Document of
The World Bank

FOR OFFICIAL USE ONLY

Report No: 82002-ID

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

PROJECT PAPER

ON A

PROPOSED ADDITIONAL LOAN AND RESTRUCTURING

IN THE AMOUNT OF US$500 MILLION

TO THE

REPUBLIC OF INDONESIA

FOR A

LOCAL GOVERNMENT AND DECENTRALIZATION PROJECT ADDITIONAL FINANCING / LOCAL GOVERNMENT AND DECENTRALIZATION PROJECT PHASE II

September 2, 2014

Indonesia Sustainable Development Unit
Sustainable Development Department
East Asia and Pacific Region

CURRENCY EQUIVALENTS

(Exchange Rate Effective May 14, 2014)
Currency Unit = Indonesian Rupiah (IDR)
IDR 11,587.00 = US$1.00

FISCAL YEAR

January 1 – December 31

ABBREVIATIONS AND ACRONYMS

AP	Advance Payment
APBD	Local Budget
APBN	National/State Budget
Bappenas	National Planning Agency
Bappeda	Local Planning Agency
BPK	State Audit Board
BPKP	Indonesian National Government Internal Auditor
CPS	Country Partnership Strategy
DAK	Specific Purpose Grants
DAU	General Purpose Grants
DBH	Revenue Sharing
DG	Directorate General
DGFB	Directorate General of Fiscal Balance
DP	Adjustment Fund
EIRR	Economic Internal Rate of Return
ES	Environmental Social
FY	Fiscal Year
GAC	Government Anti-Corruption Plan
GDP	Gross Domestic Product
GoI	Government of Indonesia
IBRD	International Bank for Reconstruction and Development
IG	Inspectorate General
ILGRP	Initiative for Local Government Reform Program
ISP	Institutional Support Program
KOMANDAN	Communication System and Data Management (*Komunikasi dan Manajemen Data Nasional*)
LG	Local Government, comprising Provinces, *Kabupaten* and *Kota*
M&E	Monitoring and Evaluation
MoF	Ministry of Finance
MoHA	Ministry of Home Affairs
MPW	Ministry of Public Works
NFI	Net Fiscal Index
NPV	Net Present Value
OBD	Output Based Disbursement
OM	Operation Manual
ORAF	Operational Risk Assessment Framework
OVR	Output Verification Report
PDO	Project Development Objective
Perpres	Presidential Regulation
PforR	Program for Results
PIU	Project Implementing Unit
PP	Government Regulation
QER	Quality Enhancement Review
QP	Qualifying Percentage
RD	Definitive Plan
RKP	Government Work Plan
RPJM	Mid-Term Development Plan (*Rencana Pembangunan Jangka Menengah*)
SIKD	Local Government Financial Information System (*Sistem Informasi Keuangan Daerah*)
SIL	Specific Investment Loan
TA	Technical Assistant
ULP	Procurement Service Unit
UU	Law
VFR	Value of Final Reimbursement
VO	Verification of Outputs
VPR	Value of Potential Reimbursement
VQR	Value of Qualifying Reimbursement
VTR	Value of Total Reimbursement
WBRS	Web-Based Reporting System

Vice President:	Axel van Trotsenburg, EAPVP
Country Director:	Rodrigo A. Chaves, EACIF
Sector Director:	John Roome, GPSOS (through June 30, 2014)
Senior Global Practice Director:	Ede Jorge Ijjasz-Vasquez, GURDR (from July 1, 2014)
Practice Director:	Marisela Montoliu Munoz, GURDR (from July 1, 2014)
Sector Manager:	Nathan M. Belete, GAGDR (through June 30, 2014)
Practice Manager:	Abhas K. Jha, GURDR (from July 1, 2014)
Task Team Leader:	Taimur Samad, GURDR
Co-Task Team Leader:	Thalyta E. Yuwono, GURDR

INDONESIA

LOCAL GOVERNMENT AND DECENTRALIZATION PROJECT ADDITIONAL FINANCING

PROJECT PAPER FOR ADDITIONAL FINANCING

CONTENTS

INDONESIA
LOCAL GOVERNMENT AND DECENTRALIZATION PROJECT ADDITIONAL FINANCING

ADDITIONAL FINANCING DATA SHEET

Basic Information - Additional Financing (AF)	
Country Director: Rodrigo A. Chaves Sector Manager/Director: Abhas K. Jha / Marisela Montoliu Munoz Team Leader: Taimur Samad Project ID: P123940 Expected Effectiveness Date: January 1, 2015 Lending Instrument: Investment Project Financing Additional Financing Type: IBRD loan	Sectors: Sub-National Government (100%) Themes: Municipal Governance (67%), Decentralization (33%) Environmental category: B Expected Closing Date: December 31, 2018

Basic Information - Original Project	
Project ID: P111577 Project Name: Local Government and Decentralization Project Lending Instrument: Investment Project Financing	Environmental category: B Expected Closing Date: December 31, 2015

AF Project Financing Data
[X] Loan [ ] Credit [ ] Grant [ ] Guarantee [ ] Other: Proposed terms: Standard IBRD Terms

AF Financing Plan (US$m)

Source	Current Project	Proposed Additional Financing	Total Amount
IBRD	220.0	500.0	720.0
Borrower	13.0	20.0	33.0
TOTAL	**233.0**	**520.0**	**753.0**

Client Information
Recipient: Republic of Indonesia Responsible Agency: Ministry of Finance (MoF) Contact Person: Ahmad Yani Telephone No.:+62-213841067 Fax No.: +62-213808395 Email: Ahmadyani1166@gmail.com

AF Estimated Disbursements (Bank FY/US$m)

FY	2015	2016	2017	2018
Annual	60.0	130.0	180.0	130.0
Cumulative	60.0	190.0	370.0	500.0

Project Development Objective and Description

Original project development objective: The objective of this Project is to improve the accountability and reporting of the central government's Specific Purpose Grants (DAK) for the infrastructure sub-sectors within pilot local governments (LGs).

Revised project development objective: The objective of the Project is to improve the accountability and reporting of the central government's Specific Purpose Grants (DAK) for the basic infrastructure, consisting of roads, irrigation, water and sanitation, within Selected Local Governments.

Project Description

Component 1: DAK Reimbursement (USD 500.0m of Bank Financing)

The component will reimburse the Borrower for Outputs produced by Sub-projects undertaken by Selected Local Governments financed by annual DAK Transfers and annual LG Contributions for basic infrastructure sectors, consisting of roads, irrigation, water and sanitation.

Component 2: Institutional Support Program (USD 10.0m of Borrower financing)

The component will support the following sub-components:

2.1 *Policy Advisory***:** Providing technical assistance and policy advice, and carrying out capacity building activities for the Ministry of Finance's Directorate General of Fiscal Balance to reform intergovernmental transfers and improve local government service delivery, including, *inter alia*, the design of output and performance-based transfers, the development of a system linking service standards to government transfers and the strengthening of the Borrower's monitoring and evaluation framework for intergovernmental transfers.

2.2 *Strengthening Local Government Capacity to Improve Public Service Delivery***:** Carrying out capacity building activities to: (i) improve DAK utilization by Selected Local Governments by, *inter alia*, providing support to Selected Local Governments to strengthen their capabilities in areas such as regional financial management, procurement, investment planning and maintenance, technical quality control, safeguards management and reporting and accountability; and (ii) improve local public service delivery.

2.3 *Strengthening Central Government Capacity for Effective and Efficient Use of DAK*:

2.3.1 Providing implementation support on the day-to-day management of the Project including in areas such as reporting, monitoring and evaluation of Project progress, information dissemination to Local Governments, implementation of the DAK web-based reporting system, updating and expansion of reference unit costs, social and environmental safeguards, and development and updating of training materials for Local Governments.

2.3.2 Providing technical assistance for verification support by, *inter alia*, (i) improving the capacity of the Verifier of Outputs to conduct technical audits, and verify safeguards and Local Government procurement process, and strengthening internal controls in Local Governments.

2.3.3 Providing technical assistance for monitoring and evaluation support by, *inter alia*, strengthening the system for monitoring and evaluation of reports on DAK utilization submitted through the DAK web-based reporting system, and carrying out mid-term and end of Project evaluations.

Component 3: Verification of Outputs (USD 10.0m of Borrower financing)

Conducting, through BPKP, the verification of Outputs, which includes technical (engineering), procurement, financial management and environmental and social safeguards and providing technical assistance for BPKP to strengthen its capacity to conduct said verification of Outputs.

Safeguard and Exception to Policies	
Safeguard policies triggered:	
Environmental Assessment (OP/BP 4.01)	[X]Yes [ ] No
Natural Habitats (OP/BP 4.04)	[X]Yes [ ] No
Forests (OP/BP 4.36)	[ ]Yes [X] No
Pest Management (OP 4.09)	[X]Yes [ ] No
Physical Cultural Resources (OP/BP 4.11)	[ ]Yes [X] No
Indigenous Peoples (OP/BP 4.10)	[X]Yes [ ] No
Involuntary Resettlement (OP/BP 4.12)	[X]Yes [ ] No
Safety of Dams (OP/BP 4.37)	[ ]Yes [X] No
Projects on International Waterways (OP/BP 7.50)	[ ]Yes [X] No
Projects in Disputed Areas (OP/BP 7.60)	[ ]Yes [X] No
Is approval of any policy waiver sought from the Board (or MD if RETF operation is RVP approved)?	[ ]Yes [X] No
Has this been endorsed by Bank Management? (*Only applies to Board approved operations*)	[ ]Yes [ ] No
Does the project require any exception to Bank policy?	[ ]Yes [X] No
Has this been approved by Bank Management?	[ ]Yes [X] No

Conditions and Legal Covenants:		
Loan Agreement Reference	Description of Condition/Covenant	Date Due
Article V, 5.01. Effectiveness; Termination	(i) MPW shall have issued a Ministerial Circular Letter requiring the use of the Supplemental Technical Guidelines (Environmental and Social Safeguards) all Selected Local Governments; and (ii) the VO Terms of Reference have been agreed between the Borrower and BPKP, and between the Bank and BPKP, and BPKP and the Bank shall have entered into the Verification Arrangement.	The Effectiveness Deadline is the date ninety (90) days after the date of the Loan Agreement
Schedule 2, Section I.A.6	BPKP shall […] undertake Verification of Outputs for the Project.	Throughout the Project life
Schedule 2, Section I.B.1(b)	The Borrower shall update the Operations Manual by no later than 30 days after the Effective Date.	30 days after the Effective Date

Schedule 2, Section I.B,5(c) and Section I.D.2	By October 31, 2015, the Borrower shall carry out a review of the application of the Supplemental Technical Guidelines (Environmental and Social Safeguards to the Project and amend the Supplemental Technical Guidelines (Environmental and Social Safeguards) if so requested by the Bank.	October 31, 2015
Schedule 2, Section I.B.5(d)	The Borrower shall annually allocate a total amount of DAK funds for Selected Local Governments for each Fiscal Year of Project implementation […], and shall notify the Bank […] no later than March 31 in such Fiscal Year.	Annually on March 31
Schedule 2, Section I.C.2(b)	BPKP shall submit to the Bank, by no later than January 1 of each Fiscal Year […], a Work Plan for verification activities, including technical and environmental and social safeguards capacity.	Annually on January 1

I. Introduction

1. This Project Paper seeks the approval of the Executive Directors to provide an additional loan in an amount of USD 500.0 million to the Republic of Indonesia for the Local Government and Decentralization Project (LGDP) Additional Financing (P123940), currently supported by an IBRD loan (P111577, 7914-ID for USD 220.0 million). The proposed additional financing will bring total Project financing to USD 753.0 million, of which Bank financing constitutes USD 720.0 million and Government of Indonesia (GoI) counterpart funding makes up the remaining USD 33.0 million. The proposed Additional Financing is being sought by GoI to scale up the coverage of the LGDP program to a total of 30 participating provinces, from an initial five pilot provinces in the first phase. The original loan will close on December 31, 2015 as scheduled.

2. The proposed Additional Financing is requested for four years (calendar years 2015 – 2018) covering reimbursements for the DAK Allocation in GoI budgets in the three fiscal years from 2015 to 2017. The operation will continue to finance reimbursements and incentives linked to the core DAK basic infrastructure sectors consisting of roads, irrigation, water and sanitation. The proposed Additional Financing also involves a comprehensive institutional support program (ISP) to support GoI effort to improve local government service delivery. The ISP includes activities that would directly support Project implementation, by strengthening institutional coordination across implementing entities, deepening targeted capacity building efforts for local governments, and improving monitoring and evaluation. The cumulative intent of these adjustments is to enhance overall DAK performance and transparency and to induce spillovers into other areas of local government (LG) performance.

II. Background and Rationale for Additional Financing

3. **Background.** The World Bank has outlined twin organizing goals to end extreme poverty within a generation and to promote shared prosperity. Ending poverty and promoting shared prosperity are unequivocally about progress in non-monetary dimensions of welfare including education, health, nutrition, and access to basic infrastructure. In an economy with significant inter-regional variations in revenue capacity and investment needs, decentralized provision of public services can enhance efficiency in the provision of these services and result in welfare gain. Fiscal decentralization enters into poverty alleviation strategy in a number of ways: (i) the proximity of policy makers to the target group reduces information and transaction costs of identifying the poor and helps in designing potentially successful 'capacity improving' and 'safety net' policies; and (ii) enhance efficiency in the provision of basic infrastructure and facilities (Rao, 1998)[1].

4. Indonesia's big bang decentralization, which began in 2001, constituted a tectonic shift in service responsibilities and funding from the center to subnational governments. Subnational governments took over primary responsibility for delivering nearly all public services. The assignment of new functions to LGs was accompanied by massive reallocation of funding – subnational expenditure grew from 2.7% of GDP in 2000 to 7.2% of GDP in 2011. Subnational

[1] See Rao, M.G., (1998)."Poverty Alleviation under Fiscal Decentralization", World Bank.

governments now manage about half of total core public spending (i.e. excluding central government subsidies and interest payments). While the expectation was that decentralization would allow subnational governments to better respond to service delivery needs, the effectiveness of decentralized provision has not yet met expectations. A 2012 Subnational Expenditure Review conducted by the World Bank concluded that subnational government spending is excessively dominated by spending on administration over productive sectors and on personnel over maintenance and capital spending. Moreover, the study finds that poor sector outcomes are greatly influenced by inefficiency in spending.[2]

5. Further, general and specific purpose transfers are intended to enable poorer regions to provide social and physical infrastructure at levels comparable to those in richer jurisdictions, such transfer will enable the depressed regions to fully utilize their growth potential and will hasten poverty reduction. Analysis results of the accuracy of DAK allocations for regions show that correlation signs of DAK allocation by province on the condition of public service in infrastructure sector are in line with DAK objective to reduce interregional service inequalities (Usman et al, 2008)[3]. Infrastructure investments funded through DAK transfers have three potential positive effects on reducing poverty. These include: (i) a public works effect; (ii) a broad-based economic growth effect; and (3) a non-income effect. It is well known that the construction of public infrastructure can provide needed wages to low-income workers and therefore assist in the reduction of poverty.

6. Local government spending remains dominated by intergovernmental transfers. In 2012, over 32% of central government budget goes to transfers which account for over 90% of local government budgets. Hence, addressing the effectiveness and efficiency of local government spending across all sectors – including infrastructure – will in part require improved transparency, accountability and incentives across key intergovernmental transfer mechanisms. Table 1 below provides a summary of the main transfers in Indonesia.

Table 1: Major Categories of Intergovernmental Fiscal Transfers, 2014

Type of Transfer	Amount US$	% of total Intergovernmental Transfer
General Purpose Grants (DAU): Fund sourced (block grant) from the Central Budget allocated to bring equality in the fiscal capacity among the regions to finance needs associated with the implementation of decentralization.	30.5 billion	57.6%
Specific Purpose Grants (DAK): Fund sourced from revenue in APBN allocated to certain regions with the aim of funding special activities of the region in accordance with national priorities.	3.0 billion	5.6%

[2] See World Bank, (2012). "Indonesia Subnational Public Expenditure Review: Optimizing Subnational Performance for Better Services and Faster Growth". Jakarta, Indonesia; for more detailed analysis on subnational expenditure performance.

[3] See Usman, S., Mawardi. S, Poesoro, A., Suryahadi, A., and Sampford, C., (2008)."The Specific Allocation Fund (DAK): Mechanisms and Uses", Research Report, The SMERU Research Institute.

Type of Transfer	Amount US$	% of total Intergovernmental Transfer
Revenue Sharing (DBH): DBH is a vertical equalization grant, which shares tax and natural resource revenues with all districts with a larger proportion of revenues Going to resource-rich districts where the revenues originated.	10.2 billion	19.2%
Special Autonomy and Adjustment Funds: Special funds include specific grants for Papua, Papua Barat and Aceh and additional funds for infrastructure development in Papua and Papua Barat. Special Adjustment Funds (*Dana Penyesuaian*) include additional allowances for teachers, professional benefits for teachers, School Operational Assistance program (*Bantuan Operasional Sekolah*, or BOS), local incentive grants (*Dana Insentif Daerah*, or DID) and various infrastructure support funds.	9.3 billion	17.7%

7. The category of transfers known as the Specific Purpose Grants (*Dana Alokasi Khusus*, DAK) finance investment expenditures that are identified as national priorities. There are currently 19 DAK sectors or expenditure categories, with the largest being education, the four infrastructure sectors (roads, irrigation, water and sanitation), and health. Since the implementation of the fiscal decentralization policy in 2001, policies regarding the DAK transfers have been well established, although the monitoring and verification of use of funds, and transparency within LGs with regard to the planning of outputs and the use of funds remain a challenge. A recent annual evaluation on the implementation of DAK transfers undertaken by the National Planning Agency (Bappenas) reveals that improvements are mostly needed in institutional, transparency and governance areas of the DAK transfer system. Institutional problems revolve around lack of coordination among various central GOI ministries, and also lack of coordination with individual districts. This results in mismatch between allocations and actual local needs.

8. In theory any of the transfers—tax and non-tax revenue sharing, DAU, or DAK—could be used to fund infrastructure. Indeed some regions do use the full array of mechanisms to finance the creation of local public assets. However, the DAK is the only transfer that is explicitly designed to fund infrastructure investments; the spending of all other transfers is at the complete discretion of local governments. As such, DAK – unlike DAU, DBH and Special Autonomy Funds – represents the only vehicle within the intergovernmental transfer system against which the central government can seek accountability and hence the 'best case' option to link to LGDP program.

9. The lack of local government management, technical, planning and fiduciary capacities also contribute to challenges in local public service delivery, as well as inefficiency of local government expenditures. Box 1 above summarizes recent analytical work that on the challenges

in improving local service delivery in the face of limited LG capacities and various constraints to effective and efficient local government spending[4].

Box 1: Constraints on the Effectiveness and Efficiency of Subnational

A number of constraints on improving the effectiveness and efficiency of subnational spending have been identified over the years. One study (Lewis and Oosterman, 2009) that examined various limitations of local government capital spending suggested that inflexible budget rules, weak capacity in planning and executing investment projects, and delays in forming tender committees because of worries over corruption charges have played a significant role in limiting local expenditure. Another analysis (Sacks et al, 2013) also focused on procurement problems, highlighting lack of leadership and the limited participation of citizens' groups in decision-making as particularly problematic in constraining reform. A recent review of World Bank/AusAID district level public expenditure reviews (AusAID, 2013) examined a broad range of potential public financial management difficulties and concluded that the most constraining factors were that local governments did not generally have a full understanding of the total envelope of budgetary resources available to them; district-level budget allocations rarely matched overall development priorities; and bottom-up proposals did not play a significant role in funding decisions. The study also showed, however, that public discussion and scrutiny of plans and budgets can significantly improve the quality of planning and resource allocation.

A common conclusion derived from various examinations is that problems vary significantly across local governments and that generalizations are difficult. With this in mind World Bank (2008) developed a tool to diagnose specific public financial management issues at the local government level. The tool started by identifying desirable public financial management related comes in the long-term. These included: prudent financial management, effective governance structures and processes, accountability and transparency, community participation in the budgeting process, and reduced corruption. Diagnostic methods were then developed that focused on ascertaining constraints to attaining those objectives. Despite success of the diagnostic tool in detecting public financial management difficulties, actual reform has proved elusive. The World Bank also manages a subnational PFM capacity building program called PEACH (Public Expenditure and Capacity Harmonization) that provides PFM capacity assessment followed with technical assistance at provincial and district government levels in the areas of planning and budgeting.

Ministry of Finance (MoF) conducts annual local governments' performance evaluation where regions are obliged to submit regional reports. This program seeks to identify and rank LGs performance. In addition, MoF, through Directorate General of Fiscal Balance, has been collaborating with several regional universities across the country in organizing a Regional Finance Course (*Kursus Keuangan Daerah-KKD*) and Course of Specific Regional Finance for Management/Accountancy (*Kursus Keuangan Daerah Khusus-KKDK*) since 2007. KKD and KKDK were formulated to achieve the objective of increasing knowledge and competency of local government apparatus to manage their regional finance including planning, budgeting, and asset and revenue management. However, these courses only cover basic financial management materials and less focus on case studies.

[4] See Lewis, B. and A. Oosterman, (2009),'The Impact of Decentralization on Subnational Government Fiscal Slack in Indonesia', Public Financial Publication, Inc; Sacks, A., Rahman., E., Turkewitz, J., Buehler, M., Saleh, I., and Ali, A., (2013), "The Dynamics of Centralized Procurement Reform in a Decentralized State: Evidence and Lessons from Indonesia", World Bank Jakarta and The Asia Foundation, Indonesia; AusAID, (2013), "AusAID's Management of Infrastructure Aid to Indonesia". Commonwealth of Australia; for more detailed analysis.

Box 2: Reforming the Specific Purpose Grants (DAK)

Increase funding. Central government policy intends to increase public capital spending at all levels of government. The DAK is Government's only mechanism for encouraging more capital spending at the local level. DAK funding has not increased in real terms since 2007. Analysis conducted as part of the Mid-Term Evaluation of the LGDP program suggest that an additional Rupiah of DAK leads to an extra 2.6 Rupiah of capital spending for participating districts and an added 1.5 Rupiah of capital spending for non-participating districts

Reduce sectoral coverage. The number of sectors covered by the DAK has expanded from three in 2001 to 19 in 2013. New sectors' distributions have increased from just 5 to 25 percent of total allocations; at the same time traditional infrastructure's share has declined from 50 percent to 25 percent. Many of the new sectors are of questionable importance; they could be eliminated without negative impact and funds could be reallocated to infrastructure subsectors of the DAK.

Reduce geographic coverage. The original intent of the DAK was to maximize impact of the grant by focusing distributions on relatively few local governments. Indeed in the early years of DAK operation allocations were made to only a small subset of local governments. Currently all local governments receive at least some DAK. This feature of grant allocation reduces the size of DAK distributions to individual local governments and weakens impact.

Allow for maintenance spending. Local governments spend too little on maintaining their assets. Empirical evidence suggests that DAK allocations are negatively associated with maintenance spending. Each additional rupiah of DAK leads to a decrease in maintenance and other non-personnel current spending of more than 0.5 rupiah. Allowing DAK to be used to fund maintenance in a more comprehensive fashion might help to reverse the trends.

Allow multi-year project implementation. When a local government is unable to complete its capital improvement project during a fiscal year it must retender the project the following year. Retendering the project creates significant time delays and economic inefficiencies. Allowing local governments to plan and implement multi-year capital developments would support the implementation of larger projects, widely recognized as needed, and eliminate inefficiencies.

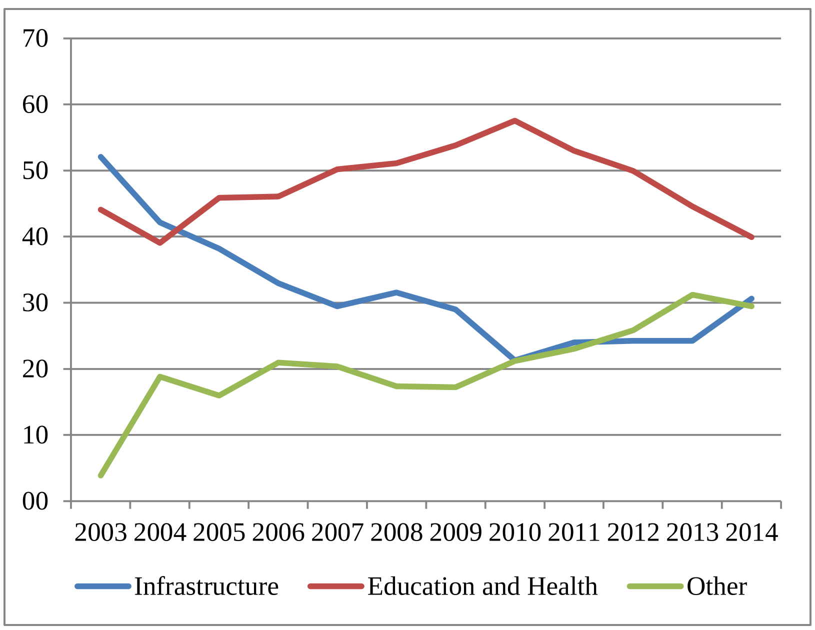
Allow for some spending flexibilities. Policies that do not allow for any flexibility lead to the ineffective use of funds, and as such require revision in order to provide room for local government on specific variations based on the needs, while still retaining some level of national uniformity and the objective to achieve minimum service standard.

10. In parallel to the LGDP lending operation, the Bank has maintained a continuous engagement with GoI on the possible structural reform agenda around DAK. Box 2 above summarizes some of the Bank's policy guidance with respect to the government's plan to reform the DAK towards a more performance-based transfer. More recently, in January 2014, the Directorate General of Fiscal Balance (DGFB) of MoF issued a "Blue Print for Institutional Transformation of DG Fiscal Balance". With a renewed focus on transparency and accountability in intergovernmental fiscal transfers and local government finances, this broader transformation agenda for the areas under the purview of DGFB involves a series of initiatives aimed at improvements in eight areas including Revenue Assignment, Expenditure Assignment, Local Financing, Monitoring and Evaluation, Increasing Local Government Capacity, Information and Technology, Organization Structure, and Human Resources. This

transformation agenda has been developed and is being implemented in anticipation of impending revisions to Law 32/2004 on district governance (*pemerintahan daerah*) and Law 33/2004 on fiscal balance. The draft revisions to these laws are still under discussion, and are expected to include rationalization of the various categories of intergovernmental fiscal transfers, with increased emphasis on effective local public service delivery.

11. Within the above context, the Local Government and Decentralization Project (LGDP) Additional Financing is part of a broader Bank strategy on intergovernmental transfers and the strengthening of subnational fiscal performance. As part of this strategy, the World Bank is also engaging with Bappenas on the reform agenda for intergovernmental transfers as part of the Five Year Plan, 2015-2019 (RPJM) currently under formulation. This dialogue builds on lessons from LGDP implementation and from a broad program of policy analysis conducted in collaboration with MoF and with support from the Bank and other multilateral and bilateral donors active in Indonesia. The World Bank's policy guidance to the RPJM process centers around four main questions: (i) whether GoI should increase funding for intergovernmental transfers; (ii) how can transfers be reformed in the short term; (ii) what actions or reforms are required in the medium-term to reform transfers; and (ii) what additional reforms might the central government consider to improve outcomes. The Bank's policy guidance on these issues is outlined in Annex 3.

Figure 1: DAK Sector Allocations as a Percentage of Total DAK Funding (2003-2014)



12. In at least one instance, the policy dialogue with government regarding the DAK may be producing results. As Box 2 shows, one of the reforms advocated by the Bank is to increase the proportion of the total DAK allocated to infrastructure subsectors. In 2014, DAK infrastructure distributions have increased to just over 30% of the total, from less than 25% the year before. Figure 1 charts DAK allocations during the period of 2003 to 2014. The central government allocates DAK recipient sectors in accordance with their priorities as set out in the government work plan for the particular year. Over the span of 2003 to 2014, the biggest allocations across

all sectors are for education, health and infrastructure. However, the infrastructure sector has experienced a constant upward trend since 2009.

13. **Summary of Government Program and Discussions**. The original Project was approved in June 2010 and became effective in January 2011 with the objective of improving accountability and reporting for the DAK transfers in the roads, irrigation and water infrastructure sub-sectors, within pilot local governments (LGs). Applying an innovative output-based approach, the Project reimburses the Government of Indonesia (GoI) based on verified outputs delivered by the LGs through DAK expenditures, and provides an additional incentive of 10% of verified expenditures to LGs to encourage solid performance. Table 2 below summarizes the original Project components.

Table 2: Summary of Original LGDP Project Components

Component	Amount (USD)	Description
Component 1: DAK Reimbursement	220.0	The component is implemented using an Output Based Disbursement (OBD) financing approach. Under this approach, the Project will reimburse the existing DAK for infrastructure (roads, water, and irrigation) based on reported and verified physical outputs delivered by participating LGs. The Verification of Outputs (VO) will be conducted by Indonesian National Government Auditor (*Badan Pengawasan Keuangan dan Pembangunan*, BPKP). Participating LGs will have sent a Commitment Letter to the MoF to be considered to be participating in the project. A portion of the reimbursement will be transferred from the MoF to the LGs to reimburse them for the funding they contribute to the DAK outputs. The amount of LG reimbursement is based on current DAK funding requirements for LGs to contribute at least 10 %. The amount transferred from MoF to the LGs will be a performance reward for the LGs meeting the eligibility criteria, and it is expected that this will also act as an incentive for increased compliance with eligibility criteria in future years.
Component 2: Institutional Strengthening to Central and Local Governments and Project Management Support	8.5	The component supports the strengthening of the basic institutional capacities for the Project at the subnational and national level. Four specific subcomponents include those for: (i) Developing a Monitoring and Evaluation System; (ii) Web-Based Monitoring and Reporting System; (iii) Technical Assistance for Central and Local Government; and (iv) Project Management Support. Component 2 will be financed from the national budget. The MoF will provide not less than US$8,500,000 equivalent from its budget to finance the activities under the component. Each year during project implementation, each participating agency - Bappenas, the MoF, and the MPW (including capacity building for LGs from MoF and MPW) - will submit a work plan for technical assistance (TA) to the Bank to support the planning, technical, procurement, financial management, social and environmental safeguards, and improve reporting capacity of both

Component	Amount (USD)	Description
		central agencies and LGs.
Component 3: Verification of Outputs	4.5	The component finances the verification of outputs (VO) through BPKP. BPKP will finance the VO function including any required hiring of new staff and capacity enhancement from their own budget. BPKP will prepare an annual work plan to be discussed with the Bank regarding its VO tasks for each upcoming year.

14. The original Project operates in five pilot provinces and 77 constituent local governments. Having completed three annual cycles of DAK investment expenditure and verification, the loan has disbursed approximately USD 171.4 million against verified outputs. With a no-cost extension of the closing date approved in March 2014, the original Project is now scheduled to close on December 31, 2015 and projects to disburse a further USD 48.6 million against DAK expenditures in GoI fiscal years 2014.

15. Discussions with GoI on a second phase of the LGDP operation began in January 2012. In April 2012, a Concept Review was held for a proposed Second Local Government and Decentralization Project to be structured under a Program for Results (PforR) approach. During consultations with MoF and program stakeholders over the course of 2012 and into 2013, MoF decided against proceeding with a PforR approach, electing conversely the Additional Financing instrument. Two related factors were cited for the decision. First, GoI noted its preference and intent to rapidly scale up the existing output-based model developed under LGDP which is demonstrating results and has been effectively socialized in participating LGs. A change in the LGDP model at this stage would result in considerable transaction costs associated with the implementation and socialization of a new model. Second, given its experience with the existing Program, GoI would be able to socialize and implement a geographical expansion of the existing Program in a timely and efficient manner.

16. The Ministry of Finance, after review and evaluation of the first LGDP program between February and August 2013, has requested the Bank to proceed with the preparation of a four year (calendar years 2015 – 2018) Additional Financing operation covering GoI fiscal years 2015-2017. Key characteristics of the proposed Additional Financing include: (i) a phased expansion of the Program to involve 30 provinces (excluding DKI Jakarta and the three provinces with special autonomy) by the third year; (ii) a strengthened and better targeted institutional support program; (iii) an improved monitoring and evaluation program; (iv) improved institutional arrangements; and (v) improved verification of outputs by BPKP.

17. **Progress to Date**. The original Project has made significant progress to date as evidenced by the processing of a substantial reimbursement against DAK infrastructure expenditures in the 77 participating LGs across the five pilot provinces. To date, the Project had disbursed USD 171.4 million, or 78% of the total loan amount of USD 220.0 million. The remaining USD 48.6 million will be disbursed in 2015 for reimbursement of 2014 outputs.

18. Project performance is currently Satisfactory. The PDO-level results indicators focus on output verification, and on reporting by LGs. In this regard, most of the verifiable outputs in

2012 were verified by BPKP as eligible for reimbursement: the percentage of qualifying contracts (QP) increased from 84% in 2011 to 89% with a slight decrease to 87% in 2013. The use of the web-based reporting system (WBRS) among participating LGs in 2013 was at 65% for technical reporting and 56% for financial reporting, a rapid increase since the launch of the WBRS in May 2012. Furthermore, the output verification process and criteria are working well. The revisions made to the reference unit costs (RUCs) and thresholds for contract values, as part of the project restructuring, have had a clear positive impact in the verification cycle for 2012 outputs, and with further refinements made to the RUCs for 2013 outputs.

19. More broadly, the Project is also yielding rich and detailed information on LG performance, both strong and weak. A detailed evaluation of the project undertaken in mid-2013 has yielded several actionable findings. First, a composite view of LG performance – based on an assessment of internal controls, physical completion of outputs, QP, contract management, and technical issues – has identified those LGs with weak performance, and the specific areas of weakness for each. This in turn enables better targeting of institutional support and capacity building for these LGs. Second, lessons and good practice examples can be obtained from a qualitative analysis of LGs with strong performance, with a view to sharing these experiences with other LGs. Third, an analysis of the performance of participating LGs in relation to a 'control' group of non-participating LGs suggests that although the impact of mere participation in the project for LG counterpart funding, reporting, or capital spending is yet to be seen (due to the limited time horizon of data available for comparison, from 2011 and 2012 only), as DAK allocations increase, Project participation becomes more important for performance. In particular, at higher levels of DAK funding, participating LGs outperform non-participating LGs in water sector reporting and amount of capital spending. Moreover, DAK is more stimulative of participating LG capital spending at the margin than it is of non-participating LGs.

20. Nonetheless, recent Project implementation support missions for the LGDP operation have also noted areas for improvement that will be addressed as part of the Additional Financing including: (i) the need for improved and continuous coordination across Project implementing agencies with the PIU including MoF, Bappenas, MoHA, MPW and with BPKP; (ii) improved framework for monitoring and evaluation, including incorporating municipal performance benchmarking; (iii) strengthened, evidence-based and targeted implementation capacity building component; (iv) improvement to verification arrangements including more accurate RUCs, improved technical and safeguards capacities in the verification team; and, amongst other (iv) improved integration of roads, irrigation and water sector planning and investment quality consideration in Project design.

21. These and other findings that have informed design adjustments reflected in this Additional Financing were part of a Mid-Term Evaluation of the LGDP program concluded in September 2013. A summary of the evaluation and key recommendations made therein is included in Annex 3 to this Project Paper. The full text of the evaluation is available in the Project records.

22. **Rationale for Additional Financing**. This program benefits significantly from the lessons and insights from the Bank's ongoing investments and analytical work in the areas of decentralization, local government and infrastructure, and serves to deepen the Bank's overall

engagement in local government reform. The proposed project is in line with the Bank's current Country Partnership Strategy (CPS) by supporting engagements for strengthening central and local government institutions. In particular, the project would support an output-based approach to financing local government infrastructure expenditures, while also promoting the use of country systems in Indonesia.

23. This program directly supports the GoI's decentralization transformation agenda, which includes an increased emphasis on the effectiveness of local service delivery, as well as its priorities for infrastructure development at the local level. The scope and size of DAK transfers are expected to increase in the coming years, particularly as the financial resources under existing transfer mechanisms, including the de-concentration and co-management funds, are shifted to DAK. This shift is articulated in Law (UU) No. 33/2004 on Fiscal Balance between central and local governments and Government Regulation (PP) No. 7/2008 regarding De-concentration and Co-Management Funds, with further refinements expected through the impending revisions to Law 32/2004 and Law 33/2004. Strengthening the intergovernmental fiscal transfers to LGs, especially improving transparency in the use of funds, is thus essential for the overall success of decentralization and improving local service delivery in Indonesia.

24. Additionally, the proposed Additional Financing would enable GoI to scale up and replicate Project outcomes to LGs nationwide beyond the five existing pilot provinces. This would contribute directly to the GoI reform agenda for DAK, and achieve broader, systemic effects to improve the performance of more LGs in line with DGFB's broader transformation agenda. Project experience to date has demonstrated that the basic approach is sound, and can deliver concrete results in terms of improving upward accountability and reporting of DAK outputs by LGs. Scaling-up and extending the Project would also provide the opportunity to enhance the scope and quality of the institutional strengthening and the monitoring and evaluation (M&E) components of the Project.

25. **Relationship to Country Partnership Strategy (CPS)**. The World Bank's Indonesia CPS for 2013-2015 clearly sets the stage for Bank involvement in local government infrastructure investment, describing the strengthening of local government performance as one of the key engagement areas under the pro-growth alignment of Bank support. It notes that weak infrastructure development is not only undermining Indonesia's economic growth, but that it also negatively affects efforts to enhance equity and reduce poverty. While the Government is committed to reducing its debt to GDP ratio, its priority for borrowing remains focused on infrastructure and energy development.

III. Proposed Changes

26. The Project development objective will change slightly to more accurately reflect the geographical scope of the operation, which will now be scaled-up across Indonesia. Thirty of the country's 34 provinces will be involved in this scale-up, with the four exceptions being the three provinces with special autonomy status (Aceh, Papua and West Papua) and the Special Capital District (DKI) of Jakarta. The unique circumstances of special autonomy, and DKI's metropolitan status and financial strength, render the DAK transfers of less relevance for these four provinces. Table 3 below illustrates the said change:

Table 3: Proposed Changes to Project Development Objective

Original PDO	Revised PDO
Original project development objective: The objective of this Project is to improve the accountability and reporting of the central government's Specific Purpose Grants (DAK) for the infrastructure sub-sectors within pilot local governments (LGs).	*Revised project development objective*: The objective of the Project is to improve the accountability and reporting of the central government's Specific Purpose Grants (DAK) for basic infrastructure, consisting of roads, irrigation, water and sanitation, within Selected Local Governments.

27. Additionally, the proposed Additional Financing includes eight primary changes or adjustments to the original Project including:

- Extension of the Project Closing Date to December 31, 2018
- Introduction of Criteria-Based Provincial Selection Methodology
- Linking DAK Incentive to Compliance with Web-Based Reporting System
- Changes to Component 2 – Restructured as part of an Institutional Support Program (ISP)
- Adjustment in Project Management Arrangements
- Enhanced Monitoring and Evaluation Framework
- Revised Procurement Arrangements
- Enhanced Safeguards Approach by Triggering OP/BP 4.04 Natural Habitats and OP 4.09 Pest Management

28. **Extension of the Project Closing Date**. The project closing date is being extended from December 31, 2015 to December 31, 2018 to accommodate the expanded scope outlined in this Project Paper.

29. **Introduction of a Criteria-Based Provincial Selection Methodology**. The selection of pilot participating provinces and constituent local governments for the original LGDP operation was done based on considerations to maintain geographic balance and to include a broad range of provinces and participating LGs with respect to performance in executing DAK transfers. For the proposed LGDP Additional Financing, GoI aims to utilize a more objective and transparent set of criteria. The LGDP Additional Financing includes a two-stage selection procedure summarized in Table 4 below. This selection criteria allows the program to choose new Provinces with the aim to progressively rollout to 30 Provinces by 2017.

Table 4: Summary of Two-Stage Provincial Selection Criteria

Stage	Criteria
Stage One	Stage 1 screens out non-eligible provinces and groups remaining provinces by geographic coverage as follows: - special autonomy provinces of Aceh, Papua and West Papua are excluded as they are subject to special treatment in the intergovernmental system - DKI Jakarta is excluded as it is a unique 'outlier' due to its size and

Stage	Criteria
	economic role - the five LGDP pilot provinces are not included in the filtering as they are already program participants - the remaining 25 provinces are grouped into 4 regional groups to ensure for geographic balance in the selection, i.e. Sumatra, Java-Bali, Kalimantan-Sulawesi, and Eastern Indonesia (Nusa Tenggara-Maluku-Papua).
Stage Two	Stage 2 tabulates an order ranking of all provinces factoring in three variables: - Proportion of DAK as a share of local budgets. Provinces receive a higher rank order the greater the ratio of DAK as a percent of total local budgets in each province. Analysis has shown that the LGDP program is disproportionately successful in leveraging LG performance improvements when DAK is a more important source of revenue for LGs. - Human Development Index (HDI). Provinces with lower HDI receive higher ranks under the criteria, demonstrating a pro-poor orientation in the formula for provincial selection. - Percentage of LGs reporting to Public Works on DAK. Provinces where a greater number of LGs are reporting on DAK expenditures to the e-monitoring system receive a higher rank. Here the criteria favor LGs and provinces with a stronger track record of administrative compliance and reinforce the transparency objectives of the program.
Stage Three	Stage 3 involves the calculation of an aggregate order rank for all provinces and includes the selection provinces from each island group as per MoF guidelines (i.e. selection of 9 new provinces for GoI FY15 as follows, two provinces from Sumatra, two from Java-Bali, three from Kalimantan-Sulawesi and two from Eastern Indonesia).

30. The application of the abovementioned selection criteria resulted in the selection of the following new provinces as part of a phased roll out to 30 provinces by 2017. Table 5 below summarizes the cumulative characteristics of these additional provinces. Additionally, Annex 5 details the selection criteria and results.

Table 5: Summary of Provincial Selection Results

Parameter	Original Project	Additional Financing	Total
Number of eligible provinces	5	25 new (with 5 original continuing)	30
Name of eligible provinces	Jambi, East Java, Central Kalimantan, West Sulawesi, North Maluku	(i) Bengkulu, Lampung, West Java, Central Java, West Kalimantan, North Sulawesi, South Sulawesi, NTB, NTT; (ii) West Sumatera, South Sumatera, Bangka Belitung, Bali, South Kalimantan, Central Sulawesi, Gorontalo, Maluku; (iii) North Sumatera, Riau, Kepulauan Riau, DI Yogyakarta, Banten, East Kalimantan, North Kalimantan, South East Sulawesi	

Number of eligible LGs within the provinces	77	364 (in 25 new provinces, approx.)	446 (approx.)
2013 DAK allocation, infrastructure (IDR billions)	1,081	5,021 (in 25 new provinces, approx.)	6,102 (approx.)

31. **Linking Local Government Incentive and Reimbursement to Reporting**. The Government of Indonesia has made a decision to strengthen under the Additional Financing the emphasis of the program on transparency and accountability by linking the LG Incentive and Reimbursement to the use of the Web-Based Reporting System (WBRS) for the reporting of eligible DAK expenditures. Under the original Loan, the LG Incentive and Reimbursement was calculated at 10% of the Value of Qualifying Reimbursement (VQR), as defined in the Legal Agreement and Verification Agreement. The use of the WBRS system was encouraged separately through technical assistance provided under component 2. The value of the LG Incentive and Reimbursement was not linked to the use of WBRS for the reporting of eligible DAK expenditures.

32. In the context of the national rollout of the LGDP program through the Additional Financing, and the importance of further encouraging the accountability and transparency of LGs with respect to their DAK expenditures, GoI has decided to provide a clear financial incentive for compliance with WBRS reporting for DAK. For the Additional Financing the Value of LG Inventive and Reimbursement will be calculated as follows:

(i) Value of Qualifying Reimbursement (VQR) times 10% summed for all Selected LGs that utilized the web-based reporting system (WBRS) for the reporting of eligible DAK expenditures; and
(ii) Value of Qualifying Reimbursement (VQR) times 7.5% summed for all Selected LGs that have not utilized the web-based reporting system (WBRS) for the reporting of eligible DAK expenditures.

33. As outlined in the Legal Agreement and the Verification Arrangement for this Additional Financing, the percentages used for calculating the LG Incentive and Reimbursement for both categories of LGs specified above may be revised by prior written agreement between the Borrower and the Bank.

34. This change to the Project design will work to incent LGs to meet reporting requirements under the LGDP program and thereby support enhanced transparency and accountability of the DAK transfer system.

35. **Change to Component 2 –Restructured as part of an Institutional Support Program (ISP)**. The Additional Financing proposes a restructuring of Component 2 to better focus institutional capacity building activities under the Program on leveraging transparency, governance and performance improvements at the LG level. The component will focus on leveraging improvements in the efficiency and effectiveness of local government performance in areas directly related to DAK implementation as well as with respect to broader performance.

36. Change to Component Objective. In order to more clearly reflect the adjusted focus of the component on leveraging local government performance improvements, the Additional Financing includes a change to the component objective as outlined in Table 6 below.

Table 6: Changes to Objective for Component 2

Original Objective	Revised Objective
This component will support the strengthening of the basic institutional functioning of the Project. (cf. PAD of LGDP page 39)	The component aims to strengthen local government service delivery capacity through a program of advisory for policy reform, local government capacity building and support to national government entities responsible for enabling local service improvements.

37. Changes to Component Design and Activities. The original LGDP operation included four broad subcomponents for: (i) Developing a Monitoring and Evaluation System; (ii) Web-Based Monitoring and Reporting System; (iii) Technical Assistance for Central Government and LGs; and (iv) Project Management Support to implement and monitor the Project. Funding and institutional responsibilities were not adequately specified under LGDP.

38. The Additional Financing proposes to restructure the component under the umbrella of an Institutional Support Program (ISP) with three subcomponents: (i) Policy Advisory; (ii) Strengthening Local Government Capacity to Improve Public Service Delivery; and (iii) Strengthen Local Government Capacity for Effective and Efficient Use of DAK.

39. The component is structured around the following design and methodological principles:

- *Support implementation of DGFB transformational agenda.* In January 2014, DGFB issued a "Blue Print for Institutional Transformation' that identified a series of initiatives aimed at improvements in eight areas. The LGDP Additional Financing will support aspects of five areas of the Transformational Agenda, including: (i) revenue assignment; (ii) expenditure assignment; (iii) monitoring and evaluation; (iv) increasing local government capacity; and (v) human resources. These actions aim to (directly or indirectly) support improvements in the utilization of DAK and other sources of local government public expenditure, with the overall objective of improving local government public service delivery.
- *Address lessons learned from LGDP implementation.* The implementation of the first phase of LGDP indicated a need for: (i) better delineation of responsibilities between DGFB and other agencies involved in Project implementation; (ii) day-to-day implementation support to the Project Implementation Unit (PIU); (iii) improved verification arrangements, including the provision of more accurate reference unit costs and improved compliance with technical standards and safeguards; and (iv) increased involvement of the Joint Secretariat in the monitoring and evaluation of DAK-financed expenditures. To address these lessons learned, the following measures have been proposed and incorporated into the design of the Additional Financing: (i) facilitate the implementation of revised institutional arrangements; (ii) strengthen the verification process; and (iii) strengthen capacities for monitoring and

evaluation of DAK utilization. Key activities to be supported under the component are specified in Table 7 below.

Table 7: Summary of Proposed Institutional Support Program (ISP)

Subcomponent	Description	Cost (US$ '000)
2.1 Policy Advisory		
2.1a Reform of Intergovernmental Transfers	• Review service standards in selected DAK sectors • Design output-based and performance-driven DAK • Advise on development of multi-year DAK Design • Policy analysis and advisory on request of GoI	400
2.1b Improving LG Service Delivery	• Policy advisory on improving LG service delivery • Test prospective tools for improving municipal management and citizen accountability in a sample LGs • Develop and use LG ranking to improve citizen ability to hold LGs accountable for service delivery • Monitor and evaluate implementation of selected tool • Implement selected tools in selected LGs	600
2.1c Capacity Building Support to DGFB	• Review M&E of DAK spending and recommend on improvements • Support training for PIU	250
2.2 Strengthen Local Government Capacity to Improve Public Service Delivery		
2.2a LG Capacity Building for Improved DAK Utilization	• Provide participating LGs with hands-on support to overcome weaknesses identified by BPKP and other instruments, including: - regional financial management, - procurement - investment planning and maintenance, - technical quality control - safeguards management, and - reporting and accountability	3,500
2.2.b LG Capacity Building for Improved Public Service Delivery	• Implement tools to improve municipal management and citizen accountability	4,000
2.3 Strengthening Central Government Capacity for Effective and Efficient Use of DAK		
2.3a Implementation Support	• Support day-to-day-management of the project, including: - reporting, - monitoring and evaluation of project progress, - information dissemination to LGs, - implementation of WBRS, - updating and expansion of reference unit costs, - social and environmental safeguards, - development and updating of training materials for LGs,	500
2.3b Verification	• Improve the capacity of the verification agency to conduct	450

Subcomponent	Description	Cost (US$ '000)
Support	technical audits, verify safeguards and LG procurement processes, and strengthen internal controls in LGs. • Implement the DAK verification method in a sample of non-participating LGs, compare performance with participating LGs and advise on improving verification process.	
2.3c Monitoring and Evaluation Support	• Strengthen the system for monitoring and evaluation of reports on DAK utilization submitted through the WBRS. • Support development of improve user interface for e-reporting by LGs and test the interface in a sample of participating LGs.	300
	TOTAL	**10,000**

Source: World Bank, based on needs identification with PIU

40. **Adjustment in Project Management Arrangements**. The Additional Financing proposes a revision to the project management arrangements for the program. Under the original Project, project management was the responsibility of a Project Implementation Unit (PIU) in the Directorate General of Fiscal Balance (DGFB) within the Ministry of Finance (MoF). MoHA, Bappenas and MPW were all assigned responsibilities under the Project. However, these responsibilities were not consistently reflected in the Legal Agreement. Additionally, these partner agencies were not included as part of the PIU structure – a factor which limited coordination and accountability under the original Project.

41. Building on these lessons, the Additional Financing will: (i) expand the PIU structure to include MoHA, Bappenas and MPW; (ii) outline management arrangements for the PIU; and (iii) clarify responsibilities of all agencies under the PIU and reflecting the same in the Legal Agreement.

42. Management Arrangements for PIU. The PIU structure will be expanded to include, in addition to MoF (DGFB), MoHA, Bappenas, and MPW. The Head of the PIU will be within MoF (DGFB), while all other agencies will act as members of the PIU. All agencies will form a high-level Steering Committee comprising of Director General or equivalent level representatives[5]. Each agency will also be part of the PIU Management Committee, comprising of Director or equivalent level representatives[6]. Both the Steering Committee and Management Committee will be headed by MoF (DGFB). The PIU Steering Committee will meet on an annual basis to review overall progress on the program and provide strategic guidance on program implementation. The PIU Management Committee will meet each semester to review progress and take decisions on key issues of Project implementation. As the Head of the PIU, MoF (DGFB) will be responsible for taking a final decisions on all Project implementation issues, in the event that consensus is not reached across the PIU Management Committee. MoF (DGFB) will also be responsible for issuing Minutes of the quarterly PIU Management

[5] Director General or equivalent level representatives are understood as 'Echelon 1' officials from each agency.
[6] Director or equivalent level representatives are understood as 'Echelon 2' officials from each agency.

Committee Meetings, and also for aggregating all Project reporting and monitoring reports to the Bank.

43. Division of Responsibilities within PIU. Table 8 below summarizes the updated division of responsibilities in the revised PIU structure.

Table 8: Terms of Reference of LGDP Project Implementing Unit

Agency	Key Responsibilities	Key Deliverables
MoF	- Issue PIU decree	- Issuance of PIU Decree - Minutes of Semi-Annual Management Committee Meeting - Minutes of Annual Steering Committee Meeting - Annual Work Program and Budget - Semi-Annual Project Report - Mid-Term Project Evaluation Report - End-of-Project Report
	- Establish a PIU team in DGFB with appropriate fiduciary, technical, social and environmental management, monitoring, evaluation, institutional capacity building and related capacities	
	- Lead overall project management as the Head of PIU	
	- Lead preparation of Semi-Annual Project Reports, coordinating with all PIU members	
	- Lead the preparation of the Mid-Term Project Evaluation Report and the End-of-Project Evaluation Report, coordinating with all PIU members, and including information on the compliance with Loan covenants and measurement of KPIs	
	- Conduct an annual review of the Verification of Outputs report, including the financial (advance payment, reimbursement and incentive) and qualitative aspects	
	- Prepare and submit reimbursement requests to the Bank based on results from the BPKP Verification of Outputs	
	- Allocate budget within MoF for project management and capacity building under component 2	
	- Carry out the procurement of goods and services for component 2	
	- Lead the continued development and operationalization of the Web-Based Reporting System (WBRS), in coordination with MoHA, BAPPENAS and MPW	
	- Facilitate, in coordination with MoHA and MPW, the extension of technical assistance to Selected Local Governments in areas of: (i) regional financial management; (ii) procurement; (iii) investment planning and maintenance; (iv) technical quality control; (v) safeguards management; and (vi) reporting and accountability	
	- Enable the provision of technical support and capacity enhancement to BPKP on the verification process	
	- Conduct policy analysis in areas related to DAK and intergovernmental transfers	
	- Lead efforts to provide outreach to Selected Local Governments, in coordination with MoHA	
MPW	- Participate actively in the PIU Steering and Management committees	- Inputs to Semi-Annual Project Report - Inputs to Mid-Term Project Evaluation Report - Inputs to End-of-Project Report
	- Dedicate staff to participate within the PIU	
	- Support overall project management as a member of the PIU	
	- Support the preparation of the Semi-Annual Project Report, Mid-Term Project Evaluation Report and the End-of-Project Evaluation Report with relevant technical review and inputs	
	- Support MoF in the annual review of the Verification of Outputs report on qualitative aspects	

Agency	Key Responsibilities	Key Deliverables
	- Update and issue the Reference Unit Costs (RUC) on an annual basis - Draft and issue, as relevant, the Ministerial Circular Letter for Supplemental Guidelines on Social and Environmental Management - Socialize the prevailing Supplemental Guidelines on Social and Environmental Management - Support the continued development and operationalization with Selected Local Governments of the Web-Based Reporting System (WBRS) - Support MoF in the extension of technical assistance to Selected Local Governments in areas of: (i) investment planning and maintenance; (ii) technical quality control; (iii) safeguards management; and (iv) reporting and accountability	- Annually Updated RUC - Inputs to program of technical assistance to Selected Local Governments
MoHA	- Participate actively in the PIU Steering and Management committees - Dedicate staff to participate within the PIU - Support overall project management as a member of the PIU - Support the preparation of the Semi-Annual Project Report, Mid-Term Project Evaluation Report and the End-of-Project Evaluation Report with relevant reviews and inputs - Support MoF in the annual review of the Verification of Outputs report on qualitative aspects - Support efforts to provide outreach and coordination with Selected Local Governments on all aspects of Project implementation - Support the continued development and operationalization with Selected Local Governments of the Web-Based Reporting System (WBRS) - Support the extension of technical assistance to Selected Local Governments in areas of: (i) regional financial management; and (ii) reporting and accountability	- Inputs to Semi-Annual Project Report - Inputs to Mid-Term Project Evaluation Report - Inputs to End-of-Project Report - Inputs to program of technical assistance to Selected Local Governments
Bappenas	- Participate actively in the PIU Steering and Management committees - Dedicate staff to participate within the PIU - Support overall project management as a member of the PIU - Support the preparation of the Semi-Annual Project Reports - Support the design, implementation and analysis associated with the Mid-Term Project Evaluation Report and the End-of-Project Evaluation Report - Contribute to and support policy analysis in areas related to DAK and intergovernmental transfers - Support the continued development and operationalization with Selected Local Governments of the Web-Based Reporting System	- Inputs to Semi-Annual Project Report - Inputs to Mid-Term Project Evaluation Report - Inputs to End-of-Project Report - Inputs to policy analysis

44. **Enhanced Monitoring and Evaluation Framework**. The Additional Financing proposes the following: (i) a strengthening of the monitoring and evaluation framework and system; (ii) revisions to the menu of outcome indicators and the definition of numerical targets for all indicators in the results framework, previously not defined under LGDP, and (iii) remove redundant performance indicators.

45. Strengthened M&E Framework and System. The Bank and MoF have developed during LGDP implementation a detailed framework for Project M&E that was in part applied to the

Mid-Term Evaluation concluded in July 2013. Characteristics of the revised framework include: (i) use of impact evaluation methodologies using control groups to assess impacts on DAK performance and spillovers; (ii) development of benchmarking, performance mapping, monitoring of physical outputs and related tools to increase the management utility of the M&E system; (iii) development of an interface at the LG level to simplify redundancy in data entry across MoF and MPW reporting systems for DAK; and (iv) clearer institutional roles and responsibilities for the implementation of the M&E framework.

46. Changes to the Project Outcome and Intermediate Outcome Indicators. The Additional Financing proposes changes to one of the two Project outcome indicators to better measure results. See Table 9 below for details.

Table 9: Changes to PDO Outcome Indicators

Original Indicator	Original Target	Changes with AF	Revised Target (by EOP)
1. Development and use of an information system to which LGs report information to the MoF and the MPW	Not applicable	1. % of DAK reports submitted online through Web-Based Reporting System	***80%***
2. % of physical outputs reported, verified, and meeting eligibility criteria	Not applicable	2. No change	***88%***

47. The Additional Financing also makes a number of changes to intermediate outcome indicators. Specifically, the revised Results Framework for this Additional Financing includes: (i) the inclusion of multiple intermediate output indicators that were part of the Project M&E framework but were not included in the original LGDP PAD; (ii) removal of two redundant indicators; and (iii) the introduction of time-bound and objectively verifiable targets for all outcome and intermediate outcome indicators. These revised indicators and targets are specified in Annex 1 on Results Framework and Monitoring.

48. Measurement of Outputs and Outcomes. The original LGDP operation – due to its focus on accountability – did not explicitly include the measurement of physical outcome and output indicators supported under the Program. The revised M&E framework for the Additional Financing will collect a much broader set of data – beyond that required to report on the indicators in the Results Framework – for all participating Provinces. It will also begin to calculate efficiency measures (i.e. cost per unit output delivered), to be used for benchmarking and time horizon analysis. A full list of physical outcome and output indicators are included in the Operations Manual and will include core measures such as:

- kilometers of roads upgraded (*peningkatan*) to a standard width of X meters;
- number of houses connected to a clean water supply; and
- hectares of cropland irrigated as a result of upgrading (*peningkatan*) of irrigation infrastructure.

49. **Revised Procurement Arrangements**. The Additional Financing reflects minor adjustments to the procurement arrangements for the Project. Specifically, the Additional Financing will include an increase in the threshold amounts for eligible contracts and the inclusion of community-based sanitation sector subprojects procured through simplified competitive procedures.

50. Increasing Procurement Thresholds to Promote Improved Practices. As outlined in further detail below, the original Project maintained a system of procurement thresholds of $400,000, $500,000 and up to $1,000,000 based on compliance with basic procurement-related actions. As part of this Additional Financing, in order to incentivize the use of e-procurement practices, the Additional Financing will raise the threshold for eligible contract values to US$ 2,000,000 based on LG compliance with specific criteria.

51. Enabling the Procurement of Sanitation Subprojects through Community Participation with the use of Simplified Competitive Procedures. As part of the Additional Financing, the menu of eligible procurement procedures will be expanded to include community participation in procurement through simplified competitive procurement procedures for sanitation sector investments.

52. These adjustments to the procurement arrangements for the Additional Financing are discussed in greater detail below in the Appraisal Summary section of this Project Paper.

53. **Enhanced Safeguards Approach by Triggering OP/BP 4.04 Natural Habitats and OP 4.09 Pest Management**. The LGDP Additional Financing, in expanding the geographical coverage of the program from 5 pilot provinces (covering eligible 77 LGs) to 30 participating provinces (covering approximately 446 eligible LGs), significantly increases the Project 'footprint'; and, as such, alters the risk profile of the program. The Additional Financing will also raise the threshold for eligible investments thereby increasing the possibility of greater social and environmental impacts caused by individual subprojects. Therefore, the Additional Financing triggers two additional Bank safeguard policies: Natural Habitats (OP/BP 4.04) and Pest Management (OP 4.09).

54. The application of both policies will ensure that explicit and enhanced measures are in place to mitigate and manage any and all adverse impacts related to the potential indirect increase in pesticide use caused by increased crop production related to the irrigation investments and potential adverse impacts on natural habitats related to all subproject typologies in peri-urban and agricultural areas. The policies will also lead to improved safeguards management at the LG level with respect to natural habitats and awareness and adoption of integrated pest management methods. The policies were not triggered for the original Project due to the pilot nature of the operation, the limited scale and scope of the investments and the adequacy of the safeguard instrument and national legal and regulatory framework effective at the time.

55. The Borrower and the Bank have agreed to a joint field-based review to take stock of the experience and application of the current safeguard instrument within the first twelve months of Project effectiveness, in light of the enhanced geographic scope and subproject size. The review

will recommend any necessary refinements to the safeguards approach. Additionally, the Borrower and the Bank have agreed to incorporate technical assistance activities in component 2 of the AF (as further detailed in the Operations Manual) to strengthen LG awareness and capacity with respect to managing natural habitat issues and promoting integrated pest management practices as indicated and mandated in the instrument, accompanying project manual, parent MPW guidelines and the overarching national legal and regulatory framework.

56. A more detailed discussion of environmental and social safeguards issued is included below in the Appraisal Summary.

57. **Project Costs**. Table 10 below reflects the revised Project costs based on the proposed Additional Financing and Restructuring.

Table 10: Costs by Component

Component	Original Cost	Changes with AF	Revised Cost
1. DAK Reimbursement	220.0	500.0	720.0
2. Institutional Strengthening to Central and Local Governments and Project Management Support	8.5	10.0	18.5
3. Verification of Outputs	4.5	10.0	14.5
Total	**233.0**	**520.0**	**753.0**

IV. Appraisal Summary

58. **Economic Analysis**. The net present value (NPV) of Project investments was calculated for the original LGDP operation as a whole, over a period of five years (2015-2019) using a discount rate used of 12%. For illustrative purposes, the internal rate of return (based on net economic benefits) was also calculated, to show the discount rate at which net present value would be zero. It should be noted that the cost and benefit figures for each province do not take into account the national-level investments for Components 2 and 3 of the Project; these are, however, included in the analysis and results shown for the Project overall.

59. The results of the cost-benefit analysis are summarized in Table 11 below. The Project NPV over five years, at a discount rate of 12%, is estimated at US$89,119,951, with an economic internal rate of return (EIRR) of 30%.

Table 11: Benefits, costs and net present value for Project investments (USD)

Participating Provinces	Total Benefit	Total Cost
North Sumatera	49,842,845	39,562,176
West Sumatera	40,657,736	28,236,419
Riau	20,221,365	16,205,140
Jambi	19,818,763	9,450,324
South Sumatera	28,396,226	19,706,236
Bengkulu	16,207,265	10,063,931
Lampung	18,287,005	15,655,499
Bangka Belitung	12,430,470	8,751,319

Riau Island	7,197,333	5,794,041
West Java	45,614,615	19,501,282
Central Java	52,318,566	33,744,112
East Java	62,370,266	31,809,410
DI Yogyakarta	6,440,186	6,263,222
Banten	7,996,180	7,995,228
Bali	12,026,966	5,852,932
West Kalimantan	32,337,273	10,662,879
South Kalimantan	24,039,020	7,923,872
Central Kalimantan	33,808,239	3,194,025
East Kalimantan	15,598,078	12,573,108
North Sulawesi	20,111,946	13,323,218
Central Sulawesi	28,090,750	18,412,233
Southeast Sulawesi	22,809,462	16,805,815
West Sulawesi	16,005,859	9,489,721
Gorontalo	8,706,362	9,888,961
NTB	17,649,360	13,481,151
NTT	46,831,049	24,253,775
Maluku	30,217,505	15,125,247
North Maluku	21,669,441	10,906,926
Total	**756,977,214**	**476,201,865**
NPV (at 12%)		**89,119,951**
EIRR		**30%**

60. **Financial Management**. A financial management capacity assessment was conducted as part of Project preparation. The assessment involved discussions with DGFB, MoF, BPKP head office and regional offices in East Java, West Sulawesi, North Maluku (existing participating provinces) and Central Java, East Nusa Tenggara (proposed participating provinces) and 10 existing and proposed participating LGs in the above mention five provinces. The FM team met and discussed with regional BPKP and local government staff (inspectorate, Regional Secretary (*Sekretaris Daerah - Sekda*), MPW, local finance unit, the local planning agency-Bappeda, and ULP). The FM team also reviewed the DAK guidelines for community based sanitation[7] issued by DG Cipta Karya, MoPW. The discussion focused on the capacity of LGs in implementing DAK, possible targeted TA, and capacity of the regional BPKP in conducting independent verification. As part of this assessment the Bank also reviewed: (i) FY 2012 BPKP output verification report for the Project; (ii) BPKP working papers of the visited LGs; and (iii) all existing regulations related to DAK implementation.

61. The financial management assessment concluded that the LGDP Additional Financing satisfies the Bank’s requirements for financial management arrangements as laid out under OP/BP 10.00. The main risks for the project include: (i) weak local government financial management capacity and internal control as reflected in FY 2012 BPK opinion (only 24% received unqualified opinion); (ii) weak monitoring of unutilized DAK funds; (iii) weak coordination between BPKP and Inspectorate General (IG) MPW to conduct technical, environment and social training and verification as part of output verification of DAK

[7] MPW Implementation Guidelines for Community-Based Sanitation (2014).

implementation; (iv) insufficient budget for BPKP to conduct the task; and (v) improvements required on DAK guidelines for community based sanitation.

62. The financial management risk for the Project is considered 'Substantial' before mitigation and 'Moderate' after mitigation. As a means to mitigate these risks, the Project will: (i) provide technical assistance to local government to improve local government internal controls supported by BPKP; (ii) strengthen coordination between BPKP with MPW; and (iii) revised DAK guidelines for community based sanitation. The Additional Financing also included the updating of both the Verification Arrangement with BPKP, reflecting the updated Project design and the expanded scope of the verification framework. Additionally, the ToRs for the independent BPK audit have also been updated. There is no pending audit report for the project.

63. Under implementation, the Bank team will aim to work with MoF to ensure that BPKP receive continuous and structured support from either the MPW Inspectorate General and/or *Balai Besar* at the provincial level for technical aspects related to the output verification. Additionally, both BPKP and MPW will need to secure adequate budget to support the enhanced output verification requirements. Lastly, GoI is encouraged to identify alternatives for the monitoring of unutilized DAK funds, including the possibility of inclusion of such tasks under the scope of the BPKP ToRs for the output verification.

64. <u>Disbursement Arrangements</u>. The prevailing disbursement arrangement will be maintained for the Additional Financing. Disbursements are on a reimbursement basis. The reimbursement is made based on BPKP's Output Verification Report(s). The Bank's reimbursement of DAK expenditures occurs once a year. The reimbursement includes the advance reimbursement against expected DAK expenditures for the year (and will be recorded as advance in the Bank's disbursement system) and reimbursement against outputs delivered at year-end and verified in the first quarter of the following calendar year. The Bank finances not more than 100% of the total cost of the Selected Government eligible investments as verified by BPKP, up to Bank's full commitment amount under this additional financing. MOF is required to transfer 10% of the amount disbursed by the Bank to MOF to the relevant Selected Local Governments.

65. The Bank has disbursed three times, for outputs delivered at the end of GoI FYs 2011, 2012,and 2013. To date, the project has disbursed 78% of the allocated loan under the original project (IBRD Loan No. 7914).. The remaining balance of USD 48.6million will be disbursed in 2015 against the 2014 verified outputs.

66. **Procurement**. Minor changes are expected in the procurement arrangements under the Additional Financing. As under the original DAK operation, the Additional Financing is expected to continue to finance, through the output-based reimbursement mechanism, the reimbursement of eligible expenditures for subproject contracts of infrastructure civil works such as maintenance, rehabilitation, improvement, development, and construction of new infrastructure facilities. Procurement will continue to require the application of competitive procurement procedures (*Pelelangan Umum and Pemilihan Langsung)* under Perpres 54/2010, as amended by Perpres 70/2012, and sanitation subproject contracts, regardless of value, may be procured through community participation through simplified competitive procedure

(*Pengadaan Barang/Jasa dengan Pelelangan Sederhana)* as per sub-paragraph 3.6.2 and sub-paragraph 3.7 of the Annex for Implementation Guidance on Procurement of Goods and Services of Community Based Sanitation as attached to the Implementing Guidance for DAK Community Based Sanitation of 2014.

67. However, the restriction on subproject contract value under the Additional Financing is being amended to increase the threshold from US$1,000,000 to US$2,000,000 and the corresponding eligibility criteria for reimbursement of outputs for the increased threshold value has been revised as follows to promote use of e-procurement for greater transparency:

(i) The Subproject was for a contract value of up to $500,000 equivalent; or
(ii) The Subproject was for a contract value of more than $500,000 equivalent and up to $1,000,000 equivalent and (A) a decree for establishing the Procurement Service Unit (ULP) has been issued by the relevant Local Government; and (B) each such ULP has been properly staffed and budgeted in a manner satisfactory to the Borrower and the Bank; or
(iii) The Subproject was for a contract value of more than $1,000,000 equivalent and up to $2,000,000, and (A) a decree for establishing the ULP has been issued by the relevant Local Government; (B) each such ULP has been properly staffed and budgeted in a manner satisfactory to the Borrower and the Bank, and (C) the Government's e-procurement system has been used to invite and receive bids and award the contract.

68. Furthermore, compliance of the procurement process of the specific subproject contracts procured by the respective participating LGs, with the competitive procurement procedures, i.e. *Pelelangan Umum* and *Pemilihan Langsung* (with post-qualification), set out in the Perpres 54/2010 as amended by Perpres 70/2012, shall also be verified for eligibility of reimbursement of such contracts. Similarly, BPKP shall verify compliance of sanitation subproject contracts with *Pengadaan Barang/Jasa dengan Pelelangan Sederhana* in sub-paragraph 3.6.2 and sub-paragraph 3.7 of the Annex for Implementation Guidance on Procurement of Goods and Services of Community Based Sanitation as attached to the Implementing Guidance for DAK Community Based Sanitation of 2014. The review will include the following actions to be taken by BPKP:

- verification of the availability and maintenance by the participating LGs/communities of complete records of procurement, contract and purchase order documents;
- review of the invitation for bids (tender notice) and request for quotations;
- review of bidding and quotations documents;
- review of bid and quotations evaluation reports;
- review of signed contracts and purchase orders;

69. The BPKP verification process will be further strengthened under the Additional Financing to enhance the level of detail in verification, on an ex-post basis, the procurement processes for verifying substantial compliance with the required procurement procedures under the applicable competitive methods of procurement under Perpres 54/70 and the Implementing Guidance for DAK Community Based Sanitation of 2014. In carrying out the verification of procurement to determine eligibility for reimbursement, BPKP shall use a check-list and reporting format satisfactory to the World Bank.

70. The Additional Financing will also provide technical assistance, through a separate Project component for institutional support, to support and build procurement implementation capacity of the ULPs in the participating LGs, to pilot implementation of a program for promoting use of e-procurement and monitoring of procurement performance, and to strengthen the capacity of BPKP to effectively undertake verification of procurement processes.

71. **Poverty, Social and Gender Impacts**. A rapid poverty, social and gender assessment has been conducted in the context of this Additional Financing. The assessment aims to identify key poverty, gender and social impacts of the Program. More detailed findings of the assessment are included in Annex 6.

72. Infrastructure investments funded through DAK transfers have three potential positive effects on reducing poverty. These include: (i) a public works effect; (ii) a broad-based economic growth effect; and (3) a non-income effect. It is well known that the construction of public infrastructure can provide needed wages to low-income workers and therefore assist in the reduction of poverty. DAK funded projects are implemented annually and can provide an especially reliable source of necessary income for the poor and near poor in this regard. The stock of infrastructure created by publically financed investments can also positively influence broad-based economic growth, which in turn can help reduce poverty. Empirical evidence for Indonesia suggests that increases in both the amount and quality of local roads infrastructure—a major focus of the DAK—have a significant positive impact on district economic growth. Finally, infrastructure can help reduce non-income poverty by providing the poor with enhanced access to important public services. In this context, the DAK project helps to provide increased access to water, for example, which helps to improve the quality of vulnerable groups' lives through enriched health outcomes.

73. New construction of small roads, irrigation channels and water supply facilities and improved infrastructure supported under DAK will improve access and reliability of road and water related services, in particular for vulnerable populations like women, youth, and elderly. The rehabilitation of roads and bridges will be beneficial for women and youth, as it improves road safety, reduces transportation costs and improves access social services. The new and improved household water connections will help women in their role as provider of clean water for their families.

74. **Environmental and Social Safeguards**. The proposed LGDP Additional Financing will finance similar activities to those financed under the original Project, expanding coverage to a total of 30 provinces and up to approximately 446 eligible local governments across Indonesia.

75. <u>Investment Typology</u>. The LGDP AF project will reimburse infrastructure investments mainly for maintenance, rehabilitation and improvement of four types of investments; i.e. roads (fixing pot holes, resurfacing of existing road, minor alignment), irrigation (fixing the retaining walls, upgrading of existing canals, minor realignment), water supply (repairing existing lines, and some upgrades) and sanitation (construction of basic bathing, washing, toilet facilities and communal piped wastewater system). There may be new construction of small roads, irrigation channels, water supply facilities and distribution pipes to improve existing service. New construction of small roads, irrigation, water and sanitation subprojects is defined based on the

criteria specified in the Ministry of Environment Decree no 5/2012 on determining the appropriate level of environmental assessment required (AMDAL, UKL/UPL or SOP). Based on this, criteria for new construction to be funded by the Project includes: (i) coverage area up to 2000 ha for irrigation subsectors; (ii) the construction of the new road with the length of less than 5km in the roads subsector; and (iii) up to 100 l/s capacity of water treatment plant system with transmission lines of up to 10 km and the distribution network for a water supply system serving to up 500 ha area in the water subsector. It is expected that these trends will largely maintain for the Additional Financing.

76. Despite the inclusion of new construction within the eligibility framework for both the original Project and the Additional Financing, experience under the original LGDP operation suggests that subproject supported under the Project are largely for rehabilitation and maintenance of existing infrastructure assets. Data for FY 2011 investments shows that of 791 total irrigation sector subprojects, none were for new construction. Similarly, of 523 total road sector subprojects, only 7 (or 1.34 percent) were for new construction. In the water sector, all 287 subprojects were for minor new construction in already built areas. New construction supported in the roads and water sector remained small in size – average contract value for new roads investment was approximately USD100,000 and USD 21,150 for water supply investments. It is expected that these trends will largely maintain for the Additional Financing.

77. <u>Summary of Key Environmental and Social Issues</u>. Subprojects will be primarily located in already converted urban, peri-urban or agricultural sites. The road and community water supply subprojects will be located in peri-urban areas. Irrigation investments are all located on established farm land area. The potential adverse environmental and social impacts of all types of subproject investments financed by the LGDP AF are expected to be minor to moderate in scale, site-specific, reversible and readily managed through application of standard mitigation measures at the local level.

78. Specifically, the potential adverse environmental impacts for the three types of subproject investment typologies might include temporary soil disturbance, vegetation removal, construction phase increase in traffic and noise, increased generation of construction waste requiring proper transport to a suitable final disposal site and, for irrigation projects, the minor to moderate risk of an indirect increase in pesticide application.

79. The proposed interventions will not involve the purchase, distribution, use or disposal of pesticides. And, it is unlikely that the improved irrigation schemes supported under the Project will lead to significant increases use of pesticides given that, overall in Indonesia, pesticides are primarily used for horticulture plots in the highlands and not irrigated crops or rice fields. In addition, the price of the pesticides is high and farmers tend to use bio-pesticides made from organic local sources, implementing Integrated Pest Management (IPM) approaches for the most part. Additionally, Indonesia is at the forefront of applying IPM approaches supported by the government regulations.

80. In terms of social impacts, land acquisition related to subproject investments is expected to be minor due to the nature of the subproject investments which are primarily focused on rehabilitation and maintenance of existing structures on converted sites. Indeed, for the few subprojects financed under the original LGDP that required new small plots of land, they were

obtained through well documented voluntary land donation. Based on the supervision record over the previous two years of project implementation, there was only one case of a road widening investment where a LG obtained land through cash compensation.

81. Potential Indigenous Peoples (IPs) presence was screened in reference to the World Bank Study on IPs Screening (2010). Under the original LGDP, Indigenous Peoples (IPs) communities are potentially present in 34 districts out of 77 participating districts. Currently, based on the supervision record and BPKP verification record, the original Project has not affected or involved IPs communities as beneficiaries. In the additional 9 provinces covered under LGDP AF there is a potential IPs presence in 59 districts of the 182 districts. As the LGDP AF will likely cover a majority of LGs in 30 provinces by 2017, it is expected that some subproject investments would take place in villages where Indigenous Peoples are present or where they have activities.

82. Safeguards Management Approach for Additional Financing. Subprojects financed under the Additional Financing will be largely of the same nature as those financed by the original Project. As, as is the case with the original Project, potential adverse environmental and social impacts will remain minor to moderate, low risk and hence does not warrant a change in the Category B environmental classification for the Project. Nonetheless, the LGDP Additional Financing, in expanding the geographical coverage of the program from 5 pilot provinces (covering eligible 77 LGs) to 30 participating provinces (covering approximately 446 eligible LGs), significantly increases the Project 'footprint' and, as such, alters the risk profile of the program. The Additional Financing will also raise the threshold for eligible investments thereby increasing the possibility of greater social and environmental impacts caused by individual subprojects. Therefore, the Additional Financing triggers two additional Bank safeguard policies: Natural Habitats (OP/BP 4.04) and Pest Management (OP 4.09).

83. The appraisal of safeguards issues conducted during preparation of the Additional Financing found that:

- the safeguards instrument for the original LGDP operation (STG for Environment and Social) has successfully been applied to screen, identify and mitigate and manage all of the social and environmental impacts associated with subproject investments;
- the nature of the subproject investments to be supported under the Additional Financing would likely be largely limited to rehabilitation and maintenance works and minor new construction and not substantively different from those under the original operation given that both the original and AF operations are subject to the same subproject eligibility criteria as outlined in the MPW Technical Guidelines for DAK for basic infrastructure, consisting of roads, irrigation, water and sanitation.

84. For the purposes of the Additional Financing, the Supplemental Technical Guidelines for Environmental and Social Safeguards (STG) have been updated to reflect: (i) the increase in Project scope from 5 to 30 provinces; (ii) triggering of two additional Bank safeguard policies on Natural Habitats (OP/BP 4.04) and Pest Management (OP 4.09); and (iii) reflect changes in GoI environmental and social management regulations. This updated STG was finalized by GoI and received by the Bank on June 22, 2014. This updated STG, accompanied by the 'parent' MPW Technical Guidelines and associated GoI regulations for integrated pest management, includes a

framework for screening, identifying and mitigating potential impacts associated with both the Natural Habitats and Pest Management policies.

85. Disclosure. The STG for Environmental and Social Safeguards was disclosed on the MPW website (see: www.djpk.depkeu.go.id/berita) on June 24, 2014 and in the Infoshop on June 23, 2014, prior to Appraisal. A final STG issued as a Circular Letter of the Minister of Public Works to all provinces and local governments participating in the Additional Financing will be disclosed after Board Approval and prior to Loan Effectiveness. The issuance of the Circular Letter and STG is stipulated in the Legal Agreement as a Condition of Effectiveness.

86. Consultation. The LGDP AF will finance investments in a total of 30 provinces, with a gradual rollout to 14 provinces in 2015, 8 more provinces in 2016 for a total 22 provinces in 2016, and once again 8 more provinces in 2017 a total of 30 provinces. Public consultation has taken place and is ongoing and will continue during project implementation with the gradual roll out of the project. A public consultation program has been developed and agreed upon with counter-parts in order to ensure that consultation that has taken place, the ongoing consultation and the future consultation during project implementation is meaningful, timely and taken into consideration. The consultation program includes recurring annual consultations, a preliminary consultation for the Additional Financing and a detailed consultation program on the final draft STG that is ongoing and will take place prior to the eligibility of new provinces. The public consultation program is structured as a continuing/ongoing process in order to address Indonesian counter-parts regulations and procedures using a government decree such as the STG as the main safeguards instrument while taking into account Bank requirements on public consultations. It also takes into account the results of the previous ongoing project and the successive roll out of the eligible provinces during project implementation.

87. Review of STG. The Supplemental Technical Guidelines (Environmental and Social Safeguards) may be amended from time to time with the prior written agreement of the Bank and the Borrower. It was agreed with GoI that, by October 31, 2015, the Borrower shall carry out a review of the application of the Supplemental Technical Guidelines (Environmental and Social Safeguards) to the Project. Based on the recommendations of such review, the Borrower shall amend the Supplemental Technical Guidelines (Environmental and Social Safeguards) if so requested by the Bank, in a manner acceptable to the Borrower and the Bank, and shall ensure that the Project be carried out in accordance with said reviewed Supplemental Technical Guidelines (Environmental and Social Safeguards) starting on January 1, 2016. The Bank will support the Borrower in developing the methodological approach for the review.

88. Safeguards Performance and Capacity Issues. The implementation of Environmental and Social Safeguards under the original LGDP project has been consistently rated as Moderately Satisfactory under the original LGDP operation. Areas for improvement include: (i) ensuring enhanced and adequate documentation for voluntary land donation (VLD); (ii) enhancing the quality and detail of LG and BPKP reporting of the safeguards implementation; and (iii) strengthening the overall capacity of BPKP to conduct social and environmental safeguards verification, particularly at the regional level; and (iv) strengthening of the overall awareness and skills of LG staff on social and environmental safeguards management. MPW along with MOF are continuously improving the awareness and increasing the capacity of the Local Governments

to apply the STG for Safeguards through the socialization process. Central BPKP has continuously socialized the verification checklist to the regional BPKPs annually. Additionally, the Additional Financing includes enhanced technical assistance to BPKP and LG on social and environmental safeguards verification and management.

89. Further details on the environmental and social safeguards issues and management approach for the Additional Financing can be found in the publically disclosed Appraisal Stage ISDS.

90. **Assessment of the Institutional Support Component**. As part of preparation for this Additional Financing, the Bank conducted an assessment of the Institutional Support component of the LGDP Program. The assessment found that, while performance has gradually improved since the initiation of the program in 2011, overall outcomes for the component have been below expectations. A range of factors are associated with this poor performance. First, MoF – as the head of the PIU and the contracting agent – lacked the technical capacity to adequately structure, bid and manage contracts for technical areas as wide ranging as social and environmental safeguards, procurement, M&E and other areas. Second, the lack of a multi-year budgeting framework has constrained the ability of MoF to adequately commit funds within a given FY. Budget resources are only made available to executing units by March of a given FY and activities have to be then procured and executed by December of the same year. Third, the Bank also failed to provide more 'hands-on' assistance on the structuring and operationalizing TA under the program.

91. The component has not been fully funded by MoF. To date, MoF has allocated USD 2.4m to the component against an overall commitment of USD 8.5m by the end of 2014. MoF has allocated an additional USD 1.0m in financing for the component in the 2014 budget. This funding gap is a function of multiple factors. First, MoF poor budget utilization on early years of LGDP constrained the ability of the PIU to request larger allocations in subsequent years as execution improved. For example, in 2011, the PIU received a full allocation of USD 1.7m but was only able to execute under half of the same. In subsequent years, the PIU was unable to justify larger allocations. Additionally, in 2013, overall MoF budget cuts impacted funding levels.

92. Despite these factors the component has had areas of improved and strong performance. The PIU has successfully mobilized technical assistance to LGs for the implementation of the Web-Based Reporting System (WBRS). Since its launch in March 2012, PIU-support technical assistance has enabled 60% of LGDP participating districts to submit technical and financial reports through WBRS. The component has also successfully supported technical assistance on procurement. The PIU worked together with the central government procurement agency (LKPP) on delivering procurement training the LGs focusing on the establishment of Local Procurement Units (ULPs) and on the use of e-procurement systems. Increasingly the identification of TA activities supported under the program is being driven be evidence and LG performance information emerging from the verification process.

93. Going forward, the Bank and MoF have been actively engaged in developing the Institutional Support component for the LGDP AF with multiple enhancements. First, the restructured component more clearly differentiates between major lines of activities, clarifying

responsibilities across agencies. Second, the program has been developed with detailed scope of works for all major proposed activities. Third, there is a clearer focus on field-based delivery of TA, i.e. being closer to the client. Fourth, the program is more directly linked to evidence on performance so that TA activities can be better targeted where needed. Fifth, new regulations allow for multi-year contracts for firms – a key hurdle in executing large TA programs over a broad geographic footprint. Sixth, the Bank and MoF have designed an M&E framework for the program that is ready-for-implementation.

94. Ensuring for full financing of the program remains a challenge. MoF has requested support from the Australian Indonesia Partnership for Decentralization (AIPD) to finance component two of the LGDP Additional Financing. The Bank team will closely monitor compliance with financing commitments under the program.

95. **Governance and Anti-Corruption.** The proposed additional financing of LGDP will continue to use the Web-Based Reporting System, which will be expanded in terms of use and coverage to wider function and areas as the participating entities also increased. This will help to improve the management of DAK through better reporting and enable the project to be monitored in timely manner, more accurate, and accessible by the relevant parties/stakeholders.

96. Further improvement to the WBRS will be explored, based on the evaluation conducted during the first phase of the program, which particularly will be focusing on the system operation and application. Improved efficiency of the institutional arrangement to manage the system, which to be made in-line with the overall DAK management and oversight arrangement in Indonesia, and the formulation of a supporting national policy to strengthen the function of the system are the two areas that intended to be achieved during the period of the proposed additional financing of LGDP.

97. **Summary and Assessment of the Verification System**. BPKP, as the independent verification agent, annually conducts field-based output verification. At the beginning of each GoI fiscal year, the PIU with technical inputs from MPW is responsible for updating the Reference Unit Costs (RUCs) to BPKP as a key input to the output verification process. Agreed RUCs in the beginning of each fiscal year constitute a core feature of the Project as BPKP uses the RUCs to determine the eligibility of subproject investments and subsequently to calculate the value of potential reimbursement. Along with RUCs, BPKP applies as part of the verification process a series of additional requirements that have to be met by the LGs in the first screening stage for verifiable outputs, which include: (i) procurement thresholds as mentioned in the Loan Agreement; (ii) contracts must utilize a competitive bidding process; (iii) outputs must be produced by December 31 of the said fiscal year as evidenced by a certification of completion; and (iv) the availability of matching funds of at least 10 % of total DAK contract values.

98. Following the first screening, BPKP will have a population of verifiable outputs and will then take a minimum of 20% sample of contracts from each LG to be further verified. The second stage of verification assesses compliance with a verification check list, agreed between the World Bank and BPKP. The verification check list includes requirements on compliance with government procurement regulations, financial management, safeguards policies in the MPW Supplemental Technical Guidelines, and technical (quantitative and qualitative) requirements as stipulated in the MPW Technical Guidelines. In conducting the technical verification in the field,

BPKP team is accompanied by technical experts from the Inspectorate General (IG) of MPW. After the second screening, BPKP determine the value of qualifying reimbursement (VQR) for each LG and the value of total reimbursement as a sum of the VQR across all LGs. As an incentive for the LGs, 10 % of the VQR will be transferred from the MoF to LGs. As part of the verification process, the BPKP is also responsible for providing feedback to LGs on their implementation of DAK funds in the form of a management letter. Additionally, BPKP provides a qualitative report to MoF to inform the design for the institutional capacity building component. The verification results from BPKP serves as the sole basis for the World Bank reimbursement to the MoF.

99. An assessment of the output verification system was conducted as a part of Project preparation. The output verification system is managed by BPKP which, as per the terms of the Verification Agreement, is responsible for verifying the timeliness and accuracy of the financial and technical reports submitted, respectively, to MoF and MPW by LGs to ensure that outputs have been achieved in compliance with the Technical Guidelines and the Supplemental Technical Guidelines (Environmental and Social Safeguards).

100. At the initiation of the original LGDP operation, BPKP did not have prior experience as a verification agent for a broad Government infrastructure program such as DAK. BPKP has conducted output verification now for fiscal year 2011, 2012, and 2013 outputs.. The quality of the verification process and system managed by BPKP has consistently improved over this period. In the first fiscal year, while generally comfortable with fiduciary aspects of the verification, BPKP struggled with the technical verification of outputs. The lack of adequate coordination with MPW was also a constraint as it was intended for the Ministry to provide support on technical verification. Nonetheless, in the ensuing year, BPKP both deepened its collaboration and with MPW Inspectorate General Office and invested in the technical capacity building of its field verification agents in the areas of internal control, civil work, environment and social safeguards. The quality of the verification results and reports were much improved in 2012 and 2013. BPKP has successfully carried out the verification to the 75 participating LGs of the original project, including the ones that located in the remote areas in eastern part of Indonesia, within a relatively limited of time. BPKP has also taken on the role of providing qualitative feedback to LGs in the form of a Management Letter that provides guidance to LGs on how to improve performance.

101. There remains room for improvement. BPKP and the Bank have discussed the need going forward to:

- Ensure appropriate time and budget allocation for field verification agents to conduct a full verification assessment;
- Intensify the training in technical, FM, procurement, and safeguards to all BPKP staff engaged in the program;
- Improve coordination between BPKP and IG MPW to conduct technical, environment and social training and verification as part of output verification of DAK implementation
- Revise the verification checklist to better reflect the impact of the project outputs;
- Improve record keeping of procurement documents and also enhance the level of detail in checking by BPKP of the procurement process carried out by the LGs so as to be able to effectively verify the level of compliance with the required procurement procedures under

the applicable competitive methods of procurement under the Perpres 54/2010 and its revisions.

102. A revised Verification Arrangement incorporating these recommendations and other has been prepared and will be signed in parallel to the processing of this Additional Financing.

ANNEX 1: RESULTS FRAMEWORK AND MONITORING

INDONESIA: LOCAL GOVERNMENT AND DECENTRALIZATION PROJECT ADDITIONAL FINANCING / LOCAL GOVERNMENT AND DECENTRALIZATION PROJECT PHASE II

Results Framework

Revisions to the Results Framework		Comments/ Rationale for Change
PDO		
Current (PAD)	*Proposed change*	
Improve the accountability and reporting of the central government's Specific Purpose Grants (DAK) for the infrastructure sub-sectors within pilot local governments (LGs).	The objective of the Project is to improve the accountability and reporting of the central government's Specific Purpose Grants (DAK) for basic infrastructure, consisting of roads, irrigation, water and sanitation, within Selected Local Governments.	Removed 'pilot' to reflect that project has been mainstreamed nationally. Modify term of 'infrastructure sub-sectors' to adjust the change of DAK policy
PDO indicators		
Current (PAD)	*Proposed change*	
Development and use of an information system to which LGs report information to the MoF and the MPW.	% of DAK reports submitted online through Web-Based Reporting System	The revised indicator enable clearer tracking of outcomes
% of physical outputs reported, verified and meeting eligibility criteria.	No change	
Intermediate Results indicators		
Current (PAD)	*Proposed change*	
DAK Reimbursement		
% of LGs that receives DAK payment 1 from the MoF by March 31.	No change	
	% of LGs providing minimum 10% matching funds	The proposed indicator formed part of the Project M&E Framework but was not reflected in the original Project documentation.
	% contracts with quality of outputs delivered according to contract by Dec 31	
	% contracts with work completed with documented physical handover by Dec 31	The revised indicator aim to provide the context of DAK project completion
Institutional Support Program		
MoF and MPW Web-Based	Reclassified as PDO level indicator.	Measurement of reporting

Revisions to the Results Framework		Comments/ Rationale for Change
Reporting Systems (WBRS) fully operated.		performance part of PDO.
% of LGs reporting financial information and outputs through MoF and MPW web-based systems.	Dropped.	Already measured by intermediate results indicator 2.
Supplement of the MPW's Technical Guidelines on Environmental and Social Safeguards issued by MPW Ministerial Circular Letter.	Maintain an issued Supplement of the MPW's Technical Guidelines on Environmental and Social Safeguards through MPW Ministerial Circular Letter applicable to all Selected Local Governments in each FY.	Revised language of indicator to ensure measurability.
The MoF will produce annual M&E reports for the project on the DAK in the participating provinces, a mid-term evaluation report and end of project final evaluation report.	Replaced 'five' by 'participating'.	Proposed change reflects expanded geographical scope.
% of LGs that have passed their budgets and allocated contribution for the DAK by February 28.	Dropped.	Already measured by intermediate indicator 1 (if an LG has not passed its budget, it cannot receive its first DAK payment).
	% of LGs with functioning procurement unit	Added to reflect the emphasis within ISP component to strengthen LG systems and capacities
Verification of Outputs		
Number of eligible outputs completed by LGs by December 31.	Reformulated as intermediate output indicator lined to component 1 for DAK Reimbursement	
	BPKP submits to PIU a quantitative and qualitative Verification Report consistent with the ToRs for the same as specified in the Verification Arrangement by May 31 of each FY	These indicators have been added to better track the progress of the Verification of Outputs component
	Issuance by BPKP of Verification Manual and socialization of BPKP regional representatives by February 28 of each FY	

REVISED PROJECT RESULTS FRAMEWORK

Project Development Objective: The objective of the Project is to improve the accountability and reporting of the central government's Specific Purpose Grants (DAK) for basic infrastructure, consisting of roads, irrigation, water and sanitation, within Selected Local Governments.

PDO Level Results Indicators*	Core	UOM**	Baseline Year (2010)	Progress To Date (2013-14)	Cumulative Target Values***				Frequency	Data Source/ Methodology	Responsibility for Data Collection	Comments
					2015	2016	2017	2018				
1. % of DAK reports submitted online through Web-Based Reporting System	☐	%	–	80%	70%	70%	75%	80%	Annually	MIS	MoF and MoHA	
2. % of physical outputs reported, verified and meeting eligibility criteria.	☐	%	–	87%	80%	84%	88%	N/A	Annually	Survey	BPKP	

* For two reasons, the number of beneficiaries was not included as a core PDO level result indicator: (i) it is extremely time-consuming and costly to measure the number of beneficiaries of several thousands of DAK-financed contracts across numerous Selected Local Governments in the 30 participating provinces throughout Indonesia, and (ii) the measurements are likely to be inaccurate because most investment in infrastructure sub-sectors (notably roads and irrigation systems) have LG-wide impacts.

** Unit of measurement

*** In each year, targets only apply as follows: (i) for 2015, targets applies only to Selected Local Governments (LGs) participating in LGDP prior to commencement of Additional Financing; (ii) for 2016, targets apply to Selected LGs participating in LGDP on or prior to December 31, 2015; (iii) for 2017 targets apply to Selected LGs participating in LGDP on or prior to December 31, 2016; and (iv) for 2018 targets apply to all Selected LGs.

Intermediate Results Indicators	Core	UOM*	Baseline Year (2010)	Progress To Date (2013-14)	Target Values**				Frequency	Data Source/ Methodology	Responsibility for Data Collection	Comments
					2015	2016	2017	2018				
Intermediate Result 1: DAK Reimbursement												
1. % LGs that receives DAK payment 1 from the MoF by March 31.	☐	%	63%	26%	30%	40%	50%	60%	Annually	Report	MoF	
2. % LGs providing minimum 10% matching funds	☐	%	N/A	90%	90%	90%	90%	95%	Annually	e-monitoring system and BPKP Report	MPW and BPKP	

Intermediate Results Indicators	Core	UOM*	Baseline Year (2010)	Progress To Date (2013-14)	Target Values**				Frequency	Data Source/ Methodology	Responsibility for Data Collection	Comments
					2015	2016	2017	2018				
3. % contracts with quality of outputs delivered according to contract by Dec 31	☐	%	N/A	27%	30%	35%	40%	45%	Annually	BPKP Report	BPKP	Based on BPKP sampled contracts
4. % contracts with work completed with documented physical handover by Dec 31	☐	%	N/A	N/A	70%	70%	75%	80%	Annually	BPKP Report	BPKP	Based on BPKP sampled contracts
Intermediate Result 2: Institutional Support Program												
5. Maintain an issued Supplement of the MPW's Technical Guidelines on Environmental and Social Safeguards through MPW Ministerial Circular Letter applicable to all Selected Local Governments in each FY.	☐	Date of issuance	N/A	N/A	Yes	Yes	Yes	Yes	Annually	MPW Circular Letter	MPW	
6. The MoF will produce annual M&E reports for the project on the DAK in the participating provinces, a mid-term evaluation report and end of project final evaluation report.	☐	Number of reports	N/A	N/A	1	1	1	1	Annually	Report	MoF	Reports for 2015 and 2016 will contain an analysis of LGDP spillover effects.
7 % of LGs with functioning procurement unit	☐	%	N/A	73%	73%	75%	75%	80%	Annually	BPKP Report	BPKP	
Intermediate Result 3: Verification of Outputs												
8. BPKP submits to PIU a quantitative and qualitative Verification Report consistent with the ToRs for the same as specified in the Verification Arrangement by May 31 of each FY	☐	Y/N	N/A	N/A	Y	Y	Y	Y	Annually	BPKP Report	BPKP	
9. Issuance by BPKP of	☐	Y/N	N/A	N/A	Y	Y	Y	N/A	Annual	BPKP Report	BPKP	

Intermediate Results Indicators	Core	UOM*	Baseline Year (2010)	Progress To Date (2013-14)	Target Values**				Frequency	Data Source/ Methodology	Responsibility for Data Collection	Comments
					2015	2016	2017	2018				
Verification Manual and socialization of BPKP regional representatives by February 28 of each FY												

* Unit of measurement

** For intermediate indicators 1-4 and 7, in each year, targets only apply as follows: (i) for 2015, targets applies only to Selected Local Governments (LGs) participating in LGDP prior to commencement of Additional Financing; (ii) for 2016, targets apply to Selected LGs participating in LGDP on or prior to December 31, 2015; (iii) for 2017 targets apply to Selected LGs participating in LGDP on or prior to December 31, 2016; and (iv) for 2018 targets apply to all Selected LGs.

ANNEX 2: OPERATIONAL RISK ASSESSMENT FRAMEWORK (ORAF)

INDONESIA: LOCAL GOVERNMENT AND DECENTRALIZATION PROJECT ADDITIONAL FINANCING / LOCAL GOVERNMENT AND DECENTRALIZATION PROJECT PHASE II

<table>
<tr><th>1. Project Stakeholder Risks</th><th>Rating</th><th colspan="3">Moderate</th></tr>
<tr><td rowspan="2">Description:
- MoF as the PIU will work closely with Line Ministries, MoHA, and Bappenas. There are still some coordination challenges across different ministries, particularly with respect to the Monitoring and Evaluation program.
- Willingness of local governments to participate in the program</td><td colspan="4">Risk Management:
- The MoF will invite central government agencies to discuss the implementation arrangement for the project and description of activities under each ministry.
- A PIU coordination meeting will be held on a six-monthly basis.
- The MoF will notify the participant districts about the Program, describes the objective of the Program, and explain the benefit and incentive for LGs.</td></tr>
<tr><td>Resp: Client</td><td>Stage: Both</td><td>Due Date: Continuous</td><td>Status: In progress</td></tr>
<tr><td colspan="5">2. Implementing Agency Risks (including fiduciary)</td></tr>
<tr><td>3.1. Capacity</td><td>Rating:</td><td colspan="3">Substantial</td></tr>
<tr><td rowspan="2">Description :
Implementation capacity:
- Limited capacity in the Project Implementing Unit in Central level to carry out daily project management due to limited number of staff
- The implementation capacity of each Local government varies based on the evaluation in the original project, the weaker performance located in eastern part of Indonesia
Fiduciary:
- Late submission and/or non-compliance with required financial report and technical reporting on outputs by local governments
- Limited capacity of LG internal controls – payments were not supported with sufficient verification of physical outputs
- Possible resistance by local governments to be verified on their DAK funds
- Weak audit arrangement on DAK program itself that in the current audit arrangement, DAK audit is undertaken as part of audit on local government expenditures</td><td colspan="4">Risk Management:
- TA consultants for the daily management and to regularly report the results to the PIU members. Possible support from Australia Indonesia Partnership for Decentralization (AIPD) for the Technical Assistance component has been confirmed, which will be fully sufficient to cover the designed TA program.
- Create grand design of the TA component for the whole project period with the estimated budget.
- Deliver tailored, targeted and intensive, capacity building based on the specific identified areas of LGs' weaknesses through a close cooperation and coordination with the related ministries.
- Draw lessons learned from various LGs experience and provide opportunity for a cross-learning among LGs
- If LGs do not provide budget and financial reports, releases of DAK can be withheld, as stipulated in the MoF regulation: PP 55/2005</td></tr>
<tr><td>Resp: Both</td><td>Stage: Both</td><td>Due Date: Dec 31, 2016</td><td>Status: In progress</td></tr>
</table>

3.2. Governance	**Rating:**	**Moderate**		
Description: Coordination within the PIU that involve many different stakeholders without the provision of unified secretariat will create risk for the information sharing and decision making.	**Risk Management:** A regular coordination meeting is to be held at least by quarterly basis.			
	Resp: Client	**Stage:** Implementation	**Due Date:** Continuous	**Status:** In progress
	Risk Management: Support the improvement of the bidding process through close oversight and capacity building in bid preparation to the implementing agency.			
	Resp: Both	**Stage:** Implementation	**Due Date:** Continuous	**Status:** In progress
4. Project Risks				
4.1. Design	**Rating:**	**Low**		
Description: - Due to high variance of DAK outputs and its yearly dynamic budget allocation, the RUC may not always matches the actual output in the field, which usually planned one year before the verification of outputs - Use of WBRS in new LG participants will require intensive capacity building and hands-on training from the PIU. The PIU has developed an offline system to accommodate Provinces with limited internet connection. This offline system still requires socialization and dissemination to the LGs. - Increased number of participating area will affect the scope of work for verification by BPKP. The BPKP may face some challenges in resources to roll out the overall verification. - Possible DAK reform towards performance-based DAK, multi-year DAK, and support the achievement of minimum service standards, following the revision of Law 33/2004. Through the reform, there will be a possibility of having changes in DAK expenditure, which might affect the project design.	**Risk Management:** - Schedule yearly review to the RUC by involving related sectors in Ministry of Public Works as early as possible - The formulation of offline WBRS version during the first phase of the project will help to overcome the challenges in the eastern part of Indonesia. - Technical assistance to support the capacity strengthening of BPKP has been included in the TA design. Initial discussion with the budget division in the Ministry of Finance has been conducted to ensure sufficient budget allocation. - Conduct assessments and analysis on the possibility of DAK reform and its impact for the proje have discussions with the related stakeholders, including MoF, MoHA, and Bappenas.			
	Resp: Both	**Stage:** Both	**Due Date:** Continuous	**Status:** In progress
4.2. Social & Environmental	**Rating:**	**Moderate**		
Description: - Local governments may have limited knowledge and understanding of the environmental and social safeguards requirements specified in the supplement of MPW Technical Guidelines; expansion of the project coverage from 5 to 14 in 2015 and 30 provinces in will result in an	**Risk Management:** The PIU together with the line ministries will deliver targeted capacity building efforts every year in each participating Province to raise awareness and understanding of the LGDP design and the safeguard instrument for the project – the Supplemental Technical Guidelines. Awareness and clear understanding of the requirements of the Technical Guidelines will be continued every year in the Additional Financing and start prior to program implementation.			

<table>
<tr><td colspan="2">increased need to monitor and supervise subprojects. In general, local governments' capacity in managing social and environmental safeguards remains limited.
- Local governments have very limited knowledge in the two additional safeguards requirements, especially on pest management.</td><td colspan="4">Training for LGs, provincial BPKPs and consultants on the use and application of the technical guidelines will be done regularly along with awareness raising efforts. Monitoring and reporting of the implementation of the guidelines by the LGs will be carried out regularly. The Project will hire safeguards specialists on a regional basis, to provide backstopping assistance to local governments and BPKPs.

Dissemination and socialization to all LG participants annually, to socialize the Supplemental Technical Guidelines of MPW that include the two additional safeguards requirements.</td></tr>
<tr><td colspan="2"></td><td>Resp: Client</td><td>Stage: Implementation</td><td>Due Date: Continuous</td><td>Status: In progress</td></tr>
<tr><td colspan="2">4.3. Program & Donor</td><td>Rating:</td><td colspan="3">Low</td></tr>
<tr><td colspan="2">Description: Only minor program or donor risks were identified as part of the preparation. Continued coordination of donor activities in the decentralization sector will be of importance to ensure for policy consistency.</td><td colspan="4">Risk Management: MoF conducts annual donor coordination meetings with donors engaged in decentralization. The Bank also conducts bilateral coordination with key donors engaged in the sector.</td></tr>
<tr><td colspan="2"></td><td>Resp: Both</td><td>Stage: Implementation</td><td>Due Date: Continuous</td><td>Status: In Progress</td></tr>
<tr><td colspan="2">4.4. Delivery Monitoring & Sustainability</td><td>Rating:</td><td colspan="3">Moderate</td></tr>
<tr><td colspan="2">Description: The involvement of many stakeholders in the Project Implementing Unit from the various ministries could create challenge in undertake a coordinated monitoring and evaluation.</td><td colspan="4">Risk Management:
- Set up a clear task and responsibilities for different ministries in their relation with the implementation of the project is expected to appropriately distribute the functions of M&E within the program
- Guidance from the recent Monitoring and Evaluation of LGDP Phase 1 could be used as a reference for the future M&E framework</td></tr>
<tr><td colspan="2"></td><td>Resp: Client</td><td>Stage: Implementation</td><td>Due Date: June 30, 2015</td><td>Status: In progress</td></tr>
<tr><td colspan="6">5. Overall Risk</td></tr>
<tr><td>Overall Implementation Risk</td><td colspan="5">Moderate</td></tr>
<tr><td colspan="6">Risk Description:
Overall Implementation Risk has been rated as Moderate due to the national scale of the roll out for the Local Government and Decentralization Project and the potentially capacity constraints and significant management and coordination requirements associated with the implementation of the Project at the national scale. The risk is considered moderate because the GoI has successfully developed a platform for Project monitoring, management and oversight under the original loan that will be strengthened going forward. Additionally, the BPKP verification process has proven to be strong and reliable.</td></tr>
</table>

Annex 3: Summary of Bank Strategy on Intergovernmental Transfers

1. The Local Government and Decentralization Project (LGDP) Additional Financing is part of a broader Bank strategy on intergovernmental transfers and the strengthening of subnational fiscal performance. As part of this strategy, the World Bank is currently engaging with Bappenas on the reform agenda for intergovernmental transfers as part of the Five Year Plan, 2015-2019 (RPJM) currently under formulation. This dialogue builds on lessons from LGDP implementation and from a broad program of policy analysis conducted in collaboration with MoF with support from the Bank and other multilateral and bilateral donors active in Indonesia.

2. The World Bank's policy guidance to the RPJM process centers around four main questions: (i) whether GoI should increase funding for intergovernmental transfers; (ii) how can transfers be reformed in the short term; (ii) what actions or reforms are required in the medium-term to reform transfers; and (ii) what additional reforms might the central government consider to improve outcomes. The Bank's policy guidance on these issues is summarized below.

Should central government increase funding for intergovernmental transfers now?

3. The Bank team has emphasized three broad principles with respect to funding levels for intergovernmental transfers.

- *Do not increase funding for DAU*. Currently, increases in DAU at the margin are mostly used to increase spending on local government staff salaries and allowances. An additional rupiah of DAU increases personnel spending by 0.86 rupiah. Local government personnel expenditure - 50 % of budgets on average - is already too high. Additional increases in the DAU are unnecessary and would likely have a negative impact on service delivery.

- *Increase funding for DAK*. Increases in DAK funding are highly stimulative of local government capital spending. An extra rupiah of DAK increases capital spending by more than 1.5 rupiah. Additional capital spending by local governments results in larger stocks of important local public capital assets in the health, education, and infrastructure sectors. Increased stocks of public assets are, in turn, strongly associated with improvements in service delivery.

- *Increase funding for Hibah (General Central-Subnational Grant Mechanism)*. Recent experience with the *Hibah* suggests that it can be favorably adapted for use in improving local government service delivery. The Water *Hibah* pilot project organized and funded by AusAID, shows that increases in grant allocations result in increased local government equity investments in PDAM which in turn help to expand the number of household water connections, especially for vulnerable groups. Government might consider using its own funds to roll out the Water *Hibah* initiative.

How should central government reform intergovernmental transfers in the short-term?

4. Presuming no changes in the structural laws governing decentralization and intergovernmental transfers, the Bank has recommended:

- *DAU policy reform might focus on a number of issues in the allocation formula*: eliminating perverse incentives regarding personnel spending and own-source revenue mobilization, more accurately estimating expenditure needs, and improving equalization performance.

- *Eliminate basic allocation*. The basic allocation in the DAU distribution formula provides an incentive for local governments to increase spending on personnel. Local government spending on staff salaries and allowances already comprises nearly 50 % of total local spending and is arguably too large. Removing the basic allocation (or pushing its weight in the formula close to zero) might help put downward pressure on personnel expenditure at the local government level.

- *Remove own-source revenues.* The inclusion of own-source revenues in the estimation of fiscal capacity in the DAU allocation formula may provide at least somewhat of a disincentive for local governments to mobilize revenues from own-sources. Removing own-source revenues from the calculation (or pushing its weight close to zero) may reverse that disincentive, something that would be especially useful as districts assume full control over the local property tax next year.

- *Cluster local governments*. The DAU formula treats all local governments similarly. This one-size fits all approach causes difficulties in the proper estimation of fiscal needs. Disaggregating local governments into smaller, more comparable groups (*kota* and *kabupaten*, e.g.; or, more ambitiously: large cities, medium/small cities, suburban places, natural resource rich districts, and remote regions, etc.) would provide a basis for a more accurate estimation of fiscal needs.

- *Increase shared revenues coefficients*. Occasionally only a portion of shared tax and/or shared natural resource revenues has been used to estimate local government fiscal capacity in the DAU formula. This aspect of the formula provides a significant benefit to districts with high personal income and oil and gas producing regions, especially, but it also constrains fiscal equalization across places. Using 100 % of all shared revenues in the calculation would improve the equalization performance of the grant.

5. Additionally, DAK policy reform might focus on issues related to sectoral coverage, geographic coverage, type of spending support, and multi-year implementation.

- *Reduce sectoral coverage*. The number of sectors covered by the DAK has expanded from 3 in 2001 to 19 in 2013. New sectors' distributions have increased from just 5 to 25 % of total allocations; at the same time traditional infrastructure's share has declined from 50 % to 25 %. Many of the new sectors could be eliminated without negative impact and funds could be reallocated to infrastructure, especially, and health and education sectors.

- *Reduce geographic coverage*. The original intent of the DAK was to maximize impact of the grant by focusing distributions on relatively few local governments. Indeed initially allocations were made to only a small subset of local governments. Now all local governments receive at least some DAK. This feature of grant allocation reduces the size of DAK distributions to individual districts and weakens impact. Government should focus the DAK on priority regions.

- *Allow maintenance spending*. Local governments spend too little on maintaining assets under their control. DAK allocations are negatively associated with maintenance spending. Each additional rupiah of DAK leads to a decrease in maintenance and other non-personnel current spending of more than 0.5 rupiah[8]. Allowing DAK to be used to fund routine maintenance of public capital assets in a more comprehensive fashion might help to reverse the trends.

- *Allow multi-year project implementation*. Although districts are permitted to roll over unused DAK into the following fiscal year to be used for 'similar purposes' they must still re-tender any associated contracts. Retendering projects creates significant time delays and economic inefficiencies. Allowing local governments to roll over funds and contracts from one fiscal year to the next would support the development of larger investments and eliminate inefficiencies.

- *Allow some spending flexibility*. Policies that do not allow for flexibility lead to the ineffective use of funds, and as such require revision in order to provide room for local government on specific variations based on needs, while still retaining some level of national uniformity and the objective to achieve minimum service standard.

6. Other transfer policy reform would focus on expunging problems associated with *Dekon/Tugas Pembantuan* (Direct Central Government Spending in Regions) and *Dana Penyesuaian* (Adjustment Funds Granted to Regions). Both *Dekon/Tugas Pembantuan* funds come from the APBN/National Budget, but they are not part of the intergovernmental transfer. *Dekon/Tugas Pembantuan* funds are sourced from ministerial/institutional funds handed out to governors as representatives of the central government in the regions.

- *Eliminate Dekon/Tugas Pembantuan*. *Dekon/Tugas Pembantuan* and related direct central government spending on decentralized functions confuses lines of service responsibility, constrains horizontal accountability, and weakens the rule of law. Such spending may also crowd out local capital spending. Evidence shows that an additional rupiah of *Dekon/Tugas Pembantuan* results in a decline in local government capital

[8] See Lewis, B., (2013)."DAK Reimbursement Project (P2D2) Impact Analysis: District Counterpart Funding, Reporting, and Capital Spending". World Bank, Jakarta; and, Lewis, B., (2013)."Notes on Propensity Score Matching for DAK Impact Evaluation". World Bank, Jakarta.

spending of 0.50 rupiah. Government could re-channel all central funds used for decentralized activities into DAK and/or *Hibah*.

- *Eliminate Dana Penyesuaian for Infrastructure*. *Dana Penyesuaian*, for infrastructure, constitutes a parliament-driven pork barrel transfer. The international experience with such pork barrel transfers is uniformly bad. Such transfers are usually allocated as a means of vote buying and/or for personal gain and these distribution methods divert attention away from primary transfer objectives. Internationally, such transfers are also strongly associated with corruption. They should be permanently discontinued and the funds transferred to DAK and/or *Hibah*.

How should central government reform intergovernmental transfers beyond the short-term (past 3 years with possible change in law)?

7. Beyond the short-term, central government needs to re-think and clarify the objectives of the transfer system and re-design the various mechanisms at its disposal to obtain stated objectives.

- *Reconsider and clarify transfer objectives*. Central government might reasonably focus the intergovernmental transfer system on just three basic objectives: enhancing fiscal equalization, improving service delivery performance, and supporting national spatial and sector objectives. Mechanisms that could be employed to achieve those objectives are already available: DAU, *Hibah*, and DAK, respectively.

- *Use DAU to equalize current spending and capital assets*. In theory, the DAU is supposed to equalize current and capital spending. The formula does not distinguish between current and capital spending, however. (And in practice DAU is mostly used for current spending). In any case, on the capital side, the appropriate equalization target is assets and not spending. The DAU should be reformulated to equalize current spending and the stock of capital assets.

- *Expand use of Hibah as performance grant*. An argument for increasing the use of the *Hibah* as a performance grant in the water sector has already been made above. Performance of the Water *Hibah* should continue to be monitored in the short-term. If the expanded use proves successful at further improving local water service delivery the program could be rolled out to other sectors (using government funds), including other types of infrastructure or in health and education sectors.

- *Improve DAK allocation methods*. Short-term recommendations made above for DAK will assist in supporting the grant's most important goal—achieving national spatial and sectoral objectives. Central government should avoid using the DAK to try to attain supplementary objectives (as draft revisions to law now intend). Also, government should re-think its current methods of grant allocation—based on general, specific, and technical criteria—which are unfocussed on main objectives, too complicated, and lack transparency.

What other reforms might central government consider to improve decentralization outcomes?

8. Lastly, the Bank has recommended a broader agenda of key thematic areas that require more attention including:

- *Improve central monitoring of transfers*. Central monitoring and evaluation of intergovernmental transfers is currently quite weak and data that are collected are closely guarded. These weaknesses constrain vertical accountability and limit feedback into improved transfer design and implementation. Central government should redouble its efforts related to transfer monitoring and evaluation. An idea worth pursuing would be to delegate some responsibility for these tasks to provinces. In any case, data collected through improved monitoring and evaluation mechanisms should be made widely available.

- *Strengthen horizontal or downward accountability*. Arguably, the most binding constraint on improving local service delivery is insufficient accountability between local governments and citizens. Central government should initiate programs to support the development of horizontal accountability. Of particular importance in this regard would be local education programs aimed at advising citizens of comparable service quality elsewhere in Indonesia and the region and strengthening demand for improvements here.

ANNEX 4: SUMMARY OF MID-TERM EVALUATION RESULTS AND RECOMMENDATIONS

1. In 2010, the Government of Indonesia and the World Bank signed a loan agreement for the Local Government and Decentralization Support Project (LGDP). The objective of the project is to improve the accountability of local governments (LGs) in five pilot provinces on the use of the Specific Purpose Grant (*Dana Alokasi Khusus* or DAK) for the infrastructure sub-sectors of roads, irrigation and water supply. Since 2011, local governments participating in LGDP are entitled to receive a financial incentive in the form of an additional Special Purpose Grant of up to 10% of their original DAK allocation. The incentives are payable upon externally verified achievement of eligible reimbursements. The Bank also finances technical assistance to help participating local governments with improving the utilization (and reporting on the utilization) of DAK. This annex summarizes the conclusions from an evaluation of the performance of LGs participating in LGDP during 2010-2012, and provides recommendations for a monitoring and evaluation (M&E) framework for Additional Financing to LGDP.

Evaluation of Local Government Performance

2. **Almost 90% of the value of potential reimbursement qualified for reimbursement by the Bank.** To improve the accountability of participating local governments on the use of the DAK, BPKP was appointed to verify a sample of DAK-financed contracts for compliance with pre-agreed criteria. In 2012, 89% of the value of potential reimbursement was qualified for reimbursement by the Bank (up from 84% in 2011) and just had a slight decrease to 87% in 2013. Poor internal controls are a likely explanation for non-compliance with eligibility criteria. Internal controls are weakest in local governments in North Maluku and West Sulawesi.

3. **Approximately 60% of participating local governments use the project's web-based reporting system (WBRS).** The full use of the WBRS for technical reporting is much more common than for financial reporting, possibly because LGs consider the system as redundant for financial reporting purposes.

4. **Participating local governments outperform non-participants in water sector reporting and capital spending.** There is no empirical evidence to suggest that mere participation in the DAK reimbursement scheme has any impact on local government counterpart funding, reporting, or capital spending, all other things remaining equal. However, as DAK allocations increase, project participation becomes more important for performance. Participating local governments that receive per capita DAK transfers in excess of about Rp. 50,000 (2012 terms) submit their water sector reports in a timelier manner than non-participating districts; participating districts that are allocated per capita DAK funds in amounts larger than approximately Rp. 125,000 (2012 terms) spend more on capital than non-participating districts.

5. **DAK is more stimulative of participating district capital spending than it is of non-participating districts**. Estimation results suggest that an additional Rupiah of DAK leads to an extra 2.6 Rupiah of capital spending for participating districts and an added 1.5 Rupiah of capital spending for non-participating districts.

Assessment of Monitoring and Evaluation Framework

6. The existing M&E framework of LGDP consists of 13 quantitative indicators that—in theory—enable the measurement of intermediate outcome indicators and thereby the achievement of the project development objective. However, for six of the 13 indicators, no data were available.

7. For none of the 13 quantitative indicators did the existing M&E framework contain time-bound and objectively verifiable targets. As a result, there is no yardstick against which to judge the performance of the participating LGs.

Recommendations

8. Recommendations emerging from the evaluation related to overall project design included:

- **Increase amount of financial incentives.** At present, local governments participating in LGDP quality for financial incentives that account for a maximum of 10% of the DAK funds allocated to four infrastructure sectors. For many participants this is not a significant amount, partly because there is already substantial variation year-on variation in DAK transfers received by individual districts (so that increases in DAK will not necessarily be attributed to the receipt of financial incentives).

- **Increase awareness of financial incentives.** Supervision missions indicate that participating local governments are often unaware of the amount (or mere existence) of financial incentives. For such governments, a change in spending behavior is *a priori* unlikely. It is especially important that technical departments responsible for the four infrastructure sectors will be give the responsibility for monitoring and oversight of the incentive.

- **Improve institutional coordination.** At present, four central government agencies are involved in the implementation of LGDP: the Ministry of Finance (the Executing Agency), the Ministry of National Planning (Bappenas), the Ministry of Home Affairs and the Ministry of Public Works (MPW). To secure broad-based support for an expanded version of LGDP, there is a need to define the responsibilities of all parties and agree upon a division of roles.

- **Provide targeted support to central government agencies.** This will include, at the minimum, technical assistance to MPW for the regular updating and expansion of the reference unit cost list, and support to DGFB to analyze the benefits of LGDP, communicate these benefits to other stakeholders (notably DPR, Bappenas, and other Directorates-General in the Ministry of Finance) and provide regular feedback to WBRS users.

- **Provide targeted support to participating local governments.** There is substantial variation in performance across LGDP participants. It is recommended to provide intensive technical support to local governments least able to qualify for financial incentives under the project (at present, these are concentrated in the provinces of North Maluku and West Sulawesi).

9. Recommendations emerging from the evaluation related to strengthening the M&E framework included:

- **Maintain the seven intermediate outcome indicators required to measure performance in the existing M&E framework.** Because the second phase of LGDP will be financed from Additional Financing (as opposed to a separate loan), the M&E framework in Annex 3 of the PAD for the original loan will continue to apply. For this reason, it is recommended to maintain the quantitative indicators that contribute to measuring the seven intermediate outcome indicators provided by this framework.

- **Remove redundant indicators.** It is recommended to remove two of the quantitative indicators because they do not appear to add value to the monitoring and evaluation of LGDP. These are indicators are: "% of work packages contained in LG's detailed work plans" and "% of LGs with current general procurement plan".

- **Introduce time-bound and objectively verifiable targets for all indicators.** The present M&E framework does not contain targets against which performance is measured. To overcome this deficiency, it is recommended to start measuring the project-specific indicators against time-bound targets. For the generic indicators (which can be measured for all LGs, also those not participating in LGDP), the performance of participating LGs would be measured against a control group of comparable but non-participating LGs.

- **Limit comparison with control group to original participants.** Because the impacts of the financial incentives and technical support provided by LGDP are not immediate, it is recommended that the comparison with a control group will only be made for LGs that participated in LGDP from the start.

- **Ensure data availability.** To operationalize the above recommendations, it is necessary to ensure that data will become available for the measurement of all indicators.

- **Reassess project impacts in 2015.** Above a certain level of DAK allocations, participants in the project already outperform non-participants in water sector reporting and capital spending. It is recommended to reassess potential impacts of the project in 2015, to verify if the impacts of the projects have been sustained and expanded to other areas.

10. Most of the abovementioned recommendations have been reflected in this Additional Financing.

ANNEX 5: PROVINCIAL SELECTION CRITERIA AND RESULTS

1. This Annex is structured into two sections. Section 1 describes the methodology that is proposed to select additional participating provinces for the gradual rollout to 30 of Indonesia's 34 provinces. The methodology utilizes a two-step filter as outlined below. Section 2 outlines the steps used each year to select the eligible provinces and districts applying the methodology. In the selection of the new participating regions consideration has been given to a combination of factors such as socio-economic factors, DAK allocation, district revenue, and LGs compliance on reporting.

Methodology and Selection Criteria for Expanding Participating Regions

2. The technique was implemented in three stages, which can be summarized as follows:

<u>Stage 1: Geographical Coverage and Other Considerations</u>

3. As part of Stage 1 the process first screens out special autonomy provinces, DKI Jakarta and current provincial recipient of LGDP program. Special autonomy provinces are subject to special fiscal treatment involving the transfer of considerable autonomy funds under the Indonesian Constitution and as such fall outside the scope of this program. DKI Jakarta was also excluded due its uniqueness as a major metropolitan area and Indonesia's primary economic agglomeration. As MoF has decided to continue LGDP implementation in the five participating LGDP, they are screened out for the purposes of this provincial selection exercise.

4. The remaining provinces were then distributed into four distinct island groups: (i) Sumatra; (ii) Java-Bali; (iii) Kalimantan-Sulawesi; and (iv) Eastern Indonesia (Nusa Tenggara-Maluku-Papua). GoI has expressed a desire to ensure that all island groups or regions are well represented in the final LGDP AF, indicated that there should be around two provinces each selected from Sumatra, Java-Bali and Eastern Indonesia, and three from Kalimantan-Sulawesi for each year. This will give the project geographic concentration and scalability in the number of LGs covered, while also allowing some diversity across Indonesia's regions.

<u>Stage 2: Application of Three Indicators/Criteria and Order Ranking</u>

5. After the abovementioned filters and clustering is applied, the selection methodology involves the analysis of three indicators/criteria and the associated rank ordering as described below.

- **Proportion of DAK to Overall Local Budget (APBD)**. The indicator is to be calculated as a provincial average, i.e. the weighted sum of all DAK to APBD ratios for LGs in a given province. The indicator favors LGs with a higher ratio of DAK to APBD. Provinces receive higher rank ordering if they have higher percentage/ratio of DAK to APBD. The current national average for this measure is 6.6%.

  *Rationale***:** The selection of this indicator is partly driven by results from the LGDP Mid-Term Evaluation that found that the greater the LGs dependence on DAK the more likely it is to respond to performance incentives under the program. Additionally, the choice of indicator reflects DAK's objective to reduce interregional service inequalities, i.e. the worse the condition of service infrastructure in a region, the more DAK the region should receive. Based on the formula, the determination of which districts receive DAK is based on the net fiscal index or the difference between fiscal capacity and needs of a specific region.

- **Human Development Index (HDI)**. The HDI measures a composite human development index by combining indicators of life expectancy, educational attainment, adult literacy, gross enrollment, and income. HDI more represents the pro-poor aspect in the criteria. As part of the LGDP AF provincial selection process the HDI measure calculated as the provincial weighted average of all HDI measures for all constituent LGs in the said provinces. Provinces receive a higher rank order the lower the lower the HDI.

  Rationale: The indicator was selected as a needs-based measure, prioritizing LGs and provinces with lower income, access to basic services and human development levels.

- **DAK Reporting Performance to Ministry of Public Works**. The indicator measures the percentage of LGs reporting through the e-monitoring system to Ministry of Public Works (MPW). The indicator will be calculated for each province as the percentage all constituent LGs reporting through the e-monitoring system. Provinces will receive higher rank ordering the better reporting performance of constituent LGs. In 2012, the average percentage of participating LGDP LGs reporting to the MPW in the three subsectors (i.e. road, irrigation and water) is around 84% or higher than the national average (79%).

  Rationale: The indicator was selected to incent improved reporting and accountability performance at the provincial and LG level.

<u>Stage 3: Aggregate Order Ranking and Selection</u>

6. After the abovementioned indicators are analyzed all provinces are ranked within each island group against each indicator. These rankings are then summed across the three variables giving each province an 'aggregate order rank'. Provinces are then selected from each island group based on the aggregate order ranking results.

7. This process is further outlined on Figure 1 below.

Figure 1: Provincial Selection Processes

Stage 1: Screening out and Grouping

- All 34 provinces in Indonesia
- Exclude Special Autonomy Provinces and DKI Jakarta (4 provinces)
- Rules out 5 current participating provinces
- Grouping into 4 distinct island groups

↓

Stage 2: Application of 3 Criteria and Order Ranking

- Criteria 1: High Portion of DAK to Local Budget
- Criteria 2: Lower Human Development Index
- Criteria 3: Higher Percent of LGs Reporting to MPW

↓

Stage 3: Aggregate Order Ranking and Grouping Selection

- 2015: Lampung, Bengkulu, West Java, Central Java, West Kalimantan, North Sulawesi, South Sulawesi, NTB and NTT.
- 2016: West Sumatera, South Sumatera, Bangka Belitung, Bali, South Kalimantan, Central Sulawesi, Gorontalo, and Maluku.
- 2017: North Sumatera, Riau, Riau Island, DI Yogyakarta, Banten, East Kalimantan, North Kalimantan and South East Sulawesi.

Applying the Selection Methodology for the LGDP Additional Financing

8. Stage 1: As noted above, Stage 1 involved a preliminary screening of special autonomy provinces, DKI Jakarta and participating provinces. The special autonomy provinces include Aceh, Papua, and West Papua and participating provinces included Jambi, East Java, Central Kalimantan, West Sulawesi, and North Maluku. The application of these filters trimmed the eligible provinces from a total of 34 to 25. As noted above, the remaining 25 provinces were then distributed into four distinct island groups: (i) Sumatra; (ii) Java-Bali; (iii) Kalimantan-Sulawesi; and (iv) Eastern Indonesia (Nusa Tenggara-Maluku-Papua).

9. Stage 2: As noted above, Stage 2 involves the analysis of all provinces against the three selection indicators/criteria and an order ranking of provinces by island group for each measure. A summary of the result of this exercise are as follows:

- **Proportion of DAK to Overall Local Budget (APBD)**. From this criteria, the two highest ranked provinces are as follow: Bengkulu and Lampung (Sumatera); West Java and Central Java (Java-Bali); West Kalimantan and North Sulawesi (Kalimantan-Sulawesi); East Nusa Tenggara and Maluku (Eastern Indonesia). The average DAK as % of APBD in these provinces is around 7% (above national average).
- **Human Development Index**. Provinces that have lower HDI get a higher ranking. Provinces that have the highest ranking from this criteria are: Lampung and Bangka Belitung (Sumatera); Banten and West Java (Java-Bali); West Kalimantan and Southeast Sulawesi (Kalimantan-Sulawesi); and West and East Nusa Tenggara (Eastern Indonesia). The average HDI for these provinces is 70 (below national average at 72.32).
- **DAK Reporting Performance to MPW**. The results against this indicator found the following provinces with the highest ranks: South Sumatera and Bangka Belitung (Sumatera); Central Java and Bali (Java-Bali); West Kalimantan and South Sulawesi (Kalimantan-Sulawesi), and West and East Nusa Tenggara (Eastern Indonesia). The average percentage of DAK reporting to MPW in these provinces is around 79% (much higher than the national average at 64%).

10. Stage 3: In this final stage an aggregate rank order across the three criteria is calculated and provinces are selected. Participating provinces are picked based on their cumulative score of rank ordering. In case of a tie in the 'sum of rank ordering', percentage of DAK to APBD is utilized to break the tie. The summary and detailed results of this exercise are provided in tables 1 and 2 below. Approximately 8 to 9 provinces are selected each year against the three-selection indicators/criteria. The idea is to select a group of provinces every year based on their cumulative score of rank ordering,

Table 1: Summary of Provincial Selection Results

Parameter	Original Project	Additional Financing	Total
Number of eligible provinces	5	25 new (with 5 original continuing)	30
Name of eligible provinces	Jambi, East Java, Central Kalimantan, West Sulawesi, North Maluku	(i) Bengkulu, Lampung, West Java, Central Java, West Kalimantan, North Sulawesi, South Sulawesi, NTB, NTT; (ii) West Sumatera, South Sumatera, Bangka Belitung, Bali, South Kalimantan, Central Sulawesi, Gorontalo, Maluku; and (iii) North Sumatera, Riau, Kepulauan Riau, DI Yogyakarta, Banten, East Kalimantan, North Kalimantan, South East Sulawesi	
Number of eligible LGs within the provinces	77	364 (in 25 new provinces, approx.)	446 (approx.)
2013 DAK allocation, infrastructure (IDR billions)	1,081	5,021 (in 25 new provinces, approx.)	6,102 (approx.)

Table 2: Rank Order Provincial Selection Results

Current P2D2 Program 5 Provinces	Year 1 (2015) 14 Provinces (Add 9 Provinces)	Year 2 (2016) 22 Provinces (Add 8 Provinces)	Year 3 (2017) 30 Provinces (Add 8 Provinces)
Jambi	Bengkulu	West Sumatera	North Sumatera
East Java	Lampung	South Sumatera	Riau
Central Kalimantan	West Java	Bangka Belitung	Riau
West Sulawesi	Central Java	Bali	DI Yogyakarta
North Maluku	West Kalimantan	South Kalimantan	Banten
	North Sulawesi	Central Sulawesi	East Kalimantan
	South Sulawesi	Gorontalo	North Kalimantan
	NTT	Maluku	South East Sulawesi
	NTB		

ANNEX 6: SUMMARY OF POVERTY, SOCIAL AND GENDER ASSESSMENT

1. The World Bank has outlined an ambitious organizing goal to end extreme poverty within a generation and to promote shared prosperity. Ending poverty and promoting shared prosperity are unequivocally about progress in non-monetary dimensions of welfare including education, health, nutrition, and access to basic infrastructure.

2. In an economy with significant inter-regional variations in revenue capacity and investment needs, decentralized provision of public services can enhance efficiency in the provision of these services and result in welfare gain. Fiscal decentralization enters into poverty alleviation strategy in a number of ways: (i) the proximity of policy makers to the target group reduces information and transaction costs of identifying the poor and helps in designing potentially successful 'capacity improving' and 'safety net' policies; and (ii) enhance efficiency in the provision of basic infrastructure and facilities (Rao, 1998)[9]. Further, general and specific purpose transfers are intended to enable poorer regions to provide social and physical infrastructure at levels comparable to those in richer jurisdictions, such transfer will enable the depressed regions to fully utilize their growth potential and will hasten poverty reduction. Analysis results of the accuracy of DAK allocations for regions also show that correlation signs of DAK allocation by province on the condition of public service in infrastructure sector are in line with DAK objective to reduce interregional service inequalities (Usman et al, 2008)[10].

3. Infrastructure investments funded through DAK transfers have three potential positive effects on reducing poverty. These include: (i) a public works effect; (ii) a broad-based economic growth effect; and (3) a non-income effect. It is well known that the construction of public infrastructure can provide needed wages to low-income workers and therefore assist in the reduction of poverty. Public works programs can be designed explicitly to help mitigate the negative impact of one-time economic shocks on impoverished groups, for example. More importantly perhaps, public works projects that are implemented in a consistent fashion over time can provide a reliable source of necessary income for the poor and near poor and thus function as a more dependable means of poverty reduction (Del Nino, Subbarao, and Milazzo, 2009). DAK funded infrastructure projects are implemented routinely, year after year, and may thus serve to help reduce poverty via the second channel.

4. The stock of infrastructure created by publically financed investments can also positively influence broad-based economic growth, which in turn can help reduce poverty. In this context, both direct and indirect effects may be important (Straub, 2008 and 2011)[11]. Increases in the stock of infrastructure can directly raise the productivity of other factors of production and thereby support increases in economic output. Indirect effects relate to the possible efficiency-

---

[9] See Rao, M.G., (1998)."Poverty Alleviation under Fiscal Decentralization", World Bank.

[10] See Usman, S., Mawardi. S, Poesoro, A., Suryahadi, A., and Sampford, C., (2008)."The Specific Allocation Fund (DAK): Mechanisms and Uses", Research Report, The SMERU Research Institute.

[11] See Straub, S. and Terada-Hagiwara, A., (2011)."Infrastructure and Growth in Developing Asia", Asian Development Bank Review, Asian Development Bank, vol. 28(1), pages 119-156; and, Straub, S. (2008)."Infrastructure and development: a critical appraisal of the macro level literature". Policy Research Working Paper Series 4590, the World Bank.

enhancing externalities of public infrastructure. More and better quality infrastructure may reduce private capital adjustment costs, for example, by facilitating investment logistics or by decreasing the need for own-provision of certain inputs such as roads, water, or electricity (Agenor and Moreno-Dodson, 2006)[12]. Alternatively, efficiencies may be gained through the improvements to human capital and labor productivity that result from increasing some public investments, such as those that help to reduce travel time to and from work, for instance (Galiani et al., 2005)[13]. Lewis and Niazi (forthcoming)[14] provide empirical evidence to suggest that increases in both the amount and quality of local roads infrastructure have a positive impact on district economic growth in Indonesia.

5. <u>Finally, infrastructure can help reduce non-income poverty by providing the poor with enhanced access to important public services</u>. Increased access to water, especially, for example, is well known to improve the quality of vulnerable groups' lives through enriched health outcomes (ADB, 2012)[15]. DAK funded infrastructure increases access of the poor to water and thereby assists in easing some of the non-income dimensions of poverty.

6. Each of the above effects may be realized for DAK funded infrastructure projects, in general. The case for greater LGDP impact, specifically, is a function of the empirical evidence that suggests that the DAK is more stimulative of capital spending in participating districts than it is of non-participating districts. More precisely, estimation results imply that an additional rupiah of DAK leads to an added 1.5 rupiah of capital spending for non-participating districts but an extra 2.6 rupiah of capital spending for participating districts. So DAK leads to relatively more capital spending and relatively larger public capital stocks in LGDP local governments and thus it is likely to result in increased poverty reduction in participating districts.

Gender

7. New and improved infrastructure supported under DAK will improve access and reliability of road and water related services, in particular for vulnerable populations like women, youth, and elderly. The LGDP project supports and encourages LG efforts in maintaining, rehabilitating and improving the quality of their road, bridge, irrigation and water infrastructure.

8. The rehabilitation of roads and bridges will be beneficial for women and youth, as it improves road safety, reduces transportation costs and improves access social services. Local roads, especially in the rural areas, often bring social improvements to the community, as they enable the community to travel to school, health clinic, local market, and government offices. The rehabilitated roads and bridges often bring mobility and accessibility improvements to the community, as they enable the community to transport their home-industries' products to the city with competitive advantage, since transport costs have also been reduced. This analysis is based

---

[12] Agénor, P. and Moreno-Dodson, B., (2006)."Public Infrastructure and Growth: New Channels and Policy Implications". Public Research Working paper, the World Bank, Washington D.C.
[13] Galiani, S., Gertler, P. and Schargrodsky, E. (2005). "Water for Life: The Impact of the Privatization of Water Services on Child Mortality", Journal of Political Economy, the University of Chicago.
[14] Lewis, B. and Niazi, T., (2013)."Fiscal Decentralization in Indonesia: Local Infrastructure Impact and Finance". Forthcoming.
[15] ADB (2012)."ADB Annual Report 2011". Asian Development Bank, Manila.

on the impact assessment of the IRFF (Infrastructure Rehabilitation Financing Facilities) at Kabupaten Pidie and Pidie Jaya, Aceh Province, 2010; available on Booklet: Route to Recovery.

9. The new and improved household water connections will help women in their role as provider of clean water for their families. Increased access to more reliable and safe water will be beneficial for women and children who usually bear the responsibility of fetching water, especially for women who are responsible for cooking and cleaning. Having water connections closer to their houses will bring health benefits, resulting from reduced exposure to environmental risks posed by contaminated water and associated waterborne diseases, as well as economic benefits brought about through reductions in the cost of medical expenses as well as time spent collecting water.

ANNEX 7: ECONOMIC AND FINANCIAL ANALYSIS

A. Project Objectives

1. The objective of the Project is to improve the accountability and reporting of the central government's Specific Purpose Grants (DAK) for the basic infrastructure, consisting of roads, irrigation, water and sanitation within Selected Local Governments (LGs). As mentioned, the program itself will be gradually expanded in 30 Provinces excluding three special autonomy provinces, namely Aceh, Papua, West Papua, and one Special Capital District (DKI) of Jakarta in the same infrastructure sector covering reimbursements for the DAK allocation in the three fiscal years from 2015 to 2017. Fourteen provinces, five original and nine new LGs, will be included in the first year of the program. During the rest of the program, eight additional provinces will be chosen annually using criteria-based provincial selection methodology.

2. Based on independent verification of physical outputs, Component 1 of the Project will reimburse up to the full DAK expenditure allocations for basic infrastructure sectors including roads, irrigation, water and sanitation, including the 10% matching funds from district-level resources.

3. Working with existing mechanisms for the transfer of DAK resources, Component 2 of the Project will strengthen institutional capacities at both the national and sub-national levels, by improving technical guidelines on DAK expenditures from line ministries, and enhancing existing systems and mechanism for monitoring and verifying DAK implementation. This is expected to have a positive impact beyond the basic infrastructure sectors supported under this Project, since greater capacity at national and sub-national levels will improve the usage of DAK resources and investments in other sectors.

B. Project Costs

4. Table 1 below summarizes the estimated Project costs, by Project component, sector, and location (provincial or national levels). The cost estimates under Component 1 are based on the average of the four most recent years (2011 through 2014) of actual DAK allocations by province and sector. The overall budget envelope for Component 1 is such that the annual DAK allocations to individual provinces and sectors are at a level similar to the actual DAK allocation for 2014, assuming the Project's investments are evenly distributed over three years.

5. In order to analyze the full economic costs and benefits, annual operating costs for the infrastructure resulting from DAK investments under this Project were included in the analysis, expressed as a percentage of the DAK investment outlays (Roads: 5%; Water: 2%; Irrigation: 5%). It was assumed that Project investments would have a service life of at least three years.

Table 1: Estimated project costs (US dollars)

Province	Component 1			Component 2	Component 3
	Roads	Irrigation	Water and Sanitation		
North Sumatera	3,601,651	923,110	339,375		
West Sumatera	2,650,885	1,053,868	271,306		
Riau	1,755,250	340,839	33,532		
Jambi	1,551,761	423,492	139,225		
South Sumatera	2,090,320	452,667	207,282		
Bengkulu	1,703,183	577,053	153,803		
Lampung	2,726,721	830,253	234,671		
Bangka Belitung	943,858	289,062	96,450		
Riau Islands	738,423	-	46,024		
West Java	2,694,780	1,385,413	455,867		
Central Java	4,589,609	2,668,286	696,567		
East Java	4,300,078	2,223,281	672,812		
DI Yogyakarta	470,151	264,187	77,721		
Banten	648,470	342,400	173,124		
Bali	861,418	491,115	95,623		
West Kalimantan	2,893,531	859,483	232,990		
South Kalimantan	1,378,277	476,813	118,053		
Central Kalimantan	2,482,828	849,628	151,936		
East Kalimantan	1,174,097	343,651	73,194		
North Sulawesi	2,139,621	601,753	216,279		
South Sulawesi	3,727,150	1,379,269	313,487		
Central Sulawesi	1,845,289	658,073	137,605		
Southeast Sulawesi	1,507,112	461,735	123,846		
West Sulawesi	1,034,956	439,789	75,554		
Gorontalo	1,003,936	300,684	73,884		
NTB	1,885,850	865,814	1,704,683		
NTT	3,611,914	1,350,568	312,987		
Maluku	1,587,637	418,636	135,131		
North Maluku	1,847,903	516,372	121,687		
Total	**59,446,659**	**21,787,293**	**7,484,697**	**10,000,000**	**5,000,000**
Total (Component 1+2+3)					**103,718,649**

C. Overview of Project Benefits

6. The benefits arising from the Project include those benefits that are readily quantifiable in monetary terms and non-market benefits – such as from lives saved due to faster road access to health facilities and lowered water-borne disease burden – for which monetary values cannot be quantified directly. Furthermore, because this Project will help to strengthen government institutions and mechanisms for managing DAK funding and implementation, substantial positive externalities are likely: in the effectiveness of DAK usage in other sectors, and potentially in the management of other categories of fiscal transfers to sub-national governments. The overall benefits from this Project are therefore likely to be greater than the estimated monetary value of the benefits given below.

7. The general types of direct benefits from the Project are described by project component below. Specific benefits may vary from province to province and within a province, depending on the unique circumstances of, and specific investments in, each location.

8. Component 1: DAK Reimbursement

Roads:

- Transport cost savings from reduced fuel consumption and maintenance costs;
- Time savings from smoother road travel;
- Gains from better market access for goods;
- Increased income of transport operators arising from greater demand for transport services;
- Enhanced capital values of property made more accessible by improved roads.

Water and Sanitation:

- Time savings in obtaining clean water;
- Cost savings for purchase of clean water;
- Lower health expenditures from reduced incidence of water-borne disease.

Irrigation:

- Increase in crop yields (per unit area);
- Increase in area under cultivation;
- Cultivation of higher value crops and higher yielding crop varieties;
- Increase in farmer incomes (from increased productivity factors above);
- Reduced risks of, and costs arising from, extreme events such as droughts or floods;
- Enhanced capital values of agricultural land with improved irrigation.

9. Component 2: Institutional Support Program

- Improved rate of completion and quality of outputs obtained from infrastructure investments funded by DAK;
- Reduced inefficiencies and irregularities in use of DAK funds;
- Greater accountability and transparency in the use of DAK funds.

10. Component 3: Verification of Outputs

- This component contributes to the achievement of results in Components 1 and 2 above.

D. Valuation of Project Benefits

11. The first step in estimating Project benefits was to estimate the quantity of outputs expected from DAK investments under this Project in each sector and province. Given the complexity of estimating future DAK investments in all 446 districts across thirty pilot provinces, representative output types were chosen for each of the sectors, based on outputs most commonly funded by DAK investments in these provinces:

- Roads: kilometers of roads upgraded (*peningkatan*) to a standard width of X meters;
- Water and sanitation: number of water tap or capacity of clean water supply; and number of basic bathing, washing, and toilet facilities, and number of communal piping wastewater facilities
- Irrigation: hectares of cropland irrigated as a result of upgrading (*peningkatan*) of irrigation infrastructure.

12. Unit costs for each output type in each province were obtained, based on actual unit cost data from the Ministry of Public Works (MPW). The value of DAK investments were then divided by the unit costs, to obtain the quantity of representative outputs that notionally would be delivered by these DAK investments in each province and sector.

13. Expected benefits deriving from each unit of representative output, according to the categories identified in Section C above, were then estimated for this Project using data from the *Evaluation of Economic Feasibility and Cost Effectiveness of ILGR Infrastructure Investment* study. This study was undertaken in 2009 under the Initiatives in Local Governance Reform Project (ILGRP), with data obtained through field surveys and interviews in Sumatra, Java and Sulawesi where ILGRP project investments had been made. Care was taken to ensure that data selected from this ILGRP study were reasonably applicable for the purposes of analysis for this Project, by excluding ILGRP output types not covered by DAK, comparing unit costs as a basis to determine the unit benefit, adjusting inflation factor and aligning locations from which the ILGRP data were derived with the analysis for pilot provinces under this Project.

14. Table 2 below summarizes the unit costs obtained, calculated output quantities, and estimated unit benefits, for the representative output types in each province. The exchange rate used throughout the analysis presented here is USD1 = IDR11,000.

Table 2: Unit costs, output quantities and unit benefits for representative outputs

Participating Provinces	Unit costs (USD)			Output quantities			Unit benefits (USD)		
	Roads	Irrigation	Water	Roads (km)	Irrigation (ha)	Water (houses connects)	Roads	Irrigation	Water
North Sumatera	106,591	170	300	219	35,114	18,289	49,438	79	139
West Sumatera	95,368	124	310	155	47,057	12,131	44,233	58	144
Riau	185,323	300	386	61	7,347	1,403	85,955	139	179
Jambi	83,302	227	403	91	9,130	4,234	38,636	116	168
South Sumatera	148,090	313	408	79	8,153	7,146	68,686	145	189
Bengkulu	100,863	380	364	76	6,827	4,755	38,636	116	168
Lampung	81,818	364	399	150	10,274	6,621	38,636	116	168
Bangka Belitung	93,864	201	392	51	7,033	3,144	43,535	98	182
Riau Islands	156,845	332	397	28		1,705	72,746	154	184
West Java	150,321	500	217	81	12,469	23,630	54,473	74	168
Central Java	209,886	445	412	98	26,416	19,029	79,301	74	168
East Java	88,612	205	439	218	48,912	17,252	40,909	74	168
DI Yogyakarta	59,718	367	316	46	4,232	3,617	22,563	139	119
Banten	82,547	320	380	46	6,290	2,682	31,189	121	143
Bali	73,045	218	360	66	12,672	3,736	27,599	82	136

Participating Provinces	Unit costs (USD)			Output quantities			Unit benefits (USD)		
	Roads	Irrigation	Water	Roads (km)	Irrigation (ha)	Water (houses connects)	Roads	Irrigation	Water
West Kalimantan	149,090	227	570	96	18,748	5,061	52,273	114	168
South Kalimantan	90,015	227	462	87	11,809	3,596	60,713	81	160
Central Kalimantan	104,550	318	439	118	13,218	4,286	52,273	114	168
East Kalimantan	100,000	280	737	76	7,947	1,606	49,998	100	283
North Sulawesi	188,441	709	658	56	4,199	4,066	66,548	132	168
South Sulawesi	188,441	709	658	98	9,625	5,894	66,548	132	168
Central Sulawesi	86,343	569	457	120	6,507	4,214	55,283	110	127
Southeast Sulawesi	89,545	714	525	109	4,180	3,813	57,333	138	146
West Sulawesi	103,937	682	604	49	3,193	1,549	66,548	132	168
Gorontalo	86,455	755	591	66	2,274	1,786	27,412	159	172
NTB	164,865	834	580	57	5,136	3,640	52,271	144	184
NTT	139,659	818	625	128	8,171	6,197	68,182	223	168
Maluku	82,909	1,124	567	108	2,097	3,353	69,824	180	179
North Maluku	110,747	909	604	83	2,812	2,494	52,273	223	168

E. Cost-Benefit Analysis

15. The net present value (NPV) of the Project investments were then calculated or the Project as a whole, over a period of five years (2015-2019). The discount rate used was 12%. For illustrative purposes, the internal rate of return (based on net economic benefits) was also calculated, to show the discount rate at which net present value would be zero. It should be noted that the cost and benefit figures for each province do not take into account the national-level investments for Components 2 and 3 of the Project; these are, however, included in the analysis and results shown for the Project overall.

16. The results of the cost-benefit analysis are summarized in Table 3 below. The Project NPV over five years, at a discount rate of 12%, is estimated at US$89,119,951, with an economic internal rate of return (EIRR) of 30%.

17. Furthermore, in addition to this economic analysis, which shows these DAK investments to be economically sound, a benefit arising specifically from this project is to improve accountability and reporting in the utilization of DAK funds. While it is difficult to quantify the value of this benefit ex-ante, the positive impact of institutional strengthening in the use of DAK resources is expected to be substantial.

Table 3: Benefits, costs and net present value for Project investments (USD)

Participating Provinces	Total Benefit	Total Cost
North Sumatera	49,842,845	39,562,176

Participating Provinces	Total Benefit	Total Cost
West Sumatera	40,657,736	28,236,419
Riau	20,221,365	16,205,140
Jambi	19,818,763	9,450,324
South Sumatera	28,396,226	19,706,236
Bengkulu	16,207,265	10,063,931
Lampung	18,287,005	15,655,499
Bangka Belitung	12,430,470	8,751,319
Riau Island	7,197,333	5,794,041
West Java	45,614,615	19,501,282
Central Java	52,318,566	33,744,112
East Java	62,370,266	31,809,410
DI Yogyakarta	6,440,186	6,263,222
Banten	7,996,180	7,995,228
Bali	12,026,966	5,852,932
West Kalimantan	32,337,273	10,662,879
South Kalimantan	24,039,020	7,923,872
Central Kalimantan	33,808,239	3,194,025
East Kalimantan	15,598,078	12,573,108
North Sulawesi	20,111,946	13,323,218
Central Sulawesi	28,090,750	18,412,233
Southeast Sulawesi	22,809,462	16,805,815
West Sulawesi	16,005,859	9,489,721
Gorontalo	8,706,362	9,888,961
NTB	17,649,360	13,481,151
NTT	46,831,049	24,253,775
Maluku	30,217,505	15,125,247
North Maluku	21,669,441	10,906,926
Total	**756,977,214**	**476,201,865**
NPV (at 12%)		**89,119,951**
EIRR		**30%**

F. Sensitivity Analysis

18. The sensitivity of the program's net benefit was analyzed with respect to two key variables: unit cost, and estimated unit benefit. The results of this sensitivity analysis are presented in Table 17 below in terms of switching values, i.e. the percentage change in the values of the selected variables at which NPV becomes zero, for each of the basic infrastructure sectors including roads, irrigation, water and sanitation supported by this project, as well as for the four sectors taken together.

19. The results of the sensitivity analysis reveal that the overall net economic benefits of the project are relatively insensitive to changes in either average unit costs or average unit benefits in the water and sanitation and in the irrigation sectors alone, and in no case would changes in unit costs or benefits in these sectors alone result in the project's NPV being reduced to zero. This is because the baseline unit costs in the roads -sector are, in every province, at least ten times greater than the baseline unit costs for the other three sectors, with a similar difference in

magnitude for unit benefits across sectors. Moreover, the share of DAK funding for the roads sector is also greater than half the total DAK allocation in each province.

20. The main conclusion to be drawn from the sensitivity analysis, therefore, is not so much that the roads sector is singularly important for this project-each sector generates positive net economic benefits of its own. However, given the dominance of the roads sub-sector in the overall quantification of costs and benefits for this project, any substantial variability in the actual unit costs and unit benefits in the roads sector experienced during project implementation should be closely monitored.

Table 4: Switching values of selected key variables

	Roads	Water & Sanitation	Irrigation	All three sub-sectors
Average unit costs	+42.6%	-	-	+27.7%
Estimated average unit benefits	-18%	-	-	-11.6 %

ANNEX 8: CURRENT AND PROJECTED DISBURSEMENT

A. Disbursement to Date

1. As of July 15, 2014, the project had disbursed USD 171.4 million, or 78% of the total loan amount of USD 220.0 million. The disbursed Loan to-date consists of: (i) Advanced Payments for the fiscal years 2011-2014; and (ii) Value of Final Reimbursement (VFR) for the fiscal years 2011-2013, as shown at Table 1. This table provides value of to-date disbursement payment.

Table 1: Value of Disbursement To-date (in USD)

	2011	2012	2013	2014
Value of Qualifying Reimbursement (VQR)	41,359,573	51,966,921	56,488,446	-
Advanced Payment (AP)	15,105,732	15,369,022	20,449,315	7,225,704
Value of Final Reimbursement (VFR)	26,253,841	36,597,899	36,039,131	-
Incentive Payment to LGs	3,927,853	5,077,938	5,361,445	-
Total per year	45,287,426	57,044,859	61,849,891	7,225,704
Total up to date				171,407,880
Loan Amount				220,000,000
Remaining Loan Balance				48,592,120

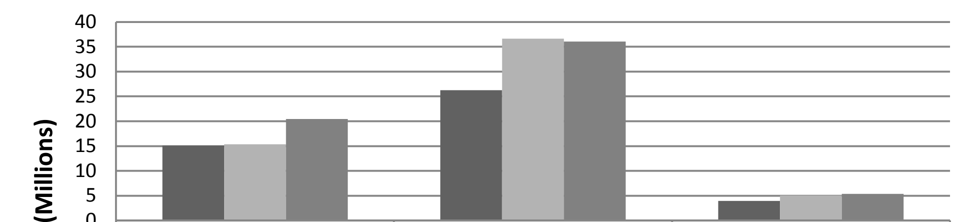
B. Projected 2014 Output Reimbursement

2. The Remaining Loan Balance of USD 48.6 million is projected to be fully disbursed by June 2015 against a projected eligible reimbursement for DAK 2014 outputs of USD 46.3 million and the associated incentive payment for LGs of approximately USD 5.3 million.

C. Reimbursement Progress and Comparison

3. The VQR (Value of Qualifying Reimbursement) is determined based on BPKP's verification of DAK Infrastructure implementation for 2011-2013. The VQR amount is equivalent to the sum of VFR and AP. Figure 1 shown the comparison between DAK 2011, 2012, and 2013 reimbursement and the incentive.

Figure 1: Reimbursement of DAK 2011, 2012, and 2013 Comparison



	Advanced Payment	Value of Final Reimbursement (VFR)	Incentive
2011	15,105,732	26,253,841	3,927,853
2012	15,369,022	36,597,899	5,077,938
2013	20,449,315	36,039,131	5,361,445

D. Total Potential Reimbursement

4. In order to justify the proposed Loan amount of USD 500.0m, an analysis was conducted to assess the total potential reimbursement under the LGDP Phase II program for the period of 2015-18. The LGDP Additional Financing reimburses against an existing Government of Indonesia financed intergovernmental transfer program, the Specific Purpose Grant (DAK) for the basic infrastructure sectors of roads, water, sanitation and irrigation. As such, any gap between the loan amount and the projected potential reimbursement amount does not reflect an 'unfunded' portion of the government program but rather that portion of the government program against which the Bank would not finance through the reimbursement mechanism.

5. The total potential reimbursement projection is based on the following conservative assumptions:

- Disbursements are based on benchmark of projected DAK allocation for GoI FY 2015-2017 using as reference values historical DAK allocation data (GoI FY 2011-14).
- LG participation rate is 91%, based on current LG participation rates under the first LGDP operation.
- The effective rate of advance payment is projected at 15% of the total value of the DAK Allocation in any given fiscal year.
- The value of contracts considered ineligible for LGDP Phase II financing as determined by the BPKP screening process is 39% of all the DAK Allocation in eligible sectors, reflecting the same rate under the first LGDP operation.
- The Qualifying Percentage over the life of the LGDP Phase II operation is estimated at 75%.

6. The estimated Project Disbursement for the period 2015-2018 is presented in Table 2. The analysis finds that – based on a conservative set of assumptions described above –projected total potential reimbursement (USD 597.2m) comfortably exceed the proposed loan value (USD 500.0m).

Table 2: Projected Total Potential Reimbursement (in USD)

	2015	2016	2017	2018
Advance payment (for current year's DAK)	46,333,107	69,584,112	92,753,859	-
Output reimbursement (for previous year's DAK)	-	76,200,512	110,785,066	146,825,604
Basic incentive for LGs (for previous year's DAK)	-	12,358,664	18,198,741	24,178,789
Total	46,333,107	158,143,289	221,737,667	171,004,393
Total 2015 - 2018	597,218,455			