ASIAN DEVELOPMENT BANK **RRP:INO 36541**

REPORT AND RECOMMENDATION

OF THE

PRESIDENT

TO THE

BOARD OF DIRECTORS

ON PROPOSED LOANS

AND TECHNICAL ASSISTANCE GRANT

TO THE

REPUBLIC OF INDONESIA

FOR THE

LOCAL GOVERNMENT FINANCE AND

GOVERNANCE REFORM

SECTOR DEVELOPMENT PROGRAM

October 2005

CURRENCY EQUIVALENTS
(as of 11 October 2005)

Currency Unit	–	rupiah (Rp)
Rp1.00	=	$0.000099
$1.00	=	Rp10,068

ABBREVIATIONS

ADB	–	Asian Development Bank
BAKD	–	Bina Administrasi Keuangan Daerah (Regional Financial Management)
BAPPENAS	–	Badan Perancanaan Pembangunan Nasional (National Development Planning Agency)
BUMD	–	Badan Usaha Milik Daerah (region owned enterprise)
CIDA	–	Canadian International Development Agency
DAK	–	Dana Alokasi Khusus (special allocation grant)
DAU	–	Dana Alokasi Umum (general allocation grant)
DFID		United Kingdom Department for International Development
DG	–	directorate general
DPOD	–	Regional Autonomy Advisory Council
EA	–	executing agency
FMIS	–	financial management information system
GFS	–	government financial statistics
GTZ	–	Deutsche Gesellschaft fur Technische Zusammenarbeit
IA	–	implementing agency
IFI	–	international financial institution
IMF	–	International Monetary Fund
MOF	–	Ministry of Finance
MOHA	–	Ministry of Home Affairs
MTEF		Medium Term Expenditure Framework
NAPFD	–	national action plan for decentralization
PCU		project coordinating unit
PDAM	–	Perusahaan Daerah Air Minum (regional government-owned water enterprise)
PEFM	–	public expenditure and financial management
Perda	–	Peraturan Daerah (regional regulation)
PPSC	–	program and project steering committee
RDA	–	regional development account
SIKD	–	Sistem Informasi Keuangan Daerah (regional fiscal information system)
SIPKD	_	Sistem Informasi Pengelolaan Keuangan Daerah (regional financial management information system)
SPM	–	Standar Pelayanan Minimum (minimum service standards)
TA	–	technical assistance
USAID	–	United States Agency for International Development

NOTES

(i) The fiscal year (FY) of the Government and its agencies ends on 31 December. FY before a calendar year denotes the year in which the fiscal year ends, e.g., FY2003 ends on 31 December 2003.

(ii) In this report, "$" refers to US dollars.

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CONTENTS

LOAN AND PROGRAM SUMMARY

Bsorrower	Republic of Indonesia (Indonesia)
The Proposal	The proposed Local Government Finance and Governance Reform Sector Development Program (Program) includes a $300 million program loan, a $30 million project loan, and a technical assistance grant (TA) of $500,000.
Classification	Target Classification: General intervention Sector Classification: Law, economic management, and public policy Subsector: National government administration Themes: Governance, capacity development Subthemes: Public governance, institutional development
Environment Assessment	Category C
Rationale	Decentralization has the potential to deliver significant welfare benefits by bringing service delivery closer to the final beneficiaries and allowing greater local discretion and opportunities for citizen participation. However, these benefits presuppose that local governments have the capacity to meet their mandates, sufficient resources are available to fund services, and accountability mechanisms exist. Indonesia decentralized rapidly and many of these preconditions are not yet in place. The original 1999 laws governing decentralization (i) devolved broad areas of responsibility for services to local governments without assessing their capacity to fulfill them or clearly specifying obligatory functions within those areas, and (ii) specified financial allocations to the national and local governments, including revenue sharing and grants. However, the allocation mechanisms are highly skewed in favor of resource-rich regions, and tend to exacerbate rather than mitigate historical regional inequalities. Although these laws were recently revised, reforms in certain areas need to be formulated and implemented in a gradual manner over the medium-term. New laws have also been adopted that lay down the principles and clarify responsibilities for budgeting and financial management in government in line with international best practices and standards. The new framework is a radical departure from the current way of doing business in the Indonesian public service, in that there is greater integration between planning and budgeting, with the latter being done along functional rather than sectoral responsibilities. Implementation of these reforms at the national and local government levels will require considerable institutional development in cross-cutting functions such as planning, budgeting, and financial management. Most local governments have limited training and experience in these areas. Taking into account the implementation environment and related capacity constraints, the Government and the ADB have agreed that

the best way to support reforms in local government finance and governance is through a phased and focused approach over the medium term that addresses the reforms in an incremental and gradual manner, based on stakeholder consultations. Phase 1 consists of an integrated package of support: a program loan to facilitate legal and regulatory changes and implementation; a project loan to provide support for modernizing financial management information systems (FMIS); and TA to enhance the technical capacity of the new intergovernmental Regional Autonomy Advisory Council (DPOD) charged with overseeing decentralization reforms.

Program Loan

Objectives and Scope

The objective of the proposed Program is to enhance the effectiveness and efficiency of delivery of basic public services by strengthening the policy, legal, and regulatory framework for decentralization as well as developing capacities at the local government level in Indonesia. Phase 1 of the Program aims to increase accountability in the management of local government finances. The Program Loan under Phase 1 is structured around five key outputs to achieve: (i) enhanced intergovernmental coordination and development of a national action plan for fiscal decentralization (NAPFD); (ii) a strengthened and harmonized framework for regional autonomy; (iii) a strengthened, rationalized and harmonized framework for intergovernmental fiscal relations; (iv) a strengthened and harmonized framework for planning, budgeting and financial management; and (v) an enhanced awareness of public expenditure and financial management (PEFM) reforms and modernization of FMIS.

Phase 2 of the Program will consist of policy actions based on the NAPFD and will result in streamlined functional responsibilities between different levels of government and a more equitable framework for intergovernmental fiscal relations to ensure that adequate funding follows functions. The agenda for Phase 2 reforms includes the following key actions:

- clear assignment of obligatory and sub-functions amongst the national, provincial and district/city governments;
- adoption of clear policy mandates and priorities in education, health and public works sectors to guide local level implementation of national priorities, leading to finalization of minimum service standards in these sectors;
- design and submission to the President of clear policy options to reform the inter-governmental fiscal framework;
- implementation of regulatory and procedural reforms to achieve horizontal and vertical equity based on continuous reviews of the fiscal balance framework supported by a sound simulation model;
- transfer of central authority and funding through special purpose grants to provide for further devolution;

- regulatory reforms for local government borrowing;
- regulatory reforms and capacity development measures to strengthen regional financial management;
- strengthening and empowerment of the DPOD to help formulate and implement forward looking decentralization reforms.

Financing Plan A single tranche program loan in the amount of $300 million from the ordinary capital resources of the Asian Development Bank (ADB) will be provided. The loan will have a 15-year term, including a grace period of 3 years, an interest rate determined in accordance with ADB's LIBOR-based lending facility, and such other terms and conditions set forth in the draft Program Loan Agreement.

Program Period The reforms supported under Phase 1 cover the period from 1 January 2004 to 31 December 2006.

Procurement The loan proceeds will be used to finance the full foreign exchange costs (excluding local duties and taxes) of items produced and procured in ADB member countries, excluding ineligible items and imports financed by other bilateral and multilateral sources. In accordance with the provisions of ADB's *Simplification of Disbursement Procedures and Related Requirements for Program Loans*, the proceeds of the program loan will be disbursed to the Republic of Indonesia as the Borrower. No supporting import documentation will be required, if, during each year that loan proceeds are expected to be disbursed, the value of Indonesia's total imports minus imports from nonmember countries, ineligible imports, and imports financed under other official development assistance is equal to or greater than the amount of the loan expected to be disbursed during such year. The Government will certify its compliance with this formula with each withdrawal request. Otherwise, import documentation under existing procedures will be required. ADB reserves the right to audit the use of loan proceeds and verify the accuracy of the Government's certification.

Project Loan Objectives and Scope The project loan implements reforms in PEFM under Phase 1 through development and upgrading of related FMIS. The project consists of five components: (i) upgrade and expand electronic access to the regional financial information system (SIKD) by 100 local governments; (ii) computerize the new Directorate General of Regional Financial Management (DG BAKD), at the Ministry of Home Affairs (MOHA) to enhance oversight of PEFM reforms; (iii) develop and implement regional financial management information systems (SIPKD) in 71 local governments; (iv) streamline and computerize the system at the Ministry of Finance (MOF) for review of local government regulations (*perdas*) and draft *perdas* on taxes and charges for consistency with higher laws and regulations; and (v) develop certification program at MOF for regional financial administrators.

Financing Plan A project loan of $30.0 million from Asian Development Fund (ADF) resources will be provided. The loan will have a 32-year fixed term including a grace period of 8 years, a 1% interest charge during the

	grace period, and 1.5% thereafter, and such other terms and conditions as are set forth in the draft Project Loan Agreement, The loan will be implemented over about 36 months, to be completed in December 2008.
Procurement and Disbursement	Procurement of goods and services will be in accordance with ADB's *Guidelines for Procurement.* Disbursement procedures will be in accordance with ADB's *Loan Disbursement Handbook*. Consultants financed from the proceeds of the ADB loans will be recruited in accordance with ADB's *Guidelines on the Use of Consultants* and other arrangements satisfactory to ADB for engaging domestic consultants.
Executing Agency Implementation Arrangements	MOF will be the Executing Agency (EA) for the program loan and MOHA will be the EA for the project loan. MOF, MOHA and the National Development Planning Agency (Bappenas) will be the implementing agencies (IA) for the program loan and MOF and MOHA will be IA for their respective components of the project loan. MOF will implement the SIKD, computerization of the review process for *perdas* on taxes and charges, and the development of certification program for regional financial administrators components. MOHA will implement the computerization of DG BAKD and development of the SIPKD components.
Technical Assistance	An advisory TA of $500,000 will strengthen technical capacity of the new DPOD. The TA will be financed by ADB on a grant basis. It is estimated that about 8 person-months of international and 42 person-months of domestic consulting services will be required. All consultants will be engaged in accordance with ADB's *Guidelines on the Use of Consultants* and other arrangements satisfactory to ADB for engaging domestic consultants. Procurement of goods and services will be in accordance with ADB's *Guidelines for Procurement*.
Impact, Benefits and Beneficiaries	The Program will enable local governments to deliver basic public services more effectively and efficiently. Program benefits include: **Closer alignment of public services and preferences** through greater devolution, clarity in the assignment of functions, and the provision of adequate resources to deliver public services. Overall quantity, as well as quality, of public services will be enhanced under the Program in line with public expectations and preferences. **Greater accountability and efficiency** through a strengthened and harmonized policy, legal and regulatory framework for regional autonomy, fiscal balance and PEFM.. Under the revised framework, which is supported under the Program, local governments will be provided with clear directions and guidelines on their new responsibilities, which will contribute to greater efficiency in budgeting, control of expenditures and standards of financial reporting, Improved reporting will increase accountability of local governments to local parliaments and their citizens. Computerization of the review system for local regulations on taxes and charges under the Program will

contribute to a more efficient, equitable and transparent taxation system at the local government level.

More sustainable intergovernmental relations through establishment of the new DPOD and greater cooperation in service delivery between local governments based on the enhanced coordination role of the provinces under the new legal framework,which are supported under the Program.

More equitable and transparent system of intergovernmental fiscal transfers through legal and regulatory reforms as well as systems development under the Program. Greater horizontal equity and vertical balance are likely to be achieved from the implementation of the Program, in turn, resulting in less regional disparities. Improved flows of financial information from local governments and more efficient processing through the development and implementation of new financial information systems will also improve government budgeting and financial management practices.

Strengthened government capacity through development of a certification program for regional financial administrators and introduction of FMIS at DG BAKD, upgrade of SIKD, and development of SIPKD and a system for reviewing *perdas* on taxes and charges, which are supported under the Program.

Implementation of these reforms is likely to benefit all Indonesian citizens, and potential investors and creditors. In addition, the direct beneficiaries of the project loan will be the constituents of the participating local governments that receive support under the SIKD, SIPKD, and tax *perda* review system components.

Risks and Assumptions

The Program faces several risks arising from the unsustained momentum of reforms, the macro-economic and political context, and regional tensions, which are outweighed by the above referenced benefits. Program risks and the risk-mitigants include the following.

Weak intergovernmental coordination. A primary risk is the continued uncertainty in the policy framework if efforts to harmonize policies, laws and regulations fail or are further delayed. In the absence of a coherent national framework, local governments may use their authority to develop their own practices, resulting in fragmented and incompatible requirements, information, and systems. This risk is partially mitigated through the adoption of a harmonized regulatory framework on PEFM, development of an integrated and modernized FMIS, and establishment and implementation of the DPOD.

Weaknesses in resolving local government debt arrears. Balanced intergovernmental fiscal relations, and debt restructuring in particular, are sensitive issues. The Government may not be willing or able to address the debt arrears problem comprehensively because of strong opposition from key stakeholders (e.g., local governments, which may

continue to dispute liability for such arrears). Although the Government has not engaged in any serious attempts at debt resolution, the recent passage of a new regulatory framework for reducing debts in specific circumstances is a good move forward. Implementation of this new framework will be supported by the Program through initiation of debt restructuring in 7 regional governments and/or regional government-owned water enterprises.

Constraints relating to fiduciary governance. Given the different layers of governments and the complex expenditure and revenue sharing arrangements, transparency of the budget process in Indonesia is relatively weak, despite the political leadership being committed to improvements. In addition to the adoption of new laws and regulations that promote PEFM reforms, MOF is taking steps to improve transparency through implementation of the SIKD. The Program will promote enhancement of the SIKD to reflect recent reforms in PEFM and modernize FMIS at national and local government levels to promote greater reliability and consistency in information disclosure. Equally important will be the need to ensure that the information shared through the SIKD is adequately evaluated to guide policy formulation to strengthen inter-governmental relations. The Program will support capacity development in this area.

Continued political commitment. Sustainability of the reforms will require continued political commitment at national and local levels over the medium-term. This risk is partially mitigated through the development of the NAPFD, which will clarify commitment for reforms in fiscal decentralization during the current administration, and the establishment of the DPOD, which will promote a more coordinated approach to reforms.

I. THE PROPOSAL

1. I submit for your approval the following report and recommendation on proposed loans to the Republic of Indonesia (Indonesia) for the Local Government Finance and Governance Reform Sector Development Program (the Program). The report also describes proposed technical assistance (TA) for Supporting an Effective Institutional Framework for Fiscal Decentralization and, if the Board approves the proposed loans, I, acting under the authority delegated by the Board, will approve the TA.

II. THE SECTOR: PERFORMANCE, PROBLEMS, ISSUES AND OPPORTUNITIES

A. Sector Description and Performance

2. Indonesia is divided into 33 provinces and more than 440 districts, with significant geographic and demographic variations. The population per province in 2003 ranged from less than 1 million in North Maluku to more than 38 million in West Java. The challenges of ensuring effective and efficient delivery of public services in such a vast and diverse archipelago, coupled with the demand for change following the downfall of the regime of President Soeharto, generated fresh pressures leading to the introduction of an ambitious decentralization reform agenda in 1998. In a radical departure from the past, when provinces acted as conduits for delivering nationally mandated priorities in an authoritarian and opaque manner, significant authority was devolved down to district governments through the enactment of Laws on Regional Autonomy (22/1999) and Fiscal Balance (25/1999). These decentralization laws became fully effective in 2001 when about 2 million civil servants were transferred from the national to local government level. [1] This almost doubled the local governments' share of total public spending from about 17% in 2000 to more than 30% in 2003. The Asian Development Bank (ADB) has supported the Government of Indonesia (the Government) since 1998 in the formulation and implementation of the decentralization laws.[2]

3. The process of decentralization initially proceeded under complex circumstances as Indonesia was in the midst of the Asian financial crisis, followed by rapid and frequent leadership changes. Subsequently, the political situation stabilized and macroeconomic management continued to strengthen since 2000 despite a series of adverse events, including several terrorist attacks in Bali, Jakarta and other parts of the country, the outbreak of severe acute respiratory syndrome, and global factors such as the war in Iraq and rising oil prices. Following the early periods of slow recovery during 2000-02, when real gross domestic product (GDP) growth was around 3-4%, Indonesia managed to achieve remarkable progress in macroeconomic management with real GDP growth at levels above 5% over 2004-05, and the fiscal deficit declining from 2.5% of GDP in 1999 to 1.2% of GDP in 2004.

4. Despite the strong macroeconomic environment and the progress in political and fiscal devolution, regional disparities in terms of poverty and access to resources persist. For example, East Nusa Tenggara, the poorest province in 2002, had a human development index (HDI) of 60.3, while Jakarta, the second richest region, had an HDI of 75.6. Gross regional product (GRP) and poverty indicators show significant variation between regions. For example, the GRP per capita of the poorest 20% of regions is less than 30% of the GRP of the richest 20%. Similarly,

[1] Local government refers to provinces and districts or cities. The terms local and regional are used interchangeably.

[2] ADB. 1999. *Report and Recommendation of the President to the Board of Directors on Proposed Loans and Technical Assistance Grants to the Republic of Indonesia for the Community and Local Government Support Sector Development Program*. Manila (Loan 1678 for $120 million); followed by a range of decentralization support initiatives in health, education and basic public infrastructure sectors (see Appendix 11).

some 20% of districts had more than 30% of their population below the poverty line, while the upper 20% of districts had less than 10% of their population below the poverty line. The correlation between GRP and poverty is strong, but not absolute, with some resource-rich regions experiencing high levels of poverty. Papua, the third richest region in term of per capita GRP, had the highest percentage of the population below the poverty level (51.2%) in 2002. There are also considerable disparities between regions in access to resources. The richest regions received 50 times more revenue per capita than the poorest in 2002.

5. Traditionally, much of the local government development spending in Indonesia has been centrally sponsored, financed and implemented. ADB and other development partners have largely supported local level development initiatives through the national Government. While the transaction costs of ensuring sound public investment and project management are always high in a large and diverse country like Indonesia, the devolution of authority to local governments has brought in new challenges. In particular, three concerns have emerged. First, an overriding issue has been appropriate level of devolution with regard to financing. Second, as new entities, the capacity of local governments remains nascent to plan and execute public investment projects effectively. Third, ensuring adequate fiduciary governance in the management of investments projects is fairly complex.

6. Over the course of 2001-05, the Government, ADB and other development partners have been assessing the effectiveness of decentralization reforms. A key finding is that the speed and complexity of decentralization in Indonesia has created gaps and inconsistencies in the policy, legal and regulatory framework[3]. While there has been no major disruption in service delivery, to fully realize the benefits of decentralization there is need for substantial strengthening and streamlining of the legal and regulatory foundation. Furthermore, there is an urgent need to formulate sound and efficient modalities of financing improvements to strengthen delivery of public services in the regions. In particular, in a highly decentralized environment, funding authority has to be gradually devolved down to the regions, but only after ensuring that adequate capacity is built and adequate governance norms are in place.

7. In late 2003, the Government requested ADB's support in formulating and implementing a forward-looking decentralization reform agenda, in line with the ongoing national level reforms. Given the complexity and the political sensitivity of reforms in this area, the Government requested that ADB's support be phased in over 2004-09, to facilitate reforms on a gradual and flexible basis. Phase 1 of the Program, being proposed for the Board's consideration, supports (i) formulation of an overall reform agenda spanning 2004-09, and (ii) implementation of key elements of the reform agenda over 2004-05. In order to guide future reforms, the Government has formulated a forward-looking agenda through the adoption of a National Action Plan on Fiscal Decentralization (NAPFD), which will be implemented as part of the subsequent phases of the Program.

B. Issues and Opportunities

1. Inter-governmental Fiscal Relations

8. **Assignment of Functions between Different Levels of Governments**: The 1999 laws assigned a number of specific functions to the national government and decentralized others to local governments. Although districts and cities became responsible for the delivery of services in

[3] There are approximately 7 Laws, 10 Government regulations, 5 Presidential Decrees and 22 Ministerial regulations that are concerned with planning, budgeting, accounting, financial reporting and accountability for the national and local governments. In addition, a whole host of new regulations are being developed.

11 key sectors, sector laws continued to assign responsibilities in many of these areas to national government agencies as well. Moreover, equal authority and responsibilities were conferred on all local governments, irrespective of size, socioeconomic status, or fiscal and human capacities. These differences in endowments, socioeconomic status and fiscal capacity affect the ability of local governments to deliver basic services and reap the benefits of autonomy. Effective decentralization is based on three premises: (i) functions should be devolved according to capacities; (ii) funds should follow functions; and (iii) local governments should be held accountable for performance. The reform agenda has not effectively addressed these critical issues.

9. **Inter-governmental Fiscal Relations**: The original Law on Fiscal Balance defined local government own-source revenues, shared revenues, transfers from the national government and borrowings. Local governments' own revenue-raising capacities are still limited, accounting for only about 6% of total revenues.[4] Local governments remain dependent on fiscal transfers from the national government, which have increased dramatically from Rp33.5 trillion ($3.98 billion) in 2000 to Rp123.2 trillion ($13.1 billion) in 2004.

10. The revenue sharing arrangements currently account for 33% of the total transfers from the national to the local governments, while the general allocation grant (DAU), the bulk of which helps finance civil service salaries and recurrent expenditures, accounts for almost 60% of total transfers to the regions. The main purpose of the DAU is to equalize fiscal capacities across regions to enable them to meet their new expenditure responsibilities, but in practice there have been three key constraints: (i) a hold harmless clause, which requires that no region can be allocated a lower DAU than the previous year, which severely limits the redistributive function of the grant; (ii) a balancing factor that was originally used to compensate local governments for the large-scale transfer of staff in 2001 and is still being included in the transfer calculations; and (iii) the formula for computing local government fiscal capacity acts against equalization, as it underestimates the capacity of resource-rich regions by including only 75% of the shared revenues in estimating fiscal capacity.

11. The Law on Regional Taxes and Charges (34/2000) was introduced to establish regional taxes and charges responsibilities. This law allows local governments to create new taxes and user charges as long as they meet certain criteria that are fairly standard in the tax assignment literature. However, this "negative list approach" enables local governments to introduce a wide array of nuisance taxes and charges. The Government has been working on revisions to this law that will provide a positive list of local taxes and charges that may be imposed by local governments.

12. In aggregate, fiscal transfers to local governments appear to be sufficient.[5] However, distortions in the allocation mechanisms, including revenue sharing, are entrenching and perpetuating regional disparities and horizontal inequity. For example, evidence suggests that in 2003 the richest local governments received more than 10 times more revenue per resident through transfers than the poorest local government.

13. **Regional Borrowing.** Indonesia's local governments have had very little experience of long-term borrowing for capital investment, outside of the lending modalities provided by the national Government. Further, the legal framework for regional government borrowing has been unclear and incomplete. The original decentralization laws, supported by a Government

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[4] The absence of an adequate revenue base limits local accountability and shields local governments from hard budget constraints.

[5] Collectively, local governments are running surpluses of around 12% of total transfers.

regulation on regional government borrowing (107/2000), provided more latitude than in the past for regional borrowing from domestic and foreign sources, including multilateral loans, while restricting borrowing by establishing maximum debt-to-revenue ratios.[6] Until 2001, multilateral lending and national government lending to local governments were channeled through the regional development account (RDA) and then on-lent through subsidiary loan agreements. The RDA, established in 1988 in Ministry of Finance (MOF), was intended to consolidate donor and domestic funds into a single source, offering standard terms to local governments. Expansion of the fund was envisaged from domestic-sourced funds and repayment under subsidiary loan agreements as well as injections of new donor and government funds. However, the performance of the RDA has largely been unsatisfactory, with at least 50-60% of loans in arrears.[7]

14. MOF introduced an interim mechanism for on-lending development assistance under Ministerial Decree (35/2003). However, before this can develop into an efficient and prudent system, several hurdles need to be overcome: (i) local government arrears under the old on-lending system need to be resolved before borrowing under the new mechanism can begin,[8] (ii) reliable accounting standards and financial management information systems (FMIS) at the national and local government level need to be in place; and (iii) timely, accurate, and sufficient financial information on local governments needs to be made available. While the interim mechanism is a medium-term solution for the provision of IFI funding for viable local government projects in such sectors as urban physical and social infrastructure, the Government needs to create an enabling environment so local governments can raise capital from other sources over the longer term. Clear rules and procedures need to be established to clarify and harmonize the regulatory framework for regional government borrowing, while at the same time ensuring overall fiscal viability.

15. **Delivery of Public Services**. Benchmarking and monitoring local government performance in service delivery are essential to ensure public resources are well utilized. The original and revised decentralization laws stipulate that the obligatory functions assigned to local governments need to be evaluated against certain minimum service standards (SPM). However, concerns over fiscal constraints and lack of clarity in the assignment of functions have impeded the development of SPM.

2. Governance in Inter-Governmental Relations

16. **Institutional Mechanisms for Inter-governmental Coordination**. Given the complexity and “big bang” nature of decentralization reforms in Indonesia, there has, as yet, been no sound institutional mechanism to coordinate the reforms or their implementation. Before the adoption of the original Law on Regional Autonomy, the Government established a Regional Autonomy Advisory Board to coordinate intergovernmental fiscal arrangements. The Board was chaired by the Minister of Home Affairs with the Minister of Finance as the Vice Chair. While this Board had provisions for two technical secretariats on finance and regional autonomy, it was not able to meet more than a few times and its technical secretariats were never established. Ongoing disagreement between MOF and the Ministry of Home Affairs (MOHA) also undermined its effectiveness. MOHA lacked the technical capacity to drive the intergovernmental fiscal agenda, while MOF lacked an official mandate. The absence of an effective institutional mechanism to guide decentralization reforms has led to the ad hoc adoption of inconsistent policies, laws, and

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[6] There were overlaps and inconsistencies in the framework for regional government borrowing between these two laws, some of which still need to be resolved under the new legislation.

[7] As of 31 December 2004. One of the key reasons for the large amount of outstanding arrears appears to be the lack of willingness of local governments and regional government-owned water enterprises (PDAMs) to repay.

[8] The Government has been providing exemptions to this decree on a case-by-case basis to several local governments that have outstanding loan arrears to the national government.

regulations and conflicting mandates by national agencies and local governments. At the local level, coordination has become increasingly complex because of the large and growing number of district administrations (more than 440) and because the provinces were not provided with clear authority under the original Law on Regional Autonomy.

17. **Public Expenditure and Financial Management.** While the enactment of the original decentralization laws increased the importance of financial management for local accountability and general fiscal management, the legal and regulatory framework did not fully clarify the roles and responsibilities of national and local governments, or of MOF and MOHA, with regard to regional financial management and regional financial information. Regulatory measures adopted in 2000 provided the basic guidelines for regional financial management, including budgeting, accounting methodologies, and financial reporting.

18. With the aim of enhancing transparency and accountability at the national level, a range of new planning, budgeting, and financial management principles and requirements has been introduced. For example, the new Law on State Finance (17/2003) introduced performance-based budgeting, a shift to expenditure classifications based on government financial statistics (GFS), and a medium-term expenditure framework (MTEF). While the original decentralization laws had several provisions on local government budgeting and financial management, these provisions needed to be reconciled to ensure consistency in procedural and institutional arrangements. Moreover, given that local governments currently prepare rudimentary budgets and financial statements, implementing such sophisticated tools will require significant investments aimed at capacity development at the local level.

19. Based on recommendations made by ADB, the World Bank and the International Monetary Fund (IMF), reorganization of MOF has been underway since 2003. The aim of the reorganization has been to establish a modern budget and treasury management system. The restructuring was necessary for MOF to exercise effective fiscal and financial management in a complex economy, particularly with the shifting roles and additional challenges brought about by rapid decentralization. However, attention needs to be given to the capacity of MOF to monitor and adequately manage fiscal risks. Although MOF has developed a regional financial information system (SIKD), this system does not reflect recent reforms in the legal and regulatory framework. Moreover, only 19 out of 473 local governments have been provided with support to enable them to submit required financial reports to SIKD through a computerized financial reporting and transmission system. The majority of local governments submit required financial reports manually.

B. Lessons Learned

20. The design of the Program incorporates key issues learned from evaluation of previous ADB projects, including the Sustainable Capacity Building for Decentralization Project (SCBD)[9] and the State Audit Reform Sector Development Program (STAR),[10] and those of other development partners in the area of policy reforms, public expenditure and financial management (PEFM), and decentralization. A consistent finding is that the challenges in implementing policy reforms of this magnitude are overwhelming in terms of the adjustment costs and political and institutional arrangements for effective management of implementation.

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[9] ADB. 2002. *Report and Recommendation of the President to the Board of Director on a Proposed Loan and Technical Assistance Grant to the Republic of Indonesia for the Sustainable Capacity Building for Decentralization Project*, Manila (Loan 1964 for $42.2 million).

[10] ADB. 2004. *Report and Recommendation of the President to the Board of Director on Proposed Loans to the Republic of Indonesia for the State Audit Reform Sector Development Program*, Manila (Loan 2126/2127 for $200 million and $25.1 million respectively).

21. **Government Commitment and the Pace of Reforms.** The Government's political commitment to the reform agenda, including the pace of reforms, is critical. Strong ownership by participating local governments, including participation in project design and tailoring of projects to reflect local capacity and needs, is critical to the sustainability of reforms.

22. **Complexity of Reform Program and Capacity to Implement.** Given weak capacity to implement program initiatives, the complexity of programs needs to be carefully examined to ensure that outputs can be met. A longer-term horizon is needed to build political consensus on the reform agenda, effectively sequence interventions, enable adoption of an incremental approach, and set realistic and achievable objectives. Flexibility about specific actions and timing should be provided as long as there is strong commitment to key objectives. Consistent with the emerging laws and regulations, provinces should be provided with a greater role in coordinating, monitoring, and facilitating support to participating district governments.

23. **Intergovernmental Coordination.** Given Indonesia's size and diversity, **c**oordination among key central government agencies and local governments will be vital to ensuring the consistency of reforms. Building strong Government ownership entails involving more than one national implementing agency. The success of the reforms will depend on the interrelated activities of a number of key stakeholders.

24. **Accountability.** In a unitary state, with the type of devolution that Indonesia has adopted, appropriate checks and balances on accountability are evolving. Program design should support implementation of the new legal and regulatory requirements for sound planning, budgeting, financial management and evaluation.

25. **Complementarity with other initiatives.** Policy actions should draw extensively from recommendations developed in past policy analyses and reviews by ADB and other development partners and build on related work (Appendix 11).

C. Donor Coordination

26. Donor coordination is critical for Indonesia's decentralization reforms. The Program is the first comprehensive program to attempt to enhance overall coordination at the national level and improve intergovernmental fiscal relations (following ADB's Community and Local Government Sector Development Program). ADB has coordinated closely with other development partners in formulating the Program. Consultations have been held with the Canadian International Development Agency (CIDA), United Kingdom Department for International Development (DFID), Deutsche Gesellschaft fur Technische Zusammenarbeit (GTZ), United States Agency for International Development (USAID), and the World Bank, ADB has been active in the Donor-Government Working Group on Decentralization, which has recommended that the Program become an umbrella for coordinating policy, legal and regulatory reforms in the area of decentralization. At the Group's request, ADB formulated the Group's Annual Workplan for 2005-06 in coordinating various related initiatives under the broad framework of the Program. The NAPFD, in particular, has benefited from consultations with other development partners supporting decentralization reforms, within the framework of the Decentralization Support Facility founded by DFID, the World Bank, ADB, and the United Nations Development Program.

III. THE PROPOSED SECTOR DEVELOPMENT PROGRAM

A. Objectives and Scope

27. The key objective of the Program is to enhance the development effectiveness and efficiency of public services delivery at the local government level. This is crucial for Indonesia as the delivery of all major socio-economic services has been devolved to the local level, while horizontal and vertical inequities in the resource allocation mechanism remain. Local governments have inherited enormous responsibilities without adequate preparation and capacities. In addition to governance concerns, the delivery of public services has been impeded by administrative weaknesses in implementation as well as financial management, auditing and accounting. ADB has been proactively engaged in addressing these challenges through a number of operations, some of which are project interventions directed at improving coverage of socio-economic services, while other interventions aim to strengthen capacities in a sustainable way such as ADB's support through SCBD and the STAR projects (see footnotes 9 and 10).

28. The proposed Program aims to draw on lessons learned from the past difficulties in the implementation of reforms as well as implementation of project interventions to supplement public services. Based on these lessons, the Program is the first systematic and holistic effort structured after intensive dialogue to support fundamental long term reforms in a phased manner. The Program scope includes (i) Phase 1, an integrated package of support comprised of a program loan to support reforms that rationalize and strengthen the policy, legal and regulatory framework, project support to strengthen the capacities of financial management at local level, and TA support to strengthen the capacity of the new institutional mechanism to coordinate decentralization reforms, and (ii) Phase 2, which will be steered by the NAPFD that has been endorsed by the Government. Details on outcome and outputs of the Program are provided below.

B. Program Loan

1. Outcome

29. **Phase 1.** The policy actions supported by the single tranche program loan under Phase 1 of the Program will promote greater accountability in the management of local government finances and will focus on five key outputs: (i) enhanced intergovernmental coordination and development of the NAPFD; (ii) strengthened and harmonized framework for regional autonomy; (iii) strengthened, rationalized, and harmonized framework for intergovernmental fiscal relations; (iv) strengthened and harmonized framework for planning, budgeting and financial management; and (v) enhanced awareness of PEFM reforms and modernization of FMIS. Through a more consistent legal and regulatory framework, local governments will be able to prepare financial information and reports that comply with higher and more comparable standards of disclosure. Table 1 presents the outcome of Phase 1 achievements within the context of the changing landscape of decentralization in Indonesia.

Table 1: Changing Landscape of Decentralization in Indonesia

Key Factor	Pre-Decentralization	Reforms Introduced in 1999 (Supported under earlier ADB Initiatives)	Reforms Introduced Since 2004 (Supported under the Program)
Political Structure	• President elected by Parliament; Provincial Governors appointed by President, and Heads of Districts by Governors	• No change in electoral system	• Direct election of President, Provincial Governors and Heads of Districts • New Regional Representative Council (DPD) established
Level of Authority	• Full central control in the form of central sponsorship and financing (deconcentration)[a] of functions exercised through provinces	• Deconcentration through provinces shifted to full devolution to districts • Review of subnational budgets required from a legalistic point of view, but not approval by higher authorities	• Central Government oversight through greater authority vested in provinces for coordination, budget evaluation, and civil service – with subnational budgets requiring formal approval by higher levels • Central funding through deconcentration to continue, but flexibility allowed in financing with plans to phase out such mechanisms
Sector and Functional Responsibilities	• Provinces and districts exercised national policy and sector mandates	• District governments entrusted with obligatory functions in 11 broad sectors, while Provinces were given broader coordination responsibility • National Government exercised considerable influence through deconcentrated funding	• Both provincial and district governments entrusted with functions in 16 broad areas, with exact responsibilities left to be defined by further regulation
Revenue Authority and Fiscal Transfers	• Local revenue authority remained constrained • Resource allocations guided by central priorities	• District and provincial governments in charge of a variety of local taxes and charges, governed by a negative list • Selected taxes are shared between national and local levels • Substantial revenue sharing arrangements, with 25% of revenues shared through general purpose transfers	• Amendments underway to specify a positive list of taxes • Formula for revenue sharing improved, and share increased to 26%, to be phased in over time • Earmarked transfers system strengthened allowing for reallocation of deconcentrated funds
Financial Management and Accountability	• Input-based budgeting with limited financial or performance accountability	• Modest movement to performance-based budgeting and enhanced accountability by regional parliaments	• Multi-year budgeting based on uniform accounting and reporting standards. Enhanced accountability to Parliaments for physical and financial performance

[a] Deconcentration refers to central sponsorship and financing of regional expenditure needs.

30. **Phase 2**. Phase 2 of the Program is integrally linked to the Phase 1 reforms and will result in streamlined functional responsibilities between different levels of government and a more equitable framework for intergovernmental fiscal relations to ensure that funding follows functions. Phase 2 will build on Phase 1 reforms and be guided by national and local priorities and lessons learned from Phase 1. The NAPFD sets out the Government's vision for forward-looking reforms under subsequent phases of the Program.

31. Appendix 1 presents the design and monitoring framework of the Program. The Government's development policy letter, the policy matrix and the NAPFD as endorsed by the Government are presented in Appendices 2, 3, and 4.

2. Outputs under Phase 1

32. The policy matrix for Phase 1 consists of a series of specific policy actions grouped under the five outputs outlined above.

a. Enhanced Inter-Governmental Coordination and Development of a National Action Plan for Fiscal Decentralization

33. **Intergovernmental Coordination.** One of the primary purposes of the Program is to improve intergovernmental coordination at national and sub-provincial levels to provide for policy, legal, and regulatory consistency on decentralization reforms. To enhance such coordination, the Government, through a presidential decree has established the Regional Autonomy Advisory Council (DPOD) under the Program. The decree provides the DPOD with enhanced coordination authority and broader local government participation than the earlier Regional Autonomy Advisory Board. Its key role is to provide advice to the President on regional autonomy policy on (i) establishment, elimination, and merger of local governments, (ii) assessment of regional government performance, (iii) assignment of functions, and (iii) fiscal balance. DPOD is chaired by the Minister of Home Affairs and includes 13 other members: Minister of Finance (also serves as Vice Chair), Minster of Defense, Minister of Justice and Human Rights, Secretary of State, State Minister for Administrative Reform, Minister of National Development Planning (BAPPENAS), Cabinet Secretary, three local government representatives (one governor and two mayors) and three experts on regional autonomy and regional finance.

34. The lack of adequate coordination, and in particular inadequate and poorly coordinated policy and technical work in the area of decentralization, have been principal constraints in the past. It is anticipated that these weaknesses will be addressed by the establishment of DPOD, its broad-based participation, efforts to coordinate technical work, and streamlined standard operating procedures, including quarterly meetings with at least two thirds of the DPOD in attendance. DPOD's Technical working groups on regional autonomy and fiscal balance include representatives from each DPOD member representing national government ministries and agencies, and other members to provide technical expertise as appropriate.[11] The proposed TA

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[11] Each working group is assigned specific tasks as follows (i) working group 1 - establish grand design for regional government autonomy functional assignments, institutional, personnel, financial, representative, public service, regional cooperation; (ii) working group 2 - review and make recommendations for establishing, eliminating, and merging local governments and setting up special area; (iii) working group 3 – make recommendations regarding capacity assessment of local governments in conducting functional assignments; (iv) working group 4 - review and make recommendations on assessment of local government finance capacity, calculation of revenue sharing by local governments, and formula and calculation of DAU for local governments based on DAU ceiling; (v) working group 5 - review and make recommendations on formulation of special allocation grants (DAK) policy for regional governments on an annual basis based on the DAK ceiling; and (vi) working group 6 – monitor and evaluate policy implementation regarding the above areas.

will provide initial support to DPOD, and the Government has undertaken to provide adequate resources to DPOD as part of its medium-term commitment under the NAPFD.

35. **National Action Plan on Fiscal Decentralization (NAPFD).** The Government has taken the most fundamental step of devolving significant authority to local governments. Yet, the complexity and political sensitivities of the agenda dictate the need for prudence and impartiality in implementation. The Government recognizes that enforcement of the legal and regulatory framework needs to be phased in over a number of years, with a clear roadmap. Further changes will inevitably be needed in a number of laws and regulations. In order to effectively guide future reforms, the Government, as part of the Program, has prepared the NAPFD as a key policy document to identify key issues and problems in harmonizing the policy, legal and regulatory framework on fiscal decentralization. Further, the NAPFD sets out a time-bound action plan, with a series of forward-looking reform measures to address these issues and problems over the next 2-3 years, along with a clear delineation of inter-ministerial responsibilities. Reflecting the high-level commitment, as well as the improving coordination within the Government, the State Minister of Bappenas and the Ministers of MOF and MOHA have endorsed the NAPFD. The NAPFD will become a principal working document of the Government and guide future initiatives in strengthening fiscal decentralization. The Section on Outputs under Phase 2 presents further details on the forward-looking agenda.

b. Strengthened and Harmonized Framework for Regional Autonomy

36. **Regional Autonomy.** Over the course of 2003-04, amendments to the original Law on Regional Autonomy were proposed, leading to the enactment of the revised Law on Regional Administration in 2004 (32/2004). ADB provided advisory support in selected areas. The revised law strengthens the framework for regional autonomy, specifically by providing a greater coordination role for the provinces, and by incorporating key reforms under recently adopted laws governing local government finance. The list of obligatory functions has been expanded in the revised law to cover 16 broad areas and districts as well as provincial governments are entrusted with service delivery responsibilities.

37. Clarity in the allocation of functional responsibilities lies at the heart of decentralization, as the framework on functional assignments in turn guides the allocation of resources between different levels of governments. For that reason, devolution of authority is complex and sensitive in any economy, but particularly more so in Indonesia, given its history and diversity. Close to four decades of centralized decision making has led to significant consolidation of power and capacity within the central line authorities. Any realignment of functional and financing arrangements can be done only in a gradual manner. Yet, the revised Law on Regional Administration has taken a significant step forward in this direction. By providing for direct elections of heads of districts and provinces, the new legal framework has the potential to align the local governments' orientation and public service delivery priorities closely with the local preferences. Moving forward, the relative roles and authorities of provinces need to be clarified and strengthened, clearly anchored on sound coordination and greater transparency and accountability with regard to local government fiscal and financial affairs.

38. **Strengthening the Delivery of Public Services.** Along with its efforts to streamline functions and financing options, the Government has also focused on the need for improving the quality and quantity of public services. As Indonesia implements the legal provisions on devolution of authority, there is recognition that certain minimum service standards (SPM) need to be established. Under the Program, the Government has adopted a new regulation to provide guidance to (i) sector ministries on formulating SPM for the obligatory functions of local governments, including the need to factor in fiscal constraints to facilitate a tighter linkage

between service delivery norms and resources, and (ii) local governments in implementing SPM. Under the regulation, sector ministries will be required to compile SPM to clarify obligatory functions in their sector and to develop recommendations for consideration by the DPOD prior to finalization.[12] Ministries have 3 years in which to compile SPM, which, once adopted, will be used for planning and budgeting by local governments and reflected in their medium-term development plans. The subsequent phases of the Program will support the development of SPM in the health, education and public works sectors (which are responsible for 75% of local government expenditures), using the new guidelines, in close coordination with the ongoing support from other development partners.

c. Strengthened, Rationalized and Harmonized Framework for Intergovernmental Fiscal Relations

39. **Intergovernmental Fiscal Transfers**. With the aim of promoting greater equalization in the allocation of resources between the national and local governments, the Program has supported the adoption of a revised Law on Fiscal Balance (33/2004). This law takes a number of important steps to enhance overall equity, while retaining the basic framework as envisioned in the original 1999 legal framework for funding local government functions and responsibilities. Box 1 summarizes the key amendments in the revised Laws on Regional Administration and Fiscal Balance supported under the Program.

40. To promote greater transparency and accountability in the management of regional finance, the Program has also supported the adoption of a new regulation under the revised Law on Fiscal Balance to clarify the framework for the SIKD.[13] Under the new regulation, MOF will be responsible for formulating standard information requirements; providing technical guidance on collecting, processing, validating, analyzing and presenting information; preparing technical plans for developing the SIKD; standardizing the system, including procedures, coding, equipment, application, and information exchange; and coordinating the communication network and information system connecting SIKD units. The project loan will support enhancement of the SIKD to incorporate the new legal and regulatory framework for public financial management.

[12] DPOD will review and reconcile financial implications of such proposals prior to submission to the President.

[13] Under the new regulation, local governments that fail to comply are subject to withholding of 10% of the DAU provided monthly. The sanction will be imposed until the required information is submitted. Once this information has been submitted, the amount of DAU which has been postponed will be provided.

Box 1: Key Provisions in the Revised Laws on
Regional Administration and Regional Fiscal Balance Supported Under the Program

The revised Laws on Regional Administration and Fiscal Balance contain a number of provisions aimed at enhancing overall operational and allocative efficiency and equity in intergovernmental relations. The key provisions include:

- *Direct elections of heads of cities and districts and governors of provinces* – this will eventually help bring public services closer to the public, by aligning national and local government priorities with public preferences

- *Greater clarity in functional assignments* – the revised Law on Regional Administration adopts a positive list to specify sectors and broad functions to be devolved to local governments. Yet, given the complexity and sensitivity, the revised law sets out general criteria for allocating functions, with focus on costs and benefits of implementing functions at different levels, and on the principle of subsidiarity, which argues in favor of greater devolution. Although these are important changes, significant reforms will be needed in subsequent phases of the Program.

- *Greater coordination role for provinces* – in contrast to the 1999 legal framework, provinces are given greater responsibility in two areas: policy and implementation coordination, and evaluation of local government performance. However, these legal requirements need to be enforced in a judicious and effective manner so as not to undermine the devolution of functional authority conferred on district governments. The implementation of NAPFD will help streamline reforms.

- *Scope for allocating funding in line with functions* – the revised Law on Fiscal Balance provides for flexibility to allocate a greater share of funds that were hitherto of a deconcentrated nature as earmarked transfers (DAK).

- *Greater room for enhancing allocative efficiency and horizontal equity* – the revised Law on Fiscal Balance achieves the following: (i) increasing, even if marginally, the general purpose grants (DAU) from 25% to 26% of total revenues (which, based on current data, would result in additional resources of about Rp.15-20 trillion or approximately $1.5-2 billion) by 2008; (ii) gradually phasing out the previous stipulation that 10% of the overall DAU pool should be shared equally by all local governments; and (iii) incorporating the natural resource transfers as an integral part in calculating the DAU allocation, and gradually phasing out the "Hold Harmless" allocations to resource-rich regions. Notwithstanding these improvements, some key constraints need to be removed, principally the linkage between wage bill and the DAU calculation, which in essence does not give any flexibility or incentives to local governments in civil service management. This is a key area addressed in the NAPFD.

41. **Local Government Revenues.** The Law on Regional Taxes and Charges enables local governments, which often lack capacity, to formulate taxes and charges that meet prescribed criteria, including, among others, lack of economic distortion. The negative (open list) approach has resulted in the proliferation of local nuisance taxes and charges that discourage local investment. Under this law, local regulations (*perdas*) on taxes and charges are submitted to MOF and MOHA for review for consistency with higher laws and regulations after adoption.[14] As part of the Program, MOF and MOHA completed a review of *perdas* on taxes and charges submitted from 1999 through 31 March 2005 to ensure these *perdas* conformed with higher laws and regulations. Out of 4,751 *perdas* on tax and charges submitted, 4,274 were reviewed and

[14] As discussed below, under the related project component, the revised Law on Regional Administration requires submission of draft *perdas* on taxes and charges to MOF and MOHA for review of consistency with higher laws and regulations prior to adoption.

MOHA revoked 477. In addition, under the Program, MOF has prepared and submitted proposed amendments to the Law on Regional Taxes and Charges to the State Secretariat with a view to reducing local government dependence on national government transfers and promoting more productive sources of local revenue. The proposed amendments include a move to a “positive list” of taxes that can expand the local tax base and help address the proliferation of local nuisance taxes and charges.

42. **Regional Government Borrowing**: The revised Law on Fiscal Balance, supported under the Program, limits combined national and local government debt to no more than 60% of GDP and local governments’ outstanding debt to no more than 75% of their previous fiscal year’s general revenue. Under this law, borrowing by local governments is divided into three categories: (i) short-term borrowing for cash flow needs in a single fiscal year; (ii) medium-term borrowing to finance non-revenue-generating projects for a term greater than 1 year, but less than the term of the head of the region; and (iii) long-term borrowing for revenue-generating projects for terms exceeding 1 year. Local governments are required to obtain approval from the local parliament and the MOF before they issue bonds, although the national government may not guarantee regional bonds. Regional government borrowing may be sourced through the national Government, other local governments, banks and financial institutions, nonbank financial institutions, and bond issuance. Local governments cannot borrow directly from foreign sources, but may do so indirectly through on-lending of foreign funds from the national government. The law allows for the DAU allocated to local governments to be intercepted in case of default on repayments to the national Government, but the national Government appears reluctant to use this solution.

43. Under the Program, the Government has adopted a revised regulatory framework to govern local government borrowing. Further, to help resolve the debt arrears of local governments and regional government-owned water enterprises (PDAMs), the Program has supported the (i) adoption of a regulation that provides a framework for addressing government receivables, including local government and PDAM debt arrears; (ii) adoption of a related ministerial decree that provides procedures for restructuring of PDAM debt arrears; (iii) identification of local government and PDAM loan portfolio status for RDA loans pursuant to subsidiary loan agreements as of 31 December 2004, including the extent of arrears; and (iv) initiation by MOF of debt workout agreements with seven local governments and/or PDAMs with arrears. These reforms will help to resolve a key constraint to local government and PDAM borrowing and therefore to fund much needed development.

d. Strengthened and Harmonized Framework for Planning, Budgeting and Financial Management

44. National level framework type of laws on planning, budgeting and financial management act as the foundation for sound local government finance and governance. As the key aim of the Program is to harmonize laws and regulations pertaining to local governments with those of the national laws, the Program also supports the implementation of the new Law on National Development Planning System (25/2004) to promote an integrated and coordinated approach to longer-term development planning by national and local governments. In particular, under the Program, the Government has approved key implementing regulations on planning and budgeting, aimed at enhancing performance orientation in the public sector.

45. Another key legislation supported under the Program is the new Law on State Treasury (1/2004), which aims to strengthen the legal framework for budget execution, assets and liabilities management, and accounting. As a follow-up to this law, under the Program, the Government has adopted a Presidential Decree establishing the Committee on Government Accounting

Standards (*Komite Standar Akuntansi Pemerintah Pusat Dan Daerah*, KSAP). It has also approved a regulation which outlines the Conceptual Framework for Government Accounting and the Statement on Government Accounting Standards (PSAP) 1-11 on a modified accrual basis and a classification framework that is generally in line with the *Government Finance Statistics Manual* (GFSM) 2001.

46. The revised Law on Regional Administration sets out legal provisions on budget preparation, approval, execution, and evaluation at the local level. Under this law, provincial budgets are required to be evaluated and approved by MOHA before implementation, while district budgets have to be evaluated and approved by the provinces. All local governments are required to develop a regional financial management information system (SIPKD) as an integrated part of the SIKD. The financial transactions of local governments need to follow the budget and pass through a single treasury account at the regional level. Local governments are required to submit an annual report on budget execution to the local parliament.

47. Under the Program, the Government has also amended the earlier Government regulation on regional financial management (105/2000), and adopted an action plan to implement this new regulation. The close coordination between MOHA and MOF in drafting this new regulation is noteworthy, as it represents a significant step toward a more coordinated and consistent regulatory framework for public financial management. Under the action plan, MOHA will work closely with MOF in drafting revisions to a related MOHA Decree (29/2000) and a template for a *perda* on regional financial management. The end result of this successful collaboration will be a unified set of implementing regulations on public financial management that will need to be effectively disseminated to local governments.

e. Enhanced Awareness of Public Expenditure and Financial Management Reforms and Modernization of Financial Management Information Systems

48. The revised Law on Regional Administration confers greater coordination responsibilities on the national and provincial governments, while retaining the spirit of devolution of authority to the district governments. Among other functions, local government heads, in coordination with local parliaments, develop local budgets and are responsible for local financial management, including supervision of budget execution and accountability. Provincial governors, while locally elected, represent the national government and report directly to the President. The revised law provides for provincial budgets to be evaluated and approved by MOHA, which has veto authority in case of disputes, and for district budgets to be evaluated and approved by provincial governors, who also have veto authority in their capacity as representatives of the national government.

49. In an effort to rationalize oversight responsibilities between MOF and MOHA and to oversee and coordinate activities related to regional financial management, in 2003, a Presidential Decree (8/2003) was issued to establish a new Directorate General (DG) of Regional Financial Management (BAKD) within MOHA. In 2004, a director general was appointed, a general structure and staffing approved, and echelon 2 and 3 appointees assumed office. In line with the revised Law on Regional Administration, DG BAKD needs to modernize its information systems so it can evaluate budgeting and financial management practices more effectively, as well as outcomes at the local government level. In addition, as recent amendments have conferred greater oversight authority on provincial governors with regard to local government budgets, DG BAKD needs to ensure that provincial FMIS are enhanced. New Laws on State Finance, State Treasury, State Audit (15/2004), and National Development Planning System also require local governments to upgrade planning, accounting, financial management, and internal

audit. However, few local government officials are equipped to exercise the demanding and complex responsibilities they now face in providing local services with limited resources.

50. At the national level, DG BAKD in MOHA is required to evaluate provincial budgets and establish the evaluation norms to be adopted by provinces when they review district budgets. In doing so, MOHA needs to coordinate with MOF on the regulatory requirements that local governments need to adopt in line with the new Laws on State Finance and State Treasury. Under the Program, MOHA has prepared and adopted a plan, including a full technical proposal and costing, for a computerized FMIS to automate processes for the receipt and policy and regulatory evaluation of financial and performance data submitted by local governments.[15]

51. Under the Program, MOHA has also developed and adopted a plan for the SIPKD to be implemented in 71 local governments (12 provinces and 59 districts in four of these provinces, chosen by MOHA). The plan, backed by technical proposals and costing, was developed in close coordination with ADB, and local governments were selected according to objective criteria agreed upon with ADB, including their fiscal and financial management capacities. The 12 provinces are: West Sumatra, Lampung, West Java, Yogyakarta, East Java, East Kalimantan, South Sulawesi, Bali, North Maluku, Gorontolo, North Sumatra, and Central Java. MOHA agreed to cluster the participating districts in West Java, West Sumatra, Yogyakarta and Lampung. At a series of workshops funded under related ADB technical assistance,[16] prior to adoption, the draft plan was discussed with the 71 local governments and the heads of these local governments subsequently entered into an agreement with MOHA to promote full transparency, implement PEFM reforms, and participate in the project.

3. Forward Looking Program (Phase 2)

52. The decentralization reform agenda is an area where successive Governments have undertaken stock-taking type of assessments and shown clear commitment for continuous reforms. This applies particularly to the present Government, headed by the first directly elected head of State. The Government's strong commitment to a coherent and well sequenced strategy for decentralization was most recently expressed by the President of Indonesia during an address to the Regional Representative Council.[17] In this speech, the President highlighted the need to (i) adopt reforms in a more systematic and coordinated manner; (ii) increase regional fiscal capacity and promote greater intergovernmental fiscal balance, including reallocating part of the deconcentration fund through special allocation grants (DAK) to finance local activities that have been decentralized; (iii) widen the base for regional taxes and charges; (iv) implement financial management reforms, including enhanced capacity at the local level; and (v) promote enhanced accountability.

53. The NAPFD adopted under the Program marks a significant step in adopting a clear and time-bound forward-looking plan on the fiscal aspects of decentralization. The Government, as outlined in the Development Policy Letter, has committed to continuously refine the NAPFD and to use it as a basis for formulating Phase 2 and subsequent phases of the Program. Box 2 presents the key elements of the forward-looking reform agenda supported under the Program.

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[15] Support to DG BAKD will be provided under the project loan to implement the related FMIS plan.

[16] ADB. 2003. *Technical Assistance to the Republic of Indonesia for Local Government Financing*. Manila (TA 4282, for $600,000).

[17] Government Statement on Regional Development Policy before the Plenary Session of the Regional Representatives Council, Republic of Indonesia. 23 August 2005.

Box 2: Key Elements of Subsequent Phases of the Program
Outline of the National Action Plan on Fiscal Decentralization

The National Action Plan on Fiscal Decentralization (NAPFD) sets out the forward-looking plan of the Government, to guide Phase 2 and subsequent Phases of the Program. It focuses on the following outputs:

- Streamlining Functional Assignments, and Enhancing Alignment between Functions and Financing
- Enhancing Public Service Delivery
- Strengthening Regional Resource Base, including measures to enhance local revenues, streamline revenue sharing, and equalize resource transfers
- Strengthening Regional Financial Management
- Evolving a Sound and Impartial Coordination Mechanism for Formulation and Implementation of Decentralization Reforms.

The NAPFD and the subsequent phases of the Program will support a number of specific actions. Among others, the indicative actions include:

- Clear assignment of obligatory and sub-functions at the national, provincial and district and or city levels, with specific focus on education, health and public works sectors which account for over 75% of public expenditures
- Elimination of inconsistencies between the regional autonomy laws and regulations and relevant sector laws
- Adoption of clear policy mandates and priorities in education, health and public works sectors, to clearly guide local level implementation of national priorities, as a prelude to the finalization of minimum service standards (SPM) in those sectors
- Design and submission to the President of clear policy options to reform the inter-governmental fiscal framework
- Implementation of regulatory and procedural reforms aimed at achieving horizontal and vertical equity in a gradual manner, based on continuous reviews of the fiscal balance situation supported by a sound simulation model
- Transfer of central authority and funding through special purpose grants (DAK), to provide for further devolution accompanied by full transparency and accountability
- Adoption of, and adherence to, a clear policy on the use of intercept mechanisms to deal with outstanding local government debt arrears
- Regulatory reforms to provide for local government borrowing from market sources, with clear plans for contingent liability management at local, provincial and national levels
- Regulatory measures to deal with bankruptcy of local governments and local government institutions
- Regulatory reforms and capacity development measures instituted to strengthen regional financial management, including effective management of local government assets
- Enhancing local government transparency and accountability through effective enforcement of sanctions for failure to report financial information on a timely basis to higher authorities
- Policy and regulatory reforms to provide local governments with flexibility in civil service administration
- Continuous strengthening and empowerment of the Regional Autonomy Advisory Council (DPOD) to function as an effective coordination mechanism to formulate and implement forward looking decentralization reforms

4. Important Features

54. The Program has five important features that build on ADB’s key role in supporting decentralization and good governance in aid of poverty reduction. First, it will support a series of

reforms to which the Government has demonstrated clear and sustained commitment since 1998. Second, it builds on a significant body of prior work by ADB and other development partners (Appendix 11) and it links with on-going projects, including ADB's STAR and SCBD projects (Footnotes 9 and 10) to provide an integrated package of support. Third, it demonstrates considerable development partner cooperation. Fourth, program activities will have a positive impact on the effectiveness of ADB lending in decentralized sectors, particularly with regard to on-lending to local governments. Fifth, the Program has been designed to sequence medium-term reforms, taking into account varying implementation capabilities at national and local government levels.

5. Financing Plan

55. For Phase 1, it is proposed that ADB provide to the Republic of Indonesia a loan of $300 million from its ordinary capital resources with a 15-year term, including a grace period of 3 years, an interest rate to be determined in accordance with ADB's London interbank offered rate (LIBOR)–based lending facility, including a commitment charge of 0.75% per annum, and such other terms and conditions as set forth in the Program Loan Agreement.

56. The ADB funds will support reforms that address complex and fundamental issues as described in the development policy letter and policy matrix (Appendixes 2 and 3). The loan size has been determined by the complexity of the Program, its development impact, and the importance of the sector.

6. Implementation Arrangements

a. Program Management

57. MOF will be the Executing Agency (EA). MOF, MOHA, and Bappenas will be the Implementing Agencies (IA). The DPOD will help coordinate policy, legal and regulatory reforms. Based on diagnostic work undertaken by ADB and the World Bank under a joint country financial accountability assessment (21 April 2001), implementation of related reforms identified under this assessment including adoption of a new legal and regulatory framework for public financial management, including reforms under the Program, and related reorganization of MOF and MOHA, financial management arrangements under the Program are considered satisfactory to ensure that the Government will fund implementation of the Program and other activities consistent with Program objectives.

b. Implementation Period

58. The reforms supported under Phase 1 of the Program cover the period from 1 January 2004 to 31 December 2006.

c. Procurement and Disbursement

59. The loan proceeds will be used to finance the full foreign exchange costs (excluding local duties and taxes) of items produced and procured in ADB member countries, excluding ineligible items (Appendix 12) and imports financed by other bilateral and multilateral sources. In accordance with the provisions of ADB's *Simplification of Disbursement Procedures and Related Requirements for Program Loans*, the proceeds of the program loan will be disbursed to the Republic of Indonesia as the Borrower. No supporting import documentation will be required, if during each year that loan proceeds are expected to be disbursed, the value of Indonesia's total imports minus imports from nonmember countries, ineligible imports, and imports financed under

other official development assistance is equal to or greater than the amount of the loan expected to be disbursed during such year. The Government will certify its compliance with this formula with each withdrawal request. Otherwise, import documentation under existing procedures will be required. Disbursements will be made under the simplified procedures for program loans.

d. Accounting, Auditing, and Reporting

60. ADB retains the right to audit the use of loan proceeds and to verify the accuracy of the Government's certification for each withdrawal application. Prior to withdrawal, the Government will open a deposit account at Bank Indonesia to receive all loan proceeds. The account will be managed, operated and liquidated in accordance with terms satisfactory to ADB. The MOF will send quarterly progress reports to ADB on the policy reform measures. The project loan will support the establishment and maintenance of sound financial management arrangements to support program and project implementation.

e. Single Tranche

61. The program loan of $300 million will be released in a single tranche effective upon fulfillment of Phase 1 conditions. The single tranche approach for Phase 1 is justified by: (i) substantive compliance with 20 key policy actions, which institute fundamental reforms in local government finance and governance; (ii) the evolving nature of Phase 2 based on the uncertain macroeconomic and political environment and emerging developments and requirements; and (iii) complexities and strong vested interests involved in implementing fiscal decentralization, which requires more time to ensure stronger support and consensus. Through the NAPFD, ADB and the Government have agreed on the agenda for Phase 2 dialogue and design. The timing for ADB's consideration of Phase 2 will be decided during the course of 2006, upon a thorough assessment of the reform outcomes and the results of additional sector work being supported by ADB.

f. Performance Monitoring and Evaluation

62. The poverty impact of the Program will be monitored and evaluated through existing mechanisms for monitoring regional disparities and achievement of the Millennium Development Goals.

g. Program Review

63. The Government and ADB will conduct a comprehensive review after 12 months and interim reviews every 6 months to evaluate the progress of reform measures, including the pace and direction of indicative reform actions set forth in the NAPFD and their impact on local government finance and governance.

C. Project Loan

1. Components and Outputs

64. The policy actions and project support of the Program are integrally linked. Both strive to promote greater accountability for local government finances, which will in turn lead to more efficient use of public resources and more effective delivery of basic public services at the local level. The project consists of five components, all of which have been discussed above: (i) upgrade and expand SIKD; (ii) computerization of DG BAKD to enhance oversight of PEFM reforms; (iii) develop and implement the SIPKD; (iv) computerization of the MOF system for

review of *perda* and draft *perdas* on taxes and charges; and (v) development of an MOF certification program for regional financial administrators.

a. Upgrade and Expand SIKD

65. The original and revised Law on Fiscal Balance and implementing regulations require MOF to set up and manage the SIKD. Over the past 2 years, the World Bank (through the Dutch Trust Fund) has supported development of the SIKD through a pilot scheme in 19 local governments. The pilot program involves trials of automated approaches to collecting, consolidating, and analyzing local government financial information and provides budget preparation functionality. The current pilot program is not an accounting system, but rather aims to integrate with, and collect information produced by, accounting systems. The pilot scheme is in the early phases of development. One early lesson is that a budget preparation module is not sufficient for the introduction of standard budgeting and reporting classifications.

66. Recent legal and regulatory reforms in public financial management enable MOF and MOHA to apply a consistent approach to the collection and analysis of information under the SIKD.[18] The new approach will require significant upgrading of the charts of accounts, budget preparation and presentation classifications, reporting, and other financial information by local governments. To ensure effective and consistent reporting that can easily be consolidated nationally, and close integration of the budget preparation, budget execution and reporting process, the project loan will introduce enhancements to the SIKD.

67. **Outputs and Activities** The component will support the upgrading of SIKD to (i) meet the requirements of the revised legal and regulatory framework for public financial management and (ii) meet specific MOHA, MOF and local government needs for improved financial reporting and accountability..[19]

68. The main activities will include: (i) conducting initial field assessments of local governments: (ii) selecting participating provinces and districts: (iii) reviewing and updating system design; (iv) preparing procurement documents; (v) procuring hardware and software; (vi) recruiting consultants; (vii) developing, installing and testing of the system; and (viii) providing maintenance, user training, and after sales service.

69. The selection of participating provinces and districts will be in line with criteria agreed with ADB, including: (i) commitment and willingness to participate; (ii) quality and timeliness of SIKD information submitted in the past; and (iii) the potential for complementarities with projects carried out by ADB and other development partners, such as ADB's STAR and SCBD projects (see footnotes 10 and 11). The plan is to extend SIKD coverage to all provincial offices currently without access to modern SIKD (around 20 provinces after allowing for the 12 provinces participating in the SIPKD component) and several pilot districts within each of the new provinces to be covered.

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[18] For some years there were conflicting views on whether SIKD requirements should be based on international accounting standards or requirements contained in the Government regulation and related MOHA Decree on regional financial management. This debate arose in part because of a lack of clarity in government accounting standards.

[19] Under this component, SIKD will be extended to an additional 100 local governments. Under the SIPKD component, an additional 71 local governments will be provided with SIPKD that will enable full compatibility with SIKD needs. Thus under these two components, electronic access to the upgraded SIKD will be available to an additional 171 local governments.

b. Computerization of DG BAKD to Enhance Oversight of PEFM Reforms

70. Within MOHA, DG BAKD is responsible for oversight of PEFM reforms. In addition to performing supervision and control functions, DG BAKD is responsible for facilitating the strengthening of regional government financial management. DG BAKD is also responsible for drafting MOHA's recommendations to MOF in relation to the allocation of budget resources to local governments each year. DG BAKD has been operational for about 18 months and has a complement of about 170 staff members spread over four directorates and one secretariat. Given the high priority accorded to provincial and local government financial matters in the decentralized Indonesian context, DG BAKD is potentially one of the most important directorates general in the Indonesian Government.

71. The new legal and regulatory framework requires that provincial budget formulation evaluations be completed and opinions provided within 15 days from receipt of draft provincial budgets. This time frame is difficult because of DG BAKD's limited financial evaluation systems, which need to be upgraded. DG BAKD also needs to adopt a human resource development plan to improve recruitment, training and development of staff. The project loan will focus on developing and maintaining computerized information systems within DG BAKD. Broader aspects of human capacity development will be pursued using direct government budget funding and grant support from other development partners.

72. **Outputs and Activities:** The project loan will provide information technology and information systems infrastructure within DG BAKD to improve the efficiency of internal operations and speed up flows of financial information to and from local governments (including through direct access to the upgraded SIKD). The outputs will include: (i) development of a comprehensive information technology and information systems infrastructure within DG BAKD, consisting of a local area network, website, servers, workstations, database management systems, electronic mail, internet gateways, and office automation software, including adequate facilities to ensure smooth communications with local governments; (ii) development of a computerized fiscal database and analytical financial and economic models within DG BAKD, drawing data directly from links to the SIKD, and eventually using direct data transfers to and from local governments; and (iii) completion of comprehensive short- and medium-term training programs for all DG BAKD staff to support effective migration from the current largely manual systems to the new information technology and information systems components.

73. The main activities will include: (i) updating and confirming systems design; (ii) procuring hardware and software; (iii) recruiting consultants; (iv) developing, installing, and testing the system; and (v) providing maintenance and user training. System manuals and training will be provided to DG BAKD staff on: (i) local area networks and operating systems management and operations training; (ii) desktop applications; (iii) financial management database; and (iv) financial and economic evaluation models.

c. Develop and Implement SIPKD

74. The revised Laws on Regional Administration and Fiscal Balance require local governments to manage and account for their finances efficiently and accurately through the gradual establishment of a SIPKD. Under these laws (i) SIPKD should be consistent with the new and emerging laws and implementing regulations on regional financial management procedures; (ii) budgets, accounts and reports generated by local governments should be in accord with government accounting standards and, at a minimum, be capable of producing the financial reports required by these new laws and implementing regulations; (iii) information collected

should be available to the local parliaments and the public; and (iv) information generated by local governments should be submitted to both MOF and MOHA in a format to be established by them.

75. **Outputs and Activities:** Under the revised Law on Regional Administration, MOHA is responsible for helping local governments to modernize their planning, budgeting and reporting arrangements and for making them more transparent and accountable. Under this component MOHA will provide SIPKD-enhanced software, hardware, and systems to participating local governments. It will also ensure SIKD system and output compatibility by coordinating closely with project implementation. Other key outputs will include: (i) development and/or upgrading of software and systems to meet the requirements of the revised regulatory framework, particularly the revised Government regulation on regional financial management and related MOHA decree; (ii) enhanced capability of staff to manage the migration from the existing mix of manual and basic computerized financial models to a comprehensive computerized SIPKD that approaches international best practice, and ensuring proper implementation thereof; (iii) a well developed scheme for training and certification of the financial management and evaluation officials (at both regional and head office levels) to help implement the new information systems environment being developed; and (iv) a comprehensive review of business processes of regional government-owned enterprises (BUMDs) with a view to eventually enabling BUMDs to submit financial information electronically to their local government owners and to support efforts to improve corporate planning and financial management arrangements in BUMDs.

76. The main activities will include: (i) finalizing field assessments of participating local governments;[20] (ii) confirming local governments' participation; (iii) preparing manuals and other materials before the SIPKD design is finalized and setting out migration paths from existing approaches to those required by the new regulation; (iv) conducting a final review of the SIPKD design; (v) preparing SIPKD procurement documents; (vi) recruiting consultants; (vii) developing, testing and implementing SIPKD; (viii) procuring hardware and off-the-shelf software; (ix) providing maintenance and user training on SIPKD; (x) developing training and certification of financial management and financial evaluation officials of DG BAKD in both national and local governments; and (xi) undertaking a study on financial management arrangements at BUMDs.

d. Establish a Review System for Perdas and/or Draft Perdas within MOF

77. The revised Laws on Regional Administration and Fiscal Balance, and the soon to be revised Law on Regional Taxes and Charges and related Government Regulations (65/2001 and 66/2001) require local governments to submit *perdas* on taxes and charges to MOF and MOHA for review and evaluation to ensure that they are consistent with higher laws and regulations. Under this law, any new tax or charge must be approved by the local parliament and any draft *perda*s creating a new tax must be discussed and explained to local citizens before they can be adopted into law.[21]

78. The legal and regulatory requirements impose tight time limits on national review. The Law on Regional Taxes and Charges requires that *perdas* on taxes and charges be submitted to

[20] The 12 participating provinces are West Sumatra, Lampung, West Java, Yogyakarta, East Java, East Kalimantan, South Sulawesi, Bali, North Maluku, Gorontolo, North Sumatra, and Central Java. The 59 participating districts are located in West Java, West Sumatra, Yogyakarta and Lampung.

[21] Under the Law on Regional Taxes and Charges, tax *perdas* are required to fulfill the following conditions: (i) the tax objects are located in the particular district and possess relatively low mobility across district boundaries; (ii) the tax does not contradict the public interest; (iii) the tax does not constitute a national or provincial tax; (iv) the tax has sufficient revenue potential; (v) implementation of the tax will not negatively impact the local economy; (vi) development of the tax takes into consideration issues of fairness and the capacity of local residents; and (vii) the tax does not undermine environmental conservation.

MOF and MOHA within 15 days after adoption by the local parliament and that if the national government has not raised an objection within 30 days of submission, the *perda* shall be regarded as automatically approved. Informally, a joint MOF and MOHA working group meets regularly to discuss and make preliminary evaluations of *perdas* on tax and charges received. MOF conducts the initial review and recommends revisions or rejection to MOHA. Based on MOF's recommendations, MOHA may cancel the *perda* or recommend that the local government revise it but it must do so within 30 days of the local government's submission. Existing manual processing arrangements severely limit the ability of MOF and MOHA to evaluate the many proposed *perdas* within the mandated time frame. About 1,000 new *perda*s are received each year. Usually there is a very large backlog and very few are evaluated within 30 days. In addition, the revised Law on Regional Administration requires local governments to submit draft *perdas* on taxes and charges to MOF and MOHA. Timely review of such drafts to ensure consistency with higher laws prior to adoption will help address the proliferation of nuisance tax issue.

79. **Outputs and Activities:** The component will establish a workflow management system to streamline the *perda* evaluation process. The outputs will include: (i) conversion of all existing *perda* documents to electronic documents; (ii) electronic capture, acknowledgment, and maintenance of all *perda* information, including information on draft *perdas* submitted to MOF; (iii) electronic monitoring of deadline dates by which evaluations need to be completed according to laws and regulations; (iv) electronic capture of any additional information required to be submitted with *perdas* and draft *perdas* on taxes and charges; (v) a more efficient review and evaluation process; (vi) electronic capture and recording of every stage of the review and evaluation process; (vii) capacity to provide information on *perdas* on taxes and charges in both hard and soft copy form; (viii) generation of regular routine and customized management reports of *perdas* and/or draft *perdas* on taxes and charges, including local government compliance and consistency with higher laws and regulations;(ix) access to information on new taxes and charges imposed by local governments; (x) access to successful examples of new taxes and charges, and to criteria used in the review process; (xi) full access to up-to-date *perda* on taxes and charges data by the public and other government agencies; (xii) progress towards online electronic transmission, with the eventual aim of enabling all local governments to submit proposed *perda* on taxes and charges electronically; and (xiii) a system design that can be replicated and linked with other systems at MOHA.

80. The main activities will include: (i) updating and confirming system design; (ii) recruiting consultants; (iii) training MOF staff and conducting an organizational review; (iv) procuring hardware and off-the-shelf software; (v) developing and testing the system; (vi) piloting the system; (vii) providing maintenance manuals and training; (viii) rolling out the system to MOF and local governments; and (ix) making the system accessible to other government agencies, including MOHA.

e. Certification by MOF of Regional Financial Administrators.

81. The new Law on State Treasury requires MOF to create new positions for local government financial administrators to implement reforms related to budget execution, asset and liability management, and accounting. MOF has asked for support to clarify the skills needed for these positions and to develop a related training and certification program.

82. **Outputs and Activities:** The component will establish a framework for certifying regional financial administrators in coordination with MOHA. The outputs will include: (i) clarification of skills needed and development of qualification criteria; (ii) development of a certification and training program for candidates seeking to qualify for these positions; and (iii) development of training programs leading to certification for successful candidates. The main activities will

include: (i) recruiting consultants; (ii) studying the certification system needed, based on similar systems in other government institutions and professional bodies; (ii) designing the certification system, including preparing draft regulations to establish the system; (iii) developing training programs, including training manuals; (iv) training MOF staff; and (v) compiling a database of certified officials.

3. Cost Estimates and Financing Plan

83. The project cost is estimated at $42.9 million equivalent, consisting of $19.4 million (45%) in foreign exchange and $23.4 million equivalent (55%) in local currency cost. Table 2 summarizes project cost estimates and Table 3 summarizes the financing plan.[22] Appendix 7 contains details of project cost estimates.

Table 2: Project Cost Estimates
($'000)

Item	Foreign exchange	Local currency	Total Cost
A. Base Cost as at 8 October 2005 [a]			
1. Upgrade and Expand SIKD	5,849.19	8,332.93	14,182.12
2. Computerization of DG BAKD to Enhance Oversight of PEFM Reforms	528.84	1,593.33	2,122.18
3. Develop and Implement SIPKD	11,048.89	10,306.88	21,355.76
4. Establish a Review System for Perdas on Taxes and Charges	157.93	579.98	737.90
5. Certification by MOF of Regional Financial Administrators	26.92	811.36	838.28
6. Project Coordination	388.41	733.71	1,122.12
Subtotal (A) [b]	**18,000.17**	**22,358.20**	**40,358.37**
B. Contingencies			
1. Physical Contingencies [c]	403.75	293.18	696.93
2. Price Contingencies [d]	670.53	792.41	1,462.95
Subtotal (B)	**1,074.28**	**1,085.60**	**2,159.88**
C. Financing Charges During Implementation [e]	**369.93**		**369.93**
Total Project Costs	**19,444.38**	**23,443.79**	**42,888.18**

DG BAKD = Directorate General Regional Financial Management at Ministry of Home Affairs; MOF = Ministry of Finance; PERDA = local government regulation; SIKD = regional financial information system; SIPKD = regional financial management information system
[a] In October 2005 prices.
[b] Includes tax and duty of $1,683,345 and recurrent expenses of $524,728. Recurrent expenses include software, licenses, maintenance fees, internet connection charges, and additional staff positions.
[c] Computed at 2.5% for consulting and training; and at 2.5% for computer hardware and software.
[d] Computed at 3.9% for foreign costs and an average of 3.5% per annum for local currency costs.
[e] Includes interest during the project implementation period (ADB financing at 1.0% per annum during grace period).
Source: Asian Development Bank estimates.

[22] The allocation of loan proceeds in the loan agreement will be presented in Special Drawing Rights (SDRs) equivalent of US$ with reference only to total expenditure in accordance with the policy on *Cost Sharing and Eligibility of Expenditures for Asian Development Financing: A New Approach.*

Table 3: Financing Plan
($ million)

Source	Percentage (%)	Foreign Exchange	Local Currency	Total
Asian Development Bank	70	17.6	12.4	30.0
Central Government	9	1.7	2.1	3.8
Local Governments	21	0.1	9.0	9.1
Total Financing	**100**	**19.4**	**23.5**	**42.9**

Source(s): Asian Development Bank estimates.

It is proposed that ADB provide a loan in various currencies equivalent to Special Drawing Rights 20,697,000 to the Republic of Indonesia from the Asian Development Fund (ADF). The ADB loan will have an amortization period of 32 years, including a grace period of 8 years, a 1.0% interest charge during this grace period and 1.5% during the amortization period, and equal amortization, and such other terms and conditions set forth in the Project Loan Agreement.

3. Implementation Arrangements

a. Project Coordination

84. The EA for the Project will be MOHA. MOHA and MOF will be the implementing agencies for this Project. A program and project steering committee (PPSC) consisting of echelon 1 officials from MOHA, MOF and BAPPENAS will be established to provide overall coordination of both loans. There will be one project coordinating unit (PCU) based in MOHA to assist with implementation. The PCU will provide support to (i) prepare the inception phase of the project; (ii) coordinate subsequent project implementation; and (iii) assist MOF, MOHA, local governments, and regional coordination committees to implement the Project. Where the Project involves local governments, regional coordination committees will be established to facilitate implementation. These committees will consist of senior representatives of (i) the regional secretariat, (ii) local government finance bureau, (iii) local government legal bureau, (iv) local government planning agency, and (v) one major sectoral agency within the local government (health or education).

b. Procurement

85. Procurement of goods and services will be in accordance with ADB's *Guidelines for Procurement.* Equipment will be procured through international competitive bidding procedures for packages exceeding $1,000,000 equivalent and through international shopping procedures or local competitive bidding procedures acceptable to ADB for packages up to and including $1,000,000 equivalent. For packages of $100,000 equivalent of less, direct purchase may be used. For all ADB-financed goods and services to be procured under the Project, ADB or authorized consultants will undertake periodic reviews to ensure that the procurement is being carried out in accordance with ADB's guidelines and procedures. Indicative procurement packages are set forth in Appendix 8.

c. Consulting Services

86. Consultants to be financed from the proceeds of the ADB loan will be recruited in accordance with ADB's *Guidelines on the Use of Consultants* and other arrangements satisfactory to ADB for engaging domestic consultants. Where firms are to be engaged, the quality- and cost-based selection method will be used. Approximately 3,266 person-months of consulting services will be required, consisting of 3,242 person-months of domestic consulting services and 24 person-months of international consulting services (outline terms of reference are included in a Supplementary Appendix).

d. Implementation Period

87. The Project will be implemented over a 36-month period. Implementation is planned to commence in 2005 with recruitment of consultants for project coordination in MOF and MOHA.

e. Disbursement Arrangements

88. Disbursement procedures will be in accordance with ADB's *Loan Disbursement Handbook* (January 2001) and detailed arrangements agreed upon by the Government and ADB. The minimum withdrawal amount will be $100,000 equivalent. Any disbursement below that amount will be made through the imprest account or reimbursement procedures. To facilitate the timely release of loan funds, an imprest account will be established to finance eligible expenditures. The imprest account will be used solely for project purposes and will be established at the Bank of Indonesia. The ceiling of the imprest account will be the lesser of estimated expenditures for the next 6 months, or 10% of total loan proceeds. ADB's statement of expenditure (SOE) procedure will be used to reimburse eligible expenditures and to liquidate advances to the imprest account. The individual payments that may be reimbursed or liquidated under the SOE procedure will not exceed $100,000 equivalent per payment.

f. Accounting, Auditing, and Reporting

89. MOF and MOHA will ensure the maintenance of a sound and solid accounting and financial reporting system to account for project activities. Separate accounting records for the Project will be maintained by each implementing agency. Independent auditors, whose qualifications, experience and terms of reference are acceptable to ADB, will audit such accounts and related financial statements annually, in accordance with the provisions of the Project Loan Agreement. The auditor's opinion should include the imprest account, SOE, utilization of loan proceeds, and compliance with loan covenants and the financial covenants of the Project Loan Agreement. Certified copies of audited financial statements, and the auditor's observations on compliance with the financial loan covenants will be submitted to ADB within 6 months of the close of each fiscal year. All reports and statements will be submitted in English.

90. A reporting system will be established to report financial and operational activities. Quarterly reports will indicate, among other things, commitments and disbursements, implementation status of approved subprojects, progress made against established targets, problems encountered during the quarter, steps taken and proposed to resolve the problems, compliance with loan covenants, and proposed project activities to be undertaken during the following quarter. MOHA will submit quarterly consolidated reports to ADB within 20 days from the end of each quarter using formats detailed in the project administration manual. All reports will be in English.

g. Project Review

91. ADB and the Government will undertake joint semiannual reviews of the Project to assess progress and identify constraints. The review will cover the status of preparation and implementation, the performance of consultants, and the possible reallocation of loan proceeds. There will be a comprehensive midterm review of the Project, after one and a half year's of implementation. The midterm review will (i) review the scope, design, and implementation arrangements of the Project; (ii) identify changes needed since the time of project appraisal; (iii) assess progress of the project implementation against performance indicators; and (iv) if necessary, recommend changes in the design or implementation arrangements.

D. The Technical Assistance

92. The technical assistance (TA) will lead to more effective intergovernmental coordination by the DPOD of the implementation of decentralization reforms. The outcome of the TA will be enhanced technical and analytical capacity of the DPOD to enable DPOD to effectively promote key policy reforms in fiscal decentralization. In line with technical working group work plans, the TA will provide support to DPOD Technical Working Group members and staff, which will include preparing technical studies supporting the need for reforms, developing frameworks for analytical work, monitoring DPOD's performance in promoting reforms, holding workshops and seminars to disseminate findings, and building consensus on the need for reforms with key stakeholders.

93. The technical studies will support achievement of NAPFD milestones. The total cost of the TA is estimated to be $625,000 equivalent, of which $236,000 is the foreign exchange cost and $389,000 equivalent is the local currency cost. The Government has requested ADB to finance the entire foreign exchange cost and $264,000 equivalent of the local currency cost. The TA will be financed on a grant basis by ADB's TA funding program The Government will finance the balance of the local currency cost equivalent to $125,000 through the provision of counterpart staff, office facilities, and other administrative expenses (see Appendix 10 for cost estimates and financing plan).

94. DG BAKD in MOHA will be the executing agency. The TA will be implemented over a 12-month period starting in February 2006 and ending in January 2007. It is estimated that the TA will require 50 person-months of consulting support, consisting of 8 person-months of international consulting services and 42 person-months of domestic consulting services. All consultants shall be selected in accordance with ADB's *Guidelines on the Use of Consultants* and other arrangements satisfactory to ADB for engaging domestic consultants. A firm will be engaged through the quality- and cost-based selection method. Bio data technical proposals will be used. Procurement of goods and services will be in accordance with ADB's *Guidelines for Procurement.*

IV. BENEFITS, IMPACTS, AND RISKS

A. Expected Impacts

95. **Policy, Legal and Regulatory Framework.** The Program will strengthen, clarify and harmonize the policy, legal and regulatory framework for decentralization, contributing to greater local government accountability and performance. It will support a more equitable and transparent system of intergovernmental fiscal transfers that will contribute to reducing regional disparities. Harmonization of the regulatory framework will provide clear guidelines and directions to local governments, and greatly improve the efficiency of budgeting, control of expenditures, and standards of financial reporting and accounting in the Indonesian public service.

96. **Institutional.** The Program will have an impact on building sustainable intergovernmental relations, in particular on coordination of policies and programs, and cooperation between local governments in service delivery. The establishment of the DPOD and its technical working groups will facilitate greater intergovernmental coordination and consensus on key policy reforms. The drafting of the NAPFD will enable the development of consensus on key policy issues, actions, and priorities for future fiscal decentralization.

97. **Social.** By supporting a proper assignment of functions and allocation of adequate resources, the Program will enhance the quantity as well as quality of public services, and thereby it will directly have a beneficial impact on the poor. The Program will also contribute indirectly to poverty reduction through improved performance of local governments in PEFM, which should enable resources to be reallocated to priority services.

98. **Economic.** The nature of the Program does not allow for quantitative financial and economic analysis. However, as the major purpose of PEFM is to achieve improved resource utilization, general economic benefits will accrue from improvements in national and local government operational efficiency through improved public expenditure performance and greater accountability. PEFM reforms will increase the potential for local governments to attract investment for development.

99. **Technical.** The Program will support significant improvements in managing financial information at national and local government levels. The benefits will be reflected through more effective systems for strategic planning, budgeting, and financial management that are consistent with varying absorptive capacities of local governments. Improved flows of financial information from local governments will help in determining grants and other resource transfers. More consistent and timely availability of data will also help improve local government budgeting and financial management practices. Improved reporting will enhance accountability of local governments to local parliaments and their citizens. Computerization of the review system for *perdas* on taxes and charges will contribute to a more efficient, equitable and transparent taxation system at the local government level. Benefits will accrue direct to citizens in the 171 local governments participating in the SIKD and SIPKD components, and citizens living in local governments participating in the tax and charges *perda* review system component. The Program will also raise awareness of the need to develop a cadre of well-qualified financial management professionals in the civil service.

100. **Resettlement, Indigenous People, and Environmental**. The Project will cause no direct or indirect involuntary resettlement nor will it lead to any issues affecting indigenous peoples. Based on the desk review, the proposed project is unlikely to have adverse environmental impacts.

B. Risks

1. Program Loan

101. The main risks relate to the uncertain policy framework and governments' commitment to reforms.

(i) **Weak Intergovernmental Coordination.** Lack of clarity in the policy framework is the principal risk. Notwithstanding the adoption of the revised Laws on Regional Administration and Fiscal Balance, there remains a degree of conflict between the perceived roles of MOF and MOHA. The new Laws on State Finance and State

Treasury assign to MOF the responsibility for national systems and procedures for budgeting, financial reporting and accounting. This presents a potential problem for effective cooperation between MOF and MOHA. This risk is partly mitigated by the close coordination between these ministries in the drafting of revisions to the Government regulation and related decree on regional financial management, which promote a harmonized and consistent framework, coordination on development of an integrated FMIS, and the establishment of DPOD. The DPOD, with technical and analytical support from technical working groups, is expected to be an effective forum for coordination on these issues. The two ministries have worked closely in formulating the NAPFD, demonstrating significant commitment for greater coordination in the future.

(ii) **Weaknesses in Resolving Local Government Debt Arrears.** The Government needs to be fully committed to debt restructuring and to coordinate effectively with Parliament in intercepting the DAU for those districts with unresolved arrears. Although the Government has not yet made any serious attempts to resolve the debt issue, recent passage of a new regulatory framework to reduce such debt in specific circumstances, and the implementation of this framework to resolve debt arrears with seven local governments and/or PDAMs is a good move forward.

(iii) **Constraints Relating to Fiduciary Governance.** Given the different layers of governments and the complex expenditure and revenue sharing arrangements, transparency of the budget process in Indonesia is relatively weak despite political leadership being committed to improvements. In addition to the adoption of new laws and regulations that promote public financial management reforms, MOF is taking steps to improve transparency through implementation of the SIKD. The program will promote enhancement of the SIKD to reflect recent reforms in public financial management and modernize FMIS at national and local government levels to promote greater reliability and consistency in information disclosure. Equally important will be the need to ensure that the information shared through the SIKD is adequately evaluated to guide policy formulation to strengthen the intergovernmental relations. The Program will support capacity development in this area.

2. Project Loan

102. There are several risks to the successful implementation of modernization of FMIS at national and local levels.

(i) **Technical Capacity.** Technical capacity in financial management can be built through investment in appropriate systems. Given the administrative and civil service system in place, however, the motivation of staff trained to use the new systems may remain low, given the lack of performance incentives. The impact of information systems modernization could thus be impaired unless it is accompanied by reforms in human resource management. This risk will be mitigated through: (a) a phased approach to reforms under the Program, which provides for targeted support over the medium term; and (ii) close coordination with other development partners to ensure that reforms in human resource management are provided in a targeted manner.

(ii) **Political commitment.** There is a risk that reforms relating to modernization of FMIS will be affected by a change in leadership. This risk can be mitigated partly

through the adoption of the investment project as a national program and provision of ADF resources, which will enhance local governments' absorptive capacity.

V. ASSURANCES

103. In addition to the standard assurances, the Government has given the following assurances, which have been incorporated in the legal documents. The Government will ensure that:

(i) Counterpart Funds will be used to finance the structural adjustment costs and local currency costs relating to the implementation of the Program and other activities consistent with the objectives of the Program, as more fully described in the Development Policy Letter (Appendix 2), and provide the necessary budget appropriations to primarily finance such costs;

(ii) All necessary counterpart in-kind contributions and funds for Project implementation at the national and local government levels will be provided in a timely manner;

(iii) Project coordination consultants will conduct independent reviews of implementation progress, procurement, disbursement, compliance with Loan Agreement covenants, and other relevant Project issues.

VI. RECOMMENDATION

104. I am satisfied that the proposed loan would comply with the Articles of Agreement of the Asian Development Bank (ADB) and recommend that the Board approve:

(i) a single tranche program loan of $300,000,000 to the Republic of Indonesia for the Local Government Finance and Governance Reform Sector Development Program to support Phase 1 policy actions under the Program, from ADB's ordinary capital resources, with interest to be determined in accordance with ADB's London interbank offered rate (LIBOR)-based lending facility, with a term of 15 years, including a grace period of 3 years, and such other terms and conditions as are substantially in accordance with those set forth in the draft Program Loan Agreement presented to the Board; and

(ii) a loan in various currencies equivalent to Special Drawing Rights 20,697,000 to the Republic of Indonesia for the Local Government Finance and Governance Reform Sector Development Project, from ADB's Special Funds resources, with interest charge at the rate of 1.0% per annum during the grace period and 1.5% thereafter, a term of 32 years, including a grace period of 8 years, and such other terms and conditions as are substantially in accordance with those set forth in the draft Project Loan Agreement presented to the Board.

Haruhiko Kuroda
President

13 October 2005

DESIGN AND MONITORING FRAMEWORK

Design Summary	Performance Targets/Indicators	Data Sources/ Reporting Mechanisms	Assumptions and Risks
Impact More effective and efficient delivery of basic public services by local governments	More equitable and efficient fiscal transfers by 2007 in relation to the outcomes in 2005 Increase in special purpose grants through greater devolution of centrally sponsored and funded initiatives resulting in greater alignment between public services and local preferences Increase in regional development spending between 2004-2007 Improvement in quality and consistency of local government financial reports Enhanced access to local government financial information	Central Bureau of Statistics Poverty data National Socioeconomic Survey CSP and MDG data Public Surveys	**Assumptions** • Macroeconomic and political stability • Continued commitment and participation by national and local governments in local government finance and governance reforms • National, local governments and PDAMs committed to resolving debt arrears • Local governments use enhanced revenues to implement infrastructure and social service projects • Participation by civil society and other stakeholders **Risks** • Lack of effective intergovernmental coordination • Delays in adopting harmonized policies and regulations • Regional tensions • Slow pace of reforms in human resource management
Outcome Increased accountability in management of local government finances	Enhanced intergovernmental coordination in implementing decentralization reforms Participating local governments prepare regional budgets, work plans and financial statements in accordance with legal and regulatory requirements	DPOD Technical Working group workplans and reports Policy statements ADB reports and reviews Copies of regional budget, work plans and audited financial statements Reports from relevant Directorate General and agencies in MOF and	**Assumptions** Continued ownership of local government finance and governance reforms and leadership to support implementation Program coordination unit which is proactive and facilitates reform implementation DPOD is effective mechanism for intergovernmental coordination

Design Summary	Performance Targets/Indicators	Data Sources/ Reporting Mechanisms	Assumptions and Risks
	The time frame for consolidation of financial data from regional government is decreased by 25%.between 2004 and 2007 Financial information filed by local governments increases by 50% between 2004 and 2007 Increase in public access to local government financial information between 2004 and 2007 Increase in number of *perda*s on taxes and charges submitted to MOF and MOHA for review between 2004 and 2007 50% of *perdas* on taxes and charges reviewed and evaluations issued by MOF and MOHA within mandated time frame	MOHA and participating local governments ADB reports and reviews	Government able to recruit and retain competent staff Timely provision of resources for capacity building and institutional development **Risks** Agencies unwilling to implement reforms simultaneously
Outputs 1. Enhanced inter-governmental coordination and development of NAPFD 2. Strengthened and harmonized framework for regional autonomy 3. Strengthened, rationalized, and harmonized framework for intergovernmental fiscal relations 4. Strengthened and harmonized framework for planning, budgeting and financial	Timely delivery of milestones listed below under activities	Copies of laws, regulations, elucidations, decrees and guidelines Policy statements DPOD workplans and reports Stakeholder consultations and surveys Regional budgets, work plans, audited financial statements, accountability statements	**Assumptions** • Government is committed to resolving inconsistencies in the legal and regulatory framework • Local governments accept national guidelines **Risks** • Delay in adopting implementing regulations and Decrees • Coordination mechanism not effective • Delay in developing of national and local FMIS

Design Summary	Performance Targets/Indicators	Data Sources/ Reporting Mechanisms	Assumptions and Risks
management at the local government level 5. Enhanced awareness of PEFM reforms and modernization of FMIS		ADB project performance audit report Consultants' progress reports of investment loan implementation ADB review missions	• Delay in implementing capacity building in PEFM
Activities with Milestones 1.1 Presidential decree issued establishing a Regional Autonomy Advisory Council (DPOD) to advise the President on decentralization reforms. 1.2 MOHA regulations and decrees issued clarifying the operation of the DPOD, including establishment of technical working groups. 1.3 NAPFD endorsed by State Minister of Bappenas and Ministers of MOF and MOHA 2.1 Revised Law on Regional Administration adopted (October 2004) 2.2 Government regulation issued to guide sector ministries in the development of minimum service standards. 3.1 Revised Law on Fiscal Balance adopted 3.2 New Government regulations issued on fiscal balance and local government information systems 3.3 (i) Amendments to Law on Regional Taxes to enhance local revenue raising submitted to State Secretariat; (ii) MOF review of tax and fee *perdas* submitted for 1999 to 31 March 2005 for consistency with higher laws and preparation of report for MOHA on such review; (iii) plan to computerize process for review of *perdas* on taxes and charges adopted by MOF 3.4 Based on MOF report, inconsistent *perdas* on taxes and charges revoked by MOHA 4.1 New Government regulation issued on local government borrowing 4.2 (i) New Government regulation issued providing a framework for workout of state receivables, including local government and PDAM debt arrears ; (ii) MOF decree issued to implement new regulation addressing PDAM debt arrears ; (iii) local government and PDAM portfolio status, and extent of arrears, as of December 2004, identified by MOF; (iv) MOF enters into debt restructuring agreements with 7 local governments or PDAMs with arrears 5.1 New Law on National Development Planning System adopted. 5.2 New Government regulations issued on short-and medium-term work plans for national and local governments 5.3 New Law on State Treasury adopted 5.4 Presidential Decree issued to establish Government Committee on Accounting Standards 5.5 New Government regulations issued on Government Accounting Standards and Conceptual Framework for Government Accounting 5.6 New Government regulation issued on public financial management 5.7 Action plan to implement new regulation on public financial management, including adoption of revisions to related MOHA Decree, adopted			**Inputs** • ADB Technical assistance support (TA 4282, 4543) • ADB Program Loan ($300 million to meet adjustment costs) • ADB Project Loan ($30 million) to fund modernization of FMIS • ADB technical assistance support to DPOD • ADB quarterly review missions. • Government counterpart funding • Executing Agency implementation of project performance management system

Design Summary	Performance Targets/Indicators	Data Sources/ Reporting Mechanisms	Assumptions and Risks
6.1 MOHA (i) adopts a plan for a computerized FMIS to automate processes for receipt and evaluation of financial and performance data submitted by local governments; (ii) selects 12 provinces, of which 4 select 59 districts within these provinces, based on objective criteria agreed up with ADB; (iii) coordinates with participating provinces which coordinate with participating districts, on institutional and regulatory arrangements to implement PEFM reforms; and (iv) in consultation with participating provinces and districts, adopts a plan to introduce a computerized FMIS and related infrastructure 6.2 MOF adopts a plan to expand the regional financial information system to an additional 100 local governments, to be chosen based on objective criteria agreed upon with ADB, and upgrade the system to reflect PEFM reforms			

DPOD = Regional Autonomy Advisory Council; FMIS = financial management information system; MOF = Ministry of Finance; MOHA = Ministry of Home Affairs; NAPFD = National action Plan for Fiscal Decentralization; PDAM = local government-owned water enterprise; PEFM = public expenditure and financial management; PERDA = local government regulation

DEVELOPMENT POLICY LETTER

Government of Indonesia
Letter of Development Policy for the
Local Government Finance and Governance Reform Sector Development Program

Jakarta, 10th October, 2005

Mr. Haruhiko Kuroda
President
Asian Development Bank

Dear President Kuroda:

The Government of the Republic of Indonesia is committed to promoting sustainable economic growth, reducing regional disparities and facilitating balanced development, and enhancing social equity. Good governance has been a key pillar in our transition and reform agenda, and our efforts since the Asian Financial Crisis have focused on enhancing transparency and accountability in public as well as private sectors. To support the implementation of these policy goals, the Government is committed to sound economic management and continuing with reforms in key economic sectors.

Indonesia can testify to the challenges of public administration, given its vast size and diversity. In order to enhance the quality of public administration and effectively deliver public services, the country embarked on a major decentralization agenda in 1999 and devolved significant authority to local governments. Subsequently, following amendments to key decentralization laws in 2004, the heads of districts and provinces are directly elected by the people starting this year. While these and other reforms are underway, the present Government recognizes the multitude of challenges facing us. Given the speed with which decentralization has been introduced, reform measures need to be formulated and implemented in an iterative and dynamic manner.

The principal challenges we face relate to the need: (i) for strong inter-governmental coordination at central and local levels; (ii) to clarify functional roles and responsibilities of different levels of governments; (iii) to achieve proper balance in the distribution of fiscal resources between different levels of government, and ensure that adequate financing is provided at decentralized levels to meet basic as well as medium-to-long term development needs; and (iv) to ensure prudent financial management anchored on fiscal responsibility and accountability. At the heart of all of this is the need to revive development and growth in Indonesia, so that quality public services can be delivered with equity and efficiency.

Decentralization, in principle, is intended to bring government closer to our citizens and increase the availability of funding for much needed regional development. Despite our commitment to implementing decentralization, we have faced many constraints that have impeded balanced development. To promote greater access to funding, while ensuring accountability for managing these funds, the Government is strongly committed to much needed reforms in local government finance and governance. Greater access to funding and attendant accountability will help local governments meet their growing development needs from alternative sources and reduce excessive reliance on transfers from the central government.

The Asian Development Bank (ADB) has supported the Government since 1999 through various programs and advisory assistance in the area of decentralization. Given our common goals on ensuring good governance and poverty alleviation, the Government requested ADB's support to strengthen the foundations of regional autonomy over 2005-09.

The Government and ADB have formulated the proposed Local Government Finance and Governance Reform Sector Development Program (the Program) to strengthen the legal and regulatory framework for decentralization, streamline and clarify functional responsibilities between different levels of governments, enhance horizontal and vertical equity in the sharing of overall fiscal resources, establish sound institutional arrangements to facilitate effective inter-governmental coordination, and enhance governance in the planning, budgeting and public administration processes.

Given the complexity of the reform agenda in this area, we have requested that ADB support the Government through a series of self-contained single-tranche interventions through this Government's tenure. It is envisaged that the Program will be implemented in 2 or 3 phases over 2005-09. The phased approach will allow us to design and implement reforms in a gradual manner with adequate consultations with all stakeholders.

Working closely with the ADB from end-2003 to mid-2005, the Government has formulated and implemented a number of important actions under Phase One of the Program, which will also provide investment support to strengthen the national and regional financial management and information systems, aimed at enhancing governance.

The key achievements of Phase One of the Program, as outlined in the Policy Matrix of the Program (Attachment 1), include: (i) the adoption of four new Laws on Regional Administration, Regional Fiscal Balance, National Development Planning, State Treasury, and 8 key implementing regulations, in a harmonized and consistent manner, to promote reforms in state finance, planning, budgeting, and financial management; (ii) submission of amendments to the Law on Regional Taxation to the Minister of Laws and Human Rights to expand the local revenue base and address the proliferation of nuisance taxes and fees; (iii) establishment of the intergovernmental Regional Autonomy Advisory Council (DPOD) to oversee decentralization reforms in a coordinated manner and operationalization of related technical working groups to provide research and recommendations on key pending issues (iv) firm commitment to an initiation of discussion with 7 regional water utility companies (PDAMs) regarding resolution of their outstanding debt arrears; and (v) development of plans to modernize management information systems to implement public expenditure and financial management reforms at the national and local level.

In summary, through Phase One of the Program, the Government has implemented a range of critical actions. As part of Phase One, we have also formulated a forward-looking National Action Plan on Fiscal Decentralization (NAPFD), presented in Attachment 2. As you would note, this Plan, prepared under the coordination of the State Minister of National Development Planning, has been endorsed by the Ministers of Finance and Home Affairs. It is the first attempt by the Government to reach consensus among key stakeholders on a range of critical issues and related actions in the area of fiscal decentralization, to be implemented in a phased and well-sequenced manner. The NAPFD provides a framework for reforms under Phase Two and Phase Three of the Program, building on the reforms implemented under Phase One.

The main emphasis of the future reforms as laid out in NAPFD will be on:

(i) Clarification of expenditure assignments between different levels of Government;
(ii) Ensuring adequate balance between expenditure responsibilities and funds available;
(iii) Enhancing horizontal and vertical equity in the sharing of overall fiscal resources;
(iv) Reviving public investments to meet core development priorities, through restructuring past loan arrears of local governments;
(v) Enhancing fiscal effectiveness, discipline and accountability;
(vi) Strengthening national and regional capacities for financial management and monitoring and evaluation; and
(vii) Improving overall decentralization coordination through DPOD.

The implementation of Phase One, along with the formulation of NAPFD setting out the future reform direction, will help the Government in consolidating the gains achieved thus far under decentralization. The reform agenda adopted under the Program also reflects the Government's vision on decentralization, as laid out in the President's recent address in mid-August to the newly established Regional Representative Council (DPD). The President emphasized that continuous improvements are needed to ensure that the benefits of decentralization reach ordinary Indonesian citizens. We are confident that the proposed Program and ADB's commitment to help us in a phased manner will help us in realizing the goals we have set out to achieve.

Thank you.

Yours sincerely,

Jusuf Anwar
Minister of Finance

Sri Mulyani Indrawati
Minister of National Development Planning

Attachments :

1. Policy matrix
2. NAPFD

PROGRAM POLICY MATRIX
LOCAL GOVERNMENT FINANCE AND GOVERNANCE REFORM SECTOR DEVELOPMENT PROGRAM (PHASE 1)

Impact: More effective and efficient delivery of public services by local governments
Outcome: Increased accountability in management of local government finances
Outputs: Program outputs include the following:

- Enhanced intergovernmental coordination and development of a national action plan for fiscal decentralization
- Strengthened and harmonized framework for regional autonomy
- Strengthened, rationalized, and harmonized framework for intergovernmental fiscal relations
- Strengthened and harmonized framework for government planning, budgeting, and financial management
- Enhanced awareness of public expenditure and financial management reforms and modernization of financial management information systems

Policy Actions		**Phase 1 Achievement/ Tranche Release Condition**
Enhanced Intergovernmental Coordination and Development of a National Action Plan for Fiscal Decentralization		
Establish an institutional mechanism to enhance intergovernmental coordination for implementing decentralization	1. Presidential Regulation issued establishing the Regional Autonomy Advisory Council (DPOD) to advise the President on decentralization reforms. DPOD to comprise, among others, Ministry of Home Affairs (MOHA), Ministry of Finance (MOF), and National Development Planning Agency (Bappenas), at least three representatives of local governments, and at least three experts in decentralization, and include a secretariat to provide technical advice on and support for regional autonomy and fiscal balance. 2. MOHA regulations clarifying the operation of the DPOD and decrees establishing technical working groups (TWGs) and appointing members to TWGs issued.	Presidential regulation 28/2005 issued (March 2005). MOHA regulations 30/2005, 31/2005 issued (July 2004) and MOHA decrees 118-888 and 118.05-914 issued (October 2005).
Develop a national action plan for fiscal decentralization	3. National Action Plan for Fiscal Decentralization (NAPFD) prepared and endorsed by the State Minister of the National Development Planning Agency and Ministers of MOF and MOHA. The NAPFD shall include time-bound actions with forward-looking reform measures aimed at: (i) greater clarity in the assignment of functions between different levels of governments; (ii) ensuring adequate funding for obligatory and other sub-functions at the local government level; (iii) improving the quality of public service delivery; (iv) augmenting local own source revenues; (v) greater horizontal and vertical balance in intergovernmental fiscal transfers; (vi) greater fiscal prudence, effectiveness, discipline and accountability; and (vii) enhancing national and local capacities for better financial management and monitoring and evaluation.	NAPFD prepared and endorsed by State Minister of National Development Planning Agency and Echelon Level One officials from MOF and MOHA (October 2005). **Effectivity Condition:** Issuance of Decree of State Minister of Bappenas and endorsement letters of Ministers of MOF and MOHA.

Strengthened and Harmonized Framework for Regional Autonomy		
Strengthen and harmonize the legal framework for regional autonomy	4. Revised Law on Regional Administration enacted to strengthen the legal framework for regional autonomy by (i) consolidating all legal provisions governing state finance and planning from recently adopted legislation[1] as relevant to local governments; (ii) enhancing the role and authority of provinces in evaluating the budgets of local governments and their execution, and in coordinating inter-governmental development initiatives; and (iii) paving way for direct election of heads of districts, to devolve further authority to local governments.	Law 32/2004 adopted (September 2004).
Establish frameworks for developing minimum service standards (MSS)	5. Government regulation issued under the revised Law on Regional Administration to guide sectoral ministries in developing MSS, including the need to consider local government conditions and capacity (fiscal, institutional, personnel), and local governments in implementing MSS.	Issuance pending submission by MOHA to Minister of Law and Human Rights (MHLR) for review and referral to the President for approval.[2] **Effectivity Condition:** Presidential approval
Strengthened, Rationalized and Harmonized Framework for Intergovernmental Fiscal Relations		
Strengthen the legal and regulatory framework for intergovernmental fiscal relations	6. Revised Law on Fiscal Balance enacted to strengthen the legal framework for intergovernmental fiscal relations by (i) stipulating that local governments shall not impose ad hoc local taxes and charges leading to a high-cost economy; (ii) adopting a more equalizing system of general-purpose transfers, which will be determined in line with fiscal needs and fiscal capacity; (iii) making the special-purpose transfers more flexible, to gradually move toward greater earmarked transfers and greater accountability; and (iv) rationalizing the system of regional borrowing with national Government recourse.	Law 33/2004 adopted (September 2004).
	7. Government Regulations issued under the revised Law on Fiscal Balance to (i) clarify and promote a more equitable framework for fiscal balance (special-purpose grants and general purpose transfers), and (ii) clarify the framework for regional government information systems, including reporting requirements by local governments.	(i) MOF submitted draft regulations to MHLR. Issuance pending submission by MHLR to the President for approval. (ii) Issuance pending submission by MOF to MLHR for review and referral to the President for approval.

[1] Laws on State Finance (17/2003), State Treasury (1/2004), and National Development Planning System (25/2004).
[2] Government regulations are deemed issued when published in the State Gazette after approval by the President. Prior to such approval, draft regulations are prepared and submitted by responsible Government ministries or agencies to the MLHR to ensure consistency with higher laws.

		Effectivity Conditions: (i) and (ii) Presidential approval.
Strengthen and promote a more consistent framework for regional taxation	8. (i) Amendments to the Law on Regional Taxes and Charges (34/2000) submitted to the State Secretariat to (a) expand and clarify the types of local taxes and charges that may be imposed, and (b) clarify the type of local taxes and charges that can be imposed to reduce or eliminate the proliferation of nuisance taxes and charges;[3] (ii) review of local regulations (*perdas*) on taxes and charges, as of 31 March 2005, to ensure conformity of such *perdas* with higher laws and regulations, prepared and submitted to MOHA (MOF report); and (iii) plan, backed by technical proposal and costing, to computerize and streamline the system and processes for review of draft *perdas* on taxes and charges under the Revised Law on Regional Administration, adopted.	(i) Submission to State Secretariat pending MOF submission to MLHR and MLHR submission to State Secretariat. (ii) MOF submitted report to MOHA (April 2005). (iii) MOF adopted plan (September 2005). **Effectivity Condition**: (i) submission to State Secretariat
	9. Based on the MOF report, *perdas* on taxes and charges that are deemed inconsistent with higher laws and regulations revoked by MOHA.	MOHA revoked inconsistent taxes and charges *perdas* (August 2005).
Strengthen the regulatory framework for regional government borrowing	10. Government Regulation issued under the revised Law on Fiscal Balance to harmonize and clarify the regulatory framework on regional government borrowing.	MOF submitted draft regulation to MLHR. Issuance pending MLHR submission to the President for approval. **Effectivity Condition:** Presidential approval
Adopt and implement regulatory framework for workout of regional government and regional government-owned water enterprises (PDAM) debt arrears	11. (i) Government Regulation issued under the new Law on State Treasury to provide a framework for workout of regional government and PDAM debt arrears; (ii) related Ministerial decree issued to operationalize this new regulation;[4] (iii) report prepared identifying and clarifying local government and PDAM loan portfolio status for regional government development account (RDA) loans pursuant to subsidiary loan agreements with local governments and PDAMs as of 31 December 2004, including extent of arrears; and (iv) MOF to initiate into debt workout agreements with 7 local governments and/or PDAMs with arrears.	(i) Government Regulation 14/2004 issued (March 2005). (ii) Pending approval of Minister of MOF. (iii) Report prepared (April 2005). (iv) MOF initiates debt workout agreements (October 2005) **Effectivity Condition:** (ii) Minister of MOF approval

[3] The Development Policy Loan financed by the World Bank, ADB and Japan International Cooperation Agency includes as a condition the amendment of the Law on Regional Taxes and Charges to expand the tax base to include real property taxes.
[4] Operationalize means to set forth procedures to enable the restructuring of PDAM debt arrears.

Strengthened and Harmonized Framework for Planning, Budgeting, and Financial Management		
Strengthen and harmonize the legal and regulatory framework for government planning and budgeting	12. New Law on National Development Planning System enacted to strengthen the legal framework for national development planning through integration of national and local government planning with budgeting.	Law 25/2004 adopted (2004).
	13. Government Regulations on Government Work Plan and on Budgeting issued to implement performance orientation in the public sector.	Government regulations 20/2004 and 21/2004 issued. (August 2004).
Strengthen the legal framework for budgeting and accounting	14. New Law on State Treasury enacted to strengthen the legal framework for budget execution, assets and liabilities management and accounting through (i) clarification of budget execution arrangements, including the establishment of a single general regional government treasury account to manage the overall local government budget; (ii) provision of a framework for making and receiving loans by local governments and recovery and writing off of receivables; and (iii) clarification of responsibilities and requirements for undertaking regional financial accounting, including the establishment of a committee on government accounting standards.	Law 1/2004 adopted (January 2004).
Establish committee on Government accounting standards under the new Law on State Finance	15. Presidential Decree issued under new Law on State Finance to establish the Committee on Government Accounting Standards (KSAP).	Presidential Decree 2/2005 issued (January 2005).
Adopt regulations on Government accounting standards under the new Law on State Finance	16. Government Regulation issued on the Conceptual Framework for Government Accounting and the Statement on Government Accounting Standards (PSAP) 1 to 11.	Government regulation 24/2005 issued (June 2005).
Strengthen and harmonize the regulatory framework on regional financial management	17. Government Regulation issued to implement reforms in financial management under the new Laws on State Finance, State Treasury, National Development Planning System, and revised laws on Regional Administration and Fiscal Balance.	MOHA submitted draft regulation to the MLHR. Issuance pending submission by MLHR to the President for approval**.** **Effectivity Condition**: Presidential approval
	18. MOHA, in coordination with MOF, to adopt a time-bound action plan to implement the revised Government regulation on regional financial management, including adoption of amendments to related MOHA Decree on Regional Financial Management and a template *perda* on required financial management.	MOHA adopted time bound action plan (October 2005)
Enhanced Awareness of Public Expenditure and Financial Management Reforms and Modernization of Financial Management Information Systems		
Develop plans to effectively implement fiscal decentralization at the national and local government levels	19. MOHA to (i) adopt a plan, backed by technical proposal and costing, for a computerized financial management information system (FMIS) to automate processes for the receipt and	MOHA adopted the FMIS plan, participating provinces and districts selected in coordination

	policy/regulatory evaluation of financial and performance data submitted by local governments; (ii) select 12 provinces, 4 of which shall identify up to 59 of their districts, based on objective criteria agreed upon with ADB to participate in the Program; (iii) coordinate with the participating provinces, who shall agree to coordinate with the participating districts, on the institutional and regulatory arrangements to implement public expenditure and financial management (PEFM) reforms within these participating provinces and districts; and (iv) in consultation with participating provinces and districts, adopt a plan, backed by technical proposal and costing, for introduction of a computerized regional financial management information system (SIPKD) and related infrastructure.	with ADB, MOHA reached agreement with participating provinces and districts on arrangements for implementing PEFM reforms, and MOHA adopted SIPKD plan. (September 2005).
Modernize and expand access to regional financial information systems	20. MOF to adopt a plan, backed by technical proposal and costing, to expand the regional financial information system (SIKD) to an additional 100 local government locations, to be chosen based on objective criteria agreed upon with the ADB, and upgrade SIKD to reflect reforms in public expenditure and financial management under the new Laws on State Finance, State Treasury, National Development Planning System and revised Laws on Regional Administration and Fiscal Balance.	MOF adopted plan for SIKD upgrade and expansion (September 2005).

Note: The term local and regional government is used interchangeably and refers to provinces and districts/cities.

National Action Plan on Fiscal Decentralization (NAPFD)

No	Issues	Development Strategies and Actions to be Taken	Timeframe	Agencies
A.1. Functional Assignments – Objective: To improve clarity in the assignment of functions between different levels of Governments.				
A.1	1. Unclear assignments of responsibilities and functions between central, provincial, and district/municipal governments	1.1. With inputs from a wide-range of stakeholders through national workshops, MOHA has been processing the formulation to revise the Government regulation on functional assignments (25/2000) reflecting fully the principle of subsidiarity, and clarifying the relative roles and obligatory functions and sub-functions of national, provincial and local governments; and 1.2 Explore feasible solutions to eliminate inconsistencies between the regional autonomy laws and regulations and the relevant sector laws.	2006 2006-2009	Minstry of Home Affairs (MOHA), Ministry of Law and Human Rights (MLHR), and sector Ministries
A.2. Balance between Functions and Funding – Objective: To ensure that the obligatory and other sub-functions are adequately funded.				
A.2	2. While the revised Law on Regional Adminstration (32/2004) has sufficient scope for funds to follow functions, the eventual landscape of intergovernmental fiscal relations will depend on continuous refinement of formulae and arrangements based on the revised Law on Regional Balance (33/2004) that are in place at present.	2.1. Undertake continuous reviews on an ongoing basis, supported by a sound simulation model, to achieve efficient and equitable distribution of resources. The review would focus on: (i) balancing between fiscal needs and fiscal capacities; (ii) the feasibility of gradually expediting removal of the "hold harmless" provision until 2007; and (iii) balancing between different sources of financing, including shared revenues (DBH), general allocation grant (DAU); special allocation grant (DAK); Deconcentrated Funds; and special assistance funds.	2006-2009	Ministry of Finance (MOF), National Development Planning Agency (BAPPENAS) and Regional Autonomy Advisory Council (DPOD)
		2.2. MOF, in coordination with Bappenas and DPOD to submit the outcomes of the ongoing reviews outlined in 2.1, on an annual basis to the cabinet for its consideration.	2006-2009	MOF, BAPPENAS and DPOD
		2.3. The Government, through DPOD, to adopt a clear time-table for the implementation of delegation of authorities between sector ministries (at least in health, education and basic infrastructure sectors) to the provincial and local governments, in accordance to the results of reviews outlined in 1.1 (ii).	2007-2009	DPOD (in close coordination at a technical level with Bappenas and the line ministries)
		2.4. MOF, in coordination with DPOD, to adopt a timetable for the transfer of deconcentrated expenditures for decentralized activities to DAK as	2008 (with implementation from 2009	MOF and DPOD (in close coordination at a technical level with

No	Issues	Development Strategies and Actions to be Taken	Timeframe	Agencies
		provided in the Government Regulation on Deconcentration and Special Assistance, in accordance to the results of reviews outlined in 1.1 (ii).	budget onwards)	Bappenas and the line ministries)
	3. The Regional Autonomy Advisory Council (DPOD), as the institutional mechanism to deal with fiscal balance recommendation and considerations, needs to be strengthened.	3.1. DPOD in coordination with MOF and Bappenas to formulate recommendations and present alternative intergovernmental financing policy options to the President on an annual basis, as part of the budget formulation process.	2007-2009	DPOD
B. Regional Expenditures – Objectives: To rationalize public expenditures and reorient them to improve the quality of service delivery.				
B.1. Minimum Service Standards				
	4. Public service delivery needs to be guided by well defined norms and standards.	4.1. Based on the emerging assignment of functions and the fiscal framework, the Government (through DPOD) to formulate a system of policy mandates and priorities to benchmark the delivery of public services in health, education, and basic infrastructure sectors, with clear sector-level milestones and indicators. The system of policy mandates will be an interim step in the development of MSS in these sectors, which is likely to be phased in over a period of 6-8 years, in line with national commitment to the achievement of MDG.	2006	DPOD
		4.2. Formulate methodologies and costing for MSS in at least 3 sectors (Health; Education; and Basic Infrastructure).	Methodologies: 2006 Costing: 2007-2008	MOF and MOHA (with participation of line ministries through DPOD)
B.2.Organizational Restructuring of Local Governments				
	5. Salaries and wage bills have grown significantly at the local government levels, partly due to expansion of organizational structure and lack of adequate incentives to restructure.	5.1. Adopt a sound regulatory framework to provide clear and adequate incentives and flexibility for local governments on the administrative structures, the number of civil servants, their qualifications and the rewards/incentive system.	2006-2007	MOHA, DPOD (in coordination with the State Ministry for Administrative Reforms (MenPAN)
C. Regional Revenues				
C.1.Own Source Revenues – Objective: To augment local own source revenues with a view to increasing fiscal capacity.				
	6. Local own revenue capacity is still low as a consequence of limited taxation authority vested in local governments. At the same time, a number of local governments have introduced “nuisance” taxes and charges.	6.1. Draft revisions to the Law on Regional Taxes and Charges (34/2000) to enhance discretion in setting rates as well as to extend the tax base and charges which are stipulated as positive lists (closed lists) submitted to the Parliament..	2006	MOF
		6.2. National Government to undertake reviews on a periodic basis of local government own source	2006-09	MOF, MOHA

No	Issues	Development Strategies and Actions to be Taken	Timeframe	Agencies
		revenue outturns and submit clear recommendations for enhancing own source tax and charges revenues on an annual basis to DPOD.		
C.2. Fiscal Transfers – Objective: To enhance horizontal and vertical balance in intergovernmental fiscal transfers				
C.2. 1.	**Revenue Sharing (Dana Bagi Hasil)**			
	7. The disbursement of shared revenues is often late, with the regions receiving their transfers only in the 4th quarter, which significantly delays budget execution.	7.1. The Government to ensure that disbursement mechanism is implemented effectively, pursuant to requirements under the revised Government regulation on fiscal balance (revisions to Government regulation 104/2000).	2006	MOF
C.2. 2.	**General Purpose Transfers (DAU)**			
	8. The application of the DAU system is neither equitable nor efficient, in that some relatively richer districts receive greater resources in relation to their routine needs while poorer regions are allocated less.	8.1. MOF in coordination with the DPOD, to submit the recommendations to the Cabinet to ensure the transparency improvement of the DAU system.	2006	MOF and DPOD
C.2. 3.	**Special Purpose Transfers (DAK)**			
	9. The fiscal transfers system in Indonesia is still in a process of evolution, with funding yet to fully follow functions. The relatively small size of DAK (about Rp.3 trillion, or slightly above a fourth of the DAU) is a manifestation. As a result, the large DAU allocations militate against accountability, and the large Deconcentrated Funds militate against devolution of authority.	9.1. MOF and BAPPENAS in close coordination with the DPOD to formulate and submit recommendations to the Cabinet to strengthen the DAK framework to improve accountability with greater devolution of authority at the regional levels to fulfill national priorities.	End 2006	MOF and Bappenas (in close coordina-tion with DPOD and the line ministries)
C.3. Regional Borrowing – Objective: To improve fiscal prudence and support regional development.				
	10. Failure to resolve the past problem of accumulated arrears on the part of a number of local governments and regional government owned water enterprises (PDAMs) is holding up investments for new development initiatives.	10.1. In light of provisions in the revised law on fiscal balance allowing the Central Government to have DAU and revenue transfers intercepted for local government's arrears, MOF to finalize a clear policy and mechanism on intercept of of these transfers. .	2006 (to be effective from 2007)	MOF
	11. The new legal framework allows municipal governments to borrow directly from the market.	11.1. MOF to formulate implementing regulations on municipal borrowing that take into account fiscal prudence and fiscal capacity, with a view to promoting regional development in a fiscally responsible manner, and follow up to ensure their approval by the President.	2006	MOF
D. Regional Financial Management – Objective: To enhance fiscal effectiveness, discipline and accountability.				

No	Issues	Development Strategies and Actions to be Taken	Timeframe	Agencies
D.1.	**Asset and Financial Management**			
	12. There is lack of clarity on the ownership of assets amongst central, provincial and local governments.	12.1. MOF / MOHA to: (i) finalize regulations under the Law on State Treasury (1/2004) in relation to asset management; and (ii) prepare manuals and training guidelines in relation to good asset management; and follow-up to ensure their approval by the President.	2006	MOF and MOHA
	13. Many local governments do not apply consistent budgeting, accounting and reporting standards	13.1 MOHA/MOF to provide capacity development support through development of central manuals and training to facilitate implementation of the Government accounting standards and the revised regulation and related MOHA Decree on regional financial management.	2006 - 2009	MOHA and MOF
		13..2 In parallel with ongoing efforts to expand the regional financial information system (SIKD) and based on the ongoing review of compliance in reporting, MOF (in coordination with MOHA) to enforce sanctions on local governments that do not provide information on regional budgets on a timely basis as inputs for the SIKD. The sanctions imposed will be reported to DPOD	2006	MOF in coordination with MOHA
	14. The legal framework needs to be strengthened for dealing with bankruptcy of local governments.	14.1. MOHA, MOF and DPOD, to formulate Government regulations outlining follow-up measures for dealing with local government bankruptcy, and to follow up to ensure their approval by the President.	2006	MOHA, MOF and DPOD
	15. The implementation of regional autonomy has led to the creation of new administrative regions, considerably straining State finances, with no tangible demonstrated impact on the delivery of public services.	15.1 MOHA and MOF to formulate a policy framework on the formation of regions, taking into account the lessons learnt from the past 5 years and an assessment of the costs and benefits.	2006	MOHA, MOF
D.2.	**Accountability**			
	16. The supervision and monitoring of regional finance is still not effective, given inadequate capacity as well as lack of adequate accountability.	16.1. MOF and MOHA, to formulate implementing regulations on internal controls at the local government levels.	2006	MOF and MOHA
		16.2 MOF and MOHA to develop a joint capacity development and accreditation program for local government finance officials, including those in the regional internal audit units (the Bawasdas).	2006	MOF and MOHA
E. Capacity Development – Objective: To enhance national and local capacities for better financial management and monitoring and evaluation				
	17. Capacity constraints are pervasive, and the	17.1 The Government to expand Capacity	2006-2009	MOF and MOHA

No	Issues	Development Strategies and Actions to be Taken	Timeframe	Agencies
	quality of human resources significantly varies across the local governments. There are also broader issues in terms of alignment between legal mandates and the allocation of resources to different agencies at local levels.	Development initiatives aimed at strengthening: (a) central and provincial level evaluation capacity of local government performance, and (b) local government financial management and overall accountability.		
F. Overall Coordination and Monitoring and Evaluation of NAPFD – Objective: To enhance the role of the DPOD in coordinating the implementation of decentralization				
	18. The absence of a well-functioning coordinating mechanism has been a serious implementation constraint in the area of decentralization. It is vital that the DPOD is adequately resourced and empowered to deliberate on key issues and present reform recommendations to the President on a periodic basis.	18.1 In line with Presidential Decree 28/2005, which established the DPOD, MOHA to ensure that the DPOD is (i) adequately resourced to coordinate the implementation of decentralization, with the attendant tasks of indepth assessments of issues and stakeholder consultations; (ii) empowered to carry out its tasks efficiently; (iii) meets as a full Ministerial Body at least once every quarter; and (iv) tasked as well as provided with adequate resources to monitor and evaluate progress achieved under National Action Plan for Fiscal Decentralization (NAPFD) and submit reports on a quarterly basis to the DPOD.	2006-2009	MOHA and DPOD Technical Secretariat

SECTOR ANALYSIS: NEWLY EMERGING POLICY FRAMEWORK FOR ADMINISTRATIVE AND FISCAL DECENTRALIZATION IN INDONESIA

A. Background

1. The original decentralization laws on regional autonomy (22/1999) and fiscal balance (25/1999) took a “big bang” approach to decentralization in Indonesia. These laws were supplemented by the Law on Regional Taxes and Charges (34/2000). Table A4.1 summarizes some key provisions of the original decentralization framework and related issues that have emerged.

Table A4.1: Summary of Original Decentralization Laws─Key Issues

Law on Regional Autonomy	Issues	Law on Fiscal Balance	Issues	Law on Regional Taxation	Issues
Direct allocation of functions to district governments (public works, health, education and culture, agriculture, communication, industry and trade, capital investment, environment, land, cooperatives, manpower) National Government responsible for foreign policy, defense, security, judicial, monetary and fiscal, and religion	Lack of clarity in obligatory expenditure assignments between local and national governments and minimum service obligations Expenditure assignments inconsistent with sector laws Limited role for provinces	Consolidated fiscal transfers General allocation grant (DAU) Special allocation grants (DAK) to finance special needs relating to national priorities De-concentrated and co-administered funds Mechanism for regional borrowing unclear and incomplete	Favors resource-rich regions Most of the grant used to pay local government salaries Funding is limited Used to fund local government obligations. Nontransparent disbursement Unresolved debt arrears from previous framework constrains future borrowing	Devolved limited tax authority to local governments Provided a negative list of taxes	Insufficient revenue base Resulted in proliferation of nuisance taxes
	Overlapping responsibilities of Ministry of Finance (MOF) and Ministry of Home Affairs (MOHA) for regional financial management		Overlapping responsibilities of MOF and MOHA for regional financial management		

Sources: Legal and regulatory analysis prepared under ADB. 2003. *Technical Assistance to the Republic of Indonesia for the Local Government Financing Project* Manila (TA 4282); ADB. 2002. *Technical Assistance to the Republic of Indonesia for Support for the Regional Government Borrowing System* (TA 3935); and ADB. 2004. *Technical Assistance to the Republic of Indonesia for Sustaining Decentralization and Local Governance Reforms* (TA 4543).

B. Emerging Policy Framework

17. **New Laws on Public Finance.** The immediate past Government recognized the need to update systems and procedures for planning, budgeting, treasury, accounting, and auditing to promote greater accountability and transparency. The Ministry of Finance (MOF) established the Financial Management Reform Committee (KPMK) to guide financial management reforms and formulate policies and legislation to bring budgeting, treasury management, and accounting practices in line with international practices. In July 2002, KPMK published a white paper, Reform of the Public Financial Management System in Indonesia: Principles and Strategy, setting out the broad principles for public expenditure and financial management (PEFM) reforms.

18. In March 2003, the first of four framework laws, Law on State Finance (17/2003), was adopted by Parliament. This law was followed by the adoption of Laws on State Treasury (1/2004), State Audit (15/2004), and National Development Planning System (25/2004). These laws introduce a range of new planning, budgeting, accounting, and financial management principles and procedures that affect all government entities, including local governments and their work units and enterprises. For the national Government, key changes include the introduction of unified performance budgeting using classifications that comply with the *Government Finance Statistics Manual* (2001).

19. In January 2005, a Presidential Decree (2/2005) was issued under the new Law on State Finance to establish the Committee on Government Accounting Standards (KSAP), which now includes representatives from the Ministry of Home Affairs (MOHA). KSAP developed the Conceptual Framework for Government Accounting and 11 government accounting standards (PSAP): Financial Statements Presentation (SAP 1); Budget Realization Statement (SAP 2); Cash Flow Statement (SAP 3); Notes to the Financial Statements (SAP4); Inventory (SAP 5); Investments (SAP 6); Fixed Assets (SAP 7); Construction in Progress (SAP 8); Liabilities (SAP 9); Error Corrections, Changes in Accounting Policies and Extraordinary Events (SAP 10); and Consolidated Financial Statements (SAP 11). The SAPs have been influenced by international public sector accounting standards, and accounting standards adopted by other jurisdictions and were incorporated into Government regulation (24/2005) issued in June 2005. Under the new laws and regulations, the Government will transition to accrual accounting.[1] During the transition (2004–2007), financial reporting will be based on a modified accrual basis (also known as a modified cash basis). In addition to adopting modifications to the cash basis, the Government will provide additional disclosure of certain items normally recognized under accrual accounting, such as near-cash balances represented by receivables and payables subsequently received or paid, and various financial assets and liabilities. Beyond 2007, financial reporting will be based on accrual accounting, under which financial transactions are counted when the transaction occurs, regardless of the timing of the related cash receipt or payment.[2]

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[1] Government financial reporting is based on cash accounting, producing one major report showing the cash financial position as at balance date and details of cash receipts and payments for the entity during the period. Cash-based financial reports show the sources, allocation, and use of cash resources. They show the cash required to finance government activities, and the Government's cash position.

[2] Accrual accounting permits assessment of the full costs of an operation and provides a simultaneous picture of changes (and stocks) of public sector assets and liabilities. Accrual accounting also provides a comprehensive picture of Government liabilities (including payment arrears) and enables the establishment of realistic budgets through an assessment of future impacts of current policy decisions.

21. For local governments, a key change in adapting to new laws and regulations will be in the definition of managerial accountability. Heads of all government entities will be made accountable for operational performance and heads of financial management (MOF nationally, and a chief financial manager regionally) will be made accountable for financial management. The Law on State Audit strengthens the authority of the Supreme Audit Institution (BPK), which is responsible for the financial and general performance audit of national and local government finances. BPK is required to finalize annual audited financial and performance statements within 6 months of the end of the financial year, which are required to include, at minimum, statements and audit opinions with regard to budget realization, balance sheet, cash flow statement, notes, and statements of state regional enterprises.

22. **New Law on Regional Administration.** The revised Law on Regional Administration (32/2004) seeks consistency with the new laws on State Finance, State Treasury, and State Audit,[3] and provides a framework for direct election of the heads of local governments and a greater coordination role for the provinces.

23. This law sets out approaches to establishing, merging, and expansion of local governments. Criteria include (a) length of operation; (b) administrative factors; (c) technical factors; and (d) physical factors. Special territories are also provided for.

24. This law bases functional responsibilities on four principles (a) externality; (b) accountability; (c) efficiency; and (d) harmony. Government affairs are delegated to the regions to be accompanied by adequate funding, means, facilities, and employees. Mandatory affairs of provinces and districts/cities are the same. However, provinces operate region-wide while districts/cities undertake service delivery. Mandatory regional affairs are (i) development planning; (ii) planning and zoning; (iii) public order / peace; (iv) public means/facilities; (v) health; (vi) education/human resources; (vii) social; (viii) manpower; (viii) cooperatives and small and medium enterprises; (ix) environment; (x) agrarian services; (xi) demography/civil registry; (xii) government administration; (xiii) capital investments; (xiv) other basic services; and (xv) others.[4] Some services may be delivered solely by one level of government while others may involve sharing or licenses between different levels.

25. Regional administration is shared by administrations and local legislatures (DPRDs), neither having absolute superiority. Subnational administration and DPRDs exist in (a) provinces; (b) districts/cities; (c) subdistricts; and (d) villages. Regions have autonomous rights, including (a) self management; (b) election of regional heads; (c) managing local public service; (d) managing local assets; (e) administering local taxes and levies; (f) sharing profits of local natural resources; and (g) collecting legitimate revenues. Regional rights and obligations are to be brought together in regional plans, budgets, and financial management systems.

26. Regional and deputy heads are elected as pairs and have the authority to manage, although many powers are shared with the DPRD, including development of policies, plans, laws, regulations, and budgets. Political heads are delegated by the President to be responsible and accountable for local financial management, including supervision of budget execution and accountability. Governors of provinces provide an annual accountability report to the President

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[3] However, some inconsistencies continue to exist: (i) additional powers of governors / MOHA minister to control deficit levels; (ii) no specific provision for a year of forward estimates; (iii) new powers for governors to review and annul district budgets or for MOHA to review and annul provincial budgets; (iv) new powers requiring MOF to consult with MOHA before approval of regional government borrowing; and (v) Law on State Finance does not specifically foreshadow the establishment of a reserve fund.

[4] Within available resources, regions may pursue additional optional affairs.

through the MOHA, as well as to the DPRD and the public. District heads provide an annual accountability report to MOHA, the DPRD, and the public. The national Government is required to undertake a national evaluation. Provincial governors, although locally elected, represent the national Government and report to the President, although they still are still accountable to the DPRD and the public. DPRDs are responsible for (i) drafting/passing local laws; (ii) approving the regional budget in cooperation with the regional head; and (iii) supervising plans, policies, laws, and finance.

27. The regional civil service (basically the same for provinces and districts) consists of (i) a regional secretariat, headed by a regional secretary (for provinces appointed by the President on the governor's recommendation; for regions appointed by governor, on the district head's recommendation); (ii) a DPRD secretariat chaired by a secretary; (iii) regional services, led by heads of services, appointed by the regional head on the recommendation of the regional secretary and reporting to the regional head through the regional secretary; and (iv) regional technical institutions (with similar leadership and reporting structure to regional services). Subdistricts have heads appointed by the district head on recommendation of the regional secretary. Subdistrict heads report to the district head through the regional secretary. The details of a district civil service apparatus are to be set out in a district regulation. Village units have chiefs appointed by district head on the recommendation of subdistrict head. Village unit chiefs report to the district head through the subdistrict head. The national Government civil service is integrated and includes local civil servants. National responsibilities include formation, procurement, appointment, relocation, termination, pensions, salaries and allowances, welfare, rights and obligations, and career development and control of numbers. Elements of appointment, promotion, transfer, and termination within local governments for echelon 2 and below has been passed to the regions, although in some cases in coordination with MOHA and the Civil Service Agency.

28. Various regional regulations (*perdas*) are required to be evaluated and approved by the national Government within seven days of enactment. Any proposal contradicting the public interest or higher laws may be annulled. If disagreement occurs, the regional head may object to the Supreme Court, which may overturn the proposal. Provincial budgets are evaluated and approved by MOHA and, if in contravention of higher laws and the public interest, then the governor and the DPRD should make the requested amendments. If they refuse, MOHA can annul the governor’s/region's regulation on the budget and declare last year’s budget ceiling to be in place. A similar provision is made for district budgets, which are required to be evaluated and approved by the governor. If rejected, the regional head and DPRD are required to make the requested amendments. If they refuse, the governor can annul the budget regulation and declare last year’s budget ceiling to be in place.

29. Planning provisions are broadly consistent with the original Law on Regional Autonomy and work plan and budget provisions with the new Law on State Finance. Regional planning is integrated with national planning, and planning and budgeting are closely linked and conducted at the provincial and regional levels by the regional planning agency under responsibility of the regional head. Provincial and district government plans are prepared for 20 and 5 years and I year. Regional work units (province and district) are required to produce an entity 5-year strategic plan and an annual work plan linked to the budget.

30. A framework is set out for regional budget preparation, execution, financial management, and reporting. Regional heads (delegated by the President) have authority for all financial management matters. However, heads are required to delegate authorities to regional officials for budget planning, budget execution, administration, reporting, accountability,

management, and supervision. Regional expenditures are to be effective re desired outcomes, allocated to key priorities, minimum service standards (SPM), price standards, and performance benchmarks. With budget preparation, the regional head is required to set broad priorities and ceilings while the budget—including the annual work plan—is prepared by the regional finance officer in conjunction with the heads of regional work units. Budget approval (and revisions to approved budgets) is a joint process involving both the head of the region and the DPRD. Procedures to apply in the event of dispute between the head and the DPRD are not clearly set out. With budget execution, all regions are required to develop a regional financial management information system (SIPKD) as part of a regional administration information system. All financial transactions should be on budget and pass through a single treasury account managed by the regional general treasurer. The regional head (or his delegate) is required to authorize all budget expenditures. Brief provisions are set out for cash management and bank accounts. Budget reporting and accountability requires an annual audited statement in line with Government accounting standards to go to the DPRD within 6 months of the year's end, including budget realization, balance sheet, cash flow statement, notes, and financial statements of local state enterprises.

31. Regions with the necessary approvals may borrow, and issue regional bonds. Any foreign borrowing (including on lending) requires MOF approval after consultation with MOHA. This new role for MOHA is not consistent with the new Law on State Finance, which only requires MOF approval.

32. The law provides for the operation of regional reserve funds and state enterprises. Uses of budget surpluses and the financing of budget deficits are addressed. MOHA is authorized to control regional budget deficits and monitor them every 6 months. Where an approved budget is not in place by the start of the year, the previous year’s approved ceilings may be used on approval (in 30 days) of MOHA for provinces and governors for districts.

33. Disputes within a province are addressed by the governor while disputes between provinces are addressed by MOHA. Cooperation agreements between regions and third parties are encouraged. Issues of city zones and boundaries are briefly addressed.

34. Villages have an elected village chief and council (both for 6 years) as well as an appointed village secretary. The village chief has authority to manage village finances. Village regulations (consistent with a district regulation) are to be adapted to govern the management of village finances.

35. Higher-level governments are required to help enhance and supervise performance and capacity of lower levels of government, down to the villages. Supervision of regional government affairs and regulations occurs through the national Government internal supervision apparatus. The national Government may make awards and issue penalties. MOHA is responsible for enhancing provincial capacity, while regional heads are responsible at the districts and lower government levels.

36. The President may establish a council to advise him on regional policies, particularly (i) regional boundaries; (ii) special zones; and (iii) fiscal balance (including revenue sharing, resource sharing, calculation of the general allocation grant (DAU) and special allocation grant (DAK). The council will be chaired by the MOHA. Membership, organization, structure, and administration will be regulated by a presidential decree.

37. The new law is broad and many national/regional regulations/decrees are still needed, including, nationally, (i) number/size of regions; (ii) division of affairs between different levels of government; (iii) intergovernmental relations; (iv) service delivery responsibilities and SPM; (v) authorities, roles, responsibilities for natural resource management; (vi) civil service structures for provinces; (vii) authorities, duties, obligations, accountabilities of regional heads and evaluations by the national Government; (viii) duties, obligations, and financing arrangements for provincial governors; (ix) policies, standards, and procedures for the regional civil service; (x) provisions in relation to taxes and levies; (xi) emergency allocations in local budgets; (xii) SPM, price standards, and performance benchmarks; (xiii) procedures for the issue of local government bonds; (xiv) decree on guidelines for tax sharing, natural resource sharing, general and special allocation grants (DAU and DAK); (xv) decree on membership, organization, structure, and administration of the council; and (xvi) decree on the number, size, and structure of vertical institutions implementing de-concentrated expenditures in the regions.

38. **Revised Law on Fiscal Balance.** The revised Law on Fiscal Balance (Law 33/2004) is fundamentally the same as the original Law on Fiscal Balance although changes have been made with respect to, among others, the framework for regional borrowing and improvement to the formulation of the DAU in 2008. In general, the revised law provides a broad framework and leaves many important issues for implementing regulations. The revised law aims for consistency with new Laws on State Finance, State Treasury, State Audit, and revised Law on Regional Administration. National public finance policy focuses on redistribution and stabilization, while regions focus on allocative effectiveness and efficiency. Intergovernmental financing, while based on paramount national authority, aims for fair sharing of authority and responsibilities and recognizes principles of regional equalization and that adequate funds should follow decentralized functions.

39. Regional financing includes decentralized responsibilities, deconcentrated national expenditures, and co–administered expenditures. A fundamental aim is to provide for reasonable equalization between regions, with a narrowing of fiscal gaps. Funding sources for decentralized responsibilities include own revenues (PAD), balance fund (DAU and DAK), regional borrowing, and other local income sources.

40. Sources of PAD are (a) regional taxes; (b) regional fees and levies; (c) income from regional assets; and (d) other legal revenue forms (interest, foreign exchange profits, sales etc.). Within the context of ultimate national authority, regions have flexibility to raise revenues. However, they cannot create regional revenue laws that are uncompetitive or lead to a higher-cost economy, and hamper mobility of people, trade, or commerce.

41. Revenue sharing is based on realized receipts in the current year's budget. Revenue sharing relates to land and building taxes, apportioned as follows: (i) province of origin (16.2%), district/city of origin (64.8%), all districts/cities of Indonesia equally (6.5%), incentives to districts/cities whose realized land tax collections exceed budgeted levels (3.5%), and collection costs (9.0%); (ii) land and building title transfers: province of origin (16.0%), district/city of origin (64.0%), and all districts/cities of Indonesia equally (20.0%); and (iii) personal income taxes: national government (80%), province of origin (8%), and districts/city of origin (12%).

42. Table A3.2 clarifies the framework for the sharing of natural resource income:

Table A4.2: Balance Fund─Sharing of Natural Resource Income
(% of total)

Sector	National Government	Producing Province	Producing District/City	Other Districts/Cities in Province	All Districts / Cities in Indonesia
Forests	20.0	16.0	32.0	32.0	0.0
Reforestation	60.0	0.0	40.0	0.0	0.0
Mining:					
- Land Rent	20.0	16.0	64.0	0.0	0.0
- Royalty	20.0	16.0	32.0	32.0	0.0
Fisheries	20.0	0.0	0.0	0.0	80.0
Oil:					
- Base Level	84.5	3.0	6.0	6.0	0.0
- Edn. Levy	0.0	0.1	0.2	0.2	0.0
Gas:					
- Base Level	69.5	6.0	12.0	12.0	0.0
- Education Levy	0.0	0.1	0.2	0.2	0.0
Geothermal Mining	20.0	16.0	32.0	32.0	0.0

Sources: Reports prepared by consultants under ADB. 2003. *Technical Assistance to the Republic of Indonesia for the Local Government Financing Project* Manila (TA 4282).

Regional shares of oil and gas revenues may not exceed 130% of estimates in the current national Government budget. When they do, adjustment occurs through a revised national budget by way of additional DAU. The 0.5% levy on oil and gas revenues is earmarked for elementary education expenditures.

43. The total DAU by 2008 is required to be at least 26.0% of net domestic revenues (tax and non-tax revenues minus receipts shared with regions). The rate remains at 25.0% for the 2005 budget, rising to 25.5% for the 2006 and 2007 budgets. In the 2006 and 2007 budgets, no region may receive less DAU than in the 2005 budget. The DAU is divided into (i) basic allocation, calculated on total salaries and allowances of civil servants in a region; and (ii) equalizing allocation, based on the fiscal gap, defined as fiscal need minus fiscal capacity. Fiscal need is defined as amounts needed to fund basic public services (health, education, infrastructure, and poverty reduction services). Broad criteria are given to help measure fiscal need: (i) total population; (ii) land area; (iii) construction cost index; (iv) GDP per capita; and (v) human development index. Criteria for fiscal need are general with no operational formula. In the equalization allocation, fiscal capacity is defined as regional own revenues plus shared revenues. General criteria are to be established for sharing the DAU between provinces and districts/cities based on authorities/responsibilities of different levels of government. Provincial and district/city DAU amounts are conceptually determined in relation to levels of fiscal gaps in each location, but no effective operational formulae are provided. DAU distributions are to be formulated in consultation with the council. General allocations (always positive) can be offset by negative equalization allocations (i.e., where fiscal capacity exceeds fiscal need). After offsets it is possible for regions to receive zero (but not negative) DAU.

44. DAK amounts are set annually in the national budget to support special activities in the regions in line with Government criteria. Not all regions receive DAK. Conceptually, the new law provides (i) general criteria, based on financial capacity (regional budget receipts minus personnel expenditures); (ii) special criteria, based on key regional characteristics, including coastal areas, foreign borders, offshore areas, remoteness, backwardness, whether prone to

floods, landslides, or famines; and (iii) technical criteria, based on infrastructure standards. The criteria do not provide a practical formula approach to selection of the total quantum or specific allocations. Generally, regions are required to provide matching funds equivalent to at least 10% of DAK allocations, although this may be waived for poorer regions.

45. Foreign grants are required to pass through the national Government (backed by agreements between foreign donors and regional governments). Emergency funds may be established to cover contingencies such as natural disasters, extraordinary events and solvency crises as declared by the President.

46. The national Government is required to annually establish maximum levels of combined national and regional government debt, which shall not exceed 60% of gross domestic product (GDP). MOF will establish a total regional debt limit by August annually for the following budget year. Regional government borrowing may be sourced through (i) the national Government (MOF), (ii) other regional governments, (iii) banks and financial institutions, (iv) nonbank financial institutions, and (v) the public through bond issues. Regional governments cannot directly borrow from foreign sources but may do so indirectly through on-lending of foreign funds by the national Government. Regional borrowing must meet prescribed criteria: (i) balances of existing loans plus new loans to be approved may not exceed 75% of total receipts in the previous year's budget (excluding DAK, emergency fund, current loans, and other financing); (ii) financial capacity ratios to be set by the Government; and (iii) zero arrears on debts from the national Government. Regional governments may not guarantee borrowings of third parties. Regional revenues and assets may not be pledged for regional loans. However, projects financed by regional bonds may pledge project assets. Regional bonds are limited to projects that finance public investments, generate income, and provide public benefits. Approval of the regional head, the DPRD, and the national Government is required in the context of annual budgets before bond issues, which are required to be backed by a *perda*. The national Government may not guarantee regional bonds. The regional head (and his delegates) is required to manage debt portfolios in line with established debt management/risk policies. Regions are required to report every 6 months to the national Government on the regional bonds' portfolio. Any debt service arrears to the national Government may be withheld from DAU or revenue-sharing payments.

47. General principles on financial management largely mirror those in the new Laws on State Finance, State Treasury and State Audit. All receipts and payments are to be provided for through the annual budget. The annual Budget Law is the basis for budget execution, financial accountability, and sound financial management. Generally operating expenditures should not exceed revenues. The regional government should draw up an annual regional work plan as part of national development planning requirements and as the basis for preparing the annual budget. The annual budget shall consist of (i) revenues, (ii) expenditures, and (iii) financing. Expenditures shall be classified by (a) Organization; (b) Program; (c) Activity; (d) Function (GFS); and (e) Type (GFS economic).

48. Broad steps in the work plan and budget preparation cycle are the following: (i) the regional government discusses plans and policies with the DPRD in June; (ii) the regional government and the DPRD determine priorities and ceilings; (iii) regional heads of work units prepare draft unit work plans and budgets; (iv) draft work plans and budgets are to be performance-oriented and include one year of forward estimates; (v) unit work plans and budgets are then discussed by the regional head with the DPRD; (vi) the chief regional finance official finalizes the budget documents and a draft budget law; and (vii) regional head discusses

the budget and draft law with the DPRD and seeks joint agreement to final issue of the related *perda*).

49. The Budget Law is the basis for making all payments. Where it is not passed on time, monthly expenditures, reflecting the previous year's levels, may be continued. Heads of work units are required to prepare budget implementation documents based on budget allocations established by the regional head. All receipts and payments pass through a single treasury account under control of the regional treasurer. In specified emergencies, regional governments can spend on non-budgeted items but must validate them in a revised budget (usually prepared only once a year and must go to the DPRD by 30 September) or alternatively in a budget realization report. Regional governments may set up a reserve fund for unforeseen contingencies, which can be funded by receipts but not by DAK, loans or other restricted receipts. The reserve fund is maintained separately from the regional treasury account and balances may be invested in low risk securities.

50. An annual statement (by way of law) is submitted to the DPRD by the regional government by 30 June in each year, covering the previous financial year. It contains an audited annual financial report covering (i) budget realization (revenues, expenditures, and output/results performance of all work units); (ii) balance sheet; (iii) cash flow report; and (iv) notes, including reports from region-owned enterprises. Financial reporting needs to be in line with Government accounting standards. An audit by BPK should occur annually and at the end of terms of the regional head and the DPRD.

51. MOF is required to establish criteria for combined national and regional government deficit levels each year. Combined levels should not exceed 3% of GDP in any year. By August each year, MOF is required to issue criteria for maximum regional deficits (combined and individually) for the next budget year.

52. De-concentrated funding occurs through delegated authority of the national Government through national line ministries and institutions to the provincial governor. The governor establishes provincial work units to execute de-concentrated expenditures. The Governor briefs the DPRD on de-concentration expenditure plans at the time of budget formulation. The de-concentration mechanism does not formally extend to districts, subdistricts, or villages. Funding is by the national Government and is based on nonphysical activities. For budgeting, accounting, and reporting purposes, de-concentrated expenditures are part of the state budget, included in work plans and budgets of relevant state ministries and institutions, and funding is distributed through the state treasury. Any surplus funds are returned to the state treasury and any income earned is state income. Any assets purchased are assets of the state although they may be donated to the provincial government. The executing work unit is responsible for administration and accounting and for submitting accountability reports to the governor. The governor submits accountability reports to relevant state ministries and institutions, which provide accountability reports to the President. Accountability reports include financial aspects and assessments of outputs and results. Outlays are subject to supervision and audit in line with the new Laws on State Finance and State Audit.

53. Co-administered funding is by the national Government after assignment by state ministries and institutions to regional heads. Funding is possible at provincial and district/city levels. The relevant governor, head of district (*bupati*), or mayor of city (collectively “regional head”), establishes work units to manage and execute co-administered expenditures. Funding is for physical activities. The regional head informs the DPRD of co-administration programs at the time of budget preparation. For budgeting, accounting and reporting purposes, co-administered

expenditures are part of the state budget and are included in work plans and budgets of relevant state ministries and institutions, and funding is distributed through the state treasury. Any surplus funds are returned to the state treasury and any income earned is state income. Any assets purchased are assets of the state although they may be donated to local governments. The regional executing work unit is responsible for administration and accounting and for submitting accountability reports to the provincial head. The provincial head submits accountability reports to relevant state ministries and institutions, which provide accountability reports to the President. Accountability reports include financial reporting and assessments of outputs and results. Outlays are subject to supervision and audit in line with new Laws on State Finance and State Audit.

54. Consistent with the original Law on Fiscal Balance, the national Government is required to set up and manage the regional financial information system (SIKD). Regional governments are required to provide the national Government with reliable information through the gradual setting up of regional financial management information systems (SIPKD). Information to be provided to national Government includes (i) budget, (ii) budget realization, (iii) balance sheet, (iv) cash flows, (v) financial notes, (vi) de-concentrated expenditures, (vii) co-administered expenditures, (viii) regional public enterprises, and (ix) data on fiscal needs and fiscal capacities. Information in relation to points (i) to (iv) should be in line with Government accounting standards. MOF can sanction non-cooperating regional governments by delaying DAU payments. Information collected is to be open to the public.

55. Regulations adopted under the original Law on Fiscal Balance remain in force unless replaced by new regulations. Any new regulations are required to be finalized within 12 months of adoption of this law, provided that implementation of the following provisions is specifically delayed: (i) new revenue sharing for oil and gas will not commence until 2009. (ii) new DAU transfer ratios are to be based on 25.5% of net domestic revenues for the 2006 and 2007 budgets, rising to a minimum of 26.0 % for the 2008 budget. For the 2006 and 2007 budgets DAU transfers shall not be less than amounts provided in 2005. (iii) De-concentration/co-administration expenditures to be gradually transferred to DAK.

56. The revised Law on Fiscal Balance provides only a broad framework. Many national regulations will need to be either confirmed from the original Law on Fiscal Balance or newly issued, including (i) revenue-sharing arrangements; (ii) calculation of the DAU (weightings, formulae, allocations between provinces and districts/cities, and the method of distribution); (iii) calculation of the DAK (total amounts; specification of general, special, and technical criteria, reporting, and accountability arrangements); (iv) procedures for grants and emergency funds; (v) regional borrowing (including borrowing and limits criteria); (vi) preparation of annual regional work plans and budgets; (vii) management of regional finances; (viii) budgeting, distribution, reporting, accountability and donation of de-concentrated outlays; (ix) budgeting, distribution, reporting, accountability and donation of co-administered outlays; (x) management of the information system (mechanisms for submitting information, principles for managing regional systems, reporting formats, and penalties); and (xi) transfer of de-concentration and co-administration expenditures to DAK.

C. Local Government Performance and Accountability

57. The performance of local governments in the core service areas of health, education, and economic development varies widely between regions. Quality of health services has always varied greatly, with some provinces having on average five times the number of health workers as others. Since 2001, some regions have prioritized health, by giving special

incentives for doctors working in rural clinics, or by creating simple medical insurance schemes for the poor. Others have increased hospital charges, thus reducing access of the poor to health services.

58. Education also had high levels of disparity before decentralization. Unfortunately, the regions with the lowest levels of education are also frequently poorly funded regions with few resources to improve investment in education. Many regions have identified education as the key sector for long-term development and provided additional allowances to attract well-qualified teachers from elsewhere, introduced competence testing for school principals, and are investing in good libraries and laboratories. Other regions are ignoring investment in this sector. In one reported case, the regent was suspended after weeks of demonstrations and strikes by teachers and pupils over low budget allocations for education.

59. Economic development overall has been slow since the economic crisis of 1997–1998. Some regions with high commodity exports have been able to maintain significant growth, but most regions have found it hard to attract investors or reduce unemployment. Some regions have developed policies to attract development, or have engaged in aggressive marketing campaigns, usually not yet well focused on investors' interests or needs, but the experience should help them. In East Java, the Jawa Pos Institute of Pro-Otonomi, a subsidiary of the largest regional daily newspaper, presents an annual award for regions with the best policies to promote economic growth and a secure investment environment, with regions competing earnestly for the coveted award. Other regions, however, have tried to increase government revenues by raising road charges so much that farmers are being forced back into a subsistence economy.

60. Much has been made of the low capacity of regional administrations to implement change, despite the extraordinary changes that all regions have undergone over the past 6 years. Few have qualified accountants and auditors and, more significantly, there is not yet a professional position created for financial managers, although all regions now have greatly increased powers in relation to finance. New **L**aws on State Finance, State Treasury, and the revised law on Regional Administration and Regional Fiscal Balance establish positions of chief financial officers within all levels of regional government, the details of which are being clarified under implementing regulations.

61. All regions are now beginning to prepare and implement strategic planning in all their entities. An earlier ADB study indicated that few of these plans are strategic for a number of key reasons: (i) lack of effective training to help senior officials progress from being mere administrators to managers, (ii) a system of planning that still separates personnel planning and organizational design from strategic planning and the budgeting process, and (iii) lack of policy support for change (as regional entity managers rely on the head of the region and the DPRD for the policy framework). Planning requirements for regional governments and their entities have been strengthened under the new legal framework and will be clarified further in new implementing regulations.

62. It is estimated that only around 60% of regions have managed to change to the unified budget system provided for under the original decentralization laws. Most regions have not yet established a clear identification of performance requirements of programs or even a clear program of work within each entity. Accordingly, migration from existing requirements to the new legal and regulatory requirements creates major challenges for capacity building in the regions.

SUMMARY POVERTY REDUCTION AND SOCIAL STRATEGY

A. Linkages to the Country Poverty Analysis

Is the sector identified as a national priority in country poverty analysis? ☒ Yes ☐ No	**Is the sector identified as a national national priority in country poverty partnership agreement?** ☒ Yes ☐ No

Contribution of the sector/subsector to reduce poverty in Indonesia:

Poverty has been reduced at an uneven pace in Indonesia—one of the poorest countries in the world in the 1960s and seemed set to achieve middle income by the 1990s. However, even before the crisis, poverty reduction was not commensurate with the rate of growth, and sharper instruments than broad-based growth were clearly required. Following decentralization in 2001, local government became the principal agent for poverty reduction and achieving Millenium Development Goals (MDGs). Local governments are responsible for delivery of most basic services required by the poor.[1] The principal instrument used by local government is the budget, but unclear rules, inadequate safeguards, and overlapping assignments of functions prevent its effective use.

Indonesian poverty, whether measured in money metric or other terms, is characterized by persistent inequality. In 2004, the national poverty prevalence was 16.6% ranging from 3.2 % in DKI Jakarta Province to 40.2 % in West Irian Jaya Province.[2] In 2003, national under-5 malnutrition was 27.1%, ranging from 16.0 % in Bali to 46.1 % in Gorontalo. Local government financial capacity was similarly unequal and the central Government lacked an instrument to address these inequalities.

The Government is preparing a poverty reduction strategy.[3] The paper recognizes the role of government but does not distinguish among the responsibilities of different levels of government. Nonetheless, as implementation of the national strategy rests principally with the local governments and their mandate to deliver health, education, business development, employment, trade, environment, and safety services with the support of line agencies and departments, strengthening local governments is the first step to implementing the national poverty reduction strategy. The Government–ADB poverty reduction partnership agreement also recognized that "support of weaker local governments is required to prevent worsening of regional inequity".

B. Poverty Analysis Targeting Classification: Other

What type of poverty analysis is needed?

The Local Government Finance and Governance Reform Sector Development Program addresses the key bottlenecks hindering the efficient and accountable functioning of local government. The main issues are related to (i) mechanisms to coordinate decentralization reforms among stakeholders, (ii) equity in financial transfers, (iii) local taxation and nuisance taxes; (iv) responsibility by level of government; (v) regional borrowing and arrears; and (vi) financial management systems.

The key national agencies involved in local government financial management, budgeting, and planning are the Ministry of Finance, the Ministry of Home Affairs, and the National Development Planning Agency. The new approach to public sector management requires integration and harmonization of the policy and regulatory environment across stakeholders. Financial transfers need to be linked to obligatory responsibilities and fiscal needs. They are not, given various constraints. The net effect has been the favoring of resource-rich districts over poor, and small districts over large.[4] Clarifying tax authorities and implementing a review system for nuisance taxes will enable districts to raise own revenues in a pro-poor way[5]. An ADB TA studying the impact of obligatory functions and minimum service standards (OF&SPM) on districts planning, budgeting, and institutional structure found that one major impediment to

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1 Water supply, sanitation, health, education, local roads, peace and order, birth certificates.
2 Note: The former province of Irian Jaya was renamed Papua and then split into three provinces under Law 21/2001: West Irian Jaya, Central Irian Jaya, and East Irian Jaya. In 2004, the National Statistical Agency provided a separate poverty estimates for West Irian Jaya and the rest of Papua.
3 Finalized in September 2005.
4 The general allocation fund (DAU) is regressive in that districts with large populations receive less per capita than small ones. Kotamadya Sabang, for example, with 28,000 people and about 8,900 poor, receives Rp2,700 per capita. Kabupaten Lembata, with 98,000 people and 33,000 poor, receives Rp1,270 per capita. At the other extreme, Kabupaten Bogor and Bandung, with 3.8 million and 4.1 million people and 450,000 and 480,000 poor, receive Rp.146 and Rp.185 per capita each.
5 Inter-district movement of goods is easy to tax, however, as agricultural products are a large proportion of cross-district trade, so agricultural workers bear the burden of the tax.

implementing the OF&SPM was confusion over function and levels of responsibility.

Local governments require borrowing instruments that match their investment needs, from a variety of sources, including International Financial Institutions and the private sector. In particular, local governments require sources of funding for long-term investments such as education, water supply, and sanitation. Local government arrears to the central Government constrain the ability of districts to expand water supply systems. The central Government needs to manage national and local debt and address key issues related to risk management, such as collateral and dealing with default. Finally, each level of government requires timely, accurate, and sufficient financial management information based on reliable accounting standards. Considerable capacity building is needed to introduce new accounting standards and new planning, budgeting, and financial management requirements under the new laws on state finance, national development planning system, and revised laws on regional administration and regional fiscal balance.

The program initiates the process of strengthening the environment for local government finance reforms by (i) enhancing intergovernmental coordination and development of a National Action Plan for Fiscal Decentralization, (ii) strengthening and harmonizing the framework for regional autonomy, (iii) strengthening, rationalizing, and harmonizing the framework for intergovernmental fiscal relations, and (iv) strengthening and harmonizing the framework for planning, budgeting, and financial management. An investment component under this program will start modernizing the public financial management systems.

These reforms provide a platform for clarifying obligatory functions, establishing minimum service standards, taking into account fiscal constraints, providing tools to address regional disparities, promoting measures to enhance accountability, and strengthening local institutions.

Thus the proposed loan initiates a coordinated and prioritized program to empower local governments to plan, budget, and deliver access to poverty-reducing services while providing the central Government with the instruments to reduce regional inequality. These reforms and the proposed follow-on phases will provide local governments with increased resources for delivering basic services through increased efficiency in the use of own resources, additional resources from the central Government where needed, greater ability to raise additional resources for investments with long term payback periods such as health and education, and the central Government is able to make more effective use of resources by directing them where they are needed. A by-product of budget transparency and linking of policy to budget will be greater satisfaction of citizenry, particularly the disaffected poor, greater confidence in government, and, hence, greater willingness to support poverty-reducing measures by the poor and nonpoor alike.

The program provides government the means to increase access to services for the poor. However, this in itself does not guarantee increased access, which depends on policies and their effective implementation. The heightened focus of central and local governments on poverty and preparation of national and local poverty reduction strategies strongly suggests this will occur.

C. Participation Process

Is there a stakeholder analysis: ☐ Yes ☒ No

Is there a participation strategy: ☐ Yes ☒ No

D. Social Safeguards and Other Social Rirsks

Subject	Significant, Not Significant, Uncertain, None	Strategy to Address Issues	Output Prepared
Resettlement	None		None
Gender	None		None
Affordability	None		None
Labor	None		None
Indigenous People	None		None
Other Risks/Vulnerabilities	Uncertain		None, but preparation of local PRSPs should ensure poverty orientation of local government.

PROJECT COSTS BY COMPONENTS

	SIKD	DG BAKD	SIPKD	PERDA	MOF Cert.	PCU	Total
A. Funded by Loan							
1. *Cost for Central*							
- Professional/Technical Management	-	-	700.2	-	139.8	879.5	1,719.5
- IT Hardware and Software	-	-	-	-	-	-	-
- Hardware	145.7	324.2	8.4	81.6	14.4	19.1	593.4
- Software	161.0	122.5	-	2.4	-	-	285.9
- System/Application Development	2,763.5	911.1	168.6	137.7	-	-	3,980.9
Subtotal IT Hardware and Software	3,070.2	1,357.8	877.2	221.7	154.2	898.6	6,579.7
- Office Equipment	5.7	9.5	14.3	4.0	10.0	6.6	50.1
- Manuals and Instructions	38.1	3.8	120.4	3.8	-	-	166.1
- Workshops and Training	1,114.4	-	308.3	91.8	346.3	-	1,860.8
- Studies and Assessment	171.5	76.2	1.9	68.0	-	-	317.6
- Others	127.1	97.2	101.4	27.7	16.7	36.0	406.1
Subtotal A1	4,527.0	1,544.5	1,423.5	417.0	527.2	941.2	9,380.4
2. *Cost for Regions*							
- IT Hardware and Software	-	-	-	-	-	-	-
- Hardware	4,160.0	-	8,048.5	54.4	-	-	12,262.9
- Software	780.0	-	1,817.6	-	-	-	2,597.6
- System/Application Development	-	-	3,636.5	-	-	-	3,636.5
Subtotal A2	4,940.0	-	13,502.6	54.4	-	-	18,497.0
Subtotal Costs	9,467.0	1,544.5	14,926.0	471.4	527.2	941.2	27,877.3
3. *Capitalized Financing Charges During Implementation*	127.7	29.6	177.3	11.2	10.6	13.5	369.9
4. *Contingencies*							
- Physical	236.7	38.6	373.1	11.8	13.1	23.6	696.9
- Price	356.7	46.0	594.0	10.1	13.6	34.8	1,055.2
Subtotal Contingencies	593.4	84.6	967.1	21.9	26.7	58.4	1,752.1
Subtotal A	10,188.1	1,658.7	16,070.4	504.5	564.5	1,031.1	29,999.3
B. Funded by Central Government							
- Counterpart Cost During Implementation	803.3	555.0	1,775.2	113.9	319.3	187.2	3,753.9
- Recurrent Costs	32.1	39.9	-	0.6	-	-	72.6
Subtotal B	835.4	594.9	1,775.2	114.5	319.3	187.2	3,826.5
C. Funded by Regional Governments							
- Counterpart Cost During Implementation	3,982.6	-	4,496.5	131.8	-	-	8,610.9
- Recurrent Costs	63.7	-	362.8	15.0	-	-	441.5
Subtotal C	4,046.3	-	4,859.3	157.0	-	-	9,062.6
TOTAL	**15,069.8**	**2,253.6**	**22,704.9**	**776.0**	**883.8**	**1,200.3**	**42,888.4**

DG BAKD = Financial Management Information System Development at Directorate General Regional Financial Management at Ministry of Finance, MOF CERT = Certification by Ministry of Finance of Regional Financial Administrators, PCU = project coordination unit, PERDA = MOF system for review of local government regulations on taxes and charges, SIKD = MOF enhancement and upgrade of Regional Financial Information System, SIPKD = Development of Regional Financial Management Information System.
Source: ADB estimates.

INDICATIVE PROCUREMENT AND CONSULTING SERVICE PACKAGE

Description (Component)	Indicative Package	Number of Contracts	Cost Estimates ($'000)	Procurement Mode	Responsible Agency
1. Regional Financial Information system (SIKD)	Hardware and software including LAN and servers, for 100 sites.	1	5,718	ICB	MOF
2. Financial management information for Directorate General (DG) Regional Financial Management (BAKD) in Ministry of Home Affairs (MOHA)	Hardware and software including LANs and servers for users	1	483	LCB	MOHA
3. Regional financial management information system (SIPKD)	Hardware and software for 71 local governments, including LAN and servers	1	10,793	ICB	MOHA
4. SIKD System Development/Application	Developing, implementing and training	1	3,193	QCBS	MOF
5. DG BAKD System Development/Application	Developing, implementing and training	1	1,055	QCBS	MOHA
6. SIPKD System Development/Application	Developing, implementing and training	1	4,286	QCBS	MOHA
7. MOF development of system to review local regulations (perdas) on taxes and charges	Developing, implementing and training	1	305	QCBS	MOF
8. MOF Certification of regional financial administrators	Developing, implementing and training	1	183	QCBS	MOF
9. Project Coordination and Monitoring	Implementing, monitoring, and reporting	1	1.028	QCBS	MOHA

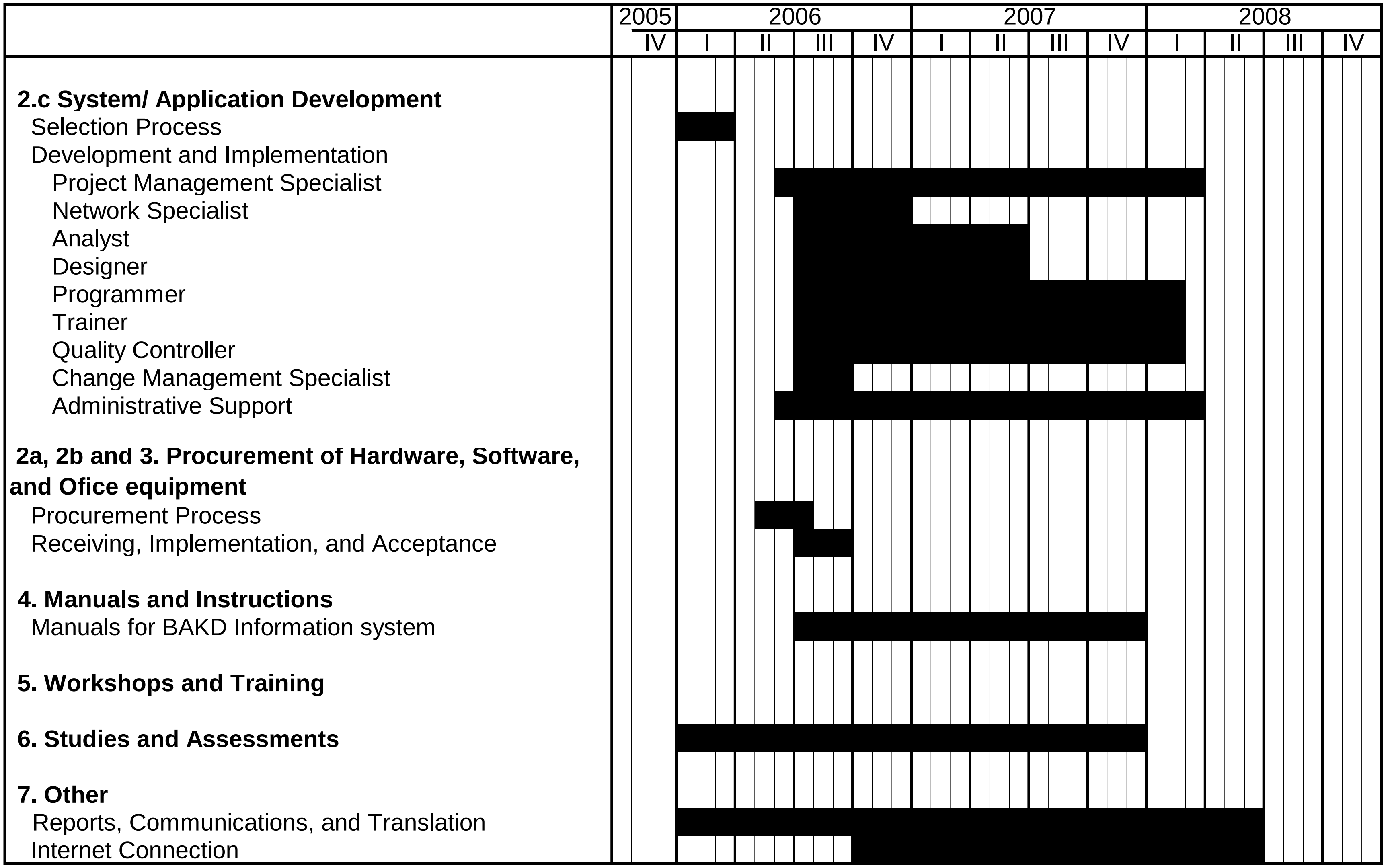
Source: MOHA and MOF plans developed under ADB TA 4282 (Local Government Financing)

IMPLEMENTATION SHEDULE

Table A9.1: BAR CHART OF IMPLEMENTATION SCHEDULE BY TIME
SIKD

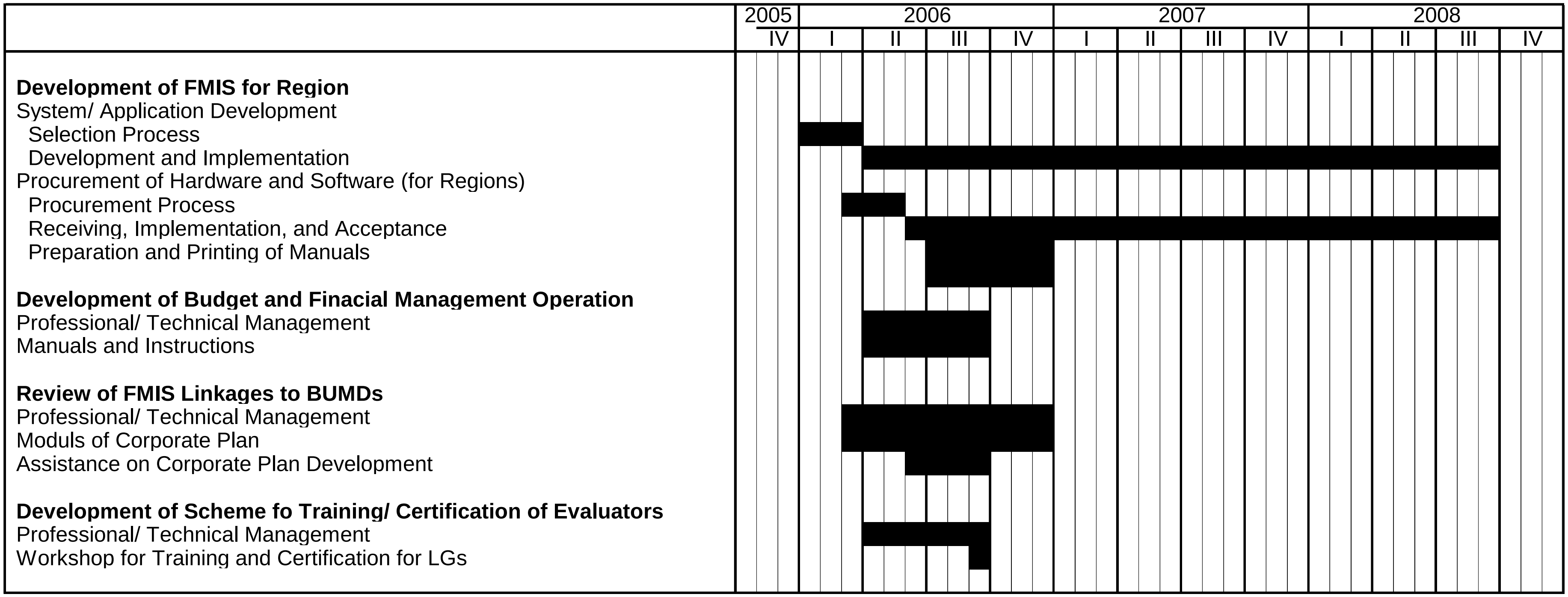
MOF = Ministry of Finance; SIKD = Regional Financial Information System

Table A9.2: BAR CHART OF IMPLEMENTATION SCHEDULE BY TIME
DG BAKD INFORMATION SYSTEM



DG BAKD = Directorate General Regional Financial Management

Table A9.3: BAR CHART OF IMPLEMENTATION SCHEDULE BY TIME
SIPKD



SIKPD = regional financial information system

Table A9.4: BAR CHART OF IMPLEMENTATION SCHEDULE
MOF PERDA ON TAXES AND CHARGES EVALUATION SYSTEM

	2005	2006				2007				2008			
	IV	I	II	III	IV	I	II	III	IV	I	II	III	IV
2.c System/ Application Development													
Selection Process	X	X											
Development and Implementation													
Project Management Expert		X	X	X									
Network Expert		X	X	X									
Analyst/Design/Programmer		X	X	X									
Trainer			X	X									
Quality Controller		X	X	X									
Administrative Support		X	X	X									
Data Conversion			X	X	X								
2a, 2b and 3. Procurement of Hardware, Software, and Ofice equipment													
Procurement Process		X	X										
Receiving, Implementation, and Acceptance													
Central (MOF)			X	X									
Regions				X									
4. Manuals and Instructions													
User Manual		X	X	X									
5. Workshops and Training													
Cost and Benefit Evaluation Analysis on Tariff			X										
Training of Regions				X									
6. Studies and Assessments													
Workshop for the assessment of the LG's current condition			X										
Technical Assistance and monitoring				X	X								
7. Other													
Reports, Communications, and Translation		X	X	X	X								
Internet Connection			X	X	X								

PERDA = local government regulation

Table A9.5: BAR CHART OF IMPLEMENTATION SCHEDULE BY TIME
MOF - CERTIFICATION OF REGIONAL FINANCIAL ADMINISTRATORS

	2005	2006				2007				2008			
	IV	I	II	III	IV	I	II	III	IV	I	II	III	IV
1. Professional/ Technical Management													
Project Management Specialist			■	■	■	■	■	■	■	■	■	■	■
Accountant			■	■	■	■	■	■	■	■	■	■	■
Procurement Specialist			■	■	■								
HR and Change Management Specialist				■									
Indonesian Contract Staff (Administration)			■	■	■	■	■	■	■	■	■	■	■
6. Studies and Assessment													
Study on certification of the financial administrators													
HRM and Training Expert - Team Leader		■	■	■									
Certification Expert		■	■	■									
HR Performance Measurement Expert			■	■									
Workshops on Functional Job Title - Financial Administrators				■									
Workshops on Functional Job Title - Financial Administrators				■									

HR = Human Resources; MOF= Ministry of Finance

Table A9.6: BAR CHART OF IMPLEMENTATION SCHEDULE BY TIME
PROJECT COORDINATION UNIT

	2005	2006				2007				2008			
	IV	I	II	III	IV	I	II	III	IV	I	II	III	IV
1. Professional/ Technical Management													
Project Management Specialist		■	■	■	■	■	■	■	■	■	■	■	■
Accountant		■	■	■	■	■	■	■	■	■	■	■	■
Procurement Specialist		■	■	■	■								
HR and Change Management Specialist			■										
Indonesian Contract Staff (Administration)		■	■	■	■	■	■	■	■	■	■	■	■

HR = Human Resources

TECHNICAL ASSISTANCE SUPPORTING AN EFFECTIVE INSTITUTIONAL FRAMEWORK FOR FISCAL DECENTRALIZATION REFORMS

Cost Estimates and Financing Plan
($'000)

Item	Foreign Exchange	Local Currency	Total Cost
A. Asian Development Bank Financing			
1. Consultants			
a. Remuneration and Per Diem[a]			
i. International Consultants (8 person-months)	168.0	0.0	168.0
ii. Domestic Consultants (42 person-months)	0.0	184.0	184.0
b. International and Local Travel	30.0	20.0	50.0
c. Reports and Communications	10.0	0.0	10.0
2. Equipment[b]	0.0	15.0	15.0
3. Training, Seminars, Workshops[c]	0.0	40.0	40.0
4. Contingencies	23.0	10.0	33.0
Subtotal (A)	**236.0**	**264.0**	**500.0**
B. Government Financing			
1. Office Accommodation and Transport[d]	0.0	50.0	60.0
2. Remuneration and Per Diem of Counterpart Staff	0.0	40.0	50.0
3. Training, Seminar and Workshops	0.0	20.0	
4. Other Administrative Expenses	0.0	15.0	15.0
Subtotal (B)	**0.0**	**125.0**	**125.0**
Total	**236.0**	**389.0**	**625.0**

[a] The technical assistance (TA) will be financed on a grant basis by ADB's TA funding program.
[b] Includes computers, printer, photo copier, in-focus projector, fax, and scanner.
[c] Includes central and local workshops on regional autonomy (e.g., criteria for formation and merger of districts, expenditure assignments/minimum service standards, institutional and human resource development, and intergovernmental fiscal relations.
[d] Transport for counterpart staff.

DEVELOPMENT ASSISTANCE FOR LOCAL GOVERNMENT FINANCE AND GOVERNANCE REFORMS

I. ASIAN DEVELOPMENT BANK (ADB)

1. Support to broadly implement decentralization and good governance, including management of public resources and expenditures, public financial management reforms, strengthening of institutions, systems and capacity, decentralized management of delivery of social services (education and health), water supply and sanitation services, and environmental protection services improving inter-governmental fiscal relation, and development of regional credit markets.

- Loan 1501-INO (Regional Development Account) (5 December 1996)
- ADTA 2699 – INO (Strengthening Regional Development Account) (5 December 1996)
- TA 3042- Capacity Building for Decentralized Social Services (23 June 1998)
- Loan 1678 – INO (Local Community and Local Government Sector Support Development Program (4 March 1999)
- TA 3176 (Capacity Building to Support Decentralized Health Services) (25 March 1999)
- TA 3177 (Capacity Building to Support Decentralized Administrative Services (25 March 1999)
- TA 3178 (Capacity Building for Setting Up District Level Financial and Budgeting Systems (25 March 1999)
- TA 3179 (Capacity Building for Participatory Planning, Monitoring and Evaluation)(25 March 1999)
- TA 3214 (Improving the Management of Government Onlending Operations (1 July 1999)
- TA 3242 (Capacity Building for Decentralization of the Environment Impact Assessment (1 September 1999)
- TA 3326 (Urban Sector Development in a Decentralizing Environment) (8 December 1999)
- TA 3394 (Public Expenditure Management and the Impact of Decentralization) (25 January 2000)
- Loan 1818 (Decentralized Health Services) (14 December 2000)
- TA 3764 (Supporting Country Accountability)(12 November 2001)
- ADTA 3777-INO (Fiscal Decentralization) 19 November 2001)
- Loan 1863 – Decentralized Basic Education (29 November 2001)
- SSTA 3909 (Support for Good Local Governance (27 August 2002)
- ADTA 3935 (Support for Regional Government Borrowing System (1 October 2002)
- TA 3967 (Local Government Provision of Minimum Basic Services to the Poor (4 November 2002)
- Loan 1964 (Sustainable Capacity Building)(12 December 2002)
- ADTA 4023 (Monitoring System for Capacity Building)(10 December 2002)
- TA 4067 (Managing Regional Disparity in Economic and Poverty Reduction Programs under Decentralization (19 December 2002)
- PPTA 4107 State Audit Reform (9 May 2003)
- ADTA 4282 (Local Government Financing) (18 December 2003)
- ADTA 4391 (Decentralized Education Management II)(14 September 2004)
- Loan 2074/2075 (Second Decentralized Health Services)(19 December 2003)
- Loan 2126/2127 (Support for State Audit Reform)(16 December 2004)
- Regional Technical Assistance 6218 (20 December 2004)
- TA 4411 (Water Supply and Sanitation)(12 October 2004)
- TA 4543 (Sustaining Decentralization and Local Governance Reforms (23 December 2004)

II. OTHER MULTILATERAL AGENCIES

1. **World Bank**. Support for implementation of regional autonomy in poor rural area, promoting development and capacity of community organizations and local governments to provide basic municipal services to the urban poor, reform of municipal governance, institutional capacity and financing priority urban investments, reforms in public financial management and procurement.

- Kecamatan Development Project 3 B
- Urban Poverty Project 3 (Urban Sector Development and Reform Project
- Support for the Poor and Disadvantaged (
- Initiatives for Local Governance Reforms
- Strengthening Indonesia's Framework for Decentralization (through Dutch Trust Fund)

2. **United National Development Program (UNDP)**. Support for poor households through income generation, basic social services, food security, with strategic alliances at the local level to help eradicate poverty in Indonesia, and capacity building to ensure that environmental policy as well as planning and management comply with local laws.

- Community Recovery Phase (CRP) Phase II
- Indonesia Decentralized Environment and Natural Resources Management

III. BILATERAL AGENCIES

1. **United States Agency for International Development (USAID)**. Support for training of local government associations of the executive branch to strengthen their capacity for advocacy, organizational management, communications, networking, training, etc., local government capacity building in the area of performance based budgeting and local economic development, and enhancing capacity of local non-government organizations.

- TA (Local Government Finance Policy Framework Study)
- Building Institutions for Good Governance
- TA (PEFFORM)
- Local Government Support Program)

2. **Japan Bank for International Cooperation (JICA)**. Support for local government borrowing, specifically enhancing on-lending and on-granting mechanisms.

- TA (Study on Transfer Mechanism for Local Government Borrowing)

3. **Canadian International Development Agency (CIDA)**. Support to assist selected Government agencies, ministries and related organizations undertake fiscal and institutional reforms supporting decentralization, improve local government performance (local government finance, performance management, policy analysis, training to improve local capacities, and information clearing houses.

- TA Governance Reform Support Project Phase II Assistance for Decentralization Efforts

4. **Gezellschaft Fur Technische Zuzammenarbeit (GTZ)**. Support to refine and consolidate the regulatory framework for decentralization and local governance, capacity building to support decentralization, and dissemination of information about regional autonomy to stakeholders, increasing public sector accountability, and cooperation between the national and regional economies.

- Support for Decentralization Measures
- Support for Good Governance
- Local and Regional Economic Development in Central Java

INELIGIBLE ITEMS

1. The proceeds of the loan will be used to finance the foreign currency expenditures for the reasonable cost of imported goods required during implementation of the Program.

2. Notwithstanding the provision of para. 1, no withdrawals will be made for

(i) expenditures for goods included in the following Customs Coordination Council Nomenclature chapters or headings as designated by the Asian Development Bank (ADB) by notice to the Government;

Table A11: Negative List

Group	Subgroup	Description of Items
112		alcoholic beverages
121		Tobacco, unmanufactured tobacco refuse
122		Tobacco, manufactured (whether or not containing tobacco substitutes)
525		Radioactive and associated materials
667		pearls, precious and semi-precious stones, unworked or worked
718	718.7	Nuclear reactors and parts thereof, fuel elements (cartridges), nonirradiated for nuclear reactors
897	897.3	Jewelry of gold, silver, or platinum group metals (except watches and watch cases); goldsmiths' or silversmiths' wares (including set gems)
971		Gold, nonmonetary (excluding gold ores and concentrates)

(ii) expenditures in the currency of the Borrower or of goods supplied from the territory of the Borrower;

(iii) payments made for expenditures incurred more than 180 days before the effectiveness date of the loan;

(iv) expenditures for goods supplied under a contract that any national or international financing institution or agency will have financed or agreed to finance, including any contract financed under any loans from ADB;

(v) expenditures for goods intended for a military or paramilitary purpose or for luxury consumption; and

(vi) expenditures for pesticides categorized as extremely hazardous or highly hazardous in Class 1a or 1b, respectively, of the World Health Organization's Classification of Pesticides by Hazard and Guidelines to Classification.