

MAKING INDONESIA'S BUDGET DECENTRALIZATION WORK: THE CHALLENGE OF LINKING PLANNING AND BUDGETING AT THE LOCAL LEVEL

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ABSTRACT

While many countries have decentralized budget spending in the last decade, few have tried to do so as quickly and as ambitiously as Indonesia. The 2001 'sink-or-swim' decentralization largely abolished the hierarchical relationship between the center, province and the district and transferred around one third of central government expenditure to the regions.¹ This replaced the deconcentrated agencies of central government (ie. central government units operating in the regions) with a presumption that (despite Indonesia being a unitary state) local governments undertake all spending responsibilities other than those specifically assigned to the national government.²

Provinces and districts are responsible for an increasing share of national personnel and material expenditures, and it is reported that some sixty percent of the routine budget and just under forty percent of development budget is managed at the sub-national level.³ Local budgets are approved by autonomous (parliament like) local councils, replacing the previous deliberative councils, with resource allocation decisions being made by an elected local mayor, the local planning agency (BAPPEDA) and local finance office (Badan Keuangan).

¹ The term 'sink or swim' was coined by Paul Smoke as an alternative to a developmental approach to decentralization, under which devolution of responsibilities is synchronized with growth in local capacity. See Smoke, 2002. The sink or swim approach risks inadequate capacity at local government level while the developmental approach risks a 'feet-dragging' approach to decentralization by powerful central agencies. The slow pace of budget reform at the national level reinforces the case for adopting a 'sink or swim' approach.

² Law 32/2004 (Articles 10 to 18) on Regional Governance defines the new responsibilities of the central, provincial, and local (district) governments. Functions assigned to central government are foreign policy, justice, defense, security, fiscal and monetary policy and religion. Sixteen obligatory functions are assigned to both provincial and district governments without differentiation between the two. Residual discretionary functions that "potentially can contribute to enhancing people's welfare" can be undertaken by local governments. Law 33/2004 on Fiscal Balance sets out the legal basis for fiscal decentralization, including the division of revenue sources and arrangements for intergovernmental transfers. For a further discussion on the issues related to obligatory and discretionary functions see USAID DRSP, 2006.

³ World Bank 2007c, p.5-6. The Bank notes that transfers have increased from nineteen percent of total central government expenditure in 2001 to thirty-three percent in 2006. Functions were transferred to local governments along with the apparatus for implementing them. Thus over two million employees were transferred from closed central agency offices to the local level.

The focus of this article is on the extent to which the decentralization will achieve its goal of making Indonesian public spending more responsive to local preferences. There is a risk that the inflexible, input focused, budgeting at the centre which originally prompted the decentralization is now being replicated at the local level by unresponsive local bureaucracies and rigid, input focused, budget preparation. This paper is in two parts. The first part provides background by reviewing the surprisingly limited evidence (available from secondary sources) on the extent to which the decentralization is achieving more responsive public spending. The second part, the core of the paper, reviews the link between local planning and budgeting in achieving greater responsiveness to local preferences, and the potential contribution of a draft regulation to integrate local planning and budgeting.

The authors conclude that the intention of a draft regulation to introduce performance budgeting at the local level will test the capacity of local governments. However, one proposal in the draft regulation in particular is quickly achievable and has the potential to contribute to the success of the decentralization, by strengthening policy contestability and flexibility in local budgeting. This involves a combination of input focused estimation of the baseline budget (as currently practiced by local governments), and, as adopted at the national level in some countries, 'change packages' proposed by local service units.

INTRODUCTION: BACKGROUND ON THE IMPACT OF DECENTRALIZATION

Indonesia is an ethnically diverse nation with large interregional poverty differences and variations in regional population density.⁴ However, under Suharto's highly centralized 'New Order' regime, local service delivery agencies were administrative instruments of remote national ministries and un-responsive to the individual priorities and problems of varied local communities. Shah notes that prior to 2001 "centralization of responsibility and concentration of controls in bureaucracy created a culture of rent seeking and command and control with little concern for citizens' preferences and needs."⁵ The abrupt nature of the 2001 decentralization has been interpreted by some as an insurance policy against fragmentation following the disturbances at the close of the highly centralized Suharto era.⁶

⁴ "Almost 300 ethnicities speaking more or less 250 different languages live throughout the archipelago." World Bank 2007c , World Bank 2007c, p. 113. In regard to regional poverty indices, "Poverty rates are below three percent in selected cities (Denpasar, Bali, and Bekasi, West Java), but above 50 percent in Manokwari, West Irian Jaya, and Puncak Jaya, Papua. (p. 113). The Human Development Index (HDI) average for Indonesia in 2002 was 0.66. At the district level, the HDI varied from as low as 0.47 in the kabupaten of Jayawijaya to 0.76 in East Jakarta." (p. 113).

⁵ Shah and Thompson 2004, p. 31.

⁶ See World Bank 2003b, p.3 and Barron and Clark 2006 , Chapters 1-3. The disturbances occurred in 1998. However, there had been several previous attempts to decentralize, the most recent of which was in Law 5/1974, which did not involve handing over of the apparatus needed for local management and was only partially implemented. An alternative explanation for the radical 'front loaded' nature of the decentralization is that it reflected the lack of progress with implementing the 1974 law. See World Bank 2003b, p.3.

The 2001 decentralization has the potential to end the malaise of remote and unresponsive government through:

- district budgets being formulated by local authorities and approved by local elected councils (DPRDs)
- a formalized local consultation process in the course of budget preparation (*musrenbang*).

However, some seven years later evidence on the responsiveness of government spending to local preferences is relatively limited.

On the positive side, while the sudden nature of the 2001 decentralization led to predictions at the time of a breakdown in delivery of basic services (due to ambiguity about functions of sub-national governments and absence of implementing regulations), there is little evidence of this occurring.⁷ The World Bank notes that “Regarding the quality of service delivery, there is no clear trend”.⁸

A recent report adds: “Disappointed with the relationship between the Regional House of Representatives (DPRD) and the Regional Head following the initial 1999 reforms, the state has set out to rebalance the relationship by reworking the Regional Head’s accountability to the DPRD and by giving the Regional Head a more independent political base through direct election. Now both bodies are expected to “articulate and aggregate” the people’s interest”.⁹ Since local officials have closer contact with the local community than officials at the national level it can be expected that the provision of public services will be more responsive to local need.¹⁰ It might also be expected that instances of corrupt behavior under the decentralized regime might be more apparent to local consumers of public services than when the instances occur remotely in Jakarta.

However, some concerns about the effect of decentralization are also beginning to emerge. These relate to 1) fiscal equalization issues and 2) effectiveness of local budgeting.

⁷ See World Bank 2003b, Chapter 1

⁸ “First evidence on a limited subset of *kabupaten/kota* shows that decentralized government services in health, education and administration have improved (Kaiser, Pattinasarany and Schulze, 2006), while the quality of police service, which has not been decentralized, has deteriorated. However, sectoral studies have highlighted the deficiencies and decline in several key services, particularly water and electricity.” World Bank 2007c, p. 116. There are reports that resource investment may be discouraged by lack of clarity about the responsible level of government.

⁹ USAID DRSP 2006, p. 79.

¹⁰ Accountability is ensured by the mayor being elected and his five year plan being passed as a law. The annual budget is subject to a community consultation (*musrenbang*) process and the budget law must be passed by the elected council. Local officials are close to the local community and can be expected to be more aware of needs than those at the national level. See Eckardt and Shah 2008 for an overview discussion.

Fiscal equalization issues

Fiscal capacity varies greatly between regions, with local governments obtaining revenue from: (i) own sources; (ii) general allocation grants from the center (DAU) (iii) shared taxes and shared natural resource revenue; (iv) specific purpose transfers from the center (DAK) and (v) other revenue, as well as deconcentration and special assistance grants (Dekon and Tugas Pembantuan) channeled through national ministries.¹¹ Financing was not decentralized in 2001 in line with expenditure assignments.¹² While this results in a high level of vertical fiscal imbalance, the minimum DAU transfers must total at least 26 percent of national revenue excluding shared taxes and revenues from natural resources.¹³ It appears that local governments, far from being starved of funds as under many decentralized regimes, face difficulties in spending the funds available to them, and are building reserves.¹⁴ Insofar as there is fiscal stress, it appears to occur at the national level in meeting central spending obligations fuelled by debt servicing and subsidies on fuel and food, rather than at the level of local governments.¹⁵

However, one implication of relinquishing central control over spending has been a parallel loss of vertical accountability of local governments, increasing the risk of unacceptable variations in the level of services provided by different districts. “A common concern about decentralization is that the transfer of authority and responsibilities to local governments weakens the central government’s ability to close gaps between the richest and poorest areas of the country, aggravating regional inequalities. Districts with the most resources are frequently those with higher school enrollment rates and better school facilities, whereas districts with fewest resources are those with less favorable education indicators.”¹⁶ Only for DAK allocations is there a line of accountability to the central government for funds provided, while for DAU

¹¹ See Hofman, Kadjatmiko, Kaiser, and Sjahrir, 2006, p. 9.

¹² Even property taxes are set and administered by the national government rather than locally, with a portion retained as an administrative fee, see Eckardt and Shah, 2006. p.6.

¹³ Article 27 of Law Number 33 Year 2004. The DAU is broken into two main components: a base allocation compensating civil service wage costs (*alokasi dasar*) and an equalizing amount to address the fiscal gap (*dasar celah fiskal*), see Law 33 Year 2004.

¹⁴ See World Bank 2007c, p. 127 for estimates of reserves by region. “Between 2001 and 2005, provinces and *kabupaten/kota* (districts and cities) accumulated more than Rp 35 trillion in reserves ... and in mid-2006 these reserves reached Rp 95 trillion or 3.1 percent of GDP. However the level of accumulated reserves varies greatly across provinces and districts, [mainly] in regions rich in natural resources, such as East Kalimantan, Riau, Aceh and Papua.”

Expenditure need is also defined to take account of poverty in the district (using the Human Development Index). However this only leads to limited equalization due to its small weight in the formula. Resource rich local governments receive the vast bulk of resource revenues, accommodating deeply felt grievances by these provinces in the previous centralized regime, but working against the equalization intended by the DAU.

¹⁵ Funds are being accumulated at local levels at a time of fiscal stress at the national level.

¹⁶ World Bank 2004, p.22.

allocations accountability for appropriate and effective spending by local governments is to the elected local council.¹⁷

Inequality between districts

The World Bank notes that “Since decentralization, income levels have improved across the country, but the richest districts have outstripped the poorest. The national poverty rate declined from 24 percent (1999) to just under 18 percent (2005). Although all districts in Indonesia experienced a decline in poverty, richer districts benefited disproportionately from the recovery. The richest districts saw the poverty headcount halved but in the poorest districts the rate only fell by one sixth. Consequently, the income gap between richest and poorest districts has widened. On average, the richest districts grew above the national average, while the poorest districts were below the national average.”¹⁸

The Bank notes that poverty is particularly concentrated in regions dependent on agriculture while those for which manufacturing contributes a relatively large share of regional GDP are associated with below average poverty.¹⁹ Resource rich regions are also likely to enjoy below average poverty, since the equalization principles underlying the provision of financial support to local governments were modified to accommodate the claims of resource rich regions.

While DAU allocations reflect differences in poverty between districts (albeit with a limited weight for equalization in the overall formula) there is no requirement that each district actually spends its DAU funds in a way which alleviates the poverty differences. For example, the World Bank found that “poorer districts “do not spend more on education from their budget than richer districts despite receiving a larger allocation from the DAU.”²⁰ A World Bank study refers to “strikingly wide range in the per capita level of education expenditures across districts”²¹.

Inequality within districts

In addition to the risk under decentralization of greater inequalities *between* districts there is a risk of growing inequalities *within* districts. “Recent government expenditure has largely been concentrated in urban centers, captured by politically connected elites, and continues to disenfranchise the rural poor...Ensuring such ‘internal equality’ is at least as important as tackling ‘center-periphery inequality,’ both to address community grievances and to prevent elites from mobilizing based on local discontent. This requires building strong, just, accessible and legitimate institutions with a focus on delivering

¹⁷ Elected local councils (DPRDs) approve the local budget and receive quarterly reports on budget execution.

¹⁸ World Bank 2007c, p. 115. The Bank defined the richest districts as “those 20 percent of the districts with the lowest poverty headcount; the poorest districts are the 20 percent with the highest poverty headcount.”

¹⁹ World Bank 2007c, p. 115.

²⁰ See World Bank 2003b, p. 23.

²¹ World Bank 2004, p. 20.

services, fighting corruption, improving transparency, increasing capacity, and ensuring participation.”²²

Effectiveness of local budgeting

While one set of concerns about decentralization achieving its goals relates to ineffective equalization across and within regions, another relates to the effectiveness with which local governments are spending the substantial allocations they receive from the center. Growth in regional inequality, while in part reflecting the limited effectiveness of fiscal equalization arrangements, can also reflect shortcomings in the procedures by which grant funds are budgeted by individual local governments.

“The current level of sub-national government revenues is high; therefore the focus should shift towards an efficient use of government resources rather than the mobilization of additional resources. One key element in ensuring spending efficiency is local governments’ performance measurements to allow comparisons across districts. Strong incentives for prudent use of local public revenues could be structured into the system of intergovernmental fiscal transfers.”²³

While there is some evidence of diversity in the way in which districts prepare their budgets, little is known about the allocative and technical efficiency of local budget preparation. Periodic review of budgeting processes at the national level through analytical instruments such as Public Expenditure Reviews (PERs) and PEFA diagnostics generally do not occur at the local level of budgeting.²⁴ However the World Bank has undertaken regional PERs in sensitive provinces such as Aceh and Papua, while Indonesia’s external audit agency (BPK) undertakes audits of district financial performance. In addition, ad hoc studies are now beginning to emerge on a sector basis, such as a recent SMERU report on DAK allocation and a World Bank report on the decentralization of education spending.²⁵ The following discussion of the quality of local budgeting draws on these diverse studies.

Capacity gaps at the local level

Centralization of budgeting at the national level which existed prior to 2001 militated against the development of policy based budgeting skills across Indonesia’s 465 local governments. Nor was capacity development for policy based budgeting a part of the decentralization process. Given the ‘sink or swim’ nature of the 2001 decentralization (as opposed to a ‘developmental approach’) these policy skills may not automatically emerge as a consequence of devolution per se and there is a risk of limited capacity at all levels:—mayors, DPRD members, local government officials and civil society groups, but particularly in local service agencies (SKPDs), on whom the responsibility for making service delivery responsive to local preferences ultimately rests.

²² Barron and Clark 2006, preface.

²³ World Bank 2007c, p. 134.

²⁴ PEFA (Public Expenditure and Financial Accountability) is a multi-agency partnership programme sponsored inter alia by the World Bank, the International Monetary Fund, and the European Commission.

²⁵ Usman et al 2008 and World Bank 2004.

Policy skills involve the ability to diagnose social and development priorities, and to translate these diagnoses into operational policy initiatives with clearly estimated impacts and budget costs, to prioritize these initiatives and to implement the most cost effective among them through budget procedures which ensure allocative flexibility. The pre-decentralization budgeting arrangements instead placed a premium on accounting for inputs, rigid budget control and implementation of policies remotely determined in the central office of the national ministries. If Jakarta's input focused approach to decentralization were also to be adopted by local governments, decentralization would be unsuccessful in strengthening the link between government spending and peoples' preferences.

The World Bank notes that there are "a number of areas in which local government is particularly weak, including planning and budgeting, accounting and reporting, undertaking external audits, regulation, and the management of public debts and investment ... this is a challenge across Indonesia where decentralization has meant local government employees are no longer only responsible for the implementation of central government policies but also for designing and implementing locally appropriate policies. This requires the ability to allocate funds equitably across districts; to identify short-, medium- and long-term development priorities and translate these into strategic plans; to understand and tackle poverty; as well as to identify and rectify sectoral and geographical gaps. These technical skills do not currently exist and are unlikely to manifest simply through responsibilities being devolved."²⁶

Consequence of weak capacity for local budgeting

The passage of the decentralization laws can not of itself be assumed to ensure allocative and technical efficiency in local budgeting if input focused, inflexible and closed budget processes at the national level have subsequently been replicated at the local government level. If district budgets are based on repetitive line item budgeting with no focus on the results sought in local planning documents, or consultative processes with the local community, and there is no mechanism for 'policy contestability' when local budgets are being prepared, there is a risk that inflexible, input focused, budgeting at the centre which prompted the decentralization is subsequently replicated at the local level. Unresponsive centralized budgeting risks being replaced by unresponsive decentralized budgeting, and the rationale of the decentralization – to bring budget decisions closer to those affected by them – is weakened.

A related risk is that local budgets are hijacked by local elites. In principle, elected councils are a safeguard against this. However, "In general, local council representatives often lack proper education and political experience. The level of policy awareness and the quality of political debate is poor. Budgets are incremental rather than policy based (as would be implied if they are to be more responsive to local preferences). Although they are expected to hold mayors and district heads accountable for their performance,

²⁶ Barron and Clark 2006, p.16. Mohamad sees "changing the culture of government apparatus from power oriented to customer oriented" as a priority. Mohamad 2007, p. 6.

these legislators are often ill-prepared to do so. Because of weak fiduciary oversight, opportunities for corruption and nepotism are on the rise.”²⁷

The musrenbang process, whereby pre-budget consultations are undertaken with the local community, is another safeguard against unresponsive local bureaucracies replacing unresponsive national bureaucracies. “Nevertheless, barriers still exist which prevent community organizations from participating in public policy. Access to governmental information is uneven and impeded, more often than not, by a bureaucratic preference for secrecy. Civil society groups, moreover, are often long on enthusiasm and indignation, but short on political savvy.”²⁸

Lack of flexibility in local budgeting is reflected in under-spending of available resources (particularly due to weak project management) and a build up of local reserves. “Large reserves indicate inefficiencies in the budgeting process that may not be easy to remove. First, budget approval processes need to be streamlined, which will require a change to Law No. 32/2004. Second, local governments need to build capacity to better budget and spend resources. Third, Law No. 33/2004 stipulates that transfers of shared revenues must occur on a quarterly basis, which requires timely production estimates from the sectoral ministries.”²⁹ The Bank also proposes that the DAU allocation mechanism should be changed by eliminating the link to coverage of the sub-national wage bill.

“Overall, public financial management systems at the sub-national level are weak and risks of corruption are very high. Findings from an in depth-assessment (and rating on a 100 percent scale) of selected local government financial management performance in 15 local governments has shown that the institutional and human capacity to manage local funds is still low and that financial management processes are still weak, and lacking in transparency and accountability.”³⁰

Allocative efficiency of local budgets

Allocative efficiency of budgeting refers to achievement of the most appropriate combination of spending across and within sectors (such as health versus education) and between recurrent and capital spending (infrastructure versus administrative and operating expenditures). Improvement in allocative efficiency is closely linked to the replacement of input focused budgeting by results focused budgeting.

²⁷ World Bank 2003a, p. iv.

²⁸ World Bank 2003a, p. iv. Accountability is ensured by the mayor being elected by the local council and his/her five year plan being passed as a law. The annual budget is subject to a community consultation (musrenbang) process and the budget law must be passed by the elected council. Local officials are close to the local community and can be expected to be more aware of needs than those at the national level.

²⁹ World Bank 2007c, p. 127.

³⁰ World Bank 2007c, p. 126. The Bank continues “The average performance, measured against the requirements of national legislation for regional financial management, only reaches 44 percent. In sharp contrast to this is the performance of some reform-minded local governments. For example, the district of Sleman in the province of the Special Region of Yogyakarta has achieved a performance score of 100 percent in the areas of cash management and reporting and accounting. However, such performance is still exceptional. The creation of incentives for regions could be an important way to move the anticorruption reform agenda forward.”

The introduction of performance budgeting presents a major challenge in Indonesia, even at the national level. Experience in the Ministry of Finance and Bappenas indicates the stubborn persistence of the input focused budgeting approach, based on detailed ‘bottom up’ quantifying and costing of inputs, without reference to impact of agency budget requests on GOI planning objectives. Budget requests are linked to the objectives described in planning documents in only a cursory fashion.³¹

With considerable diversity in budgeting practices across local governments, and only limited performance information available at the district level, there is little available information on allocative efficiency of local budgeting, or whether the right balance is being struck between competing local priorities, both between sectors (does high administrative spending crowd out health spending?) and across localities (does spending in towns crowd out spending in rural areas?). USAID notes that “It is nonetheless apparent that there are significant differences in service achievement across localities and sectors. While few improvements in the quality and reach of services can be seen in general, a few regions have been innovative. On the negative side, in some cases slippage has been experienced in reach and quality (e.g. immunization, early child nutrition). There is also evidence that infrastructure stock for health, schools, roads, and water works are suffering from underinvestment in selected regions.”³²

Minimum Service Standards: SPMs

The central government has some limited control over the way in which local governments use their unconditional grants. First, an annual budget circular is issued by MOHA indicating the national priorities to be taken into account in preparing each local budget (see Fig. 1 outlining local planning/budgeting processes). Second, in an attempt to ensure that multiple funding streams across more than 460 local governments are consistent with implementing the obligatory functions of local governments, as well as the national planning goals in the Presidents RPJM and other documents such as the MDGs, the GOI introduced (subsequent to decentralization) a set of minimum service standards (SPMs), prepared by national ministries for their respective sectors.³³

To date the creation of SPMs appears to have had little impact on local budgeting, both because of the diverse and sometimes non-operational nature of the standards themselves,

³¹ A cursory connection is made by requiring spending units to identify program objectives when submitting their input based budget requests. However there is no link between changes in the level of inputs requested and the consequent impact on achievement of these targets. Hence it is impossible for Bappenas/MoF to approve or reject requests for increased financing on the basis of the impact of each request on program objectives.

³² USAID 2006, p.22.

³³ Spending to achieve the poverty goals in the President’s national five year plan (RPJMN) 2005-09 is split between national level (deconcentrated and assistance funds through the provinces and specific purpose funds (DAK allocations) disbursed through local budgets) and local spending from general purpose (DAU) allocations and own revenues. Triaswati 2006 provides estimates of the financing gap between current resourcing of main public services and financing needed for target achievement. See also UNDP 2004, which estimates the financing gap in four areas, food security, basic health, basic education and physical security, and Government regulation Number 65 Year 2005 on Minimum Service Standards (PP No. 65 Tahun 2005).

the limited performance information available in individual local governments on gaps against standards, and the failure of budget preparation templates used at the local level to link budget requests by local service units to achievement of minimum standards.³⁴ Current reporting systems provide little information on the extent to which local governments are spending grants in accordance with national priorities. Systematic collection of soundly based performance information is a high priority next step in implementing the decentralization.

Given the somewhat blurred assignment of responsibilities between local and national governments it is also unclear where meaningful responsibility for implementing a SPM resides. SPMs are discussed in more detail in Annex 1.³⁵ However, at the very least, they are unlikely to achieve their desired end without the improvements in local budget preparation discussed in Part B of this paper.

Under-investment in infrastructure?

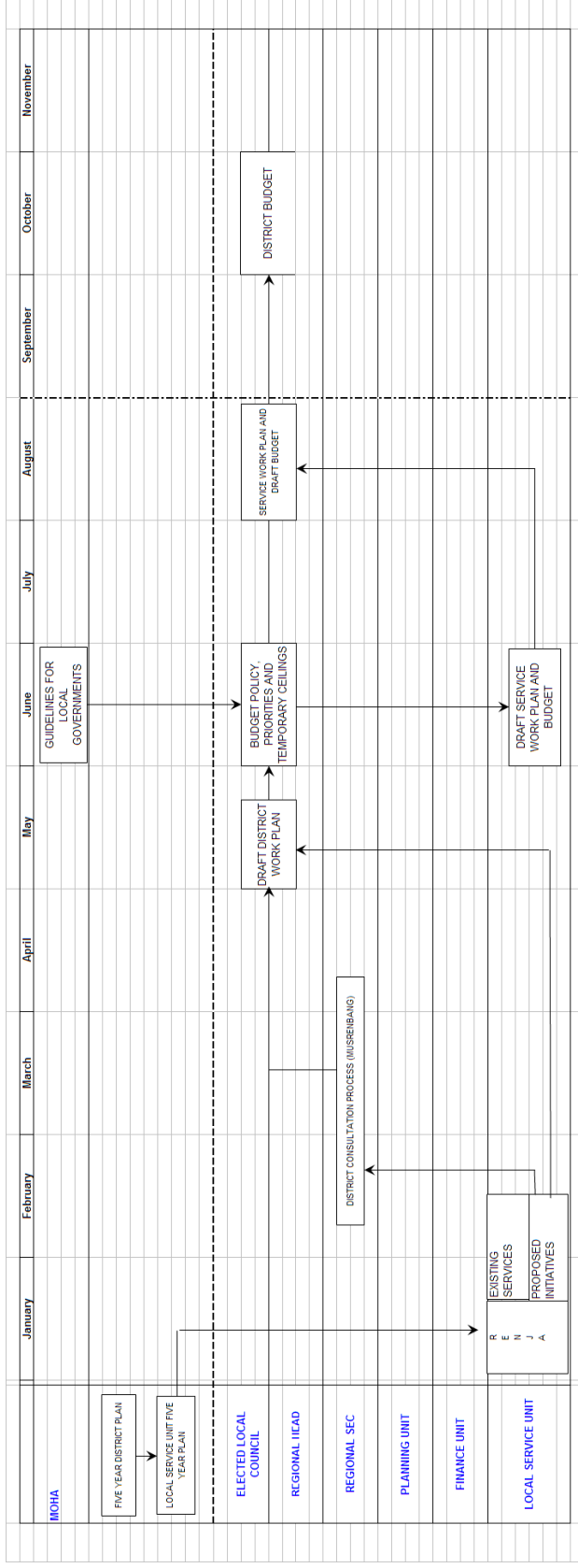
A further aspect of the allocative efficiency of local budgets relates to recent concerns about under-investment in infrastructure now that spending decisions are left to district budgets. Districts provide information only on the state of regional infrastructure in the sectors that receive DAK allocations (used by MoF to determine the allocation of DAK by sector and region).³⁶

³⁴ The templates are set out in Permen 13 on local budgeting procedures.

³⁵ Under Regulation 108/2000 heads of regions are accountable for achieving the standards. However, they have limited control over most of the relevant spending decisions.

³⁶ It appears that this information is not up to date. See Usman 2008, p.22.

Figure 1: Local planning/budgeting



However, “Sub-national governments’ development spending on infrastructure has not matched the rate of growth in their real revenues.”³⁷ The World Bank notes particularly under-maintenance of sub-national roads and local water supply.³⁸ It suggests that “This may in part reflect sub-national priorities, with education and health occupying an increasing proportion of sub-national development spending, but it is also possible that local governments have limited ability to manage increased infrastructure spending. The lower spending on infrastructure could also reflect planning delays, in which case the balance between infrastructure and other spending categories may revert over time. In this respect, it is of some concern to note that sub-national governments’ bank deposits have rapidly accumulated from less than Rp 10 trillion in January 2001 to more than Rp 70 trillion (2.6 percent of GDP) in April 2006, suggesting an inability or an unwillingness of sub-national governments to spend their full budget allocations. A more detailed study is required to determine why sub-national government infrastructure investment has not kept pace with sub-national government revenues, particularly given the low quality and poor access indicators prevalent for much of Indonesia.”³⁹

Technical efficiency of local budgets

Differences between local governments may also occur in respect to the technical efficiency of their budgeting (the cost of achieving a particular service level rather than

³⁷ World Bank 2007c, p. 82.

³⁸ The World Bank notes that “the poor condition of sub-national roads suggests that expenditures on sub-national road maintenance should be increased. Given the poor state of existing sub-national roads, it is likely that additional maintenance will yield a high social rate of return.” World Bank 2007c, p. 84.

In regard to water supply “The appalling situation of most PDAMs (local water supply utilities) is the result of a combination of inappropriate policies. Many countries set water tariffs below full cost-recovery levels, but the average water tariff for low-income households in Indonesia is less than half the lowest tariff in Vietnam (a much poorer country), and far below those of other ASEAN countries. Nearly half of all PDAMs are reported to set tariffs below the cost of operations and maintenance. The situation in Indonesia is exacerbated by weak corporate governance arrangements. This allows local governments as owners of the PDAMs to declare “dividends” even in loss-making situations, permitting the diversion of PDAM cash-flow for alternative political priorities. Poor operating performance in Indonesia is exacerbated by excessive fragmentation. Many PDAMs are smaller than optimal, resulting in excessively high operating costs. Consequently, the possibility of mergers should be considered.” World Bank 2007c, p. 86.

³⁹ World Bank 2007c, p. 82. Accumulation of reserves has been greatest in resource rich provinces. The Bank notes “There are four factors contributing to under-investment and spending by local governments. First, sub-national government budgets tend to be approved disbursements only after substantial delays, sometimes not until late in the second quarter of the fiscal year. This has been exacerbated by the introduction of a new budget authorization process (Law No. 32/2004), whereby the Ministry of Home Affairs has a right of approval over provincial budgets and provincial authorities over district budgets. Second, central government transfers (especially those derived from shared natural resources) tend to come in late in the fiscal year. Third, direct central government spending in the regions crowds out local spending and forces local governments to review their spending plans—a cumbersome and slow process. Fourth, sub-national governments may not have the capacity to spend the resources at their disposal, especially when such resources increase significantly and suddenly. This is especially true in the case of the 64 percent increase in DAU from 2005 to 2006, which led to a sudden and significant increase in reserves (see Chapter 1). “The World Bank ... has estimated that Indonesia needs to invest around five percent of GDP annually in public infrastructure, much of which is local in character, in order to sustain a 6 percent medium-term economic growth target.” World Bank 2007c, p. 117.

the appropriate choice of that service level). Poor technical efficiency often reflects wasteful spending due to over-manned administrative structures, corrupt use of funds and wasteful asset management, all of which may be a problem at the local level.

Overspending on local administration

“The largest spending item of sub-national governments is government administration, followed by education. Spending on administration is particularly significant at the provincial level (38 percent of total spending) and the district level (30 percent). This is in stark contrast to what is found in more modern economies, which typically allocate 5 percent or less of their budgets to such expenses. The largest items in administrative spending include salaries and allowances for the local head of the executive and his/her staff and parliamentarians, as well as public office building rehabilitation and construction.”⁴⁰

The Bank notes that districts account for more than two-thirds of all personnel spending, or 41 percent of total government apparatus spending. “Public spending on government apparatus and supervision increased by 110 percent in the period 2001-05.... In 2001, spending in this sector accounted for 9 percent of the total national budget, increasing to 12 percent of total national expenditures in 2005. Sub-national governments alone account for more than 67 percent of the increase in spending on government apparatus.”⁴¹

However, “Full coverage of the sub-national civil service wage bill provides a disincentive for sub-national governments to streamline their civil services. The main variable determining the basic DAU allocation is a district’s wage bill. Any cut in a district’s wage bill (without a concomitant cut in all other districts) implies a decrease in the basic allocation of the DAU (with a one-year lag). As mentioned, the basic allocation is about half of the total DAU. Consequently, this component of the DAU formula effectively eliminates half of any reformist government’s savings in its wage bill savings by reducing the DAU.”⁴²

The PER concludes that high levels of administrative spending particularly crowd out spending in health and agriculture.⁴³ In contrast, “the cost burden of the oversupply of teachers for primary and junior secondary schools alone reaches over Rp 5 trillion, or about 8 percent of the total education budget.”⁴⁴

Misuse of funds

Limited evidence on the inappropriate use of funds is available from reports of the Supreme Audit Agency (BPK). A recent BPK report on budgeting in ten provinces found

⁴⁰ World Bank 2007c, p. 116.

⁴¹ World Bank 2007c, p. 25-26. The Bank continues “The growth in administrative spending at the sub-national level can, at least partially, be explained by the creation of more than one hundred new districts over this period, an increase of 30 percent from 336 districts in 2001 to 437 districts in 2005.

⁴² World Bank 2007c, p. 121.

⁴³ World Bank 2007c, p. 117.

⁴⁴ World Bank 2007c, p.44.

that more than half of the regencies and municipalities misappropriated funds received from the central government.⁴⁵ BPK is reported as stating that in the second semester of 2007 there were "...733 indications of administrative malfeasance in local governments worth Rp 20.12 trillion, 193 indications of budget inefficiency worth Rp 459.27 billion and 214 indications of budget misuse worth Rp 2.1 trillion."⁴⁶ This was attributable to lack of transparency and accountability as well as insufficient internal control.

It will always be difficult for the central government to ascertain whether it is receiving value for money from its unconditional grants to local governments. Although the national Ministry of Finance collects detailed data on local spending MOHA does not collect data on service levels, while the central government has no knowledge of the cost in each district of providing local health or other services. The technical efficiency of local spending is therefore a 'black box'.

CONNECTING PLANNING AND BUDGETING AT THE LOCAL LEVEL

Where there is limited information of a direct and evidential nature on the allocative and technical efficiency of local budgeting, it is also possible to assess the potential of the decentralization to achieve its objectives through an institutional review of the potential for local planning and budgeting procedures to link local spending to local preferences. A full review is outside the scope of this paper. However, the following sections examine the *potential* of a new regulation (currently being drafted by the Ministry of Home Affairs) for building a bridge between local planning and budgeting.

Local planning and budgeting processes

The preceding part of this paper suggests that, on the limited evidence available, decentralization may not be completely fulfilling its objective of making public spending more responsive to local preferences. The challenge is to avoid cloning at the local level the rigidities in central budgeting that originally motivated the decentralization. This requires local budgeting procedures that are more policy based and responsive to local needs and preferences.

Local planning documents are the platform for articulating and prioritising local needs and are the formal expression of local preferences. Following the election of the local mayor his/her five year development plan (RPJMD) is enacted by the local council.⁴⁷ District work plans (RKPDs) are then developed annually in support of the RPJMD, based on the work plan proposals of local service agencies (Renja-SKPDs). Each local work unit (SKPD) prepares a five year plan (Renstra) and a one year work plan (Renja).

⁴⁵ Reported in The Jakarta Post, April 24 2008. The full report is not publicly available. However a BPK official commented that "I believe that most of the problems were more related to the quality of human resources than the (finance and budgeting) system". (Jakarta Post 24 April 2008, p.2). A BPK official is quoted in the same newspaper as indicating that many bridges and roads in the regions did not meet standards because they were built using less funds than had been intended.

⁴⁶ Reported in The Jakarta Post, April 11, 2008.

⁴⁷ This may reflect situational analyses undertaken by planning staff in the local Bappeda.

The one year plans are combined by the district administration into the annual district work plan (RKPD), which forms the basis of annual budget preparation.

These somewhat complex local planning and budgeting processes are described in Annex 3 and illustrated in Fig 1, although precise procedures appear to vary between districts. Suffice to say that on paper local budget preparation appears to be firmly based on a platform of short and long term local planning strategies. Any lack of policy contestability in local budget preparation does not reflect the absence of a formal set of planning procedures at the local level.

However, as revealed by the budget request forms completed annually by local spending units, in reality local budget preparation is more an exercise in rudimentary cost accounting than plan implementation. At present, planning and budgeting at the district level proceed on largely separate tracks

- planning priorities are described in the district's five year plan (RPJMD) and its annual work plan (RKPD), and are determined with limited reference to the cost of implementing the priorities. The planning function has focused on prioritization of spending plans without costing of specific measures for achieving planning priorities
- the local budget is determined mechanistically through the detailed costing of inputs, without connecting proposed variations in input levels to achieving planning priorities.

Thus the strong planning focus which exists at the local level fails to connect procedurally with the budget requests made by local service units. These are built up on activity based budgeting principles from assumed levels of output (and associated standard unit costs) without the proposed changes in outputs being linked to achieving planning objectives.⁴⁸ In a complex, paper-intensive and time consuming budget preparation process, detailed financing requests crowd out performance budgeting justifications, and planning and budgeting run on parallel tracks, with planning relatively unresponsive to budget realities and budgeting unresponsive to the planning analysis.⁴⁹ This precludes a policy contestability culture in budget preparation in which options for achieving specific planning targets are prioritized on the basis of their cost and policy benefits.

If the annual budget fails to respond flexibly to the local planning process, but is driven by inputs and last year's allocations rather than targets and next year's results, the potential of decentralization will fail to be realized. Unresponsive budgeting at the national level will be replaced by unresponsive budgeting at the district level.⁵⁰

⁴⁸ Outputs are proposed by service agencies at the activity level and standard unit costs used to derive financing requirements.

⁴⁹ This is however preferable to the reverse (the planning targets drive the budget) due to the reduced risk of over committing the local resource envelope.

⁵⁰ One result of the disconnect between planning and budgeting is that local planning and budgeting processes are overly drawn out and complex (Annex 3). In integrating planning and budgeting the existing sequential business processes for planning and then budgeting need to be simplified and merged in a single

This weakness in connecting budget requests to achievement of planning priorities occurs despite the current requirement for the budget requests of local service units (SKPDs) to specify the funding they are seeking in a multi-year context, ie. for the coming budget year and one out-year.⁵¹

Why do local planning and budgeting operate on separate tracks rather than forming a single integrated policy contestability process? Planning and budgeting currently occur at different stages in the year (planning from January to May and budgeting from June to October), involve different local officials, and focus on different issues. Local planning priorities are set on a needs or demand driven basis, without reference to the cost of possible measures or how they should be programmed to meet an annual budget constraint. Local budgets, on the other hand, are based on activity based budgeting principles, ie. the requests for budget allocations by SKPDs are built up from the projected outputs and unit costs for each of their activities, and are not based on the impact of proposed output variations on the achievement of planning targets. The district budget committee decides budget allocations to each SKPD without knowing whether there are better ways of achieving local planning targets through alternative allocation decisions. This absence of policy contestability allows current spending patterns (for which resources are already assigned) to crowd out new spending patterns (which may require resource reallocations).

It is true that program objectives are entered in the budget request forms filled out by each SKPD. However, merely stating the objective of the program provides little guidance to the local budget committee in deciding whether the budget allocation for that program should be greater or less than the amount requested, or the previous year. A policy contestability process for preparing the budget requires, for each planning target, a knowledge of different options for achieving the target, the cost of each option and its impact on target achievement (see section on Element 2 below). The best set of options across all programs (consistent with available funds) can then be chosen for inclusion in the budget.

The draft regulation on local planning and budgeting

Breaking down the ‘Chinese wall’ between local planning and local budgeting is, in the view of the authors, a key to ensuring that local budgeting is responsive to local preferences. This requires the insertion of a policy contestability process in preparation of the local budget, in which spending options (from the planning side) are prioritized on the

step, avoiding the creation of additional steps and reducing complexity. This is a challenge in integrating the business processes, but even more so a coordination challenge for the separate departments of MOHA that are currently responsible for the local planning processes and local budgeting processes. The Departments are the Directorate General for Local Development (BANGDA) and Directorate General of Regional Finance Administration (BAKD).

“Capacity for planning and budgeting needs to be improved greatly at the local level. Budget approval processes need to be streamlined and off -budget spending needs to be incorporated. Only then will the budget reflect planning, thereby ensuring efficient government spending and preventing the occurrence of large surpluses.” World Bank 2007c p. 134.

⁵¹ The requirement is in Permen 13.

basis of benefits *and* costs (the latter from the budgeting side). To achieve this an overlap will have to be introduced between the two processes, in which planning and budgeting information is considered simultaneously rather than sequentially.

The period since 2001 has seen implementing regulations for the decentralization progressively being worked through. Laws 17 and 33 call for an end to “separate tracking’ of planning and budgeting by requiring district budgets to be prepared in a performance based medium term expenditure framework (MTEF). This is intended to commence in 2009, although the reality is likely to be different. Achieving this integrated planning/budgeting process is the object of a new regulation on planning and budgeting currently being drafted by the Ministry of Home Affairs (MOHA). The effectiveness of this new regulation will have a major effect on the responsiveness of local budgeting to the local preferences expressed in district planning documents.⁵²

Three reform ‘Elements’

A challenge for the draft regulation on local planning and budgeting is to introduce much simpler and more robust procedures for performance budgeting than have been considered to date at the national level. Given local capacity constraints, district budget reform needs to be simple, common sense and ‘bomb-proof’. To be successful the new regulation needs to build on *existing* processes and budget request forms rather than replacing them with an entirely new approach which causes confusion and may not in reality be implemented. Within these limitations, the key design issue is the way in which local planning and budgeting processes can be combined.

The draft planning/budgeting Permen contains directives for the preparation of the district strategic plan (RPJPD, RPJMD), district annual plan (RKPD), and the strategic and annual plans of district service units (Renstra SKPD and Renja SKPD) using a performance budgeting approach and a medium term expenditure framework.⁵³ The strategy adopted is to preface the existing input based budgeting process with a policy prioritization stage which is much more ‘planning connected’.

The regulation is still in draft form and stops short of a fully enumerated set of procedures for connecting local planning/budgeting. However a key change is that a more formal process for preparing the annual district work plan (RKPD) is to be introduced, with each district using a new suite of forms for preparing its work plan. The new forms will support (at last potentially) a policy contestability process in preparing the district work plan, with the approved changes to programs and activities then migrating into the *existing* detailed and input based budget preparation process.

⁵² The drafting of the new regulation on planning and budgeting has involved international and local consultants advising the Planning and Development Department (BANGDA). BANGDA has tested the approach in a series of regional consultations.

⁵³ Alta Folscher, defines performance budgeting as follows : “performance budgeting refers to the linking of expected results to budgets. Like program budgeting except that it adds an emphasis on targeting and measuring outputs and performance, with data analyzed against aims and standards. Usually used as a term across countries to cover a range of specific processes.” Folscher 2007, p. 120.

This is a significant change to the status quo. In the period since decentralization the Ministry of Home Affairs has been content to leave the format of the annual district work plan (RKPD) prepared each May largely to each district to decide.⁵⁴ This has contrasted with the tightly defined templates to be used for detailed budget requests from service units to the local budget committee, prepared in June, which are prescribed in Permen 13 on local budgeting processes.

Importantly, at time of drafting of this paper, new forms to be used by each district for preparing its annual work plan involve three elements⁵⁵

- **Element 1)** a requirement for each local service unit to provide more detail on program targets and indicators by program and activity, including gaps in the achievement of targets for each program. Under Element 1 spending units are asked, when submitting their proposed workplans, to identify program objectives, performance indicators, gaps to be filled, together with targets for gap filling and the funding needed for target achievement. Targets and performance indicators are to be drawn from the district strategic plan (RPJMD)
- **Element 2)** a change in local budget preparation in which local service units break out of their detailed activity based budget requests information about their proposed new initiatives ('change packages') to achieve planning goals, or savings where existing spending contributes little to goal achievement (such as padded out administrative spending).⁵⁶ For each 'change package', information is to be provided about the cost of individual proposals in the new budget year and two following years ('out-years') *and the impact of the proposal on the achievement of relevant planning targets*
- **Element 3)** a requirement for local service units to provide multi-year costings both for their baseline budget and the costs of their new initiatives. This ensures that budgeting takes place within a MTEF. Where a local service unit does not propose any new initiatives for the next budget year the previously established forward estimate for that year becomes its initial ceiling for its new budget request.⁵⁷

⁵⁴ Renjas and the RKPD have hitherto been planning documents which contain policies and priorities, but which are formulated without reference to the associated costs to the budget.

⁵⁵ The following is a simplified statement of the changes proposed in the draft regulation. The three Elements described here are contained in the templates (attached to the regulation) to be filled out by the district administration and individual service units, rather than being clearly stated in the text of the regulation.

⁵⁶ Often requests by spending units for increased funding are simply ambit claims and not based on any well defined change in activity levels. The proposed approach forces SKPDs to make a link between requested increases and achievement of planning targets.

⁵⁷ When SKPDs propose new initiatives they will be required to provide information on the cost of the initiative in the coming budget year *and* subsequent out-year. This will enable choices of new initiatives by the Local Budget Committee to be made in the knowledge of the out-year impact of the initiative on the district budget (eg. the future operating costs of a new health centre).

As currently drafted, the new regulation on local planning and budgeting marks a significant step from input based budgeting to a performance approach, incorporating the best practice elements of results focused budgeting in an MTEF. The regulation adopts a quite ambitious three Element approach to linking planning and budgeting – comprehensive reporting of performance indicators at both the program and activity levels of the budget classification, identification of new initiatives and introduction of an MTEF. These three elements are closely connected. In particular, the change package proposed by each local service unit under Element 2 should be grounded in the analysis of gaps against planning targets provided under Element 1. The requirement for SKPDs to elaborate their requests for both the next budget year and two subsequent out years under Element 3 ensures that planning priorities and their operating cost implications can be programmed over several budgets in a rolling process.

Local capacity constraints

The key question is whether this three Element approach is over-ambitious given existing *capacity constraints in local government*. In the authors' assessment the combination of the three Elements presents achievability challenges which may limit its implementation by many local governments.

A large literature exists on the replacement *at national government level* of incremental line item budgets by more flexible, results focused, budgeting within a medium term expenditure framework. Targets derived from planning documents such as Poverty Reduction Strategies, Millennium Development Goals, five year plans and national sector strategies are identified and programmed into annual budgets through a rolling three year forward estimates process which focuses on sector strategies and policy contestability. However, where there is weak local ownership of the shift to policy based budgeting, and despite extensive technical assistance from donors, achieving success with performance budgeting/MTEF reforms has proven a slow task, including at the national government level in Indonesia.⁵⁸

At the national level in Indonesia strongly entrenched input based budget preparation has stubbornly resisted migration to a performance focus and medium term framework, despite these reforms being mandated in Indonesian legislation and acknowledged in the budget request forms filled out by each national ministry. It has proven very difficult to orchestrate the necessary change in perspective, both at the level of central coordinating ministries and spending ministries, as officials find new approaches difficult to understand, are reluctant to take risks, cling to familiar and tried procedures or do not complete the parts of their budget request forms which they do not understand. Is it plausible that national coordinating ministries which find it difficult to themselves introduce performance budgeting/MTEF reforms will be able to orchestrate the necessary change in attitudes and processes across more than 460 local governments who in any

⁵⁸ MTEF and PBB have been introduced in principle at the national level in Indonesia. However progress is elusive. Although out year estimates are required in budget requests prepared by national ministries, they are often not filled out and seem to play no role in budget preparation. There are various versions of an MTEF for the purpose of integrating planning and budgeting, and at the national level Indonesia has not yet come out in favor of a particular approach.

case submit their budget requests to the local rather than the national level? Limited progress at the national level with local implementation of SPMs, discussed in Annex 1, does not provide reassurance.

Equally, however, allowing local budget processes to ‘take care of themselves’ is also not an option. Replacement of the (pre-2001) regime of centralized budgeting for local areas by decentralized budgeting which pays little attention to local planning processes risks defeating the intention of the decentralization to make budgeting more responsive to local communities. It also risks creeping re-centralization as national ministries try to compensate for emerging gaps and distortions in local spending through expansion of parallel national programs for filling the gaps (see Annex 2).⁵⁹

CONCLUSIONS

Introduction of sophisticated budget preparation techniques which have not yet been managed successfully at the national level across more than four hundred and sixty Indonesian local governments involves a challenge. While there appear to be wide variations in the capacity of local governments, given capacity limitations at the district level what are the chances of more sophisticated results focused budgeting succeeding at district level when it has yet to succeed at the center?

Elements 1 and 3 in particular may take some time to implement effectively. In regard to Element 1, given the absence of performance information at the local level, it may be difficult for local service units to provide the requested detail on program targets and indicators by program and activity, including gaps in the achievement of targets for each program. A process of installing performance information (PI) data collection and monitoring systems will be required by each local government, using national criteria and definitions.

In regard to Element 3 (the requirement for an MTEF), the intention is that local service units should submit in their budget requests the three year cost of maintaining their existing service levels. In the absence of new policy proposals from the service unit, the first out year estimate for an SKPD will then become the ceiling for its next year’s budget request. However, this means that the forward estimates must be robust and accurate, excluding any padding for hidden increases in costs or extension of service levels. This will be difficult to achieve when the forward estimates are generated by the local spending units rather than the local budget office.

The use of an MTEF for local budget preparation will also require projections of the district resource envelope. Since on average around 90 percent of district revenues are

⁵⁹ The IMF concludes “The mechanism for coordinating fiscal management practices in the regions needs strengthening. Consideration should be given to adopting a joint decree that establishes a high level coordination forum comprising MoF, MOHA and Bappenas as core members. Such a high level forum would concentrate on improving sub-national fiscal reporting and formulate regulatory provisions for: enhancing policy formulation for expenditure and revenue assignments; and regional financial management. The group should meet at least once a month to review the current status and consider new policy initiatives.” IMF 2006, p.40.

provided by transfers from the central government, this would necessitate the central government making forward estimates available for transfers to lower levels of government. The preparation of such FEs of grants to lower levels of government may not currently be envisaged by the Ministry of Finance.

In the authors' view the achievability of the first and third Elements of the draft regulation is limited at present and they are unlikely to be effectively implemented in the initial years following promulgation of the new regulation. Since they are goals to work towards there is merit in recognizing them formally in the new regulation. However, in the shorter term they are unlikely to prevent continuation of input focused budgeting which lacks a link to planning targets based on policy contestability.

The second Element of the draft regulation, however, ranks much higher on the achievability scale and offers more hope of a 'quick win' in local planning/budgeting reform. Fig. 2 provides an illustrative roadmap for reform, in which Element 2 precedes Elements 1 and 3.

Element 2: the 'change package' Element

Given the challenges involved in introducing performance based budgeting in Indonesia's input budgeting environment, it is desirable that the draft regulation preserve as much of the existing local budget preparation processes as possible, but nonetheless insert a 'performance wedge' which can be built on in future years.

The second and most innovative Element in the draft regulation achieves this through the adoption of a 'change package' approach to annual budget preparation. This is an approach intended to increase the flexibility and deepen the policy content of annual budgets, and has been adopted by countries as diverse as Ireland, Chile and Australia. The change package approach is also incorporated in some modern commercial software for government budget preparation.⁶⁰

The change package approach focuses on the impact of *variations* in program allocations on the achievement of government objectives. This contrasts with full performance budgeting, which focuses more holistically on the impact of total program spending on the achievement of objectives, requiring clearly defined program objectives, program targets, performance indicators, estimates of gaps against targets and program allocations based on the prioritization of gap filling actions.

Where change packages are used to assist budget preparation spending agencies submit their proposed 'change packages' accompanied by the performance impact of each proposed change, as well as its cost. A stylized budget request form to be filled out by spending agencies is illustrated in Fig. 3.

⁶⁰ See for example the BARS software used by a number of US states. The splitting of the agency budget request into baseline and enhancement components is a widely adopted budgeting practice. Separately identifying proposed enhancements (rather than burying them in total program funding requests along with baseline program spending) makes the link between budget decisions and achievement of medium term planning targets easier to manage by the coordinating budget committee. It also enables each SKPD to be held accountable for delivering improvements against planning targets for which it has previously been given additional finance (over and above the *then* existing baseline).

Available fiscal space is then distributed by the budget coordinating committee among competing change proposals from line agencies on the merits of the proposals, ie. through a contestability process. *Approved* proposals are then included in the ceiling for the successful line agency and its detailed input based budget requests.⁶¹ The accompanying Box refers.

⁶¹ The change package approach appears similar to Chile's 'bidding fund' approach. "The bidding fund is a pool of unallocated resources to which ministries can submit bids either for new programs or to substantially extend or reformulate existing programs. Ministries submit bids in a standard format that incorporates information on (the) contribution to the relevant agency's overall strategic goals and outputs. These bids are sent to the Ministry of Planning, where they are reviewed and graded. They are then included in the relevant ministry's formal budget proposal." Shah 2007, p. 166.

Figure 2: Roadmap for integrating local planning/budgeting in an MTEF framework

PHASE 1a		PHASE 1b		PHASE 2		PHASE 3	
OBJECTIVE	STAGES	OBJECTIVE	STAGES	OBJECTIVE	STAGES	OBJECTIVE	STAGES
Strengthen link between SKPD budget requests and achievement of planning targets	<i>SKPD justify variations in funding requested in Renja-SKPD</i>						
	<i>Pilot in 2008; rollout in 2009</i>						
	<i>Develop guidelines on costing principles</i>	Improve scope and quality of performance indicators	<i>Review existing performance indicator collections</i>				
	<i>2008</i>		<i>2008</i>				

	<p><i>SKPD separate new initiatives from existing spending in Renja</i></p> <p>.....</p> <p><i>Pilot in 2008; rollout in 2009</i></p>		<p><i>Fill gaps in performance indicators relative to plans</i></p> <p>.....</p> <p><i>2009</i></p>	<p>Improve quality and reach of FEs</p>	<p><i>Cleanse existing RKA-SKPD forward estimates</i></p> <p>.....</p> <p><i>Pilot in 2009; rollout in 2010</i></p>		
<p><i>SKPD agree costings of new initiatives in Renja with Badan and agree performance impact with Bappeda</i></p>		<p><i>Develop gap filling strategies for each sector</i></p>			<p><i>Establish $t+1$ column for Renja SKPD to match RKA-SKPD</i></p>	<p>Migration from FEs to FE based budgeting</p>	<p><i>Prepare manual for forecasting internal and external financing for district</i></p>

	2010		Pilot in 2009; rollout in 2010		2009	2008
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PHASE 1a		PHASE 1b		PHASE 2		PHASE 3	
OBJECTIVE	STAGES	OBJECTIVE	STAGES	OBJECTIVE	STAGES	OBJECTIVE	STAGES
			Base change packages on gap filling strategies		Create database in Badans for holding FEs		Establish procedure for parameter updates of FEs
			2010 and beyond		Pilot in 2009; rollout in 2010		2009
					Progressively increase reach of FEs in RKA and Renja from one to 3 or 5		Use FEs as the baseline for beginning budget preparation

		<i>years</i>					
<i>2010</i>		<i>2010 and beyond</i>					
<i>Give SKPD indicative ceilings for the out-years based on forward allocation of headroom</i>							<i>2011</i>

Implementation of the change package approach

MOHA's draft regulation for integrating local planning and budgeting stipulates a change in local budget preparation in which local service units (in effect) identify 'change packages' (new initiatives) in their budget requests, including the three year cost of the proposed changes and the impact on planning objectives. Examples of new initiatives are new local capital works projects, increased maintenance spending on local roads or schools, and boosting of service packages provided by local health centers.

This is a simple and common sense approach to introducing an element of policy contestability to the budget preparation process. It enables the local budget committee to design a policy based budget without the range of performance information required by full performance budgeting. Budget allocations are assigned to approved initiatives in support of local planning goals, with necessary fiscal space for the initiatives being ensured through the detailed negotiation of each spending unit's baseline budget. There is no necessary correspondence between the agencies asked to contribute to additional fiscal space through lower allocations in their baseline budget, and beneficiaries of additional resources.

The change package approach is consistent with continuing the current input focused mode of the baseline budget request (which characterizes Indonesian budgeting at both national and sub-national levels). The approach adds a performance focus to traditional input budgeting by requiring each local service unit (SKPD) to break out from the input focused detail of its budget request any new policy proposals ('new initiatives') embedded in the request. Whereas the Renja-SKPD currently comprises a listing of SKPD *priorities* for the coming year in a non-financial (ie. planning) environment, SKPDs will, under the draft regulation, be required to provide a list of proposed new initiatives for implementing the priorities, *including the impact of each proposal on local planning targets and its multi-year cost to the budget if adopted*.

The change package proposed by each local service unit would comprise (one or more) policy based proposals (spending and/or saving) for inclusion in the draft budget. While the new regulation is not yet finalized, in the current draft the budget request forms ask each local service agency to break its proposed new initiatives into 'activities which are removed', 'activities which are modified' and 'new initiatives'. The intention is for preparation of the RKPD to be based on both performance and financial information, rather than prioritizing occurring on the basis of only performance or only financial information. This strengthens the link between planning and budgeting, rather than budgeting being a prioritizing exercise without reference to costs and budgeting being a mechanical exercise for financing inputs.

Each new initiative would need to be costed by the proposing local service unit using a traditional input focused approach, with costs ideally being agreed with the local budget office. Each proposal making up the service unit's change package would be submitted to the local budget committee on prescribed templates with three year costings (since linking of planning and budgeting is itself linked to the introduction of an MTEF).

Importantly, the new initiative information is intended to support a policy contestability process in the district budget committee (in May of each year) to link the planning and budgeting processes. The district budget committee will then be in a position to approve new initiatives from SKPDs up to the limit of resources available for the district budget, basing its choice on the impact of each proposed initiative on local planning targets (and, hopefully, eventually national minimum service levels (SPMs)), and its three year cost (including operating and maintenance costs of completed projects).

The budget committee's approved list of new initiatives is then reflected into the ceilings transmitted to each SKPD to use in June when preparing its (conventional and detailed) input based budget request. While each SKPD subsequently applies for funding for the inputs for individual programs and activities in the usual way, the new initiatives approved earlier, when the annual district work plan was being prepared, will be embedded in its input based request. However, the draft Permen does not include a description of the actual stage-by-stage business process for using the proposed new initiatives to prepare the RKPD. This will need to be included in documents to support the new Permen, including a manual for implementing the new forms.

Under performance budgeting budget allocations are directly linked to program objectives. While it is desirable to know the impact of program spending on the achievement of objectives (as under full performance budgeting) this is frequently not possible, particularly at the local level, where performance indicator information is limited. Moreover, where indicators do exist there is limited capacity in local service units and budget committees to directly link particular indicator values to a set of detailed budget requests by economic line item.

Adoption of a change package approach is a compromise which improves on traditional input focused budget preparation based on often arbitrary adjustments to previous years' allocations, but without of the need to link total program allocations to a comprehensive set of program objectives.

Moreover the change package approach should be more familiar to local governments than full performance budgeting. They are used to dealing with local capital works proposals as (in effect) change packages, and Element 3 generalizes this across *both* capital and recurrent spending in an integrated budgeting framework.

Earlier in this paper it was stated that the strong planning focus which exists at the local level fails to connect procedurally with the financial allocations for local budget programs and activities. The review of new initiatives proposed by local service agencies introduces a formal link between planning and budget preparation (through a policy contestability process) which is missing under the current planning and budgeting procedures. It drives a 'performance wedge' into the existing input focused budgeting process without the need for a full set of performance indicator data such as that requested under Element 1 of the draft regulation.⁶²

This should enable the local budget committee to prepare a budget in which available fiscal space is flexibly assigned to those initiatives which provide the most cost effective support for planning goals.

Fiscal space at the local level

Proposed change packages can be financed in district budgets only to the extent that local 'fiscal space' is available. It is important to note that, under the proposed approach, the baseline budget for each local service unit continues to be re-negotiated each year (rather than the starting point for budget preparation being an existing set of FEs).⁶³ The size of the fiscal space available for change packages would be set through the current practice of detailed negotiation of each spending unit's baseline budget, including cuts in baseline budgets by the traditional process of detailed line item negotiations or through formulaic cuts such as efficiency dividends (Fig. 4 refers). Local budget committees will be able to

⁶² There is no necessary correspondence between the specific spending units asked to contribute to additional fiscal space through lower allocations in their baseline budget, and beneficiaries of additional resources.

Given that wages of civil servants form a major part of local spending the approach provides the opportunity for new initiatives to be substituted for unproductive existing spending, particularly salaries.

⁶³ The forward estimates provide an initial ceiling for service units which do not make new policy proposals.

create fiscal space for performance orientated change packages by clamping down harder on less productive spending in the same service unit or in other units in the district at the budget hearing stage. These cuts will make additional fiscal space available for achievement of planning targets. This is difficult under the present practice of undertaking planning and budgeting sequentially rather than as a single integrated budget preparation process based on policy contestability.

The traditional negotiation between the budget committee and each spending unit on the details of the unit's baseline budget gives the committee an element of control over the size of local fiscal space through the downward pressure it can exert on agency baselines. Policy contestability therefore relates not only to the selection of competing proposals from the change package submitted by each spending agency but also to trade-offs between funding of new measures and funding of agency baseline budgets.

Figure 3: Stylized budget request form to be completed by each spending agency

1	2	3	4	5	6	
7						
1. SKPD Name: Sector goals: (from RPJM-D and RENSTRA-SKPD)						
2. Program name: Program background: Key problems/issues facing the program (to set background to the policy objectives and activities that are set out below)						
3. Program Objective/new initiative objective	Indicator	Description	2006 actual spend by SKPD mln. Rp	2007 actual budget alloc to SKPD mln. Rp	2008 budget requested by SKPD mln. Rp	2009 forward estimate for SKPD mln. Rp
4. Program objective, eg Achieve primary school pupil teacher ratio (PTR) of 50	Current service level relative to target eg current PTR = 60; aim is to reduce by 10	Activities already funded under the program			Proposed funding for 2008 to maintain current level of services ie PTR of 60	Proposed funding for 2009 to maintain current level of services ie PTR of 60
5. New initiative No. 1 eg train 30 additional teachers	Statement of improvement in PTR	Statement of what will be output and statement of cost basis			First year cost of new initiative No. 1 (incl teacher training)	Ongoing operating cost of initiative No. 1 (incl salaries of 30 extra teachers)
6. New initiative No. 2 eg open 2 new schools in municipality	Statement of improvement in PTR	Statement of what will be output and statement of cost basis			First year cost of initiative No. 2	Ongoing operating cost of initiative No. 2
				PROGRAM TOTAL :		

Will it work?

As currently drafted, the new regulation adopts a quite ambitious three Element approach to linking planning and budgeting. However

- as mentioned above, district planning/budgeting processes are already over-complex, and integration of planning and budgeting should be achieved via a reduction in complexity rather than adding to it
- performance indicator data is often unavailable at the district level, and recognition of spending priorities can in any case often be based on qualitative rather than quantitative information about local needs and preferences
- local work units generally lack the analytical skills required to analyze their program performance
- the large number of local governments, and even larger number of local government work units, precludes assistance for budget reform being provided on an individual basis to each.

While ambitious performance budgeting/MTEF reform agendas promote comprehensive and coordinated change, they do have a downside. Where capability is limited ambitious reform agendas can also obscure entry points and simple first steps. In the face of capacity constraints such as exist at the local level there is a case for applying Occam's razor to the design of budget reform – 'the simplest solution is the best', at least as a starting point. While the three Element approach in the draft MOHA regulation involves a quite ambitious approach to integrating local planning and budgeting processes, Element 2 provides a potentially 'stand-alone' beginning point on the road to performance budgeting by introducing a policy contestability stage based on change packages proposed by local work units. This is more achievable in the light of district capacity constraints than a 'full' three Element approach (in which the new budget is based on detailed performance reporting, plus new initiatives plus FEs of existing policy).⁶⁴ *It would focus reform actions by local governments unused to managing reform on those changes which make the most immediate contribution to more policy based budget preparation.* Fig. 2 above provides a road map for building on this first step.

Post-Script on Regional diversity

Budget reform at the district level differs from reform at the national level in one major respect. At the level of the national finance ministry an uncooperative director general of a budget department, or a disinterested secretary general of a finance ministry, can turn what is on paper a well planned reform program into slow progress on the ground. As is well recognized in the reform literature, a high level champion of reform is often necessary to break through institutional rigidities.

At the local level, however, the eggs are not all in the one basket. Experience suggests that at any one time there are likely to be at least a few local governments with a

⁶⁴ Element 2 is a simplified version of the MTEF based budgeting approach originally proposed (but not implemented) at the national level to MoF in 2003-04. The major difference is that SKPD present requests for total funding for each program and activity rather than just for new initiatives to vary the existing forward estimate.

reformist outlook, strongly held local goals and an interest in making their local budget work harder to achieve the local goals. The minority of better managed local governments not restricted by conservatism or capacity limitations could devote time and energy to Elements 1, 2 and 3 simultaneously rather than (as for less capable localities) focusing primarily on Element 2.⁶⁵ (See Figure 4 after end of text)

More progressive local governments can both provide a test bed for reform, and a demonstration to other localities that reform is in fact do-able. In Indonesia even a five percent success rate across local governments would mean around twenty five local budgets for which a policy contestability process connects local planning and budgeting, and twenty five sets of officials capable of managing rudimentary policy based budgeting. Even if processes remained unchanged in the remaining seventy five percent of jurisdictions this would be a clear advance on the current situation.⁶⁶

In other local governments the introduction of Element 2 might be a reform wedge. A key reason why performance data is not assembled by districts is that there is no demand for it under the current input based approach to district budgeting. DAU grants are forwarded to local governments regardless of the benefits they generate while DAK grants are made by MoF without systematic reference to performance gaps. Since there is limited accountability of districts for the impact of budgets on planning targets there is limited need to collect performance information. One implication of beginning with Element 2 will be the creation of a 'market' for performance information in the local budgeting process. This will support progress in subsequently introducing a more complete performance budgeting approach under Elements 1 and 3.

Once a 'performance wedge' is in place in a minority of local governments there is the possibility of a demonstration effect on other local governments (and even agencies at the national level). Reform would be capable of demonstration as well as exposition. Workshops can mix officials from best practice and unreformed local governments, and operational issues associated with reform discussed between local officials for whom reform is meaningful only in terms of changes to the business processes they actually manage - which changes are likely to cause confusion or too much additional work at key pressure points in the budget preparation cycle, and which, on the basis of peer group discussion, they feel they can make work in their own environments.

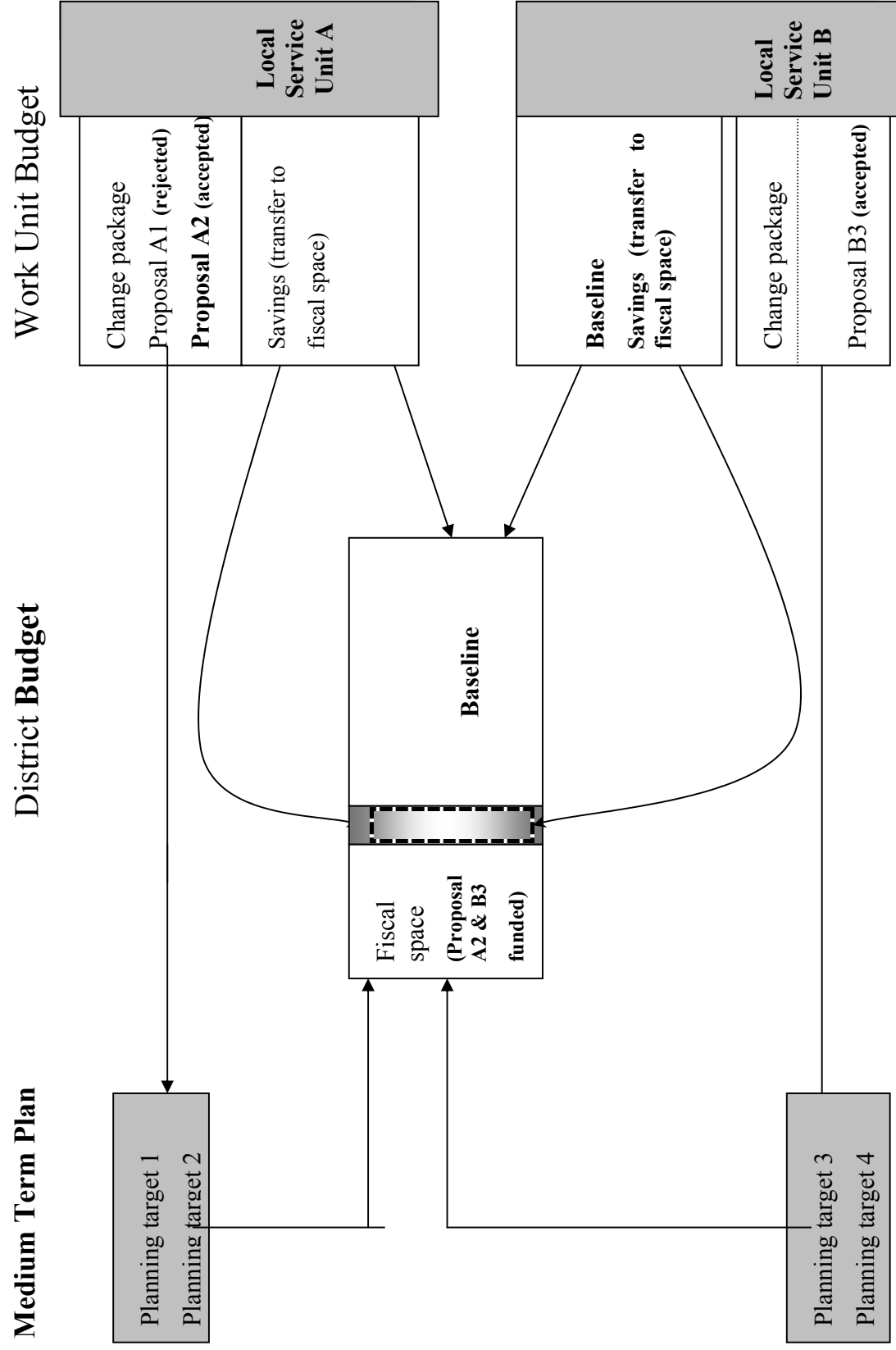
⁶⁵ This also has the advantage of removing the need to substantially alter Permen 13 on district budgeting (which outlines the procedures for detailed activity based budgeting) when the new Permen on planning and budgeting is issued. Amending Permen 13 itself presents problems due to the need for coordination between the MOHA planning and development departments (BANGDA) and the MOHA budgeting department (BAKD).

⁶⁶ It is ironic that the cost to the budget of undertaking budget process reform is usually quite small – the changes involved are in procedures rather than inputs, and the impediments to reform are of a non-financial nature. However, where the reform involves the parallel implementation of an integrated financial management information system (IFMIS) which is networked across budget agencies substantial costs may be involved (frequently covered by external donor funding).

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Figure 4: Change packages, savings and fiscal space



ANNEX 1: NATIONAL MINIMUM SERVICE STANDARDS (SPMS) FOR LOCAL GOVERNMENTS

Since 2001 the approach of the central government has been one of retrospective development of implementing regulations for the decentralization, including the planning, budgeting, reporting and transparency aspects. This is to establish procedures for local budgeting and to strike a balance between local and national priorities.

In order to manage the risk that local priorities in sectors such as health and education may fall short of what the central government regards as minimum standards, a regulation has been passed requiring local governments to implement Minimum Service Standards (SPMs) for individual sectors. These standards are set by the responsible national agencies.⁶⁷

Ministerial decrees containing SPMs have now been issued for most sectors. After an initial burst of work on SPMs progress has slowed. While comprehensive lists have been developed for health and education progress has been slower for other obligatory functions (including infrastructure). In the case of health more than fifty PIs were developed covering outcomes, outputs, inputs. However a current Ministry of Health review is trying to limit the list to indicators based primarily on outcomes.

Consistent with decentralization, districts are allowed to choose the best approach to achieving each SPM. This is reflected in the local budget through the funding of different activities, eg if budget funds were to be appropriated directly to the objective of reducing infant mortality, the funds could be spent either on an advertising program to persuade birthing mothers to come to district health centers, or additional staffing of the health centers, or an outreach education program on avoiding dehydration of infants due to diarrhea, or a combination of all three. Whatever approach is adopted the key point is that the benchmark for infant mortality is met. The rationale of decentralization is to allow local populations in different jurisdictions to make this choice in the light of their own preferences and local circumstances, and (more theoretically) to allow citizens to move to the jurisdiction offering their preferred policy mix. In Indonesia's case local preferences are influenced by very high levels of cultural diversity.

Implementing SPMs

In the absence of technical guidelines from MOHA, SPMs vary greatly between sectors in their detail, focus on inputs versus outputs and realism of standards. SPMs are not well understood either at national or district level and there is little evidence that they influence local budget decisions.⁶⁸ In particular it is not clearly understood whether they should be based on outcome, output or input indicators and there has been a tendency in

⁶⁷ These are provided for only by regulation, including in Regulation No. 25 of 2000 on xx??, Regulation No 105 of 2000 on local government budgets and Regulation 108 of 2000 on performance standards for local government heads, Regulation number 65/2005 on Guidance in Setting Minimum Service Standard and Ministry of Home Affairs Regulation number 6/2007 on the Guidance of Minimum Service Standard Formulation.

⁶⁸ A more input focused concept such as standard spending assessments relates better to the input focused approach to budget preparation.

those national ministries which have prepared SPMs to present large numbers of indicators rather than a set of key performance indicators. Some national ministries have not yet prepared SPMs.⁶⁹

In Lewis' words, "It must be admitted that central government's ability to develop and implement complex multi-sectoral plans that are based on some notion of ordered and marginal change over time is, at this stage and for the most part, nonexistent. As a result, a collaborative, consensus-based, incremental, and phased approach to developing and financing minimum standards across all sectors, while perhaps ideal, would appear to be practically unworkable."⁷⁰

It is also unclear what (if any) action is implied by the existence of gaps between minimum service standards and standards currently realized in each district, or whether minimum standards are intended to be milestones or final goals.

Shortcomings in performance information at the district level

The value of SPMs is also limited by a lack of performance information at district level which could be used to identify gaps in each locality between the status quo and relevant minimum standards. Although data collection at district level is required under Law 32 it is not funded specifically. Since MOHA does not apply penalties for not supplying data most districts do not spend anything on data collection. This makes it difficult to base local budgets on milestones in the achievement of planning indicators

However at least for health and education it seems that significant information is available from local management information systems. This is held by the relevant SKPD and may be sent to the local Bappeda and statistical office. However, in contrast to the financial information passed up the line to the province and national MoF, performance information is not assembled in any systematic way.⁷¹ While performance information is also passed to MOHA by local governments this is not (due to bureaucratic rivalry or inertia) forwarded by MOHA to the technical ministries at the national level. They are therefore not in a position to assess the adequacy of service provision across the nation and complain about fulfilling their sector responsibilities in an informational 'black box'.⁷²

⁶⁹ SPMs have been prepared for agriculture, health, education, public works, social and state apparatus.

⁷⁰ Lewis 2003, p. 13.

⁷¹ Even in regard to the financial information a recent PEFA report notes "Art 102 Law 33/2004 and Government Regulation No. 11/2001 require SNGs [sub-national governments] to submit annual financial reports to the central government. However, there is a lack of compliance by SNGs, and as at August 2007 only about 420 of the 473 SNG had submitted their reports for FY 2005." PEFA 2008, p. 33.

⁷² Under the decentralization law local governments are to liaise with the sector ministries which issue the SPMs. This information is provided through the Agency for Regional Autonomy (DPOD), which passes SPMs down to districts and receives reports on achievements. However the reports do not appear to be passed on to national ministries. While MoF maintains a data base on sub-national financing DPOD does not maintain a national database on level of achievement of SPMs. Hence sectoral agencies at the national level complain that they lack information on gaps in achieving the SPMs.

Arguably a national performance database should be maintained (by Bappenas?) analogous to the financial database on sub-national governments maintained by MoF. However, in the absence of such a database there is limited information available at the national level on the extent to which the SPMs are being achieved.

In the absence of responsiveness of local governments to the SPMs there is a risk that the national government will adopt other measures, particularly increased use of conditional grants (DAK) and reversion by central ministries such as Health and National Education to ministry programs at the district level (eg through Dekon funding and co-provision arrangements). This is discussed in Annex 2.

ANNEX 2: CO-PROVISION BY NATIONAL AGENCIES

Under the legal framework of decentralization national ministries are obliged to vacate areas assigned to local governments. However, several commentators have noted ambiguity in the functions assigned to local governments. While Law 22/1999 provides a positive list of responsibilities for local government, a positive list is also provided for the national level. Residual responsibilities in regard to the national list lie with local governments, but appear not to be mandatory (perhaps reflecting differences in capacity across local governments, and may be shared with the national government. This results in possible gaps and unclear accountability in regard to which agencies are responsible for achieving particular planning targets. The World Bank notes “Six years into decentralization, the assignments of functions across levels of government is far from clear due to weaknesses in the decentralization laws themselves. Clarity in assigning functions is needed to guarantee accountability at the local level. Law No. 32/2004 was passed with the aim of significantly reshaping intergovernmental administrative relations. It introduced the direct election of sub-national heads and provided more clarity than the preceding Law No. 22/1999 in terms of obligatory functions. However, the government’s implementing regulation, which intends to regulate the assignment of these functions, has still not been passed by the DPR. Moreover, the central government still needs to ensure that sectoral laws promulgated by sectoral ministries do not contain conflicting interpretations of service responsibilities across levels of government.”⁷³

Perhaps reflecting this ambiguity of roles, co-provision by national ministries, through their own programs and through Dekon funding, has been rising.⁷⁴ National ministries have also resisted the intention that the deconcentrated funding which they administer through the provinces should be transferred to the DAK, and spent as specific purpose funds through local budgets.⁷⁵ Despite the far reaching nature of the decentralization, and the presumption in the law that districts undertake all functions unless they are specifically assigned to the national government, national and sub-national agencies both contribute to the performance of key sectors.

⁷³ World Bank 2007c. p. 115.

⁷⁴ For example, the Ministry of National Education provides school operation grants (BOS) and a scholarship program for the poor while the Ministry of Health provides subsidies for the treatment of the poor in public hospitals and local health centers.

⁷⁵ “The official governmental policy, as embodied in Law No. 33/2004, is to re-channel central spending to decentralized tasks through the special purpose transfer (DAK). However, central departments have so far managed to delay the implementation of this agenda. They have been able to do so in large part because of continuing legal ambiguities concerning precise service assignments across levels of government (Smoke, 2003). A Ministry of Home Affairs government regulation, based on Law No. 32/2004, is intended to clear up the assignment problem, but has not yet been issued. This regulation will outline central, provincial and district government spending authority in 30 sectors. However, for many sectors the delineation of authorities remains vague and the draft regulation notes that forthcoming ministerial decrees from central departments will provide additional details regarding the assignment of services across levels of government.” World Bank 2007c, p. 118.

The World Bank notes that the share of the central government in education spending has risen from 33 percent in 2001 to 38 percent in 2005.⁷⁶ The share of districts fell from 62 percent to 57 percent over the same period. This in part reflects what is termed ‘bad’ Dekon funding, ie. spending on education which in the spirit of the decentralization should flow through the district budgets (bypassing the national ministry) but is instead channeled through the national ministry’s Dekon payments to the provinces.

MOH is also attempting to achieve gap filling actions at the district level by making Dekon funding flowing through to districts conditional on reporting the way in which the funds are spent (ie. on which aspects of health).

These developments risk duplication of activities between central and local governments and resulting inefficiency. Moreover, this can also be seen as a tendency to creeping re-centralization which undermines the original intention of decentralization.

Ideally resources available for achieving a particular objective such as an SPM should be managed in a coordinated way, so that gaps in the total available from all sources can be identified, along with over-resourcing when all sources are taken into account. The creation of separate program for each major objective which accounts for total resourcing of that objective is the normal approach. In the case of Indonesia’s decentralization this would imply a common program structure which embraces national and sub-national levels. All available spending on a program would be reported in one place.⁷⁷

The original regulation on district budgeting did in fact prescribe a common program and activity structure to be used by all districts. However, this was subsequently judged to be inconsistent with the intention that district spending respond to local priorities and it has been dropped from the recent revision of the district budget regulation. While minimum service standards exist it is unclear how much resourcing is provided. A need for additional resourcing for a particular standard would therefore be apparent only from ex post evidence of lack of progress in filling gaps against the standard, rather than ex ante programming of an adequate level of resourcing from all sources.

⁷⁶ World Bank 2007c, p 32.

⁷⁷ A large portion of local government expenditures are lumped into a fixed costs category (*tidak langsung*) which is not mapped into service program categories and limits the ability to accurately cost programs. Thus, transparent budgeting is impeded and budget users are not held to account for the use of public resources.

ANNEX : 3 LOCAL PLANNING AND BUDGETING PREPARATION PROCEDURES

This Annex provides background to the local planning and budgeting processes outlined in Fig. 1 in the text. The information is based on regulations for local planning and budgeting.

It should be noted that while the content of each district budget is approved at the provincial level there is no central supervision of local planning and budgeting processes, and it appears that there is considerable diversity in the practices of different local governments.

A. Planning

RPJMD

This is the local government's five year strategic plan which includes a statement of vision and mission of the local government. The RPJMD is enacted by the local council following the election of the mayor, implying accountability for implementation of the platform on which he/she was elected, although the plans generally do not contain outputs or outcomes.

The RPJMD is intended to be based on priorities in the *national* five year development plan, but interpreted against local needs. Coordination between central government and regions involves a meeting organized by Bappenas (the national planning agency) and attended by sector ministries, and provincial and local planning agencies. However, there appears to be no mechanism for ensuring that national priorities are reflected in the local plan.

Nor are there formal procedures for provinces to coordinate district plans to take account of 'spillovers' between regions or potential economies of scale through coordination of plans, although regional governments have formal responsibility for coordination in this area.

Renstra-SKPD

This is the three year strategic plan prepared by each *local work unit*. It contains the vision and mission for the work unit, and the sector targets which it hopes to achieve (based on the RPJMD). The Renstra is updated in the early stages of each budget preparation cycle, although in many cases the contents are of a general nature.

Renja-SKPD

This is the annual plan of each *local work unit*, based on its Renstra. This is a list of priorities to be funded and is the closest point of linkage between planning and budgeting, but in the budget. However, the Renja currently prepared by each local service unit does not support a policy contestability process in preparing the RKPD because it only includes district planning priorities and does not include the cost and impact of possible measures to implement these priorities (this will however occur under Element 2

of the new regulation, which proposes that each local work unit propose a change package).

RKPD

This is the annual work plan of each *local government*, based on the Renjas prepared by its local work units, the RPJMD and the projected resources available to the local government for the coming budget year. In the past the RKPD has taken on the focus of a development budget, focusing on projects in particular. However, Regulation 105/2000 stipulates a move to performance budgeting, in which the distinction between capital and recurrent spending is less important.

While the “RKPD is prepared to ensure interlinkage and consistency between planning, budgeting, implementation, and supervision” (Permen 13, Article 82(1)), currently there are few links with the annual budget. However, the draft regulation for integrating planning and budgeting (which is the subject of this paper) proposes a new procedure for preparing the RKPD involving the identification of change packages by each local work unit. Proposals approved by the local budget committee will then be reflected in the temporary ceiling of the work unit (see the PPAS below), which then proceeds to prepare its budget request in the normal input focused way (see RKA-SKPD below).

B. Budgeting

KUA and PPAS

Whereas the previous steps relate to district planning, the KUA is the initial stage in preparing the district budget. The KUA contains the local budget resourcing framework, strategies and priorities for consideration by the local legislative council (DPRD). The local government and the local legislative council jointly draw up the General Budget Directions and Policies, guided by the RPJM, Renstras and other planning documents, the views of the public through the Musrenbang process, annual performance reports for previous years, main thoughts of the local legislative council and the Local Government Fundamental Financial Policies set annually by the Minister of Home Affairs. The latter makes a formal connection between national budgeting priorities and those of the district.

The KUA contains the budget policies and the PPAS a temporary ceiling for each local work unit (also approved by the local council). On the basis of the temporary ceiling each local work unit prepares its detailed budget request. The ceilings should in principle accommodate the achievement of minimum service standards (SPMs) by the relevant work unit, but there is little evidence that this occurs.

RKA-SKPD

This is the draft budget prepared by each local work unit. It is prepared within the temporary ceiling advised in the PPAS and uses standard unit costs and outputs for each activity of the work unit. The RKA-SKPD is prepared by each work unit for the new budget year and the following year (ie. it is prepared in a limited medium term expenditure framework), although there is no guidance on whether the out year estimates should (or should not) contain a new policy content. Little attention is paid to preparation of out year estimates by work units and the out year figures do not appear to be used by the local budget committee as a starting point for preparation of the t+2 budget.

It is also stated in Regulation 13/2006 that the RKA_SKPD be prepared using performance budgeting principles: “The performance based budgeting approach as referred to in Article 90 paragraph (2) shall be carried out by taking in the interlinkage between financing and expected outcome from the activity and the expected results and benefit, including efficiency in achieving the said results and outcomes.” (Article 91(4)). However it is not clear how the interlinkage between financing and expected outcomes can be established and this aspect is currently limited to a statement by the work unit of the objective of each program for which it presents a budget request.

APBD

This is the district budget, which according to Regulation 105/2000 (Article 8) is to be prepared using a performance approach (ie. every planned expenditure allocation must be related to the specific level of performance expected to be achieved). In reality the budget is input rather than performance based.

The budget committee reviews revenue estimates prior to formulating the expenditure budget. The proposed budget is then reviewed by the mayor and transmitted to the local council (DPRD) for approval as the budget law. Since information on transfers from the central government (around 90 percent of revenues on average) is available only in late in the calendar year this can involve a two stage process, in which expenditure estimates are finalized only when information on transfers is received from the central government.

The APBD is based on programs and activities (combining routine and development budgets) but is split between direct and indirect expenditures (only the former is directly affected by the implementation level of the program or activity).

ACRONYMS

APBD	Regional budget
Badan	Agency
BAKD	Budgeting department of MOHA
BANGDA	Development and planning department of MOHA
Bappeda	Regional Development Planning Board
Bappenas	National Development Planning Board
BPK	Supreme Audit Agency
DAK	Specific Allocation Fund
DAU	General Allocation Fund
DBH	Shared revenue funds
DPOD	Council for the Deliberation of Regional Autonomy
DPRD	Regional legislature
FE	Forward estimate
GFMRAP	Government Financial Management and Revenue Administration Project
GOI	Government of Indonesia
IFMIS	Integrated financial management information system
KPI	Key performance indicator
KUA	Policy stage of annual budget preparation
MDGs	Millennium Development Goals
MoF	Ministry of Finance
MOHA	Ministry of Home Affairs
MTEF	Medium term expenditure framework

Musrenbang	Public consultation on development planning
PAD	Locally derived revenue
PBB	Performance based budgeting
PDAM	Local water supply utility
PEFA	Public Expenditure and Financial Accountability
PER	Public Expenditure Review
Permen	Government regulation
PI	Performance indicator
PPAS	Ceiling setting stage of annual budget preparation
Renja	Annual work plan
Renja-KL	Work plan of a national ministry
Renja-SKPD	Work plan of a regional spending unit
Renstra	Strategic plan
RKA-SKPD	Annual budget for spending unit
RKPD	Regional Government annual work plan
Rp	Indonesian Rupiah
RPJMD	Regional government strategic plan
SKPD	Regional level work units
SPM	Minimum service standards set by the national government

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