

**Extracts from
Indonesia: Decentralization—Managing the Risks**

“Expenditure Assignments and Management”

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I. EXPENDITURE AND REVENUE ASSIGNMENTS

A. Expenditure Assignments

A first priority for the government's implementation of the provisions for decentralization is to further specify expenditure assignments. The Governance Law defines these assignments over levels of government only in broad terms (see Box 1). Articles 7–11 roughly define the authority of the districts to be all public services except those expenditures explicitly expected to be performed by the center, including international policies, defense and security, judiciary, monetary and fiscal policy, religion, and “others.” According to the law, the districts *must* perform functions in: public works, health, education and culture, agriculture, communication, industry and trade, capital investment, environment, land, cooperative and manpower affairs.¹ The “other” responsibilities of the center include national planning, macroeconomic policy, intergovernmental fiscal relations, state administration and organization, as well as human resources development. The latter could cut across several expenditure responsibilities “assigned” to lower levels, and continue to cause a lack of clarity even in functions explicitly stated to be the responsibility of the districts.

The provinces are only assigned a coordinating role, and serve as a fallback, in case a district, or its neighboring districts within the province, cannot perform given assigned functions. The law is not clear on the criteria to determine whether a district is incapable of performing its functions. In any case, the mix of functional and economic roles assigned to the districts requires further specification in order to efficiently transfer these functions to districts and to avoid the overlap of functions that has been a characteristic of Indonesia's intergovernmental fiscal system in the past.²

A more detailed assignment of functions and the actual transfer thereof will be a huge task. The broad principles are fairly straightforward. For each function, the authority to make policy, set standards, supervise, and implement should be defined, and assigned over levels of government. But, any broad function assigned by law to the district level is in reality a whole host of functions. Take health care, for example. Law No. 23/1992 defines health care

¹Clause 11 seems redundant, but serves in part to ensure that districts can be forced to perform these functions, and not spend the resources allocated to them on other, noncore functions.

²See Anwar Shah and Zia Qureshi, *Intergovernmental fiscal relations in Indonesia: Issues and options*. World Bank Discussion Paper No. 239, the World Bank Washington, D.C., 1994.

Box 1. Expenditure Responsibilities Over Levels of Government

Article 7

- (1) Regional Authorities shall cover the authorities in all fields of governance, except authorities in the fields of international policies, defence and security, judicature, monetary and fiscal, religion and authorities in other fields.
- (2) Authorities in other fields as intended in paragraph (1) shall cover the policies on national planning and macro national development control, financial balance fund, state administration and state economic institutional systems, human resources development, natural resources utilisation as well as strategic high technology, conservation and national standardization.

Article 8

- (1) Governance authorities delegated to Regions in the context of decentralization must be accompanied with the delivery and transfer of financial support, facilities and infrastructures as well as human resources in accordance with the delegated authorities.
- (2) Governance authorities delegated to Governors in the context of deconcentration must be accompanied with financial support in accordance with the delegated authorities.

Article 9

- (1) The authorities of Provinces as Autonomous Regions shall include the authorities in the field of inter-Regency and Municipality governance, as well as the authorities in other certain fields of governance.
- (2) The authorities of Provinces as Autonomous Regions shall also include the authorities that are not or not yet able to be conducted by Regency Regions and Municipal Regions.
- (3) The authorities of Provinces as Administrative Regions shall cover the authorities in the field of governance delegated to Governors as Government representatives.

Article 10

- (1) Regions shall have the authority to manage national resources located in their area and shall be responsible to maintain the environment conservation in accordance with laws and regulations.
- (2) Regional authority in marine area as intended in Article 3 shall cover the following matters:
 - a. exploration, exploitation and management of marine wealth to the extent of the aforementioned marine area boundaries;
 - b. administrative interests administration;
 - c. spatial administration;
 - d. law enforcement of regulations issued by Regions or the authority of which delegated by Government; and
 - e. assistance for the enforcement of state security and sovereignty.
- (3) The authority of Regency Regions and Municipal Regions in marine area as intended in paragraph (2) shall be at the extent of one-third of marine area of Provincial Regions.
- (4) Further regulation on the provision, as intended in paragraph (2) shall be stipulated with Government Regulation.

Article 11

- (1) The authorities of Regency Regions and Municipal Regions shall cover all governance authorities other than authorities excluded in Article 7 and set forth in Article 9.
- (2) Governance field that must be performed by Regency Regions and Municipal Regions shall include public works, health, environment, land, co-operative, and manpower affairs.

Source: The Governance Law.

to consist of family health, nutrition improvements, food and drink security, environmental health, occupational health, mental health, disease control, curative health care and rehabilitation, public health education, protection of pharmaceutical production and health devices, addictive substances, school health, sports health, and traditional therapy. These activities are translated into 18 programs delivered nationwide through health centers and hospitals. In addition, “back-office” functions such as procurement, personnel, and training are performed at the various levels of government. Defining expenditure responsibilities, policies, standards, supervisory mechanisms and other such functions for just health care is therefore a huge task. Beyond that, the logistics of transferring the management of personnel—and sometimes physically relocating staff—and premises, the transfer of control over ongoing projects, training people for new tasks, and the like, are daunting.

Some of the functions assigned to districts may not necessarily be particularly appropriate for that level. Within the health care classification, the control of communicable diseases, drug procurement, and environmental health are likely to have benefits beyond a province, and are unlikely to be optimally assigned to districts. Similarly, many of the “back-office” services currently performed at the provincial level, or in deconcentrated units (personnel, procurement, training) in all sectors, are not well suited to be assigned to districts. For examples for the education sector in Indonesia, such as the establishment of national curricula, see the report of the December 1998 mission (Ahmad et al. (1999)).

The government is aware of the need to further specify details to make the expenditure assignments operational, but seems to have underestimated the required work. The Ministry of Home Affairs has identified that 5 laws, 11 regulations, and 2 presidential decrees need to be changed to implement the Governance Law (see Annex II). However, the office of the Coordinating Minister for Government Organization has already identified 25 regulations dealing with the civil service alone that need change in light of the new law. Each ministry is likely to face a task of significant magnitude.

In reassigning functions, the government could learn from the experience gained with the 26 sample districts that have experimented with decentralization since 1995. These districts served as an experimental implementation of Law No. 5/1974, and its implementing regulation No. 45/1992. One of the key challenges that this experiment faced was that the instructions (PP No. 8/1995) focused on organizational structures rather than on functions to be transferred. Moreover, the instructions did not include an administrative mechanism by which the function transfer should be implemented. The lack of such transfer procedures halted many attempts to actually decentralize a function. Throughout the experiment, there was a lack of coordination and unified approach to the decentralization, and little monitoring was done, which resulted in insufficient learning from the experiment.

Lack of coordination is a serious challenge for the ongoing decentralization efforts. Many of the line ministries are facing similar issues in defining and assigning functions; setting policies and standards; preparing staff for transfer to lower levels, etc., but a common approach seems to be lacking. The government should therefore consider a coordinated approach to the implementation of the Governance Law.

It is recommended that:

- **Expenditure assignments among different levels of government be clarified** by first examining the extent to which functions could be provided by the private sector, then assessing the appropriate level of government for the relevant service delivery.
- **The government should establish a coordination function**—by setting up a coordinating group for decentralization.
- **The coordinating agency could develop common approaches and framework regulations, guidelines and manuals, and closely monitor the decentralization process**, in order to take corrective actions early on.

Minimum standards

In the course of specifying the detailed distribution of functions across levels of government, the authorities have to decide whether to set standards of service provision for the decentralized functions. Minimum service standards are mainly justified by a government's social objectives, including to ensure that each citizen of the country, no matter where he or she lives, should have the same access to basic public services such as basic education, health care, clean water, and minimum social protection. However, setting such standards involves a fine balance: if they are too restrictive, the gains from decentralization may prove elusive, and the district governments will be unable to exploit local circumstances.

In Indonesia, the line ministries seem to show considerable enthusiasm for defining standards or, less restrictively for issuing guidelines. Local governments usually interpret the guidelines as if they are standards to be met, even if the service level provided does not make much economic sense for a particular region. Perhaps the most pervasive standards are concerned with government organization itself. Currently, the central government prescribes the maximum number of civil servants in each jurisdiction, determines what type of bureaus a local government can have, and determines the staffing of the various bureaus of each level of government. The underlying rationale is a certain level of service delivery that central government determines for the regions.

Besides the possible efficiency losses entailed in minimum standards, there is a fiscal risk as well. Too many **restrictions** on local spending could unnecessarily increase the costs of service delivery. And because local governments in Indonesia have only a minimal tax base, they will come back to the center to ask for more money to fulfill the decentralized functions, arguing that the minimum standards imposed by the center require more spending. Alternatively, if financing is not provided, the standard becomes an unfunded mandate, which is unlikely to be fulfilled.

Minimum standards that are equally applicable to the whole of Indonesia may be **difficult to define** because conditions vary so much from region to region—a motivation to start

decentralizing in the first place. In general, it is better to define standards in terms of desired outcomes or outputs rather than in terms of inputs. It makes little sense to prescribe a similar level of environmental management effort for each district, but the central government could prescribe ambient air or water quality nationwide. The standards should also be truly minimum standards, in order not to bind local government too much, and overburden the central budget. As a result, service delivery beyond the minimum standards could be provided by a local government's own revenues, including by user charges. For instance, government could provide some minimum environmental services from general means, but beyond that minimum, locally levied pollution charges could serve to maintain water and air quality.

Finally, **standards may be hard to monitor by the central government**, and may quickly lose their credibility if not enforced. The role of central government in supervising these standards is that of auditor, but also provider of information to civil society, which should enforce the standards through the emerging democratic process. Interesting examples for this can be found in South Africa and Australia, where the central government does monitor service delivery, and publish reports on comparative performance of regions in service delivery.

It is recommended that:

- To the extent that **minimum standards can be defined and are considered important, financing should be provided by special purpose grants.**
- **Unfunded mandates should be avoided.**

The safety net

The issue of the social safety-net has taken on a critical role in the wake of the economic crisis and down-turn in activity levels. Local resources, as well as extended family support mechanisms, come under severe stress when the need for assistance is widespread. In most countries, for this reason, the residual social safety-net responsibilities remain that of the central government. The mechanisms for the effective delivery of the social safety-net have to be carefully determined, since the traditional special-purpose grants mechanism used for this purpose may be difficult to implement and monitor. Thus, in order to ensure effective delivery of the safety net, there should be a careful choice of programs that entail self-selection of recipients, together with appropriate safeguards on the disbursement of funds. The World Bank is deeply involved in the design of the social safety net in Indonesia.

- **Safety-net expenditures** of the central government should be implemented through **special purpose grants**, and should also involve appropriate monitoring of outcomes.

Reallocation of expenditure responsibilities

The three major considerations when looking at the transfer of functions from the central to provincial and district governments in Indonesia are: (1) definition of functions; (2) labor related issues; and (3) capital related issues.

Definition of functions

Be careful to consider all levels of a service. In education, for example, the central curriculum development and control of teacher qualifications have to be considered as well as the classroom provision of the service. What level of government is going to be responsible for setting curricula? If it is transferred to local government, will it create diseconomies of scale?

Even for transferred functions, it may be desirable for the central government to maintain some expertise. It may, for example, wish to continue with some specific purpose transfers in education to cover the special needs of some provinces, and may therefore need the knowledge of some of the current central office employees. If this is the case, the transfer arrangements may need to establish what capacities the central government needs to maintain, and the provision of data on the function to the central government.

Limit cost shifting. Several government services, health services in particular, are a continuum that range from minor provision to super specialty services. This type of service cannot easily be divided between different levels of government without creating tension between them because of cost shifting. Who decides, for example, whether a patient is in need of hospital treatment or treatment in a clinic? A lower level of government always has an incentive to over classify the needs of a patient if it means the cost will be transferred to a higher level of government. This tendency needs to be limited in case the tertiary functions are performed at a higher level.

Is it the service or the service outlet that is being transferred? Often, service outlets (such as offices or other buildings) are the source of a range of services and it is obviously better if all those services (including delivery outlets) can be transferred. This is sometimes difficult, however, as the outlets in different parts of a country or province (particularly in remote areas) may be responsible for a different range of services. In these circumstances, it may be possible to have the provision outlet owned by either level of government and the owner lease space to the other. It is more difficult if individual employees are providing some services that are to be transferred and some that are not to be transferred. **This argues for separating financing and provision.**

Is the local government responsible for the provision of services to its residents or in its area? This is a particular problem when there are “city provinces” such as Jakarta and people from surrounding provinces come in for services. What happens when people move across provincial boundaries for services such as education, hospital services etc? Does the receiving province or the province of residence cover the cost? Cross-province agreements,

or special-purpose grants, can be reached for major cost services but these are expensive to administer and require sophisticated data collection. An alternative is to build cross-border factors into the general allocation transfer system so that the receiving province is assumed to be providing services to more than its population, and the surrounding provinces are assumed to be providing services to less than their total population.

Labor related issues

The employees providing a service must come under the control of the level of government responsible for the service. That level of government must therefore have the financial capacity to pay the wages, and the authority to appoint and dismiss the employees, from the date of transfer.

Service administration staff creates a particular problem. It is unlikely that a decentralized system of service provision will require exactly the same number of administration employees as a centralized system of service provision. If the result of the change is to reduce the number of staff, or to reduce the number required in any one province, what level of government will be responsible for the 'excess' staff, either due to their employment termination or their transfer to another province?

Ancillary wage expenses must be considered. Costs for accumulated ancillary wage expenses must be covered and the recipient level of government funded for them. Payments such as for accumulated holiday pay, long service leave and pension entitlements, if they exist, must be transferred to the provinces if they are to be able to provide the services in the long term. They cannot be funded only for the recurrent or routine salary expenses.

Special location expenses. Are the present central government employees paid special allowances or incentives to work in some locations? If they are, what is to happen in this regard? Will such allowances continue once the employees are transferred to provincial control? If they are necessary to maintain the provision of the service, will the relevant provinces be given additional funding? Any such additional funding can be provided through the general fiscal transfer system or as special grants, but either way, there needs to be an assessment of what is "necessary" so that provinces cannot simply make their own decisions and have them funded by the central government through gap-filling transfers.

Capital related issues

The service provision facilities. Ownership or control of leased assets being used for service delivery must be transferred when responsibility for the service is transferred. Where an asset is the source of provision of both transferred and non-transferred assets, an arrangement has to be made as to which level of government will have ownership or control of that asset. The other levels of government should then be charged a fee for the use of the facilities. Shared ownership of such assets should be avoided.

Some local governments are likely to have a more appropriate stock of assets than others. For those provinces relatively poorly provided with assets, the best way to overcome this inequity is probably by specific purpose capital payments that are kept outside any equalization arrangements. This would allow the central government to give assistance to those provinces in special need without having to be too concerned about the differences in level of assets at the time of transfer.

The quality of the facilities. Some local governments will have better quality facilities than others and will therefore have lower maintenance costs associated with their upkeep. In principle, differences in such costs (e.g., the proportion of poor quality roads in total length of local roads) could be taken into account in the fiscal transfer system, but this is difficult to implement as data for assessing the quality of facilities do not always exist.

Debt on assets. At the time of transfer, the central government will probably have some debt attaching to assets (e.g., leased properties, and debt financed projects) that are to be transferred. Some provinces will have more of these assets than others. However, the central government is unlikely to be able to attribute debt to specific assets. Probably the easiest thing to do here is for the central government to continue to hold the debt and adjust the total transfer to the provinces in the future. In the Indonesian case, the debt servicing cost could, in the short term, be seen as part of the general allocation transfer as it would be “payments on behalf of the local governments.” Adjustment would be necessary as debt servicing costs reduce over time or decrease/increase as interest rates vary, but the latter could only result from a refinancing of the loans and whether this should be allowed without the agreement of the provinces would need to be negotiated.

Responsibility for future assets. Even though the central government may provide special purpose grants for financing certain asset purchases, there should be no general expectation that the center will provide for all such purchases in sectors whose responsibilities have been decentralized.

Local capacity limits and contracting out of services

The Financial Balance Law stipulates that the total amount of general allocation will increase from the current level (about 15 percent of domestic revenue) to about 21 percent of domestic revenue, and 90 percent of the general allocation should be distributed to district governments. As pointed out in Chapter 1, this implies a drastic increase in transfers to district level governments, and will require a corresponding increase (by as much as 50 percent from the current level) in their expenditure responsibilities. Even if the devolution of specific responsibilities to district governments is made clear by a set of sectoral regulations, a fundamental problem facing the **district governments** is that many, and probably most of them, **will not be able to fully absorb the transfer of responsibilities within the timeframe** envisaged by the Governance Law (two years) and the Fiscal Balance Law (one year).

Currently, functions of district governments are very limited, focusing mainly on, for example, the maintenance and daily administration of education and health facilities and water supply. As almost public projects are planned and funded by higher level governments (mainly the central government), district governments have neither the experienced staff nor the technical and managerial tools (such as project design, evaluation, and management; program financial accounting and monitoring; and software supporting these functions) to implement these projects. There is also a very uneven distribution of capacities across districts, as indicated by BAPPENAS' recent exercise rating the capacity of the different district governments. Although a transfer of some personnel from higher level governments to districts may help strengthen local capacities, the current personnel management system does not provide the incentive for large-scale personnel transfers.

At least in the short and medium run, an effective way for Indonesia's district governments **to ensure adequate and quality service provision is to contract-out services where local capacity is lacking.** Specifically, such districts can contract for service provision with other governments (under which one government pays a higher level government or neighboring government to provide a service), or with private firms (a government pays a firm or nonprofit agency to provide a service), or through joint service agreements (under which two or more governments join in financing and producing services.)

In addition to the capacity argument, the use of intergovernmental service contracts or joint service agreements is also justified on the ground of economies of scale and interregional spillover effects. The Governance Law empower the district governments to undertake functions in virtually all areas of public services, including education, health, infrastructure, and environmental protection. Some services, such as teaching universities, research hospitals, inter-district roads, and public pension and unemployment insurance systems, are likely to have a larger benefit area than the size of a typical Indonesian district and would involve lower unit costs if provided by provincial governments or jointly by districts.

Intergovernmental service contracts are extensively used in developed countries, including the United States and Australia. For example, more than half of the cities and counties in the United States contract with other governments to provide some of their services and more than 60 percent of county governments enter into joint service agreements. The services that are most often provided through contracts include water supply, sewage disposal, jails, animal control, and property tax assessment. Services that are often performed under joint service agreements include police, fire protection, libraries, and health services. In addition, many American cities and counties transfer to the private sector the provision of services like refuse collection and disposal, project engineering, and recreational facilities. In the case of Indonesia, some more important functions of future district governments, including planning, evaluation, and management of capital projects, should be considered for contracting out. Many central and provincial governments agencies that are currently undertaking these functions, as well as their personnel who will be made redundant during the decentralization process, can provide consulting and management services to district governments.

For service contracting to operate effectively, mechanisms should be put in place to address a few potential problems. First, **an open and competitive bidding process** must be applied to all contracts, to minimize the cost-of-service provision and prevent corruption. Secondly, the **inputs to and outputs of the services to be provided by contractors must be carefully specified**. Without the specification, local governments will not be able to ensure the timely delivery and the quality of services. Thirdly, a system should be established to **monitor the performance of the contractor and the service quality**, which involves a requirement of regular reporting of project progress and the use of independent inspectors. To assist the local governments in the above areas, the central government could develop guidelines for the procedure of contracting out services, and even standard contracts for typical district level services.

B. Public Expenditure Management Issues

Institutional considerations

The government has proposed the reorganization of the Ministry of Finance. The fundamental structural, procedural, and reporting changes, contained in the Governance Law and the Fiscal Balance Law, will necessitate a new set of public expenditure management relationships within and between the various levels of government, and will affect the functions of a newly organized Finance Ministry.

The recommendations made in previous IMF technical mission reports³ regarding the upgrading of the role of the Ministry of Finance in budget preparation and execution, and possible new organizational structures for the ministry, continue to be relevant to the new central-regional fiscal arrangements. These new arrangements will require coordinated and centralized budget planning and monitoring activities to be managed by the Ministry of Finance. This may require additional provisions (either in the laws or supplementary regulations) to clarify the role of the Ministry of Finance.

The Ministry of Finance must estimate total state revenues, which will be used to establish the aggregate balancing funds pool to be distributed to the regions. During the fiscal year, the Ministry must monitor actual revenue levels and provide timely advice on options to adjust the disbursements of regional balance funds (transfers) to recognize the differences that will emerge between realized and estimated revenues. In the context of managing the general government's borrowing and debt levels, the Ministry of Finance must also set and monitor borrowing limits for each of the regions—the Governance Law does not specifically give the

³B. Potter, E. Mottu and M. Hawtin, "Indonesia: Fiscal Management, Decentralization and Organization of the Ministry of Finance," FAD, IMF (December 1998); and B. Potter, P. Desai, D. Shand, J. Stevenson and M. Wooley: Indonesia: Budget Management in the Short and Medium Term," FAD, IMF (October 1998).

Ministry of Finance this power. These two fiscal aggregates are important influences on the capacity of the regional governments to deliver their budgets (APBD). Also, they are fiscal aggregates that must be managed by the Ministry of Finance in the execution of the state budget (APBN).

It is recommended that:

- **The Ministry of Finance enhance its capacity to establish, monitor, and report** on key fiscal aggregates that impact on regional government budgeting, by establishing new organizational and procedural arrangements, as part of its current reorganization project.
- **The Ministry of Finance should be the sole organization responsible for modifying important fiscal aggregates** impacting directly on the capacity of regional governments to deliver their budgets during the fiscal year.
- That the implementing **regulations should clearly define the financial and budget management responsibilities of the Ministry of Finance** in the new central-regional fiscal arrangements.

Budget management issues—revenue sharing volatility

The new central-regional revenue sharing arrangements present both the central and regional governments with budget management challenges. Even in the best of times, actual revenue flows over the fiscal year will differ from the estimated revenues upon which a budget's expenditures are based. The inclusion of "volatile" heads, such as oil and gas revenues, in revenue sharing arrangements with the regions will add to the complexity of managing APBN and APBD (local budget) execution.

If the government implements the sharing of oil and gas revenues proposal, budget managers will be required, during the fiscal year, to implement either or both of the following options: (1) adjust expenditures; (2) seek to increase revenue mobilizations (including borrowings) from other sources, particularly in the case of revenue shortfall, in order to achieve the budgeted expenditure targets.

Unfortunately, these adjustments described above are best performed at the central government level—with the center rather than the regions left carrying the consequences of unanticipated budget outcomes. Specifically, the central government has a greater range of fiscal response options than have the regional governments. Adjustments to central government expenditures can be spread over a large number of programs, over a large geographical area, and over a large number of people. On the revenue side, the central government has a greater number of revenue bases. For instance, a lower-than-expected result in one collection head (say oil revenues) could be compensated for by a higher-than-expected performance in other collections. Also, the central government has a greater number

of borrowing options than do regional governments. These characteristics mean that regional governments have fewer fiscal options to respond to fluctuating revenue realizations. Therefore, the Ministry of Finance needs to develop, in consultation with regional governments, budget management strategies to cope with transfers from the central government which might significantly differ from the original budget numbers. The objective of these strategies should be to “smooth out” large variances to revenue flows and to give the regional budget managers more time to respond to shocks that may occur to the central government’s budget estimates.

A major limitation to this approach occurs when the central government’s capacity to borrow (either short or long term) or to improve revenue mobilization elsewhere is severely restricted, as is currently the case in Indonesia. In these circumstances, expenditure compression (at both the national and regional levels) is likely to be the only feasible response to a significant decrease in revenues. Nevertheless, the central government should make every effort to seek ways to ameliorate the impact of a significantly lower-than-expected realization of revenues by “sharing the burden.”

In a situation where the central government has some flexibility, the following process may assist with ‘sharing of the burden’ in the event of actual revenues varying by more than the normal variations due to the estimation process.

- Disbursement of the balancing funds (transfers) should be done on a regular basis, perhaps monthly, within a planned quarterly total. Subject to the capacity of the central government to fund the transfers, it should seek to transfer the amounts originally budgeted or a significant proportion of the projected amount.
- Planned balancing funds disbursements for the remainder of the fiscal year would be adjusted as soon as possible to take account of year-to-date revenue mobilization performance plus emerging economic prospects for the remainder of the fiscal year (or perhaps for the next four quarters). Recalibrated balancing funds transfers would be settled, allowing the regions to rework their budgets. To the extent it is able to do so, the central government should attempt to account for the impact of any sudden changes to the revenue base in the recalibration of the distribution over the remainder of the fiscal year (or perhaps over a rolling four quarter period). This sequence is repeated at the end of each quarter.
- Any recalibration methodology will need to recognize agreed levels and sequencing of transfers. It should not be used by central government to avoid such financial obligations.

Special consideration, however, would need to be given to how to cope with **a large variation in the last quarter** of a fiscal year. It may prove difficult to meet any agreed level of transfers *in a fiscal year* if the aim is smoothing out. With volatile revenues in the sharing arrangements, it may be more practical from a budgeting and cash management perspective

to seek to meet the sharing target over a rolling six or eight-quarter time frame. Such refinements will come over time as more experience is gained with the implementation of the provisions of the two laws.

The above-mentioned approach has important advantages. It gives a degree of stability regarding the level of balancing fund transfers for the next quarter to the regional budget managers. At the same time, managers are also given adjusted quarterly transfer estimates for, at least, the remainder of the fiscal year, allowing them to prepare fiscal responses to estimated changes to their revenue streams from the central government. Such an approach shifts a large part of the revenue risk management function to the central government, where they are likely to have a greater capacity to cope with varying revenue flows in the national budget. Another benefit with this approach is the spreading out of the shocks and the avoidance of large, sudden variations.

This approach reduces the need for regional governments to devote a portion of their (limited) resources to **reserve funds** to cope with variable income streams, as envisaged under the Fiscal Balance Law. In Indonesia, where there are 27 provinces and over 300 districts/municipalities, there is potential for a large amount of government funds to lay idle for long periods during the fiscal year in reserve (or stabilization) funds. In terms of reducing the costs of delivering budgets, increasing the effectiveness of cash management at all levels of government, and making the maximum amount of resources available for expenditure on public sector programs throughout the fiscal year, the above approach to balancing funds disbursements is attractive.

The suggested approach, however, does not completely shift revenue planning responsibilities to the central government. Regional governments will still be required to forecast revenue streams from their own sources and prepare expenditure response plans to cope with actual revenue receipts different from those used to prepare the APBD. However, at the central government level, there will be an increased need for the Ministry of Finance to include, in their APBN budget, contingency plans to cope with volatile revenue streams. In this regard, the central government's budgetary reserve would need to be increased.

If the central government has the capacity to absorb large revenue shortfalls due to factors beyond its control, the Ministry of Finance should seek to minimize the shock effect such volatility will have on regional budgets. This would be achieved by "smoothing" balancing fund transfers over longer time periods and employing appropriate risk management strategies within its budget.

However, it needs to be stressed that in times of severe economic crisis, the only fiscal response to a significant shortfall in revenues may be expenditure compression. In these circumstances, few options exist for "sharing the burden"—both the central and regional governments have to decrease expenditures in line with receipts. Smoothing and sharing may not be feasible.

It is recommended that:

- Revenue-sharing, if required, should be out of total central government revenues, rather than out of specific, volatile, sources;
- Budget-management issues need to be specifically addressed in connection with revenue-sharing as well as the general allocation transfers.

Local government borrowing

Articles 11 to 15 of the Fiscal Balance Law (and Article 81 of the Governance Law) permit local governments to borrow to finance parts of their budgets. We note that these provisions provide adequate safeguards for appropriate limits and restrictions to be placed on these activities via government regulations. International experience suggests the Ministry of Finance (alone or in addition to the Ministry of Home Affairs) must pay close attention to all borrowing activities of local governments as it can have important effects on the delivery of the state budget and its financing.

The following actions should be taken to assist the Ministry of Finance in this regard:

- The Ministry of Finance, as permitted under Article 15 of the Fiscal Balance law, should set annually in APBN documentation **debt-stock limits for each regional government** permitted to borrow. This limit should only be varied by the Ministry of Finance.
- It is important that the **central government not provide a sovereign guarantee for domestic borrowings by regional governments** (as recognized in the legislation).
- Under Article 28 of the Fiscal Balance Law, **regional governments should be required to report their borrowing activities and debt positions to the Ministry of Finance on a regular basis, say, quarterly.**

Revenue flows

We note that the Ministry of Finance has commenced work on reviewing existing systems and procedures for the receipt of tax and non-tax revenues and their transmission through the banking system to bank accounts of the various levels of government, including the Ministry of Finance's bank account at Bank Indonesia. The new revenue raising and sharing arrangements and the introduction of the balancing funds arrangements have reinforced the need for the Ministry of Finance to:

- design and implement an efficient revenue allocation system so that revenues due to a particular level of government are made available to that government as quickly as possible; and

- reduce the time it takes for state monies to be moved from the point of collection to the relevant treasury account of the regional/central government in order to facilitate good cash management and reduce the costs of budget execution.

Budget classification structures and financial management information systems

The Fiscal Balance Law (Articles 27 and 28) provides clear guidance on financial reporting requirements of the regions and the role that the Ministry of Finance has in this reporting system. Currently, the Ministry of Finance is developing a new revenue and expenditure classification structure based on the IMF's Government Finance Statistics (GFS) standard⁴. It is normal practice in many countries for regional governments to prepare, execute and report on their budgets using a version of the classification structure used at the national level. However, the current regional budget classification structure allows the specification of revenues and expenditures codes for the generation of financial management statistics required by regional program managers.

The alignment of central and regional government appropriation and budget management classification structures will facilitate the compilation of both comparative and consolidated financial statistics for all levels of government.

In order to enhance fiscal transparency and accountability and to simplify fiscal reporting it is recommended that:

- The Ministry of Finance should provide **guidance to the regions on the classification** structure, which will form the basis of the regional financial management information system.

⁴ Note that the GFS is currently undergoing a revision.