PROJECT INFORMATION DOCUMENT (PID)
ADDITIONAL FINANCING

Report No.: PIDA9857

Project Name	Local Government and Decentralization Project Additional Financing (P123940)
Parent Project Name	Local Government and Decentralization Project (P111577)
Region	EAST ASIA AND PACIFIC
Country	Indonesia
Sector(s)	Sub-national government administration (100%)
Theme(s)	Municipal governance and institution building (67%), Decentralization (33%)
Lending Instrument	Investment Project Financing
Project ID	P123940
Parent Project ID	P111577
Borrower(s)	Government of Indonesia
Implementing Agency	Ministry of Finance
Environmental Category	B-Partial Assessment
Date PID Prepared/Updated	26-Jun-2014
Date PID Approved/Disclosed	26-Jun-2014
Estimated Date of Appraisal Completion	01-Aug-2014
Estimated Date of Board Approval	22-Sep-2014
Decision	

I. Project Context

Country Context

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 percent of GDP in 2000 to 7.2 percent of GDP in 2011. Subnational 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.

Local government spending remains dominated by intergovernmental transfers. In 2012, over 32 percent of central government budget goes to transfers which account for over 90 percent 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.

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.

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 supply infrastructure sub-sectors, within pilot local governments (LGs). Applying an innovative output-based approach, the Project reimburses the GOI based on verified outputs delivered by the LGs through DAK expenditures, and provides an additional incentive of 10 percent of verified expenditures to LGs to encourage solid performance. The Project operates in five pilot provinces and 77 constituent local governments. Having completed two annual cycles of DAK investment expenditure and verification, by July 2013, the loan has disbursed approximately USD 122.8 million against verified outputs. After a level two restructuring to extend the closing date of the project, the closing date of the project is scheduled for December 31, 2015 and project to disburse a further USD 97.2 m against GOI fiscal year 2013 and 2014 DAK expenditures.

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 under 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 new model. Second, given its experience with the existing Program and good lessons learned from the current LGDP, GOI would be able to socialize and implement a geographical expansion of the existing Program in a timely and efficient manner to a gradual nationwide over 4 years.

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 three-year Additional Financing operation covering GOI fiscal years 2014 and 2015. Key characteristics of the proposed

Additional Financing include: (i) an expansion of the Program to a gradual rollout nationwide of 30 Provinces;(ii) a strengthened and better targeted institutional support program; (iii) an improved monitoring and evaluation program; and (iv) improved Project Management or institutional arrangements.

Sectoral and institutional Context

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.

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.

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.

II. Proposed Development Objectives

A. Current Project Development Objectives – Parent

The objective of the 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). This will be done through improved financial and technical reporting, and verification of outputs delivered by LGs with the DAK grants.

III. Project Description

Component Name

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

Comments (optional)

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 roads, water, sanitation and irrigation.

Component Name

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

Comments (optional)

The component will support the following sub-components: (i) Policy Advisory; (ii) Strengthening Local Government Capacity to Improve Public Service Delivery; and (iii) Strengthening Central Government Capacity for Effective and Efficient Use of DAK.

Component Name

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

Comments (optional)

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

IV. Financing *(in USD Million)*

Total Project Cost:	500.00	Total Bank Financing:	500.00
Financing Gap:	0.00		

For Loans/Credits/Others	**Amount**
Borrower	0.00
International Bank for Reconstruction and Development	500.00
Total	500.00

V. Implementation

The institutional arrangements for LGDP AF will generally follow those established for the original LGDP project, which will continue to be implemented by Ministry of Finance, led by the appointed staffs in the Directorate General of Fiscal Balance (DGFB) and involve representatives from Bappenas, Ministry of Public Works (MPW), and Ministry of Home Affairs (MoHA). With the increase of project geographical coverage, from five to g30 Provinces within three years, the AF envisages an expanded role for the whole member of the PIU. More detailed tasks division to improve the role of each central government agency, increase the focus on M&E, and improve coordination is prepared through a detailed Terms of Reference, which will also be reflected in the Loan Agreement.

A key characteristics of the Additional Financing to the LGDP is improved institutional arrangements through: (i) better delineation of responsibilities between MoF and other agencies involved in LGDP implementation, and (ii) targeted support to partner agencies to adequately implement these responsibilities.

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

- Introduction of Criteria-Based Provincial Selection Methodology
- 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

14. The current instrument for Environmental and Social Safeguards Management used in the original Project, i.e. the Supplemental Technical Guidelines for Environmental and Social Safeguards Management (STG) issued as a Ministerial Circular letter on the MPW in December 2010, has been updated as of June 2014 to reflect the newly triggered safeguards policies. The draft June 2014 STG has been disclosed in-country on June 24, 2014 and in the Infoshop on June 23, 2014.

VI. Safeguard Policies (including public consultation)

Safeguard Policies Triggered by the Project	**Yes**	**No**
Environmental Assessment OP/BP 4.01	x	
Natural Habitats OP/BP 4.04	x	
Forests OP/BP 4.36		x
Pest Management OP 4.09	x	
Physical Cultural Resources OP/BP 4.11		x
Indigenous Peoples OP/BP 4.10	x	
Involuntary Resettlement OP/BP 4.12	x	
Safety of Dams OP/BP 4.37		x
Projects on International Waterways OP/BP 7.50		x
Projects in Disputed Areas OP/BP 7.60		x

Comments (optional)

VII. Contact point

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