Indonesian Intergovernmental Framework
Incentives, Mandates, Restrictions, and Sanctions

Blane D. Lewis
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Decentralization Support Facility

Introduction

Interest in incentives in the context of Indonesian decentralization abounds at the moment. Multilateral agencies, including the World Bank and Asian Development Bank, regularly stress the importance of getting incentives right in their research reports and operational documents related to sub-national lending activities. Bi-laterals have taken up the refrain too. The government of Australia, for example, has recently issued a white paper that emphasizes the importance of incentives in encouraging better sub-national performance. They are applying performance incentives in the design of a new project in Indonesia. The government has also expressed strong interest in developing a proper system of incentives for the intergovernmental framework. And it has asked the Decentralization Support Facility for assistance in exploring various options in this regard.

This paper has two main objectives. The first is to try to explain, in brief, the interest among various parties in incentives in the Indonesian intergovernmental fiscal framework. The second and chief purpose is to examine Indonesia’s experience thus far in designing and implementing incentives in the system of intergovernmental relations. This paper is the first of several forthcoming efforts on incentives. The next step to be carried out is to review the international experience with performance incentives in intergovernmental fiscal relations. Based on the descriptive examination of Indonesia’s experience with incentives, mandates, restrictions, and sanctions in this paper and the forthcoming review of international experience, a policy paper will be written for the Ministry of Finance to make recommendations for a more purposeful and meaningful incorporation of performance incentives and the like into Indonesia’s intergovernmental fiscal framework.

The paper proceeds as follows. First some focused background material on decentralization in Indonesia is provided. This is done with a view to understanding the present interest in incentives and to motivate the rest of the discussion in the paper. Second, the main incentive mechanisms in intergovernmental relations are examined. A broad definition of incentives is employed, that is, one that includes mandates, restrictions, and sanctions, as well. Finally, the paper closes with a review of the main points and some conclusions regarding Indonesia’s experience thus far with incentives.

Background

There is widespread discontent among central government officials and international agency personnel with the manner in which sub-national governments use their fiscal resources. Three sets of facts illustrate the reasons for the general dissatisfaction with sub-national fiscal performance. The first relates to a lack of spending, the second concerns inefficient spending,
and the third is associated with the apparent low level of infrastructure service quality, in at least some sectors.

First, sub-national governments have under-spent the resources at their disposal and have accumulated large reserves. At the start of decentralization, sub-national governments held about Rp 7 trillion in reserve funds. Through the end of March 2007, provinces and kabupaten/kota had accumulated over Rp 95 trillion in unspent balances. Figure 1 provides the details of the accumulation of sub-national bank deposits, a reasonable proxy for reserve funds. The aggregate figure amounts to just over 3 percent of 2006 GDP. An accumulation of reserves of this magnitude is probably excessive and, as such, represents a significant forgone opportunity to increase spending to support service delivery and economic development.¹

![Figure 1: Sub-National Government Bank Deposits Since Decentralization](image)

Second, the spending that sub-national governments have carried out has been arguably allocatively inefficient. Sub-national government expenditure on administration, for example, is very high. In 2004, provinces and kabupaten/kota spent 32 percent of their combined budgets on administrative activities. Best practices from more developed countries suggest that a figure of around 5 percent should be sufficient to cover administrative needs.² By contrast sub-national governments spent only 29 percent of their budgets on education, just 17 percent on infrastructure, and only 7 percent on health. See Table 1 for the details.

¹ Of course sub-national governments should keep some funds in reserve to smooth expenditures in the short-term (in the context of the business cycle) and the long-term (in order to address the eventual decline in some natural resource revenues). Determining precisely how much sub-national governments should hold in reserve is not a question that is easily answered. Some analytical work is currently underway to examine actual reserve fund needs.² For example, in 2001, state and local governments in the United States spent 3.1 percent and 4.6 percent on administration, respectively (United States Census Bureau Statistical Abstract of United States, 2004-2005).
Table 1: Sub-National Government Spending (2004)

<table>
<thead>
<tr>
<th></th>
<th>Province Rp (Bn)</th>
<th>Province Percent</th>
<th>Kabupaten/Kota Rp (Bn)</th>
<th>Kabupaten/Kota Percent</th>
<th>Consolidated Rp (Bn)</th>
<th>Consolidated Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Administration</td>
<td>12,327</td>
<td>38.0</td>
<td>35,529</td>
<td>29.9</td>
<td>47,856</td>
<td>31.6</td>
</tr>
<tr>
<td>Agriculture</td>
<td>1,823</td>
<td>5.6</td>
<td>4,201</td>
<td>3.5</td>
<td>6,024</td>
<td>4.0</td>
</tr>
<tr>
<td>Education</td>
<td>3,815</td>
<td>11.8</td>
<td>39,805</td>
<td>33.5</td>
<td>43,620</td>
<td>28.8</td>
</tr>
<tr>
<td>Health</td>
<td>3,000</td>
<td>9.3</td>
<td>8,108</td>
<td>6.8</td>
<td>11,108</td>
<td>7.3</td>
</tr>
<tr>
<td>Infrastructure</td>
<td>8,321</td>
<td>25.7</td>
<td>17,147</td>
<td>14.4</td>
<td>25,468</td>
<td>16.8</td>
</tr>
<tr>
<td>Mining</td>
<td>195</td>
<td>0.6</td>
<td>74</td>
<td>0.1</td>
<td>269</td>
<td>0.2</td>
</tr>
<tr>
<td>Trade</td>
<td>479</td>
<td>1.5</td>
<td>681</td>
<td>0.6</td>
<td>1,160</td>
<td>0.8</td>
</tr>
<tr>
<td>Labor</td>
<td>426</td>
<td>1.3</td>
<td>452</td>
<td>0.4</td>
<td>878</td>
<td>0.6</td>
</tr>
<tr>
<td>Environment</td>
<td>619</td>
<td>1.9</td>
<td>1,233</td>
<td>1.0</td>
<td>1,852</td>
<td>1.2</td>
</tr>
<tr>
<td>Other</td>
<td>1,399</td>
<td>4.3</td>
<td>11,728</td>
<td>9.9</td>
<td>13,127</td>
<td>8.7</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>32,404</strong></td>
<td><strong>100</strong></td>
<td><strong>118,958</strong></td>
<td><strong>100</strong></td>
<td><strong>151,362</strong></td>
<td><strong>100</strong></td>
</tr>
</tbody>
</table>

Third, key types of sub-national infrastructure appear to be in a state of disrepair. Only 53 percent of Indonesians have electricity in their homes and just 55 percent have proper sanitation facilities. Barely 14 percent of Indonesians have access to piped water and the road network covers just 1.7 kilometers per 1,000 inhabitants (World Bank Public Expenditure Review, 2007). Indonesia’s regional rankings are quite low according to these criteria. Table 2 provides the specifics. Despite these problems, sub-national governments in general seem not to be undertaking any significant corrective actions on their own accounts.

Table 2: Local Service Delivery in Indonesia in Regional Context

<table>
<thead>
<tr>
<th>Infrastructure Type</th>
<th>Indonesia</th>
<th>Regional Rank</th>
</tr>
</thead>
<tbody>
<tr>
<td>Electrification Ratio (percent)</td>
<td>53</td>
<td>11 of 12</td>
</tr>
<tr>
<td>Access to Sanitation (percent)</td>
<td>55</td>
<td>7 of 11</td>
</tr>
<tr>
<td>Access to Clean Water (percent)</td>
<td>14</td>
<td>7 of 11</td>
</tr>
<tr>
<td>Road Network (km per 1,000 inhabitants)</td>
<td>1.7</td>
<td>8 of 12</td>
</tr>
</tbody>
</table>

The three outcomes described above together provide a strong rationale for discontent with the status quo alluded to above. The current zeal for incentives in Indonesia probably stems at least in part from the overall lack of satisfaction with sub-national government behavior. That is, many argue that the poor performance is a direct function of the lack of proper incentives in the fiscal system. If only Indonesians could get the incentives right many of the outcomes would be improved, it is often claimed.

Current Incentives, Mandates, Restrictions, and Sanctions

This section of the paper discusses incentives, mandates, restrictions, and sanctions in the Indonesian system of intergovernmental fiscal relations. Many of these relate in some way to sub-national government expenditure and revenue. A profile of sub-national spending has already been presented in Table 1. For additional background, Table 2 provides a snapshot of sub-national revenues for 2004.
Table 3: Sub-National Government Revenue (2004)

<table>
<thead>
<tr>
<th>Province</th>
<th>Own-Source Revenue</th>
<th>Shared Tax Revenue</th>
<th>Shared Non-Tax Revenue</th>
<th>DAU</th>
<th>DAK</th>
<th>Other</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Rp (Bn)</td>
<td>Percent</td>
<td>Rp (Bn)</td>
<td>Percent</td>
<td>Rp (Bn)</td>
<td>Percent</td>
<td>Rp (Bn)</td>
</tr>
<tr>
<td>Own-Source Revenue</td>
<td>22,696</td>
<td>49.3</td>
<td>10,131</td>
<td>8.3</td>
<td>32,827</td>
<td>19.3</td>
<td></td>
</tr>
<tr>
<td>Shared Tax Revenue</td>
<td>8,759</td>
<td>19.0</td>
<td>13,706</td>
<td>11.2</td>
<td>22,465</td>
<td>13.4</td>
<td></td>
</tr>
<tr>
<td>Shared Non-Tax Revenue</td>
<td>2,833</td>
<td>6.2</td>
<td>8,773</td>
<td>7.2</td>
<td>11,606</td>
<td>6.9</td>
<td></td>
</tr>
<tr>
<td>DAU</td>
<td>8,217</td>
<td>17.9</td>
<td>75,794</td>
<td>62.1</td>
<td>84,011</td>
<td>50.0</td>
<td></td>
</tr>
<tr>
<td>DAK</td>
<td>13</td>
<td>0.0</td>
<td>3,661</td>
<td>3.0</td>
<td>3,674</td>
<td>2.2</td>
<td></td>
</tr>
<tr>
<td>Other</td>
<td>3483</td>
<td>7.6</td>
<td>10055</td>
<td>8.2</td>
<td>13,538</td>
<td>8.1</td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td>46,001</td>
<td>100</td>
<td>122,120</td>
<td>100</td>
<td>168,121</td>
<td>100</td>
<td></td>
</tr>
</tbody>
</table>

Incentives

Several incentive mechanisms are present in the intergovernmental fiscal system. Performance incentives have been integrated into the system of property tax transfers to the regions, for example, albeit in a rather minor way. The property tax is a central tax in Indonesia, although local governments assist with collections. The bulk of property tax revenue is shared with the regions. The center returns 64.8 percent and 16.2 percent of total property tax receipts to kabupaten/kota and provinces (by derivation), respectively. The center (initially) keeps 10 percent of the total for itself and in addition charges 9.0 percent for administration. The center subsequently allocates its 10 percent share to local governments; 6.5 percent is distributed in lump sum payments across all places and 3.5 percent is allocated to local governments as a function of their achievement of the previous year’s (urban and rural) property tax revenue target.

No data exist with which to judge the effect of the property tax incentives described above. Many suspect that the mechanism is not even implemented, at least not regularly. In any case, the impact, if any, could not be very considerable, given that only 3.5 percent of property tax revenues are subject to the incentives. In 2006, this amounted to about Rp 550 billion or about 0.33 percent of total sub-national revenue budgets (and about 0.02 percent of GDP). Another salient feature of the incentive scheme is that responsibility for property tax collection is shared between deconcentrated Ministry of Finance tax offices and local governments. As such attainment of targets depends in part on central government performance as well as that of kabupaten/kota. This surely further weakens the incentive structure.

Incentives have also played some role in the allocation of the general purpose grant (DAU). The DAU is the most important source of funds for sub-national governments. It makes up approximately one half of total sub-national revenues and nearly two-thirds of local government budgets. The pool of finance for the DAU is 26 percent of (planned) net domestic revenues. In 2006 the DAU reached nearly Rp 146 trillion (4.8 percent of GDP). From the total pool of finance, a portion sufficient to cover the entire regional wage bill is hived off and allocated to the regions as a function of their respective salary needs. The remainder of the DAU pool is distributed across regions according a fiscal equalization formula. In 2006 about 50 percent of the DAU was allocated to fund sub-national civil servant wages.

The stated rationale (in Law 32/04) for covering sub-national salary payments from the DAU is to ease the local fiscal planning burden associated with the regular transfer of staff among
regions or between the center and regional governments. Most analysts have argued that from the local perspective, however, the DAU allocation scheme serves as a disincentive to rationalizing sub-national civil service employment. Why would sub-national governments bother firing excess staff as long as the center is paying their salaries? Any disincentive that does exist, however, is somewhat diluted by the fact that regions do not have complete control over the hiring and firing of their civil servants. Much of this authority is reserved by agencies of the central government. The easiest way for regions to rationalize their stock of personnel is through attrition, a mechanism of rather limited scope.

The disincentive effects are further complicated by the fact if a region were to cut staff it would receive more funds for non-staff spending. (That is, as the regional wage bill declines, the portion of the pool of finance reserved for staff payments decreases and that for non-staff spending increases; thus any region with a positive fiscal gap would receive more in equalization funds.) Looked at from this perspective one could argue that the DAU allocation scheme offers a spending incentive for reformist regions—i.e. those less interested in building up staffing levels and more interested in service delivery and economic development. Of course the reduction in funds for a region depleting the number of its civil servants would far exceed the increase in non-wage funds it would receive in compensation. And all regions would receive some additional equalization funds whether they cut their staff rosters or not. These features weaken reformers’ incentives. All things considered, therefore, the DAU allocation scheme probably does serve as some disincentive to reducing excess personnel at the sub-national level. Unfortunately this is impossible to rigorously test and quantify given the dearth of data.

Another incentive that has been embedded in the DAU allocation system concerns the treatment of own-source revenues in the equalization formula. The latter is based on the difference between estimated expenditure needs and fiscal capacity. Expenditure needs are derived from a set proxies (population, area, a cost index, etc.) and fiscal capacity is based on a region’s other revenues (i.e. besides those from the DAU and also the special purpose grant—DAK—which is not included in the formulation). Potential own-source revenues are used in estimating fiscal capacity as opposed to actual revenues, whereas actual revenues are used for all other sources. Potential own-source revenues are determined via a simple regression model that specifies revenues as a function of gross regional domestic product (a proxy for the local tax base); a region’s potential own-source revenue is its predicted own-source revenue, as derived from the estimated model.

The intent of the formulation was to encourage regions to increase their own-source revenues, in the context of the overwhelming importance of transfers. That is, it was hoped that regions would strive to be “above the potential revenue line” so that they would be able to “keep” some portion of their own-source revenues alongside DAU allocations. The argument was that the incentive would be helpful in guarding against the common outcome of declining local tax effort and local revenues in the face of large and/or increasing intergovernmental transfers.

As it turns out, the empirical evidence shows that growing central-local transfers are associated with rising own-source revenues in Indonesia. It is doubtful, however, that this result is a consequence of the scheme outlined just above. The idea was never understood by regional government officials, in the first instance, and the feature has recently been eliminated from the
DAU allocation methodology. A more likely explanation is that increased transfers lead to increased reserve funds, which in turn lead to increased interest earnings, a form of own-source revenue. Recent analysis (Lewis and Suharnoko, 2006) suggests that increased interest earnings on unspent balances may explain up to half of the increase in own-source revenues in the post-decentralization period.\(^3\)

Scant other evidence exists on the impact of the intergovernmental transfer scheme on local fiscal outcomes. Lewis (2005) shows that increasing transfers lead to fairly predictable increases in local government spending and savings and that rich local governments (i.e. those with substantial natural resource revenues) spend less and save more of transfer increases at the margin than non-rich local governments. The study also shows that increases in transfers lead to increased local own-source revenues (as mentioned above) for both rich and non-rich regions. Another study (Lewis 2006) demonstrates that increasing transfers to local governments are associated with reduced cost efficiency in local tax administration. More empirical analysis of the relevant issues would be useful.

**Mandates**

The best known spending mandate in Indonesia relates to the education sector. The constitution stipulates that 20 percent of both central and sub-national government spending must be allocated to education activities. Furthermore, recent law (UU 20/03) specifies that school personnel expenses are not to be included in the 20 percent calculation. That is, government must spend 20 percent of public funds on education above and beyond teacher salaries.

As noted above, sub-national governments currently spend about 29 percent of their budgets on education. But 80 percent of such spending is devoted to teacher salaries, leaving just 6 percent of sub-national budgets devoted to non-personnel education spending. In order to reach the 20 percent requirement, sub-national governments would need to allocate an additional Rp 21 trillion to education, thereby making the share of education (including teacher salaries) about 45 percent of total budgets. The budget shares of other sectors would need to be reduced commensurately.

The direct impact of this mandate on sub-national education spending is unclear. At the central level, the 20 percent rule certainly strengthens the hand of the Ministry of National Education (MoNE) in annual budget negotiations. It probably encourages MoNE to spend more resources in the regions on functions that have already been decentralized than it otherwise would (since it is difficult for MoNE to spend significantly on its own proper functions).\(^4\) Such spending may actually crowd out sub-national government education spending and reduce the efficiency of

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\(^3\) Between 1999/00 (the last full fiscal year before decentralization) and 2004, 46 percent of the increase in own-source revenues is accounted for by interest earnings on bank deposits. In addition, about 20 percent of the increase was derived from the electricity sales tax (administered by PLN) and another 20 percent was from "other" user charges (mostly newly created charges). Finally, about 10 percent of the absolute increase in own-source revenues was from puskesmas health fees (Lewis and Suharnoko, 2006).

\(^4\) In 2004, MoNE spent about Rp 7.3 trillion in the regions on apparently decentralized functions; kabupaten/kota and provinces spent Rp 39.8 trillion and Rp 3.8 trillion, respectively. See Lewis and Chakeri (2004) for a discussion of central spending in the regions on sub-national functions.
overall education expenditure. On the whole it would seem that the education spending mandate is neither realistic nor desirable.

Starting in 2009, relevant sub-national governments will be awarded an additional 0.5 percent share of state oil and gas revenues. At that time, sub-national shares will rise to 15.5 percent and 30.5 percent of total domestic oil and gas revenues. According to law (UU 33/04), recipient sub-nationals must spend the additional 0.5 percent on education. Neither the law nor regulations mention how achievement of this requirement will be monitored by the central government nor what sanctions will be applied should it not be observed by sub-nationals. As such, it is difficult to see how this particular spending mandate will have any real impact.

With a view to improving the targeting of sub-national expenditures, the Ministry of Home Affairs (MoHA) is currently organizing the development of minimum service standards for core sub-national functions; the approach has been codified in a recent government regulation (PP 65/05). Minimum service standards are at varying stages of readiness across the full range of sectors in which they are being developed. Those for education and health are in a relatively advanced state.

This is government’s second attempt at developing a system of minimum service standards. An examination of the standards set for local public education, developed during the first phase, revealed that they were excessive in number, confusingly mixed in type (i.e. input, output, and outcome), and internally inconsistent. More importantly perhaps, the fiscal viability of achieving standards in education and other sectors was judged to be more than a little dubious (Lewis, 2003).  

While round two of the government’s efforts on developing minimum service standards might result in better outcomes, this is far from a foregone conclusion. A recent study of Indonesia’s current overall approach to setting minimum service standards concludes that prospects of successful implementation are doubtful (Ferrazzi, 2005). Impact can only be determined after sufficient time has elapsed, of course, presuming that the effort is actually implemented this time. But at present the most likely outcome would appear to be one of unrealistic, unfunded, and unenforceable mandates. As such, it would not be expected that minimum service standards would have much success in focusing sub-national expenditures on priority tasks, as intended.

Restrictions

The intergovernmental regulatory framework places a number of restrictions on sub-national borrowing, the intent of which are to avoid “excessive” debt accumulation at the regional level. Limits and other conditions placed on sub-national borrowing include both “micro” and “macro” restrictions. Micro restrictions apply to the amounts that may be borrowed by any individual sub-national government. Outstanding debt of a sub-national government may not exceed 75% of the previous year’s general revenues. In addition, a sub-national government’s debt service coverage ratio (defined as general revenues net of civil servant salaries and local parliament expenditures

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5 Work is currently underway at DSF to estimate costs of achieving newly developed minimum service standards in health and education.
divided by debt service obligations) must be at least 2.5. Finally, a sub-national government may not borrow if it is in arrears on its debt repayments to the central government.

Sub-national borrowing must also comply with certain macro aggregate restrictions. There are two such limits. Consolidated public sector debt must not exceed 60% of GDP, and the consolidated public sector annual deficit (which may be financed by borrowing) must not exceed 3% of GDP. The central government may use the above aggregate restrictions to set overall borrowing limits for provinces and local governments, as well as those for individual sub-national governments (i.e. above and beyond those described here) if it sees fit to do so (although it has not as of yet).

In the event, sub-national borrowing has been far from excessive from a macro-economic point of view. By the end of 2004, the total outstanding debt of sub-national governments and water enterprises was Rp 4.2 trillion; by comparison, the outstanding debt of the central government at the end of 2004 was Rp 1,291.3 trillion. The cumulative amount borrowed by sub-nationals from 1975 through 2004 was Rp 5.7 trillion in nominal terms or Rp 26.2 trillion in constant 2004 terms; these figures represent about 0.2% and 0.9% of 2004 GDP, respectively. The main reason for such limited borrowing has more to do with weak demand and supply constraints than with the regulatory constraints discussed above (Lewis, 2006).

On the other hand, sub-national borrowing might be judged excessive in that, although amounts borrowed have been relatively limited, repayment of loans has been poor. That is, any amount of loans is excessive if loans are unpaid. At the end of 2004, total payments due were Rp 7.1 trillion, of which only Rp 3.4 trillion had been paid—an arrears rate of 48 percent. This is less a failure of the regulatory limits noted above however, than it is a demonstration of central government inattention to loan administration and unwillingness to employ available sanctions (see more below).

Since decentralization, the size of some allowances paid to sub-national executives and parliamentarians has been restricted in regulation by the fiscal capacity of the sub-national governments. In these instances, fiscal capacity has been defined as a function of own-source revenues. Currently, for example, the amount of communications and operational allowances provided to DPRD members is based on whether the sub-national government is a high, middle, or low fiscal capacity region. Again, the fiscal capacity categorization is related to the level of own-source revenues.

The intent of these restrictions has been to shelter poor regions from excess burdens associated with the payment of allowances. While the restrictions may, in fact, do that, they also provide a clear incentive for increasing own-source revenue. While this may be judged a good thing, in general, positive effects are diminished if the increase in own-source revenues goes to support increased administrative spending.

Sanctions

Most sanctions in the Indonesian intergovernmental system revolve around delaying or cutting regional “balance funds” (i.e. intergovernmental revenue sharing and DAU transfers). The center
may delay payment of balance funds to a sub-national government that fails to report its finances to the Ministry of Finance as required by law, for example. Or it may cut ("intercept") a sub-national’s balance funds if the latter does not repay a loan taken from the central government on time or in full.

Until recently, the government had proved reluctant to employ such sanctions. But in June of 2006, the Ministry of Finance delayed DAU transfers to five local governments (3 in Papua, 1 in South Sulawesi, and 1 in Central Java) that had not submitted their 2006 budgets to the ministry, as required. Within one week, four of the five local governments had complied with the budget submission obligation and within two weeks the remaining kabupaten had also turned in its budget.

Despite this success, the central government remains disinclined to employ the sanction related to loan non-repayment however. One stated reason for its lack of enthusiasm relates to some uncertainty about whether the intercept may be applied to loans taken out before it was legally introduced (Law 25 was issued in 1999 and began implementation in 2001). But at least four local governments that took out loans from the central government after 1999 (two of which borrowed after 2001) are currently in default. The center could apply the intercept to these cases without concern about the timing issue but has so far at least chosen not to do so.

Summary and Conclusions

Overall, the Indonesian experience with attempts to structure incentives (broadly defined) into the intergovernmental system has been rather ad-hoc. There has been no systematic approach to the design of the incentive structure. Partly this is the result of different central government departments operating independently in devising the mechanisms (Ministry of Education: 20 percent education spending rule; Ministry of Home Affairs: spending restrictions on local parliamentary allowances and minimum service standard mandates; Ministry of Finance: property tax and own-source revenue performance incentives; sub-national debt restrictions; balance fund sanctions, among others). Other times it is a consequence of one central agency out-maneuvering another, as in the case of the requirement that the DAU cover the sub-national wage bill. (The Ministry of Home Affairs insisted on this principle, overriding the objectives of the Ministry of Finance). On many occasions it is a function of a single central agency working in a non-strategic manner, as is the case with many of the incentives created by the Ministry of Finance.

Lax or partial implementation of incentives would appear to be the rule. Use of property tax and own-source revenue incentives has been inconsistent. And as noted, the central government has proved reluctant to intercept balance funds of regions that fail to repay central government loans. Legally mandated incentives are of little use if government is not prepared to act on them.

Several incentive mechanisms have not yet been legally activated and therefore not yet implemented. This set contains the mandated expenditure on education of 0.5 percent in oil and gas transfers as well as the institution of minimum service standards. The Ministry of Finance has no monitoring mechanisms in place for the former suggesting a lack of serious intent. The government is counting heavily on the implementation of minimum service standards to focus
sub-national spending on priority activities. But past experience with such standards in Indonesia is inauspicious and expectations are not high for full and successful implementation.

In many cases, incentives structured into the intergovernmental system and implemented would not appear to have had any discernable (intentional) impact. This is most certainly the case with the macro restrictions on sub-national borrowing discussed above. In other cases, any impact that has occurred would seem to have been unintended and perverse, although the magnitude of these effects is hard to judge. Here one could cite DAU coverage of sub-national civil servant wages, the 20 percent rule for education spending, and fixing DPRD allowances to own-source revenues. The first probably functions as a disincentive for rationalizing sub-national staff levels; the second has arguably led to reductions in the efficiency of education spending; and the third probably contributes to excessive administrative expenditure.

At least one mechanism has had quite striking impact. This comes in the form of the balance fund sanction. The recent (partial) withholding of DAU transfers to regions that did not comply with budget reporting requirements led offending sub-nationals to almost immediately conform to relevant regulations. This suggests the kind of positive impact incentives may have if designed and employed correctly.