruments.

GR 38 / 2007 provides that some 6 core functions are exclusive CG responsibilities while a further 31 functions are shared or concurrent functions which all have sub functions and sub sub functions which are assigned in coordinated and shared ways between CG, PGs and LGs respectively. Furthermore, there are some 26 functions which are obligatory for RGs and a further 6 which are optional. This compares to Law 32 / 2004 which provides no list of shared or concurrent functions but does provide (a much) shorter list of 16 obligatory and 6 optional functions which apply to RGs. The function of communications and information does not appear in the obligatory list of Law 32 / 2004 but it does appear in both the shared and obligatory lists of GR 38 / 2007. This chapter concludes by reviewing selected issues in the assignment of functions including issues relating to inconsistencies between Law 32 / 2004 and GR 38 / 2007.

The concepts of norms, standards, procedures and criteria or NSPCs are reviewed in some depth. The NSPC concept is an important approach set out in GR 38 / 2007 aiming to resolve inconsistencies between the decentralization and sector laws and regulations. It is envisaged that most NSPCs will be in the form of MRs. Some of these MRs may already exist and where existing MRs are consistent with the decentralization legal regime (and especially GR 38 / 2007) there is no requirement to replace them. However, where inconsistencies exist, particularly in relation to the assignment of functions between levels of Government, it is envisaged that a series of MRs will be issued to resolve inconsistencies - in most cases in favor of GR 38 / 2007 arrangements - though where the arrangements found in GR 38 / 2007 are found to be inappropriate there may be a need to change this GR over time. DeKominfo currently thinks that around 10 new NSPCs (or MRs) may need to be issued broadly in line with the main sub functions and sub sub functions for which it is responsible under GR 38 / 2007. NSPCs are essentially about policy and its implementation and providing the new NSPCs are well formulated and based on wide consultation, they provide scope for improving policy and its coordinated implementation.

The report provides a profile of DeKominfo and related activities at PG and LG levels. The Province of Yogyakarta and the Kabupaten of Sleman are used for case study purpose. DeKominfo has a wide range of functional responsibilities which are backed by six core laws covering: posts, telecommunications, the press, broadcasting, information and electronic communications; and transparency of public information. These core laws are backed by a large number of GRs, MRs and lower level Ministry legal instruments the details of which are provided. At Provincial and LG levels organizational arrangements are in some sort of flux with reorganization of Communications and Information Units underway following the issue of GR 41 / 2007 setting out guidelines for the organization of RGs. The issue of NSPCs for communications and information provides an opportunity to assist with the structuring of appropriate organizational arrangements at RG levels bearing in mind the new functional roles that the RGs are now expected to play in communications and information.

The heart of the study sets out in the text and a detailed appendix the results of the detailed mapping between GR 38 / 2007 and the 6 main laws (and related regulations) covering communications and information. The results of the mapping are somewhat mixed. In brief: (i) three of the laws (posts, telecommunications; and broadcasting) are somewhat out of date and warrant the issue of NSPCs for many matters under their responsibility; (ii) the law on the press receives very little attention in GR 38 / 2007 and warrants some updating in GR 38 / 2007 as well as an NSPC to clarify arrangements; and (iii) the remaining two laws on information and electronic communications; and transparency of public information are both newly issued in 2008 and while already explicitly recognizing the role of GR 38 / 2007 it will be important that the GRs and MRs currently under preparation below these laws take account of the need for NSPCs that are consistent with GR 38 / 2007.

In the general sense GR 38 / 2007 has broadly followed the existing legal structure and recent CG practices in communications and information and thus itself continues to assign most important policy, regulatory and supervisory roles to the CG with lesser subsidiary roles in implementation, monitoring etc assigned to the RGs. GR 38 / 2007 does not provide for any radical new decentralization of functions in communications and information areas so in that sense the issue of NSPCs may involve updating and tidying up work at the margins rather than involving any revolutionary changes. It is noted that it is not unusual for countries to take strong central approaches to setting national policies in areas such as posts, telecommunications, broadcasting and E commerce. However, it was beyond the scope of the present study to assess whether the assignments contained in GR 38 / 2007 are appropriate in the policy sense – the study's role is confined to mapping for legal consistency.

The report also outlines DeKominfo's progress in preparing NSPCs. Progress to date is relatively slow with no apparent clear strategy on the number and nature of NSPCs that will be prepared, although 3 draft NSPCs were prepared in 2008. While there are a range of options from a single omnibus NSPC through to multiple NSPCs, this report argues that final NSPC numbers might be limited to around 6, broadly covering the same number of core laws currently administered (posts, telecommunications, the press, broadcasting, information and electronic communications; and communications / transparency of public information). By way of example one of the draft NSPCs that has been prepared in DeKominfo is presented in the report. It relates to the dissemination of national information. The NSPC appears to be progressing satisfactorily though some suggestions are provided in relation to it.

8.2.2 MOE Study

This report focuses on a review and analysis of the consistency of: (i) decentralization; and (ii) sector laws and regulations based on a case study of the environmental function. Important background is provided regarding the shift in the legal and institutional framework from the centralized new order period to the current period of significant decentralization in a democratic era. The methods of the study involved: (i) review and mapping of all laws and regulations; (ii) interviews and fieldwork; and (iii) case study in relation to mitigation of natural and environmental disasters.

The report explores the new legal framework for assigning functions between levels of Government. The emerging focal role of the Government and especially MOHA in

designing and implementing the new framework of assignments are outlined as are the evolution from the new order period. Understanding the new order period is important as many current laws and regulations in the environment function were written in this period. Law 32 / 2004 provides the basis for the new functional assignments regime GR 38 / 2007 provides the detail. These two legal instruments are analysed in detail including inconsistencies between the two and current arrangements for the environment function which is a function shared between all levels of Government and an obligatory function for RGs to undertake. Selected issues that might improve the clarity of functional assignments are outlined.

As with the DeKominfo study this report also studies in some detail the meaning and implications of the important concepts of NSPC. In this case the MOE will set out a series of MRs to clarify assignment and other arrangements for setting policy and for managing the environment. However, where there is significant inconsistency between GR 38 / 2007 and higher level laws on the environment it is unlikely that a MR will be able to prevail legally and in such cases changes to laws are still likely to be necessary. As well as detailing requirements for NSPCs the basic hierarchy of laws and regulations in both the new order and current periods are explained in the report.

The heart of the report (including a detailed annex) presents the results of the mapping of existing environmental laws and regulations to GR 38 / 2007. In brief the 2 main laws relating to the environment (Law 23 / 1997 on Environment Management and Law 18 / 2008 on Waste Management) are assessed as broadly consistent with GR 38 / 2007. The 9 main GRs on the environment were also reviewed and in all cases the distribution of authorities between levels of Government appears broadly consistent with GR 38 / 2007. Most of the GRs recognize the supremacy of the CG in setting national policies and standards while frequently providing specific subsidiary roles for PGs and LGs in monitoring, supervision and enforcement. Most of the GRs are nevertheless broad in nature with much of the detail left to lower level Ministerial legal instruments. In many respects it is necessary to go to the lower level MOE Ministerial legal instruments to establish the roles of different levels of Government. Accordingly, some 101 MOE MRs and other legal instruments were reviewed for consistency with GR 38 / 2007. Some 5% of these were assessed as being inconsistent and requiring major revision. A further 15% were assessed as broadly consistent but requiring modest revision. The overwhelming majority (80%) were assessed as being consistent and requiring no particular revision. In a broad sense there is fairly good consistency between the decentralization and sector laws and regulations and updating the framework to provide for full consistency should be a manageable operation from the legal drafting perspective, though achieving broad stakeholder consensus for a policy and administrative regime that is practically capable of being implemented will be far more challenging.

The report sets out the progress made in preparing NSPCs in the MOE. While Ministries potentially have a range of options for presenting their NSPCs from a single omnibus MR up to a large number of distinct and separate MRs, at this stage the MOE has opted for the latter more comprehensive approach with plans to prepare 19 separate NSPC type MRs. These 19 fields of the environment precisely follow the 19 sub sub functions provided for in the environment annex (H) to GR 38 / 2007. This represents an arduous and challenging approach to preparing the NSPCs but if successfully undertaken will also allow at the same time updating of policy, technical, institutional and other arrangements as well as for presentation of narrower aspects of functional assignments.

NSPCs thus have the potential to provide a modern and well coordinated regulatory regime for managing the environment at all levels of Government. Progress to date has been mixed, a small number of the NSPCs have been completed but the majority are still work in progress, with in some cases progress proving very slow.

The report also draws on related work undertaken by TA 7010 analysing the consistency of MOE budget expenditures – particularly deconcentration expenditures in the regions - with GR 38 / 2007. This is an important consideration as many concerns have been expressed that CG Ministries are presenting budgets – and particularly deconcentration budgets - that are not consistent with GR 38 / 2007, with fears that CG continues to undertake activities that are now the rightful responsibility of RGs. These concerns are found to be somewhat overrated at least for the MOE where there is no evidence of significant abuse of deconcentrated expenditures which in the main over the period 2005 to 2008 have been validly related to CG responsibilities under GR 38 / 2007.

There is also provision of a case study of the role of MOE in the mitigation of natural and environmental disasters. A number of problems are highlighted in terms of both vertical assignments (lack of clarity as to the respective roles of the 3 levels of Government) but also importantly in terms of horizontal arrangements at CG levels (there have at times been overlaps and lack of clarity as to the responsibilities of different CG agencies). Lessons learned from the case study include: (i) the need for better legal clarity and coordination amongst levels of Government and Government Agencies; (ii) the need for improved recognition and arrangements that mitigation of disasters needs to be treated as a national concern; and (iii) the need for improved clarification of the roles and authorities of the national Disaster Management Agency (BNPB), including its relationship with MOE. Importantly, the case study indicates that good and consistent laws and regulations will not be enough as these are often not understood or closely followed as environmental disasters emerge.

8.2.3 Some Common Findings of Both Studies

Apart from the abovementioned principal conclusions of both studies which address the TOR, the following important broader findings particularly with regard to institutional and human capacity building approaches can also be recorded commonly for both studies:

- For both functions the roles of RG counterparts are not well defined or resourced. Experts for both the environment and communications / information have campaigned to upgrade the status of their counterpart bodies in the regions. The possibility of upgrading their status is potentially supported by the passing of GR Number 41 / 2007 on the organizational arrangements of RGs, though reorganizations will need to be closely related to proposed NSPCs in both Ministries. One particular issue is that GR 41 / 2007 requires management of regional organizations by clustering (perumpunan) and further work is needed on appropriate structures for particular functions at PG and LG levels;
- Some Departments such as health have infrastructure widely spread throughout the country, much of which is now under RG control (e.g. Puskesmas or Centers of Public Health). Neither MOE or DeKominfo either directly or indirectly has access to such an infrastructure. An important question for both institutions is what regional structure should apply and what should be the Minimum Service Standards (MSS) for institutions in the field?

- Both CG institutions have limited human and financial resources and act principally in providing advice and recommendations to various levels of Government. It is unlikely that either will be able to operate effectively, except with regard to national policy setting, unless better coordinated arrangements are set in place for harnessing the support of RGs, especially with regard to implementation, supervision and monitoring of policies;
- Even though both MOE and DeKominfo already have many laws and legal instruments that might be seen as representing the NSPCs required by GR 38 / 2007 these existing instruments in many cases are not backed by adequate resources and capacities to implement GR 38 / 2007 arrangements either in terms of directly implementing CG assignments or in supporting RGs to undertake matters assigned to them;
- To address uncertain and challenging management and coordination arrangements for expenditure assignments it will be helpful in drafting, socializing and enacting the various MRs / NSPCs that are needed in various fields and subfields, in the years to come, if foreign DPs can provide further TA;
- Extensive consultations such as workshops will be important to allow all stakeholder elements to sit together to determine the real needs of their assigned functions, what are the pressing agendas to be realized, and how problems identified can be solved. The mechanical steps of elaborating and drafting various regulations and legal instruments can flow from this within responsible Ministries and Departments. Broad consultation with other closely related Departments and Ministries is also likely to be needed. Narrow and limited approaches will not provide for effective implementation. There is need for an extensive communications process;
- The Government must eliminate “sector egocentrism” if GR 38 / 2007 is to make all actions of all branches of Government work more effectively through well coordinated and consistent national policies that are also taken up and applied at regional levels in the spirit of decentralization; and
- Underlying institutional inefficiencies exist that may hinder the preparation and use of NSPCs. In both institutions there is frequently a lack of incentives, information; and also a lack of monitoring. There are not sufficiently adequate mechanisms for compelling CG institutions to prepare well researched and appropriate NSPCs nor for Provincial and LGs to abide by them and GR 38 / 2007. Stronger policies and approaches may be needed. Law 32 / 2004 and GR 38 / 2007 themselves may need to be revised to further improve clarity regarding vertical and horizontal bureaucratic coordination. Similarly, CG may need to consider extending powers to PGs to participate more aggressively in the assignment and monitoring of functions at Province wide level, including management of conflict resolution between Kabupatens and Kotas in relation to assignment of responsibilities. Some start has already been made in this direction in GR 38 / 2007 but observations in the field suggest that more reforms are needed.

8.3 *Issues and Lessons*

There was some hope at the start of this study that clear black letter law solutions would be able to easily provide solutions to any legal inconsistencies identified. In some cases as identified in the studies this will be possible. However, in many other cases the issues are not so black and white in nature, for example many of the laws and regulations applicable to the environment and communications / information were prepared prior to 1999 and broadly reflect the heavily centralised and deconcentrated nature of Government at that time. However, such matters are often treated in implicit and subtle ways and it will not be easy to adapt such old legal instruments without completely rewriting them. This is a very major job which may be beyond the capacities of many CG institutions and the Government as a whole.

By the same token at least for the 2 functional areas studied GR 38 / 2007 takes a fairly common approach that the core role of the CG is to set national policies, to regulate national standards etc and to provide overall guidance, supervision and monitoring while the RGs are to be more involved in implementation, regional level monitoring and reporting and so on. This standard model is not unusual in unitary states and will make the enunciation of NSPCs more practically achievable. However, many supporters of decentralization will not like the completely subsidiary roles provided to RGs in relation to policy and standards and this may be a future cause for effectiveness of those NSPCs that are prepared.

The main lessons learned in relation to this output are:

- The matters to be addressed are complex and time consuming in nature and will require a long term concerted approach by relevant Ministries, their RG counterparts and any DPs that decide to support the effort;
- In the case of the 2 institutions studied it would be technically feasible to prepare all the required NSPCs in the space of a year or two providing adequate resources were applied to the task and provided there was strong and meaningful communication with the RGs. It is likely that the issue of a series of MRs in itself will not be enough, there is likely to be a need to change some laws and in some cases to change GR 38 / 2007 itself. The exercise would be helped if the status of GR 38 / 2007 could be upgraded to that of law or preferably have the backing of the Constitution;
- It is noticeable that while the 2 year time target for CG institutions to prepare their NSPCs is rapidly approaching very few institutions have made much progress and even MOE and DeKominfo which are considered to be at the forefront of tryers are likely to take many more years before they reach their objectives for completing NSPCs. Thus while the assignments for a small number of functions may be clarified in the space of a few years many others will remain unclear unless there is a sudden intensification of effort; and
- Recent exercises have been heavily based in MOHA and conducted remotely from planning and budgeting of CG Ministries. Greater involvement of Bappenas and MOF, including leveraged use of budget funding might assist to speed up clarification of their roles and functions not only in relation to their laws and regulations but also in relation to their plans and budgets.

9. Progress in Relation to Output 5 – Strategy for Devolving the Land and Buildings Tax

9.1 Output Objectives and Work Undertaken

The original TA design had the objective of undertaking a study to support planning and legal amendments in relation to the devolution of the property tax from CG to RGs, including support to a broader roadmap for devolution of CG taxes. The main required output was a policy based report.

Work under this output was completed by two consultants: (i) Niniek Gyat; and (ii) Mike McDermott. The main methods adopted were: (i) significant consultation particularly at CG level, but also in 3 pilot RG locations; (ii) development of a data base in relation to the land and buildings tax and the land transfer tax; and (iii) two workshop were held with interested stakeholders to review and revise the study findings.

9.2 Summary of Report Findings

9.2.1 Situation Analysis

The report reviewed tax reform policies, especially devolution of property taxes, which include the land and building tax and the land transfer tax. Based on international experience, most countries assign property taxes to their LGs to some extent. However, if one defines a “purely local” tax as one in which LGs can: (i) decide whether or not to levy the tax; (ii) determine the precise nature of the tax; (iii) establish the base on which to tax individual taxpayers, (iv) determine the tax rate; and (v) enforce the tax - then very few countries have such taxes. Most countries have different functions assigned for different multi-tiers of Governments.

The most common reason for the property tax becoming a local tax is when citizens-voters-consumers residing in a particular political jurisdiction both pay for what they get from the public sector and get what they pay for – that is, benefit from the expenditures financed by the taxes they pay, in a framework of accountability and transparency. Other tax criteria which are important as local taxes are adequacy, equity, and suitability as a local tax (immobility).

Transferring the property tax into a local tax also aims to increase local source revenues. While there is no empirical reason to expect that the property tax can ever fully fund a LGs needs, they can fund a substantial proportion of them – even the majority. This has important relevance to Indonesia, given the very broad assignment of expenditure functions to the LG level. A well balanced tax mix is needed for better utilization of locally owned resources. A consolidation of the general, but qualified, international policy consensus about optimal tax mix is as follows:

- Local taxes should only fund those services that benefit the local community;
- There is no single tax that is ideal or preferred everywhere – indeed, a mix of taxes may be desirable;
- The governing unit that spends the tax dollars should be responsible for raising them, including setting local tax rates;

- Differential tax rates should be used to capture differences in the cost of delivering local services;
- Local tax rates, in general, should not be regulated by higher levels of Government;
- LGs should not overtax businesses as they do in almost every country; and
- Senior Governments must ensure that LGs have the funding tools to ensure fiscal sustainability.

In administering the property tax, there are several critical functions which will determine the results achieved. These functions are: (i) identification of the properties being taxed; (ii) preparation of a tax roll (which contains a description of the property and the amount of assessment) and responding to assessment appeals; and (iii) issuing tax bills, collecting taxes, and dealing with arrears.

Most countries have separate and distinct arrangements for: (i) their property taxes (land and building); and (ii) national resource taxes (for petroleum, minerals, forestry etc). Only a few countries identify national resource taxes as local taxes, with most countries putting them as national taxes which are often shared to local levels. Indonesia is somewhat unique in the intermixing of resource rental taxes with land and property taxes, particularly for the mining (including petroleum), forestry and fisheries sectors. There is a case for separating and redefining the two, with devolution of conventional land and property tax elements while maintaining resource rental royalty type taxes as central taxes which are broadly shared.

High growth in levels of property taxation is associated with economic development (an external factor) and expenditure decentralization (a policy choice). The slow growth in fiscal decentralization is often a primary factor holding back increased reliance on the property tax. Indonesia has experienced rapid decentralization since 2001 but to date more on the expenditure than the revenue side. Additional important growth factors include the availability of other sources of revenue for LGs that might crowd out the property tax, and the Government's lack of success in finding ways to address the difficult administrative problem of valuations. Concerns about the capacity of RGs to handle administration and valuations locally have been important factors in the lack of devolution to date.

The property tax is commonly applied with aims of improving fiscal growth management with tax rates set differently among areas and to address different policy objectives. The purposes can include: (i) increasing competition among regions to enhance local development, (ii) better utilization of land use (for instance, agricultural land), (iii) managing density of an area or zoning; and finally (iv) increasing local revenues.

Based on international experiences, there are five key lessons that Indonesia should be aware of as it moves to devolve the property tax: (i) property tax reform requires strong political and operational support; (ii) property tax reform must be undertaken on a comprehensive basis, integrating policy and administration; (iii) property tax reform must be implemented strategically; (iv) property tax reform must involve a simplification of policy and administration, and (v) property tax reform should effectively utilize computer technology.

Indonesian property tax reform began in 1986 following the enactment of Law 12 / 1985 on Land and Building Tax, which was then revised by Law 12 / 1994. The 1985 Law replaced seven different property-related taxes with a single flat tax of 0.5% of the market value of land and improvements. It eliminated a previous concession for residential property and progressive rates for rural land, and it introduced variable assessment ratios, ranging from 20% to 100%. The new land and building tax broadened the tax base by curtailing exemptions. It also moved from assessment by rental values to capital values. It further introduced a valuation deduction on the building for all properties, thus in effect exempting most rural housing and low value urban structures and making the property tax essentially a land tax in rural and low value urban areas. On the administrative side, strict deadlines and penalties were introduced to ensure timely and accurate property registration and tax payment. The banking sector was assigned responsibility for tax receipt and accounting components of the collection system. The law stipulated a new division of property taxes among the various levels of Government. Further changes in 1994 saw the property valuation deduction extended to land and building values and the assessment ratios changed to 20% or 40% depending on the value of property.

Property tax in Indonesia is currently a CG tax and is administered under the Directorate General of Taxation, Ministry of Finance. The property tax consists of Land and Building Tax and Land Transfer Tax. The land and building tax is divided into five sectors: rural, urban, estates, forestry; and mining.

Although revenues from the land and building and transfer taxes increased by 1,167% percent between 1994 and 2006 (annual compound growth of around 25% p.a.), the performance of land and building taxes, by international standard, was nevertheless not so impressive. Revenues and growth have been dominated by the mining sector, with payers few in number and mainly administered by State Owned Enterprises. In 2005, the mining sector provided more than 74% of the total land and building tax revenues, followed by urban (19.3%), rural (3.4%), estates (2.2%) and forestry (0.9%).

The land and buildings tax as commonly used in other countries focuses on the urban and rural sectors. Annual compound growth from 2003 to 2006 of the urban and rural sectors, have been 17.6% and 10.9% respectively. However, their level as a proportion of GDP remains quite small. From 2003 to 2006 urban taxes averaged around 0.11% of GDP and rural taxes were around 0.02% of GDP. These levels compare to OECD and transitional countries where ratios of property taxes to GDP are around 2.2% and 0.6% respectively.

DKI Jakarta's contribution to the urban sector is the highest, with 38% of the total. The total urban share of Java island is more than 80%. Other Provinces, merged for analysis based on islands, have very low shares. Indonesia is an important case where "the extent to which those Governments have control over property taxes is an important determinant of the extent to which they are able to make autonomous expenditure decisions". Fiscal growth management is essential in places facing enormous urban pressures such as Jakarta. The Jakarta Government is trying to deconcentrate the city – stretch it to the east and the west, keeping the south for water catchment. They need to be able to supply fiscal incentives for this.

The property tax is currently distributed as revenue sharing for Provincial and LGs to assist tackle vertical imbalances. The distribution of shared revenues is regulated by GR 55 / 2005 on Fiscal Balance.

The underdeveloped property market in Indonesia has caused land transfer revenues to remain low in part because most transactions do not report their real values and this indicates a potential revenue loss of land transfer taxes.

9.2.2 Principal Recommendations

(i) Devolution Should Proceed

Based on tax criteria, international experience and the results of this study, the land and building and transfer taxes should be local taxes more than a central tax. The study supports early but orderly devolution of these taxes and has accordingly prepared a broad strategy and roadmap for transferring land and building and transfer taxes into local taxes which is consistent with recent Government and DPR intentions to move towards devolution of the property tax.

(ii) Key Aspects of Finalising Policy and Legal Frameworks

Successful reform will require a comprehensive policy and legal framework. The policy framework for devolution will need to provide appropriate balance between CG direction as set out in guiding laws and regulations and RG policy and management flexibility. Guidance on key policy matters is set out below:

- **The speed of devolution** should be controlled by the CG in consultation with RGs. Matters relating to policy (particularly rate setting), general administration and collections should all be devolved to LGs very quickly. Matters relating to the fiscal cadastre and valuations should be devolved more slowly in line with demonstrated capacities in particular regions;
- **Government intention to initially focus on devolving the urban and rural property taxes are supported, but the estates property tax is also suitable for immediate devolution.** Furthermore, over time mining, forestry and fisheries property taxes should be redefined to separate out resource rental / royalty elements from conventional land and property tax elements. Redefined taxes on land and improvements could be devolved to LGs, while resource rental components of collections could remain as CG taxes for broader distribution;
- **Tax Bands for the Land and Buildings Property Tax** should be set by the CG with flexibility for LGs to set their own rates within legislated bands. Appropriate bands for the medium term would be in the range of 0.1% to 1.00% of full assessed values;
- **Rates for the Land and Buildings Transfer Tax (BPHTB)** which is currently set at 5% of value (minus a threshold) for the buyer should be maintained as a maximum and should be devolved as a LG tax based on derivation. Some flexibility should be given to LGs to progressively scale the rates so flexible bands of between 2% and 5% for the buyers tax might be provided for. The current sharing of some 20% of the BPHTB across all LGs should discontinue. Note that a tax of 5% of value also applies to sellers of property and is recorded as Income Tax by the CG, This practice could remain, especially as there is no capital gains tax in Indonesia;

- **Progressive steps within the approved bands for both the property tax and the transfer tax should be encouraged** by CG but ultimately LGs based on local circumstances should have discretion to determine the progressivity of their tax rates or even to set a single flat rate within the approved bands where considered suitable;
- **Assessed valuation ratios as currently used should be abolished in future** with tax rates applied to the full assessed values of properties not a proportion of them;
- **Tax free thresholds should be kept at low levels to prevent leakages.** Maximum (not minimum) thresholds should be set in the CG legislation but some limited flexibility for LGs to change them over time or to meet particular needs might be built in;
- **Exemptions should also be kept to a minimum to prevent leakages.** The current limited list of exemptions appears broadly appropriate. There should be limited scope for LGs to introduce new exemptions without prior approval of say the Minister of Finance;
- **The CG Collection Fee of 9% appears excessive and should be formally adjusted downwards** to current informal arrangements of 0.9% for the rural tax and 1.8% for the urban tax. The estate taxes fee could be similarly set. Fee levels should be subject to periodical independent review;
- **Where PGs in future take on new roles in assessing property values they should be compensated for this work** in line with fees assessed by independent periodical cost reviews;
- **Current revenue shares of 16.2% to the Provinces (land and buildings) and 16% (Transfers) should be abolished for the urban, rural and estates taxes** but in the immediate term could remain for the mining and forestry property taxes. Further study and modelling during implementation planning should review options for new distribution arrangements of the mining and property taxes between Provinces and other possible compensatory mechanisms to lessen the impact on Provinces losing out;
- **For “worse off” Local Governments** which will lose out because of no longer having access to the 6.5% general sharing of the urban and rural land and buildings tax and the 20% of the transfer tax, there should be further detailed modelling to see if some form of recompense is warranted, perhaps by redesign of sharing of the mining and forestry property taxes. However, a compensation mentality should not be encouraged – emphasis should be on those now collecting low amounts of land and buildings tax collecting more in the future;
- **DAU calculation mechanisms must be structured to provide incentives for LGs to maximize the collections of property taxes.** This requires returning to the use of “revenue capacities” and not “actual revenues” in the DAU formulation;
- **Legal amendments will be needed.** Following finalization of the policy framework related laws and regulations should be amended, including amendments to Law 34 / 2000; Law 12 / 1985 and Law 12 / 1994 on Land and Building Tax; Government Regulation 65 / 2001 on Local Tax; Related Ministerial

Decrees; Law 33 / 2004 on Fiscal Balance between CG and RG (with consequential changes to GR 58/05 and MOHA Regulation 13/06); Law 32/2004 on RG; GR 55/2005 on Balancing Funds; and GR 38/2007 on Division of Authority between Central, Provincial; and Local Governments. Related RG regulations will also need to be prepared for which the CG might prepare a template to guide (not direct) preparation of Provincial and LG regulations.

(iii) Planning for Improved Property Tax Administration at Regional Levels

- Improvement of tax administration at local levels is very important for the transfer of property tax into a local tax to be successful. In fact, this is a pre-condition for the changes. The transfer should be done strategically. An asymmetric approach is proposed with more comprehensive and speedier devolution occurring in locations with the capacity and motivation to proceed quickly, and slower approaches to devolution where such attributes need to be built up over time;
- A very comprehensive approach should be taken to study existing and required business processes and to develop detailed change management and project implementation plans. Planning will need to provide the modalities and time frames for undertaking key aspects of devolution, including: (i) administration; (ii) computerization; (iii) collections; and (iv) valuations. Formulating detailed future roles for the Provinces and LGs will be an important part of the planning work. This work will need to include assessment of organizational and staffing needs in differing locations, with the likelihood that a range of organizational situations will need to be considered, given likely wide differences between regions in the nature and speed of devolution;
- Key areas of tax administration that will need to be addressed during the planning and implementation phases are:
 - Identification of the properties being taxed;
 - Preparation of a tax roll (which contains a description of the property and the amount of assessment) and responding to assessment appeals; and
 - Issuing tax bills, collecting taxes, and dealing with arrears.

(iv) Provide Strong Support to all Aspects of Reform

- Local and PGs should be equipped with adequate human resources and proper infrastructure and systems to support the reforms. Provision of strong supporting arrangements is critical. Proposals covered in the report consist of: (i) capacity building (including institutional and systems aspects), (ii) technical assistance; and (iii) socialization;
- There are other supporting aspects which will over time assist the property market to work more efficiently, including: (i) the existence of a Land Information System, (ii) a developed property market; and (iii) the existence of National Land Policy; and

- Finally, some key performance indicators are provided to enable checking of progress in relation to reform implementation.

9.3 *Issues and Lessons*

While devolution of the property tax has long been a controversial issue particularly for the DG taxation in MOF and the DPR there is a growing consensus on the case for devolution, which is broadly supported by the current study. This support is also reflective of many in the tax policy areas of MOF, Bappenas and MOHA and also has the in principle support of the relevant DPR Commission looking at broader aspects of reform to the law on Regional Taxes and Fees. There are unfortunately risks that the DPR will rise before the 2009 elections without passing the tax reforms that have been agreed in principle.

The main lesson that can be taken from this output is that a well reasoned and feasible framework for devolving the property tax can be put in place and that the next phase must give significant attention to practical issues of implementation. Practical implementation will not be without significant challenges and will take many years to achieve. Providing the legislative reforms are passed it is an areas that warrants significant long term technical support by the ADB and / or other donors, with significant opportunities for reaping positive decentralization outcomes.

10. Progress in Relation to Output 6 – Analysis of Deconcentration Expenditures in the Regions

10.1 Output Objectives and Work Undertaken

The objective set under the original TA design was to undertake a study in 2 ministries and identify key areas for switching deconcentration funds to DAK, leading to at least a 50% switch of appropriate funds from deconcentration to DAK in the 2009 budget compared with actual 2007 levels. Following the inception report it was agreed that reference should be to the 2010 (not 2009) budget and that the 2 ministries for study would be: (i) Ministry of National Education (MONE); and (ii) Ministry of Environment (MOE).

Work under this output was completed by two consultants: (i) Andre Oosterman; and (ii) Riri Mairizal. The main methods adopted were: (i) significant consultation particularly at CG level (MOF, Bappenas, MONE; and MOE); (ii) collection of significant historical fiscal data for the two ministries studied for the period 2005 to 2008; and (iii) a workshop was held with interested stakeholders to review and revise the study findings.

10.2 Summary of Report Findings

The report addressed important policy objectives under LGFGR 2 which aim to reduce levels of CG funding in relation to activities that are legally (in accordance with GR 38 / 2007) the responsibilities of RGs (provinces, kabupaten and kota), in order to provide fiscal space for higher priorities.

The primary objective of the detailed mapping and data analysis that occurred under this study was to verify to what extent CG ministries allocate deconcentrated funds – Dana Dekonsentrasi (deconcentration) and Dana Tugas Pembantuan (co-administration assistance funds) – to finance activities that constitute RG responsibilities, in which case the activities should be financed through the Dana Alokasi Khusus (DAK) mechanism or be withdrawn.

The report contains an assessment of such 'incorrect allocations', as recorded in the revised budgets (APBN-P) of the two pilot ministries, MOE and MONE, during 2005-2008. Based on this assessment the study identified: (i) key areas for switching deconcentrated funds to DAK; (ii) the possibility of at least 50% switch of incorrectly allocated deconcentrated funds to DAK for the 2010 budget compared to 2007 levels.

Findings for the MOE fiscal mapping revealed there were no key areas identified for switching deconcentrated funds to DAK. In 2008, MOE allocated less than US\$ 2 million to deconcentration, to finance 'management of water quality at national and cross boundary levels, which GR 38 / 2007 classifies as a CG responsibility. In addition, Annex H to GR 38 / 2007 lists a series of CG responsibilities for environmental management that could only be efficiently undertaken in collaboration with sub-national government agencies. For these reasons, it is not recommended that GOI further reduce deconcentrated spending on environmental management (from already low levels) to zero.

With regard to the possibility of a 50% switch of incorrect allocations in MOE, the Government already channels a major portion of its sectoral expenditures in the environment through the DAK (over 40% in 2007 and 2008). The impact of a 50% switch in insignificant deconcentrated amounts would therefore have no significant impact on budgeted DAK amounts for MOE.

Findings for the MONE identified key programs for potentially switching deconcentrated funds to DAK. These were: pre-school, basic, secondary and non-formal education. In recent years, the MONE allocated over 95% of its deconcentrated budgets to finance these four programs that Annex A to GR 38 / 2007 clearly identifies as RG responsibilities.

With regard to the possibility of a 50% switch of incorrect allocations in MONE in 2008, a 50% switch would have increased DAK for MONE by about IDR 17.9 trillion, or over 224% of total DAK for the sector in that year.

The main policy recommendations of the study were:

- Recommendation 1 – Review options for elevating Article 20 of GR 38 / 2007 (on the assignment of Government functions) to law. This article states: ‘It is compulsory for all legal provisions directly related to the allocation of responsibilities to be based on and be adjusted to this Government Regulation’. The purpose of this recommendation is to prevent CG ministries from issuing new laws (or continuing to use existing laws) aimed at retaining central control of funds that are incorrectly allocated according to GR 38 / 2007;
- Recommendation #2 – Review options to ensure that DAK may be utilized for the channeling of funds to finance both physical and non-physical development expenditure. This is recommended to avoid requirements that RGs must spend increases in DAK allocations solely on physical activities, for which they may not have the absorptive capacity;
- Recommendation #3 – Given that MOE already allocates its deconcentrated budgets in accordance with GR 38 / 2007, do not prioritize a switch from deconcentrated funds for environmental management to DAK;
- Recommendation #4 – Review and recommend on suitable fund channeling mechanisms for Bantuan Operasional Sekolah (BOS operational assistance to schools) and other activities currently financed from deconcentrated budgets of the MONE, with reference to criteria mentioned in Article 4 of GR 38 / 2007 (externalities, accountability, efficiency, and intergovernmental relationships); and
- Recommendation #5 – Based on the outcome of Recommendation #4, either assign the responsibility for BOS, and other activities currently financed from deconcentrated budgets of the MONE, from LGs to the CG (i.e. review options to revise GR 38 / 2007), or gradually transfer deconcentrated spending on these activities to DAK.

10.3 Issues and Lessons

After some delays in selecting the 2 pilot ministries and gaining access to the fiscal data this study proceeded relatively smoothly without major issues or concerns.

The central lesson is that at CG levels current budget formats provide sufficient information to allow reasonable assessment of the extent to which deconcentrated expenditures are being correctly or incorrectly allocated. The identification of some significant wrongly allocated expenditures in MONE – especially significant spending on BOS by the CG have led many policy makers to respond by indicating that CG responsibility remains appropriate and that it is GR 38 / 2007 which is wrong and should be changed. While significant incorrect areas have been identified it remains to be seen if they will be corrected in the 2010 CG budget.

11. Personnel, Administration and Budget

11.1 Personnel Recruitment and Management

Initial challenges were experienced in identifying and recruiting a full team of 13 individual consultants in a short space of time. At the time of appointment of the Team Leader only one other consultant (the Project Administrator) had been appointed and thus the TA management was asked to play a significant role in the identification and recruitment of consultants.

In TAs of this nature which focus heavily on the use of domestic Indonesian consultants (33 of the 47 months or 70% of total months) there are some advantages to recruiting individuals rather than using a firm. Advantages include: (i) greater speed of action; (ii) more easily able to incorporate the views of the GOI in team composition; and (iii) increased scope to manage consultant inputs flexibly in line with emerging needs of the TA. At the same time there are potential risks to the approach with TA management at times having lesser control over team members with whom they have no contractual relationship whatever – firms who have direct contractual relationships with consultants have better scope to control and discipline them.

Two somewhat new features of personnel recruitment and management that occurred under this TA were as follows:

- Two of the 13 consultants were non Jakarta based (Bandung and Yogyakarta respectively). At times this presented challenges for project management and also the development of strong working relationships with IAs in Jakarta. Offsetting this was the additional insights that location in key regional centres brings and the easier access to views of decentralized RGs. Future use of regionally based consultants could continue to be considered in the future; and
- The TA included intermittent access to an External Advisory Panel (EAP) comprised of 3 very senior Academics who specialize in fiscal decentralization and who also provide high level advisory services to the Government. While the EAP members are busy people and not always readily available they did provide useful connections and helpful peer reviews in relation to a number of the TA components. They also supported a number of the workshops and discussion groups convened by the TA. The EAP experience is worth continued trials in the future.

One challenge that this TA faced which is experienced by most TAs in Indonesia (and elsewhere in the world) is the development of harmonious and effective relationships between consultants and senior level Government officials so that the work of the TA is internalised to fully and seamlessly meet the needs needs of the GOI. Both consultants and the GOI need to continue working hard at identifying suitable tasks for consultants to support and to then work wholeheartedly together as a team to achieve the objectives of the assistance. While not always practically feasible in general it would be beneficial if consultants could be more regularly located within IAs sitting next to their counterparts rather than being remotely located in a TA Office.

Notwithstanding the challenges of identification and recruitment at the outset and the scope for improved bonding between consultants and counterparts the team once fully in place performed broadly satisfactorily and there are no major personnel issues or problems that warrant recording in this report.

11.2 Administrative Arrangements

The TA operated under standard administrative arrangements working through the EA in DG Fiscal Balance of MOF and through IA Directorates in MOF, Bappenas and MOHA. At appropriate times the EA convened group meetings of all IAs to address particular issues. Around 8 of these larger meetings were held through the course of the TA with most of them related to development and monitoring of progress in relation to the LGFGR 2 policy matrix and actions required before Board approval. Much of the activity focused around the ADB missions for: (i) fact finding; (ii) appraisal; and (iii) negotiations.

Managing a TA of this nature cutting across 3 major Ministries (MOF, MOHA; and Bappenas) and three pilot Ministries (MOE, MONE, DeKominfo) as it did is no easy coordination or management task, yet at most time the work and decision making proceeded smoothly. Credit in this regard must go to the efficient and supportive operations of the EA, Professor Heru Subiyantoro and his two main MOF, DG Fiscal Balance support staff for TA management namely, Ibu Enny Murniasih and Bp. Denny Kurniawan. All IAs in MOF, MOHA and Bappenas are also to be commended for their efficient support and participation in the work of the TA.

Office space and other facilities provided by DG Fiscal Balance were more than adequate for the needs of the TA and the support provided is appreciated. All significant equipment purchased by the TA (as recorded in Annex 1) has been handed over to the EA.

Administrative arrangements and coordination with the ADB worked very smoothly throughout the course of the TA with very efficient arrangements in place for financially and administratively supporting the general operations of the TA as well as for the funding of special events, especially workshops and the training visit to Georgia State University by a party of Government Officials. The flexibility afforded by ADB in the management of the TA was appreciated.

11.3 Budget Management

Table 11.1 provides a summary of commitments and expenditure to date in relation to the originally approved budget. Because the TA was very active almost all approved funds of US \$ 700,000 have now been fully committed and by the time all disbursement are fully recorded it is expected there will be final expenditures at levels very close to the approved amount of \$ 700,000. The ADB will provide the EA with a full and final statement of all actual expenditures once remaining limited activity under the TA is concluded and all expenditures are brought to account.

Using the commitments data the main variations in relation to the originally approved budget were:

- Relatively minor overexpenditures in relation to: international consultants;

- Relatively modest (to more significant) underexpenditures in relation to: (i) national consultants; (ii) international and domestic travel; (iii) reports and communications; (iv) equipment; (v) miscellaneous administration and support; and (vi) contingencies; and
- Relatively significant overexpenditures in relation to training, seminars and conferences.

The main pattern in variations was lower than originally budgeted administrative and running costs of the TA, with the great bulk of savings achieved channeled into training, seminars and conferences. This shift in resources was supported by the EA and consistent with its stated policy wishes in the management of TA resources.

Table 11.1: ADB TA 7010 – Commitments and Expenditure to 15 February 2009

Item	Original Approval	Committed	Disbursed ⁶
1. Consultants			
1.a Total Consultant Remuneration / per diems	480,000	535,332	430,992
(i) International Consultants	(315,000)	(386,205)	(328,690)
(ii) National Consultants	(165,000)	(149,127)	(102,302)
1.b International / Domestic Travel	58,600	42,327	29,493
1.c Reports and Communications	8,400	8,291	3,970
2. Equipment	12,000	9,016	8,294
3. Training, Seminars / Conferences	30,000	79,326	52,182
4. Miscellaneous Admin and Support	31,000	14,915	13,730
5. Contingency	80,000	7,752	-
Total	700,000	696,959	538,661

⁶ Disbursements include advances made to the TA / EA which were not yet fully spent as at 31 December [held in trust for future spending].

12. Summary of Lessons Learned

12.1 LGFGR 1 and NAPFD

- Speeding up progress with implementation of the investment loan under LGFGR 1 is an important issue for GOI and ADB to address as it can help guide future capacity building planning and efforts;
- Ongoing technical support to the preparation of an updated NAPFD, 2010 – 2014 is important;
- The design of LGFGR 2 with 2 sub programs covering an extended medium term period of 6 years will be supportive of medium term continuity and consistency, which is desirable, both with regard to actions and personnel;
- The NAPFD provides a useful medium term guide for both the GOI and DPs, but needs more effort from all stakeholders for it to become the universally accepted plan to harmonize efforts in fiscal decentralization reform; and
- Enhanced efforts are needed on the part of DPs to better harmonize their efforts in the field of fiscal decentralization reform and strengthening (hopefully under a widely supported NAPFD).

12.2 Development of Policy Matrix

- The existence of a GOI accepted medium term framework for policy actions (the NAPFD) greatly assisted the development of the LGFGR 2 policy matrix;
- The planned update of NAPFD 2010 to 2014 should take into account proposed actions under Subprogram 2 of LGFGR 2 (2009 to 2011) and vice versa the Subprogram 2 matrix should flexibly consider content of the new NAPFD; and
- Broad consultation, strong leadership on the GOI side and reasoned flexibility on the part of ADB Staff leadership all contributed to the emergence of broad consensus on what was practical and feasible, but also meaningful.

12.3 Fragmentation of RGs

- Issues underlying the pemekaran debate are amongst the most complex and difficult that any government confronts. Not surprisingly a clear consensus on the content of a grand strategy paper is still in all likelihood some time off;
- Significant patience and enduring on the ground consultation and involvement is needed if DP efforts are to make a significant contribution to the nature of the final grand strategy paper developed; and

- Short one off policy studies do provide the opportunity to inject fresh (and at times conflicting) information to the ongoing debate. However, without a sustained on the ground presence it will be difficult to develop a consensus amongst the at times unwieldy stakeholders as to the policy road forward.

12.4 Consistency of Sector and Decentralization Laws and Regulations

- The issues in clarifying functional assignments are complex and not all can be solved by simple black letter law;
- The standard model applied by GR 38 / 2007 is for the CG is to set national policies, national standards etc and to provide national supervision with the RGs more involved in implementation, regional level monitoring and reporting etc. This model makes the enunciation of NSPCs more practically achievable at least in the 2 pilot GG institutions studied;
- Preparation of effective NSPCs will be complex and time consuming and will require a long term concerted approach by relevant Ministries, their RG counterparts and any DPs that decide to support the effort;
- It is likely that the issue of a series of MRs (as NSPCs) will not be enough, there is likely to be a need to change some laws and in some cases GR 38 / 2007 itself. The exercise would be helped if the status of GR 38 / 2007 could be upgraded to that of organic law or preferably to have backing of the Constitution;
- After almost 2 year very few institutions have made much progress and even MOE and DeKominfo which are at the forefront of tryers are likely to take many more years before they reach their objectives for completing NSPCs. While assignments for a small number of functions may be clarified in a few years many others will remain unclear without a sudden intensification of effort; and
- Recent work has been based in MOHA and remote from planning and budgeting of CG Ministries. Greater involvement of Bappenas and MOF, including leveraged use of budget funding might speed up clarification of functions not only in relation to laws and regulations but also in relation to their plans and budgets.

12.5 Devolution of the Property Tax

- There is a growing consensus on the case for devolution as supported by the current study. However, there are risks that the DPR will rise for the 2009 elections without passing property tax reforms agreed in principle;
- A well reasoned and workable framework for devolving the property tax can be put in place along the lines proposed in this study;

- The next phase should give significant attention to practical issues of implementation which will involve significant challenges and will take many years to achieve; and
- Providing legislative reforms are passed this is an areas that warrants significant long term technical (and perhaps capital funding) support by the ADB and / or other DPs, with significant scope for reaping positive decentralization outcomes.

12.6 Analysis of Deconcentration Expenditures

- At CG levels current budget formats provide sufficient information to allow reasonable assessment of the extent to which deconcentrated expenditures are being correctly or incorrectly allocated;
- The identification of significant wrongly allocated expenditures in MONE – especially on BOS has led many policy makers to respond by indicating that CG responsibilities remain appropriate and that it is GR 38 / 2007 which is should be changed; and
- While incorrect allocations have been identified it remains to be seen if they will be corrected in the 2010 CG budget.

12.7 Personnel, Administration and Budget Matters

- There are both advantages (speed, flexibility and Government ownership) and risks (blurred lines of management control) to employing relatively large TA teams on an individual basis;
- Use of non Jakarta based consultants can work well providing arrangements are output focused and provide for adequate consultation with Jakarta based clients;
- The role of the External Advisory Panel warrants further trialling in similar policy based TAs;
- A key challenge is ongoing development of more effective relationships between consultants and GOI officials so the work of TAs is internalised to meet the needs of the GOI. This partly involves better identification and design of suitable tasks;
- Where practically feasible consultants should be more regularly located within IAs sitting next to counterparts rather than being remotely located in a TA Office; and
- Many in the GOI continue to favor enhanced use of TA resources to provide training and development opportunities for permanent public service staff as distinct from simply employing consultants. Some movement in this direction occurred under the current TA and there is scope for further intensifying efforts here in the future.

13. Conclusions

This final report at the moment mainly represents the views of the TA management team. ADB and the EA should consider conducting their own independent evaluation of TA performance through the planned final tri partite meeting and using other evaluation techniques, following which this report could be revised if found necessary.

In terms of the originally designed impact, outcomes and outputs the TA was supposed to achieve the TA is rated overall as being quite successful based on the more detailed analysis contained in the text, summarized briefly as follows:

- **Longer Term Impact.** Policies and processes adopted by both TA 7010 and the LGFGR 2 program have firmly addressed to the longer term impact objectives and targets set and should over time make strong contributions to their attainment;
- **Outcomes.** The work of TA 7010 has been unambiguously positive in relation to the originally intended outcomes. Mapping of progress under LGFGR 1 and a stocktake of NAPFD progress occurred satisfactorily and a policy matrix for LGFGR 2 (Subprograms 1 and 2) was prepared and agreed by ADB and GOI. All agreed policy actions and legal reforms were completed in time for the LGFGR 2 program loan to be approved and disbursed in December 2008. A detailed policy framework for Subprogram 2 covering the period 2009 to 2011 is also in place;
- **Outputs.** The required quantity of outputs have been delivered in less elapsed time than was originally designed and within the unit costs provided for in the budget. Questions of quality of TA outputs are more difficult to come to grips with, involving broader issues, including: (i) effectiveness of engagement; (ii) the extent of GOI takeup in policies and practices; and (iii) the extent to which GOI systems, institutional and human capacities have been strengthened. Assessment of the quality of TA outputs has been assisted by the External Advisory Panel and strong internal peer review processes. Nevertheless quality needs where possible to be independently assessed by the ADB, the EA and IAs of the different output components. The TAs own assessment has been that quality of the main outputs produced has been sound and the team takes heart from the conclusion that the main outcomes sought for the TA were fully and quite successfully achieved. It is unlikely that the outcomes would have been so successfully achieved without reasonable quality having been achieved with regard to the main outputs.

Finally, it is restated that the policy matrix developed was very broad and comprehensive in nature and involved very many policy actions beyond the 4 technical output areas on which much of the TA technical work was focused. While the TA did support completion and verification of a number of policy matrix areas beyond its 4 core professional output areas, it is clear that the majority of actions completed under Subprogram 1 of LGFGR 2 (over the period 2006 to 2008) were completed independently by many different Government Officials, the strong involvement of whom must be applauded and seen as an important plus for the LGFGR 2 program moving forward.

Annex 1 – List of Consultants by Output

Output Position / Actual Months	Consultant
1. Adviser / Team Leader – International – 8.6 months	James Lamont
2. Project Administrator – Domestic - 5 months	Riri Mairizal
3. Fiscal Decent. Expert – Policy Matrix / Sector Review - International - 0.5 months	Jorge Martinez
4. Expert in: (a) Fiscal Decentralization – Policy Matrix / Sector Review – Statistics; and (b) Data Analysis of Decon / DAK in Education and Environment Ministries International 3 months in total	André Oosterman
5. Fiscal Decentralization Expert – NAPFD Update – Domestic - 4 months	Khoirunurofik
6. Expert in Optimal Size of Local Governments – International - 2 months	Jorge Martinez
7. Expert in Optimal Size of Local Governments – Domestic – 6 months	Handry Irmansyah
8. Property Tax Expert – International - 2 months	Mike McDermott
9. Property Tax Expert – Domestic – 5 months	Niniek L. Gyat
10. Expert to Review Sector Laws / Regulations – Domestic – 4.75 months	Wihana Kirana
11. Expert in Review / Amend Sector Laws/ Regulations – Domestic – 4.75 months	Rusadi Kantaprawira
12. Expert in Data Analysis of Decon / DAK in Education and Environment Ministries – Domestic 4 months	Riri Mairizal
13. Consultant on External Advisory Panel (Domestic) – 1.5 months	Bambang Brodjonegoro
14. Consultant on External Advisory Panel (Domestic) – 1.5 months	Robert Simanjuntak
15. Consultant on External Advisory Panel - Domestic – 1.5 months	Raksaka Mahi

Annex 2 – List of Major Reports Prepared⁷

English Language Only⁸

1. ADB, LGFBR 2 Policy Matrix, October 2008.

English and Indonesian Languages

1. ADB TA 7010, *TA Inception Report*, March 2008.
2. ADB TA 7010, *Review of Progress in Implementing the National Action Plan for Fiscal Decentralization, 2005-2009*, November 2008.
3. ADB TA 7010, *Strategy and Roadmap for Devolving the Property Tax in Indonesia*, December 2008.
4. ADB TA 7010, *Central Government Spending in the Regions: An Analysis of Deconcentrated Spending by the Ministries of Environment and National Education*, December 2008.
5. ADB TA 7010, *Understanding Sub-national Government Fragmentation in Indonesia and Options for Reform: Background for a “Grand Strategy” for Pemekaran*, February 2009.
6. ADB TA 7010, *Review of Consistency of Decentralization and Sector Laws and Regulations – Case Study of Communications and Information*, February 2009.
7. ADB TA 7010, *Review of Consistency of Decentralization and Sector Laws and Regulations – Case Study of Environment*, February 2009.
8. ADB TA 7010, *TA Final Report*, February 2009

⁷ All reports listed here are available on a CD which is to be distributed to ADB, the EA in MOF and all IAs. Additional copies of the CD can be obtained from the EA in MOF.

⁸ The two “English only” documents above are ADB and not ADB TA 7010 prepared documents. Their preparation was supported by inputs from ADB TA 7010.

Annex 3 – LGFGR 2 Policy Matrix

Objective	Subprogram 1 Actions Taken/ Results Achieved (Core Prior Actions in Bold) 2006-2008	Subprogram 2 Milestones and Triggers (Triggers in Bold) 2009-2011	Expected Results
1. DECENTRALIZATION FRAMEWORK AND PROGRAM MANAGEMENT: Strengthening management and coordination of fiscal decentralization matters			
1.1 Ensure continued implementation of medium and long term decentralization agenda	a. NAPFD 2005-09 updated with options for revisions in the policy actions for the medium term reviewed	a. Revised version of NAPFD issued covering the medium term 2010 to 2014 and continues to be regularly reviewed to monitor progress	• Consistent medium and longer term plans lead to improved outcomes for fiscal decentralization
	b. Draft Grand Strategy Document setting long term direction for fiscal decentralization prepared under leadership of Minister of Finance	b. Grand Strategy Document finalized and used to set long term directions for fiscal decentralization	
1.2 Streamline and strengthen coordination functions of relevant national government agencies	a. New Directorate General of Fiscal Balance established in MOF to provide leadership in the development of fiscal and governance aspects of decentralization	a. DG Fiscal Balance MOF continues program leadership, including regular consultations with all stakeholders and transparent circulation of fiscal decentralization information on a regular basis, including a comprehensive annual report	• Improvement in coordination of decentralization matters with enhanced quantity and quality of advice to the President
	b. Technical capacity development of DPOD Secretariat commenced with preparation of a Capacity Development Report and a two year training plan covering administrative, management and policy coordination strengthening for DPOD	b. Options for strengthening DPOD reviewed, capacity building plan for DPOD Secretariat finalized and implemented with marked growth in training and development opportunities for staff	
		c. Board, technical team and working groups of DPOD meet (at least 4 annual meetings of Board and Technical Team) with increased flow of recommendations to President	
2. REGIONAL AUTONOMY AND LOCAL GOVERNANCE: Clarifying arrangements for regional administration to improve services and accountability			
2.1 Improve policy and legal framework to rationalize number	a. Government Regulation 78/07 enacted defining the criterion for establishment, splitting and merging of Regional Governments	a. Processing of applications for new regions occurs strictly in line with the new policy and regulatory regime	• Clear policies and procedures in place for considering claims for new

Objective	Subprogram 1 Actions Taken/ Results Achieved (Core Prior Actions in Bold) 2006-2008	Subprogram 2 Milestones and Triggers (Triggers in Bold) 2009-2011	Expected Results
of Regional Governments so increase efficiency while still providing for local representation	b. Government Regulation 6/08 on evaluating performance of Regional Governments (including in relation to new establishment and merger) passed	b. 75% of related DPR Commission members and 25% of staff from relevant departments trained on new policies and legal framework	Regions
	c. Work has started on Draft Grand Strategy Paper on Territorial Subdivision by MOHA	c. Grand Strategy Paper on Pemekaran (Territorial Subdivision) finalized along with any consequential legal instruments	
2.2 Increase clarity in the intermediate roles of Provinces and Governors	a. Draft Government Regulation prepared to clarify the intermediate role of Provinces and Governors as part of review of Law 32/04 on Regional Administration	a. Law 32/04 amended clarifying role of Province and Governor	• Removal of overlaps and inefficiencies between levels of Government
		b. Consequential amendments to lower Regulations passed in support of Law 32/04 changes with implementation of new arrangements	
2.3 Reform of decentralized civil service arrangements to enhance flexibility and to shift resources to more productive activities	a. Government Regulation 41/2007 on regional organizational structures passed setting guidelines for the organizational structuring of Regional Governments	a. Basic (staffing) allocation delinked from DAU imparting flexibility to Regional Government staffing	• More productive resource allocation by Regional Governments leading to improved efficiency and enhanced impacts from Regional Government outlays
	b. Review of options for delinking the basic (staffing) allocation from the DAU in support of more flexible staffing and organizational arrangements begun in the regions	b. Performance incentives tested with system of intergovernmental financing transfers to stimulate reductions in administrative costs and switching to higher priorities	
2.4 Improve clarity of expenditure assignments and service responsibilities across levels of Government to improve efficiency and equity of expenditures	a. Government Regulation 38/2007 on assignment of expenditures among government tiers passed	a. Framework for addressing inconsistencies finalized with implementation commenced	• Enhanced clarity of expenditure assignments improves capacities to have money follow function thus improving vertical balance in the system of intergovernmental financing
	b. Study to identify inconsistencies between Regulation 38/2007 and sector Laws started and strategy to rectify inconsistencies being developed	b. Further refinements to Law 32/2004 and Reg. 38/2007 or a Presidential Regulation passed to further clarify assignments	
	c. Detailed review of inconsistencies in 2 pilot Ministries (Environment and Communications) started and draft report and legal amendments being prepared	c. At least 85% of Ministries have undertaken reviews and prepared draft amendments to Sector Laws/ Regulations to make them consistent with Regulation 38/2007	

Objective	Subprogram 1 Actions Taken/ Results Achieved (Core Prior Actions in Bold) 2006-2008	Subprogram 2 Milestones and Triggers (Triggers in Bold) 2009-2011	Expected Results
3. INTERGOVERNMENTAL FISCAL SYSTEM: Enhancing equalization, predictability and transparency in release of fiscal transfers and shared revenues			
3.1 Improve equalization and transparency of the DAU which is the major transfer mechanism used in the Indonesian system of intergovernmental financing	<p>a. Review of options for the DAU basic allocation/links to regional wages completed with a view to removing perverse incentives to employ excessive staff in the regions and to free up more funds for distribution on an equalization basis</p> <p>b. Hold harmless clause in DAU formulation which favors better off regions removed significantly enhancing the equalization effects of the DAU with additional resources flowing to Regional Governments that are less well off</p> <p>c. DAU formula reviewed in 2008 to improve equalization including: (i) disparities in tax bases, (ii) inclusion of all revenue sources, (iii) definitions and indicators of expenditure needs</p> <p>d. Latest formulae and weights for fiscal capacities and needs published in 2008 budget documents</p>	<p>a. Develop the legal basis to implement delinking of wage payments for the DAU providing an environment for flexible management of regional staffing levels without limiting access to the DAU which will have more funds available for distribution on an equalization basis</p> <p>b. Negative incentives associated with DAU like the adjustment fund removed</p> <p>c. Regular review of DAU formula made part of long term capacity building of DG Fiscal Balance in MOF</p> <p>d. Budget documents publish annually the latest formulae and weights used</p>	<ul style="list-style-type: none"> • More rational resource allocation and improvements in horizontal equity over time through provision of additional funds for allocation on an equalization basis
3.2 Make provision for forward estimates of major transfers to enhance capacities for medium term planning and budgeting	<p>a. Preliminary design work on preparing and publishing forward estimates for all major Government transfers to the regions completed as part of broader Central Government movement to the MTEF system</p>	<p>a. System of forward estimates fully designed and incorporated into budget and financial management information systems</p> <p>b. Forward estimates progressively prepared and published for all major transfers/shared revenues following further empirical studies</p>	<ul style="list-style-type: none"> • Improved medium term planning and budgeting at regional levels leading to higher impacts on service delivery performance
3.3 Gradually reduce levels of Central Government funding in relation	<p>a. Government Regulation 7/2008 sets out guidelines for managing deconcentrated expenditure (Dekon)</p> <p>b. Savings of Rp 4.2 trillion in incorrect allocation</p>	<p>a. At least a 50% reduction in incorrect Dekon expenditure identified in the two pilot Ministries studied under Subprogram 1</p> <p>b. Continuing ongoing analysis of Dekon reduction</p>	<ul style="list-style-type: none"> • Improvement in resource allocation with freed up resources from the Central Government budget

Objective	Subprogram 1 Actions Taken/ Results Achieved (Core Prior Actions in Bold) 2006-2008	Subprogram 2 Milestones and Triggers (Triggers in Bold) 2009-2011	Expected Results
<p>to activities that are legally Regional Government responsibilities, so as to provide space for higher priorities</p>	<p>of central government funds for financing of regional government responsibilities in the 2008 budget for health, education and public infrastructure</p>	<p>options in the context of preparing annual budgets, leading to consistent documented reductions over time across remaining Ministries</p>	<p>available for higher priorities in Regional Governments</p>
	<p>c. Detailed mapping and data analysis undertaken in two pilot Ministries (Environment and Education) with draft paper and recommendations on further reductions in incorrect allocation of funds to these Central Government Ministries for financing related to Regional Government responsibilities prepared for the 2010 budget</p>		
<p>3.4 Improve design and management of DAK funding allowing improved targeting of investment expenditure to priority sectors in the regions</p>	<p>a. DAK increased by 24 percent in 2008 budget to IDR 21 trillion mainly targeting health, education and infrastructure sectors</p> <p>b. Joint Ministerial letter (MOF, MOHA, Bappenas) signed on strengthened monitoring and evaluation of the DAK</p> <p>c. Work on update of MOF guidelines on DAK framework and guidelines undertaken by line ministries including consideration of Joint Ministerial Letter on DAK preparation, monitoring and evaluation</p>	<p>a. Guidelines prepared, socialized and widely used on the use, supervision and monitoring of DAK transfers with focus on 9 key Central Ministries</p> <p>b. Performance evaluation studies show evidence of improved targeting of priority sectors in DAK transfers</p>	<ul style="list-style-type: none"> • Increase in well targeted investment expenditure in the regions supporting improved service delivery
<p>3.5 Trial performance and sanctions based elements of transfers</p>	<p>a. Strategy paper prepared on concepts for increased use of performance incentives and sanctions regarding transfers (e.g. timely budgets and reporting, reducing administrative outlays, better resource allocation)</p> <p>b. The paper in 3.5 (a) to include coverage of mechanisms for implementing sanctions where they already legally exist, e.g. timely reporting, repayment of debts</p>	<p>a. Implemented agreed new incentives/ sanctions on a trial basis initially</p> <p>b. Fully implement sanctions which already exist by law, including in relation to timely submission of budgets and SIKD information and for the intercept of transfer funds to repay central debts</p>	<ul style="list-style-type: none"> • Improvement in regional financial management and performance
<p>3.6 Ensure smooth cash releases of</p>	<p>a. MOF Decrees 142/2006 (Natural Resource Revenue) and 217/2007 (Oil Revenue – Aceh</p>	<p>a. Ongoing empirical reviews confirm that funds continue to flow to all Regional Governments</p>	<ul style="list-style-type: none"> • Improved budget

Objective	Subprogram 1 Actions Taken/ Results Achieved (Core Prior Actions in Bold) 2006-2008	Subprogram 2 Milestones and Triggers (Triggers in Bold) 2009-2011	Expected Results
shared revenue transfers to address delays and unevenness in Regional Government budgeting	Province) passed to provide basis for smooth and timely flows of shared revenues	timely and in predictable ways	execution by Regional Governments with enhanced scope for improvements in investment outlays
	b. Timely and predictable flow of funds to Regional Governments achieved in 2008 as required by the law		
4. OWN SOURCE REVENUES: Reducing dependency on fiscal transfers by developing more buoyant sources of local revenues			
4.1 Amend Law 34/00 on Regional Taxes and Charges	a. Amendments to Law 34/2000 under consideration by the Parliament including movement to a closed list approach for regional taxes and devolution of property tax	a. Disseminate and implement 2008 amendments to Law 34/2000	<ul style="list-style-type: none"> • More efficient tax system supports investment and growth
		b. Review Law 34/2000 for further amendments in line with the roadmap for reform	
4.2 Implement computerized system in MOF for receiving and processing regional tax laws	a. Finalize design and procurement and commence development of the new system	a. Fully implement the new computerized system leading to large declines in backlogs in processing regional taxes (50% of end 2008 backlog removed and 2008 processing times cut by 50%)	<ul style="list-style-type: none"> • Streamlined system for central MoF review of new regional taxes
4.3 Develop a medium term roadmap for decentralized tax reform	a. Include in the Draft Grand Strategy for Fiscal Decentralization medium to longer term directions in relation to taxes and charges policies for decentralized locations	a. Have the road map formally approved and incorporated into the NAPFD and Grand Strategy for Fiscal Decentralization Papers	<ul style="list-style-type: none"> • Clear roadmap of medium term direction in tax and charges policies for the regions
		b. Publish an annual review reporting on progress in implementing the reforms identified in the roadmap	
4.4 Gradually devolve the property tax to the regions	a. Strategy paper develops draft proposals and draft legal amendments to gradually decentralize the property tax	a. Make amendments to Laws and commence gradual implementation of devolving the property tax, including review of the proportion of valued assessments actually charged	<ul style="list-style-type: none"> • Increased property tax collections
5. REGIONAL RESERVES AND DEBTS: Strengthening management of regional reserves and debts			
5.1 Improve monito-	a. MOF monitors the accumulation of financial	a. Improved systems in place for monitoring	<ul style="list-style-type: none"> • Improved resource

Objective	Subprogram 1 Actions Taken/ Results Achieved (Core Prior Actions in Bold) 2006-2008	Subprogram 2 Milestones and Triggers (Triggers in Bold) 2009-2011	Expected Results
ring and analysis of reserves accumulation in all locations and develop policy responses to recent high growth in reserves	reserves by Regional Governments through BI b. MOF developing a concept paper setting out approaches to developing long term trust fund arrangements for supporting future generations, especially in wealthier regions	accumulation of financial reserves b. Pilot implementation of long term trust fund approaches in at least two Provinces and four Local Governments	allocation and long term saving mechanisms for wealthier regions
5.2 Develop improved data systems for monitoring sub national debt	a. MOF Decree 45/2006 passed that sets out requirements/ guidelines for publishing Regional Government debts b. MOF Treasury constructs and uses a computerized Debt Management and Financial Accounting System (DMFAS) for regional debt management	a. Comprehensive information on Regional Government debt is available on web and transparently published in line with MOF decree 45/2006 b. DMFAS fully operational and providing useful data for a comprehensive analysis of regional debt	<ul style="list-style-type: none"> Improved information on regional debt stimulates policies to eliminate Regional Government debt arrears
5.3 Pursue effective restructuring of PDAM debts to improve the climate for new investment in water supply facilities	a. New MOF Decree 120/2008 further streamlining applications procedures with generous debt rescheduling passed to encourage speedier restructuring of PDAM debts b. Under the new Decree MOF has entered into discussions / dissemination with all 175 Regional Governments and PDAMs with arrears as part of ongoing technical support to facilitate participation of all PDAMs with arrears in the new restructuring scheme	a. All available debt recovery and write off mechanisms used to support rescheduling/repayment of PDAM debts b. Minimum of 85% of PDAM non-performing debts restructured or rescheduled and paying on time in relation to new agreed arrangements	<ul style="list-style-type: none"> Renewed investment and improved service delivery by PDAMs, particularly for water supply
5.4 Finalize MOF Decree providing for use of DBH/ DAU intercept mechanisms to repay debts and implement	a. Working Group has prepared a new MOF Decree on mechanisms to allow recouping of arrears by intercepting DAU and DBH payments b. Draft MOF Decree on intercept mechanisms finalized	a. MOF Decree on intercept mechanisms implemented in at least 85% of Regional Governments with arrears at end 2008 b. Arrears in 85% of Regional Governments fall in line with scheduled intercept arrangements	<ul style="list-style-type: none"> Increase in access of Regional Governments to long term investment financing following removal of longstanding arrears constraints

Objective	Subprogram 1 Actions Taken/ Results Achieved (Core Prior Actions in Bold) 2006-2008	Subprogram 2 Milestones and Triggers (Triggers in Bold) 2009-2011	Expected Results
5.5 Support development of sub national bond market including enhanced support in selected pilot locations	a. MOF Decree 147/2006 issued to provide authority and guidelines for issuing Regional Government bonds	a. Central Government supports five pilot creditworthy Regional Governments to develop regional bond raisings (including training, due diligence studies, document preparation, generation of private credit ratings, and regulatory regime to deal with defaults and bankruptcies)	<ul style="list-style-type: none"> • Increase in access of Regional Governments to long term investment financing for infrastructure
	b. Initial dissemination and training in relation to the new regime for bond raising proceeds		
6. CAPACITY DEVELOPMENT, PUBLIC FINANCIAL MANAGEMENT AND ACCOUNTABILITY: Developing human and systems capacities and strengthening public financial management and accountability			
6.1 Enhanced involvement at Presidential level to improve funding and coordination of central and donor efforts to develop and rollout resources to support greatly needed human and systems capacity building in the regions	a. Team established in MOHA to prepare a Presidential Regulation on capacity building to improve coordination of Central Government and donor efforts in capacity building	a. Implement relevant parts of Presidential Regulation to improve capacities for PFM in the Regional Governments by improved coordination, management and resourcing of capacity building	<ul style="list-style-type: none"> • Elevating capacity building to the Presidential level raises the scope for strengthened human and systems capacities and improved PFM performance
	b. Draft Presidential Regulation on Capacity Building under preparation by MOHA to support capacity building for decentralization and Regional Governments		
6.2 Develop comprehensive plan to support implementation of the newly reformed PFM regulatory regime in Regional Governments	a. MOHA Regulations 13/2006 and 59/2007 and related MOF and Bappenas Regulations issued which provide a clear framework for PFM reform.	a. GOI commits for 3 years to provide annual growth of at least 25% in funding through MOHA and MOF (compared to actual 2008 levels) to support training for human resources and systems development in Regional Governments, including central training materials preparation	<ul style="list-style-type: none"> • Improved PFM system in place backed by a comprehensive capacity building plan leading to better PFM, resource allocation and accountability
	b. Initial central manuals and training materials developed to support socialization in the regions.	b. Regional training plan for subprogram 2 fully implemented with access to training and capacity development initiatives for all Regional	

Objective	Subprogram 1 Actions Taken/ Results Achieved (Core Prior Actions in Bold) 2006-2008	Subprogram 2 Milestones and Triggers (Triggers in Bold) 2009-2011	Expected Results
	<p>c. MOHA provided training to 100 central government and 400 Regional Government officials in PFM in 2007. MOF provided training to 1,528 RG Officials in PFM through Regional Universities in 8 different locations in 2007.</p> <p>d. Computerized FMIS designed to support rollout of new PFM systems in 171 Regional Governments with training planned for 9,642 officials; 648 have already been trained up to July 2008</p> <p>e. Joint MOF and MOHA plan of action being prepared to intensify PFM training of new PFM approaches during Subprogram 2 with access to all Regional Governments and with participation of DPs.</p> <p>f. DG Treasury, MOF designed (in the form of a detailed draft Regulation to be submitted to MENPAN) a certification system for new functional positions for key Government finance officials, including those based in the regions such as the regional treasury offices throughout the country.</p>	<p>Governments</p> <p>c. Computerized FMIS implemented and fully functional in 171 regional locations with software made available free for expansion to remaining interested Regional Governments</p> <p>d. Planned training for 9,642 officials in FMIS usage completed and further training provided for Officials in RGs where expansion beyond the initial 171 locations occurs</p> <p>e. Finalize Regulations and implement scheme for new functional positions certification for key financial officials</p>	
<p>6.3 Improve systems and coordination in collection and analysis of regional financial data</p>	<p>a. Framework developed by MOHA and MOF for improved coordination in the collection and analysis of regional financial data (especially between MOF, MOHA, and BPS)</p> <p>b. Computerized SIKD designed to support rollout of new SIKD information collection and transmission systems in 171 locations to comply with regional financial reporting requirements</p>	<p>a. Improved coordination framework reduces overlaps in the need for financial reporting to multiple agencies by Regional Governments</p> <p>b. Computerized SIKD information collection and transmission system fully functioning in 171 locations and in MOF with software made available free for expansion to remaining interested Regional Governments</p> <p>c. Time delays in publishing consolidated Regional Government information</p>	<ul style="list-style-type: none"> • Improved and more timely access to Regional Government and nationally consolidated financial information

Objective	Subprogram 1 Actions Taken/ Results Achieved (Core Prior Actions in Bold) 2006-2008	Subprogram 2 Milestones and Triggers (Triggers in Bold) 2009-2011	Expected Results
		<p>progressively reduced from approximately three years to one year</p> <p>d. Available consolidated information is displayed on the MOF web site in a timely fashion</p>	
<p>6.4 Develop coordinated approach to broader (non financial) performance monitoring and evaluation initiatives</p>	<p>a. Framework paper referred to in 6.3 (a) to include coverage of improved coordination of overlapping bureaucratic monitoring by various agencies including, various Directorates of MOHA, MOF, Bappenas, BPS and line Ministries in broader (non financial) areas</p>	<p>a. Improved coordination framework reduces overlaps in the need for general reporting to multiple agencies by Regional Governments</p>	<ul style="list-style-type: none"> • More coherent and better coordinated system of evaluation to support policy making
<p>6.5 Continue efforts to compare and publish benchmarked performance in service delivery (and other areas) between regions</p>	<p>a. Government Regulation 6/2008 passed that provides for evaluation of performance of Regional Governments (including service delivery)</p>	<p>a. Regional Government Performance Measurement System (RGPMS) developed with centralized data base fully functioning in 40 regional governments</p>	<ul style="list-style-type: none"> • Availability of information on service delivery performance between regions stimulates actions to improve lagging regions
	<p>b. MOHA Decree is under preparation to provide technical guidelines, including standard performance indicators for service delivery monitoring</p>	<p>b. Centralized benchmark type information is analyzed with comparisons between Regional Governments and results are published and widely circulated</p>	

Annex 4 – List of Equipment Procured Under TA 7010

No.	Item	Quantity	Brand / Type	Serial / Reference No.
1	Computer Desktop including Monitor and Keyboard	1	HP g3235d Home PC HP vp15s	S/N. CNX8021WL S/N. CNC80404HP
2	Mouse	1	HP	S/N.PQ0750052114
3	Printer HP Color Laser Jet	1	HP 2605dn	S/N. CNHJ7CMOKG
4	Scanner	1	HP Scanjet G2410	S/N. CN74RS202
5	Printer Laser Jet	1	HP P1505 Series	S/N. CNCJ112186
6	Printer Laser Jet	1	HP P1505 Series	S/N. CNCJ248311
7	Printer Laser Jet	1	HP P1505 Series	S/N. CNCJ143764
8	Computer Desktop including Monitor and Keyboard	1	HP g3333d Home PC HP w15e	S/N. CNX 8241XHN S/N. CNK8161683
9	Mouse	1	HP	S/N. PQ080015055
10	Projector	1	Toshiba	S/N. 3763-8197
11	Screen for LCD	1	SILVERSCREEN	-
12	Laptop	1	Fujitsu	S/N. C080507329
13	Laptop	1	Compaq Presario V3000	S/N. 2CD752058T
14	Fax	1	Panasonic KXFL512	S/N. 7HAWC050026
15	Air Conditioner	1	Panasonic	S/N. 82494311
16	Air Conditioner	1	Panasonic	S/N. 82494363
17	Metal Filing Cabinet	1	Brother – 4 Drawyer	-
18	Cupboards for Tea Cups	2	Wooden – no brand	-
19	Telephone Handset	2	Panasonic KX-TS505MXW	S/N. 7KBFA407435 S/N. 7KCFA427857
20	Telephone Handset	1	Sahitel S77W	S/N. 58010001839
21	Internet Modems and Cables	2	Shito DSL805E	S/N. 1473074900011 S/N. 1473074900014