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Intergovernmental Loans: Their Fit into a Transfer System

DANA WEIST¹
The World Bank

1. Introduction

Governments decentralize for various political and economic reasons. It can be a means to move decision making closer to people, to enhance the efficiency and responsiveness of service delivery, and to make tax systems more productive. In some countries, it may also promote national cohesion (e.g., Indonesia). Done well, decentralization can lead to all of the benefits promised by a multi-tiered intergovernmental system: better public services, enhanced local accountability, and a potential tool for poverty alleviation. But if decentralization is done badly, it can lead to macroeconomic instability, deterioration in service delivery, corruption and collapse of the safety net.²

Decentralization outcomes depend critically on the soundness of its design – which spans political, fiscal, and administrative policies and institutions – and thoroughness of implementation (Litvack, et al. 1999). The key challenges are to balance responsibilities with accountability and resources, and to create incentives for the implementation of decentralization to match formal decentralization arrangements. These arrangements involve a combination of intergovernmental fiscal relations (expenditure and tax assignments, intergovernmental transfers/grants, and regulations for subnational borrowing), accountability mechanisms (electoral rules, transparency and information dissemination, channels for participation), channels for administrative responsibility and oversight (civil service arrangements, monitoring capacity), and programs to build local capacity. These arrangements should be thought of as a system,

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² See for example, Bardhan and Mookherjee (2000), Crook and Manor (1998), Kahkonen and Lahni (2001), and Prud'homme (1994).

with the component parts being internally consistent and designed to minimize unintended consequences (Bahl 2000).

Matching grants (transfers) to support specific types of investments are a common element of intergovernmental finance systems around the world. They are usually justified on the basis of the existence of spillover benefits or central government interest in priority programs such as health or environmental protection (Bird and Smart, 2001). The level of central government transfers for any type of investment should be determined by balancing the priority of the investment from the central government perspective with the affordability of long-term transfers at the national level, and with the need for local support. Matching grants have the advantage that they require some local revenue effort and demonstrated ownership. However, determining the proper matching share can be quite complicated.

Some argue that matching grants favor better-off local governments who can afford to match larger amounts, or conversely, penalize poorer local governments who cannot afford the matching requirement and may therefore forego the investment. Others argue that the larger investments needed in wealthier local governments are proportional to the matching funds received and that equity is not a concern. If one believes that uniform matching rates are inequitable, the income level of the local government could be used to differentiate the matching rate.

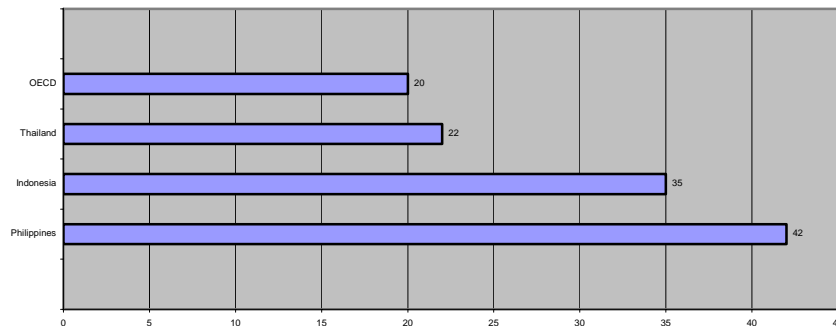
This paper focuses on the importance of integrating capital financing systems (intergovernmental loans and transfers) with intergovernmental transfer systems. These two systems are often considered separately, with often unintended outcomes. Most recognize that without predictable transfers from higher levels of government, local governments are often unable to finance basic service delivery or infrastructure investment. However, linkages between the two systems affect other areas as well. To pursue equalization objectives, promote an efficient use of resources, and develop municipal credit systems, intergovernmental loans and transfers should be integrated within a consistent financing framework. Without such a framework, poorer local governments are unlikely to invest in needed infrastructure, and intergovernmental transfers may impede the development of a local credit market, especially when grants are available for the most creditworthy borrowers for infrastructure investments that could be financed through borrowing. The paper focuses on the capital financing systems for local governments in three East Asian countries, and reviews the outcomes of lack of integration of these systems, and the challenges of establishing a consistent financing framework.

2. Overview of Decentralization in East Asia

Decentralization is occurring around the world, and fundamentally changing the role that subnational governments play in delivering and financing services.³ Unlike Latin America and Central and Eastern Europe, which went through substantial periods of decentralization in the 1980s and 1990s, decentralization is a more recent phenomenon in East Asia. The Philippines first embarked on intergovernmental reform in 1991, with the enactment of its far-reaching Local Government Code. In 1994, as a response to the pressures of globalization and to manage the transition from a command to a market-oriented economy, China initiated a comprehensive fiscal reform program (the tax sharing system), which has profoundly affected the balance of powers between central and local governments. The 1997 Thai Constitution mandates decentralization to local administrations. In January 2001, Indonesia launched a “big bang” approach to decentralization that has substantially changed the way that public services are financed and delivered.

The growing subnational responsibility for service delivery and financing is shown in Figure 1 below, which shows the subnational share of total revenues collected in Indonesia, the Philippines, and Thailand.⁴ By comparison, subnational governments in the OECD account, on average, for only 20 percent of total revenue collections.

Figure 1. Subnational Revenues as a Share of Total Revenues, Selected Countries



Working at the subnational level in East Asia is complicated by the large number of local governments, and the limited role of the province. As shown below in Table 1, substantial service delivery responsibility has been devolved to 348 districts in Indonesia, about 1,500 cities and municipalities in the Philippines, and almost 7,000 local governments in Thailand. In addition to the complexity of dealing with numerous local governments, many of them have limited capacity to discharge their newly delegated responsibilities.

³Of the 75 developing and transition countries with population greater than 5 million, all but 12 claim to be embarking on some form of fiscal decentralization. See Burki et al. (1999).

⁴Decentralization is also a prominent issue in “smaller” countries – e.g., Cambodia, Laos, Mongolia, Papua New Guinea, and Vietnam, although these countries are not addressed directly in this paper.

Table 1. Structure of Local Governments, Selected East Asian Countries⁵

	Tier 1	Tier 2	Tier 3
Indonesia	30 Provinces	348 Districts, Municipalities	4,038 Kabupaten 68,783 Villages
The Philippines	80 Provinces	114 Cities 1496 Municipalities	41,945 <i>Barangays</i>
Thailand	75 Provinces, 811 Districts	1129 Municipalities, Bangkok, Pattaya	6746 <i>Tambon</i> Administrative Org

Table 2 below summarizes some of the key elements of a well designed intergovernmental fiscal framework, namely:⁶

- clearly defined and reasonable expenditure responsibilities
- local revenue autonomy
- a stable, predictable and formula based transfer system
- framework for responsible borrowing
- consistent financing framework, that promotes the integration of grant and loan financing

The Table shows that the Philippines has the strongest intergovernmental fiscal arrangements (though with scope for improvement), perhaps because of its longer experience with decentralization. Most of these elements are weak in Indonesia and Thailand. It's notable that none of the three countries has a well developed system of capital transfers for infrastructure investment – such transfers are relatively small in the Philippines, the DAK is not fully operational in Indonesia, and most capital transfers are allocated based on political decisions in Thailand.

In developing countries, investment loans or grants for financing local infrastructure typically flow either through a central ministry (e.g., Ministry of Finance, Ministry of Local Government), sectoral ministries (e.g., Ministry of Health), or a financial intermediary (e.g., a Municipal Development Fund). The experience of financial intermediaries has been mixed.⁷ Those intermediaries that have used transparent eligibility criteria for defining local governments and types of projects, financed economically and financially viable projects, had high repayment rates, used market-based interest rates, and encouraged the development of private credit markets for subnational lending have been the most successful. Many intermediaries do not meet these characteristics, with credit directed for political purposes, high default rates, subsidized interest rates, and impediments to the development of private credit markets.

Figure 1 below shows that five, key elements are needed to establish a municipal credit system: (i) creditworthy local governments, (ii) viable projects, (iii) financing through a financial intermediary or credit market, (iv) a supportive intergovernmental

⁵ See World Bank (2003a, 2003b),

⁶ Mechanisms for local accountability are a critical element of an intergovernmental fiscal framework, but they are not discussed in this section.

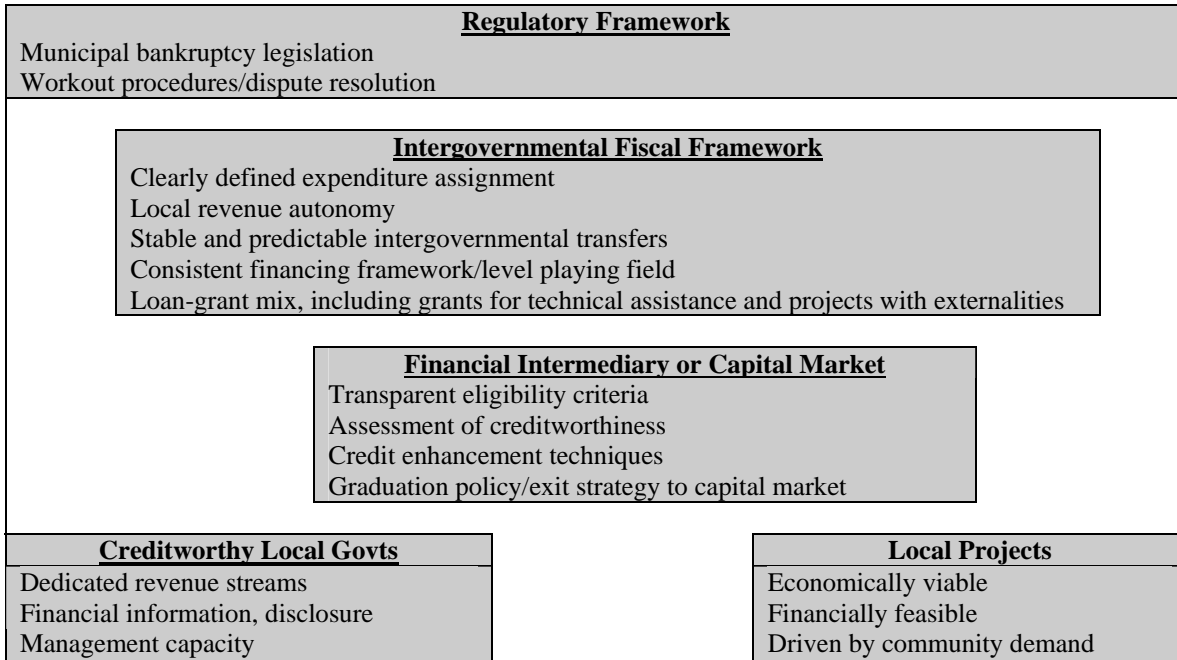
⁷ See for example, George Peterson, *Building Local Credit Systems*, Urban Management Program Policy Paper, August 1997.

fiscal system, and (v) an overall regulatory framework. The weaknesses in intergovernmental fiscal systems noted in Table 2 introduce several impediments to the development of a municipal credit system, which are discussed in each country context below.

Table 2. Assessment of Intergovernmental Fiscal Relations in Selected East Asian Countries

	Indonesia	The Philippines	Thailand
Clearly defined and reasonable expenditure responsibilities?	Somewhat. Central government retains responsibility only for judiciary, religious affairs, national defense and security, fiscal and monetary affairs, and international diplomacy; provincial role very limited; inconsistencies among laws, regulations, and decrees; confusion about minimum service standards	Mostly. Many functions devolved; unclear devolution of environment, natural resources and infrastructure. LGUs can join cooperative units in delivering services. Central government imposes unfunded mandates and wields undue influence in some areas.	Somewhat. 245 functions are being devolved in phased manner. Central government still actively providing “local” services; sectoral decentralization of health and education distinct from devolution to local governments.
Local revenue autonomy? <ul style="list-style-type: none"> ▪ Local revenue sources ▪ Ability to set tax rates ▪ Administrative capacity 	Limited. Limited local tax bases, some discretion in setting tax rates; weak administrative capacity, much scope for nuisance taxes	Yes, though ample scope for expansion of Real Property Tax, local business tax; and other user charges. Limited authority to increase tax rates.	No. Very limited local taxes; revisions in local tax laws under discussion for past 10 years; weak capacity
Stable, predictable and formula based transfer system? <ul style="list-style-type: none"> ▪ Equalization ▪ Public goods/externalities 	Somewhat. Significant reliance on shared taxes (huge disparities in natural resources); DAU (equalization) is formula-based; DAK (matching grants) relatively unused.	Yes. IRA formula stable and generally predictable; equalization could be improved; ODA for cost sharing; augmentation funds confuse responsibility.	Somewhat. Formula-based transfer system is slowly being implemented; other transfers (especially for capital projects) distributed on <i>ad hoc</i> basis.
Framework for responsible borrowing? <ul style="list-style-type: none"> ▪ Legal basis for borrowing ▪ Hard budget constraint 	Somewhat. Legally permitted, but currently on hold. Local borrowing limited by rules. Need for prudential regulation of subnational borrowing, work-out arrangements. Small local tax base undermines hard budget constraint	Yes. Most borrowing through MDF or GFIs. Debt service limited to 20% of income. Need for prudential regulation of subnational borrowing; work-out arrangements	Yes. RUDF established with small market. Working on municipal bankruptcy code. Need for prudential regulation of subnational borrowing; work-out arrangements
Consistent financing framework? <ul style="list-style-type: none"> ▪ Economic and financially viable projects ▪ High loan repayment rates ▪ Integration of financing and transfer systems ▪ Promote private capital markets 	No. Onlending complicated by KMK35 and RDA/RDI flawed, with many local government defaults	Yes, but. IRA intercept provision assures high repayment for MDF and GFIs; DOF/NEDA financing framework never implemented; impediments to competitive local capital markets	No. RUDF promotes viable projects and loan repayment. Lack of integration between transfer system and onlending system. MOF is discussing establishment of Credit Guarantee Corporation.

Figure 1. Building Blocks of a Municipal Credit System



3. The Philippines Experience

The Local Government Code shifted many functions and revenues to Local Government Units (LGUs) in the Philippines, which include provinces, cities and municipalities. It provides LGUs with a formula-based fiscal transfer to support their responsibilities. The Code defines the total Internal Revenue Allotment (IRA) in any one year as 40 percent of the gross national (internal) government tax revenues averaged over the three years prior to the current year. The IRA provides all LGUs with direct, unrestricted transfers. It is allocated first among subnational levels -- 23 percent to provinces and cities, 34 percent to municipalities, and 20 percent to *barangays* – and then within level by a formula based on population (50 percent), land area (25 percent) and equal share (25 percent).

The IRA accounts for 94 percent of total transfers (World Bank, 2003b). Categorical grants to LGUs are relatively small, and come from various sources: (i) lump sum allocations under the General Appropriations Act (GAA) of various years, (ii) allocations made by national government sector agencies from their own budgets, and (iii) lump sum and/or line item appropriations at the direction of legislators. The Code does not mention matching grants. Transfers account for more than three-quarters of provincial and municipal revenues. Cities, however, have more financial autonomy, relying on the IRA for about 40 percent of their income.

Prior to 1991, LGUs were restricted to borrowing from Government Financial Institutions (GFIs) for their capital financing requirements, including various government banks and the Municipal Development Fund (MDF). Local government borrowing was never a substantial source of LGU financing, compared to revenues from sources such as the IRA, grants and local taxes.⁸ In the mid-1980s, GFIs stopped lending to LGUs because of mounting LGU loan arrears and defaults. The national government instituted a first debt relief program for LGUs in the 1980s and a second one after the enactment of the Code, giving LGUs a clean slate vis-à-vis government lenders. The 1991 Code allowed local governments to float their own bonds, enter into build-operate-transfer arrangements and, in general, tap various sources of credit financing. LGUs were no longer confined to sourcing credit from GFIs.

To support the Code's decentralization objectives, in 1996 the Department of Finance (DOF) prepared an LGU Financing Framework.⁹ The Framework defined a vision and an action program for moving to market-based financing of LGU capital investments. The vision was anchored on two premises:

“First, LGUs have varying levels and records of creditworthiness and bankability. Second, their financing needs are huge. Therefore, the private sector (BOT investors, bondholders, commercial banks), the GFIs and MDF all have a role to play in meeting LGU financing needs....The ultimate objective is to graduate LGUs to private sources of capital which are vast and promising, but remain largely untapped.”

The Framework recommended that steps be taken to achieve seven reform objectives: (i) increase LGU use of BOT (build-operate-transfer) arrangements; (ii) develop the LGU bond market; (iii) promote LGU access to private banks; (iv) optimize the involvement of GFIs in LGU financing; (v) restructure and reorient the MDF; (vi) improve LGU capacity to raise their own revenues; and (vii) tap ODA technical assistance and financing.

As part of this Framework, the Inter-government Coordinating Council (ICC) and the National Economic Development Authority (NEDA) developed a matrix specifying the loan-grant-equity mix that would apply to LGU projects which required loan or grant financing, whether the project was supported by multilateral or national funds. The matrix was an attempt to enhance the transparency of subsidies for LGU programs, to clarify the eligibility of certain investments for matching grants, and to specify the matching grant formula that would be applied to projects of certain types, for LGUs of a given class. However, support for the loan-grant-equity mix formula declined with changes in government administration, and it was used only for projects implemented by the Municipal Development Fund Office (MDFO), which must adhere to World Bank conditions on the use of its loan funds.

⁸ On average, LGU borrowing accounted for only 1.25 percent of their total income for the period 1981-1993 (2.0 percent for cities, 0.5 percent for municipalities and 1.35 percent for provinces). See Llanto et al. (1996).

⁹ The Framework was published in 1996 and presented at a Consultative Group meeting in Tokyo in 1997.

The principles and strategy embodied in the framework are still valid and are important to the Philippines decentralization process. Yet, the framework has only been weakly implemented. As a result, LGU borrowing for critical investments occurs in a non-competitive environment, and funds from multilateral sources are channeled in inefficient ways. For example, the World Bank's own projects do not always assure the same credit conditions, which leads to instances where LGUs invest in certain types of infrastructure because of the more lenient credit terms, rather than because of the soundness of the investment or its contribution to the community.

Little progress has been achieved in enabling LGUs to access private capital based on creditworthiness; the MDFO, the Development Bank of the Philippines (DBP) and the Land Bank of the Philippines (LBP) monopolize the LGU credit market (World Bank, 2003b). Private financial institutions have no market presence – their inability to become depository banks for LGUs impedes their entry into this market. Further, only government finance institutions can intercept the IRA transfer to guarantee local repayments, which disadvantages private banks, and hardly creates a “level playing field.” With almost no mobilization of domestic capital, almost all long-term credit to LGUs is provided through Official Development Assistance (ODA).

The most significant development has been the creation of an LGU Guarantee Corporation (LGUGC) to guarantee debt issues financed from private sources. The LGUGC is the first privately-managed local government guarantee corporation established in a developing country in Asia. Since the inception of the LGUGC, six LGU bond issues have been floated (totaling PhP1.35 billion), all with the guarantee of LGUGC.¹⁰

The loan-grant-equity matrix has been implemented inconsistently. Though recent cost-sharing schemes reflect significant progress in rationalizing LGU grant policies, much more remains to be done, including making an inventory of all budgetary resources going to LGUs; developing a transparent formula for matching grants for all eligible LGU projects, regardless of funding source; and clarifying the grant-making mechanism for LGUs.¹¹ Successful implementation of the policy would further require that the Philippines Government consistently apply the policy, and that multilateral and bilateral donors “play by the rules” established.

4. Thailand's Experience

Prior to FY01, over 70 percent of the intergovernmental grants in Thailand were allocated for specific investment projects. The Ministry of Interior allocated these grants in an *ad hoc* and highly politicized manner. The amounts allocated varied greatly from year-to-year, and actual allocations were not known until well after the fiscal year began. Hence the basic requirement of a decentralized system having transparent and stable

¹⁰ Note that the total amount guaranteed by the LGUGC to date is roughly equivalent to the outstanding portfolio of the Development Bank of the Philippines but is substantially less than the outstanding LGU portfolio of the Land Bank.

¹¹ The cost-sharing arrangement is dependent on the sector of the grant, and typically follows a certain percentage sharing between the national government and the LGU. See World Bank (2003b).

intergovernmental transfers was violated. Nor did the grants reflect the broader intergovernmental framework and the vertical fiscal imbalance between the central and local governments.

Since the decentralization reforms have begun, the intergovernmental transfer system has been in a process of transition. The National Decentralization Committee determines the amount of shared taxes and grants, as well as how they are allocated to local governments. The Department of Local Government Promotion in the Ministry of Interior allocates grants to local governments. From FY00 to FY03, the total amount of grants (the “distributable pool”) and the allocation criteria differed every year. In FY02, for example, good governance and tax effort grants were initiated, which were discontinued in FY03. In FY04, a portion of the general purpose grant will be allocated to enhance local revenue mobilization. Specific grants are declining in importance, while general grants are increasing as an incentive to encourage the performance of the mandatory functions specified in the Decentralization Action Plan. Encouragingly, the share of grants allocated as specific grants has declined from 60 percent in FY01 to 20 percent in FY04. In FY04, 40 percent of general grants were allocated to municipalities, 54 percent to *tambon* administrative organizations, and 6.6 percent to provincial administrative organizations, to implement the decentralized functions defined by the Decentralization Action Plan. General grants are allocated in six categories: (i) fiscal equalization, (ii) tax effort promotion, (iii) local good governance promotion, (iv) devolution of compulsory functions, (v) train ticket compensation, (vi) local development, and (vii) education.

Equalization transfers are among the largest general transfers (44 percent of total general transfers in FY04), and they are allocated by formula based on the following factors: (i) an equal share (25 percent), (ii) population (30 percent), (iii) area (5 percent), (iv) inverse of local own revenue mobilization (20 percent), and (v) inverse of specific grants (20 percent). While these equalization transfers are a welcome addition to the intergovernmental fiscal system in promoting predictability, it is not yet known whether they have equalized differences in fiscal capacity or expenditure need.

The decentralization objectives espoused in the new Constitution are being implemented (albeit slowly), and by the end of 2001, local governments – including provincial administrative organizations, municipalities and *tambon* administrative organizations -- provided about 20 percent of government goods and services. Many of the 980 new municipalities will need to invest in their infrastructure to fulfill their new responsibilities.

In support of its decentralization objectives, and as a means to build local capacity and develop a municipal credit market, in 1997 the Thai Government began preparing a financial intermediary called the Regional Urban Development Fund (RUDF.) When the RUDF was initially designed, the Thai economy was growing. The situation changed drastically during the East Asian economic crisis, and many unanticipated events delayed the RUDF’s implementation, including volatile financial markets, declining local government revenues, and various Government programs that competed with the RUDF

in providing “cheaper” funds for local infrastructure. These funds were included both grants (e.g. Miyazawa funds for economic stimulus during the crisis, Senatorial allocations) or below-market loans with easier terms available from other government agencies (e.g., Municipal Development Fund, Ministry of Interior’s Cooperative Fund.) For example, few other funds require full feasibility studies to be eligible for loan funding.

The initial design underestimated the effort and new learning required by municipalities to participate in the RUDF program; municipalities’ knowledge and skills in subproject preparation and analysis (including feasibility studies), managing revenue-generating assets, and engaging the community in municipal decision making were rudimentary, at best. Nonetheless, the RUDF has successfully achieved the following:

- established a new financial intermediary and its requisite policies and procedures,
- developed analytical tools for measuring municipal creditworthiness,
- provided technical assistance in determining subprojects, conducting feasibility studies, and organizing civic fora,
- promoted community participation in local decision making through civic fora,
- built a portfolio of economically feasible and financially viable sub-projects,¹² and
- financed an estimated Baht 620 million (approximately \$15 million) in local infrastructure.

Despite these accomplishments, the RUDF financed about half of its original projected pipeline of subprojects (\$30 million). In retrospect, the delays associated with establishing a financial intermediary during Thailand’s economic crisis were substantially underestimated, and many design aspects were overly complex and/or inappropriate.

Notably, numerous obstacles within the intergovernmental framework impeded the functioning of the RUDF. For example, the Department of Local Administration’s Municipal Development Fund and lending by the Krung Thai Bank offered municipalities lower interest rates without the conditions associated with the RUDF for prudent operation (i.e., requiring a civic forum and feasibility study, regulating local procurement activities, etc.). Some of the sub-projects prepared with technical assistance from the RUDF were subsequently financed by the Municipal Development Fund because of its lower interest rates.

When the elements of a municipal credit system are considered, Thailand has made progress in establishing a financial intermediary, strengthening the creditworthiness of *selected* municipalities, and developing a limited number of viable projects. These are important achievements, but they alone do not constitute a municipal credit system. Nor would additional financing from a credit corporation establish a viable municipal credit system.

¹² Typical local projects include: municipal office buildings, municipal markets, childrens’ centers, schools, pawnshops, a water gate, and a public library.

The decentralization objectives stated in the 1997 Constitution are being implemented, albeit slowly. By 2006, local governments are expected to account for 35 percent of government revenues and will have substantially more responsibility for providing and financing local services. In developing local capacity and promoting the development of a municipal credit market, the RUDF continues to be a key instrument to implement the government's decentralization objectives. However, unless the overall intergovernmental framework under which the RUDF operates is rationalized, the potential impact of the RUDF on strengthening the capacity of local governments and establishing a viable municipal credit system will be limited.

5. Indonesia's Experience¹³

Indonesia's law on fiscal relations (Law 25/1999) introduced significant changes in its transfer system (Hofman, et al. 2002, World Bank, 2003a). It established a general allocation grant -- the *Dana Alokasi Umum* (DAU) -- which is financed by a minimum of 25 percent of central, domestic revenues. The DAU consolidated previous transfers for local civil servants' salaries and the *Inpres* program. It is allocated among the provinces (2.5 percent), and *kota* and *kabupaten* (cities and districts, 22.5 percent each.) Allocations within levels of regional government are based on a formula, which depends on measures of expenditure needs and revenue capacity. Law 25/1999 also contains provisions for special earmarked grants, the *Dana Alokasi Khusus* (DAK). These are mainly sectoral, conditional grants designed in consultation with line ministries, but to date have been limited in use. Regional governments rely on transfers (exclusive of shared taxes) for over two-thirds of their revenues.

Indonesia's legislative framework for borrowing is defined through Law 25/1999, Government Regulation 107/2000 and a decree from the Ministry of Finance (KMK 35/2003.) Laws 22/1999 and 25/1999 allow the regions to borrow, and borrowing from foreign sources through the central government.¹⁴ Law 25/1999 states that borrowing is permitted only for projects generating a financial return, but PP107/2000 clarifies that financial returns can be direct or indirect. It further states that regions cannot have outstanding debt that exceeds 75 percent of the previous year's general revenue, and the debt-service coverage ratio must not exceed 40 percent. Regions are also permitted to borrow funds for short-term periods for cash flow management.

The legislative framework reflects a largely market-based credit system. The central government does not guarantee local government loans, and all creditor conditions are the responsibility of the local borrower. For central lending to the regions, the central government can intercept the DAU if the region fails to meet its debt service obligations—a common problem in the previous credit system, where local defaults and arrears in the RDA/RDI accounts were prevalent.

¹³ This section draws heavily on Jasmin Chakeri, KMK35: Implementation and Potential Problems, Presentation to the World Bank Indonesia Country Team, World Bank Indonesia website (undated)

¹⁴ As in the area of financial management, which is also treated in both laws, borrowing is treated a slightly different way in both laws. This overlap, and partial conflict is the result of a turf battle between two ministries which is yet to be resolved.

KMK 35/2003 permits on-lending for cost-recovery/revenue-generating projects, and defines on-granting (transfers) for non-cost recovery/non-revenue generating projects. The share of required counterpart funds depends on region's fiscal capacity, where fiscal capacity is defined as:

$$\text{General Revenues} - \text{Employee Expenditures}$$

Based on this value, regions are categorized into high, medium and low fiscal capacity, with different matching rates based on their category. Lack of clarity in the details of the on-granting framework and delays in finalizing it led to a period where local investment spending declined significantly, especially for donor funded investments, which account for a significant share of Indonesian investment.

The most recent revisions to Law 25 relax some of the restrictions related to local borrowing, and the provisions of KMK35 are less relevant. A provision in the revised law requires that regions report their borrowing and debt positions to the central government twice a year. If such reports are not provided, or payments on central government loans are not made on a timely basis, regions face the threat of delayed transfer payments for revenue sharing or the DAU.

6. The Challenges of Developing an Integrated Financing System

In the Philippines, the lack of integration between transfers and capital financing resulted in non-competitive LGU borrowing, inefficient use of funds from multilateral sources, and little progress in enabling LGUs to access private capital based on creditworthiness. In Thailand, the Government's objective of establishing a financial intermediary to support the decentralization process, build local capacity and establish a municipal credit market was impeded by inconsistencies in the intergovernmental fiscal framework. In Indonesia, the lack of a matching grant system (e.g. DAK) and delays in implementing the on-granting framework led to a period of declining infrastructure investment. In all three countries, developing a transparent formula for matching grants for all eligible local government investment projects, regardless of funding source, would substantially strengthen the intergovernmental fiscal system.

In none of the countries reviewed above has an integrated financing system been established. It could be argued that the decentralization frameworks in Indonesia and Thailand are relatively recent, and that such a framework will be fully developed once the other aspects of the intergovernmental fiscal system are further defined. As borrowing restrictions are lessened in Indonesia through the revision to Law 25, and local governments become more active borrowers in Thailand, however, the importance of such a framework is attenuated. The Philippines proposed its framework in 1996, although it has been unable to implement it in the intervening period.

What explains this poor performance? In all three countries, a substantial portion of funds from central agencies (or deconcentrated spending) for current and capital

spending flows through the system that is often unmonitored. Until such flows are measured and understood, it will be difficult to implement a consistent framework. A second problem is the multiplicity of entities involved in financing local investments – Finance, Planning, sectoral ministries, Congress/Parliament, donor agencies. Coordinating among such entities may be difficult without an overarching entity or authority responsible for overseeing the entire intergovernmental fiscal system.¹⁵

Finally, the general lack of emphasis on integration of the two systems may account for the lack of attention. The need for considering expenditure needs and fiscal capacity is well acknowledged in designing transfers for equalization objectives. Broadening the intergovernmental fiscal framework to reflect matching transfers for infrastructure investment and borrowing, may result in more systematic approaches that avoid the unintended effects of separate systems.

¹⁵ The South Africa Finance and Fiscal Commission is one of the few authorities with responsibility for intergovernmental transfers and borrowing.

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