PROGRAM-FOR-RESULTS INFORMATION DOCUMENT (PID)
CONCEPT STAGE

Report No.: 74391

Program Name	Strengthening DAK Transfers To Local Governments
Region	East Asia and Pacific
Country	Indonesia
Sector	Sub National Governments (100%)
Lending Instrument	Program-for-Results
Program ID	P123940
{If Add. Fin.} **Parent Program ID**	-
Borrower(s)	Republic of Indonesia
Implementing Agency	Ministry of Finance, Directorate General of Fiscal Balance
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Concept Review Decision	21-Apr-2012
Other Decision	

I. Introduction and Context

Country Context

1. Over the past decade, the implementation of decentralization in Indonesia has increased the authorityand responsibilities of local governments (LGs) in managing resources and pursuing development. The success of decentralization, however, is constrained by limited capacity among LGs, and the lack of adequate frameworks for measuring and monitoring LG performance and results. Systems to ensure transparency and accountability, as well as fiduciary controls, are also limited.

2. The Government of Indonesia law No. 33/2004 Article 1 (3) on Intergovernmental Fiscal Balance between Central and Local Government states that "Intergovernmental fiscal balance is a fair, proportional, democratic, transparent, and efficient financial distribution system to finance the implementation of decentralization, by taking into consideration regional potential, condition, and needs, as well as the amount of fund to implement De-concentration and Agency Tasks". Table 1 below provides a summary of the main transfers in Indonesia.

Table 1. Major Intergovernmental Fiscal Transfers, 2012

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.	30.2 billion	57.2%
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.	2.9 billion	5.5%
Revenue Sharing (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.	11.1 billion	21%
Special Autonomy and Adjustment 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.	7.7 billion	15%

Source: Ministry of Finance, 2012

3. The Specific Purpose Grants (*Dana Alokasi Khusus*, DAK) transfers finance investment expenditures that are identified as national priorities. There are currently 22 DAK sectors or expenditure categories, with the largest being education, four infrastructure sectors (roads, water, sanitation, and irrigation), and health. 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 Deconcentration and Co-Management Funds. 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 the resultant service delivery in Indonesia.

4. Since the implementation of the fiscal decentralization policy in 2001, policies regarding the DAK grant 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 problem revolves around lack of coordination among various central GOIministries, and also lack of coordination with individual districts. This results in mismatch between allocations and actual local needs.

5. Governance and transparency are closely linked, with transparency typically referring to weak monitoring and reporting, while the governance more broadly is about local community preferences not being fully taken into account. This transparency and governance issue also contributes to mismatch between allocation and local needs. However, greater transparency in the use and allocation of DAK will also support the broader governance agenda.

6. The Bank is currently working with the Government of Indonesia (GOI) through the Local Government and Decentralization Project (LGDP/DAK Reimbursement) on improving the reporting and verification of outputs delivered using the DAK transfers. Through LGDP/DAK Reimbursement, the GOI is strengthening the reporting and verification of outputs from LGs to the central government, thereby promoting greater upwards accountability in the DAK transfer system. While the DAK system is nationwide, the LGDP/DAK Reimbursement is being piloted in five provinces, with GOI planning to scale the program nation-wide following the first phase currently being implemented.

Sectoral and Institutional Context

7. GOI regulation PP No. 55/2005 on Stages of DAK Management states that DAK management at the central government level includes: (i) MOF for planning, monitoring and evaluation (M&E), decisions for allocation and transfer funds to the LGs; (ii) the Ministry of Home Affairs (MOHA) responsible for M&E, financial administration, and coordination of the DAK Technical Guidelines; (iii) the National Planning Agency (Bappenas) responsible for planning of DAK activities and M&E; and (iv) the line ministry—for example, the Ministry of Public Works (MPW) in the case of infrastructure—responsible for technical data, creating Technical Guidelines for the implementation of the transfers, and M&E. Based on national laws and regulations, multiple ministries have some form of responsibility for the DAK transfers, and coordination amongst the various national agencies is thus very important.

8. In terms of monitoring, LGs are required by regulation to provide financial reports to the Ministry of Finance (MOF), the Ministry of Home Affairs (MOHA), and the relevant line ministry. If LGs do not provide the reports, then releases of DAK can be withheld. Both of these requirements are stipulated in Government Regulation PP 55/2005. In 2008, MOF for the first time enforced withholding DAK releases when Districts did not provide financial reports on time. In terms of technical reporting, the aim of the on-going Local Government and Decentralization Project (LGDP) is to improve both financial and technical reporting, where LGs will receive incentives for delivering good quality outputs by December 31 each year as mentioned in the MPW Technical Guidelines, and by reporting the outputs produced to both the Ministry of Finance and the MPW as the line ministry.

9. Currently, reporting systems of the financial aspects of the DAK from LGs to the MOF are manual, with every LG submitting a summary of the DAK disbursement to the MOF in hard copy. As part of the institutional strengthening sub-component in the on-going LGDP, the Bank is supporting the development of an integrated web-based reporting system, which will improve the transparency and accountability for DAK usage. An initial step by the GOI to address the monitoring challenges of DAK was to develop a Web-Based Transfer Monitoring System (WBTMS) for financial reporting in 2010. The MOF use this system to monitor transfers to LGs, while the LGs are able to see the amount of allocation and upload financial reports. This system has been socialized to all Provinces since 2009, and has been used by the LGs since 2010. At the same time, the MPW has created an e-monitoring system, which enables MPW to better monitor technical reports sent by LGs. This initiative shows that the GOI is beginning to strengthen its governance system related to intergovernmental transfers to LGs, including the DAK grants. However, the two web-based monitoring systems are not yet linked.

Relationship to CPS

10. This concept note describes the initial outlines for Strengthening DAK Transfers to Local Governments. This program benefits significantly from lessons and insights from the Bank's ongoing investments and analytical work in this area, and serves to deepen the Bank's overall engagement in local government reform. This program would contribute directly to the Bank's current Country Partnership Strategy (CPS) for Indonesia 2009-2012, Investing in Indonesia's Institutions. Through the CPS, the Bank seeks to strengthen both central government and existing LG institutions, rather than develop separate stand-alone Bank projects, in order to increase the effectiveness of planning processes and the impact of budget expenditures.

11. The proposed program support is in line with the Bank's current CPS by supporting the two core engagements for strengthening central and local government institutions. In particular, the proposed program would support the approach highlighted in the CPS Progress report whereby the Bank would scale up approaches using output- and results-based financing of local government infrastructure expenditures.

II. Program Development Objective(s)

12. The objective of GOI's intergovernmental transfers is stipulated in Law 33/2004 as a "fair, proportional, democratic, transparent, and efficient financial distribution system to finance the implementation of decentralization, by taking into consideration regional potential, condition, and needs." The DAK transfers are part of the overall intergovernmental transfer system and therefore share the same objective stipulated in the law. DAK transfers finance specified activities as determined by the central government, but under the jurisdiction of local governments (Province, Kabupaten, and Kota).

13. The objective of this proposed program is to support the GOI in promoting greater transparency and quality in the delivery of outputs using Specific Purpose Grants (DAK) in the infrastructure sectors. This will be achieved by disbursing against results and policy

actions specified in the disbursement linked indicators (DLIs), which will be structured around the GOI's own regulations on DAK transfers. This program will focus on a geographic slice of the national GOI DAK transfers, as discussed with the MOF.

Key Results

14. This program will focus on infrastructure sectors (which represent some 25 percent of the total DAK allocation), as these sectors receive the second largest allocation of DAK transfers after the education sector (which accounts for 40 percent of the total DAK allocation). A second reason for focusing on the infrastructure sectors is to align the program with the GOI's stated medium-term strategy of improving the quality and quantity of infrastructure expenditures and outputs.

15. The program will disburse when DLIs are met by either the central and/or local governments. The indicative areas for the DLIs consist of reforms for central and local governments. The proposed size of the program will be US$ 250 million over three years. Total DAK allocation for the infrastructure sectors in 2012 is US$ 703 million, while the total DAK allocation is US$ 2.9 billion. Disbursement under this program will be based on central government and LG performance as measured by achievement of the DLIs. The DLIs will be structured around compliance with the GOI's own regulations for improved performance and increased transparency. The table below presents the indicative areas within which the DLIs will be developed. During project preparation this will be done jointly with the GOI.

Table 3. Indicative Areas of Results and Associated DLIs

Results	Description of DLIs to be developed jointly with the GOI partners
Central Government	
DAK Allocation	Continued timely issuance of MOF regulation in DAK allocation
MPW Technical Guidelines	Revised Technical Guidelines, which include safeguards requirements issued by the MPW and implemented by local governments
Monitoring and Evaluation (M&E)	• Implementation of the M&E requirements as mentioned in the government regulations • Implementation of an integrated WBRS among DAK stakeholders (MOF, MOHA, Bappenas, and MPW)
Local Governments	
Planning and budgeting	Percentage of LGs that include detail plan of DAK projects in their published local budget
Increased Participation	Increase percentage of community inputs in LG planning for DAK, e.g. *Musrenbang (deliberative development planning)* and local regulations
Fiduciary Process	• Terms of Reference (TOR) for performance audit • Number of LGs that establish procurement service unit (ULP)

M&E	Implementation of an integrated WBRS, which include output data and reports uploaded and publicly accessible. M&E reports published by LGs
Outputs	Increased number of DAK outputs delivered and improved quality of outputs measured by MPW Technical Guidelines and Minimum Service Standards (MSS) regulation

III. Program Description

16. This Strengthening DAK Transfers to Local Governments Program will focus on creating greater transparency in the allocation and use of DAK transfers and improving the quality of outputs. With reference to an existing baseline, targets will be set for the DLIs for each year of the program, with appropriate mechanisms to reward performance with respect to the targets achieved. The proposed DLIs for this program include actions, reporting, intermediate and/or final outputs. The proposed DLIs will be divided between the central government and local governments.

17. In addition, as an incentive for participating LGs, MOF is planning to set up a mechanism in the DAK to reward good performing local governments. LGs that meet or exceed certain performance targets will be rewarded through additional DAK the following year or through other means of transfers. The performance targets will focus on DLIs dealing with improved planning, budgeting, fiduciary aspects, and improvements in implementation of DAK, including the quality of outputs delivered. This program will therefore also support the GOI in setting up such a mechanism to reward LG performance.

18. Disbursements of Bank financing will be made at the request of the borrower upon achievement of the DLIs. The Bank will discuss further with the GOI a third-party entity that will be responsible for verifying achievement of the DLI, and for requesting disbursement. This third-party will most likely be the independent inspectorate general (Irjen) of the MOF in conjunction with that of the MPW, or it could also be the State Financial and Development Board (BPKP). The MOF will transfer the rewards for the LGs based on DLIs met. Based on experience from the on-going LGDP/DAK Reimbursement, the GOI requested that the Bank team adjust the project cycle for disbursement to match with the Government's budget cycle, which is based on the calendar year.

IV. Initial Environmental and Social Screening

19. As is the case with the ongoing LGDP/DAK Reimbursement, the PforR will provide financing to participating local governments (LGs) for projects that include maintenance, rehabilitation and improvement of existing infrastructure (roads, water, sanitation and irrigation), and in some cases, investments for new small-scale civil works. Learning from the ongoing LGDP/DAK Reimbursement, potential environmental and social risks of the program, particularly adverse impacts, will be insignificant, on-site, are not irreversible and can be managed locally. The program would improve the environmental quality and welfare of the beneficiaries. Physical relocation.

20. To manage environmental and social risks, the proposed program will continue to implement the Technical Guidelines pertaining to Environmental and Social Guidelines and the Operations Manual adopted by the LGDP/DAK Reimbursement. The environmental and social management system of the GOI, as reflected in the Guidelines, will be assessed and will have to be improved based on the Environmental and Social System Assessment (ESSA). Socialization, training and assistance to LGs on the implementation of the Guidelines may also need to be intensified based on the findings of the ESSA. Participation of the affected beneficiaries in identifying the impacts and measures to mitigate them will have to be improved for effective and sustainability of the investments. Documentation and disclosures of processes and results of environmental management and land acquisition at the LG and program level will have to be strengthened. The Web Based Reporting System (WBRS) will need to include indicators for environmental and social risk management.

21. The MPW will have to ensure that the Technical Guidelines and their updates are implemented consistently at the LG level. The capacity of the LGs to implement the Technical Guidelines also needs to be continuously strengthened. Coordination among local agencies, as well as with the central agencies in charge of environmental and social management is still limited in the LGDP/DAK Reimbursement and therefore needs to be improved as part of the PforR. It is anticipated that the reputational and political risks of the proposed program will be low, given the nature of the projects financed by the program. The current system and practice for environmental and social risks management used by the central and local governments also means that the likely risks are negligible.

22. During program preparation and appraisal, the Bank in collaboration with the GOI will carry out an ESSA to assess the environmental and social management systems applicable to the program, which include among others, the likely risks and impacts of the proposed program, regulations for environmental and social management, the GOI's environmental and social risk management system, capacity for effective management in light of current performance, and management system against PforR core principles. The LGDP/DAK's Technical Guidelines and Project Operations Manual, as well as their implementation to date, will be part of the assessment, and they may need to be updated to be more applicable for the PforR. The Bank will consult the relevant stakeholders regarding the draft system assessment and disclose it in the Infoshop and GOI's website prior to appraisal. The disclosed draft will specify the period in which comments will be received and considered. During appraisal, the Bank together with the GOI will finalize the environmental and social system assessment and agree upon the necessary actions to improve the performance of the program. After appraisal, the final system assessment and the agreed actions will be disclosed in the Infoshop and GOI's website.

V. Tentative financing

Source:		($m.)
Borrower/Recipient		2,500.00
IBRD		250.00
IDA		
Others (specify)		
	Total	2,750.00

VI. Contact point

World Bank

Contact: Taimur Samad
Title: Senior Urban Economist
Tel: 5781+3037
Email: tsamad@worldbank.org

Borrower/Client/Recipient

Contact: Ministry of Finance
Title: Robert Pakpahan
Tel: Director General for Debt Management
Email: -

Implementing Agencies

Contact: Ministry of Finance
Title: Heru Subiyantoro
Tel: + 62-21- 3841067
Email: herusubiyantoro@gmail.com

VII. For more information contact:

The InfoShop
The World Bank
1818 H Street, NW
Washington, D.C. 20433
Telephone: (202) 458-4500
Fax: (202) 522-1500
Web: http://www.worldbank.org/infoshop