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Concept Note On Incentives for Attaining Minimum Service Standards In Indonesia

April 2011



CONCEPT NOTE ON INCENTIVES FOR ATTAINING MINIMUM SERVICE STANDARDS IN INDONESIA¹

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By Gabe Ferrazzi

A. Background

1. The Consultant was asked to explore possible approaches to incentivizing regional government service providers mandated to achieve minimum service standards (MSS). This particular kind of service standards are set out more clearly than in their original form in the 1999 decentralization reforms, gaining more prominence in Law 32/2004 and GR 65/2005. They are inextricably associated with obligatory functions that are about basic service provision.
2. MSS have been promoted for a decade now, and their implementation has been rather slow, for several reasons. One of the hurdles is deemed to be the uncertainty over their financing (whether they are properly funded or represent unfunded mandates), and a closely related issue is whether the incentives are in place to spur regional government to make genuine efforts to close MSS gaps. Incentives can of course be relevant to overcoming other challenges of implementation beyond the mere lack of funds.
3. Development partners (principally donors/IFIs) have promoted the notion that incentives are critical to placing development efforts on a successful path. CIDA's BASICS seeks to reward innovation (or more to the point, earnest efforts) in the pursuit of MSS. The USAID-KINERJA also emphasizes incentives for regional government performance in service provision. DPs (DSF for instance) in Indonesia have in the recent past stressed performance monitoring, a precursor or at least a requisite to providing incentives; there must be a way of knowing if the incentives are needed and if they are doing any good. All of this DP assistance is useful, but it has not met the MSS incentives challenge head on. While this is a large topic, the Consultant aims to sketch the contours of the main opportunities and issues that need to be dealt with if MSS are to see accelerated and fruitful implementation.

B. About Incentives in Service Provision

4. "Incentives" are often equated with financial inducements. This is generally the case in Indonesia. When referring to incentives to attract regional investments, tax holidays are the prime "facility" in play. But as seen in the integrated economic zones (KAPET), financial incentives do not always work.² On the other hand, other kinds of incentives can sometimes have a strong effect. To address under-served districts, the Government of Indonesia (GoI) has offered both **financial** and **non-financial** inducements, the latter being the opportunity to become permanent employees as civil servants. The non-financial incentives are deemed to also have had a positive effect in this initiative.³
5. The under-served example above suggests that it is important to think about both **institutional** and **individual** level incentives. These are not automatically well aligned. Individuals may

¹ Prepared by Gabriele Ferrazzi, Consultant to the Decentralization Support Facility.

² See for instance, Agunan P. Samosir, P. Agunan dan Tri Wibowo (2004). Analisis Efektivitas Pemberian Insentif Fiskal Di Kawasan Timur Indonesia (KTI) - Studi Kasus Kapet Pare Pare, *Kajian Ekonomi dan Keuangan*, Vol 8, No. 1: 1-18.

³ Ministry of Health, Republic of Indonesia (2010). Health Workers for Health Services in Remote, Underserved, Country Borderline Areas and Small Islands, case poster.

not be very cooperative if they themselves do not feel any advantage in pursuing what the institution as a whole deems to be a proper course.

6. It is also important to recognize that people are motivated by both **positive incentives** and **disincentives**. It is generally believed that it is preferable to encourage desired behaviour through positive reinforcement. In some cases it is necessary to use negative measures (ideally as a last recourse). Sanctions, or the possibility of sanctions, can in the right circumstances prod actors to do the “right” thing.

7. Incentives can be **purposefully created** to achieve a particular objective. But it is often the case that **incentives are at work**, driving the noted behavior. These may have evolved over a long period of time, and even remain “unseen” or unquestioned. When the noted behavior runs counter to the desired behavior, it is important to realize that there may be some strong incentives that explain and tend to continue that behavior. Attitudes and procedures that encourage or discourage accountability are examples of a broader understanding of incentives that is sometimes neglected.

8. Sometimes, attempts to introduce new incentives can have the opposite effect, creating **perverse incentives**. It has happened that supposedly helpful interventions have not had the degree of success anticipated. They have sometimes resulted in unexpected reactions or consequences. In the field of service provision, regional finance specialists warn that transferring additional funds to local government with large service gaps can sometimes have little effect. Local governments (LGs) will be pleased to receive the extra funds, but will wish to continue to receive the funds year after year; their effort to close the service gaps may be anemic, or they may not properly report their successes. Keeping service gaps large is possibly encouraged by a funding formula that rewards large service gaps. In fact, the worse the LG does in service provision, the more funds it will receive in a poorly crafted incentive scheme. There is actually no incentive for the LG to truly improve services. If it does, there is no incentive to report the improvement as that will work to reduce the funding. Indonesia has seen examples of perverse incentives. In the Left Behind Villages⁴ scheme of the nineties, previously reasonably well off villages suddenly reported themselves as poor – to be eligible for the special funds attached to the Left Behind Village designation.

9. Departing from the last point above, in the use of incentives it is important to know the actual level of **performance**. This will allow government and other funders to know if the incentives are needed and they are having any effect. A government regulation to measure service delivery, among other functions of regional government, has been issued (GR No. 6/2008).⁵ More recently, the omnibus planning regulation from the Ministry of Home Affairs (Permendagri 54/2010) provides some monitoring and evaluation procedures and templates that can be used to track progress toward MSS. It is not clear that these are adequate or adequately applied.

10. In this note, a broad meaning of incentives is used to understand why MSS have been slow to be applied, and to explore the measures that may be necessary to accelerate their application.

C. Incentives at the district/city level

11. It is important to recognize that the service functions that are accompanied by the MSS are “devolved” functions (“*desentralisasi*” in the Indonesian terminology). This means that it is the

⁴ Inpres Desa Tertinggal, an initiative promoted by Mubyarto in 1993 while he was Asisten Kepala Badan Perencanaan Pembangunan Nasional/Bappenas .

⁵ PP Nomor 6 Tahun 2008 tentang Pedoman Evaluasi Penyelenggaraan Pemerintah Daerah

political leadership and administrator of the regions that are primarily responsible. The political dynamics, accountability relationships and management systems within the regions will bear the primary responsibility for achieving the MSS.

12. The Bupati then must be committed to achieving the MSS; these need to be expressed or approximated in his/her political pledges; making education accessible, reducing communicable diseases, making child birth safer, making clean water available. These need to find their way into the mid-term plans and annual plans/budgets. Here the political role of the local legislatures (DPRD) also becomes important.

13. As it is clear that not all leaders always care, or remember their pledges, about basic services, there is a role for political accountability to the public to remind political leaders of public expectations. Moreover, vertical accountability also needs to be exerted as the national level has also a residual responsibility for ensuring national achievements in basic service provision – even when the functions are devolved to regional government.

14. The points of interest in the strengthening the above linkages within the context of districts/cities are potentially several:

- i. Ensuring medium term plans start off capturing political promises in terms of MSS
- ii. Ensuring consistent planning, budgeting and execution
- iii. Bupati and DPRD insistence that their units (SKPD) track the performance against MSS
- iv. Bupati/Sekda commitment to assess unit (SKPD) performance (including replacement, demotion) on basis of MSS
- v. DPRD insistence that Bupati's report include progress against MSS
- vi. Internal inspectorate and external technical audits to take into account the planning-budgeting-execution consistency on MSS
- vii. Civil society to demand from DPRD/Bupati services and evidence of performance against MSS.

It is largely up to the Bupati/Mayor then to put his money where his promises are. This may requires that some activities outside of the MSS are given fewer resources. That would be healthy in the main, particularly if it leads to fewer egregious abuses of funding; paying for salaries of attracting international talent to the regionally sponsored football club or huge stadiums that are essentially white elephants. But some hard decisions will also need to be made in allocating resources over a range of legitimate desires; basic needs ought to prevail.

In short, the regional politicians themselves hold the key to success, and the incentives therefore need to be created at this level primarily. If they are not, it is up to civil society and vertical institutions to play a role to spur such commitment.

D. The role of Provinces/Governors in incentivizing district/city efforts

15. It is often acknowledged, even by some provinces, that the functions assigned to provinces are better funded than the "package" assigned to districts/cities. It could be argued that provinces simply are not able to properly absorb the funds. In any case, many provinces are passing on some "excess" funds to their districts/cities, as a form of assistance, often referred to as "Bantuan Propinsi." It appears that the criteria used in the allocation vary considerably between provinces, and that there are "political" considerations at work.

16. There are voices pushing provinces to allocate their Bantuan based on widely accepted factors, to ensure some form of equity. For instance, some voices have called for a formula that takes into account population, geographic area and development needs.⁶ But this approach simply mirrors the DAU formula, which is also problematic in terms of its connection to MSS gaps. Whether it is the DAU “fiscal need” or some other expression, such as “development needs,” the way these concepts are operationalized is critical to the successful pursuit of MSS.

17. Ideally, the “needs” of regions will be seen in relation to the key responsibilities of the regions; basic service provision, as defined by the MSS. The need is thus best equated as MSS “gaps.” It will be a challenge for some time however to determine what the MSS gaps are. But that technical task of data/reporting procedures is not insurmountable, and some districts and provinces are already taking firm steps in this direction.

18. With an understanding of MSS gaps, it makes sense then for Bantuan Provinsi to be directed to supplement other sources of funding to close the MSS gaps. But how this is done can make all the difference in success. As noted earlier, funding MSS gaps can lead to perverse incentives if done badly. One way to avoid this problem is to make the Bantuan provinsi subject to two principles; need and effort.

- **Need:** defined as MSS gaps information, channeled to the province annually by districts/cities
- **Effort:** determined in the annual review of draft budgets of the districts/cities, undertaken by the Governor/province, where districts/cities add a supplementary report on MSS that links to their proposed budget.

19. Some simple indicators of effort should be used to determine whether the districts/cities are seriously seeking to close their gaps. The province could focus its support for health and education, or whatever political promises it made that touch on MSS (though these are district/city functions and such promises must be properly couched).

- a) Reliable information on MSS gaps of provincial focus
- b) Reliable estimates of funds needed to close the MSS gaps of provincial focus
- c) Targeted closing of the MSS gaps of provincial focus for upcoming year
- d) Budget applied toward closing MSS gaps of provincial focus
- e) Overall spending patterns (e.g., overall focus on MSS vs. grandiose or white elephant projects)

20. The tendency may be to devise a formula that could recognize both need and effort, but a more qualitative and simple approach, based on good judgment, and offering transparency, may be best.

E. Central incentives for MSS application

Although the districts/cities (with provincial support) should feel most responsible for attaining the MSS, there is also a wide range of measures that can be taken by the central government to spur MSS achievement. These are explained below.

⁶ Hanoto (2011). Bantuan Provinsi Tidak Berimbang Rabu, 23 Maret

Returning to the original intent of MSS

21. The number of Ministries that have developed minimum service standards is now 13, listed below:

- i. Health
- ii. Public Works
- iii. Housing
- iv. Women's empowerment and Children's Protection
- v. National Education
- vi. Social Affairs
- vii. Environment
- viii. Labour and transmigration
- ix. Food crops
- x. Home Affairs
- xi. Population Control
- xii. Communications
- xiii. Arts

The most relevant regulations (Government Regulation 65/2005 on Guidelines for the Development and Application of Minimum Service Standards) explain the MSS as the minimal level of basic services that must be delivered. This has not been well understood by certain ministries, and the range of functions that has been accompanied by MSS is considerably broader than what was intended. The Ministry of Home Affairs and the Inter-Ministerial Team/DPOD that vetted the proposed ministerial MSS did not see fit to enforce the more narrow definition.

22. While the ministries are deserving of praise for their enthusiasm, the MSS concept has been diluted to the point that it is now difficult to refocus regional and national resources to boost the basic services that ought to be the real focus of the effort; a much larger range of functions/organizations can now lay claim to resources, making the effort much less feasible (and complex) than it should have been.

23. It is important to return to the original notion of the MSS, tying them to only basic services. Other functions can still be made obligatory, and have technical standards applicable to them (covered under the Indonesian acronym NSPK⁷). They will need funds to be implemented of course, but there ought to be more flexibility in how intensely they are pursued, thus allowing for emphasis to be truly given to basic services/MSS. This more principled adherence to the regulations will need to be lead by the DPOD, ideally, or will need Presidential direction, with ministries being dropped from the MSS effort, and in some cases some MSS being dropped in sectors that otherwise do have the mandate to guide regional government basic service.

Simplifying the many centrally promoted initiatives on service standards

24. It is necessary to have a clear and common view of what service standards are in play in the regions. Regional actors must have clarity on what standards are relevant and are priority. This picture is compromised with the plethora of overlapping or poorly differentiated concepts (MSS, PSS, SOP, "NSPK", NSE, ISO). Clarification (and integration/simplification at regional level) is badly needed. This means that the CG must have more coherent approach in promoting the various tools.

⁷ NSPK needs no translation, standing for *Norma, Standard. Prosedur dan Kriteria*

Rewarding the tracking and reporting of MSS achievement

25. It is striking that the Ministry of Health does not which regional governments are fulfilling the health related MSS, or are falling short. This would seem to be the prerequisite to even launch an MSS, let alone seek to provide incentives for their fulfillment.

26. Just as the Ministry of Finance is rewarding regions for timely and accurate financial reporting, it may be advisable to support regions to develop their data, analysis and reporting (to themselves, and to higher levels). This may be a short term inducement, for two years perhaps, and predicated on outputs (reliable MSS achievement reports).

Increasing capacity development (CD) on the application of MSS

27. The CG has yet to mount an intensive CD effort to enhance the regions' ability to track, report and apply MSS (from policy to budgeting). The efforts have superficial and ad hoc, and incoherent across national ministries/agencies. For instance, KemenPAN has added the concept of PSS, without a serious attempt to help regions differentiate the PSS from MSS.

28. There is no single orientation or training that offers civil servants an overall view of ways of improving service delivery. This is needed, and should be a constant and continuously improved offering that is fed through LAN, Universities and other CD providers. Offering this training or others to regions on a cost sharing basis would remove some conceptual/technical hurdles in achieving MSS.

Shifting the discourse on the DAU and incorporating MSS as fiscal needs expenditure norms

29. There are a number of misconceptions among stakeholders (at national and local level) that stand in the way of a proper approach to assessing performance and financing MSS. The two worst misconceptions are that the "aparatur" is soaking up practically all of regional budgets, "leaving little for public services." The second, and connected belief is that the DAU is absorbed to fund the *aparatur*, again leaving very little DAU, if any, to fund "public services."

30. The above misunderstanding shifts the discussion to the search for additional sources of funds, so that "public services" can be funded. It is not clear how this misconception has arisen, but it probably has much to do with the very real problem that there is a growing governance overhead in the regions, particularly for districts/cities. This is undoubtedly caused by regional splitting, where efficiencies are lost due to scale, as well as incentives in the DAU (basic allocation) which rewards a fat establishment.

31. However, the above observations are extended into a statement that the "aparatur" is soaking up the lion's share of the budget – with no public services resulting. The "aparatur" that is usually indicated includes teachers, mid-wives, nurses and other front line service workers. These represent the bulk of civil service/contractual staff in fact. But they are part and parcel of service delivery; teachers teach, nurses give care etc. It is an affront to these workers to say that their wage bill is an overhead that does not contribute to the delivery of public services.

32. Equally, it is therefore logically wrong then to say that the DAU is not contributing to service delivery; it is probably the main contributor to service delivery as it pays the wage bill of the mentioned front line service staff.

33. The real issue with the DAU, is that its overall size and division is not well related to the service needs of regions as embodied in the MSS. Ideally, the MSS expenditure norms (as developed recently by the Health Ministry for instance) should be a guide to the amount of funds regional governments to attain the phased targets toward the full MSS achievement. This can of course be reduced by the practical consideration that demand will lag any established normative supply (if the phasing does not take care of that automatically).

34. Incorporating the MSS expenditure norms (however crude initially) into the DAU should allow the Central Government (CG) to gauge the size of the DAU needed to meet the targets related to the MSS for the given year/period. It may need to slim down the Special Allocation Fund (DAK), which already contains funding that ought to be applied toward MSS (if these are indeed national priorities). It may also need to redirect deconcentration funds that are now spent “on behalf” of the regions to the DAU to bring it up to the needed size to adequately cover MSS commitments.

35. The CG can of course decide that the DAU will meet only a particular proportion of the MSS expenditures, indicating that it expects locally raised resources (taxes/charges) to also cover a portion. However, it must be mindful that at any stage of ramping up and focusing budgets to meet the MSS, regional governments also ought to have sufficient additional funds to discharge other obligatory functions in some way, and to spend on some activities that are entirely of their own identification (but not frivolous hopefully).

36. By taking these steps, and communicating effectively, the CG can send out a clear signal that the resources are available to meet the phased targets toward full MSS achievement. Regional governments can therefore be more forcefully taken to account by the CG and citizens on the achievement of MSS targets, and eventually the full MSS levels.

Redesigning the DAK and delegating its allocation to the Governor

37. The Special Allocation Fund (DAK) is meant to be “allocated to the certain regions with the objective of funding special activities that represent regional functions and relate to national priorities”.⁸ The spending rules for the DAK are set by the respective ministries. It is widely acknowledged that the attainment of nationally set MSS represent a “national priority.” This sensible rationale is however undermined by the actual mechanism of the DAK.

38. The DAK does not respond to the regional distribution of MSS performance, but rather to general infrastructure needs. These needs are also not attuned to specific regions, but instead reflect a general investment need across regions. Regional actors complain that while they may need to teach under a tree, it is comforting to know that they now have a new library, thanks to the DAK.

39. Because regional governments must lobby for their quota, and lose part of the gains in the cost of the lobbying process (paying brokers etc.), the full value of the amount of the DAK is also not obtained, and there is no predictability in the amount of the fund; making the correspondence with MSS gaps even more distant. That the DAK is set by the centre also takes away from the rationale for making coherent plans for DAK allocations at the district/city level as these are not factored in the DAK decisions. The DAK on the whole is a weak tool for encouraging the attainment of MSS.

40. To encourage districts/cities to anticipate more predictable DAK allocations and apply them specifically toward the fulfillment of MSS, the DAK will need to be guided by the Governor, with the

⁸ Definition is derived from Law No.33/ 2004 Article 1 (23) and PMK No. 55/2005 Article 1 (24).

same approach that has been suggested for the “Provincial Assistance” (*Bantuan Propinsi*) explained above. The DAK may still be disbursed directly to the districts/cities from the centre (to avoid a two step process) but it would follow the logic of the *Bantuan Propinsi*.

41. Should the DAU formula be adjusted to reflect MSS expenditure norm, then the MSS component of the DAK can be redirected to the DAU. It will be important then to reduce the DAK accordingly, and keep the DAK to “very special needs”, not the MSS – which actually relate to the core functions of the regional governments.

42. Even if the DAU does not incorporate MSS expenditure norms, it may be a better vehicle for absorbing central funds meant for regional functions than the DAK as it stands today. This will be even more the case if the wage bill (in the basic allocation) is shed from the DAU, allowing regions to gain from civil service efficiencies.

Making on-lending and on-granting of donor funds easier

43. Two projects in recent years have sought to develop mechanisms to reward districts/cities with funds to pursue MSS (WB/AusAid Dialog and CIDA-BASICS). CIDA had hoped to provide the provincial level with a fund that could be used to incentivize districts/cities to accelerate their achievement of MSS. The donors/IFI could not proceed as hoped as the mechanisms for on-granting were not operational or favorable to these innovations. The opportunity was lost to explore how the provincial level/Governor could stimulate districts/cities with funds as a reward for increasing their efforts to reach MSS.

44. Recently, a new regulation has been issued (Government Regulation 10/2011 on the Procedures of Provisioning Foreign Loans and Receiving Grants⁹). It is not clear if this regulation is any friendlier to the described innovations. It is important to have a clear ruling from the government on the legality and feasibility of on-lending and on-granting schemes that seek to develop such incentives for districts/cities to attain the MSS.

Inviting donors to reward output achievement: Output Based Aid

45. In recent years, donors have experimented with spurring local government to be more aggressive and effective in delivering services by buying/reimbursing service results. Yogita Mumssen, Senior Infrastructure Economist of the World Bank, explains "Output-based aid is pro-poor and primarily focused on ensuring access to basic infrastructure and social services for the poor in developing countries" Experimentation with this approach has been done in Latin American Countries beginning in the early 2000's, and the findings are encouraging. About 200 projects have been noted across sectors – including energy, telecommunications, health, and water and sanitation; the majority funded by the World Bank Group. A global organization has now been established to support these initiatives, the Global Partnership on Output Based Aid (GPOBA).¹⁰

46. Some exploration has been seen in the Surabaya City water provision effort, where 15,000 connections are expected to be made by the city – driven by the incentive of reimbursement. The recent WB DAK Reimbursement Loan announced June 28/2010 also falls under the category of results

⁹ Peraturan Pemerintah Republik Indonesia Nomor 10 Tahun 2011 Tentang Tata Cara Pengadaan Pinjaman Luar Negeri Dan Penerimaan Hibah.

¹⁰ World Bank (2010). *Output-Based Aid, Improving Service Delivery to the Poor*. Obtained from <http://web.worldbank.org/WBSITE/EXTERNAL/TOPICS/EXTSDNET/0,,contentMDK:22523439~menuPK:64885113~pagePK:64885161~piPK:64884432~theSitePK:5929282,00.html>

based financing. The scheme will be implemented in five provinces and all of their districts (Jambi, East Java, Central Kalimantan, West Sulawesi, and North Maluku).¹¹ However, it is more correct to label the DAK reimbursement as an “infrastructure inputs” reimbursement scheme, rather than truly outputs based mechanism.

47. An MSS focused approach would be more likely to yield the results (mostly outputs) that are actually desired. The World Bank floated this idea to government officials based on a DSF proposal in mid 2010, but the government was not interested in assuming any more debt at the time. Should there be any more appetite for debt for basic service delivery innovation, certainly this form of incentive should be attempted, given its promise elsewhere.

Making a stronger connection between service provision and local taxes

48. Indonesia has decentralized expenditures, but not revenues, leading to a large fiscal imbalance. Districts now collect less than 10% of their overall revenues from local sources. The great reliance on transfers undermines the accountability link between service provision and service users. If the latter pay more for local services, they will be more likely to care about the quality and value obtained. Whether the services meet basic quality standards will be a more relevant question if citizen are paying for a significant portion of services. The shift in this direction will take some time, but it is crucial in the long term to achieve it. Indonesia now collects about 12-13% in taxes against GDP, whereas middle income countries are edging closer to 20%. There is room for Indonesia to increase taxes, and it makes sense to allow a good portion of increased taxation to come from locally assigned revenues.

Administrative sanctions for non-compliance with MSS

49. As a last resort, after all of the supportive measures have been taken, it may be necessary to apply sanctions to bring some regions into compliance with MSS. It is to be hoped that the vertical mechanisms (e.g., making achievement information known nationally), and the elections/direct voice mechanisms of accountability will be enough. However, in some places these may not work, for various reasons. Some sanctions are already foreseen, or possible under the current legal system. It is important however to not punish citizens rather than recalcitrant administrations. Sanctions could be applied or developed, including:

- Publicly announcing ranked performance
- Warnings from Governor/MoHA that the region is falling behind expected targets on way to MSS fulfillment)
- Direct orders to spend on specific lagging MSS efforts (as part of approval of draft budgets)
- Direct replacement of DPRD/Regional Head with appointee to manage the region temporarily, to redirect the spending intensively for one or more years
- Dissolution of region/incorporation into more viable region

¹¹ World Bank (2010). *Project Appraisal Document on a Proposed Loan in the Amount of US\$ 220 Million to the Republic Of Indonesia for a Local Government And Decentralization Project*. April 23.

F. Encouraging dialogue

50. A more intensive dialogue is needed among national and regional stakeholders on the merits of the incentives describes in this brief paper, as a precursor to deeper analysis and use of specific incentives.



