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(Ph.D. in Public Management)

Performance-Based Grants in Indonesian Decentralization:
Incorporating Incentives to Improve Public Service Delivery

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INTRODUCTION

A unitary central government tends to provide uniform public services nationwide, contrary to subnational governments who are believed to respond better to public preferences. Therefore, a decentralized government is believed to be able to improve the efficiency of public service delivery (Musgrave 1973, Oates 1972, 1993).

The ultimate goal of decentralization is efficiency in public service delivery (Oates 1972, 1993, Musgrave 1973), and the motive for most decentralization is public service improvement (Ahmad et al 2005). For this reason, efforts to improve implementation of decentralization should put strong emphasis on achieving better public service. The efforts can cover broad and often interconnected areas, ranging from political, administrative, and fiscal aspect of decentralization. This research in particular will investigate the area of fiscal decentralization, especially the management of intergovernmental grants.

In most decentralized countries, the majority of subnational governments’ revenues come from intergovernmental grants. Depending on issues to be addressed, the design of the grants may vary, but the objectives are mostly to finance subnational spending and to implement national priorities (Bergvall et al 2006), in order to achieve the goal for decentralization.

Decentralization in practice does not always deliver the results predicted by theories. International experiences show that funding from central government to subnational governments does not always result in improved public service delivery. Problems with decentralization generally stem from, among others, lack of capacity at subnational governments to exercise responsibility for public service delivery, misaligned responsibilities due to incomplete process (possibly for political reason), and political capture within lower tiers of governments (Ahmad et al 2005).

The challenges of decentralization are complex and intertwined. By itself, no single solution can response best to the challenges. It is argued that holistic response by people at the
local level is crucial to address this issue, and incentives are critical to gain positive response. For this reason, innovative reforms with performance-based grants (PBG) system have been applied to improve subnational governments’ capacity and performance. Introduced in mid-nineties in developing and middle-income countries, there is considerable evidence that the incentives provided through PBG have resulted in genuine improvement in subnational governments’ performance, especially in core administrative and financial area (UNCDF 2010). Performance-based incentive is recommended to induce desirable behavior from subnational government (Lewis and Smoke 2008), to improve administrative performance and service provision, e.g. through rewarding proper initiatives and penalizing inefficiency (Steffensen 2007), and to improve the quality and responsiveness of subnational government (World Bank 1995).

The idea of PBG is to incorporate incentives into intergovernmental grants by linking funding with performance or output. This is the main point that differentiates PBG from the traditional input-based grants. Advocates of PBG argued that this grants can improve the accountability of grant recipients by tying funds transfer with standard attainment, thus strengthening the link between input (funds) and performance (standard attainment). As a result, PBG also promotes accountability by emphasizing result-based, bottom-up, and client driven approach (Broadway and Shah 2009).

Indonesian governments started the adoption of PBG ideas in intergovernmental grants in 2010. Indonesian PBG became a new addition to input-based grants which had been implemented since the beginning of decentralization 2001. Having been introduced as pilot projects, the implementation of PBG to date appears to show promising results. Given the relatively short period of PBG implementation to date, however, there is no conclusive research that either support further expansion of PBG or oppose it.

This research tries to fill that void by evaluating the implementation of PBG as a component of intergovernmental grants in Indonesia and how it affects the accountability in
public service delivery in decentralization, especially in monopolistic public service which provision mainly depend on local governments. The evaluation is undertaken to answer the following questions: (1) Does PBG in Indonesia strengthen the accountability of local governments in public service delivery? (2) If so, how?, and (3) Is PBG generally applicable to local governments in Indonesia?

Between 2010 and 2012, Indonesian government has implemented 5 PBG projects, 2 have been completed and 3 are ongoing. This research will use one of the completed projects, PBG for drinking water, as a case study to observe the impacts of PBG on local governments’ accountability in public services delivery. Drinking water is an example of monopolistic public services, and the accountability of local governments to deliver this service is crucial for citizens’ welfare.

The findings of this research are expected to contribute to better understanding of PBG system in general, and to the effort of Indonesian government to enhance its intergovernmental grants system to further the objective of its decentralization, especially regarding the implementation of PBG.

*Research keywords: performance-based grants, incentives, accountability, decentralization, intergovernmental grants, developing countries, performance.*
CHAPTER I

RESEARCH BACKGROUND, OBJECTIVES, AND ORGANIZATION

Indonesia used to be a centralized country. Since January 1, 2001, Indonesian central government, triggered by monetary crises and political transition, officially implements decentralization policy. The decentralization changes the roles of both central and subnational government (i.e. provincial and local governments) in Indonesia. Not only that, decentralization also brings significant difference in various areas, such as power sharing, functions sharing, and resources allocation between central government and subnational governments, especially local governments which under decentralization received the devolution of public service functions.

Because of the variations in geographical characteristics, natural resources, cultural heritages, and other local potentials, local governments have different capacity to deliver public services. To provide local governments with necessary resources to exercise the function, central government provides funding in the form of intergovernmental grants to local governments. The grants are the embodiment of intergovernmental financial relation between central government and local governments in the implementation decentralization, where subnational governments have the autonomy to manage their budget according to local priorities.

More than a decade into the decentralization, Indonesia consistently uses the traditional input-based approach to its intergovernmental grants. In 2010, in addition to the existing grants, Indonesia begins to implement the performance-based grants (PBG). The adoption of PBG into Indonesian intergovernmental grants raises an interest of whether this grant should be implemented in greater scale in the future. The decision of this matter needs to take many different aspects into consideration; however given only the short period that has been elapsed, research on PBG implementation in Indonesia, both to support or to oppose the expansion of PBG implementation, is relatively few.
This research tries to evaluate the implementation of PBG as a part of intergovernmental grants in Indonesia and how it affects the accountability in public service delivery in decentralization, especially in monopolistic public service which provision mainly depend local governments. In this chapter, the background of the research is discussed. The discussion includes the situation that initiates the research, the significance and objectives of the research, research questions, methodology, and chapter plan.

1.1. PBG: Introducing Incentives in Intergovernmental Grants

Since the beginning of the decentralization implementation, a considerable portion of national budget has been dedicated to intergovernmental grants. According to Indonesian decentralization laws (Law No. 32/2004 and No. 33/2004), at least 26% of net domestic revenue established in national budget is to be allocated as intergovernmental grants.

There are several components in Indonesian intergovernmental grants; each has the characteristics of either general/unconditional grants or specific/conditional grants. For most subnational governments, intergovernmental grants are the main source of revenues in their budgets. Based on the data of Indonesian Central Bureau of Statistics (Badan Pusat Statistik/BPS), from 2007 to 2010, the grants make up to more than 80% of local revenues. In 2010, adding to the existing intergovernmental transfers, Indonesian government started to adopt the performance-based grants (PBG) system in its intergovernmental grants.

PBG was first implemented in 1997, with Uganda as a pilot project (Boschmann 2008). It is a type of grants that provides incentives to its recipients by encouraging them to accomplish a specific task by focusing on performance, and transfers the funds only if certain performance standards are satisfied. With this feature, capacity and accountability are expected to improve, along with public service quality (UNCDF 2010). As an intergovernmental grant, the design of PBG differs across country (Bergvall et al 2006, Steffensen 2007), depending, among others, culture, governments structures, and mandatory functions (Steffensen 2007). Despite the
difference in the detailed arrangement, PBG essentially keeps its main principle of linking incentives, performance, and funding.

Incorporating incentives for performance is the main and innovative feature that differentiates PBG from the traditional input-based grants, which provide funding prior to the implementation of a task. The feature is expected to encourage subnational governments to support national priority programs and to promote accountability culture, especially in targeting areas with greatest needs (Tremolet and Evans 2010).

The PBG in Indonesia is basically specific or conditional grants, which transfer can only be made after certain standard is reached. The idea is consistent with the main idea of PBG in general which, according to Steffensen and Larsen (2005), is to link incentives, performance, and funding to motivate subnational governments to demonstrate desirable behavior, e.g. improving specific public services, participating in a national priority program, reforming local bureaucracy, and involving more public participation in policy making.

A case study in drinking water PBG in Indonesia will be used in this research. The results of the evaluation are expected to contribute to the consideration of whether PBG has the potential to be implemented in greater scale in the future, and which aspects of that calls central government’s attention in order to improve PBG implementation, provided such system is to be continued.

1.2. The Significance and Objectives of the Research

Aiming at the improvement of public service delivery, sectors targeted by PBG are also targeted by other type of intergovernmental grants in Indonesia. To date, central government keeps providing funds to subnational governments (especially local governments) in the form of PBG and other grants as well. The drinking water sector, for example, receives intergovernmental grants in the form of PBG and DAK, other type of conditional grants. Given the similar targeted sectors, the implementation of PBG raised interests of the importance of
implementing PBG, why it is necessary and what impacts it has on intergovernmental grants management and finally on public service delivery.

Only a short period has elapsed since PBG was first implemented in 2010. There is gap in the discussion of the implementation of PBG in Indonesian intergovernmental grants; most available studies focus on either the existing intergovernmental grants or PBG, but not both. This research tries to highlight how PBG is different from the existing intergovernmental grants and what limitation is there in the existing grants that call for the needs and desirability of introducing PBG system. The research argues that existing grants have limitation in addressing public service and thus there’s a need for an innovative approach to improve the situation. This is the first reason for conducting the research.

Second, in intergovernmental grants, there’s also an accountability issue to be concerned. In decentralization, efficiency in public services is achieved assuming local governments have better knowledge about local preferences (Musgrave 1973, Oates 1972, 1993). Recent studies argued that, in addition to that knowledge, local governments also need to be accountable to citizens (Broadway and Shah 2007). Traditional input-based grants, however, have been argued to have significant limitation that compromises accountability, such as controls on inputs and process with little or no concern for results (Broadway and Shah 2009). Despite the said limitation, until 2010 input-based grants are the only approach used by Indonesian government in its intergovernmental grants. Literatures on PBG suggest that as intergovernmental grants, PBG promotes accountability between citizens and government (Steffensen and Larsen 2005, UNCDF 2010) and between levels of government in bottom-up and top-down approach (Steffensen and Larsen 2005). In light of this, the research evaluates whether PBG implementation in Indonesia in fact results in improved accountability.

The World Bank (2004) in its World Development Report 2004 argued that the accountability relationships involve all actors in public services, which include citizens, governments, and service providers. The report also suggests that in public services, where
service providers are generally monopolistic, accountability is enforced through a long route: citizens hold service providers accountable by holding the government accountable. Monopolistic public services are different from public services in competitive markets, in which short route of accountability applies, and citizens are unlikely to hold providers directly. Similar finding is also reported by Meijer and Schillermans (2009), who found that citizens usually do not hold the providers directly accountable for public services. In their findings, one of the conclusions is that the accountability of providers is not the result of the citizens’ actually holding them responsible, but the result of providers’ own anticipation of the potential of being hold responsible by citizens.

Using drinking water service as a case study, this research in addition tries to confirm, by analyzing how PBG for drinking water impacts accountability, whether the above arguments on the long route of accountability have validity.

Third, PBG is relatively a new system in Indonesia, compared to other intergovernmental grants, and however effective it is in light of accountability and performance, there is question of whether and how it can be broadly expanded and smoothly accepted to different public services of different subnational governments. One of the crucial questions here is how the recipient local governments perceive PBG relative to other intergovernmental grants, but study on the subject is rare. The research tries to shed light on the subject by investigating how the local governments respond to the implementation of PBG, in comparison with other intergovernmental grants, focusing on the factors that make PBG more or less attractive compared to other conditional grants.

The research is conducted in the context of fiscal decentralization in Indonesia, within the frameworks of intergovernmental grants, assuming current system, laws, and regulation on fiscal decentralization are continued to put into practice. The objectives of the research are as follows:
a. Evaluating the implementation of existing Indonesian intergovernmental grants, identifying the limitation, and evaluating the role of PBG in intergovernmental grants system.

b. Using drinking water service as a case study, evaluating how PBG impacts accountability of local governments in public service.

c. Investigating the responses of local governments to the implementation of PBG.

1.3. Research Question

With the implementation of decentralization, indicators for government effectiveness and democracy in Indonesia show promising results. According to the World Bank, Indonesian governance indicators, including voice and accountability and government effectiveness, have improved from 2000 to 2010. Improved democracy also has impact on local governments’ budget decision. Skoufias et al (2011) find that in Indonesian regions where direct elections are imminent, local governments tend to have higher current expenditures on public works.

But are higher expenditures on public works equal improved public service delivery performance? Experience has shown that there is no one-to-one link between increase in public spending and improvement in public service delivery performance (Huther et al 1997). However, this does not necessarily mean that increasing financial support for public service is useless. Providing financial support for improving public service is crucial; in fact an important way to communicate accountability is through the provision of financial resources, the so-called financial accountability (Glynn 1993). In this regard, increasing financial support should not be seen merely as increasing the amount of funds. A mechanism to ensure accountability in utilizing the funds needs to be put in place, as well as incentives to encourage accountable behavior of funds recipient.

This is a thought to consider in intergovernmental grants. Traditionally, intergovernmental grants are input-based which provides little incentives for performance and

1 Source: http://info.worldbank.org/governance/wgi/sc_chart.asp
accountability. Recently in Indonesia, effort to change this situation has been taken by introducing PBG, in addition to the existing intergovernmental grants – all of them are input-based. Previous research highlight the findings that the incentives feature in PBG has positive impacts on encouraging desirable behavior, including accountability if this is the desired condition to achieve.

This research aims to confirm whether the results of PBG implementation in Indonesia are consistent with previous research. The research focuses on the incentives feature of PBG and accountability, and posing these research questions:

(1) Does PBG in Indonesia strengthen the accountability of local governments in public service delivery?

(2) If so, how does PBG strengthen the accountability?

(3) Is PBG generally applicable to local governments in Indonesia?

To answer the research questions, the research uses a conceptual framework developed from the accountability relationships framework introduced by the World Bank (2004). The framework explains the accountability relationships between three actors in monopolistic public services: citizens (as clients), governments (as policy makers), and service providers. To evaluate the case study. A case study of PBG for drinking water in Indonesia is selected to evaluate the impacts of PBG on accountability in public services delivery. The case is selected because (1) drinking water is a monopolistic public service, which enables evaluation based on theoretical framework, and (2) drinking water is essential since it is one of human basic needs, but the drinking water service has decreasing performance. This raises interest of why this condition exists despite the national policy that puts drinking water as a priority. The two reasons above make drinking water sector an ideal case study, since the research can observe how the incentives feature in PBG work and whether there’s a difference between the condition before and after PBG implementation.
1.4. Methodology

The research uses the following methodology:

a. Library research

Library research aims at collecting and summarizing academic reviews, theories, and ideas on intergovernmental transfers in the context of decentralization, evaluating the designs, implementation, and assessments of PBG by previous research. Library research targets on collecting raw data for analysis.

b. Questionnaire

Questionnaire to local government officials aims at investigating the response of PBG recipients. From the questionnaire, the research tries to observe whether PBG is supported by local governments, and whether they can adapt well to the new system. The questionnaire also tries to gather information about the advantages and disadvantages of PBG implementation from grants recipients’ viewpoint.

c. Interviews

Interviews with Indonesian central government officials aim at collecting first-hand information on how current systems are implemented and the expectations on improvements. Interviews also seek information about the implementation of PBG, expectations on PBG, and deficiencies to be addressed in the implementation of PBG and other intergovernmental grants.

1.5. Data collection

The methods used to collect research data are as follows:

a. Library research

Data related to Indonesian government affairs are obtained from Indonesian Ministry of Finance, Ministry of Public Works, Ministry of Home Affairs, Ministry of National
Development Planning, and Central Bureau of Statistics. Other data are obtained from publication by Indonesian development partners. The findings of previous research in relevant fields are obtained from academic journal, reference books, and publications by international institutions and government agencies.

b. Questionnaire

Questionnaire is distributed to 35 local governments (cities and regencies) who received drinking water PBG in 2010 and 2011. Of the 35 subnational governments, 17 responded. The distribution on questionnaire is conducted from February to March 2012.

c. Interviews

Interviews were conducted in March 2012. Interviewees are officials from the Ministry of Finance, the Ministry of Public Works, and AusAID as the donor who sponsored PBG for drinking water.

1.6. Organization of the Dissertation

This dissertation consists of these following chapters:

a. Chapter 1: Introduction

This chapter describes research background, research significance and objectives, research questions, methodology, data collection, and organization of the thesis.

b. Chapter 2: Literature Review

This chapter reviews theoretical background and previous research in decentralization, intergovernmental grants, incentives, accountability, and PBG. Several countries’ experiences with PBG implementation are also presented.

c. Chapter 3: Conceptual Framework and Hypothesis

This chapter explains research conceptual frameworks, the basis for developing the framework, and research hypothesis.
d. Chapter 4: Decentralization in Indonesia

This chapter describes the implementation of decentralization in Indonesia, how the functions are divided between central government and local governments, how the resources are shared, and how intergovernmental grants operate in the decentralization scheme.

e. Chapter 5: Evaluation of Indonesian Intergovernmental Grants

This chapter analyzes the implementation of intergovernmental grants in Indonesia, focusing on balancing funds, the most significant component in intergovernmental grants, and the newly-introduced PBG. The analysis aims at identifying the limitation of intergovernmental grants, what areas that needs improvements, and how PBG can contribute to improve the intergovernmental grants system.

f. Chapter 6: Case Study – PBG for Drinking Water

This chapter analyzes the case study to find the answer to the research questions mentioned earlier in this chapter. The analysis focuses on the implementation of PBG for drinking water in Indonesia, how it works, and whether it has impacts on local governments’ accountability in drinking water service, and how it can has such impacts. In this chapter, the result of the survey to investigate local governments’ responses on PBG implementation is also presented.

g. Chapter 7: Conclusion

This chapter describes the answers to research questions, summarizes research findings, and proposing recommendation on future PBG implementation.
CHAPTER II
LITERATURE REVIEWS

This chapter reviews theories and previous researches in decentralization and intergovernmental grants. The focuses of the discussion are (1) decentralization, (2) intergovernmental grants to provide the funding of decentralization, and (3) performance-based grants (PBG) as an option to incorporate incentives in intergovernmental grants and to improve accountability relationship in public service delivery.

The purpose of the reviews is to clarify the concepts of decentralization and intergovernmental grants according to theories and previous research, and to explain how the concepts connect to PBG in particular. This chapter will also identify the areas which previous research have not sufficiently covered, and describe in what way this research can contribute to fill the gap.

2.1. The Meaning of Decentralization

There are several factors that trigger decentralization. A country can decentralize to maintain the national unity in the presence of separatism risk, to accommodate the transition from less democratic to more democratic government, and to respond to financial crisis (Wallace and Bahl 2005). In Eastern Europe and the former Soviet Union, it was part of the political and economic transformation; in Latin America, it was to reinforce the transition to democracy; in South Africa, Sri Lanka and Indonesia, it was a response to ethnic or regional conflict; and in Chile, Uganda and Cote d’Ivoire, it was to improve the delivery of basic services (Shah and Thompson 2004).

Despite the reasons, decentralization arguably contributes to the improvement of public services performance, because it increases the efficiency, responsiveness, and accountability of government. A unitary central government tends to provide uniform public services nationwide,
contrary to subnational governments who are believed to respond better to public preferences (Musgrave 1973, Oates 1972, 1993).

In a broad sense, decentralization can include government and non-government. Rondinelli and Nellis (1986) defined decentralization as the transfer of responsibility for planning, management, raising and allocation of resources from central government to (1) field units of central government, (2) subordinate unit or lower level of governments, (3) semi-autonomous public authorities or corporation, (4) area wide regional or functional authorities, or (5) non-government private or voluntary organizations.

In a limited scope that only include government entities, decentralization can also be broadly defined as the shifting of responsibilities between tiers of government by several fiscal, political, and administrative instruments (Asfaw et al 2007); the restructuring or reorganization of authority so that there is a system of co-responsibility between institutions of governance at the central, regional and local levels according to the principle of subsidiarity, thus increasing the overall quality and effectiveness of the system of governance, while increasing the authority and capacities of sub-national levels (UNDP 1997).

Decentralization has 3 dimensions: political, administrative, and fiscal dimension. Rodriguez-Pose and Ezcurra (2010) argued that the processes of decentralization includes the varying degrees of transfers of powers (political decentralization), the transfer of resources to subnational tiers of government (fiscal decentralization), and the granting of autonomy to subnational entities relative to central government (administrative decentralization). The dimensions of decentralization—political, administrative, and fiscal—interact with each other. An increase in a decentralization dimension can lead to an increase in other dimension. Alternatively, the increase can lead to a decrease in other dimension. For example, fiscal decentralization might generate greater administrative decentralization if local units used increased resources to assert administrative autonomy from the center. On the other hand, fiscal decentralization might lead to less administrative decentralization if central governments
systematically counteracted the release of resources with an increase in bureaucratic or regulatory controls (Schneider 2003).

Political decentralization refers to the degrees to which central government allow subnational government entities to undertake the political functions of governance (Schneider 2003). Political decentralization can also refer to representative governments, and can support democracy by increasing the influence of citizens or their representatives in the formulation and implementation of policies. The World Bank argues that in political decentralization, citizens or their elected representatives have more power in public decision making. The policy made under this greater influence is assumed to be more relevant to the needs of local citizens, compared to the decision made only by central authorities, because the selection of representatives from local electoral jurisdictions allows citizens to know better their political representatives and allows elected officials to know better the needs, desires, and interests of their constituents.²

Rondinelli (1990) mentioned that administrative decentralization could be distinguished by the degree of authority and power, or the scope of functions, which the government of a sovereign state transfers to or shares with other organizations within its jurisdiction. Based on this, he categorized administrative decentralization into 4 types: deconcentration, delegation, devolution, and transfer to non-government organizations, each is briefly described as follows:

- **Deconcentration** is the transfer of power and functions to field agencies or local administrative offices of central government.

- **Delegation** is the transfer of power and functions from central government to parastatal offices (owned or controlled partly or wholly by the central government).

- **Devolution** is the transfer of power and functions from central government to subnational governments.

- Transfer to non-government organizations (also commonly known as privatization) is the transfer of power and functions to entities that are not part of government institutions.

Devolution is the type of decentralization that best captures the essence of function, power, and resource sharing, because in devolution such transfers occur between two government entities: central government and subnational governments, each with its responsibilities (Rondinelli 1990). Similarly, Pollit (1998) argued that devolution is the strongest form of decentralization, as each is a separate legal entity, and therefore the transfer is usually difficult to reverse.

The devolution of public functions refers to the function sharing, the political and administrative authority refers to the power sharing, and fiscal instruments refer to the resource sharing (Pollitt et al 1998). The resource sharing involves the transfer of funds to finance the implementation of devolved functions, commonly known as intergovernmental grants and mostly discussed under fiscal decentralization.

2.2. Fiscal decentralization

Fiscal decentralization is another dimension of decentralization. Subnational governments, regardless of the political or constitutional definition of the nations, are almost never self-sufficient financially, because their ability to generate revenues falls short of their expenditure responsibilities. This makes them depend on financial transfers from central government (Broadway and Shah, 2007).

The definition of fiscal decentralization itself evolves as more researches are conducted and new evidences emerge from its implementation. To this extent, fiscal decentralization has been defined and redefined, reflecting the dynamic of researches in this area. Some definition of fiscal decentralization are: the transfer of authority and responsibility for public functions from the central government to subordinate or quasi-independent organizations or the private sector (Litvack and Seddon 1999), the devolution of power and responsibilities of national (central),
government towards sub-national (local) governments (Neyapti 2005), and the empowerment of people by the (fiscal) empowerment of their local governments (Bahl 2005).

In the definitions above, there are some elements that present in fiscal decentralization: the transfer of public services functions from the higher level to lower level of governments, accompanied by authority and resources to exercise the functions. With regard to this, the working definition of fiscal decentralization in this dissertation is “the devolution of public functions from central government to subnational government with the administrative authority and fiscal instruments to execute such functions”.

Steffenson (2010) mentioned that fiscal decentralization has 3 objectives:

- Improved efficiency: by strengthening the links between the mix of services with the citizens’ demand and needs, being closer and more responsive to the local preference (matching of local preferences);
- Improved financial accountability by bringing the government and decisions closer to the people in terms of options for voice, influence, information exchange, control and monitoring etc., and
- Improved effectiveness: by improving the likelihood of strengthening of competition in public services provision, mobilizing citizens’ contribution, innovation, etc.

Traditionally, there are four pillars in fiscal decentralization: the assignment of expenditure responsibilities, the assignment of revenue and its local administration, the subnational borrowing and debt, and the design and provision of intergovernmental grants. How the pillars are managed highly depends on the choice a country makes regarding its decentralization implementation, such as what functions to decentralize, how to decentralize and to what extent.

Oates (1999) mentioned that the basic issue of the arrangement between levels of government is aligning responsibilities and fiscal instruments at the proper government level.
Thus, it is important to understand which functions and instruments are best centralized, and which are best decentralized. Understanding this will help in exploring the roles of the different levels of government and the ways in which they relate to one another. This is also the subject matters of fiscal federalism.

2.3. Fiscal Federalism Theory

It should be noted that the use of the word ‘federalism’ in fiscal federalism is different from its standard use in political context, in which federalism is associated with a political concept in which a group of members are bound together by covenant with a governing representative head. As a normative concept, federalism is the advocacy of a pragmatic balancing of citizen preferences for (1) joint action for certain purposes, and (2) self-government of the constituent units for other purposes (Ahmad 2010). In political context, federalism is a system based upon democratic rules and institutions in which the power to govern is shared between national and provincial/state governments, creating what is often called a federation.

The word ‘federalism’ in fiscal federalism context does not refer to a specific form of government, neither does it imply that a government should be federal to apply the principles it offered. However, because of the difference in the political context, legislation, and fiscal principles resulting from different forms of government (e.g. whether it is unitary or federal), the application of fiscal federalism principles obviously provide different opportunities and results.

Fiscal federalism is most often used in the earlier studies on the fiscal relation between multi-tier governments, most notably in the works of Musgrave (1959) and Oates (1972, 1993). It is not to be confused with fiscal decentralization. Fiscal decentralization is highly related to fiscal federalism. Generally speaking, the concept introduced by fiscal federalism is put into practice by fiscal decentralization. Sharma (2005) clarified that fiscal federalism constitutes a
set of guiding principles, a guiding concept that helps in designing financial relations between the national and subnational levels of the government. Fiscal decentralization, on the other hand, is a process of applying the principles of fiscal federalism. Boschmann (2008) referred to fiscal federalism as the structure of financial and broader relationships between central and subordinate levels of government. The process of altering the structure of fiscal federalism by devolving powers to lower levels of government is generally known as fiscal decentralization. Essentially, fiscal federalism is a state of affairs, whereas fiscal decentralization is a specific process meant to alter that state of affairs.

Over the years, major theories of fiscal federalism have shifted from an economic efficiency-oriented focus to a broader focus involving social and political factors. The first generation theory (FGT) is largely normative and focused on maximizing social welfare. The second generation theory (SGT) is built on FGT, but assumes that political factors (e.g. the motivation of voters and public officials) can come into conflict with social welfare maximization.

2.3.1. First Generation Theory of Fiscal Federalism

The first generation theory of fiscal federalism (FGT) put more focus on the economic efficiency of decentralization. For this reason, Musgrave (1973) pointed out that public services should be provided and their costs shared in line with the preferences of the residents of the relevant benefit region, and that particular services should be voted on and paid for by the residents of this region. In other words, services with nationwide benefits (e.g. national defense) should be provided by the central government, while those with local benefits (e.g. clean water) should be provided by subnational governments.

Oates (1972) argued that given the required condition, it is always efficient for subnational governments to provide the Pareto-efficient levels of output for their respective regions, compared to the central government. Physical proximity between subnational
governments and local residents is the main argument that subnational governments are more aware about the residents’ preferences and local conditions. The concept is summarized in his classic Decentralization Theorem (Oates 1972:35):

“For a public good the consumption of which is defined over geographical subsets of the total population, and for which the costs of providing each level of output of the good in each jurisdiction are the same for the central or the respective local government—it will always be more efficient (or at least as efficient) for local government to provide Pareto-efficient levels of output for their respective jurisdictions than for the central government to provide any specified and uniform level of output across all jurisdictions.”

In FGT, Musgrave and Oates based their assumption on efficiency grounds, assuming public decision makers are benevolent and act solely on the consideration of maximizing social welfare. To achieve this, government must perform the three functions of the public sector: ensuring efficient use of resources, establishing equitable distribution of income, and maintaining the economy at high levels of employment with reasonable price stability (Oates 1972, 1993)—the three functions are commonly summarized as allocation, distribution, and stabilization.

In the implementation of decentralization, it is crucial that all jurisdictions can exercise their fair share in maximizing social welfare. Taking this point and the public sector functions into account, FGT puts emphasis on correcting the so-called horizontal and vertical inequality. Attempts to correct this lead to the employment of intergovernmental grants, in which higher levels of governments provide funds to lower levels of governments.

2.3.2. Second Generation Theory of Fiscal Federalism

The second generation theory of fiscal federalism (SGT), in addition to economic perspectives, includes other factors such as social and political condition in understanding
decentralization. It is based on first-generation fiscal federalism but assumes that public officials have goals induced by political institutions that often systematically diverge from maximizing the welfare of the residents. Oates (2005) summarized that the second generation of fiscal federalism examines the workings of different political and fiscal institutions in a setting of imperfect information and control, with a basic focus on the incentives that these institutions embody and the resulting behavior they induce from utility-maximizing participants.

SGT departs from the assumptions that participants may have other objectives to maximize, and this can influence the outcome of decentralization through political process. This makes political process and decentralization inseparable. Inman and Rubinfeld (1997) argued that, in addition to the efficiency reason (on which FGT is based), political participation is also among the reasons to consider in the concept of fiscal federalism. For example, the ability of governments to provide public service efficiently may depend crucially on how representatives are selected in the national legislature. Locally chosen representatives may place parochial interests above collective interests in efficient public services. Therefore, the implementation of fiscal federalism necessarily carries with it a balancing of economic efficiency, political participation, and protection of individual rights and liberties.

There is an important point that can be highlighted in the rising of SGT: the presence of incentives can drive away participants involved from the ideal goal of welfare maximization. For this reason, SGT puts emphasis on the importance of fiscal incentives in achieving welfare maximization.

Based on the literature, public service delivery is upheld in FGT and SGT. SGT, however, provides new insights into the principle of fiscal federalism introduced in FGT (Oates 2005). This is not to say that FGT is less important than SGT or vice versa, or that both generations compete with each other. Weingast (2009) pointed out that FGT and SGT are complementary. FGT studies the optimal design of fiscal institutions in the context of welfare maximization without respect to incentives, while SGT extends FGT lessons to the context of
incentives and self-interested political officials.

SGT inspires a new approach in designing decentralization and its instruments, given the more realistic environment where political motives and incentives are inseparable from the decision making process. This condition can also extend to the implementation of intergovernmental grants.

2.4. Intergovernmental Grants

With decentralization, most public service functions are devolved to subnational governments. This requires additional funding. While some subnational governments do not encounter significant problems in generating the funds by themselves, some others may find it impossible to do so. In fact, most subnational governments are almost never self-sufficient financially, because their ability to generate revenues falls short of their expenditure responsibilities. This makes them depend on financial transfers from the central government (Broadway and Shah, 2007), commonly known as intergovernmental grants or intergovernmental transfers.

Intergovernmental grants are one of fiscal decentralization’s pillars. The grants cover a broad range of who gives and receives the grants and what to give as grants. Essentially, intergovernmental grants can be given by central governments to subnational governments, by subnational governments to the central government, and by one subnational government to another subnational government. What to give as grants can also take various forms: cash, goods (both perishable and non-perishable), capital (such as buildings and vehicles), and services (such as training and technical assistance). Despite this broad range, intergovernmental grants most commonly discussed in literature are cash grants from a higher level of government (central government) to a lower level of government (subnational government). Since cash grants are involved in the majority of discussions, some literature uses the terminology of “intergovernmental grants” interchangeably with “intergovernmental transfers”.

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2.4.1. Definition of Intergovernmental Grants

Bahl and Wallace (2007) defined intergovernmental grants as “a grant of funds from the government that raised the funds, to another level of government”. This definition essentially has captured the substance of intergovernmental grants. It should be noted too, however, that in line with the principles of “money follows functions” in fiscal decentralization, the grants of funds should be administered in a way that foster the accountability of all levels of governments involved.

In various forms and for various reasons, central government provides funds to subnational government. But not all of these funds can be classified as intergovernmental grants. Depending on who uses the funds and whose functions are funded, the grants of funds may, or may not, be classified as intergovernmental grants. For the funds to be qualified as intergovernmental grants, the funds recipient must have administrative authority over the funded function.

This issue is especially relevant when we consider the level of decentralization involved, as categorized by Rondinelli (1990). In deconcentration, the power and functions shift within the central government administration (i.e. a line ministry and its branch offices). Therefore, the funds involved only revolve within the central government budget as well. In this case, there are no intergovernmental grants involved. The same case also applies to privatization, in which the funds are transferred to non-governments.

The thin line of the relevance of intergovernmental transfers exists in delegation. In delegation, transfers of power and functions occur to parastatal. Parastatal, according to Oxford Dictionary of English, is “organization having some political authority and serving the state indirectly”. In this context and from the viewpoint of the central government, parastatal may take the form of a subnational government office (which has some political authority in its jurisdiction) receiving assignment from the related line ministry, to execute the ministry’s program on its behalf (thus serving the central government indirectly).
Delegation occurs when, for example, the ministry of public works (central government) assigns local public works department (subnational government) to do the maintenance of interstate highway. Interstate highway is the responsibility of the central government, however for efficiency reason the maintenance may be best delegated to subnational government. In this case, the funds for maintenance are provided by the central government to subnational governments. The funds, however, cannot be considered as funding subnational governments’ functions. This is because the function funded belongs to the central government; subnational government has no administrative authority for the function, it only receives an assignment to execute the central government’s function on central government’s behalf as an agent. As Bird (2000) clarified, this is a top-down approach, in which the focus of evaluation is how well subnational governments serve the central government’s policy objectives.

In a fiscal decentralization context, the grants of funds can only be considered as intergovernmental grants in devolution setting. In devolution, the transfers of power and functions from the central government to subnational governments, which are separate entities, are followed by administrative authority. With this, there is a link between the funds and the functions; an application of “money follows functions” principle. Most importantly, local autonomy prevails in this case. It is a crucial point since it also clarifies that subnational governments are to be accountable for the management of the funds, including planning the utilization, implementing the plan, and reporting the implementation. Bird (2000) called this a bottom-up approach, which focus is on improved governance and allocative efficiency.

The approach is most relevant to a country’s situation, which influences the design of its intergovernmental grants. In this thesis, the approach considered most relevant to intergovernmental grants is the bottom-up approach for 2 reasons: first, bottom-up approach provides funding to execute subnational functions, and second, it preserves local autonomy. Taking all these points into account, the working definition of intergovernmental grants in this
thesis is “grants of funds from central government to subnational governments managed in fiscal decentralization scheme to implement the functions devolved under decentralization”.

2.4.2. Classification of Intergovernmental Grants

The classification of intergovernmental grants can be based on several viewpoints. Tidemand et al. (2003) classified intergovernmental grants based on orientation (development-oriented and non-development oriented), and durability (capital grants and recurrent grants). Broadway and Shah (2009) suggest classifications that include matching grants (require grant recipients to provide counterpart funds) and non-matching grants (no counterpart funds required); closed-ended (grantor put a ceiling on the maximum amount of grants) and open-ended (unrestricted amount).

Many literatures classify intergovernmental grants as conditional grants and unconditional grants (Musgrave 1973, Oates 1972, 1993, Shah 2007, Broadway and Shah 2009, Steffensen 2007). Unconditional grants are often referred to as general-purpose grants, non-specific grants, block grants, or general grants; while conditional grants can also be referred to as specific grants, earmarked grants, categorical grants, restrictive grants, or selective grants. Musgrave (1973), Broadway and Shah (2009), and Steffensen (2010) argued that each type of grant can respond best to a specific issue.

a. Unconditional grants.

Unconditional grants are provided as general budget support with no strings attached, and are intended to preserve local autonomy and enhance inter-jurisdictional equity. These grants are typically mandated by law, but occasionally they may be of an ad hoc or discretionary nature. They simply augment the recipient’s resources (Broadway and Shah 2009).

Because of the inequality in fiscal capacity, it is impossible for all subnational governments to provide comparable level of public services at comparable tax rates
(Broadway 2007). In this case, unconditional grants can be an attempt to equalize the potential of subnational governments to provide comparable level of public services at comparable tax rates. Unconditional grants mainly focus on equalization, bridging inequality, contributing to subnational funding (Steffensen 2010), and avoiding distortions and efficiency costs which arise from tax structure differentials among subnational governments (Musgrave 1973).

For equalization objectives, unconditional grants can reduce the gap between subnational governments’ fiscal capacities, and as a consequence provide a stronger fiscal base for subnational governments to provide public services of a certain standard. From a theoretical point of view, this will enable citizens to have access to public services of the same quality regardless of their domicile. Unconditional grants also arguably enhance the welfare of local residents and preserve local autonomy (Broadway and Shah 2009), because they simply augment the budget resources of the recipient without imposing any conditions on how to spend them. Unconditional grants are considered most suitable when local autonomy is the main concern.

b. Conditional grants

Conditional grants are intended to encourage subnational governments to undertake specific programs or activities. These grants may be regular, mandatory, discretionary, or ad hoc. Conditional grants typically specify the type of expenditures that can be financed (input-based conditionality), but they can also require attainment of certain results of service delivery (output-based conditionality). Conditional grants may or may not incorporate matching provisions – known as conditional matching grants and conditional non-matching grants (Broadway and Shah 2009).

Conditional grants work most effectively to subsidize, providing subnational governments for spillover and externalities (Musgrave 1973, Steffensen 2010, Broadway and Shah 2009). They also encourage subnational governments to undertake specific
activities and to influence local priorities, especially in sectors considered as low priority locally, but high priority nationally (Steffensen 2007). In addition, conditional grants are useful to stimulate behavioral changes, to promote adoption to reform, to encourage cooperation from subnational governments (Lewis and Smoke, 2008), to achieve national minimum standard for public services, to harmonize central and local policies (Broadway 2007, Slack 2009), and to encourage additional resources allocation from subnational governments in expectation that eventually it will replace the central government’s allocation (Broadway and Hobson, 2003).

The grants are also useful to induce subnational governments to increase spending on the assisted functions, particularly when a line ministry within the central government wants to ensure that the recipient local governments spend the funds in the ministry’s area of interest (e.g. health, education, sanitation, etc) without distorting local priorities among alternative activities (Broadway and Shah 2009). The degree of the central government’s influence can be further modified by matching or non-matching and/or closed-ended or open-ended requirements, and by input or output/performance-based approach.

2.5. Accountability in Public Services Delivery

Accountability is a widely used term, but it is rather complex (Mulgan 2000) and not always clear (Schedler 1999). General definitions of accountability include the obligation of actors to provide information about, and/or justification for, their actions to other actors, along with the imposition of sanctions for failure to comply and/or to engage in appropriate action (Brinkerhoff 2004). Cohen and Peterson (1997) described accountability as holding public servants responsible for outcome, efficiency as positive relationship of resource outputs and inputs, and effectiveness as a measure of the appropriateness of output. At a basic level of analysis, many authors agree upon a minimal definition: accountability is an interactive communication between accountor and accountee, in which the former’s behavior is evaluated
and judged by the latter, in light of possible consequences (Schillemans 2008, Meijer and Schillemans 2009).

Accountability implies that an agent explains and justifies his behavior towards a significant other. Here the agent is an actor in the accountability process. Accountability as it is understood here, refers to the processes by which actors provide reasons for their actions and the mechanisms that are designed to ensure these processes (Meijer and Schillemans 2009). Pollitt et al. (1998) mentioned that accountability refers to a relationship in which one party (the accountor) is obliged to render some account of his or her actions (or the actions of a particular organization) to another party (the accountee). Glynn (1993) summarized that accountability is all about responsibility relationship, both externally and internally. An important way to communicate accountability is through the provision of financial and related information, the so-called financial accountability.

In line with Glynn (1993), the World Bank (2004) also views accountability as a responsibility relationship. In its World Development Report 2004, the World Bank defined accountability as “set of relationships among service delivery actors with 5 features: delegating (explicit or implicit understanding that a service will be supplied), financing (providing the resources to enable the service to be provided or paying for it), performing (supplying the actual service), having information about performance (obtaining relevant information and evaluating performance against expectations and formal or informal norms), and enforcing (being able to impose sanctions for inappropriate performance or provide rewards when performance is appropriate)” (World Development Report 2004, p. 48). This definition of accountability is used in this research.

Glynn (1993) mentioned that in public sector, accountability means that those who are charged with drafting and/or carrying out policy should be obliged to give explanation of their actions to their electorate -- the electorate being a composite group that includes clients, employees, and taxpayers. A public agent like subnational governments, however, can only be
held accountable under certain conditions. Khemani (2005) argued that a public agent can be held accountable for a particular aspect of service delivery if: (1) the agent assumes and is assigned responsibility for that aspect of service delivery; (2) the agent has some minimum resources and capacity for that aspect of service delivery; and (3) the agent actually undertakes appropriate actions towards service delivery, given resource and capacity constraints. This implies that subnational governments must be equipped with sufficient authority and resources to exercise their government functions, before they can be held accountable for public service delivery.

The World Bank (2004) mentioned that conceptually, accountability can be achieved through both long route and short-route of accountability. In public services, there are three actors that are involved: governments, citizens, and service providers; each has accountability relationships with another. In the short route of accountability, citizens can directly hold providers responsible for the services they deliver. This is usually the case in public services in competitive markets, where there are options to select providers. Public services in monopolistic markets, on the other hand, operate under a different situation. In this case, holding providers directly responsible is usually unlikely, thus citizens hold the governments accountable, and then the governments hold the providers accountable. This is the long route of accountability. When the relationship along accountability breaks down, service delivery fails. This signifies the importance of promoting accountability in order to improve public services.

Measuring accountability is not always attainable. However, quantitative measurement is not the only way to observe if there’s a change in accountability. Friedman (2009) argued that accountability can be examined quantitatively and qualitatively. Accountability can be measured quantitatively if the numerical scale is known, e.g. in providing the answers to questions such as how much did the accountor do, or how much did the accountor produce. Qualitatively, accountability can be observed from the quality of accountor’s efforts, e.g. in answering questions like how well did the accountor do something, or whether the change the accountor
caused make a *difference*. Whether it is quantitative or qualitative, observing changes in accountability requires a clear definition of the objectives of a policy/program and the development, if practicable, of measures of output and outcome (Glynn 1993). For this reason, stating standards or targets to achieve, and establishing measurement for output or performance, can enable the observation of change in accountability, whether the change itself is quantitative or qualitative.

2.6. Incentives in Intergovernmental Grants: How Incentives Impact Accountability

In many countries, intergovernmental grants make up a significant portion of local governments’ budgets; thus with the implementation of decentralization, the amount of intergovernmental grants tends to increase. This means that more funds are allocated to subnational governments, in light that this will enable them to deliver public services to the citizens, which are now their responsibilities under decentralization.

When it comes to public services, what matters for effective delivery are incentives and accountability structures (Besley and Ghatak, 2003). Incentives are defined as rewards that influence recipients’ behavior and/or decisions. It is the compensation relative to individual, group, or organizational performance; something that influences action (Uzzi 1995); or any gifts and rewards given out on a regular basis (Molenaar et al 2002). Incentives can be non-financial (e.g. acknowledged reputation, voters’ approval, reelection) and financial. A financial incentive can be defined as a monetary transfer, either in-cash or in-kind, provided directly to the recipient with the intention to induce a behavioral change. The transfer can also be made conditional on the behavioral change. Financial incentives can also be provided in the form of an ‘in-kind’ subsidy for a specific activity (Scott and Schurer 2009). Despite the importance of incentives in influencing behavior, many projects and programs aimed at promoting decentralization have been introduced without sufficient attention to the incentives (or disincentives) they create, with respect to dimensions such as revenue mobilization, administrative performance, accountability, and governance (UNCDF 2010).
Funding decentralization with intergovernmental grants provision arguably weakens the accountability to citizens (Shah 2007). In intergovernmental grants, there’s often misunderstanding that the money is ‘somebody else’s’ thus spending efficiency is not a major concern. People tend to be more careful if they spend their own-generated money. Bird and Smart (2002) argued that since intergovernmental grants can be mistakenly perceived as ‘other people’s money’, local citizens do not put as much pressure on subnational government as they would if the money were actually ‘theirs’, as in the case of money generated from local taxes. Rodden (2003) referred to this phenomenon as ‘fiscal illusion’: intergovernmental grants create the appearance that local spending is funded by nonresidents. This view is misleading and as a result, accountability is compromised.

Bahl and Linn (1992) confirm this argument based on their study on developing countries, which pointed out that when the source of funds for local spending is intergovernmental grants, subnational governments are less accountable for their fiscal decision because, with intergovernmental grants, subnational governments can increase spending without increasing local taxes. Other than that, accountability is also compromised when intergovernmental grants are allocated for explicit ‘gap filling’ (i.e., regions with larger deficits receive larger grants). In this case, intergovernmental grants subsidize spending beyond revenues by providing subnational governments with incentives to spend beyond their means (Weingast 2006).

The decisions made by subnational governments (and local parliaments), like those made by the central government (and national parliament) were influenced by incentives they faced (Bird 2000). For this reason, incentives for strategic behavior in managing intergovernmental grants can also be the cause of weak accountability. Strategic behavior is intentional actions directed toward the achievement of a desired goal (Nevis et al 2003). It is not necessarily ‘bad’ behavior, but it can be ‘bad’ if it involves conflicting interests, where a party can gain more by sacrificing other party. In the presence of incentives for ‘bad’ strategic behavior, subnational governments can act at the cost of constituents’ welfare maximization (Oates 1972, 1993,
Vigneault 2007) and public services provision (Vigneault 2007).

An approach to control ‘bad’ strategic behavior, or opportunistic behavior, while at the same time improve subnational governments’ accountability, is by promoting citizens’ control, either direct control or through representative system. When political decentralization is efficient, the local representatives selected in local election (the parliament) should be able to control the behavior of subnational governments, at least to some extent. In addition to parliament control, improved democracy resulting from decentralization enables greater citizen participation and citizen control on governments’ decision (Faguet 2011). Citizen control is a powerful instrument for improving the governance and the actual quality of public services. For example, participatory complaint surveys are an effective method for citizens to monitor public service delivery, provide feedback to service units, and create a culture of citizen engagement and government accountability.

The World Bank (2004), in its accountability relationship framework, summarizes the accountability in public services. According to the framework, the accountability of subnational governments is initially triggered by citizens’ demand for public services. Through various formal and informal political processes, the demand creates incentives for subnational governments to be accountable in delivering public services. However, in many developing countries, the political process often fails to create strong incentives for accountability.

Prud’homme (1995) pointed out that in many developing countries, election results are based on personal, tribal, or political loyalty, and it says very little about local preferences. Electoral mandates are vague and inconsistent, and even though local politicians want to fulfill them, there’s usually mismatch between available resources and promised expenditures. The elected politicians often lack incentives to keep their promises, and even if they don’t, local bureaucracies in subnational government may not be persuaded to cooperate, for they too have good reasons to pursue their own agenda. This makes representative system in political process a weak instrument to create incentives for subnational governments’ accountability.
Citizen control is also weak in many developing countries. OECD (2008) mentioned that in these countries, credibility of political commitment is low. Citizens often lack knowledge and information about what their governments can and must deliver. The outcome of this situation is governments that don’t listen to the citizens and are willing to sacrifice citizens’ benefit to pursue their own objectives. This will result in weak influence of citizens in making governments accountable.

An empirical study by Eckardt (2008) supports this statement. In his study, Eckardt found that poorly performing subnational governments are often deeply rooted in their political and social environment. Weak political incentives may cause ineffective checks and balance, lack of transparency, and failure in translating local citizens’ demand into public spending and policies. If these happen, public service delivery often fails because political and bureaucratic agents face incentives to misallocate public resources.

An example of this situation can be observed in Indonesia. Indonesia’s performance post decentralization big bang exceeded expectations of many. In OECD Economic Survey 2010, Indonesia is praised for “…having made considerable progress over the years in improving social condition of its population, especially among the disadvantaged groups… nevertheless, in some respect, social outcomes remain sub-par in relation to regional peers.” Similarly, Oxford Analytica Daily Brief Service (June 9, 2010), also acknowledges Indonesia’s democratic transition has exceeded expectation. Eckardt (2008) points out that Indonesia has made remarkable progress in creating a decentralized system of government and its decentralization policies neatly reflect the concept of democratic decentralization. With this, hopes are high that decentralization will bring better governance, as well as enhance accountability and performance of subnational governments.

However, years after decentralization was first implemented, public service delivery has been a major issue that is often related to fiscal decentralization. Some major public services sectors, education and health care in particular, need to be paid attention to (OECD 2010).
Despite Indonesia’s democratic transition that exceeds expectation, an accountability gap remains. Political, judicial, and societal checks—which restrain administrative misconduct in long-established democracies—continue to be compromised by deep-seated clientelism. Democratic rules and procedures are not yet sufficient guarantees for adequate provision of public services (Oxford Analytica Daily Brief, June 9, 2010). There is also the possibility that decentralization can increase local elites capturing resources and reorienting policies (and resources) to serve their private interests, rather than the public’s interests. Thus, it is feared that there will be degradation of services formerly delivered by the central government (Eckardt, 2008).

The findings above indicate that citizens’ demand is not always influential enough to enforce subnational governments’ accountability in public service delivery, even when there’s significant improvement in democracy post decentralization. Broadway and Shah (2009) argued that citizens are not always empowered to hold public officials accountable for their non-compliance with their mandates, and/or for corrupt acts or face high transaction cost in doing so. As a result, dysfunctional governance in the public sector results from opportunistic behavior by public officials which may occur, and welfare maximization is no longer the main consideration. This condition is predicted by the second generation theory of fiscal federalism (SGT), which suggests that there are some political factors and incentives issue that influence the outcome of decentralization.

Referring to the accountability relationship framework developed by the World Bank (2004), in which citizens’ demand is assumed to be the trigger for governments’ accountability, the findings suggest that another trigger may need to be developed in case citizens’ demand is insufficient to initiate the accountability. The research argues that intergovernmental grants, if they are enhanced from the traditional form of input-based to performance-based grants (PBG) by incorporating incentives into the grant design, can be an alternative trigger for accountability. The enhancement is crucial because intergovernmental grants, as argued by Shah (2007) are
inherently prone to weak accountability.

The results of intergovernmental grants, whether they are positive or negative, depend on the incentives—intended or not—that are built into the grants system (Smart 2007). Incorporating incentives into the grants’ design is the innovative feature of PBG. Previous research pointed out that incentives have a significant role in determining the final outcome of intergovernmental grants, because incentives can induce certain behavior (Weingast 2009, Lewis and Smoke 2008) and improve accountability (UNCDF 2010), whether it is undesirable or desirable. As incentives for opportunistic behavior can lead to lower accountability (Bahl and Linn 2002, Bird 2000, Shah 2007, Smart 2007, Vigneault 2007), incentives for promoting good governance behavior can also lead to improved accountability and performance (Steffensen and Larsen 2005, Steffensen 2010, UNCDF 2010). Better performing subnational governments were consistently more open to pressure of informed, organized, and political communities, which strengthen their incentives to be accountable, responsive, and manage and deliver services more efficiently (Eckardt 2008). Experiences with foreign aid to developing countries also show that well-designed programs are often not working because they offer little or no incentives to the stakeholders involved. Adding incentive features improves the chance to get more cooperation, resulting in a higher success level of program implementation (Easterly 2002).

For this reason, incorporating the right incentives in intergovernmental grants can make intergovernmental grants recipients become more accountable in exercising their roles—whether it is the function of budget allocation, public service delivery, or other government functions. Taking incentive into consideration in designing intergovernmental grants will increase the chance of improvement in accountability and public service delivery. Given appropriate incentives—in terms of heightened expectations of improved services from their constituents and some access to resources for which they were politically responsible—even very small subnational governments have at times demonstrated significant improvements in administrative capacity within a relatively short time (Fiszbein 1997).
PBG is an option to incorporate incentives in order to improve accountability. In PBG, incentives are used as stimulation to induce desirable behavior from subnational governments, like supporting national priority programs and compliance to regulations and/or standards, which eventually improve accountability. The research argues that an alternative trigger for subnational governments to be accountable in delivering public services, in addition to the citizens’ demand as suggested by the World Bank (2004), can also be embodied in the intergovernmental grants design, by tying the grants transfer (entitlement) to the achievement of a certain performance or standard (attainment).

2.7. Performance-Based Grants (PBG)

Boschmann (2008) mentioned that PBG was first implemented around 1997, with Uganda being one of the first countries to adopt this system. Since 2003, PBG has become a countrywide system, covering all types of subnational governments in the country. Since 2007, PBG is funded entirely from the Ugandan consolidated national budget, but some portions (e.g. assessment cost) are funded by joint donor basket funding arrangement. The implementation of PBG in Uganda has inspired other developing countries to start implementing PBG or to revise current PBG system (e.g. the Philippines, Bhutan, China, Pakistan). Some countries are starting to pilot it (e.g. Laos, East Timor, Bangladesh).

The initiative of PBG is based on the reform to introduce greater incentives to subnational governments, in order to enhance their accountability, capacity, and performance. Being a form of conditional grants, PBG shares similarities with traditional, input-based conditional grants. Both typically specify the type of expenditures that can be financed, and are intended to encourage subnational governments to undertake specific programs or activities, usually those considered as national priority by the central government. As is also the case for conditional grants, both can be used by central governments which often use conditional grants to make subnational governments provide certain public services, especially when they do not provide
such services at the required level out of their own resources (Ahmad and Thomas, 1997).

PBG is to be integrated into intergovernmental grant system, providing subnational governments with tangible incentives to improve their institutional, organizational, and functional performance, thereby reducing the risks associated with intergovernmental grants and making decentralization more effective, efficient, and responsive as a strategy for delivering public services (UNCDF 2010).

2.7.1. Definition of PBG

PBG is a form of specific grants, which operate based on conditionalities. Access to PBG is conditional upon the overall performance of PBG (potential) recipients (e.g. subnational governments), as approved by grantor (e.g. central government). In other words, subnational governments need to show that they have complied with certain criteria or requirements in order to access their grants. Unless they can demonstrate this performance, they are unable to access all or part of their grants. To this extent, PBG can be defined as:

- Grants system that incentivizes improvements in performance by linking local governments’ performance in predetermined areas with both access and the amount of funding. This system is a strong performance-based incentive, coupled with ex-post monitoring and assessments (UNCDF 2010).

- Output-based transfers that link grant finance with the service delivery performance. These transfers place conditions on the results to be achieved while providing full flexibility in the design of programs and associated spending levels to achieve these objectives (Broadway and Shah 2009).

- Transfers intended to influence recipients’ behavior based on certain measures of output or performance, and in doing so, influence targeted performance (Steffenson and Larsen 2005).

A common feature that highlights the definition of PBG is the use of incentives to
encourage certain standards of performance to strengthen the relation between performance and reward. Good subnational government performance, as measured by the fulfillment of related criteria/requirements, is rewarded through eligibility for grants. The theoretical literature suggests that incentives are most likely to be effective for well-defined and measurable behaviors (Scott and Schurer 2009). The employment of performance measurement provides a clear definition of the objectives of a policy/program, and thus satisfies a condition required in accountability as suggested by Glynn (1993). This principle is highly regarded in PBG, in which access to grants will only be possible after all required conditions are satisfied.

Taking all these points into account, the working definition of PBG used in this thesis is grants allocated to subnational governments to finance specific projects, where the transfer of funds is conditional to the attainment of certain standards.3

### 2.7.2. PBG Rationales

UNCDF (2010) mentioned that the overall rationales for PBG is to provide tangible

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3This research used the term ‘performance-based’ to highlight the importance of achievement of performance standard. In addition to the traditional approach that mainly focuses on input-based grants, literature also mentions grants that focus on the opposite side of input, naming the grants as, among others, ‘output-based’ or ‘performance-based’ or ‘outcome-based’. Output, outcome, and performance each have different meanings and represent different stages of a process. Merriam Webster dictionary (Source: http://www.merriam-webster.com/dictionary/output) defines ‘output’ as ‘something produced, e.g. the amount produced at a given time’; ‘outcomes’ as ‘something that follows as a consequence’, and ‘performance’ as ‘something accomplished’.

Referring to this, among the three, output should come first and be measured in terms of quantity. Performance is measured based on what is accomplished by the output (thus emphasizing the quality of the output), and outcome is the consequence of having the output. For example, in a clean water project, the output is piped water connections installed in certain number of households. The performance of the project is demonstrated by how well the connections function, e.g. they provide 24-hour access to clean water. The outcome of the project is the consequence of having the connections, e.g. less health problems (due to increased hygiene) and preserved ground water (because the households replace the use of ground water with piped water).

In this research, output-based grants, performance-based grants, and outcome-based grants are viewed indifferently, that is, as result-based funding. What is highlighted here is the shifting of focus from ‘input’ to its opposite side, namely ‘results’, in providing funds to subnational governments. Pearson (2011) argued that result-based funding has different meaning for different people. There is no commonly agreed definition for result-based funding, and different terms are usually used to explain similar, sometimes even identical, concepts. Some terms frequently used (but not limited to) are: payment by result, result-based, performance-based, and output-based – the latter is also referred to as a subset of the broad family of result-based mechanism in Tremolet and Evans (2010).
incentives to subnational governments to improve their performance by linking their access to grants and/or the amount disbursed to their performance in pre-determined areas. Specific objectives of PBG are as follows:

- Provide incentives to subnational governments to improve in key performance areas and to adhere to national standards.
- Ensure that spending takes place where there is a clear absorptive capacity.
- Supplement capacity building needs assessments and monitoring and evaluation system.
- Improve management and organizational learning.
- Strengthen capacity development effort (focus and incentives).
- Improve accountability.
- Promote a greater level of streamlining, mainstreaming, and coordination of development partners’ support.

Shah (2009) argued that PBG creates an incentives regime to promote the results - based accountability culture. In public service delivery, citizens are the principals and public officials are the agents. The principals have bounded rationality—they act rationally based on the incomplete information they have. In order to have a more informed perspective on public sector operations, they face high transaction costs in acquiring and processing information. On the other hand, agents (public officials) are better informed and their self-interest motivates them to withhold information from the public domain as the release of such information contributes to their being held accountable. This asymmetry of information allows agents to indulge in opportunistic behaviors which go unchecked due to high transaction costs faced by principals and a lack of or inadequacy of countervailing institutions to enforce accountable governance. Results based accountability through the use of output - based grants empowers citizens by enlarging their information base and lowering their transaction costs in demanding action.
UNCDF (2010) argued that PBG increases the odds to break the vicious cycle of ineffectiveness, and promote the virtuous cycle of improvement, illustrated in Figure 2.1 below:

**Figure 2.1. Vicious Cycle of Ineffective Subnational Governance**

- Weak institutional capacity of subnational governments
- Citizens discount subnational government relevance, low pressure for performance
- Reinforced by disjointed capacity building response, inadequate/unpredictable funding, weak performance incentives
- Low impact of subnational government development spending

Source: UNCDF (2010), adapted from Yongmei Zhou (2007)

As shown in Figure 2.1, weak capacity of subnational governments is magnified by, among other, lack of performance incentives. Because of this, subnational government only creates low impact by its development standing, resulting in local citizens’ discounting their government’s relevance. Eventually, this will make citizens put low pressure on subnational governments, leaving the capacity of subnational government weak.

Arguably, the incentives feature in PBG can break the cycle, turning the vicious cycle into a virtuous cycle illustrated in Figure 2.2 below:

**Figure 2.2. Virtuous Cycle of Effective Subnational Governance**

- Subnational government units can learn by doing, develop capacity and establish track record
- Subnational government units increasingly exercise authority and accumulate capacity for inclusive and accountable local governance
- Citizens perceive increased relevance of subnational government units, bottom-up pressure for accountability.
- Reinforced by coherent capacity building response, increased performance-based transfer of funds to subnational government units, strong performance incentives

Source: UNCDF (2010), adapted from Yongmei Zhou (2007)
As shown in Figure 2.2, PBG provides incentives for subnational governments to develop capacity and focus on accountability; they will start to deliver public services according to the expectation of citizens. This will increase citizens’ perception of the government’s relevance, increasing the bottom-up pressure for accountability. Eventually this will form accountability culture in subnational governments, fostering subnational government units to develop greater capacity.

It is important to note that, in order to achieve the expected results, PBG needs to be complemented and coordinated with other measures, such as fiscal and institutional reforms. PBG is not equally effective in all environments or circumstances, and are most useful and effective when these following prerequisites, among other, are in place (Steffensen 2010):

- Strong policy support for performance incentives and the political will to cope with pressure from subnational governments that are performing poorly.
- Based on solid analytical work, documentation of strengths and weaknesses of previous approaches.
- PBG is robustly and carefully designed with significant involvement from key-stakeholders: core ministries, development partners, subnational governments, etc.
- The overall subnational government framework is conducive for PBG approach.
- Capacity building arrangement is appropriate, linked to performance assessment, and allows for a sensible mix of supply and demand driven approaches.
- PBG operations, measures, and outcomes are highly transparent and publicly disclosed, particularly with respect to the results of regular subnational government performance assessments.

2.8. PBG’s Supporting Theories

The emergence of SGT recognized the existence of political and social choice, and how they create incentives for certain behavior. While efficiency assumption still holds, as it did in
FGT, SGT acknowledged that by itself, efficiency consideration cannot motivate everybody involved—politicians, government officials, and other stakeholders—to work effectively toward economic welfare. Incentives are arguably a factor worth considering in the design of system and mechanism addressing community welfare.

As a means to support public service delivery, intergovernmental grants are also exposed to the idea of incentives. Performance-based grants, as noted earlier, are a product of incorporating incentives into intergovernmental grants. The idea of performance-based grants arises from New Public Management (NPM), New Institutional Economics (NIE) (Broadway and Shah 2009, Shah 2010), and managerialism.

2.8.1. New Institutional Economics

According to Klein (1999), the term New Institutional Economics (NIE) was first introduced by Williamson in 1975. NIE attempts to understand the institutions of social, commercial, and political life using a combination of interdisciplinary approaches including economics, organization theory, law, sociology, and anthropology. The heart of NIE, however, is economics. The goal of NIE is to explain what institutions are, how they arise, what purpose they serve, how they change, and how they should be reformed.

Institution is rules of a society that facilitate coordination among people by helping them to form expectation, which each person can reasonably hold in dealing with each other (Ruttan and Hayami 1984). It is also incentive systems that guide human behavior, which consists of formal rules, (e.g. constitutions, laws, regulation), put in place by the government and informal constraints (e.g. norms of behavior, codes of conduct) (North 2008). By setting the rules, institution influences the choice and behavior of people and organizations, the rules form humanly devised constraints that shape human interaction (North 1990), and facilitate the coordination of relationships between individuals, people, or organizations (Herath 2005).
North (2008) explained that NIE emerged as a response to the limitation of neoclassical economic theory that does not address how to create efficient market. It focuses on already developed market and does not explain the role of political market, assuming frictionless market (it can work without government or institution), static implication on policy (not accounting for time, history, and the way humans learn), and ergodic worldview (world with constant underlying economic structure, like in natural science). Though some assumptions in neoclassical theory remain useful (e.g. price theory), the world is dynamic with continuous change, with new economic models and theories being developed over history. This is why the assumptions of frictionless market, static implication, and constant underlying economic structure do not hold.

To correct this, North argued, the assumptions need to be improved by recognizing the role of institutions, considering time change and human learning over time, and understanding fundamental change over time. Institutional change involves purposeful and calculated human efforts, and its pursuance is motivated by favorable results to the wellbeing of a particular person or group. It involves human intentionality, which is the very heart of society. Institutions that reward productivity and creativity are required for economic growth.

NIE acknowledges the important role of institution in economic development (Herath 2005) and that it has important effect on economic performance (Joskow 2008). The effects of alternative public policies aimed at improving performance in various dimensions will vary along with the institutions that are available to respond to them.

Institutional arrangement is another aspect of NIE. In this arrangement, agreements are made by individuals to govern their relationship. Such agreements are embodied in contracts. A complete contract specifies a course of action, a decision, or terms of trade contingent on every possible future state of affairs (Klein 1999). A contract can be considered as actual means of coordination, organizing coordination among agents, based on a set of mutually agreed promises (Brosseau 2008). It can be an analytical tool to identify whether agreements are settled,
and an enforcement tool to take action when the agreements are violated.

Many contracts can be analyzed in light of this agency problem. Contracts specify the relationship between two parties, i.e. agent and principal, and defining for whose interest the agent is supposed to act. The relationship, according to Toye, can be problematic if principal is not perfectly informed at zero cost about the action of the agent (and this is usually the case), resulting in opportunistic behavior by the agent which benefits himself while at the same time reduces the welfare of the principal (Toye 1995).

Two points can be drawn from NIE. First, institutions – or incentives, as North put it – that facilitate efficiency is vital to the success of an organization. The theory acknowledges the importance of human intention behind each decision, and that incentives drive human’s choice toward a particular action. Second, contracts are crucial to analyze the relationship between interested parties and to foster coordination based agreements between the parties. These points are adapted in performance –based grants.

2.8.2. New Public Management

Rhodes (1996) stated that New Public Management (NPM) design initially comes from the “marriage” of opposites, that is of managerialism and NIE. In public administration, managerialism is held most dearly by members of the managerial class, that places faith in the ability of managers to provide for the needs of society by application of specialized skills and knowledge. The ideology rests on the value of efficiency (including economic efficiency which emphasizes the pursuit of maximum output with minimum input), that provides guidance to managers in the application of their expertise toward the achievement of organizationally defined goals (Edwards 1998). In a general sense, managerialism in public services is characterized by the belief that the objectives of the services can be promoted at lower cost when the appropriate management techniques are applied (Cutler and Waine, 1998 in Clarke et al., 2000). Rhodes (1996) summed up that term managerialism refers to introducing
business-type management practice to the public sector. It emphasizes professional management, explicit standards and measures of performances, managing by results, value for money, and is costumer oriented.

The NPM refers to introducing incentives structure (such as market competition) into public services provision. It emphasizes disaggregating bureaucracies, greater competition through contracting out and quasi market and consumer choice. In NPM, government is assumed to be entrepreneurial; it shares a concern with competition, markets, customers, and outcomes. This transformation of the public sector involves ‘less government’ (or less rowing), but ‘more governance’ (or more steering) (Rhodes 1996).

NPM is an approach that seeks to emulate private-sector practices by (1) treating beneficiaries of public programs as customers, (2) highlighting what products the customers want, (3) using competition among potential sources (public and private), and (4) using other innovative forms of motivation to improve how agencies provide products customers want (Camm and Stecher 2010).

A central feature of NPM is a greater emphasis on performance measurement and indicators. In order to improve public sector efficiency and effectiveness, most governments in developed nations now stress performance budgeting and performance management, a move that represents a significant shift in public management from controlling input and procedures to achieving results measured in term of output and outcomes (Haque 2007). Jun (2009) mentioned performance management and output as major ideas of NPM. Other ideas include structural devolution and decentralization, vertical coordination and autonomy within a single agency, managerialism and management techniques, market driven techniques, competition, and citizens as customers.

Several OECD studies characterize the term NPM as constituting a unified, consistent and coherent set of ‘business-like’ or neo-managerial practices, focusing exclusively on aspects of public governance. It is a continuously monitored management-by-objectives,
with accountability for results (Raghavan 2004). NPM is referred to as a pattern of policy and practice described as a style of organizing public services. Hood (1991) stated that most discussion of NPM stressed a set of doctrines: professional management in the public sector, explicit standards and measures of performance, greater emphasis on output controls, shift to greater competition in the public sector, stress on private sector styles of management practice, and stress on greater discipline and parsimony in resource use. Not all of the doctrines are equally present in all cases, nor are they necessarily fully consistent, partly because they do not have a single intellectual provenance.

Raghavan (2004) argued that a doctrine is a view of how a single organization design should be resolved. The doctrines of NPM reveal a set of principles, devised to bring out the nature of NPM and its workings. The impact of assessing NPM can be divided into two broad classifications: general impact and particular impact. The following table summarizes some of the impact of NPM:

<table>
<thead>
<tr>
<th>General impact</th>
<th>Particular impact</th>
</tr>
</thead>
<tbody>
<tr>
<td>Close to customers</td>
<td>Savings (reduced budget appropriations)</td>
</tr>
<tr>
<td>Performance-driven</td>
<td>Improved processes (faster/accessible complaint procedures)</td>
</tr>
<tr>
<td>Commitment to continuous quality improvements</td>
<td>Improved efficiency (better input-output ratios)</td>
</tr>
<tr>
<td>Highly decentralized, with street staffs empowered to be more flexible and innovative.</td>
<td>Greater effectiveness (less functional illiteracy, crime and inequality, more employment)</td>
</tr>
<tr>
<td>Practicing tight cost controls</td>
<td>Resilience of administrative system</td>
</tr>
<tr>
<td>Using performance-related systems for recruiting, posting, promoting and paying staff.</td>
<td>An increase in overall capacity/flexibility (better committed staff/skilled public servants)</td>
</tr>
</tbody>
</table>


The introduction of NPM gained positive attention in the field of public management, but it does not mean that this approach is not subject to critiques. Haque (2007) pointed out that NPM lacks coherent analytical framework, and that the discussion of NPM has often been
fragmented, inconsistent, technical, and uncritical. Hughes (2008) argued that there has never been a clear exposition of what is involved in NPM and that there is no theory of bureaucracy that clearly sets out this approach.

The field of public management keeps progressing with the emergence of the so-called post-NPM approach, aimed at correcting the shortcomings of NPM. Even though its heyday has passed, the three-fold legacy of NPM, as noted by Lynn (1998), remains:

- A stronger emphasis on performance-motivated administration and inclusion in the administrative canon of performance-oriented institutional arrangements, structural forms, and managerial doctrines fitted to particular contexts—in other words, documented advances in the state of public management art;
- An international dialogue on and a stronger comparative dimension to the study of state building and administrative reform; and
- The integrated use of economic, sociological, social-psychological, and other advanced conceptual models and heuristics in the study of public institutions and management, with the potential to strengthen the field’s scholarship and the possibilities for theory-grounded practices.

2.8.3. **The Theories’ Influence on PBG**

As argued by Broadway and Shah (2009) and Shah (2010), PBG emerged from NIE and NPM, while NPM, according to Rhodes (1996), emerged from NIE and managerialism. Figure 2.3 below summarizes the influence of the theories on PBG.
The principles of NIE, managerialism, and NPM are adopted in PBG. NIE acknowledges the importance of incentives in guiding human behavior, and this principle is adapted in PBG as its design is intended to encourage desirable behavior from grant recipients. Managerialism promotes the introduction of business-like values such as efficiency and performance measurement. The measurement is an important part in PBG, as access to the grants depends on whether a certain performance standard is achieved. NPM strongly emphasizes performance and orientation on results, rather than input, which also becomes a feature in PBG. The focus on incentives suggested by NIE and the emphasis on performance introduced by NPM are highlighted in the design of PBG (Shah 2010). In PBG, the incentive
feature presents itself in a way that recipients must achieve certain performance in order to access the grants. This is the innovative side of PBG: using incentives to encourage the desirable behavior (e.g. improved performance, better accountability) of grant recipients, by linking to resources (funding) and the attainment of certain requirements based on measured criteria.

2.9. PBG and Traditional, Input-based Conditional Grants

The main difference of these two lies in conditionalities of funds transfer. Traditional, input-based specific grants provide the funds regardless of observation of a certain standard, while PBG can only provide such funds after the standard attainment is observed. Performance-based grants link grant finance with service delivery performance. The grants place conditions on results to be achieved while providing full flexibility in the design of programs and associated spending levels to achieve the objectives (Shah 2006).

The difference can have significant impact because, by insisting on standard attainment, an accountability culture is promoted; the point is made clear that the grants are to support the provision of public services, not merely to finance the spending of subnational governments. Another point is that there is a link between input (intergovernmental grants) and performance (public service delivery). This direct link between input and output is not usually present in the design of traditional specific grants. The comparison of traditional specific grants and PBG is summarized in the table below:

<table>
<thead>
<tr>
<th>Feature</th>
<th>Traditional grants</th>
<th>PBG</th>
</tr>
</thead>
<tbody>
<tr>
<td>Grant objectives</td>
<td>Spending levels</td>
<td>Quality and access to public services</td>
</tr>
<tr>
<td>Grant design and administration</td>
<td>Complex</td>
<td>Simple and transparent</td>
</tr>
<tr>
<td>Eligibility</td>
<td>Recipient government departments/agencies</td>
<td>Recipient government departments/agencies and non-government providers. In case of the latter, the funds are first received by the recipient government before used by the providers.</td>
</tr>
<tr>
<td>Condition</td>
<td>Expenditures on authorized functions and objects</td>
<td>Output-service delivery results</td>
</tr>
<tr>
<td>-----------</td>
<td>-----------------------------------------------</td>
<td>--------------------------------</td>
</tr>
<tr>
<td>Allocation criteria</td>
<td>Program or project proposals approvals with expenditure details</td>
<td>Demographic data on potential clients</td>
</tr>
<tr>
<td>Compliance verification</td>
<td>Higher level inspections and audits</td>
<td>Client feedback and redress, comparison of baseline and post grant data on quality and access</td>
</tr>
<tr>
<td>Penalties</td>
<td>Audit observation on financial compliance</td>
<td>Public censure, competitive pressures, voice and exit options for clients</td>
</tr>
<tr>
<td>Managerial flexibility</td>
<td>Little or none. No tolerance for risk, and no accountability for failure</td>
<td>Absolute. Rewards for risks but penalties for persistent failures</td>
</tr>
<tr>
<td>Local government autonomy and budgetary flexibility</td>
<td>Little</td>
<td>Absolute</td>
</tr>
<tr>
<td>Transparency</td>
<td>Little</td>
<td>External, competition, innovation, and benchmarking</td>
</tr>
<tr>
<td>Focus</td>
<td>Internal</td>
<td>External, competition-based.</td>
</tr>
<tr>
<td>Accountability</td>
<td>Hierarchical to higher-level government, controls on input and process with little or no concern for results</td>
<td>Result-based, bottom-up, client-driven</td>
</tr>
</tbody>
</table>

(Source: Broadway and Shah 2009)

By moving away from systems characterized by general unconditional grants and conditional grants based on discretionary functions, PBG can foster local autonomy on conditions that it is accompanied by sound and unambiguous guidance, clear requirements, capacity building, and other support. Shah (2007) argued that generally, emphasizing result-based accountability can thrive if the following elements are present:

- Contracts or work program agreements based on pre-specified output and performance targets and budgetary allocation
- Replacement of lifelong rotating employment with contractual appointment with task specialization
- Managerial flexibility, but accountability for results
- Redefinition of the public sector role as purchaser, but not necessarily provider of public services
- Adoption of subsidiarity principle—that is, public sector decisions made at the level of government closest to the people, unless a convincing case can be made not to do so
- Incentives for cost efficiency
- Incentives for transparency and competitive service provision
- Accountability to taxpayers

Experience has shown that if the right incentives are provided to subnational governments, sector-wise controls and earmarking of funds can be relaxed without compromising national target and priorities, while at the same time fostering good governance (UNCDF 2010). The argument that incentives can foster fiscal management and accountability is also mentioned by Feruglio and Andersen (2006). However, it is most important to note that PBG approach in isolation should not be seen as a panacea for all the problems associated with decentralization. The overall policy environment, confusing or contradictory policy arrangements, civil-service constraints, and other such factors can make it very difficult for PBG to achieve the desired results. This highlights the need to keep sight of the wider picture in designing PBG for local governments (UNCDF 2010).

It should be noted, too, that the systems of performance-based allocations such as PBG are not equally suitable for all types of grants and for all expenditure areas. It is therefore important to define how PBG fit into the overall architecture of intergovernmental fiscal relations and to ensure that PBG can be articulated with other grant schemes, and are integrated into the overall intergovernmental fiscal relation. The overall intergovernmental relationship between the central government and subnational governments should be considered, as well as the incentives or disincentives it provides for local governments’ performance.

2.10. Countries Experiences in Incorporating Incentives in Intergovernmental Grants

Although not always specifically named PBG, some OECD countries have embedded fiscal incentives into their intergovernmental transfer systems for years, to stimulate spending in particular areas—through matching grants, grant access conditions, minimum service standards, and requirements for specific actions to be accomplished in order to get access to grants.
(UNCDF 2010).

The Canadian Government, for example, provides health grants to the provinces, provided only if the provinces satisfy a number of minimum conditions, such as open and equal access to health facilities and no billing of clients. Failure to meet these conditions can lead to the withdrawal of federal support or a reduction in the grants (Shah 2006). The US Government, under Race to the Top Competitive Program, allows states to apply for education grants if, among other things, they comply with requirements for progressive improvement in standards and access, including reforms in procedures for certification and evaluation of teachers and principals (Shah 2009). In the UK, local authorities in agreement with central government select a number of indicators for measurement and can then receive up to 2.5% of their budget as reward for good performance (Kaiser 2009).

In Japan, incentives are applied in public works plan. Local governments in Japan have independence to decide a significant portion of public works projects. Because of this, it is possible for local governments to make decision that is not in line with the central government’s priorities. To address this, the central government established guidance on public works plans. The instruments of this guidance include direct or indirect regulations, fiscal or non-fiscal incentives and persuasion. Purpose-specific grants (subsidies) are often used to lead local governments to such projects that the central government intends. In addition to the usual purpose-specific subsidies, some special budget measures are set for the implementation of development plans and public works projects (Bessho 2010). Public works expenditures for road projects, forest road projects, and urban planning projects are stipulated by law and must be implemented according to comprehensive plans to conform to national standards (Mochida 2006).

Some developing countries also have included incentives and implemented performance-based approach in its fiscal system. A study by UNCDF (2010) sampled six African countries (Uganda, Kenya, Tanzania, Ghana, Sierra Leone, and Mali) and six Asian
countries (Indonesia, Lao PDR, East Timor, Solomon Islands, Nepal, and Bangladesh) that have implemented PBG initiatives either in piloting or country-wide stage. The study also evaluates the potential of PBG implementation in another three Asian countries (Philippines, Bhutan, and Pakistan).

Uganda, for example, implemented PBG for capital and poverty-related investments. Conditionalities to access the grants includes linkage between the development plan and investment plan, availability of budget and budget framework paper, functional internal audit, three-year local government revenue, and the enhancement plan. Grants recipients are also required to provide co-funding and establish a special account to manage the grants. Another example is Kenya, which implemented PBG for capital investments, service delivery, and debt servicing. Conditionalities to access the grants include the availability of debt-recovery plan, revenue enhancement plan, service delivery plan, and citizen participation in preparation of service-delivery plan (UNCDF 2010).

Funding public services with performance-based approach was applied in Indonesia in 2009, to finance piped drinking water service expansion in Surabaya, the second largest city in Indonesia. The project is funded by the World Bank and Global Partnership for Output-Based Aid (GPOBA), a partnership of donors and international organizations working together to support output-based aid (OBA) approaches. OBA and PBG approach works under the same principle: both link incentives with performance and funding. The difference is that, under OBA, the funds are not provided as intergovernmental grants, instead the funds are transferred directly to water supply company (World Bank and GPOBA 2009).

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4 Members of GPOBA include AusAID (the Australian Government agency responsible for managing Australia’s overseas aid program), Department for International Finance Development/DFID (a part of the UK Government that manages Britain’s aid to poor countries and works to get rid of extreme poverty), Swedish International Development Cooperation Agency/SIDA (a Swedish government agency under the Ministry for Foreign Affairs), International Finance Corporation/IFC (a member of the World Bank Group), and World Bank. GPOBA’s mandate is to fund, design, demonstrate, and document OBA approaches to improve delivery of basic infrastructure and social services to the poor in developing countries (Source: www.gpoba.org).
In principle, as far as the project quality is concerned, OBA required accountability and performance to access the funds inasmuch the same way as PBG. However, in OBA system, the accountability relationship exists between the companies (as service provider) and the central governments (the Ministry of Public Works), instead of local government. Considering the devolution of water service function to local governments, this practice was not supportive to the implementation of decentralization. In decentralization, local governments are supposed to be in charge of public service delivery, and should be involved in the funds provision. OBA, although arguably benefited local citizens, put less emphasis on the accountability in its relation to decentralization. The funds to finance public service in the region is not managed by the related local governments, offering little or zero incentives for local governments to actively participate in the service delivery.

2.11. Gap in Literature Reviews: Areas that Need More Exploring

The literatures provide valuable contribution to the understanding of decentralization and intergovernmental grants, as well as of accountability and incentives. There are findings that accountability involves relationships between stakeholders in public service delivery. The literatures also point out that, even though citizens welfare maximization is supposed to be the main decentralization objective, there are plenty of evidences showing that local governments can act against the citizens’ interest in the presence of incentives for opportunistic behavior. The findings clearly suggest that incentives can influence decision, choice, and behavior, which eventually impact accountability.

The literatures provide many different insights on how incentives and accountability relates to local governments’ behavior when it comes to managing financial resources – namely intergovernmental grants – in decentralization context. However, the areas explored by previous research are mostly related to intergovernmental grants in general public service delivery. An area that is not yet widely explored by previous research regarding decentralization and
intergovernmental grants is how the accountability and incentives work in specific case, such as in monopolistic public services. This research tries to contribute to this area by analyzing if incorporating incentives in intergovernmental grants can be an alternative to improve local governments’ accountability in public services, especially when the service is monopolistic.

Especially in Indonesia case, how the incentives work in decentralization scheme is almost an untouched subject. This may be due to the fact that Indonesian intergovernmental grants have never explicitly stated the employment of incentives until the implementation of PBG in 2010. Given the relatively short period since its implementation, research on PBG in Indonesia is relatively rare. This research tries to investigate the impact of PBG implementation on Indonesian local governments’ accountability, and to identify the needs for PBG in Indonesia intergovernmental grants system.
CHAPTER III
CONCEPTUAL FRAMEWORK AND HYPOTHESIS

From the literature reviews in Chapter II, it can be observed that previous research found various experiences and evidence that incentives play a significant role in determining the result of decentralization, for example through the political system and resources allocation such as intergovernmental grants. When incentives for opportunistic behavior are present, the utilization of resources is very likely to serve other interests beside public welfare maximization. On the contrary, incentives for accountable behavior, are conducive to the improvement of public services. Previous research also indicates that the traditional form of intergovernmental grants that put a heavy emphasis on input result in weak accountability (Shah 2007, Broadway and Shah 2009).

Related to the previous findings and the theories that underlie them, the research argues that incentives which encourage desirable behavior need to be incorporated in the design of intergovernmental grants. There are many options to decide what behaviors are to be considered as ‘desirable’, depending on what objectives to achieve. In this research, the desirable behavior is behaviors that foster accountability in public services; that is, behaviors that demonstrate that the actor responsible for public service delivery is performing its responsibility in the best possible way considering its capacity.

The discussion in this chapter will mainly focus on how the incentives influence the accountability in public service delivery. This chapter describes how performance-based grants (PBG) work in using the incentives feature to improve public services, and how the actors involved in public service delivery are responsible to other actor(s) in accountability relationships. Based on these, a research conceptual framework and hypothesis are developed.
3.1. PBG Framework

PBG framework describes how incentives, performances, and accountability are linked in intergovernmental grants. The framework is developed based on efficiency in public service delivery suggested by the first generation theory of fiscal federalism (FGT) and second generation theory of fiscal federalism (SGT), through the introduction of incentives as suggested in the New Institutional Economics (NIE), and performance as proposed by the New Public Management (NPM).

Given the increased autonomy under decentralization, in many cases, the effectiveness and efficiency of public service delivery are the most highly ranked characteristics of the autonomous subnational governments (Nikolov 2005). Efficiency in public service delivery is a message of FGT and SGT. SGT, however, added that there are certain political and social factors that influence behavior, and that the factors can distract decentralization from its goal to deliver improved public service. In other words, under certain influences, people involved in decentralization may choose a decision that is not maximizing the welfare of local citizens, as in the case of agency problem (Toye 1995, Shah 2010). This point is also acknowledged in New Institutional Economics (NIE), which stresses the role of incentives in driving behavior. Incentives that facilitate efficiency are vital to success in achieving objectives.

How incentives can facilitate efficiency depends on to what areas incentives are given, and the areas can cover a broad range. To name a few, the areas can cover subnational administrative issues (e.g. budget reporting and bookkeeping), technical issues (e.g. infrastructure quality and durability), as well as social and political issues (e.g. public participation in policy making process). Despite choices on areas to cover, ideally incentives should foster efficiency (Steffensen and Larsen 2005). Stressing performance is a way to improve efficiency in public sector management. The idea of performance-oriented, result-based approach is suggested by the New Public Management (NPM), shifting the traditional emphasis on input and procedures to performance.
The points of NIE and NPM, which are incentives and performances, are adopted in the theoretical frameworks as factors that are interconnected with effective decentralization funding. To drive the utilization of decentralization funding toward improving public service, the incentive factor needs to be considered. This is because incentives can affect behavior, and efficiency reason alone is not enough to drive such behavior toward maximization of local citizens’ welfare. There are social and political motives that influence subnational governments’ decisions.

PBG incorporate the idea of linking incentives, performance, and funding to improve accountability and to deliver improved public service. Figure 3.1 below describes how PBG works to achieve the objective.

Conceptually, PBG gives incentives to grant recipients to make appropriate choices. In the decentralization scheme, the appropriate choices can be shown by, for example, supporting
national priority programs or prioritizing certain public services. The incentives focus on performance achievement in order to gain access to funding. The funding is subject to conditionality; it cannot be accessed unless certain performance targets and standards are achieved. A contract is enacted between grant recipients (e.g. subnational governments) and grantor (e.g. central government) to set the rules of PBG implementation. The contract specifies the performance targets and standards to be achieved, and eligibility, terms, and conditions to access the funds.

The specified target and standards are useful to maintain quality and improve accountability. To achieve this, it is also important that transparent procedures are present, flow of funds is properly administered (Boschmann 2008), and results attainment is emphasized (Shah 2010). PBG provides such elements: PBG arrangement and implementation are specified in a contract, while access to funds is subject to performance achievement.

The implementation of PBG in decentralization encourages subnational governments to use their autonomy to make an appropriate decision, which in this case, the decision that will enable improved performance, accountability, and service delivery. The autonomy of local governments in decision making, and how the decision can be influenced by incentives, is explained in the decision space approach below.

3.2. Incentives: A Decision Space Approach to Influence Choice

Decentralization enables a higher level of autonomy to subnational governments in planning and decision-making process in political, administrative, and fiscal aspects, in expectation that this will make subnational governments make choices that better match local needs and preferences. Thomas (1998) proposed the term ‘decision space’ to describe the range of effective choice that is allowed by the central authorities (the principal) to be utilized by local authorities (the agents). Decision space is designed for various functions and activities over which local authorities will have increased choice.
According to Thomas (1998), the decision space approach takes into account (1) the incentives that central government can offer to subnational governments to encourage them to make decisions that can help achieve the decentralization objective, (2) the subnational governments’ characteristics that influence decision making and decision implementation at the local level, (3) innovation resulting from exercising the liberty to make local choices, and (4) the impact of local choice on performance. The decision space approach is summarized in Figure 3.2 below:

The decision space approach suggests that the central government can introduce change in performance through (1) centralized directed change, and (2) incentives and decision space. With decentralization implementation, subnational governments have higher autonomy that gives them more decision space. This means that local governments have more room to make decisions regarding local policies, as decision space allows subnational governments to make choices. The choices may stimulate them to make innovation, or to maintain the current...
condition. Thus the result of the choice can be observed in performance, whether the performance is increased, decreased, or stagnant.

How the subnational governments use their decision space depends on their characteristics. However, this is not the only influential factor. According to Figure 3.2 above, how the subnational governments use their decision space can also be influenced by the introduction of incentives. Provided the right incentives, subnational governments’ decision can be steered, to some extent, toward a certain direction. If incentives for innovation are employed, it can be expected that subnational governments will make decisions that foster innovation. On the other hand, if the incentives are for status quo, no changes are expected. The incentives can be developed further to have impact beyond subnational governments’ decision, for example by incentivizing performance improvement.

Decision space approach is also useful to influence accountability. Thomas and Mitchell (2011) argued that decision space and accountability are decentralization dimensions that are interrelated in improving public service delivery in a decentralization framework. Concerning decision space and accountability, decision space increases the responsiveness of subnational governments’ choices to uphold local priority, which strengthen their accountability. In return, with improved accountability, subnational governments are encouraged to use their decision space to make appropriate choices.

In a decision space approach, decentralization is seen as a set of functions and degrees of choices that are formally transferred to subnational governments (Thomas 1998). This extends to the choice of intergovernmental grants utilization made by subnational governments. Though mainly determined by the central government in allocation, once intergovernmental grants are managed in the subnational budget, the subnational governments’ decision plays a significant role in shaping the impact of grants on public service delivery. For this reason, decentralization programs should consider incentives that can drive the subnational governments’ decision on intergovernmental grants management in the subnational budget, so as to encourage local choice
towards improving accountability and achieving the decentralization objective, which is public service improvement.

3.3. Accountability Relationship Framework

In decentralization, public service delivery is mainly the responsibilities of subnational governments. In exercising their responsibilities, subnational governments can deliver the services by themselves, in which case the governments are directly accountable to citizens. Another option is subnational governments delegating the delivery to service providers. When a public service is delivered by the service providers, the accountability relationship is no longer only between citizens and subnational governments, but extends to (1) the accountability relationship between subnational governments and the providers, and (2) the accountability relationship between citizens and the providers.

The World Bank (2004) in its World Development Report 2004 developed an accountability relationships framework between three actors in public service delivery: clients, providers, and policymakers. As discussed in the previous chapter, many authors agree upon this minimal definition of accountability: an interactive communication between accountor and accountee, in which the former’s behavior is evaluated and judged by the latter, in light of possible consequences (Schillemans 2008, Meijer and Schillemans 2009). In its framework, the World Bank puts an emphasis on relationships between actors, and maintains the minimal definition of accountability in which interactive communication between accountor and accountee is highlighted.

Actors in public service delivery is defined as individuals, households, communities, firms, governments, and other public, nongovernmental, and private organizations that finance, produce, regulate, deliver, or consume services. In economic theory the actors who hold others accountable are sometimes called principals, and the actors who are held accountable are called agents. Actors include:
- **Clients/citizens**: Service users who as citizens participate individually or in groups (e.g., labor unions) in political processes to shape and attain collective goals. As clients, individuals receive services to satisfy their household demand. All clients are citizens (in most settings) but, depending on the service, not all citizens are clients.

- **Politicians/policymakers**: The service delivery actors authorized by the state to discharge its legislative, regulatory, and rule-making responsibilities. Politicians may be elected or achieve their positions through nondemocratic means. They can also be policymakers (e.g. the general who is president but also runs the military, the telecom minister who administers the sale of frequencies). But more commonly policymakers are the highest nonelected officials—either from a civil service or appointed. Politicians set general directions. Policymakers implement these directions and set and enforce the conditions for public and private service providers to operate. Usually accountability sub-relationships between politicians and policymakers are derived from the constitution, administrative law, or rules of public administration.

- **Providers**: Public, private nonprofit, and private for-profit entities that actually provide services. These may range from government line ministries with hundreds of thousands of employees to a private hospital chain, or from a vast urban water utility to a single, community-run, village school (The World Bank in World Development Report 2004, p. 48).

According to The World Bank (2004), in the accountability relationships framework, citizens are the clients of public services such as health, education, and drinking water. As clients, citizens have a relationship with public service providers, such as hospitals, schools, and water companies. The relationship here is different from services offered in competitive markets. In competitive markets, citizens can directly hold providers accountable for the services by rewarding providers with repeat business (if they are satisfied) or by imposing penalty through legal and social sanctions (if they are dissatisfied). This is the short route of accountability—there
is direct accountability of providers to citizens.

Public services, on the other hand, operate under a different situation. Citizens do not seek public services in competitive markets; instead public services are demanded from the governments as policymakers. The governments then have the providers deliver the services. Therefore, the citizens hold the governments accountable, and then the governments hold the providers accountable. This is the long route of accountability. When the relationship along this route breaks down, service delivery fails. The relation between the three actors–policymakers, clients, and providers–can be summarized in Figure 3.3 as follows:

The relationship of accountability between citizens and providers is client power. Client power is based on transactions through which citizens express their demand for services and can monitor supply and providers. Between governments and providers, the relationship is compact: the broad, long-term relationship of accountability connecting governments and providers.
Usually compact is not as specific and as legally binding of contract, but an explicit contract can be a form of compact. Lastly, the relationship of accountability connecting citizens and governments is voice (and politics). This is the most complex relationship of accountability, comprising many formal and informal processes including voting and electoral politics, lobbying and propaganda, lobbying and clientelism, media activities, access to information, etc. Citizens delegate to governments the functions of serving their interests and finance the governments through taxes. The governments perform by providing services. In this case, citizens enforce accountability through voice and politics, such as elections, as well as less definitive means, such as advocacy and legal actions.

As competitive markets is not usually the case in certain public services, service providers like electricity companies and water companies become monopolistic. With the absence of competitors, enforcing accountability through the short route (where the citizens as clients can directly hold the providers accountable) does not work effectively. Therefore, the long route of accountability becomes the option to demand the providers’ accountability. In the long route, the citizens hold the providers accountable by holding the governments accountable for public service delivery. The providers themselves are held accountable by the governments, instead of by the citizens. It is the governments that will ensure the service delivery by the providers.

A similar concept of accountability is suggested by Meijer and Schillermans (2009), who argued that the route to accountability consists of direct and indirect accountability. Similar to the long route of accountability, indirect accountability involves governments as an intermediate between citizens and the public sector organization that provides services. Direct accountability (also known as citizens accountability or horizontal accountability, a similar concept to the short route of accountability), on the other hand, enables citizens to directly hold the providers accountable for their services. According to them, direct accountability refers to mechanisms and practices where public sector organizations directly account for their conduct in the
broadest sense of the words to citizens, clients or more generally to societal stakeholders. It is a contemporary extension of the system of accountability and a reinstatement of the original idea of democratic accountability to citizens.

3.4. Research Conceptual Framework

The conceptual framework used in this research is developed based on the idea of using incentives to motivate subnational governments to use their decision space in making appropriate choices (Thomas 1998), as well as to improve accountability, performance, or results (Shah 2010). Steffensen and Larsen (2005) argued that incentives need to be linked with performance as this promotes accountability in local decisions, which finally results in the improved service delivery—or in other areas targeted for improvement.

The conceptual framework is mainly adapted from the accountability relationships framework developed by the World Bank (2004). The conceptual framework is developed assuming decentralization, in which there’s a relationship between central and subnational governments in delivering public service. Figure 3.4 below illustrates the conceptual framework in this research.

![Figure 3.4. Research Conceptual Framework](image.png)
The framework above is seen from the long route of accountability, as in the case of monopolistic public services. In the long route, the framework begins with demand from citizens to governments (central and subnational) for good public services. Responding to this, the governments then make efforts to deliver the citizens’ demand. Within the government itself, there’s also a coordination to improve public service. In decentralization, the central government devolves public service functions to subnational governments, and thus subnational governments have the main responsibilities to deliver the services. In the framework, it is assumed that instead of delivering the services themselves, subnational governments assign service providers to deliver the services. The framework concludes with the service providers, responding to the assignment, delivering good public services to the citizens.

The accountability relationships framework, however, only works under ideal conditions. Halpern et al. (2008) argued that the ideal conditions that need to be present are (1) citizens that demand accountability, probity, and good public services from their governments and service providers, (2) political actors or service providers who are motivated to respond to this demand. (3) sufficient information for the citizens to understand the level of service and probity delivered, and (4) functional feedback systems through which the citizens can reward or punish political actors and service providers according to their behavior.

The first condition, citizens’ demand for good public services, is a general case everywhere, and thus this condition is reasonably satisfied in almost all situations. The fulfillment of other conditions, however, is rather uncertain. Subnational governments and service providers are not always motivated to respond to citizens’ demand (the second condition), and information is not always made available for citizens (the third condition). This situation may arise from, among others, the absence of a functional reward and punishment system (the fourth condition), and the weak influence of citizens’ demand on subnational governments’ decisions (the first condition is satisfied but it is not enough to make the governments respond).
From this viewpoint, the ideal conditions for the long route of accountability can be seen as interrelated, rather than independently separate from each other. This also confirms the significance of incentives in guiding behaviors. The outcome of the unfulfillment of the ideal conditions is that the accountability relationships do not work properly, and public service delivery is compromised.

The research argues that since the delivery of public services in decentralization is the main responsibility of subnational governments, strengthening accountability frameworks can also be started within the decentralization process by providing the right incentives to subnational governments. What is considered as ‘the right incentives’ may vary; in most developed countries, citizens’ demand may be a sufficient incentive to force subnational governments to take action. In most developing countries, the case may be different, thus a different incentives scheme needs to be employed.

The accountability relationships framework suggests that citizens’ demand is the trigger to incentivize subnational governments to ensure good public service delivery. But is it the only trigger?

Referring to the framework, the research analyzes how incentives can come from a different source other than citizens’ demand. One notable source of incentives is within the decentralization system itself by incorporating incentives in intergovernmental grants. In many developing countries, intergovernmental grants are one of the subnational governments’ main revenues; therefore, it is crucial that intergovernmental grants promote the right incentives for the achievement of decentralization objectives, e.g. through intergovernmental grants design that put emphasis on performance and promote accountability in public service delivery.

3.5. Hypothesis

Previous research points out that the results of intergovernmental grants depend on the
incentives in the grant system (Bird 2000). For this reason, increasing intergovernmental grants without considering the incentives effect are unlikely to positively impact public service delivery. If the right incentives are provided, the incentives can foster efficiency (Steffensen and Larsen 2005), good governance (UNCDF 2010), and accountability (UNCDF 2010, Feruglio and Andersen 2006).

Based on these findings, the research argues that the same principle will also work in Indonesia, and proposes the following hypothesis: “PBG improves public service in Indonesia by strengthening local governments’ accountability in the service delivery.” A case study in Indonesian drinking water service will be used to observe whether incorporating incentives in intergovernmental grants positively impacted local governments’ accountability in delivering public service.

The hypothesis will be verified using the long route of accountability in the research conceptual framework described in Figure 3.4. As suggested by the previous findings, the long-route of accountability is usually the case for public services with no competitor (World Bank 2004, Schillemans 2008, Meijer and Schillemans 2009). In Indonesia, drinking water service fits this condition.

To evaluate whether accountability improved with the implementation of PBG, compared to the condition before PBG, the research will evaluate whether the five accountability features introduced by the World Bank (2004) are observed:

- Delegating. Is there a clear understanding about what subnational governments must do in delivering a specific public service?
- Financing. Do subnational governments have financial capacity to deliver the service? If they do, do they make the financial support (such as investments and subsidies) available?
- Performing. Do subnational governments, or the service providers they appointed, actually supply the service?
- Having information about performance. Is such information made available to all actors in
the service delivery, e.g. the governments (central and subnational), citizens, and service providers?

- Enforcing. Is there a reward and punishment system as a consequence of delivering the service?

Referring to the research background in Chapter I, the research focuses on the impact of incentives in intergovernmental grants in improving local governments' accountability in public service delivery, with these research questions to explore: (1) Does PBG strengthen the accountability in public service delivery? (2) If so, how does PBG strengthen the accountability? and (3) Is PBG generally applicable to local governments in Indonesia?
Decentralization is not a new concept to Indonesia. In its history, Indonesia has been undergoing centralization and decentralization several times. The last policy endorsing decentralization made it effective again as of January 1, 2001.

Current decentralization in Indonesia applied three decentralization modes of decentralization: deconcentration, delegation, and devolution (Ferrazzi 2008). To make clear which level of government is responsible for what, the governments’ functions are divided between central government and subnational governments (i.e. provincial and local governments), and resource sharing is organized to provide financial support in exercising the functions.

The objective of this chapter is to review the implementation of decentralization in Indonesia, how it is financed, and how it affects public service delivery in general. This chapter describes how decentralization operates in the country’s political and administrative system. Function division between levels of government and how it is funded will also be discussed. The focus of this chapter is the financial aspect of decentralization, or fiscal decentralization, which is embodied in intergovernmental grants. For this purpose, the management of intergovernmental grants will be discussed from both national budget and subnational budget standpoints. Lastly, this chapter presents several public service indicators to give a brief overview of public service’s current state in comparison with the condition before the decentralization.

4.1. Brief History of Indonesian Decentralization

The history of decentralization in Indonesia can be traced back to 1903 when Indonesia was a Dutch colony. With the enactment of the Dutch Decentralization Law of 1903, local
council for autonomous residencies and municipalities in Indonesia were created. To implement the law, the Dutch colonial government issued a decree regarding the principles of formation, arrangement, position, and authority of a council who would manage the finance that had been split (LAN 2003).

When Japan occupied Indonesia from 1942 to 1945, the situation of wartime demanded centralization of power. After Indonesian independence in 1945, the country became a republic, and the Indonesian governments started to rearrange the relation between central and subnational governments. A law to redefine the structure of governments at the local level was issued in the same year. The structure was further elaborated in 1948. In 1957, the government issued a law to provide some degree of power to subnational governments. This policy was soon changed when Indonesia entered a more authoritarian period under Old Order regime, called ‘Guided Democracy’, in 1959. In 1965, a law reinforcing centralization was enacted. When the New Order regime took over the power in 1967, centralization was pervasive, with central government controlling all aspects of governments including politics, public administration, and fiscal balance. Another law issued in 1974 stipulated the principles of such arrangements. The centralized control was exercised through all levels of bureaucracy and military, creating discontentment in many regions (Satriyo et al. 2003).

In 1998, following the Asian financial crisis that also hit the country severely in 1997, the activities of separatism movement escalated. Demand for independence was strongly voiced mainly by regions rich in natural resources, arguing that central government had been over-exploiting the regions’ resources while abandoning the welfare of local people. The discontentment that had been deeply rooted during the fallen New Order regime emerged and was considered a threat to the unity of the nation. Decentralization was seen as one of the alternatives to avoid national disintegration. Responding to this, two laws concerning decentralization were issued in 1999, and Indonesia effectively implemented decentralization on January 1, 2001. Both laws were later replaced by new laws in 2004, and to date the
implementation of decentralization in Indonesia is based on the laws. Figure 4.1 below summarizes the milestone of Indonesian decentralization.

Decentralization in Indonesia includes administrative, fiscal, and political decentralization. Under administrative decentralization, Indonesian government shares its power and functions through deconcentration, delegation, and devolution. As for fiscal decentralization, the four pillars of fiscal decentralization can be observed in Indonesia: the assignment of expenditure responsibilities, the assignment of revenue and its local administration, the subnational
borrowing and debt, and the design and provision of intergovernmental grants. All of the four pillars are present in Indonesian laws concerning fiscal decentralization.

4.2. Administrative Division under Decentralization

Indonesia is divided into provinces (provinsi), which are further divided into regencies (kabupaten) and cities (kota). Provinces, regencies, and cities have their own subnational government and local parliament (Regional People’s Representatives Assembly/Dewan Perwakilan Rakyat Daerah/DPRD). Provinces are headed by governor (gubernur), regencies by regent (bupati), and cities by mayor (walikota). Regencies and cities are at the same government level.

Regencies and cities are divided into districts (kecamatan), headed by head of district (camat). Districts are further divided into villages (desa) and towns (kelurahan). Desas are headed by head of desa (kepala desa), while kelurahans are headed by head of kelurahan (lurah). Generally, desa is considered more rural than kelurahan. Figure 4.2 below describes the Indonesian structure of government.
Since the implementation of decentralization in 2001, the number of provinces, regencies, and districts has increased. When decentralization was first implemented, Indonesia consisted of 31 provinces, and 348 cities and regencies. A decade after decentralization, the number of provinces is 33, while the number of cities and regencies is 497. Rapid increase in the number of cities and regencies occurred in 2002 and 2003. Table 4.1 below presents the change in the number of provinces, cities and regencies from 2001 to 2011, and Table 4.2 summarizes the number of Indonesian subnational governments (provinces, regencies, cities, districts, and villages and towns) as of January 2011:

### Table 4.1. Number of Provinces, Cities and Regencies

<table>
<thead>
<tr>
<th>Year</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
<th>2011</th>
</tr>
</thead>
<tbody>
<tr>
<td>Provinces</td>
<td>31</td>
<td>32</td>
<td>32</td>
<td>33</td>
<td>33</td>
<td>33</td>
<td>33</td>
<td>33</td>
<td>33</td>
<td>33</td>
<td>33</td>
</tr>
<tr>
<td>Cities and Regencies</td>
<td>348</td>
<td>385</td>
<td>434</td>
<td>434</td>
<td>434</td>
<td>434</td>
<td>459</td>
<td>489</td>
<td>491</td>
<td>491</td>
<td>497</td>
</tr>
<tr>
<td>Total</td>
<td>379</td>
<td>417</td>
<td>466</td>
<td>467</td>
<td>467</td>
<td>467</td>
<td>492</td>
<td>522</td>
<td>524</td>
<td>524</td>
<td>530</td>
</tr>
<tr>
<td>% increase</td>
<td>-</td>
<td>10.03%</td>
<td>11.75%</td>
<td>0.21%</td>
<td>0.00%</td>
<td>0.00%</td>
<td>5.35%</td>
<td>6.10%</td>
<td>0.38%</td>
<td>0.00%</td>
<td>1.15%</td>
</tr>
</tbody>
</table>


### Table 4.2. Number of Indonesian Subnational Governments

<table>
<thead>
<tr>
<th>Type</th>
<th>Number</th>
</tr>
</thead>
<tbody>
<tr>
<td>Provinces (Provinsi)</td>
<td>33</td>
</tr>
<tr>
<td>Regencies (Kabupaten)</td>
<td>399</td>
</tr>
<tr>
<td>Cities (Kota)</td>
<td>98</td>
</tr>
<tr>
<td>Districts (Kecamatan)</td>
<td>6,994</td>
</tr>
<tr>
<td>Village and Town (Desa and Kelurahan)*</td>
<td>77,565</td>
</tr>
<tr>
<td>*(Desa=69,249 Kelurahan=8,216)</td>
<td></td>
</tr>
</tbody>
</table>

(Source: Minister of Home Affairs Decree No. 66/2011)

### 4.3. Decentralization Laws and Regulations

Indonesian decentralization, and in particular fiscal decentralization for intergovernmental grants, is regulated in several laws and governments regulation. The laws

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5 According to the Decree of the People’s Representative Assembly (“Ketetapan MPR”) No.
that directly touched the issue of decentralization are Law No. 32/2004 and Law No. 33/2004. Both laws are derived from previously enacted laws, which regulated areas related to fiscal decentralization, and are detailed in several government regulations. Figure 4.3 below summarizes the legal framework of Indonesian fiscal decentralization.

III/MPR/2000 on The Source of Law and Hierarchy of Laws, the Indonesian basic hierarchy of laws are:
1. Undang-Undang Dasar 1945 (the “Constitution”). It can only be amended by MPR.
2. Ketetapan Majelis Permusyawaratan Rakyat (the “Decree of the People’s Representative Assembly”), is made by MPR.
3. Undang-Undang (the “Laws”), is joint agreement between President and DPR.
4. Peraturan Pemerintah Pengganti Undang-Undang (the “Regulation in Lieu of Law” or “Interim Law”), is made by President.
5. Peraturan Pemerintah (the “Government Regulation”), is made by President.
6. Keputusan Presiden (“Presidential Decree”), is made by President.
7. Peraturan Daerah (“Regional Regulation”), is joint agreement between the head of subnational government and local parliament/Regional People’s Representative Council (Dewan Perwakilan Rakyat Daerah/DPRD).

According to the Constitution (chapter 5 verse 2), President issues Government Regulation to implement a Law. This becomes the basis for issuing government regulation after the enactment of law. Government regulation details the mandates of law for effective implementation.
Calavan et al. (2009) pointed out that during the first years of decentralization, subnational governments went ahead of the political pace of decentralization in the early years. For this reason, the latest laws included various provisions reminding subnational governments that they are part of a hierarchical system and impose clearer limits on their authority. Some notable points in Law No. 32/2004 are:

- Subnational governments “have relations” with central government and other regional governments. The “relations” shall include authority, finance, public service, and exploitation of natural resources (article 2, paragraph 4 and 5).
- The principles of sharing authority and management is to be divided based on criteria of externality, accountability, and efficiency with due attention to “harmonious relations
between government strata”. Provincial, regency, and city governments are all related, interdependent, and synergistic as parts of one government system (article 11).

- Central government assumes the role in “supervision” of regional governments, including (1) supervision of implementation of government affairs; and (2) supervision on regional ordinances and regulations issued by the local executive (article 218, paragraph 1).

- Clarification that fostering and supervision of management (1) for regional governments at the national level will be coordinated by the Ministry of Home Affairs; (2) for the regency or city by the governor; and (3) for village or neighborhood governments by the regent or mayor (article 222).

Law No. 32/2004 mainly regulates the assignments of expenditures, responsibilities, and revenues and its local administration. Other aspects of public administrations such as local election and subnational governance are also elaborated. This law also serves as a reference in Law No. 33/2004 in regulating the funding of such assignments. Law No. 33/2004 mainly regulates the financial relation between central and subnational governments, including regional borrowings and intergovernmental grants.

Law No. 32/2004 and Law No. 33/2004 were later derived in several government regulations that further detailed the law implementation. In 2005, a set of government regulations concerning fiscal decentralization were issued (Government Regulation No. 54, 55, 56, 57, and 58/2005). Areas covered by the government regulations include intergovernmental grants (consist of ‘balancing funds’ and other grants), regional borrowings, regional financial management, and regional finance information system. In 2007, functional sharing between central governments, provincial governments, and local governments was also enacted in a government regulation (No. 38/2007). In 2008, another government regulation (No. 7/2008) concerning the funding of the central government’s functions was issued, to make more explicit the functions to be exercised by each level of government. At a more technical level, government regulations can be derived in ministerial decrees.
4.4. Functions Sharing and Funding

Determining the design of fiscal decentralization that works well for a country should start with determining the power and functions to be decentralized, and to what level the decentralization will be implemented. Rondinelli (1990) put the emphasis on the alignment of responsibilities between levels of government, recognizing that not all functions of a nation should be decentralized. Some that are essential to the survival of a nation, services that benefit from economies of scale and standardization in production, that depend on large networks of facilities or a hierarchy of services, that can only be distributed equitably by a government large and powerful enough to redistribute wealth in the face of opposition, that create territorial spillover effects, or that depend on massive capital investments, may be better administered by central governments than by decentralized units.

Similarly, Ter-Minassian (1997) mentioned that, while decentralization in spending responsibilities can entail substantial welfare gain because of efficiency in the allocation of resources, centralized functions are efficient for national public goods, whose benefits extend nationwide or whose provision is subject to substantial economic of scale.

The main shift of power after decentralization is to local governments. With decentralization focusing on regencies and cities, its implementation results in local governments receiving a substantial share of functions devolution, which is public service functions, and decentralization funding. Local governments, who are assumed to have the best knowledge of their regions’ and peoples’ potentials, are expected to be the ‘development engines’ by utilizing those potentials. Local governments are expected to plan regional development, formulate regional policies, and execute the policies in a way that is accommodative and responsive to the regions’ conditions.

The mandate for functions sharing is stated in Law No. 32/2004. It is then explained further in Government Regulation No. 38/2007. According to the regulation, for the central government, government functions consist of absolute functions and concurrent functions.
a. **Absolute functions**

Absolute functions are functions which are exclusively of the central government, consisting of 6 functions: international politics, fiscal and monetary, defense, religions, national security, and system of law.

b. **Concurrent functions**

Concurrent functions are functions other than the six absolute functions. In each function, specific tasks are divided between each level of government (central, provincial, and local governments) with consideration of externality, efficiency, and accountability. Concurrent functions assigned to subnational governments consist of obligatory functions (public services), and discretionary functions (management of local potential).

As for subnational governments (provincial and local governments), government functions consist of obligatory functions and discretionary functions.

a. **Obligatory functions**

Obligatory functions are government functions which are related to basic public services that must be provided by provincial and local governments.

b. **Discretionary functions**

Discretionary functions are real government functions that have the potential to improve local citizens’ welfare in accordance with local conditions, uniqueness, and local potentials.

Financial support for subnational governments to exercise public service functions is regulated in Laws No. 33/2004. According to the laws, subnational revenues come from 3 sources:
- own-source revenues (locally-raised revenues in a region, collected based on subnational government regulation in implementation of decentralization).
- balancing funds (a component of intergovernmental grants; funds from the national budget
allocated to regions to finance the needs of the regions in implementation of decentralization).

- other revenues (revenues other than own-source revenues and balancing funds, e.g. grants from third parties, donation, and intergovernmental grants other than balancing funds)

Own-source revenues are in most cases not sufficient to finance the implementation of decentralization. This makes financial support from central government the main source of revenue in a subnational budget. Balancing funds are the most notable in terms of nominal value. The funds are part of intergovernmental grants. Intergovernmental grants other than balancing funds (i.e. emergency funds, grants including PBG, adjustment funds, and special autonomy funds) are classified as ‘other revenues’ in a subnational budget. Figure 4.4 below summarizes the functions sharing and funding between central government and subnational governments:

![Figure 4.4. Functions Sharing and Funding](image-url)

Sources: Summarized from Government Regulations No. 38/2007 and No. 7/2008
As illustrated in Figure 4.4, the financial aspect of decentralization is to be managed in national and subnational budget. According to the laws, functions which are the central government’s responsibilities (absolute functions and concurrent functions) are funded by national budget. Similarly, functions which belong to subnational governments (obligatory functions and discretionary functions) are funded by subnational budget. Consequently, the funding of central government’s functions is to be administered in national budget, and that of subnational governments is to be administered in subnational budget.

4.5. Intergovernmental Grants

Intergovernmental grants are the main revenues source for most Indonesian subnational governments. According to the Ministry of Finance (2010b), the objectives of intergovernmental grants are:

- Improving local fiscal capacity and reducing both vertical imbalance and horizontal imbalance.
- Harmonizing funding needs in regions with regard to government functions sharing between central, provincial, and local governments.
- Improving the quality of public service delivery and reducing the gap in public service delivery between regions.
- Supporting fiscal sustainability and macro economy policies.
- Improving regions’ competitiveness.
- Improving local governments in exploring regions’ economic potentials.
- Improving the efficiency of national resources utilization.
- Synchronizing national development programs with local development programs.

To achieve the objectives, different types of intergovernmental grants are used. There are five components of intergovernmental grants to date, each of them can be categorized into two major classifications: unconditional grants and conditional grants.
4.5.1. Intergovernmental Grants Components

Figure 4.5 below summarizes the components of intergovernmental grants.

Figure 4.5
Indonesian Intergovernmental Grants

1. Balancing funds

According to Law No. 33/2004, balancing funds are funds from national revenue, allocated to regions to finance regions’ needs in the implementation of decentralization. Balancing funds consist of three elements: the general allocation funds (Dana Alokasi Umum/DAU), specific allocation funds (Dana Alokasi Khusus/DAK), and revenues sharing funds (Dana Bagi Hasil/DBH). Under current laws and regulations, all local governments will receive at least one element of balancing funds. DAU are general grants or unconditional grants.

a. General Allocation Funds (Dana Alokasi Umum/DAU)

Referring to Law No. 33/2004, DAU comes from national revenue, allocated to achieve horizontal fiscal balance and to finance regions’ needs in the implementation of decentralization. At the beginning of the implementation of
decentralization, a hold harmless policy was imposed on the DAU, much more to the extent of political rather than financial interests. Hold harmless policy required that current year’s DAU should not be less than the previous year’s. This policy prevented the horizontal imbalance between regions from reducing, as well as decreased local governments’ incentives to be more efficient in planning their budget and in implementing their programs. Hold harmless policy was abolished in 2008. For most local governments, DAU is used to finance administrative expenditures, especially official salaries.

Currently, a formula approach is applied in the calculation of DAU to each local government. This approach has enabled central governments to keep already prosperous regions from receiving too many funds, and to maintain proper spread of general allocation funds to needy regions. Some regions with high fiscal capacities are also excluded from DAU allocation, based on the formula.

As unconditional grants, DAU can be used according to local priorities without intervention from central governments. DAU is transferred to subnational governments every month in a year, in an amount equal to 1/12 of annual DAU allocation.

b. Specific Allocation Funds (Dana Alokasi Khusus/DAK)

DAK is defined in Law No. 33/2004 as funds from national revenue allocated to certain local governments to finance specific functions, which are local governments’ functions and parts of national priority programs. DAK is conditional/earmarked grants and formula-based. The central government decides which local government is to receive DAK based on general criteria, specific criteria, and technical criteria. Most subnational governments rely on DAK to finance capital expenditures. DAK is matching grants as well, requiring subnational government to allocate at least 10% of DAK nominal value as
counterpart funds in a project.

DAK is formula-based, and it targets sectors considered as national priorities. The sectors may change every year, depending on central government policies. DAK is transferred to subnational governments in three installments, 30%, 45%, and 25% of annual DAK allocation, respectively.

c. Revenue Sharing Funds (Dana Bagi Hasil/DBH)

According to Law No. 33/2004, DBH is funds from national revenue, allocated to regions based on percentage to finance regions’ needs in the implementation of decentralization. There are two subjects of DBH: taxes and natural resources. DBH is formula-based.

According to Government Regulation No. 55/2005, DBH is shared between central, provincial, and local governments. Table 4.3 and Table 4.4 summarize the sharing of DBH Taxes and DBH Natural Resources among central and subnational governments.

### Table 4.3.
Sharing of DBH Taxes

<table>
<thead>
<tr>
<th>Taxes</th>
<th>Central Government (%)</th>
<th>Subnational Government (%)</th>
<th>Transfer time</th>
</tr>
</thead>
<tbody>
<tr>
<td>Property taxes</td>
<td>10</td>
<td>90</td>
<td>Weekly</td>
</tr>
<tr>
<td>Property acquisition taxes</td>
<td>20</td>
<td>80</td>
<td>Weekly</td>
</tr>
<tr>
<td>Personal income taxes</td>
<td>80</td>
<td>20</td>
<td>Quarterly</td>
</tr>
<tr>
<td>Tariffs on tobacco products</td>
<td>98</td>
<td>2</td>
<td>According to regulation</td>
</tr>
</tbody>
</table>

### Table 4.4.
Sharing of DBH Natural Resources

<table>
<thead>
<tr>
<th>Natural resources</th>
<th>Central Government (%)</th>
<th>Subnational Government (%)</th>
<th>Transfer time</th>
</tr>
</thead>
<tbody>
<tr>
<td>Forestry</td>
<td>20</td>
<td>80</td>
<td>Quarterly</td>
</tr>
<tr>
<td>General mining</td>
<td>20</td>
<td>80</td>
<td>Quarterly</td>
</tr>
<tr>
<td>Fishery</td>
<td>20</td>
<td>80</td>
<td>Quarterly</td>
</tr>
<tr>
<td>Oil</td>
<td>84.5</td>
<td>15.5</td>
<td>Quarterly</td>
</tr>
<tr>
<td>Gas</td>
<td>69.5</td>
<td>30.5</td>
<td>Quarterly</td>
</tr>
<tr>
<td>Geothermal</td>
<td>20</td>
<td>80</td>
<td>Quarterly</td>
</tr>
</tbody>
</table>
DBH sharing of subnational governments is further divided between provincial and local governments, and some are subject to redistribution to all local governments in the same provinces. Some part of DBH share of the central government is also subject to redistribution.

DBH has the same characteristics as unconditional grants, except for DBH natural resources from oil and gas. For revenues from oil and gas, provincial governments are required to allocate 0.1% of the amount for elementary education, while local governments are required to allocate 0.2% for the same sector.

2. ‘Grants’ (Hibah)

Before discussing ‘grants’ (written in apostrophe), it is important to explain that the word ‘grants’ here is a terminology referring to a component in Indonesian intergovernmental grants. Throughout the previous chapter, and for the rest of the dissertation (unless mentioned otherwise), the word grants (without apostrophe) represent a concept in which central government transfers some amount of funds to lower level of governments.

Referring to the word grants as a concept, all components in Indonesian intergovernmental transfers qualified as grants. Referring to the word ‘grants’ as a terminology, Law No. 33/2004 defines ‘grants’ as local government revenues from foreign government, foreign organizations/institutions, central government, domestic organizations/institutions, and individuals in the form of foreign currency, Indonesian rupiahs, goods and/or services including experts and training that do not require repayments. PBG is classified under this category.

The terms and conditions of ‘grants’ are stipulated in ‘grants’ agreements between
the central government and recipient local governments; therefore, ‘grants’ can be customized according to the type of projects and goals to accomplish. ‘Grants’ can be designed as unconditional or conditional. The existence of ‘grants’ agreement is the point that distinguishes ‘grants’ from other intergovernmental grants components. While the other components are regulated by a one-size-fits-all guideline, ‘grants’ agreement is customized according to individual recipient condition and is more legally binding. In Indonesian intergovernmental grants system, PBG is classified as ‘grants’.

3. Emergency Funds (Dana Darurat)

In Law No. 33/2004, emergency funds are defined as funds from national revenue allocated to regions facing national-scale disaster, extraordinary situation, and/or solvability crisis. The funds are earmarked grants. Until 2012, emergency funds have never been allocated in the national budget. If emergency funds are to be allocated, they must be used to address specific purposes according to Law 33/2004, thus the funds are conditional grants.

4. Special Autonomy Funds (Dana Otonomi Khusus)

According to Law No. 18/2001, No. 21/2001, and No. 35/2008, special autonomy funds are funds allocated to finance the implementation of special autonomy in certain regions. Regions classified as special autonomies are stated in laws. Currently, three provinces are designated as special autonomies: Aceh, Papua, and West Papua. All cities and regencies in those provinces, as a result, also gain this status.

As special autonomous regions, the provinces enjoy administrative, political, and financial privilege. The financial privilege is in the form of additional DAU and DBH natural resources in oil and gas. Except for additional 2% of total national DAU allocation for Papua and West Papua provinces, special autonomy funds are unconditional grants.
5. Adjustment Funds (Dana Penyesuaian)

Unlike other grants which establishments and allocations are mandated in specific laws, adjustment funds are established every year in a law of the national budget. Unlike other laws, the law of the national budget is implemented in current fiscal year only, as each fiscal year requires a new law. Specific laws, on the other hand, are implemented until they are abolished. Since adjustment funds are only stated in the law of the national budget, the funding is rather ad-hoc.

The creation of adjustment funds is arguably to support regions in executing specific national policies established by the central government and the parliament (Dewan Perwakilan Rakyat (DPR)/People’s Representatives Assembly). Adjustment funds consist of several components, which names or terminologies varied from year to year. Despite the terminologies, adjustment funds have specific purpose, thus qualified as conditional grants.6

4.5.2. Intergovernmental Grants in National Budget

The allocation of intergovernmental grants in central government budget is generally formula-based. Of all components of intergovernmental grants, balancing funds (consisting of DAU, DAK, and DBH) are the most significant in nominal value. Until now, intergovernmental grants were dominated by unconditional grants, especially in the form of balancing funds DAU. Theoretically, this should enable subnational governments to exercise their fiscal autonomy by managing their budget according to local priorities. Table 4.5 below summarizes the allocation of intergovernmental grants in the national budget from 2005 to 2010.

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6 Adjustment funds raise concerns because political intervention by DPR seems to dominate its creation. Kumorotomo (2010) argued that this situation is motivated by interests to allocate more funds to certain regions in case such allocation is not possible under DAU and DAK. After hold-harmless provision was abolished in 2008, regions are not guaranteed increasing DAU allocation. Similarly, in DAK allocation, the employment of formula also prevents the assurance of increasing DAK allocation. To make up for the decreased funding, adjustment funds were introduced. The Ministry of Finance (2010b) confirmed that the components of adjustment funds are not yet formula-based or allocated according to a set of criteria, but the government is working to resolve the problem.
### Table 4.5
Intergovernmental Grants Allocation in National Budget

<table>
<thead>
<tr>
<th>Components</th>
<th>Allocation per year and % of Gross Domestic Products (GDP)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2005</td>
</tr>
<tr>
<td>Total Balancing funds</td>
<td>143.3</td>
</tr>
<tr>
<td>DBH</td>
<td>50.5</td>
</tr>
<tr>
<td>DAU</td>
<td>88.8</td>
</tr>
<tr>
<td>DAK</td>
<td>4.0</td>
</tr>
<tr>
<td>Total special autonomy funds and adjustment funds</td>
<td>7.2</td>
</tr>
<tr>
<td>Special autonomy funds</td>
<td>1.8</td>
</tr>
<tr>
<td>Adjustment funds</td>
<td>5.5</td>
</tr>
<tr>
<td>Total intergovernmental grants</td>
<td>150.4</td>
</tr>
</tbody>
</table>

(Source: Indonesian Ministry of Finance (2010a). The difference in sums is due to rounding).

In 2005 (the fifth year of fiscal decentralization), intergovernmental transfers were IDR 150.4 trillion. In 2010, it increased to IDR 344.6 trillion. All components of intergovernmental transfers increased during that period. DAU, the most significant component in term of nominal value, increased from IDR 88.8 trillion in 2005 to IDR 203.6 trillion in 2010. The highest increase was DAK, from about IDR 4 trillion in 2005 to IDR 21.1 trillion in 2010 – about 400% increase in nominal value. DBH is fluctuative during the period, but the figure increased from 2005 to 2010. DBH is mostly enjoyed by regions rich in natural resources and those with many tax subjects. In 2010, region benefiting the most from DBH-natural resources is East Kalimantan province, a region rich in oil reserves, while Jakarta Special Capital Territory received the highest DBH-taxes. Figure 4.5 below summarizes the trends of intergovernmental grants from 2005 to 2010.

#### Figure 4.5
Intergovernmental Grants Trends

(Source: Indonesian Ministry of Finance (2010a)).
According to Law No. 33/2004, at least 26% of estimated net national revenues must be allocated as DAU. The average percentage of allocation between 2007 and 2010 is 30%. In 2010, intergovernmental transfers combined with line ministries budget allocation to subnational governments reached 60.62%, in an amount of IDR 682.69 trillion (Ministry of Finance 2010b).

4.5.3. Intergovernmental Grants in Subnational Budgets

Fiscal decentralization in Indonesia is more focused on expenditure decentralization, compared to revenue decentralization. Subnational governments are given autonomy to generate local taxes (e.g. restaurant and hotel taxes, motor vehicle taxes, entertainment taxes) and retribution (e.g. parking retribution, market retribution). However, most taxes are still controlled by the central government. Concerning personal income taxes, for example, 80% of the total is the central government’s while the remaining 20% are shared to subnational governments. Other major taxes like corporate income taxes, sales taxes, and value added taxes are controlled by the central government.

Expenditure decentralization, on the other hand, is more evident. Given limited revenue sources for most subnational governments, and the significant difference in fiscal capacity between regions, the devolution of government functions needs to be supported by financial support from the central government. For this reason, intergovernmental funds, especially balancing funds –DAU, DBH, and DAK– continue to be a major revenue source for most subnational governments. Figure 4.6 below summarizes the nominal amount of subnational governments’ revenues from 2007 to 2010.
DAU has been the major source of revenues for most subnational governments. However, the percentage of DAU to total subnational revenues tends to decrease from 2007 to 2010. DBH and DAK fluctuated slightly during the period. On average from 2007 to 2010, DAU accounted for 59.21% of total subnational governments’ revenues. DBH is the second highest with 16.96%, and DAK is the third with 7.44%. This shows that despite the decreasing percentage, DAU is still dominating the subnational revenues. Own-source revenues (OSR) and other revenues increased every year from 2007 to 2010. On average, 7.24% of subnational governments’ revenues come from PAD, and 9.16% come from other revenues.

Figure 4.7 below summarizes subnational expenditures from 2007 to 2010. Major expenditure in subnational budgets are salary expenditure (averaged 46.32% of total expenditure from 2007 to 2010), capital expenditures (averaged 26.99%), and goods and services expenditure (averaged 17.14%). From the three major expenditures, only salary expenditure experienced steady increase annually, reaching 51.08% of total subnational expenditures in 2010 from 42.59% in 2007. On the contrary, capital expenditure decreased from 30.84% in 2007 to 21.24% in 2010, while goods and service expenditures decreased from 17.61% to 16.58% during the same period.
The data shows that salary expenditures for subnational officials, especially local government officials, is the most significant expenditure in local budgets. In comparison with central and provincial government, in 2010, central government official salary expenditure covers 20.8% of total national expenditures, and 26.37% of provincial expenditures, while local government official salaries in average cover 50.7% of total local expenditures (Ministry of Finance 2010a). If compared internationally, the expenditure for official salaries is very high, compared to around 5% in more developed countries (Lewis and Smoke 2008).

Why are salary expenditure so high compared to other subnational expenditures? When decentralization was started, central government officials who used to work under line ministries regional offices were transferred to subnational governments, and became part of subnational bureaucracy. To ease the burden of official salaries, the central government included the official salary component into DAU formula (to be discussed in the next chapter). This component is still included in DAU formula. As decentralization developed, subnational governments could recruit more officials with central government’s approval. At first, 100% of

salary expenditure was covered in the formula. For fiscal year 2011, the government and DPR agreed to cover 83.1% of provincial salary expenditure and 68.56% of local salary expenditure (Ministry of Finance, 2010b). Despite the decreasing coverage from the central government, salary expenditure still dominates. In 2011, it covers 46.16% of subnational expenditures (Ministry of Finance 2012).

4.6. The State of Public Service Delivery

According to World Development Indicators 2010, most public services indicators in Indonesia show that there is improvement in public services post decentralization. Table 4.6 below shows that indicators in education and health are generally improving from 2000 to 2008. A notable exception is access to water in urban area, which declined from 90% in 2000 to 89% in 2008.  

<table>
<thead>
<tr>
<th>Year</th>
<th>Education</th>
<th>Health</th>
<th>Water</th>
<th>Sanitation</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Primary School Enrollment (%)</td>
<td>Secondary School Enrollment (%)</td>
<td>Infant Mortality (/1000 live births)</td>
<td>Life Expectancy (years)</td>
</tr>
<tr>
<td>2000</td>
<td>94</td>
<td>50</td>
<td>38</td>
<td>66</td>
</tr>
<tr>
<td>2008</td>
<td>96</td>
<td>65</td>
<td>29</td>
<td>68</td>
</tr>
</tbody>
</table>


Despite the improvement domestically, compared to the neighboring countries which are closest in wealth –Vietnam, Philippines, and Thailand– indicators for health, water, and sanitation services place Indonesia in a relatively low position. Table 4.7 summarizes several indicators of education, health, water and sanitation in 2008 in Indonesia and other countries in South East Asia. Infant mortality rate is the highest compared to the three other countries, while

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life expectancy is the lowest (the same as Philippines). Access to improved water source in Indonesian rural area is 71%, and in urban area 89%; both are the lowest compared to the three other countries. In the case of access to improved sanitation, Indonesia is among the lowest with 52% of population having access to sanitation. This is second only after Cambodia, whose GDP per capita is among the lowest in South-East Asia (based on GDP per capita in 2008).  

Table 4.7. Selected Public Service Indicators South-East Asian Countries, 2008

<table>
<thead>
<tr>
<th>Country</th>
<th>Education</th>
<th>Health</th>
<th>Water</th>
<th>Sanitation</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Primary School Enrollment (%)</td>
<td>Secondary School Enrollment (%)</td>
<td>Infant Mortality (/1000 live births)</td>
<td>Life Expectancy (years)</td>
</tr>
<tr>
<td>Brunei</td>
<td>93</td>
<td>95</td>
<td>6</td>
<td>78</td>
</tr>
<tr>
<td>Cambodia</td>
<td>96</td>
<td>Not Available</td>
<td>49</td>
<td>62</td>
</tr>
<tr>
<td>Indonesia</td>
<td>96</td>
<td>65</td>
<td>29</td>
<td>68</td>
</tr>
<tr>
<td>Lao PDR</td>
<td>89</td>
<td>37</td>
<td>46</td>
<td>66</td>
</tr>
<tr>
<td>Malaysia</td>
<td>Not Available</td>
<td>69</td>
<td>6</td>
<td>74</td>
</tr>
<tr>
<td>Myanmar</td>
<td>Not Available</td>
<td>50</td>
<td>53</td>
<td>64</td>
</tr>
<tr>
<td>Philippines</td>
<td>88</td>
<td>60</td>
<td>25</td>
<td>68</td>
</tr>
<tr>
<td>Singapore</td>
<td>Not Available</td>
<td>Not Available</td>
<td>2</td>
<td>81</td>
</tr>
<tr>
<td>Thailand</td>
<td>91</td>
<td>70</td>
<td>12</td>
<td>74</td>
</tr>
<tr>
<td>Vietnam</td>
<td>99</td>
<td>Not Available</td>
<td>20</td>
<td>74</td>
</tr>
</tbody>
</table>

(Source: The World Bank, World Development Indicators 2010)

8 Access to improved water source refers to the percentage of the population with reasonable access to an adequate amount of water from an improved source, such as a household connection, public standpipe, borehole, protected well or spring, and rainwater collection. Unimproved sources include vendors, tanker trucks, and unprotected wells and springs. Reasonable access is defined as the availability of at least 20 liters a person a day from a source within one kilometer of the dwelling (Definition by World Health Organization/WHO and United Nations Children Emergency’s Funds/UNICEF – Joint Measurement Program/JMP).


9 Access to improved sanitation facilities refers to the percentage of the population with at least adequate access to excreta disposal facilities that can effectively prevent human, animal, and insect contact with excreta. Improved facilities range from simple but protected pit latrines to flush toilets with a sewage connection. To be effective, facilities must be correctly constructed and properly maintained (Definition by World Health Organization/WHO and United Nations Children Emergency’s Funds/UNICEF – Joint Measurement Program/JMP).


10 According to World Development Indicator 2010, GDP per capita as of 2008 (in current US Dollar) in descending order for South East Asian countries is as follows: Brunei Darussalam (37,414), Singapore (36,738), Malaysia (8,099), Thailand (3,993), Indonesia (2,172), Philippines (1,925), Vietnam (1,070), Lao PDR (910), and Cambodia (741). Data for Myanmar is not available.

The data shows that in general, decentralization is marked with improvement in most public service. However, even with the improvement, Indonesia still performs relatively low compared to neighboring countries with roughly similar wealth. In specific cases like water service, indicators show worsening condition after decentralization. The indicators do not show the cause of such condition, but they imply that there is room for improvement in public service delivery in Indonesia.
CHAPTER V

EVALUATION OF INDONESIAN INTERGOVERNMENTALGRANTS

In Indonesia, intergovernmental grants have been the main source of revenues for most local (and provincial) governments. As described in Chapter IV, Indonesian intergovernmental grants consist of five components: balancing funds, special autonomy funds, adjustment funds, emergency funds, and ‘grants’ (hibah). All of the components can be classified into unconditional and conditional grants.

Among the five components, the most significant in nominal values is balancing funds. Balancing funds have three subcomponents: the unconditional grants DAU and DBH, and the conditional grants DAK. From 2005 to 2010, balancing funds always made up more than 80% of intergovernmental grants. Because of its significant proportion, balancing funds have greater effect on subnational budgets, compared to other intergovernmental grants components. The accountability of balancing funds management at the local level also significantly impacts the subnational governments’ performance in delivering public services.

This chapter evaluates balancing funds in light of their role in improving public service delivery. Previous research argues that unconditional grants aim at equalization (Steffensen 2009, Broadway and Shah 2009), which means equalizing the (fiscal) capacity of subnational governments to provide comparable public services at comparable rates (Broadway 2007). Conditional grants aim at, among other things, improving specific sectors considered as high priority nationally (Steffensen 2009) to achieve minimum service standard in public service delivery (Broadway 2007, Slack 2007).

This chapter focuses on whether balancing funds function as their intended designs, in the sense that DAU and DBH have equalizing effect, and DAK puts emphasis on financing specific sectors. Consistent with the research focus, which is incentives and accountability, this chapter also evaluates balancing funds in light of the incentives embedded in them (if any) even
implicitly, and how the implementation of balancing funds demonstrates accountability. The evaluation results will be used to identify (1) the limitation of balancing funds, and (2) the improvement that needs to be introduced in Indonesian intergovernmental grants, and (3) the significance of implementing PBG in Indonesia.

5.1. General Allocation Funds (Dana Alokasi Umum/DAU)

As unconditional grants, DAU can be used according to subnational priority without intervention from the central government. Law No. 33/2004 states that DAU aims at ensuring equal distribution of fiscal capacity to reduce the inequality in financial capacity among regions with due consideration to the needs and potentials of each region. DAU is established based on fiscal gap, which is the difference between fiscal needs and fiscal capacity. In this sense, regions with high fiscal capacity and low fiscal needs will receive less DAU than regions with low fiscal capacity and high fiscal needs. This principle confirms DAU as a factor for equal distribution of fiscal capacity.

DAU is allocated based on the formula stipulated in Law No. 33/2004. According to the law, at least 26% of net domestic revenues established in the national budget must be allocated for DAU. This makes DAU the most significant part of intergovernmental transfers in terms of nominal value, and also the major revenue source for most subnational governments.

DAU formula uses weighted variables. While the law states the fixed variables to be used in the formula, the weight of each variable can differ according to the central government’s proposal and national parliament’s (DPR) approval. The formula for DAU allocation is as follows:

\[
\text{DAU} = \text{Basic Allocation} + \text{Fiscal Gap} = \text{Basic Allocation} + (\text{Fiscal Needs} - \text{Fiscal Capacity})
\]
a. Basic allocation

The variable of basic allocation is total salaries of subnational government employees, which used to be provided in full as basic allocation. However, a recent trend in DAU formula does not provide for full support of subnational official salaries. In 2011, the variable weights are 83.1% for provinces and 68.56% for cities and regencies. This means that DAU only covers 83.1% of official salaries in provinces, and 68.56% of official salaries in cities/regencies (Ministry of Finance 2011).

b. Fiscal needs

Fiscal needs mean the financing requirements of the region in providing basic public services. The variables of financing requirements are total population index (TPI), areas size index (ASI), construction cost index (CCI), gross regional domestic products per capita (GRDP per capita), and human development index (HDI). The formula also accounts for the average total expenditures (ATE) in subnational budgets. Taking all the indexes into account, the formula for fiscal needs is:

\[
\text{Fiscal needs} = \text{ATE} (\text{TPI} + \text{ASI} + \text{CCI} + \text{HDI} + \text{GRDP per capita})
\]

c. Fiscal capacity

Fiscal capacity means financing sources of the region derived from the variables of own-source revenues (OSR) and revenue sharing funds (Dana Bagi Hasil/DBH), which consist of revenue sharing from taxes (DBHT) and from natural resources (DBHNR). The formula for fiscal capacity is:

\[
\text{Fiscal capacity} = \text{OSR} + \text{DBHT} + \text{DBHNR}
\]

DAU used to adopt hold-harmless policy, a policy requiring current year’s DAU should be at least the same as last year’s. The policy was abolished in 2008, and DAU allocation formula is adjusted to exclude already prosperous regions from receiving too much DAU. Based on the formula, some subnational governments may have decreasing DAU or not receive DAU
DAU allocation process consists of 2 steps. The first step is allocating total DAU from the national budget. The allocated amount is stipulated in the annual Law of the National Budget (Undang-undang Anggaran Pendapatan dan Belanja Negara/UU-APBN). The second step is allocating DAU to each subnational government. The allocation amount per subnational government is formalized and established by presidential decree, and is transferred monthly each in an amount of 1/12 of the allocation.

Figure 5.1 below illustrates the process of DAU allocation. In the allocation process, the total DAU pool is divided into city/regency pool and provincial pool. Unless decided otherwise, the proportion is 90% and 10%, respectively. Each pool is then distributed to cover basic allocation and fiscal gap, using the weighted variables based on DAU allocation formula.

* According to Government Regulation No. 55/2005, the proportion of DAU allocation between provinces and cities/regencies is determined based on the sharing of authority. If the proportion is not determined, 90% and 10% ratio between cities/regencies and provinces are used.

(Source: Author’s summary based on Law No. 33/2004 and Government Regulation No. 55/2005)
A concern in the allocation of DAU is that it is mostly used for administrative expenditures such as local official salaries (Usman et al. 2008, Lewis and Smoke 2008), thus leaving only a relatively small portion for closing the fiscal gap. Generally DAU is barely enough to cover salary expenditures because the expenditure, most of the time, is higher than DAU. This implies that DAU’s other function, closing the fiscal gap, is reduced.

Table 5.1 summarizes the percentage of salary expenditure to DAU and to total revenues in 2006, 2008, and 2010, for both local governments and provincial governments.

<table>
<thead>
<tr>
<th>Year</th>
<th>Subnational governments</th>
<th>Salary/DAU</th>
</tr>
</thead>
<tbody>
<tr>
<td>2006</td>
<td>Cities/regencies</td>
<td>69.4%</td>
</tr>
<tr>
<td></td>
<td>Provinces</td>
<td>141.5%</td>
</tr>
<tr>
<td>2008</td>
<td>Cities/regencies</td>
<td>207.5%</td>
</tr>
<tr>
<td></td>
<td>Provinces</td>
<td>116.6%</td>
</tr>
<tr>
<td>2010</td>
<td>Cities/regencies</td>
<td>102.8%</td>
</tr>
<tr>
<td></td>
<td>Provinces</td>
<td>150.9%</td>
</tr>
</tbody>
</table>

(Source: Author computation based on subnational budgets submitted to the Ministry of Finance for fiscal year 2006, 2008, and 2010).

The portion of salary expenditure in Indonesian local budgets is very high compared to other countries. In 2010, budgeted salary expenditure for central government was 20.8% of total national expenditure. For provincial governments, the figure was 26.37% of total provincial expenditures, and for local governments it was 50.7% of total local expenditures (Ministry of Finance 2010a). If compared internationally, the expenditure for official salaries is very high, compared to around 5% in more developed countries (Lewis and Smoke 2008).

5.2. Revenue Sharing Funds (Dana Bagi Hasil/DBH)

The fiscal decentralization framework in Indonesia requires the central government to share the income from natural resources and taxes to the provinces and local governments. The shared revenues are known as revenue sharing funds or DBH. According to Law No. 33/2004, the shared revenue from natural resources (DBH natural resources) consist of revenues from oil
and gas, forestry, other general mining, geothermal, and fishery. The sharing arrangements differ across types of natural resources and levels of government (central, province, producing and non-producing cities/regencies). As for shared taxes revenues (DBH taxes), the shared revenues apply to property taxes (or land and building taxes), land rent, and domestic personal income taxes.

a. **DBH Taxes**

The sources of DBH Taxes are property taxes, land rent, and domestic personal income taxes. Income taxes are shared in the central government’s favor, which is entitled to 80% of the amount. Income taxes are one of major revenues and most of the taxes are still centralized. Income taxes shared with subnational governments is domestic personal income taxes. The shares of subnational governments are transferred on a quarterly basis. The allocation formula of DBH Taxes is summarized in Figure 5.2 below:

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In 2009, Law No. 28/2009 on Local Taxes and Local Retribution was issued. According to this law, property taxes and land rent will be a part of local taxes. The Ministry of Finance and Ministry of Home Affairs are mandated by this law to arrange the shift of property taxes from central taxes to local taxes by 2013, and the shift of land rent in one year after the law enactment – which is due in 2011.
b. DBH Natural Resources

The sharing of natural resources’ favoring producing regions emerges as a response to natural-resources rich regions, which considered themselves to be undertreated during the New Order regime. Centralization at that time had been driving almost all natural resources revenues from those regions to Jakarta, leaving them with poor infrastructures and low-quality life for local people. When the regime fell following the Asian economic crisis in 1997, strong demands for larger shares emerged, threatening the unity of the nation. The newly appointed government accommodated the demands in decentralization laws, deciding that revenues from natural resources will be distributed in favor of producing regions through DBH natural resources.

DBH Natural Resources come from revenues from oil, gas, forestry, general mining, geothermal, and fishery. For oil and gas revenues, the central government has the major share of 84.5% and 69.5%, respectively. Provincial governments’ shares are 3.1% and 6.1%, while local governments’ are 12.4% and 24.4%, respectively. For general mining, geothermal, and forestry, the central government’s shares are less significant at 20% of revenue figures. Provincial governments’ share is 16% and the remaining 64% goes to local governments. As for fishery, the central government keeps 20% of revenues and distributes the remaining 80% equally to all local governments.

In general, producing regions (cities/regencies) gain the most from natural resources revenues, followed by regions in the same provinces. For forestry, general mining, and geothermal, the share for all local governments is 64%. Of this amount, 32% is the entitled to producing regions, while the remaining 32% is distributed equally to all cities/regencies in the same provinces. The same rule also applies to revenues from oil and gas, but with different proportions. DBH natural resources are administered by the central government and transferred to subnational governments on a quarterly
basis. Figure 5.3 below summarizes the allocation formula for DBH natural resources.

5.3. Specific Allocation Funds (Dana Alokasi Khusus/DAK)

Specific grants DAK focus on achieving national priorities and aim at supporting certain regions to finance specific public service infrastructure and to enhance regional development. Most subnational governments rely on DAK for capital expenditures (Ministry of Finance 2011, Gervais 2010).

DAK is conditional grants which utilization must comply with the central government’s guideline. It is also a matching grant that requires counterpart funds from local governments (in an amount of at least 10% of the DAK allocation amount). According to Law No. 33/2004, DAK is allocated to certain regions to fund specific activities that are of regional affairs, and
that are determined as national priorities. National priorities to be supported by DAK financing are determined every year, but several basic public services like education and health remain as targeted sectors since DAK was first established.

DAK allocation process consists of 2 steps: (1) selection of eligible recipients, and (2) computation of DAK amount to each eligible recipient. DAK allocation is conducted by the Ministry of Finance. Technical data are provided by line ministries, other data are provided by relevant government agencies, e.g. line ministries and Central Bureau of Statistics. According to Law No. 33/2004, three criteria are used for DAK screening process:

1. General criteria are based on consideration of a subnational government’s fiscal capacity, with priority given to regions whose fiscal capacity is lower than the national average, indicated by net fiscal index.

2. Specific criteria are prepared with attention given to laws and regulation, such as regions with special autonomy (currently Papua Province and West Papua Province), and regions which meet certain regional characteristics. The regional characteristics are disadvantaged regions (daerah tertinggal)\textsuperscript{12}, coastal/island/border regions, natural disaster-prone regions, food security regions, and tourism regions.

3. Technical criteria are based on considerations determined by related line ministries using indicators that illustrate infrastructural characteristics in each sector.

Figure 5.4 below summarizes the DAK allocation process. To be eligible for DAK, a subnational government needs to pass one of the three criteria (general, specific, or technical criteria).

\textsuperscript{12} According to the State Ministry of Accelerated Development of Disadvantaged Regions, disadvantaged regions are regions which are less developed compared to other regions, and which populations are relatively poor. Indicators to determine whether a region is disadvantaged include regional economy, human resource, work force, business environment, infrastructures, natural resources, and environment. Typical characteristics of disadvantaged regions are high poverty rate, limited economic activity and focused on natural resources, minimum infrastructures, and low quality of human resources. Usually they are located in isolated areas. (source: http://webgis.kemenegpdt.go.id/sidt/pages/home.php)
In the screening process, subnational governments are firstly screened through general criteria. If that is satisfied, the subnational governments are classified as eligible DAK recipients. Otherwise, they will be screened through specific criteria. If they cannot satisfy the specific
criteria, they will be screened through the technical criteria. If they still fail to satisfy the technical criteria, they are classified as ineligible. Otherwise, they will be eligible for DAK.

After eligible recipients are determined, the amount of DAK allocation for each recipient is computed. The computation is formula-based, using indexes and weighted average (Ministry of Finance 2010). DAK is transferred three times in a fiscal year, in an amount equal to 30%, 45%, and 25% of total DAK allocation, respectively, conducted 15 days after the Ministry of Finance receives DAK utilization reports.

In recent years, there’s a growing trend in the number of areas considered as national priorities and the number of DAK recipients. In 2003, the first year of DAK implementation, five sectors were determined as national priorities with 354 recipients. In 2010, 14 sectors were determined as national priority with 523 recipients. Fragmentation, thus, becomes a concern. With the increasing number of sectors and recipients, if total DAK pool does not increase at least proportionally, fragmentation is inevitable. Table 5.2 summarizes the number of DAK prioritized sectors and recipients.

<table>
<thead>
<tr>
<th>Year</th>
<th>Sector</th>
<th>Provincial Governments</th>
<th>Local Governments</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td>Regencies</td>
<td>Cities</td>
</tr>
<tr>
<td>2003</td>
<td>5</td>
<td>24</td>
<td>265</td>
<td>65</td>
</tr>
<tr>
<td>2004</td>
<td>6</td>
<td>0</td>
<td>283</td>
<td>71</td>
</tr>
<tr>
<td>2005</td>
<td>8</td>
<td>2</td>
<td>305</td>
<td>72</td>
</tr>
<tr>
<td>2006</td>
<td>9</td>
<td>0</td>
<td>348</td>
<td>86</td>
</tr>
<tr>
<td>2007</td>
<td>9</td>
<td>0</td>
<td>348</td>
<td>86</td>
</tr>
<tr>
<td>2008</td>
<td>11</td>
<td>24</td>
<td>363</td>
<td>88</td>
</tr>
<tr>
<td>2009</td>
<td>13</td>
<td>28</td>
<td>386</td>
<td>91</td>
</tr>
<tr>
<td>2010</td>
<td>14</td>
<td>32</td>
<td>398</td>
<td>93</td>
</tr>
</tbody>
</table>

(Source: Indonesian Ministry of Finance).

The allocation of balancing funds DAU, DBH, and DAK are all based on formula. However, some allocation procedures are often criticized for being too complicated and less transparent. For example, the procedure of DAU calculation is extremely complex and not transparent. The complexity of DAU formula has been subjected to criticism as it does not
provide transparency and is difficult to confirm (Fane 2003, Brodjonegoro and Vazquez 2002). To date, how the calculation was conducted has never been made available to the public, thus it is nearly impossible to confirm the allocated amount. The same is also true with DAK. DBH is the only exception, since there is a reconciliation procedure between the central government and subnational governments to confirm the share of DBH.

5.4. The Limitation of Balancing Funds

The purposes of balancing funds in Indonesia includes strengthening subnational governments’ fiscal capacity, reducing fiscal disparity (i.e. fiscal capacity inequality) between the central and subnational government and among subnational governments, improving the quality of public service, and reducing the gap in public service among regions (Ministry of Finance 2011). In public services delivery, the unconditional grants component in balancing funds functions as equalization grants, which aim at reducing fiscal disparity among local governments. Equalizing local governments’ fiscal capacity arguably enables local governments to provide comparable public service at comparable tax rates (Broadway 2007). The conditional grants, on the other hand, provide funding for specific public service to improve it or to promote the achievement of a certain standard (Broadway 2007, Slack 2009). The importance of equalization is based on the premise that all people in a nation are entitled to a reasonably similar standard of public services provided by governments (Ahmad et al. 1999).

This section will evaluate the effect of DAU, DBH, and DAK as individual components and as systems on local governments’ fiscal capacity inequality, or fiscal disparity. Local government is the focus of this analysis because public services are devolved to local governments; therefore their fiscal capacity is important for public service provision.

The fiscal disparity is measured by the Coefficient of Variation (CV). CV measures variability in relation to the mean and is used to compare the relative dispersion in one type of data with the relative dispersion in another type of data. CV can be used to measure the
equalizing effect of grants on fiscal disparity, with lower CV indicating reduction in fiscal disparity (Blochliger 2007). In this analysis, CV is calculated in 4 steps to observe the change in local governments’ fiscal disparity with the addition of each balancing fund component.

a. **CV is calculated based solely on own-source revenues per capita (OSR).**

OSR of a local government consists of local taxes, local retribution, profit from subnational enterprises, and other OSR (e.g. interest revenues and donation). It is the most relevant indicator of a subnational government’s capacity to generate revenues by its own efforts. Thus using OSR can highlight the difference in fiscal capacity between subnational governments.

b. **CV is calculated based on OSR and DBH per capita (OSR+DBH).**

Unlike OSR that depends on local governments’ efforts to generate revenues, DBH mainly arises as a result of regional advantage which can provide additional revenues. Regions with favorable conditions to generate taxes and regions rich in natural resources benefit the most from DBH, since the formula of DBH favors such regions in the sharing of revenues. Therefore, DBH significantly strengthens the fiscal capacity of such local governments. The impacts of the increased fiscal capacity will be evaluated in this section.

c. **CV is calculated based on OSR, DBH, and DAU per capita (OSR+DBH+DAU).**

The unconditional grants DAU are also equalizing grants. The effects of DAU will be evaluated by observing the change in fiscal disparity (which have been calculated based on OSR and DBH), after including DAU in the figure.

d. **CV is calculated based on OSR, DBH, DAU, and DAK per capita (OSR+DBH+DAU+DAK).**

In recent years, DAK has become more fragmented as more subnational governments receive DAK funding and more sectors are regarded as national priorities. The coverage of DAK is widening, but with smaller amount. This may indicate that DAK has lost its
specificness. The last step of CV calculation tries to answer whether DAK, considering the fragmentation and widening coverage, has shifted from its original role as conditional grants, which provide capital investment assistance to selective regions in specific sectors.

The result of the CV calculation for local governments’ fiscal disparity is summarized in Figure 5.5 below.

From Figure 5.5, it can be observed that fiscal disparity between cities/regencies originally exists to some degree when only OSR is considered as local revenues. Fiscal disparity then increases with DBH allocation, and decreases after DAU allocation. This is not surprising since DAU is meant to be equalization grants. When DAK is allocated, fiscal disparity decreases even further.

The interesting point is the reduced fiscal disparity as a result of DAK allocation. DAK is a specific grants financing capital investment; it has some specific purposes, but equalization is not one of them. Yet, the graphs show that the contribution of DAK to reduced fiscal disparity becomes more evident over the years. In 2001 and 2002, the contribution of DAK to reduced fiscal disparity is very small. Between 2003 and 2010, the gap between CV with OSR+DBH+DAU+DAK and CV with OSR+DBH+DAU is widening, suggesting that the impact of DAK on reducing fiscal disparity becomes more obvious.
The situation can be interpreted as follows. Since revenue decentralization is not yet applied as rigorously as expenditure decentralization, most taxing power lies within the central government’s control, as well as revenues generated from natural resources. Some parts of tax revenues and natural resource revenues are transferred back to subnational governments in the form of DBH taxes and DBH natural resources. Because of the difference in regional advantages, some subnational governments receive substantial amount of DBH taxes (like special capital territory, Jakarta) or DBH natural resources (like subnational governments in oil-rich regions of Aceh, East Kalimantan, and Riau), compared to other regions. This can further push fiscal disparity.

To promote equality in local governments’ fiscal capacity, DAU is added into the scheme. The allocation formula of DAU takes DBH into consideration, in expectation that regions with higher DBH (relative to their fiscal needs) will not be favored with higher DAU. According to the result of CV calculation, this equalization mechanism actually works: a decrease in fiscal disparity between regions with the introduction of DAU can be observed.

Finally, there is conditional grant DAK where recipients are determined based on selection criteria, and which purpose is to encourage development in targeted sectors. It has been shown that the number of DAK recipients is increasing as well as the number of targeted sectors. CV calculation shows that DAK contributes to reducing fiscal disparities at a greater degree over the years. This situation indicates the shifting of DAK characteristics: from specific grants to equalization grants, suggesting that DAK tends to lose its specificness and becomes more equalizing.

It should be noted that the provision for salary expenditure included in the DAU formula affects the equalizing effect of DAU. Figure 5.6 below shows that the CV (that has decreased after DAU allocation) increases again after salary expenditure are accounted for. This indicates that the equalizing effect of DAU is partially offset by salary expenditure.
To put it together, the net effect of balancing funds in general is reductive to fiscal disparity among local governments, as shown by CV analysis. From the equality viewpoint, this means that balancing funds as a system equalizes local governments’ fiscal capacity. Since fiscal capacity is associated with local governments’ potential to generate revenue in order to provide standardized public services (Martinez-Vazquez and Boex 1997), more equal fiscal capacity will also equalize local governments’ potential to provide public services. The outcome of this condition is more comparable public services that can be accessed by citizens anywhere across the country.

Based on the CV results, some points to note in how balancing funds work as a system are (1) DAU and DBH work in opposite directions in reducing inequality, (2) salary expenditure reduce the equalizing effect of DAU, and (3) DAK shifts from specific to equalization grants. The last point signifies that intergovernmental grants have lost the functions of specific grants which provide funding for capital investment to the majority of subnational governments.

5.5. Incentives in Balancing Funds

Balancing funds do not explicitly state any incentive for improved efficiency, accountability, or performance, but some incentives features are embedded in the allocation formula of DAU, DBH, and DAK. In DBH, incentives can be observed in the shared revenues.
from property taxes. The allocation formula provides 3.5% of revenue from property taxes to be distributed to local governments whose contribution realization for property taxes exceeded the budgeted amount. Although the collection of such taxes is administered by central governments, local governments assist the process by providing accurate data and encouraging local citizens to comply with property tax obligation. However, since the property taxes and land rent have become local taxes, the incentives issue is no longer relevant in the context of intergovernmental grants, as the revenues will be parts of own-source revenues (OSR).

In DAU allocation formula, for example, official salary is accounted as a variable in determining DAU allocation. This can stimulate subnational governments to employ more people. Therefore, an incentive for efficiency is embedded in DAU formula to discourage ambitious recruitment of new employees and/or launching more generous fringe benefit plans. As basic allocation in the DAU formula only covers a part of salary expenditure (in 2011, 83.1% of salary expenditure in provinces and 68.56% in cities/regencies, according to Ministry of Finance (2011)), the part that is not covered by DAU must be provided from other sources, thus adding a financial burden to subnational budgets. This can be an incentive for subnational governments to stop employing more people. This incentive, however, is not always effective.

For subnational governments who perceive hiring people as an alternative to providing employment, partially covered salary expenditure may still be seen as an incentive to recruit.13

Some incentives feature can be observed in the DAK allocation formula. Examples from drinking water and sanitation service will be used for illustration.

a. **DAK for drinking water**

The allocation of DAK for drinking water is formula-based. One of the components in the allocation formula is the drinking water technical index. The higher the index, the higher DAK allocation a subnational government will receive. How the index is calculated

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13To control the growth of subnational government officials, the recruiting and dismissing of subnational government officials are regulated by the central government.
is determined by the Ministry of Public Works, and the index figures may change every year. In 2012, the technical index (TI) for drinking water is determined as follows (Ministry of Public Works 2011):

\[
TI = 5\% \text{ WS} + 40\% \text{ LP} + 5\% \text{ WC} + 40\% \text{ IC} + 5\% \text{ AW} + 5\% \text{ RP}
\]

Where:

- Water scarcity index (WS) = Number of villages with water scarcity in a city/regency / Number of villages with water scarcity in Indonesia
- Low-income population index (LP) = Number of low-income population in a city/regency / Number of low-income population in Indonesia
- Water coverage index (WC) = % population without access to piped water in a city/regency / % population without access to piped water in Indonesia
- Idle capacity index (IC) = Idle capacity of water in a city/region / Idle capacity of water in Indonesia
- Awareness index (AW) = % budget allocated for water sector, not including DAK, by a city/regency / % budget allocated for water sector, not including DAK, by all local govs
- Reporting index (RP) = Score of DAK for drinking water implementation in the previous year / Total national score of DAK for drinking water implementation in the previous year

It can be observed from the formula that the allocation of DAK for drinking water favors subnational governments who allocate more budget for drinking water, as shown by the awareness index (AW). This is a positive incentive to encourage subnational governments to increase spending in drinking water sector, as this can improve accountability of subnational governments in providing water service through providing additional resources.

The incentive is particularly important in the presence of the fungibility effect. It’s been a concern in previous research and literature that conditional grants, like DAK, are prone to fungibility (Slack 2007), a situation where grants recipients shift their funding to unassisted sector, as a result of receiving grants. This is contrary to the spirit of allocating conditional grants; the intention of providing the grants is to support recipients’ financial condition so that more funds are allocated to the targeted sector. In other words, conditional
grants are supposed to complement, rather than to substitute, the recipient’s own financial resources. Responding to this, the allocation formula of DAK for drinking water includes the awareness index. The index accounts for the allocation of the subnational budget for drinking water outside DAK.

An incentive for performance that can also be observed in the formula is the reporting index. The Ministry of Public Works gives a score to the result of DAK implementation. The higher the score, the more favorable the reporting index becomes, which will lead to higher DAK allocation. This can encourage subnational governments’ compliance to reporting requirements.

b. Sanitation

Another example is sanitation sector. Technical index (TI) for sanitation sector in 2012 is determined as follows:

\[
TI = 25\% \text{ LP} + 30\% \text{ SC} + 15\% \text{ AW} + 15\% \text{ RP} + 15\% \text{ RS}
\]

Where :

- Low-income population index (LP) = \(\frac{\text{Number of low-income population in a city/regency}}{\text{Number of low-income population in Indonesia}}\)
- Sanitation coverage index (SC) = \(\frac{\% \text{ population with access to sanitation in a city/region}}{\% \text{ population with access to sanitation in Indonesia}}\)
- Awareness index (AW) = \(\frac{\% \text{ budget allocated for water sector, not including DAK, by a city/regency}}{\% \text{ budget allocated for water sector, not including DAK, by all local govt}}\)
- Reporting index (RP) = \(\frac{\text{Score of DAK for drinking water implementation in the previous year}}{\text{Total national score of DAK for drinking water implementation in the previous year}}\)
- Regional Sanitation Strategy Index (RS) = \(\frac{\% \text{ subnational government’s ownership of regional sanitation strategy documents}}{\text{}}\)

For the sanitation sector, the same incentives case as the drinking water sector applies to the reporting index and awareness index. Another incentive that can be observed in the sanitation formula is in the sanitation coverage index. The sanitation coverage index favors the percentage of population with access, implying that the more people to get
access to sanitation, the higher the allocation of DAK for sanitation. This appears like a contradictory concept, but in this case performance is incentivized. Reward is given to improved performance. Subnational governments, where large parts of the population have access to sanitation, are appreciated for making efforts to improve sanitation condition. The technical index for sanitation gives 30% weight for the sanitation coverage index, the highest of other variables in the formula.

All in all, it can be said that incentive features, albeit implicitly, have been incorporated in the DAU and DAK allocation formulas. The incentives, however, do not clearly link to improved performance and accountability. The subnational governments’ awareness of the incentives feature is not yet empirically measured, but since the information on formulas are publicly available, the correlation between incentives (e.g. higher DAK allocation) and performance (e.g. higher sanitation coverage, higher counterpart funding allocation from subnational budgets) should have been observed.

5.6. Accountability in Balancing Funds

To date, the focus of most studies related to fiscal decentralization has often been efforts to optimize revenue sources, while studies on the optimization of expenditure focuses are rarely conducted. Studies of the implementation and impact of DAK are rare. Linked to this, questions that frequently emerge concern simple things like how the distribution mechanisms and management of DAK are proceeding. Although there are several criteria for the allocation of DAK, the accountability processes at the national and regional levels have not yet been widely publicized (Usman et al 2008).

The DAU system is primarily focused on a gap-filling approach to subnational finance. The employment of formula to determine DAU allocation for each subnational government is an objective manner, but accountability to local citizens for service delivery performance is
neglected (Shah et al. 2012). The same case is also true for DBH, as the allocation formula does not take accountability to local citizens into account either.

As far as accountability to local citizens for service delivery performance matters, monitoring the accountability of DAK is more likely than of DAU and DBH. As specific/conditional grants, the input provided as DAK can be associated with specific output. This is different from DAU and DBH, in which output can cover a wide range of services, whether they directly benefit the citizens or not.

However, monitoring the quality of DAK-funded projects and other technical aspects are not strongly enforced. A reason for this is because line ministries have limited resources to check each individual project. Even if the monitoring is conducted, its purpose is rather corrective than preventive. The DAK procedure allows line ministries to recommend to the Ministry of Finance to delay DAK transfer based on monitoring results, but this rarely happens because many local governments depend on DAK for capital expenditures. Also, the transfer of DAK funds is mainly tied with the administrative requirements rather than the result of monitoring. A concern about this practice is that, even though a DAK project has been completed as planned, the quality issue is not a major focus. How the project will benefit the citizens is not rigorously evaluated, and this can weaken the incentives for improved performance and accountability in public service delivery.

At this point, a mechanism to ensure the accountability of balancing funds to local citizens for public service delivery is not yet in place. This needs to be addressed because balancing funds are provided in subnational governments’ functions to deliver public services, and therefore the accountability for public service should be ensured.

Currently, efforts to maintain the accountability of balancing funds mainly depend on the

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14 The reason for keeping politics at bay may be due to the intention to put a limit to lobbying for higher DAU. However, through annual budget discussion between the central government and the national parliament (DPR), funds can be allocated under different names to provide additional financial support for certain regions. Political process, eventually, always find a way to cater to political interests.

15 Interview with Gustaf Kasmiri, Section Head of DAK, Ministry of Finance (March 2012).
audit conducted by the Supreme Audit Board (Badan Pemeriksa Keuangan/BPK). Some weakness in the internal control of balancing funds identified by the audit are, among others: lack of coordination between subnational governments and central government’s ministries, mismanagement in the transfer of DAK where subnational governments are given the funds regardless of their readiness to implement the projects, and the allocation of DAK to subnational governments which, according to DAK selection criteria, are not eligible (Bisri 2008).

5.7. Balancing funds and local governments’ spending behavior

From the viewpoint of local budget management, whether local governments’ actions maximize the citizens’ welfare can be observed in their spending behavior. The major source of revenues for most subnational governments is DAU. On average from 2007 to 2010, DAU accounted for 59.21% of total subnational governments’ revenues. DBH is the second highest with 16.96%, and DAK is the third with 7.44%. In the same period, DAU tend to decrease, but it remains the largest part of local revenues.

A brief overview on local governments’ revenues and expenditures are presented in Chapter IV, and in this chapter Figure 4.9 is presented again for further discussion on the trends of local governments’ spending behavior.
Since DAU is mainly used to cover salary expenditure, decreasing DAU implies less support from central governments to pay local officials. However, as shown in Figure 4.9, the spending behavior of local governments show that salary expenditure keeps increasing, while the remaining expenditure items (except grants and subsidy expenditures) show decreasing trends. This indicates that local governments cut composition of those expenditure items to compensate the decreasing DAU, in order to finance increasing salary expenditure.

The indication can be observed in the trends of capital expenditures and goods and services expenditures, which are the second and third highest expenditures in local budgets. Both are decreasing between 2007 and 2010. The most notable decrease is in capital expenditures. Figure 4.9 above shows a striking correlation that as salary expenditure increase, capital expenditures decrease significantly.

This situation also indicates that in general, local governments make minimum efforts, as far as local budgets are concerned, to complement the conditional grants DAK with funds from local budgets. Transfers of DAK are fluctuating during the period, and according to the CV analysis in the previous section of this chapter, DAK has become more fragmented in recent years, implying less allocation to each local government for capital support. However, the decreasing DAK is not accompanied by increasing capital expenditures to compensate the reduced financing. In other words, there’s an indication that when intergovernmental grants decrease, local governments do not step in to make up the difference for maintaining or even improving the level of current public services.

Khemani (2005) argued that accountable local governments should undertake appropriate actions towards service delivery, given resources and capacity constraints. Referring to this, when there’s space for improvement (given the constraints), accountable local governments will act toward citizens’ welfare maximization by, among others, prioritizing sectors with highest direct benefits to the citizens in their budgets. In Indonesia, however, this does not seem to be the case. In general, the spending behavior of most local governments heavily focuses on
serving local bureaucracy, and when the intergovernmental grants intended to support the bureaucracy (e.g. DAU) decrease, the situation that usually accompanies it is that local governments cut other expenditure items, and increase the spending level for local officials.

5.8. The Significance of A Performance-Based Approach

Based on the findings presented in this chapter, the research identifies some limitations of balancing funds as follow:

a. Balancing funds are mainly serving equalization purpose, with diminishing focus on improving specific public services.

The approach to improving public service delivery is more toward equalization of fiscal capacity, rather than addressing particular public services. However, promoting public service delivery in all regions which meet certain standards through the allocation of balancing funds alone is most likely not met.

This is because the equalization of fiscal capacity is not optimal considering (1) the allocation method of balancing funds, and (2) the significant amount of salary expenditure component in the DAU allocation formula. After taking the effect of DBH and salary expenditure into consideration, DAU is actually not very equalizing. On the other hand, DBH only provides for a small fraction of the population, and DAK is allocated to almost all local governments irrespective of their fiscal capacity. Amendments that make DAU more equalizing are possible, but DBH works in the opposite direction to improve system fairness. This condition leaves changing principles of conditional grants the only option to provide additional support, which will help poor regions deliver minimum service standards (Gervais 2010).

However, the improving public service delivery through conditional grants is also problematic. Conditional grants DAK play a major role in maintaining capital investments in many regions (Ministry of Finance 2011), but in recent years DAK have wider coverage
and provide easier access to almost all subnational governments, at the cost of fragmentation.

From the CV analysis in the previous section, it can be concluded that balancing funds are losing the functions of conditional grants. DAK becomes more equalizing like the unconditional grants DAU, thus compromising its intended design to address specific public sectors.

b. **Balancing funds do not explicitly communicate incentives to encourage accountable behaviors from local governments.**

In the conditional grants DAK, some incentive features are in place, but the target, standard, and achievements measurement are not explicitly described. This makes it difficult to find the relation between input and output/performance. As for the unconditional grants DAU and DBH, despite the objective formula used in their allocation, accountability to citizens is often neglected (Shah et al. 2012). To sum up, in balancing funds, there’s an absence of an explicit link between incentives, performance, and access to funds to promote accountability in public service delivery.

Another issue regarding incentives is that, in local budget management, balancing funds do not provide strong incentives for local governments to prioritize expenditures that can directly benefit the citizens. Decreasing DAU, for example, correlates with increasing salary expenditure and decreasing capital expenditures. Confirming whether there’s a causal effect between the situations requires another approach, but as an indication, the data suggest that most local governments put a high priority in serving its bureaucracy (as indicated by the large proportion of salary expenditure). At the same time, expenditure items which are more directly related to the citizens’ benefits, such as capital expenditures, are given significantly lower proportion in local budgets. The concern arises of whether local governments act accountably in allocating local budgets, in the sense that they have appropriately used the available resources and capacities to maximize citizens’ welfare.
To address the limitation of balancing funds identified above, the research argues that (1) Indonesian intergovernmental grants need conditional grants that can work effectively to address specific public services, and (2) the design of such grants needs to consider incentives for accountability. For this reason, implementing PBG is an option to address specific public services while at the same improving the accountability in service delivery.

The argument refers to the theories and previous research which show that improving specific public service sectors is best achieved by implementing conditional grants (Musgrave 1973, Steffensen 2007, Broadway 2007, Broadway and Shah 2009, Slack 2009), while at the same time offering incentives for achievement of performance and accountability. The importance of incentives is recognized in the New Institutional Economics theory (NIE), which acknowledges that incentives play a role in guiding human behavior (North 1990, 2008). The New Public Management theory (NPM) points out the importance of improving efficiency and effectiveness by stressing performance, shifting from controlling inputs and procedures to achieving results, measured in term of output, performance, and outcome (Hood 1991, Rhodes 2006, Haque 2007, Jun 2009).

The point of each theory— incentives suggested by NIE and performance suggested by NPM—is connected to funding which is embodied in PBG (Shah 2010). The link between incentives, performance, and funding is important to promote accountability, improved institutional capacity, and local autonomy. The principles of the performance-based approach arguably have a positive impact based on the developing country experiences (UNCDF 2010). Introducing PBG in Indonesia is a start to implement the conditional grants that uphold the principles of performance and accountability in providing specific public services, and to make up for the absence of effective conditional grants in intergovernmental grants.
5.9. PBG in Indonesian Intergovernmental Grants

PBG is classified under an intergovernmental grant component called ‘grants’ (hibah).16 ‘Grants’ accommodate not only PBG, but also other conditional grants other than DAK. ‘Grants’ fund regional affairs (devolved functions), with due consideration to a region’s fiscal capacity, and are prioritized for public services. Like balancing funds and other intergovernmental grants, ‘grants’ are regulated in the law regarding fiscal decentralization, Law No. 33/2004. At a more technical level, ‘grants’ are regulated in Government Regulation No. 2/2012.

According to the regulation, there are three sources of funds for ‘grants’: foreign grants, foreign loans, and national revenues, as shown in Table 5.3 below.

<table>
<thead>
<tr>
<th>Foreign grants</th>
<th>Foreign loans</th>
<th>National revenues</th>
</tr>
</thead>
<tbody>
<tr>
<td>- Regional affairs</td>
<td>- Regional affairs</td>
<td>- Regional affairs</td>
</tr>
<tr>
<td>- Projects supporting national development programs</td>
<td>- Projects supporting national priorities</td>
<td>- Public services and capacity building</td>
</tr>
<tr>
<td>- Projects specifically requested by foreign grantors</td>
<td></td>
<td>- Other activities resulting from central government’s policy that add financial burden to subnational budgets</td>
</tr>
<tr>
<td>(Source: Government Regulation No. 2/2012)</td>
<td></td>
<td>- Specific activities determined by the central government</td>
</tr>
</tbody>
</table>

Although ‘grants’ has been a component in intergovernmental grants, it was not effectively used until 2009. Before that, if specific projects in regions were to be funded by central governments but not through DAK (or through loans), the funding was channeled to local governments through ministerial funds, known as deconcentration funds and co-administration funds. Both funds are administered by line ministries; they remain parts of the national budget and are never accounted for by subnational governments in subnational budgets.

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16 ‘Grants’, which is the name of a component of Indonesian intergovernmental grants, is written with apostrophes to differentiate it from grants (without apostrophe), which represent transfer of funds from one government transferred to another (level of) government.
The first effective ‘grants’ project were traditional input-based grants, which came from foreign loans in 2009 for the development of mass rapid transit (MRT) system in Jakarta. In 2010 and 2011 several ‘grants’ projects followed, all of them are performance-based. The ‘grants’ projects are summarized in the following table:

**Table 5.4**

<table>
<thead>
<tr>
<th>‘Grants’ Projects</th>
<th>Executing agency</th>
<th>Disbursement mechanism</th>
<th>Grants period</th>
<th>Source of funds</th>
<th>Total amount (IDR)</th>
<th>Number of recipients</th>
<th>Targeted Output</th>
</tr>
</thead>
<tbody>
<tr>
<td>Jakarta Mass Rapid Transit</td>
<td>Ministry of Transportation</td>
<td>Input based</td>
<td>2009 – 2014</td>
<td>Foreign loan (Japan)</td>
<td>5.3 trillions</td>
<td>1</td>
<td><em>(The loan is used to acquire tender assistance services, construction, and vehicles)</em></td>
</tr>
<tr>
<td>Local Basic Education (L-BEC)</td>
<td>Ministry of Education</td>
<td>Performance-based (PBG)</td>
<td>2009 – 2012</td>
<td>Foreign grants (European Commission and Netherlands)</td>
<td>125 billions</td>
<td>50</td>
<td>Improvement of education capacity</td>
</tr>
<tr>
<td>Drinking water (completed)</td>
<td>Ministry of Public Works</td>
<td>Performance-based (PBG)</td>
<td>2010 – 2011</td>
<td>Foreign grants (Australia)</td>
<td>35 billions</td>
<td>35</td>
<td>77,000 house connections for piped water</td>
</tr>
<tr>
<td>Waste Water (completed)</td>
<td>Ministry of Public Works</td>
<td>Performance-based (PBG)</td>
<td>2010 – 2011</td>
<td>Foreign grants (Australia)</td>
<td>35 billions</td>
<td>5</td>
<td>4,826 waste water connections</td>
</tr>
<tr>
<td>Water and Sanitation Program (WASAP-D)</td>
<td>Ministry of Public Works</td>
<td>Performance-based (PBG)</td>
<td>2010 – 2012</td>
<td>Foreign grants (Netherlands)</td>
<td>18 billions</td>
<td>6</td>
<td>Community-based and institution-based sanitation system</td>
</tr>
</tbody>
</table>

(Source: Indonesian Ministry of Finance)

5.9.1. **PBG Approval Process**

The process is mainly driven by line ministries. Unlike DAK which uses a formula-based approach in its allocation, as a part of ‘grants’, PBG is based on certain considerations and policies. According to Government Regulation No. 2/2012, general considerations used to determine grants recipients (including PBG recipients) and the allocated amount are:
- Low fiscal capacity
- Regions requested by foreign grantor
- Regions which meet criteria determined by line ministries
- Regions decided by central government to be recipient

The considerations above are not the only points that count for recipient selection. Other eligibility criteria for PBG recipients can be customized according to the design and target of each project. Figure 5.7 below summarizes PBG approval process.

Figure 5.7. PBG Approval Process

Line Ministries
Proposing potential PBG recipients and projected amount

Ministry of Finance
Endorsing PBG recipients and projected amount

PBG allocation to each recipient

Ministry of Finance and Subnational Government
Signing Grants Agreement

Considering fiscal capacity, grantor’s request, line ministry’s criteria, and government policies

Additional documents can be asked from potential recipients

Upon choosing the potential recipients and the projected amount, line ministries submit the proposal to the Ministry of Finance. Based on this, the Ministry of Finance prepares ‘grants’ agreement to be signed by the Ministry official and the head of subnational governments (governor, mayor, or regent) or their representatives. Before the signing of ‘grants’ agreement, the Ministry of Finance can ask subnational governments to provide additional documents confirming their willingness to comply with terms and conditions of the grants, e.g. local regulation on capital investment, local budget containing allocation for counterpart funds, and other documents as necessary.¹⁷

¹⁷ Based on interview with Yuddi Saptopranowo, Section Head Regional Grants III, Indonesian Ministry
5.9.2. **PBG Implementation and Funds Disbursements**

Line ministries issue guidelines on PBG implementation. The activities conducted by subnational governments are strictly limited to those determined in the guidelines and must comply with the grant agreement. Monitoring and supervision are conducted by related line ministries. Periodical reports must be submitted to line ministries and the Ministry of Finance. The detailed arrangement on implementation, supervision, monitoring, and reporting are described in the guidelines. As in the case of PBG allocation, the arrangement for these aspects can also be customized according to the projects.

Disbursement of PBG funds is subject to administrative and technical requirements. The administrative requirement includes submission of certain documents. Technical criteria include verification result of the attainment of a certain standard/target in project implementation. The standard/target may differ for each project, and are explained in the project guideline. Disbursement can only be made if both administrative and technical requirements are satisfied. Failure to meet the standard/target results in ineligibility to receive PBG funds.\(^\text{18}\)

\(^{18}\) Ibid.
CHAPTER VI
CASE STUDY: PBG FOR DRINKING WATER

This research uses PBG for drinking water in Indonesia as a case study to evaluate the impacts of PBG implementation on local governments’ accountability in delivering public services. As a consequence of functions sharing in decentralization, Indonesian local governments are responsible for the provision of drinking water service. To deliver the service, most local governments assign water supply companies as service providers, while a small percentage of local governments exercise the provision themselves. Beside the companies and local governments, private sectors also provide this service by retail sales, delivering the water on a door-to-door basis rather than through water pipes network, but the number is insignificant compared to water supply companies.

The research selects PBG for drinking water for two reasons. First, drinking water is a monopolistic public service, and the delivery of the service is predicted to follow the long-route of accountability suggested by the theoretical framework in Figure 3.4. In drinking water service, a complete set of actors in the long route of accountability are present: citizens that demand water service, local governments as policy makers who are responsible to ensure the service delivery, and service providers (water supply companies) who exercise the delivery based on assignment from local governments.

Second, drinking water is a sector with high importance in the national agenda, but it is in relatively poor condition. Drinking water has been assigned a national priority sector since 2005, and is included in the targets of Millennium Development Goals (MDG) 2015. However, according to the data of the Indonesian Central Bureau of Statistics, drinking water is one of the public services with decreasing indicators post decentralization. The performance of this sector is also relatively low. In 2010, The Indonesian Ministry of National Development Planning classified drinking water service as “needs special attention”, the lowest of three categories used
by the central government to monitor the progress of MDG targets. Compared to neighboring South East Asian countries of comparable income, in 2008 the performance of drinking water service in Indonesia is among the lowest, according to the World Bank in its World Development Indicators 2010.\\(^{19}\)

The situation raises interest of why drinking water service in Indonesia is still in a poor condition despite its importance to citizens (water is one of the vital basic needs) and the national policy that puts it as a priority. Why does this happen and how can this be changed? This makes the drinking water sector an ideal case study since the research can observe whether there’s a difference between the condition before and after PBG implementation, and how the incentives feature in PBG work to improve local governments’ accountability in this service.

This chapter explains the condition of drinking water before PBG implementation, the background of PBG for drinking water, how PBG is implemented, and the impact of PBG implementation on local governments’ accountability in drinking water service delivery. In this chapter, the research tries to find the answer of whether the incentives feature in PBG makes positive improvement in local governments’ accountability, and if it does, how it works. Finally, this chapter describes the results of the survey conducted to investigate local governments’ response to PBG implementation.

### 6.1. The Condition of Drinking Water Service in Indonesia

Drinking water is defined in Minister of Public Works Decree No.15/PRT/M/2010 as “household drinking water which, with treatment process or without treatment process, satisfy health standards and is directly drinkable”. In 2009, most Indonesian households rely on self-provision for water. Figure 6.1. below illustrated the primary source of drinking water for Indonesian households in 2009.

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As illustrated in Figure 6.1 above, the majority of households use groundwater as drinking water, obtained through protected wells (28%), unprotected wells (8%) and pumps (18%). The use of groundwater has raised concern in recent years due to its detrimental effects on the environment, including the intrusion of salt water and land subsidence. Bottled water (13%) gained more popularity especially among urban households because of its practicality – people can drink directly from the container, unlike other sources (including piped water) where the water needs boiling. Piped water accounts for 16% of the population. There are also households which use more than one source of drinking water, but the survey only measures the primary source (Ministry of Public Works 2012).

Drinking water has been one of the national priorities. The Indonesian government commits to achieve the target of MDG in the water sector, which is to halve the number of population without sustainable access to drinking water by 2015. The percentage to be achieved is 75.3% in urban area, 65.8% in rural area, and 68.9% in total, using the condition in 1993 as the baseline. In order to achieve the MDG target by 2015, the central government established
annual target of total households (urban and rural) with access to safe drinking water. The annual target is summarized in Table 6.1 as follows.\(^\text{20}\)

<table>
<thead>
<tr>
<th>Remark</th>
<th>Annual Target</th>
</tr>
</thead>
<tbody>
<tr>
<td>Percentage of total households with access to drinking water</td>
<td>2010</td>
</tr>
<tr>
<td></td>
<td>62%</td>
</tr>
</tbody>
</table>

(Source: Ministry of National Development Planning/National Development Planning Agency (Kementerian Perencanaan Pembangunan Nasional/Badan Perencanaan Pembangunan Nasional (Bappenas))

In 2010 total households with access to safe drinking water is 44.19%. This is below the annual target, which is set at 62%. Based on the review of the MDG target achievement progress in 2010, the Ministry of National Development Planning classified the water sector as “need special attention”. This is the lowest of the three categories in which the MDG progress results is classified, after “already achieved” and “on-track” (Ministry of National Development Planning 2010).

The governments’ investment in drinking water service as a percentage of gross domestic product (GDP) tends to decrease after decentralization. According to The World Bank (2006a), average annual spending in drinking water sectors from 1994 to 2000 are as follows:

<table>
<thead>
<tr>
<th>Level of government</th>
<th>Average (in IDR trillion, except in % of GDP)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>842</td>
</tr>
<tr>
<td>Provincial governments</td>
<td>55</td>
</tr>
<tr>
<td>Local governments</td>
<td>29</td>
</tr>
<tr>
<td>Total</td>
<td>926</td>
</tr>
<tr>
<td>% of GDP</td>
<td>0.23%</td>
</tr>
</tbody>
</table>


---

According to Table 6.2 above, the spending as a percentage of GDP increased during the period of 1993-2000. This trend ceased to continue in decentralization era. From 2004 to 2009, the percentage of spending for drinking water tends to decrease annually, as summarized in Table 6.3 below:

<table>
<thead>
<tr>
<th>Component</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
</tr>
</thead>
<tbody>
<tr>
<td>Drinking water sector</td>
<td>3,135</td>
<td>3,621</td>
<td>4,115</td>
<td>4,760</td>
<td>5,190</td>
<td>5,609</td>
</tr>
<tr>
<td>GDP</td>
<td>2,295,826</td>
<td>2,774,281</td>
<td>3,339,217</td>
<td>3,950,893</td>
<td>4,951,357</td>
<td>5,613,442</td>
</tr>
<tr>
<td>% of GDP</td>
<td>0.14%</td>
<td>0.13%</td>
<td>0.12%</td>
<td>0.12%</td>
<td>0.10%</td>
<td>0.10%</td>
</tr>
</tbody>
</table>


The most notable decrease in drinking water service is in urban area after decentralization. Starting from 2001, generally there is an increasing trend of access for rural households but decreasing access for urban households. The year of 2010 is the turning point; in this year, the percentage of access for rural households exceeded that of urban households. Figure 6.2 below summarizes the change in percentage of households with access to drinking water from 1993 to 2010.

(Source: Central Bureau of Statistics, several years of National Economics Survey (Survey Ekonomi Nasional/Susenas), in Ministry of National Development Planning/National Development Planning Agency (Bappenas) (2010)).
According to the Ministry of Public Works (2012), the relatively rapid development of water service in rural areas, in comparison with urban areas, is mostly influenced by the central government’s intervention. The central government-stimulated community-based water supply facilities have continued to proliferate and reach more beneficiaries. At the same time, local governments’ funding for drinking water has lagged behind the national target, both in funding amount as well as coverage, and local investments in urban drinking water cannot keep pace with population growth and depreciation.

One of the possibilities of why local governments’ investments is relatively low is the fragmentation in DAK for drinking water. DAK is said to be the major source of funding for capital investments (Ministry of Finance 2011), thus decrease in DAK for drinking water may decrease local governments’ investment in this sector.

Table 6.4 and Figure 6.3 below summarize the allocation of DAK for drinking water from 2005 (the first year drinking water became a targeted sector) to 2010.

### Table 6.4
Allocation of DAK for Drinking Water

<table>
<thead>
<tr>
<th>Year</th>
<th>Number of recipients</th>
<th>Total DAK for drinking water (In IDR billion)</th>
<th>Average (In IDR billion)</th>
<th>Minimum (In IDR billion)</th>
<th>Maximum (In IDR billion)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2005</td>
<td>259</td>
<td>203.50</td>
<td>0.79</td>
<td>0.46</td>
<td>2.39</td>
</tr>
<tr>
<td>2006</td>
<td>433</td>
<td>608.00</td>
<td>1.40</td>
<td>0.38</td>
<td>6.19</td>
</tr>
<tr>
<td>2007</td>
<td>434</td>
<td>1062.37</td>
<td>2.45</td>
<td>0.53</td>
<td>8.85</td>
</tr>
<tr>
<td>2008*</td>
<td>450</td>
<td>1142.29</td>
<td>2.54</td>
<td>0.11</td>
<td>9.61</td>
</tr>
<tr>
<td>2009*</td>
<td>431</td>
<td>1142.29</td>
<td>2.65</td>
<td>0.00</td>
<td>7.73</td>
</tr>
<tr>
<td>2010</td>
<td>452</td>
<td>357.23</td>
<td>0.79</td>
<td>0.56</td>
<td>2.45</td>
</tr>
</tbody>
</table>

*combined figure of drinking water and sanitation.

Source: Indonesian Ministry of Finance
From the data, the average DAK allocation increased from 2005 to 2007. In 2008 and 2009, the figure still increased, but it should be noted that in those years the DAK was given as joint allocation for water and sanitation. The proportion of DAK allocation for water and for sanitation in regions was decided by subnational governments. In 2010, average DAK allocation for clean water is close to the average allocation in 2007.

Observing the average DAK allocation between 2005 and 2010, fragmentation is obvious. Adjusting the current value to inflation, the average DAK allocation in 2010 is actually lower than that in 2005. This indicates fragmentation in DAK for clean water. As the number of DAK recipients increase without proportional increase in DAK pool, average allocation for each recipient decreases.

Smaller allocation limits the choices of subnational governments to do major investments with DAK, unless they are prepared to provide more counterpart funds. Without such willingness, and if subnational governments prefer to keep relying on DAK, capital investment in water sector can be disturbed.
6.2. Drinking Water Service Provided by Water Supply Companies

The World Bank (2007) mentioned that piped water (i.e. drinking water provided by water supply companies) is the most sustainable, safest and, in the long term, least costly solution for the provision of water in urban centers. However, the majority of the total population does not have access to piped water. As described in Figure 6.1, piped water is one of the drinking water sources, used as primary drinking water source for 16% of Indonesian population, mostly in urban area. The urban area, as shown in Figure 6.2, is facing declining access to drinking water service. The decrease also happens to access to piped water.

According to the data of the Central Bureau of Statistics, the percentage of population with access to piped water (i.e. the number of population with access to piped water divided by total population) increased from 1993 to 2000, the last year before decentralization implementation. The percentage then decreased in the decentralization era, starting from 2001 and continuing to 2010. In 2010, the percentage was 12.44%, lower than the condition in 1993 when the coverage was 14.71%. Figure 6.4 below illustrates the service coverage from 1993 to 2010:

(Source: Central Bureau of Statistics)
Coucouvinis (2010) argued that the decline is caused by lack of investments in water supply companies. In 2007, only 0.37% of local budgets were allocated for water supply companies. Investment in water supply generally cannot keep pace with population growth, and service coverage continues to decline. This condition resulted from local governments’ reluctance to invest in water supply companies, which signifies a lack of trust in the companies. Prior to decentralization, the central government was largely responsible for the financing and construction of water supply infrastructure at the local level. After decentralization, central government investment decreased, but local governments did not step in to fill the gap as they were supposed to. The decrease in investments can hinder water supply companies from expanding piped water service coverage. Hawes (2010) mentioned that the under-investment is sustained and the proportion of investments is declining in comparison with population over the past decade.

While DAK fragmentation may be a reason for decreasing investments in drinking water in general, it is hardly the reason for decreasing investments in piped water in particular. Local governments tend to prioritize spending money by through their departments (e.g. public works department in case of water service), instead of investing the in water supply companies (Coucouvinis 2010). This can be detrimental to the piped water service, since the companies – being local government-owned enterprises – cannot raise water tariffs according to the companies’ policy. Water tariffs are regulated by local governments, and the tariffs do not always cover the cost. Many water supply companies are thus unable to add water connection to expand their service coverage, especially to poor citizens, because they cannot raise sufficient funds from sales (World Bank 2007).

In order to accountable in providing public services, local governments need to allocate sufficient amount of funding from their budgets. When the services are not directly provided by the local governments, they also need to support the service providers and ensure that the
providers deliver the service effectively by providing technical assistance and investments. Providing funds is a way of being accountable to local citizens (Glynn 1993).

PBG for drinking water targets expansion of piped water service by providing incentives for local governments to increase their investments in water supply companies. With increased investments, it is expected that more citizens, especially poor citizens in urban area, can have access to piped water.

6.3. Overview of PBG for Drinking Water

PBG for drinking water is implemented in 2010 and 2011, involving 35 local governments. The funding for PBG came from foreign grants provided by the Australian Government through AusAID. The main objective of the project is to support the achievement of one of MDG targets, which is to reduce by half the proportion of the population without sustainable access to safe drinking water and basic sanitation, with priority on low-income citizens. A secondary objective is to strengthen the financial position of water utilities, and to enhance the commitment of local governments to their water supply company/waste water treatment company. The outcome of the project is expected to be improved public services provided to the population (Ministry of Public Works 2010).

PBG for drinking water is granted to local governments, on the condition that they will make investment in their water supply companies. It targeted 77,000 household connections to piped water. Assuming six persons per household, about 462,000 persons would benefit from the additional connections. The amount of the grant is set at IDR 2 million per connection for the first 1,000 connections, and IDR 3 million subsequently. The line ministry responsible for this project is the Ministry of Public Works. It acts as executing agency and works closely with AusAID in monitoring, evaluating, and verifying the implementation. Ministry of Public Works also has issued a Water and Sanitation PBG Project Implementation Manual (PIM), a guideline of PBG project implementation. The PIM poses a number of criteria to the local government as
the recipient of the grant, and the ultimate beneficiary. In addition, the PIM specifies technical requirements for the service connections.

The eligibility criteria, selection of grants recipient, project implementation, and verification and reimbursement process are explained in the Consolidated Report of Verification Survey for Water and Sanitation Hibah (Australia-Indonesia Partnership 2011a). The explanation is summarized in the following sections.

6.3.1. Eligibility Criteria

Local governments interested to participate in PBG for drinking water program have to fulfill a number of criteria to determine eligibility. There are four categories of eligibility: recipient eligibility, beneficiary eligibility, technical eligibility, and additional eligibility. All eligibilities must be met to qualify as grants recipient.

a. Recipient eligibility

The recipient of PBG for drinking water is local government. To be eligible, the local government must meet the following criteria:

- The local government and its water supply company do not have outstanding debt to the central government, or are involved in a program to restructure their outstanding debt.
- There is sufficient capacity to distribute water to new consumers.

b. Beneficiary eligibility

Beneficiary is customers who benefit from household connections funded by PBG for drinking water. The eligibility criteria for beneficiary are:

- Categorization as low income household as determined by the head of the region.

- Installed electrical power of ≤ 1,300 VA, while 50% of the targeted beneficiaries have installed electrical power of ≤ 900 VA.
- Willingness and ability to meet the water supply company’s customer requirements.
c. Technical eligibility

- Connection is made subsequent to conclusion of the grants agreement between the Ministry of Finance and local governments.

- The technical specifications of the service connection are in line with the quality standard in use by the water supply company, which should refer to the technical standard issued by the Ministry of Public Works and the national standards of Indonesia.

d. Additional eligibility

- Availability of a list of potential beneficiaries.

- Availability of an implementation document covering at least the value of the grant for the number of service connections to be installed per year.

- Availability of a technical planning document, i.e. detailed engineering design (DED), for the service connections to be installed.

- Readiness for verification and audit.

- Availability of operational funds for related activities in the local governments receiving grants.

6.3.2. Selection of PBG Recipients

Figure 6.5 below summarizes selection process of PBG recipients. The Ministry of Public Works made a list of potential PBG recipients, based on the water capacity available in each region to serve additional customers. The Ministry of Finance provides fiscal capacity data and outstanding debt data of potential recipients. Based on the data, the potential recipients are sorted into shortlisted candidates. A baseline survey is then carried out in regions whose local governments satisfied the recipient criteria. The survey is to confirm the status of beneficiary criteria; it aimed at identifying low-income households interested in connecting to a piped-water system of the water supply company. If the beneficiary criteria are satisfied, the Ministry of
Public Works, the Ministry of Finance, and local governments coordinate to check the status of technical and additional eligibility. After all eligibility criteria are met, the process for grants application by local governments begins.\textsuperscript{21}

Local governments selected as PBG recipients are required to submit certain documents to confirm their commitment in PBG projects. This confirmation signifies the local autonomy in PBG; local governments have the liberty to decide their participation in the program. Grant agreements are then signed by the Minister of Finance and mayor/regent, or their representatives. Thirty-five local governments are selected as recipients of PBG for drinking water in 2010 and 2011. The process of selecting recipients, implementing the programs, monitoring, verification, and disbursements are conducted in close coordination with the donor, AusAID.

6.3.3. PBG Implementation

Figure 6.6 below summarizes the implementation process of PBG for drinking water. PBG for drinking water requires pre-financing. Recipient local governments allocated the funds

\textsuperscript{21} Based on interview with Reni, project officer, Directorate of Drinking Water Improvement, Ministry of Public Works, March 2012.
from local budget for equity investment in their water supply company. With this investment, water supply companies build piped-water household connections for low income households, and report the works to local governments.

Application for reimbursement can be processed if the connections worked well according to standards determined by the Ministry of Public Works. For PBG project, the proof of the connection’s functionality came from paid water bills for two consecutive months. Verification is performed by the Ministry of Public Works and AusAID representatives. After the connections are verified, local governments can apply for funds reimbursement to the Ministry of Finance.

6.4. Recipients of PBG for Drinking Water

PBG for drinking water is granted to 35 local governments; 22 received the grants in 2010 and 13 received the grants in 2011.\textsuperscript{22} The composition of local governments receiving

\textsuperscript{22} A local government, Kab. Situbondo, withdrew participation after its share was allocated.
PBG based on their fiscal capacity\textsuperscript{23} in 2009 is illustrated in Figure 6.7 below.

The majority of participating local governments are classified as local governments with low fiscal capacity, with 24 out of 35 local governments. Local governments with medium, high, and very high fiscal capacity are 6, 4, and 1, respectively.

Table 6.5 below summarizes the general information of local governments who received PBG for drinking water, including the grants allocation, grants realization, and fiscal capacity in 2009. The table shows that as for target achievement, on average 97\% of piped water connections had been installed and functioning well. A piped water connection is considered achieving PBG requirements if it has been functioning well for three months, confirmed by payments made by customers to water supply companies. This emphasizes that PBG insists not only on the availability of output resulting from the grants funds, but also on the fact that the output is functioning well (performance).

\textsuperscript{23} Fiscal capacity is calculated by the Ministry of Finance for each subnational government (i.e. provincial and local governments) every year. The compilation of the calculation is published as 'Fiscal Capacity Map’ in annual ministerial decree, which classified subnational governments into 4 categories: low, medium, high, and very high. The last decree regarding fiscal capacity is Ministry of Finance Decree No. 244/PMK.07/2011. The decree defines fiscal capacity as “subnational governments’ financial capacity as reflected on the revenues in subnational budget (not included DAK, emergency funds, loans, and other revenues which utilization is restricted to certain expenditures) to finance local expenditures after deducted by salary expenditures, with consideration to the number of poor population”. The formula of fiscal capacity used for grants allocation is different from that of fiscal capacity used for DAU allocation. The same terminology often caused confusion.
Table 6.5.
Recipients of PBG for Drinking Water

<table>
<thead>
<tr>
<th>Year</th>
<th>No.</th>
<th>City/Regency (Kab/Kota)</th>
<th>Grant Allocation</th>
<th>Realization</th>
<th>Fiscal Capacity in 2009</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td>Amount (IDR 000)</td>
<td>Targeted House Connection</td>
<td>Amount (IDR 000)</td>
</tr>
<tr>
<td>2010</td>
<td>1</td>
<td>KAB. BANGKALAN</td>
<td>2,300,000</td>
<td>1,100</td>
<td>100.0%</td>
</tr>
<tr>
<td></td>
<td>2</td>
<td>KAB. BANJAR</td>
<td>5,000,000</td>
<td>2,000</td>
<td>100.0%</td>
</tr>
<tr>
<td></td>
<td>3</td>
<td>KAB. BOGOR</td>
<td>12,500,000</td>
<td>4,500</td>
<td>100.0%</td>
</tr>
<tr>
<td></td>
<td>4</td>
<td>KAB. BOYOLALI</td>
<td>2,450,000</td>
<td>1,150</td>
<td>100.0%</td>
</tr>
<tr>
<td></td>
<td>5</td>
<td>KAB. CIAMIS</td>
<td>8,000,000</td>
<td>3,000</td>
<td>43.8%</td>
</tr>
<tr>
<td></td>
<td>6</td>
<td>KAB. CIANJUR</td>
<td>2,000,000</td>
<td>1,000</td>
<td>100.0%</td>
</tr>
<tr>
<td></td>
<td>7</td>
<td>KAB. CILACAP</td>
<td>2,900,000</td>
<td>1,300</td>
<td>100.0%</td>
</tr>
<tr>
<td></td>
<td>8</td>
<td>KAB. DONGGALA</td>
<td>2,000,000</td>
<td>1,000</td>
<td>100.0%</td>
</tr>
<tr>
<td></td>
<td>9</td>
<td>KAB. GARUT</td>
<td>9,950,000</td>
<td>3,650</td>
<td>100.0%</td>
</tr>
<tr>
<td></td>
<td>10</td>
<td>KAB. JOMBANG</td>
<td>2,600,000</td>
<td>1,200</td>
<td>100.0%</td>
</tr>
<tr>
<td></td>
<td>11</td>
<td>KAB. KAPUAS</td>
<td>2,000,000</td>
<td>1,000</td>
<td>100.0%</td>
</tr>
<tr>
<td></td>
<td>12</td>
<td>KAB. KARAWANG</td>
<td>14,000,000</td>
<td>5,000</td>
<td>100.0%</td>
</tr>
<tr>
<td></td>
<td>13</td>
<td>KAB. KLATEN</td>
<td>8,000,000</td>
<td>3,000</td>
<td>100.0%</td>
</tr>
<tr>
<td></td>
<td>14</td>
<td>KAB. KUDUS</td>
<td>2,000,000</td>
<td>1,000</td>
<td>100.0%</td>
</tr>
<tr>
<td></td>
<td>15</td>
<td>KAB. KUNINGAN</td>
<td>14,450,000</td>
<td>5,150</td>
<td>100.0%</td>
</tr>
<tr>
<td></td>
<td>16</td>
<td>KAB. LAMPUNG UTARA</td>
<td>1,400,000</td>
<td>700</td>
<td>100.0%</td>
</tr>
<tr>
<td></td>
<td>17</td>
<td>KAB. LOMBOK TIMUR</td>
<td>1,000,000</td>
<td>500</td>
<td>100.0%</td>
</tr>
<tr>
<td></td>
<td>18</td>
<td>KAB. MUARA ENIM</td>
<td>3,500,000</td>
<td>1,500</td>
<td>100.0%</td>
</tr>
<tr>
<td></td>
<td>19</td>
<td>KAB. PANDEGLANG</td>
<td>2,000,000</td>
<td>1,000</td>
<td>100.0%</td>
</tr>
<tr>
<td></td>
<td>20</td>
<td>KAB. SERANG</td>
<td>11,000,000</td>
<td>4,000</td>
<td>100.0%</td>
</tr>
<tr>
<td></td>
<td>21</td>
<td>KAB. SIDOARJO</td>
<td>14,000,000</td>
<td>5,000</td>
<td>100.0%</td>
</tr>
<tr>
<td></td>
<td>22</td>
<td>KAB. SITUBONDO*</td>
<td>2,000,000</td>
<td>1,000</td>
<td>0.0%</td>
</tr>
<tr>
<td></td>
<td></td>
<td>TOTAL 2010</td>
<td>125,050,000</td>
<td>48,750</td>
<td>92.9%</td>
</tr>
<tr>
<td>2011</td>
<td>1</td>
<td>KAB. SUKOHARJO</td>
<td>2,000,000</td>
<td>1,000</td>
<td>100.0%</td>
</tr>
<tr>
<td></td>
<td>2</td>
<td>KAB. WONOGIRI</td>
<td>5,000,000</td>
<td>2,000</td>
<td>100.0%</td>
</tr>
<tr>
<td></td>
<td>3</td>
<td>KAB. WONOSOBO</td>
<td>14,000,000</td>
<td>5,000</td>
<td>100.0%</td>
</tr>
<tr>
<td></td>
<td>4</td>
<td>KOTA BALIKPAPAN</td>
<td>2,000,000</td>
<td>1,000</td>
<td>100.0%</td>
</tr>
<tr>
<td></td>
<td>5</td>
<td>KOTA BANJARBARU</td>
<td>3,500,000</td>
<td>1,500</td>
<td>100.0%</td>
</tr>
<tr>
<td></td>
<td>6</td>
<td>KOTA BANJARMASIN</td>
<td>14,500,000</td>
<td>5,000</td>
<td>96.6%</td>
</tr>
<tr>
<td></td>
<td>7</td>
<td>KOTA BOGOR</td>
<td>5,000,000</td>
<td>2,000</td>
<td>100.0%</td>
</tr>
<tr>
<td></td>
<td>8</td>
<td>KOTA JAYAPURA</td>
<td>1,000,000</td>
<td>500</td>
<td>100.0%</td>
</tr>
<tr>
<td></td>
<td>9</td>
<td>KOTA MALANG</td>
<td>11,000,000</td>
<td>4,000</td>
<td>100.0%</td>
</tr>
<tr>
<td></td>
<td>10</td>
<td>KOTA PADANG</td>
<td>3,500,000</td>
<td>1,500</td>
<td>100.0%</td>
</tr>
<tr>
<td></td>
<td>11</td>
<td>KOTA PALANGKARAYA</td>
<td>1,500,000</td>
<td>750</td>
<td>100.0%</td>
</tr>
<tr>
<td></td>
<td>12</td>
<td>KOTA PALEMBOANG</td>
<td>17,000,000</td>
<td>6,000</td>
<td>100.0%</td>
</tr>
<tr>
<td></td>
<td>13</td>
<td>KOTA PEKALONGAN</td>
<td>1,000,000</td>
<td>500</td>
<td>100.0%</td>
</tr>
<tr>
<td></td>
<td></td>
<td>TOTAL 2011</td>
<td>81,000,000</td>
<td>30,750</td>
<td>99.7%</td>
</tr>
<tr>
<td></td>
<td></td>
<td>TOTAL 2010 AND 2011</td>
<td>206,050,000</td>
<td>79,500</td>
<td>96.6%</td>
</tr>
</tbody>
</table>

*Withdrew participation after the grants was allocated.
Source: Minister of Finance Decree No. 245/PMK.07/2010 (fiscal capacity data) and Australia-Indonesia Partnership (2011b) (other data).
6.5. Accountability Relationship Framework in Drinking Water Service

Referring to the conceptual framework described in Chapter III, an accountability relationships framework in drinking water service is established in Figure 6.8 below:

Since water is a monopolistic public service, the short route of accountability is not expected to be observed. Instead, the accountability is ensured through the long route of accountability (Word Bank 2004). Similar to the conceptual framework, in this framework citizens demand good water service from the governments. The governments then make water supply companies to deliver the demands.

Water service is a decentralized sector; this makes the main responsibility is on local governments, to whom the central government provides intergovernmental grants as financial support. In this case, the intergovernmental grants is PBG, which will be the focus of analysis. The framework in Figure 6.8 suggests that central and local governments are coordinated through the employment of PBG, and that the features of PBG arguably benefit the coordination. The result of this process, provided all the ideal conditions are met, is the delivery of good drinking water services.
The data presented in the previous sections show that drinking water service (piped water) is decreasing. This signifies that the accountability relationship is not working as expected. Referring to the framework, there are 3 possibilities sources of distraction on the long-route of accountability: (1) citizens’ lack of demand for piped water service, (2) local governments’ lack of capacity to improve the service, or (3) both of them.

The next sections will evaluate why the accountability relationship does not work effectively in drinking water service in Indonesia, focusing on the possible causes of distraction in the accountability relationships.

The first step is to evaluate whether there’s citizens’ demand for piped water service. To do this, the research uses secondary data about the demands from citizens. From the data, it will be observed whether citizens voice their demand of piped water to the governments. Theoretically, citizens’ demand is the trigger in the long route of accountability, without which the governments do not have any pressure to take action. It means that if citizens’ demands exist, local government should have the incentives to improve the demanded service.

The second step is to evaluate whether local governments have the capacity to improve the service. This research will focus on financial capacity, indicated by local governments’ investments in piped water. Conceptual framework suggests that as a part of accountability, local governments need to provide financial support to water supply companies in order to supply the citizens’ demand for good piped water service. To have an insight of local governments’ financial capacity to increase investments, the research estimates the amount of investments needed in order to reach piped water service coverage according to national standard, and compares the estimated investments with local governments’ financial capacity.

From the evaluation results, the possible cause of the decreasing service will be identified. Based on this, the research will evaluate whether the situation changes with the implementation of PBG and if it does, how PBG work to cause the change.
6.6. Citizens’ Demand for Drinking Water Service

Drinking water can be provided by governments (local governments and central government), water supply companies, and the private sector. If provided by local governments, drinking water is supplied by public service agencies or by community-based drinking water facilities operated by the communities. The funding comes from local budgets, either from the central government through intergovernmental grants (including DAK for drinking water) or from own-source revenues. DAK targets urban slum areas, fishermen villages, and rural areas (Ministry of Public Works 2010).

The central government through line ministries also provides drinking water, mostly community-based. A community-based water supply system is used in communal scale and managed independently by the communities, based on guidelines issued by the governments. Although the design of the system is expected to be easy to operate and maintain, transferring the management of the system to the communities is not always a desirable option. Vazquez (2011) documented the experience of Guatemala, where rural households do not prefer community-based water supply facilities. According to the findings, this reflects the community’s fatigue in providing the labor and other input to maintain the system. The community will benefit from the government’s technical and management assistance to improve the quality of water supply. The assistance will also reduce voluntarily input and prevent the system from falling into disrepair (Whittington et al. 2007, Harvey and Reed 2009).

Most private sectors provide water by selling it retail, targeting residential areas where water access is limited. Water is delivered in carts by passing street vendors, and is sold at a high price, making water provided by the private sector the most expensive option (Hawes 2010).

In interviews with AusAid and Ministry of Public Works officials, it is found that citizens’ demand for piped water from water supply companies is actually high. Waiting lists of potential customers can be found in almost all water supply companies. Even among poor households,
willingness to have piped water connection from the companies is very high. This is because poor households are least likely to have ready access to safe drinking water, thus making them dependent on private sectors which sell water at a higher price than water supply companies.

Long waiting lists of water supply companies also appear in many local newspapers and publications, e.g. in Makassar, the biggest city in Sulawesi island (40,000 as of August 2012, according to Kabar Makassar, a local newspaper), Samarinda, the capital of Kalimantan Timur province (7,369 as of September 2012, according to the official website of Samarinda Water Supply Company), Kendari, the capital of Sulawesi Tenggara province (10,000 as of October 2012, according to Antara, Indonesian national news agency).

According to the accountability relationships framework, the trigger of the long route of accountability is citizens’ demand for service. There is a strong indication that citizens’ demand for piped water is high, and given the democratic governance, the demand already reached the governments. However, the service coverage of piped water remains low. The waiting lists are not always addressed immediately by water supply companies. An almost uniform reason is that they lack the capacity to provide water to all applicants due to, among others, limited raw water capacity, limited production capacity, and obsolete water system—all these can be traced to limited investment funds for service expansion. The under-investment argument is also mentioned by, among other, the Ministry of Public Works (2012), Coucouvinis (2010) and Hawes (2010).

The framework also suggests that, in the long route of accountability, the next step after citizens’ demand is the governments’ effort to ensure that the citizens get the service they ask. In the case of piped water, the effort can be observed in the form of investments for piped water

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24 Based on interview with Poppy Lestari (AusAid), Putri and Reni (Ministry of Public Works), March 2012.
25 http://www.kabarmakassar.com/?p=12320
service. The fact that investments remain low despite strong demand from the citizens raises a question of why local governments do not increase its investment.

A possibility is that local governments lack the financial capacity to increase their investments. This can be the reason due to the high dependency on DAK for capital expenditure (Ministry of Finance 2011, Gervais 2010), which may be an indication for low financial capacity. According to the Ministry of Finance, 42.3% of all Indonesian local governments are under the category of low fiscal capacity in 2009, 26.8% in the medium category, 15.7% in the high category, and the remaining 15.2% are in the very high category. Based on the data, local governments with low fiscal capacity represent the largest group, which can be the reason for their low investments. Besides, decentralization in Indonesia is more focused on expenditure side, rather than revenue side (Nugrahanto and Muhyiddin, 2008). While all public service functions have been devolved to local governments, most revenue sources such as major taxes are still managed by the central governments. This makes most local governments depend on intergovernmental grants as the major revenue sources.

Is this the case for local governments’ low investments in drinking water service? The next section will evaluate local governments’ financial capacity to identify whether financial capacity is the main reason for the low investments in drinking water service.

6.7. Local Governments’ Financial Capacity to Invest in Drinking Water Service

According to the accountability relationships framework, following citizens’ demand, local governments who are mainly responsible for the delivery of public services, will respond to fulfill the demand. The response of local governments is expected to be observed in, among others, budget allocation for piped water service, including for investment in water supply companies to expand piped water service coverage. However, the current situation shows that even though there is citizens’ demand for piped water, its service coverage has been declining, as well as local governments’ investments in water supply companies.
The research tries to evaluate whether this situation results from local governments’ lack of financial capacity. To achieve this, local governments’ financial capacity is estimated and assessed against a hypothetical situation where the capacity is assumed to be used for investment in piped water. The objective of this approach is to identify whether local governments have the financial capacity to allocate more funds for investments in the service.

The research argues that, if the estimation shows that local governments have the financial capacity to invest, budget limitation is not the main reason for the lack of investment. In this case, local governments could have been more accountable to local citizens in providing water service if they had increased their investments in water supply companies. This is because with the investments, water supply companies can expand their service coverage and deliver water service to more citizens.

The research uses local governments participating in PBG for drinking water and their water supply companies as samples. There are 35 participating local governments, but only 24 have water supply companies that have been audited for fiscal year 2010. Because the estimation requires data of water supply companies, the research only includes the 24 regions (cities and regencies) which local governments received PBG and which water supply companies have been audited for fiscal year 2010. Data related to water supply companies is obtained from the results of audits conducted by Supreme Audit Body (Badan Pemeriksa Keuangan/BPK) or by Government Audit Agency (Badan Pemeriksa Keuangan dan Pembangunan/BPKP). Data related to local governments’ budget is obtained from the Ministry of Finance.

6.7.1. Estimating Investment Needs and Borrowing Capacity

According to the Ministry of National Development Planning, the target of service coverage for drinking water in 2011 is 62.50% of total population.28 Since water supply
companies’ service areas do not cover the whole population, it is assumed that this target is to be achieved within the companies’ service areas. In other words, the target of 62.50% is assumed to represent 62.50% of the population in the companies’ service area. To achieve this target, the research tries to estimate investments required from each local government, and evaluate whether the local government has the financial capacity to make the investments.

The estimation is hypothetical. Data from local budgets in fiscal year 2010 and from water supply companies’ audited reports 2010 will be used to estimate the investments need. Assumptions used in the estimation are:

1. Local budget surplus from fiscal year 2010 is available to use for investment in water supply companies.
2. In case budget surplus is not sufficient, local governments take long term loans to cover the difference. The loans are to be paid in 10 years, assuming annual fixed interest rate of 11.75%, which is currently applied to loans from central to local governments, provided the loans are in domestic currency.
3. Maximum amount of loans is determined by local governments’ borrowing capacity. According to Government Regulation No. 54/2005 on Regional Loans, borrowing capacity is represented by Debt Service Coverage Ratio (DSCR). A local government is eligible to borrow if its DSCR is at least 2.50.
4. The yardstick for water service coverage to be achieved is 62.50%, which is the national target of households with access to piped water in 2011.
5. Citizens receive piped water from household connections.


29 According to the Government Regulation No. 54/2005, DSCR formula is as follows:

\[
DSCR = \frac{\text{Own-source revenues} + (\text{DBH} - \text{DBH for Reforestation}) + \text{DAU}}{\text{Salary expenditures}} > 2.5
\]

Loans principals + Interests + Other loans-related expenses

30 Citizens can get piped water from (1) household connection installed in citizens’ residences, (2) public hydrant installed for communal use in certain neighborhoods, (3) water depots and water trucks which sell water via retail system, where citizens pay certain amounts of money to get certain quantity of water.
6. All work to install piped water connections can be finished by the end fiscal year 2011.

Using these assumptions, the investment need and the borrowing capacity are then estimated. The estimation of investment need follows these following steps:

1. Estimating the difference in water service coverage between the actual condition in 2010 and the target in 2011, which is 62.5%. The difference is the starting point to estimate the investments needs. For example, in Kab. Serang (Serang regency), actual water service coverage in 2010 is 29.39%. Thus, the difference from the target is 33.11% (62.5% - 29.39%).

2. Estimating the number of additional piped water connections required to close the difference. To calculate this, first the research estimates the additional number of the population in the service area represented by the difference in point (1). In Kab. Serang, the difference of 33.11% represents 248,582 people. Assuming a household consists of five people, 49,716 additional piped water connections (248,582/5) are required to reach the 2011 target.

3. Estimating the amount of investments needed to install additional piped water connections in point (2). Assuming the investment cost for one connection is IDR 6 million (about JPY 50,000), the investments need is estimated to be IDR 6 million times additional connections. Following the above example, estimated investments need for Kab. Serang is IDR 298.3 billion (cost per connection of IDR 6 million x additional connection of 49,716 units).

The estimation of borrowing capacity follows these steps:

1. Estimating the loans to cover the investments, in case budget surplus is not sufficient. In Kab. Serang, budget surplus in 2010 is IDR 66.7 billion. This means that the local

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31 This assumption is used by the auditor to audit the water supply companies.
32 Based on the cost estimation of PBG for drinking water used in AusAID (2010).
government will need additional loans in an amount of IDR 231.6 billion (investments need of IDR 298.3 billion – budget surplus of 66.7 billion).

2. Estimating the borrowing capacity with the additional loan. Based on DSCR formula, borrowing capacity of Kab. Serang is 3.19. The figure is higher than the minimum DSCR requirement of 2.50, which means that Kab. Serang has sufficient borrowing capacity to take the full loans.

The results of estimation are as summarized in Table 6.6 below:

<table>
<thead>
<tr>
<th>Area</th>
<th>Water supply company’s service coverage in 2010</th>
<th>Difference from 2011 target (62.5%)</th>
<th>Additional population to cover to reach service coverage of 62.5%</th>
<th>Additional house connection required to reach service coverage of 62.5%</th>
<th>Total investment needs (IDR million)</th>
<th>Local budget surplus (IDR million)</th>
<th>Additional Loans (IDR million)</th>
<th>DSCR with additional loan</th>
</tr>
</thead>
<tbody>
<tr>
<td>Kab. Bangkalan</td>
<td>14.54%</td>
<td>47.96%</td>
<td>302,440</td>
<td>60,488</td>
<td>362,928</td>
<td>10,902</td>
<td>352,026</td>
<td>1.83</td>
</tr>
<tr>
<td>Kab. Banjar</td>
<td>30.00%</td>
<td>32.50%</td>
<td>198,022</td>
<td>39,604</td>
<td>237,626</td>
<td>89,560</td>
<td>148,066</td>
<td>4.86</td>
</tr>
<tr>
<td>Kab. Boyolali</td>
<td>66.12%</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Kab. Ciamis</td>
<td>30.39%</td>
<td>32.11%</td>
<td>126,893</td>
<td>25,379</td>
<td>152,271</td>
<td>162,500</td>
<td>0</td>
<td>-</td>
</tr>
<tr>
<td>Kab. Cianjur</td>
<td>54.76%</td>
<td>7.74%</td>
<td>32,833</td>
<td>6,557</td>
<td>39,400</td>
<td>102,919</td>
<td>0</td>
<td>-</td>
</tr>
<tr>
<td>Kab. Cilacap</td>
<td>45.80%</td>
<td>16.70%</td>
<td>157,976</td>
<td>31,595</td>
<td>189,571</td>
<td>36,479</td>
<td>153,092</td>
<td>6.75</td>
</tr>
<tr>
<td>Kab. Donggala</td>
<td>44.40%</td>
<td>18.10%</td>
<td>90,685</td>
<td>18,137</td>
<td>108,822</td>
<td>17,308</td>
<td>91,514</td>
<td>2.98</td>
</tr>
<tr>
<td>Kab. Garut</td>
<td>38.23%</td>
<td>24.27%</td>
<td>143,549</td>
<td>28,710</td>
<td>172,259</td>
<td>118,854</td>
<td>53,405</td>
<td>20.24</td>
</tr>
<tr>
<td>Kab. Jombang</td>
<td>19.24%</td>
<td>43.26%</td>
<td>217,133</td>
<td>43,427</td>
<td>260,559</td>
<td>53,445</td>
<td>207,114</td>
<td>4.33</td>
</tr>
<tr>
<td>Kab. Karawang</td>
<td>30.35%</td>
<td>32.15%</td>
<td>353,949</td>
<td>70,790</td>
<td>424,739</td>
<td>204,002</td>
<td>220,737</td>
<td>6.05</td>
</tr>
<tr>
<td>Kab. Klaten</td>
<td>37.54%</td>
<td>24.96%</td>
<td>165,221</td>
<td>33,044</td>
<td>198,265</td>
<td>27,500</td>
<td>170,765</td>
<td>1.91</td>
</tr>
<tr>
<td>Kab. Kuningan</td>
<td>34.28%</td>
<td>28.22%</td>
<td>110,707</td>
<td>22,141</td>
<td>132,848</td>
<td>55,496</td>
<td>77,352</td>
<td>4.65</td>
</tr>
<tr>
<td>Kab. Lombok Timur</td>
<td>37.11%</td>
<td>25.39%</td>
<td>82,374</td>
<td>16,475</td>
<td>98,849</td>
<td>17,343</td>
<td>81,506</td>
<td>8.09</td>
</tr>
<tr>
<td>Kab. Muara Enim *</td>
<td>38.86%</td>
<td>23.64%</td>
<td>71,747</td>
<td>14,349</td>
<td>86,096</td>
<td>84,369</td>
<td>1,727</td>
<td>1,075.26</td>
</tr>
<tr>
<td>Kab. Pandeglang</td>
<td>6.76%</td>
<td>55.74%</td>
<td>638,686</td>
<td>127,737</td>
<td>766,423</td>
<td>57,190</td>
<td>709,233</td>
<td>0.75</td>
</tr>
<tr>
<td>Kab. Serang</td>
<td>29.39%</td>
<td>33.11%</td>
<td>248,582</td>
<td>49,716</td>
<td>298,299</td>
<td>66,653</td>
<td>231,645</td>
<td>3.19</td>
</tr>
<tr>
<td>Kab. Sidoarjo</td>
<td>31.04%</td>
<td>31.46%</td>
<td>576,427</td>
<td>115,285</td>
<td>691,713</td>
<td>139,390</td>
<td>552,323</td>
<td>3.50</td>
</tr>
<tr>
<td>Kab. Situbondo</td>
<td>26.66%</td>
<td>35.84%</td>
<td>152,956</td>
<td>30,591</td>
<td>183,548</td>
<td>104,309</td>
<td>79,239</td>
<td>5.60</td>
</tr>
<tr>
<td>Kab. Sukoharjo</td>
<td>11.91%</td>
<td>50.59%</td>
<td>373,846</td>
<td>74,769</td>
<td>448,616</td>
<td>52,731</td>
<td>395,885</td>
<td>1.11</td>
</tr>
<tr>
<td>Kab. Wonogiri</td>
<td>46.94%</td>
<td>15.56%</td>
<td>87,014</td>
<td>17,403</td>
<td>104,417</td>
<td>108,589</td>
<td>0</td>
<td>-</td>
</tr>
<tr>
<td>Area</td>
<td>Water supply company’s service coverage in 2010</td>
<td>Difference from 2011 target (62.5%)</td>
<td>Additional population to cover to reach service coverage of 62.5%</td>
<td>Additional house connection required to reach service coverage of 62.5%</td>
<td>Total investment needs (IDR million)</td>
<td>Local budget surplus (IDR million)</td>
<td>Additional Loans (IDR million)</td>
<td>DSCR with additional loan</td>
</tr>
<tr>
<td>-----------------------------</td>
<td>-----------------------------------------------</td>
<td>-----------------------------------</td>
<td>---------------------------------------------------------------</td>
<td>---------------------------------------------------------------------</td>
<td>-------------------------------------</td>
<td>-----------------------------------</td>
<td>---------------------------------</td>
<td>-----------------------------</td>
</tr>
<tr>
<td>Kab. Wonosobo</td>
<td>72.85%</td>
<td>Achieved</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Kota Balikpapan</td>
<td>75.97%</td>
<td>Achieved</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Kota Banjarmasin</td>
<td>98.53%</td>
<td>Achieved</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Kota Palangka Raya</td>
<td>48.58%</td>
<td>13.92%</td>
<td>28,317</td>
<td>5,663</td>
<td>33,981</td>
<td>16,679</td>
<td>17,301</td>
<td>23.61</td>
</tr>
</tbody>
</table>

*The estimated loans for Kab. Muara Enim is relatively low (IDR 1.7 billion). Assuming a 10-year repayment period and 11.75% interest rate, its annual loan repayment is very low compared to its annual revenues. Using DSCR formula on page 152, the computation results in a very high DSCR of 1.075.26.

From the 24 local governments in the table, four have achieved the water coverage target in 2011. According to the estimation results, the remaining 20 local governments need to increase the coverage between 7.74% and 55.74%, requiring additional investments between IDR 39,400 million and IDR 766,423 million. Figure 6.9 below shows the estimated investment needs and sources of investments financing for the 20 local governments.

![Figure 6.9: Piped Water Investment Needs](image)

Figure 6.9 shows that only three local governments (Kab. Cianjur, Kab. Ciamis, and Kab. Wonogiri) can cover the whole investment using their budget surplus. Seventeen local
governments need to seek external financing, which is assumed to come from loans, if they want to achieve the target of 62.5% piped water service coverage. Assuming access to loans is readily available, the external financing is to be obtained from loans. The loan amounts are estimated to stand between IDR 1,727 million (Kab. Muara Enim) and IDR 709,223 million (Kab. Pandeglang).

Taking additional loans will impact a region’s capacity to repay. Therefore, the central government put a ceiling on the maximum loans allowed to local governments. When a local government decides to take a new loan, it is required to compute its borrowing capacity, represented by the Debt Service Coverage Ratio (DSCR). DSCR is an indication of a local government’s financial capacity to pay its loans. The payments of outstanding loans (i.e. loans which have already been taken before) are also included in projecting DSCR. According to Government Regulation No. 54/2005 on Regional Loans, minimum DSCR after considering all loans should be at least 2.50 every year until the loan is fully repaid. The summary of estimated DSCR is presented in Figure 6.10 below:
The estimation results show that, for 17 local governments that need loans, 4 local governments (Kab. Pandeglang, Kab. Klaten, Kab. Bangkalan and Kab. Sukoharjo) cannot meet the minimum DSCR if they take the full loans to cover the investment needs. The remaining 14 local governments have DSCR above 2.50, ranging from 2.98 (Kab. Donggala) to 1,075.26 (Kab. Muara Enim – not shown in Figure 6.10). This indicates that the majority of local governments included in the estimation have sufficient capacity to take full loans needed, in order to meet the target of water service coverage of 62.5% in 2011.

6.7.2. The Implication of Estimation Results

Before discussing the implication of the estimation results, it is important to clarify that the estimation tries to predict what the financial capacity of local governments would look like, in a hypothetical situation where local governments are assumed to maximize the use of their budget surplus and borrowing capacity, in order to reach the national target of piped water service coverage of 62.5%. Considering this, there are some factors to notice regarding the estimation results.

First, the research does not aim at providing evidence that local governments have all the funds at all times to finance the needs for investment in piped water, or in any public service for that matter. It is acknowledged that, in reality, local budget surplus is not going to be used (and is not supposed to be used) completely to finance only one kind of investment. What the research is trying to confirm is whether most local governments have the capacity to make investments, or at least some part of the investments, if they choose to make it one of their priorities.

Second, the actual drinking water service coverage varies widely in the regions included in the estimation. For the regions which have not achieved the service coverage target of 62.5%, their service coverage range from 6.76% (Kab. Pandeglang) to 54.76% (Kab. Cianjur).  

33 For convenient presentation, Kab. Muara Enim is not shown in the figure because of the very high DSCR compared to other regions.
Especially in regions with low service coverage, achieving the 62.5% target in a fiscal year is not always technically possible. It is acknowledged that the estimation only covers the financial side, assuming the investments are technically feasible.

Taking the above factors and the assumptions into account, the estimation results indicate that most local governments participating in PBG for drinking water programs have the capacity to invest in piped water as to reach the national target in 2011 (62.5%). From 24 local governments evaluated in this estimation, 7 have already achieved national target of piped water service, while 17 others have not. From 17 local governments that have not reached national target for piped water service, 14 local governments have the financial capacity to invest in the service, including 3 local governments that can cover the investment only from their budget surplus. This finding confirms the results of Ehrhardt et al. (2010), who mentioned that based on their sample, 83% of Indonesian local governments actually have the capacity to invest in piped water to achieve MDG target by 2015. However, under-investment in piped water service is obvious, with only 9% investing enough to meet the national target.

The conclusion that can be drawn from the estimation results is that, if local governments make drinking water a priority, financially they are able to increase their investments in this sector. It does not necessarily mean that local governments can provide for all investments at once, but if they prioritize water investments in budget allocations, they do have the financial capacity to make significant investments by using their budget surplus and/or borrowing capacity. Therefore, the financial issue is hardly the cause of the lack of investments in piped water; most local governments have the capacity to increase investments in this service.

6.8. Distraction in Accountability Relationships and the Role of PBG

The evaluation results in Section 6.6 and 6.7 are summarized in Figure 6.11 below:
Figure 6.11 highlights the research findings, which are (1) citizens’ demand for piped water service is high, and (2) most local governments have the financial capacity to increase their investments level by using their budget surplus combined with loans in order to support water supply companies in service expansion. However, the data shows that this does not happen. Service coverage of piped water is declining as well as local governments’ investments.
in this service. This signifies that the result of drinking water service delivery is not yet satisfactory.

Conceptually, if the citizens present their demand, local governments will face pressure to provide the demand. Research findings suggest that in piped water service, the demand does not result in increased investment to improve the service, even though most local governments have the financial capacity to do so.

There are many possibilities as to why this is the case. As argued by the Ministry of Public Works (2012) and AusAID (2009), households have developed an alternative to cope with the needs for drinking water in the absence of piped water connections. This may ease the sense of urgency for immediate reform in drinking water service. As shown in Figure 6.8, groundwater still provides a significant supply of drinking water, and is used by the majority of the population. Also, as argued by Hawes (2010), buying water from private sectors, despite its high price, is still a common practice wherever piped water is not available.

Also, some institutions at the local level have not yet adopted core principles of transparency, governance, and participation that have proven to be critical (Indonesian National Program of Community Empowerment, 2011). This can result in local governments’ not taking into account the citizens’ demand appropriately. In Indonesia, citizens are given the opportunity to give input to local budgets and development plans through an annual planning process. In the process, a forum is established from the lowest government unit (desa/village) to be taken to higher levels—a type of bottom-up approach. Olken (2010) stated that in Indonesia, the facilitation of opportunity where citizens can express their direct interests significantly increases citizens’ knowledge about development projects. The facilitation also results in greater perceived benefits of the projects, and higher reported willingness of the citizens to contribute to the success of projects implementation. However, the type of projects selected e.g. road, irrigation system, water, sanitation) did not always change as a result of citizens’ expressing their direct preferences.
The research argues that, regardless of the exact reasons for the low investments, the root of this situation is lack of incentives. Citizens’ having alternative drinking water sources, for example, reduces local governments’ incentives to improve piped water service. Lack of political pressure to adapt citizens’ proposal of prioritizing water service also results in reduced incentives. AusAID (2009) argued that the deteriorating condition of water supply companies is an impact of local governments channeling funds to other sectors. This again shows the lack of incentives for local governments to increase investments in piped water service.

The lack of incentives finally leads to the weak accountability relationship between local governments and citizens, and between local governments and water supply companies. The accountability to citizens is weakened because local governments are less responsive to the citizens’ demand, while the accountability to water supply companies is weakened because as owners, local governments fail to provide sufficient support for service expansion. On the other hand, this also weakens the accountability of water supply companies to local governments. The companies are supposed to execute the service on behalf of local governments, but because of the lack of support, they also lack the capacity to deliver good quality service.

As acknowledged in the second generation theory of fiscal federalism and the new institutional economic, incentives are acknowledged to be essential in influencing behaviors and responses on a particular subject. Hence, stimulating changes in behavior can be done by offering incentives. Since the citizens’ demand is not an effective incentive to local governments, the incentives should be provided from another source.

As decentralization is also a part of the long route of accountability in the framework, the central government can step in to provide the incentives to encourage local investments in piped water. The incentives are provided as PBG, which is a part of intergovernmental grants that comes with decentralization implementation. The research identifies several features of PBG which provide incentives to improve accountability relationships as follows:
a. Citizens’ Demand (Accountability relationships between citizens and local governments)

The accountability relationships between citizens and local governments emerge as demand for piped water. As shown by the data, access to piped water in Indonesia is uniformly limited in all provinces. The limited access is especially true for poor people. In 2005, more than 80 percent of Indonesian households in the poorest quintile of the population rely on water from wells and from natural sources such as rain and river springs, whereas the rate of households using these sources, declines to less than 35 percent for the richest quintile (World Bank 2006b). Generally, poor citizens are those who are least likely to have influence over policy makers because, among other things, they may not be well informed about the quality of public services or they may place less weight on public services when evaluating policy makers (World Bank 2004). For many reasons, their demand for public services like piped water is likely to go unnoticed.

A feature in PBG that can address this situation is the eligibility criteria for PBG beneficiaries, which requires that beneficiaries must be low income households. This requirement allows poor citizens to have their demand fulfilled, and thus improve the accountability of local governments to the citizens.

Having access to piped water also provides side benefits, other than the availability of safe drinking water itself. Low income households that have piped water connections installed reported that they have less health problems, which can also be associated with higher school attendance in days for their children and thus an advantage from an education viewpoint. Another positive impact is that they have more opportunities to open small businesses where water is essential, like catering, laundry, and motorcycle wash. 34PBG

34 Interview with Rita Herlina, Head of Regional Grants Sub Directorate, Ministry of Finance (March 2012).
also requires that the piped water connections are not only installed, but also function well for a specified amount of time. This ensures the sustainability and quality of water service post installment.

Another way that PBG improves accountability between local governments and citizens is how PBG encourages budget allocation that brings direct benefit to citizens. By requiring local governments to pre-finance the piped water investments, PBG drives local budget allocation to projects whose benefits can immediately and directly be enjoyed by the citizens. Prioritizing projects with direct benefits is especially important since historically, the expenditure items that receive the highest allocation is that with indirect benefits, like salary expenditures.

b. Local Governments’ Financial Support to Service Providers (Accountability relationships between local governments and water supply companies)

This aspect of accountability relationships significantly improves as a result of PBG implementation. Data shows that local governments’ investments in water supply companies are relatively low in the past decade. At the same time, a way to be accountable as the companies’ owners is to provide the financial support necessary to improve service delivery. By requiring local governments to invest in water supply companies, PBG improves the accountability of local governments to the companies.

Data of the 24 local governments sampled in Section 6.7 show that the majority of local governments increased their investments in water supply companies with the implementation of PBG. Table 6.7 below summarizes the investments made by the local governments from 2007 to 2009, in comparison with the minimum investments made in a particular year to comply with the PBG requirement (either in 2010 or 2011, depending on the time when the local governments were participating in the PBG program).
Table 6.7.
Local Governments’ Investments
(In IDR million)

<table>
<thead>
<tr>
<th>Local Governments</th>
<th>2007*</th>
<th>2008*</th>
<th>2009*</th>
<th>Average</th>
<th>Minimum investment required in PBG**</th>
</tr>
</thead>
<tbody>
<tr>
<td>Kab. Bangkalan</td>
<td>0</td>
<td>100</td>
<td>33</td>
<td></td>
<td>2,300</td>
</tr>
<tr>
<td>Kab. Banjar</td>
<td>6,325</td>
<td>6,500</td>
<td>8,625</td>
<td>7,150</td>
<td>5,000</td>
</tr>
<tr>
<td>Kab. Boyolali</td>
<td>9,080</td>
<td>7,500</td>
<td>2,600</td>
<td>6,393</td>
<td>2,450</td>
</tr>
<tr>
<td>Kab. Ciomas</td>
<td>1,500</td>
<td>3,250</td>
<td>4,000</td>
<td>2,917</td>
<td>3,500</td>
</tr>
<tr>
<td>Kab. Cianjur</td>
<td>32,076</td>
<td>0</td>
<td>0</td>
<td>10,692</td>
<td>2,000</td>
</tr>
<tr>
<td>Kab. Cilacap</td>
<td>200</td>
<td>0</td>
<td>0</td>
<td>67</td>
<td>2,900</td>
</tr>
<tr>
<td>Kab. Donggala</td>
<td>2,000</td>
<td>1,934</td>
<td>350</td>
<td>1,428</td>
<td>2,000</td>
</tr>
<tr>
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<td>11,000</td>
<td>0</td>
<td>3,667</td>
<td>9,950</td>
</tr>
<tr>
<td>Kab. Jombang</td>
<td>4,000</td>
<td>4,000</td>
<td>5,370</td>
<td>4,457</td>
<td>2,600</td>
</tr>
<tr>
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<td>6,750</td>
<td>2,154</td>
<td>3,160</td>
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<td>14,000</td>
</tr>
<tr>
<td>Kab. Klaten</td>
<td>2,000</td>
<td>1,000</td>
<td>2,000</td>
<td>1,667</td>
<td>8,000</td>
</tr>
<tr>
<td>Kab. Kuningan</td>
<td>4,200</td>
<td>1,500</td>
<td>1,200</td>
<td>2,300</td>
<td>14,450</td>
</tr>
<tr>
<td>Kab. Lombok Timur</td>
<td>12,000</td>
<td>11,500</td>
<td>9,500</td>
<td>11,000</td>
<td>1,000</td>
</tr>
<tr>
<td>Kab. Muara Enim</td>
<td>2,905</td>
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<td>10,384</td>
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</tr>
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<td>Kab. Pandeglang</td>
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<td>0</td>
<td>1,333</td>
<td>2,000</td>
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<td>Kab. Serang</td>
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<td>15,000</td>
<td>10,522</td>
<td>11,000</td>
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<td>Kab. Sidoarjo</td>
<td>3,000</td>
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<td>0</td>
<td>3,617</td>
<td>14,000</td>
</tr>
<tr>
<td>Kab. Situbondo</td>
<td>0</td>
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<td>7,175</td>
<td>3,333</td>
<td>2,000</td>
</tr>
<tr>
<td>Kab. Sukoharjo</td>
<td>57,000</td>
<td>5,950</td>
<td>5,320</td>
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</tr>
<tr>
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<td>2,750</td>
<td>7,368</td>
<td>4,068</td>
<td>5,000</td>
</tr>
<tr>
<td>Kab. Wonosobo</td>
<td>3,240</td>
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<td>11,065</td>
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<td>14,000</td>
</tr>
<tr>
<td>Kota Balikpapan</td>
<td>3,700</td>
<td>9,100</td>
<td>4,165</td>
<td>5,655</td>
<td>2,000</td>
</tr>
<tr>
<td>Kota Banjarmasin</td>
<td>26,500</td>
<td>40,000</td>
<td>31,500</td>
<td>32,667</td>
<td>14,500</td>
</tr>
<tr>
<td>Kota Palangka Raya</td>
<td>250</td>
<td>250</td>
<td>250</td>
<td>250</td>
<td>1,500</td>
</tr>
</tbody>
</table>

Source:
* Local budgets submitted to the Ministry of Finance. Please note that the investment data is not exclusively for drinking water, but represent all investments made in the fiscal year.
** Ministry of Finance. The minimum investments are equal to the amount of PBG allocated to each local government, and are to be used solely for the improvement of piped water service. Some local governments (e.g. Kab. Serang, Kab. Ciamis, Kab. Pandeglang, Kota Palangkaraya, Kab. Bangkalan) allocated more than the minimum amounts, either to be invested in a single year or multiyear.

According to the data in Table 6.7, 14 out of 24 local governments (58%) allocated more investments to comply with PBG, compared to their average investment in 3 fiscal years (2007-2009). For the 14 local governments, the difference between the average investments and the minimum investments made under PBG range from IDR 478 million to IDR 12,150 million. Figure 6.12 below illustrates the investments allocation of the 14 local governments.
Among the 14 local governments in Figure 6.12, 12 are local governments with low fiscal capacity in 2009. One local government has medium fiscal capacity (Kab. Sidoarjo), and one has high fiscal capacity (Kota Palangkaraya). From the figure, it can be observed that low fiscal capacity does not always result in low investment, given the right incentives. For example, Kab. Wonosobo, Kab. Karawang, and Kab. Kuningan have low fiscal capacity. At the same time, they receive a high amount of PBG which means they need to pre-finance high investments. This requirement can be met with satisfactory results; all of them achieve 100% of the target.

The investments from local governments also strengthen the accountability of water supply companies to local governments. According to the Ministry of Home Affairs (2012), local government investment is different from grants; investments need to be recovered. The recovery comes in the form of dividends paid by the companies, and in the form of social/economic/other benefits to the regions. Putting investments in the companies therefore increases local governments’ incentives to improve the monitoring and
coordination as efforts to ensure investments’ recovery. The increased monitoring and coordination provides higher incentives for water supply companies to perform and thus improves their accountability to local governments.

6.9. Local Governments’ Responses to PBG

PBG for drinking water is a pilot project for PBG implementation. The system is relatively new compared to DAK, another type of conditional grants in intergovernmental grants which has been providing funding for drinking water service since 2005. Concerns were high at the beginning of its implementation of whether local governments have difficulties in adapting to the new system.

To investigate the response of local governments, a survey was conducted in February and March 2012. The targets of the survey are local government officials working in financial and revenue management department. This department is responsible for managing the financial aspect of intergovernmental grants revenues. Of 35 local governments, 17 participated in the survey. The first part of the questionnaire examines their perception on drinking water funding through DAK and through PBG. The second part of the questionnaire explores the reasons for their preference to a particular funding, whether it is DAK or PBG.

The first part of the questionnaire focused on 4 aspects to compare DAK and PBG:

1. Administrative procedure in planning activities
2. Administrative procedure in requesting reimbursement
3. Time required for fund reimbursement
4. Workload

Respondents were asked the same questions regarding DAK and PBG. The responses are analyzed using a sign test. The results are as follows:
The statistical results indicate that there’s no significant difference in respondents’ perception on administrative planning, administrative reimbursement, and time for reimbursement between DAK and PBG. However, respondents have the perception that PBG requires less workload compared to DAK. When asked about the overall preference between DAK and PBG, eight respondents prefer PBG (47.1%), four prefer DAK (23.5%), and five have no preference (29.4%), as illustrated in Figure 6.13 below.

In the second part of the questionnaire, respondents are asked open-ended questions about the reasons for their preference for DAK or PBG. The respondents’ answers can be summarized in Table 6.8 below:

<table>
<thead>
<tr>
<th>Exact Sig. (2-tailed)</th>
<th>d1 - c1</th>
<th>d2 - c2</th>
<th>d3 - c3</th>
<th>d4 - c4</th>
</tr>
</thead>
<tbody>
<tr>
<td>.388a</td>
<td>.388a</td>
<td>.388a</td>
<td>.013a</td>
<td></td>
</tr>
</tbody>
</table>

a. Binomial distribution used.
b. Sign Test

Figure 6.13
Funding Preference

In the second part of the questionnaire, respondents are asked open-ended questions about the reasons for their preference for DAK or PBG. The respondents’ answers can be summarized in Table 6.8 below:
Table 6.8.
Reasons for Preference of PBG or DAK

<table>
<thead>
<tr>
<th>Advantage</th>
<th>PBG</th>
<th>DAK</th>
</tr>
</thead>
<tbody>
<tr>
<td>+ Clear guideline about the projects/activities that can be funded</td>
<td>+ Local governments have higher flexibility to decide what projects to finance, provided the projects satisfy DAK guidelines.</td>
<td>+ No pre-financing eases the burden of local budget</td>
</tr>
<tr>
<td>+ Project implementation can expand beyond one fiscal year</td>
<td>+ Technical guidelines are prone to ambiguity, some grey area exists for eligible and non-eligible projects/activities</td>
<td>+ Funds are received in advance, supporting local cash management</td>
</tr>
<tr>
<td>+ Targeted specific sector, thus focus on solving specific problem</td>
<td>+ Project implementation is limited to one fiscal year</td>
<td></td>
</tr>
<tr>
<td>+ Grants agreement provides clear instructions on allocation and other arrangements</td>
<td>+ Wide scope of activity can reduce focus on the most urgent area</td>
<td></td>
</tr>
<tr>
<td>+ Quality standards enable focused verification and transparency</td>
<td>+ Wide scope of activity causes reporting problems if executing unit fails to detail the report properly</td>
<td></td>
</tr>
<tr>
<td>+ Improved budget and reporting accountability</td>
<td></td>
<td></td>
</tr>
<tr>
<td>+ Clear activity to be funded makes it easier for accounting records</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Disadvantage</td>
<td>- Pre-financing requirement adds burden to local budget</td>
<td>- Local parliament’s resistance to pre-financing hinders budget approval</td>
</tr>
<tr>
<td></td>
<td>- Local parliament’s resistance to pre-financing hinders budget approval</td>
<td></td>
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<td></td>
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</tbody>
</table>

From the questionnaire result, generally local governments can adapt to PBG system and PBG implementation is perceived positively. It is also identified that pre-financing is the major concern of respondents. Four respondents said pre-financing is burdensome to the local budget, while three mentioned that it raised resistance from local parliaments. However, the three respondents who acknowledged resistance confirmed that the parliaments finally agreed with the pre-financing scheme.
The response on pre-financing is somehow contradictory with the analysis result. In the previous section, the analysis result indicates that most local governments have the capacity to increase investments, and also according to the data, all local governments participating in PBG programs can manage to provide the pre-financing for investments in piped water.

The research argues that this condition further confirms the needs for incentives to influence budget decision. Budget scarcity is a common problem faced by all governments, and for this reason priorities need to be determined. Increasing investments in a sector may well mean major spending in local budgets, but this does not necessarily mean that local governments cannot afford to do it. With the right incentives, budget decisions can be influenced toward certain priorities, and this is the principle that has been applied in PBG. Most importantly, in the case of PBG, the spending is actually temporary because the funds used for pre-financing will be reimbursed through grants. Thus, cash flow management, rather than increased spending, is the main issue in pre-financing.
CHAPTER VII
CONCLUSION

Improvement in public service delivery is the motive for most decentralization (Ahmad et al. 2005), and the ultimate goal of decentralization (Oates 1972, 1993, Musgrave 1973). This improvement is made possible by the devolving of public service functions to subnational governments (i.e. provincial and local governments), who are believed to have better knowledge of citizens’ needs and preferences.

In most developing countries, the main financial support for decentralization is mostly provided by the central government in the form of intergovernmental grants. Therefore, it is important that the intergovernmental grants provide the right incentives so as to achieve the decentralization goal (UNCDF 2010). PBG features incentives to encourage improvement in performance and accountability, and links access to funds with the attainment of certain standards. By incorporating incentives, PBG also promotes accountability by emphasizing a result-based, bottom-up, client-driven approach (Broadway and Shah 2009).

In Indonesia, PBG was first implemented in 2010, targeting specific public services such as drinking water, sanitation, and education. In light of PBG being a part of Indonesian intergovernmental grants, the research tries to identify the significance of PBG in the intergovernmental grants. As for PBG implementation, using PBG for drinking water as a case study, the research evaluates the impact of PBG on local governments’ accountability in public service delivery, and investigates whether PBG is applicable to local governments.

With regard to PBG implementation, the research accepts the hypothesis that PBG improves public service in Indonesia by strengthening local governments’ accountability in the service delivery. This chapter concludes the research by describing the answers to the three research questions: (1) Does PBG in Indonesia strengthen the accountability of local governments in public service delivery?, (2) If so, how does PBG strengthen the accountability?
and (3) Is PBG generally applicable to local governments in Indonesia?. This chapter also explains the suggestion for future implementation of PBG, based on the research findings.

7.1. PBG in Indonesia strengthen the accountability of local governments in public service delivery

In the research conceptual framework, accountability is defined as “a set of relationships among service delivery actors with five features: delegating (explicit or implicit understanding that a service will be supplied), financing (providing the resources to enable the service to be provided or paying for it), performing (supplying the actual service), having information about performance (obtaining relevant information and evaluating performance against expectations and formal or informal norms), and enforcing (being able to impose sanctions for inappropriate performance or provide rewards when performance is appropriate)” (The World Bank, World Development Report 2004, p. 48). In light of this definition, the research observes whether there’s a change in local governments’ behavior concerning the delegating, financing, performing, having sufficient information, and enforcing the delivery of public services as a result of PBG implementation.

In Indonesia, drinking water service is included in the public services devolved to local governments under decentralization. This satisfies the delegating feature in the definition of accountability above. However, the fulfillment of other features, namely financing, performing, having sufficient information, and enforcing, is rather doubtful given the input-based approach in intergovernmental grants.

Based on the case study of PBG for drinking water, based on hypothetical analysis on local governments’ financial capacity, the research finds that most local governments have the financial capacity to increase their investments in piped drinking water, through the utilization of budget surplus or combining the budget surplus with loans. This is consistent with the findings of Ehrhardt et al. (2010) in their study on Indonesian local governments. Despite
sufficiency in financial capacity, local governments’ investments for piped drinking water service tend to decline, even though the percentage of population who has access to piped drinking water is decreasing, and citizens’ demand for piped drinking water is high.

One of the requirements of PBG for drinking water is local governments allocating local budgets for investments in water supply companies to pre-finance piped water service expansion. Reports on PBG implementation show that all participating local governments could allocate investment from their budgets regardless of their fiscal capacity, even with the pre-financing requirement which involves careful cash management. Among the 35 recipients of PBG for drinking water, 22 are local governments with low fiscal capacity, and all of them could fulfill the pre-financing requirement and achieve the specified standard.

Referring to the definition of accountability in the research conceptual framework, the research observes the following changes in Indonesian local governments’ behavior concerning the delivery of public services:

- **Financing.** Providing financial resources is an important way to communicate accountability (Glynn 1993), however this is what most Indonesian local governments often lack. An example of this situation can be found in drinking water service. Prior to the implementation of PBG for drinking water, most local governments actually had the financial capacity to increase their level of investments, but did not do so. The implementation of PBG stimulates local governments to increase their investments level in public service delivery. There’s a change in local governments’ decisions, as far as financing is concerned, with the implementation of PBG. Friedman (2009) argued that accountability can be observed from the qualitative effect, that is, by observing whether the change makes any difference. Referring to this and the analysis result, the research argues that local governments’ increasing investments in public services is indicative of improvement in local governments’ accountability in delivering the services.
Performing. The present condition of the Indonesian public services remains highly unsatisfactory to citizens, with problems including slow service delivery and poor quality under unskilled service providers constantly occurring in the process. As a result, an extensive number of customers’ complaints have steadily built up because of the low satisfaction level (Mohamad 2007). The case of drinking water shows a similar condition, with decreasing service coverage despite high demand from the citizens, indicating that the service is not adequately supplied to meet the demands. In many regions in Indonesia, citizens applying for house connection need to face long waiting lists. PBG for drinking water addresses this issue by requiring local governments to invest in water supply companies, so the companies as service providers can respond to the citizens’ need. PBG further encourages quality standard by requiring the installed house connections to function well for at least three months to be qualified for the grants. This arrangement improves accountability of local governments to citizens, as the governments ensure certain standards.

Sufficient information. Besides ensuring performance, verification of standards attainment also provides an information base for governments, both local and central, e.g. about how the water service is delivered, what problems there are, and how the service providers perform. In PBG for drinking water, the verification is conducted by central governments based on local governments’ request, and the request is based on the information on work conducted by water supply companies. The availability of information will improve the coordination between (1) local governments and their water supply companies, as the companies perform the work on behalf of the governments, whose investments recovery depends on the companies’ quality of work, and (2) local governments and the central government, as coordinator of public services at the national level; constant communication with local governments will help to identify problems and to formulate policies to address them. The availability of information also encourages transparency and a mechanism for check-and-balance, which fosters accountability.
- **Enforcing.** PBG funds is transferred to local governments given all requirements are satisfied. In PBG for drinking water, a house connection is considered satisfying requirements if it has been functioning well for 3 months, confirmed by payments made by customers to water supply companies. When this is verified, local governments’ pre-financed investments will be reimbursed through the grants’ transfer. The conditionalities serve as a basis for accountability enforcement. Local governments need to demonstrate accountability in delivering the services, otherwise they will lose the opportunity to get their investments reimbursed.

7.2. **PBG works by promoting incentives to stimulate desirable behavior: focus on performance and accountability**

Based on the research finding, it can be argued that fiscal capacity is not always the reason for lack of investments in public sector in Indonesia. Investment is allocated in local budgets enacted by local governments and local parliaments, signifying the political agreement on how to make use of local budgets. It is a matter of choice: which sectors to be allocated more funding are determined by the decision to make such sectors local priorities. While low fiscal capacity can expose local governments to tighter budget constraints, allocation for additional investment in certain public sectors is still possible as long as local governments prioritize the sector while making budget decisions. Another indication that local governments may not properly prioritize investments in public services can be observed in the structure of local expenditures. The data shows that between 2007 and 2010, the percentage of salary expenditures increased at the expense of almost all remaining expenditures, most notably capital expenditures, signifying lower priority for investments.

The research argues that the main reason for this situation is incentives. When citizens’ demand is does not result in considerable consequence if it is not satisfied, incentives for local governments to take action is low. For example, in the drinking water sector, most citizens still
have access to alternative water sources like wells, rivers, or rain water. Because of this, the citizens’ demand for piped water does not provide strong incentives for local governments to provide piped water service, at least not as a service that requires immediate attention. As a result, local governments withdraw from making investments in water supply companies to expand piped water service.

The findings about local governments’ lack of investments despite sufficient financial capacity, and the composition of local budgets with heavy emphasis on the administration of local bureaucracy, suggest the importance of incentives to influence local governments’ decisions. As argued by Thomas (1998) in decision space approach, local governments’ choice is influenced by incentives, local characteristics, and decision space. Decentralization brings greater autonomy for local governments, providing greater decision space including in local budget management. The challenge is to balance the decision space with the right incentives so as not to encourage opportunistic behaviors, such as self-serving bureaucracy which neglects the welfare of the citizens.

PBG incentivizes local governments to use their decision space for more focus on citizens’ welfare, which can be materialized, among other things, in increased investments in public services. Research findings confirm that there’s an increase in Indonesian local governments’ investment levels after the implementation of PBG.

7.3. Local governments can adapt relatively well to PBG.

Compared to the input-based conditional grants DAK, PBG is relatively more demanding in term of conditions to satisfy to be eligible for the grants. Monitoring is heavily enforced, since access to funds is directly linked to the verification of results. PBG also requires pre-financing, which means there’s risk on local governments’ side that the investment will cost the local budget if they fail to satisfy PBG requirements.
DAK for drinking water has been implemented since 2005, compared to PBG that is relatively new—the first PBG project which started in 2010. Because of this, DAK system is more familiar to local governments. As a new system, local governments are not yet familiar to PBG. These factors may hinder local governments’ willingness to accept PBG, which may drive their preference to DAK.

To understand how Indonesian local governments perceive PBG in comparison to DAK, a survey was conducted among local governments who received PBG. In the survey, the responses from respondents (local government officials) do not support the idea that for officials DAK is preferable to PBG. Given the same projects and the same funding, 47% of respondents prefer the funding to be allocated as PBG rather than DAK, 24% prefer DAK, and 29% show no preference. Clarity in what to fund, how much, and how to verify the projects/activities contributed to transparency and accountability, and eased the reporting process. Respondents show concern, however, that the pre-funding requirement adds a burden to local budgets.

In general, survey results indicate that the respondents can adapt relatively well to the PBG system. Compared to DAK, the respondents have no different perception on administrative procedures and waiting time for funds transfers. The respondents, however, perceive PBG and DAK differently in terms of administrative workload, with PBG being perceived to require less workload than DAK.

7.4. Conclusion: What can be learned from Indonesian PBG for drinking water?

This research uses a conceptual framework (Figure 3.4) derived from accountability relationships framework (Figure 3.3) developed by the World Bank (2004). The accountability relationships framework suggests that accountability in public services can be achieved through the short-route and the long-route of accountability. The short-route is normally the case for public services in competitive markets, while the long route is for public services in a monopolistic market. In the short-route of accountability, citizens can directly hold service
providers accountable for the quality of the service. In the long-route, citizens usually don’t hold the providers directly; instead they hold the governments accountable, then the governments hold the providers accountable for the services.

The research conceptual framework focuses on the long-route of accountability. Under ideal conditions, citizens’ demands for public services makes local governments work to ensure that service providers deliver the demanded services. Incentives for local governments to do this may come from, among others, the political process. Given an effective political system, politicians in local governments will try to satisfy local preferences as to secure their electability in the next election. For the same reason, politicians in parliaments will ensure that local governments respond positively to citizens’ demands. And to cater to the citizens’ interests, information on governments’ capacity to deliver services and how they actually deliver the services is made publicly available, empowering citizens to control their governments. Therefore, an effective political process will ensure, or at least will increase the probability of, good public services to citizens.

However, in many developing countries, election results barely show local preferences. The election results are most often based on personal, tribal, or political loyalty. Electoral mandates are vague and inconsistent, available resources and promised expenditures are usually mismatched, the elected officials often lack incentives to keep their promises, and bureaucracies in subnational governments may have their own agendas to pursue (Prud’homme 1995). The availability of information is not enough unless citizens have legal, political, and economic means to press their demands against the governments (World Bank 2004). These factors, among others, can cripple citizens’ demand to impact local governments’ accountability, thus distracting the long-route of accountability.

Based on the findings, the research argues that pressure for local governments’ accountability can also originate from decentralization, by strategically incorporating incentives in intergovernmental grants to encourage accountable behavior. Implementing PBG to promote
incentives under a decentralization scheme can influence local governments’ behavior toward better performance and improved accountability. In particular, incorporating incentives into intergovernmental grants can be an option to stimulate local policies that directly benefit public service delivery, especially when citizens’ demand is not strong enough to influence local policies. This finding can contribute to the accountability relationships framework as an alternative trigger for local governments’ accountability, in addition to citizens’ demand (voice).

7.5. Toward Future Directions

Despite its promising results, it should be noted that the effectiveness of PBG is subject to pre-requisites. UNCDF (2010) suggests that PBG by itself is not a solution for all accountability problems, and it is most useful and effective under certain conditions, e.g. solid analytical works, involvement of key stakeholders in its design, and transparent and publicly disclosed information. The research acknowledges these conditions and strongly recommends that, in addition to PBG implementation, other aspects that support good governance should be improved at the same time. For example, clarity in function assignments needs to be promoted so as not to create confusion about who should do what and be responsible to whom.

The design of PBG also needs to be adjusted and perfected, and the implementation procedures enhanced over time to accommodate the experience gained from previous PBG projects. In the following sections, the research suggests alternative schemes for PBG implementation and factors to consider in PBG allocation in a nation’s priority service areas.

a. Alternative scheme for PBG

In PBG for drinking water in Indonesia, the motivation to comply with all requirements may be due, or partly due, to the pre-financing requirement. The requirement makes local governments ‘pledge’ their budget as ‘collateral’ to the result of project implementation. Knowing that the funds used for pre-financing can be lost in the case of
incompliance, local governments are motivated to attain the standards so as to get the funds reimbursed. This is beneficial from the viewpoints of accountability and performance standard.

This requirement is rather strict as local budgets assume all pre-financing. In some circumstances, it might be necessary to acknowledge that potential PBG recipients are facing serious financial constraints which make them unable to assume full pre-financing. For this reason, the research suggests that future PBG schemes can consider adapting alternative approaches with less strict requirements such as:

- **Partial pre-financing scheme.**
  
  In this scheme, a portion of PBG is transferred up-front to support pre-financing from the local budget. The pre-financing portion will be reimbursed later if PBG requirements are satisfied. This scheme also requires local governments to provide ‘collateral’, but less burdensome than the full pre-financing.

- **Installment transfers scheme.**
  
  In this scheme, PBG is transferred in several installments. The first installment is transferred up-front as working capital for a local government. The verification result of the first installment will determine the local government’s eligibility for the second installment, and so on. This scheme makes the local government ‘pledge’ the project instead of money from the local budget. Unless it complies with the PBG requirement, the project is at risk of being unfunded and unfinished.

- **Reward scheme.**
  
  This scheme does not require a contribution from the local budget; rather it offers a reward if local governments can reach a certain achievement. No punishment is imposed if the target is not reached. For example, rewards are given to a local government whose region’s sanitation coverage improves by at least x%, or to local
governments whose audited financial statements are unqualified, etc. The challenge for this scheme is to determine indicators for such achievements.

b. Factors to consider in PBG allocation

The case on Indonesian intergovernmental grants provides an insight into how carefully designed conditional grants can easily shift into equalizing grants, as in the case of DAK. Although this can be justified as helping to reduce fiscal disparity, the resulting absence of conditional grants’ role in intergovernmental grants system can have adverse impact investment in public service. To correct this, the role of conditional grants needs to be restored and improved.

Learning from Indonesia case, the research suggests that intergovernmental grants need to be more focused on utilization, rather than mobilization, of financial resources. Input-based grants put a lot of emphasis on financial resources mobilization by supplying local governments with unconditional and conditional grants, but what the input would become is of little interests in this instance. Central governments sometimes use an allocation formula that is meticulously designed to ensure fairness in input allocation, however without sufficient consideration on the result, the mobilization of input can have distorted consequences and not in line with the grants’ original purpose.

Focus on performance rather than input is strongly encouraged to improve accountability. Besides accountability, focus on performance also fosters local governments’ commitment to improve certain public service sectors. Also, conditional grants need to take into account the readiness and willingness of local governments to receive the grants and participate in the projects. In PBG, incentives are offered but at the same time so are the consequences for failure. Therefore, local governments need to consider whether they are willing to participate. In line with the spirit of decentralization, which upholds local
autonomy, local governments should be given the liberty to use their autonomy to decide whether to receive or not to receive certain grants from central governments.

In input-based conditional grants, allocation is made by central governments without prior approval from local governments, signifying a top-down approach. Since PBG requires strong commitment from local governments to comply with rather strict requirements, local governments’ approval should be taken into account before PBG allocation to each recipient. This approval is also necessary considering the punitive mechanism that is implicitly embedded in PBG: failure in complying with PBG requirements will result in delay, or even cancellation, of grants transfer. This consequence needs to be well communicated to minimize negative reactions from local governments in case they fail to fulfill the requirements.

Adopting PBG on a greater scale in any nation may require a lot of adjustments of institutional arrangements, both in local and central bureaucracy. Since PBG requires verification of a project’s implementation before transferring the funds, this system requires strong policy support from the central government, in particular the sectoral ministry, to handle the work and to cope with the pressure of making unpopular decision when local governments perform below standards. Political will to enforce negative consequences needs to be present. Further research in institutional arrangements, as well as political and social factors surrounding PBG implementation, are strongly encouraged.
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QUESTIONNAIRE

Name : ____________________________________________
Position: __________________________________________
Region: ____________________________________________
Phone : ____________________________________________
E-mail : ____________________________________________

The questionnaire consists of 2 parts.
- Part 1 is Likert scale questions. 1 indicates strong disagreement, 5 indicates strong agreement. Please circle a number according to your opinion.
- Part 2 is open questions. Please feel free to write down your opinion.

Part I

A. Water Service to Communities

<table>
<thead>
<tr>
<th></th>
<th></th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
<th>5</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Generally, water service coverage increased after decentralization.</td>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>5</td>
</tr>
<tr>
<td>2</td>
<td>Generally, water service quality increased after decentralization.</td>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>5</td>
</tr>
<tr>
<td>3</td>
<td>Current condition of water service has already achieved local government’s expectation.</td>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>5</td>
</tr>
<tr>
<td>4</td>
<td>There’s a need for water service improvement for the benefit of communities.</td>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>5</td>
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</table>

B. Funding Water Service

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<tr>
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<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
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</thead>
<tbody>
<tr>
<td>1</td>
<td>Water service is one of the priority sectors in local budget allocation.</td>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>5</td>
</tr>
<tr>
<td>2</td>
<td>Funding from central government is the main source of capital expenditure in water service.</td>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>5</td>
</tr>
<tr>
<td>3</td>
<td>Local budget can afford water service delivery without support from central budget.</td>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>5</td>
</tr>
<tr>
<td>4</td>
<td>Additional funds from central government are necessary to improve water service delivery.</td>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>5</td>
</tr>
<tr>
<td>5</td>
<td>Compared to DAK, PBG for drinking water involves higher level of central government’s intervention.</td>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>5</td>
</tr>
</tbody>
</table>
C. DAK for Drinking Water

<table>
<thead>
<tr>
<th></th>
<th>Administrative procedures are relatively simple.</th>
<th>1 2 3 4 5</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Time required to reimburse the funds is relatively short.</td>
<td>1 2 3 4 5</td>
</tr>
<tr>
<td>2</td>
<td>Additional workload is insignificant.</td>
<td>1 2 3 4 5</td>
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</table>

D. PBG for Drinking Water

<table>
<thead>
<tr>
<th></th>
<th>Administrative procedures are relatively simple.</th>
<th>1 2 3 4 5</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Time required to reimburse the funds is relatively short.</td>
<td>1 2 3 4 5</td>
</tr>
<tr>
<td>2</td>
<td>Additional workload is insignificant.</td>
<td>1 2 3 4 5</td>
</tr>
</tbody>
</table>

**Part 2**

1. Assuming the same amount of funds and projects, would you prefer receiving funds in the form of DAK or PBG? Why?

_____________________________________________________________________________
_____________________________________________________________________________
_____________________________________________________________________________
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2. If there is another PBG program in the future, would you recommend your local government to participate? Why?
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3. Please write down your comments on the implementation of PBG for drinking water.
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Date:___________________________