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# Fiscal Decentralization in Indonesia: A New Approach to an Old Idea

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**Summary.** — The system for financing and delivering local public services in Indonesia, as in many developing countries, is highly centralized. Growing awareness of the weaknesses of the present system has recently generated much interest in decentralization and numerous government policies and programs toward that end. In spite of these efforts, the role and capacity of local governments remain weak. In this paper, we outline the most critical obstacles to decentralization and examine a strategy to reduce their significance. Instead of centering our analysis on the definition of a normatively desirable decentralization outcome, we focus on the development of a process through which genuinely feasible outcomes could be defined and implemented, in this case an interministerial and intergovernmental process for evaluating local governments. Copyright © 1996 Elsevier Science Ltd

## 1. INTRODUCTION

The recent history of public sector decentralization in developing countries is primarily a story of disappointing performance or outright failure. With few exceptions, the literature is full of stories about extensive and costly fiscal decentralization programs that have made only limited progress in meeting their stated goals.<sup>1</sup>

We believe the main reason for this state of affairs is that reform efforts have tended to focus on the desired outcomes of decentralization as defined by Western normative models of the public sector, rather than on the context-specific processes by which feasible and sustainable outcomes could be defined and implemented. Many initiatives have been donor driven, far too comprehensive, and inattentive to the complex institutional realities that logically govern the extent to which, and the pace at which, decentralization can occur in a particular country.

In this paper, we examine the case of Indonesia, a country which has, like many developing countries, been attempting to decentralize its public sector with heavy support from international donors for more than a decade. We briefly describe the country's centralized government system and recent decentralization efforts. Drawing on an analysis of the key reasons for

the slow progress to date, we outline a strategic process for furthering productive debate on decentralization, and, ultimately, decentralization itself.

This proposed process, which was recently adopted on an experimental basis in Indonesia and fully funded by the government, is based on a local government evaluation system that has four prominent features. First, the process strategically involves all of the key central government actors who compete with each other for local development resources and whose power is threatened by stronger local governments. Second, the process differentiates among local governments and functional tasks, so that decentralization can be defined and implemented in a gradual and selective way that maximizes the probability of success. Third, the process creates some incentives for

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appropriate behavior at both the central and local levels of government. Finally, and most important, the process provides a mechanism for the government to develop its own agenda for decentralization, more independent of the objectives of the international donors whose priorities have tended to drive expensive but ill-fated decentralization efforts.

## 2. THE PRESENT INTERGOVERNMENTAL INSTITUTIONAL FRAMEWORK

Local infrastructure services in Indonesia are developed and operated in a multitiered and complex system of regional administration (deconcentration) and regional (provincial and local) government (devolution). Many legal powers for raising revenue and providing services are vested in central government agencies, but certain functions are the responsibility of decentralized jurisdictions serving the dual role of administrative subdivisions of the central government and semi-autonomous subnational governments.<sup>2</sup>

Central government ministries and their regional offices are expected to work cooperatively with agencies of provincial and local governments in planning and implementing development projects and providing services. Overall coordination is the responsibility of Bappenas (National Development Planning Board) at the central level and the individual Bappedas (Regional Development Planning Boards) at the provincial and district level. Every five years Bappenas prepares a national development plan (Repelita), which provides the basis for preparing regional plans by the Bappedas.

Unlike in many Western countries, there is no clear division of service functions among levels of government in Indonesia. Although it is often true that the more local a service in nature, the more likely it is to be handled by a decentralized level of government, the pattern of service provision is complex and uneven across regions. Many types of services involve more than one level of government in their financing, provision or both. Even in cases where particular services are the statutory responsibility of local governments, such as urban water supplies, solid waste management and local road development, higher levels of government are usually involved to some degree with planning, design, finance and/or implementation.

On the revenue side, during the past 15 years the central government has typically financed at least 70% of total decentralized government expenditures with intergovernmental grants, often with another 10–15% coming from shared central revenue sources.<sup>3</sup> Decentralized governments' own sources of revenue, primarily minor taxes and user charges, are subject to central control, and many of them are not particularly productive. Finally, loan financing is a

minor but growing source of revenue for many decentralized governments.<sup>4</sup>

## 3. HISTORY/OVERVIEW OF DECENTRALIZATION EFFORTS

Indonesia is a unitary state, so that provincial and local governments are the creation of the central government. During most of the colonial period, government administration was highly centralized, although municipalities were more autonomous than at present. The present centralized system of field administration was functioning in some areas of the country by the early part of this century.<sup>5</sup>

### (a) *Early decentralization efforts*

A number of attempts have been made at various times in Indonesia's postindependence history to establish representative decentralized institutions and to increase the level of regional autonomy, but political considerations often sidetracked these efforts.<sup>6</sup> Establishing the unity of the country — an ethnically diverse and geographically dispersed collection of more than 14,000 islands annexed over a long period of time and under various voluntary and involuntary arrangements — has always been a major concern of national leaders, and this has tended to make Indonesia's leaders suspicious of genuine decentralization. A number of secessionist crusades have arisen over the years. Such movements still exist in Aceh (North Sumatra) and East Timor, and one has recently emerged in Irian Jaya. These movements, which are perceived by the central government as serious threats to national security, have figured prominently into the ongoing decentralization debate.

A modest turning point in the decentralization environment was reached in 1974, when Law No. 5 on "Basic Principles of Government at the Regional Level" provided a basis for the broad involvement of decentralized governments in public service provision.<sup>7</sup> Pressures arising from discontent among some provinces and latent opposition groups at the central level created an environment conducive to the passage of this law. Although it is unlikely that the government had serious intentions to decentralize at that time, the legislation did raise awareness of the potential benefits of decentralization and provided a clear legal basis for further action in the future.

### (b) *Recent decentralization efforts*

Several more recent policy documents have again established the government's official intentions to decentralize. Most important is the 1987 "Urban

Development Policies in Indonesia," which declares the development and operation of many urban services to be under the authority of decentralized governments and concretely identifies a number of their related responsibilities.<sup>8</sup> These intentions are reiterated in numerous other policy documents, and more importantly, in recent national development plans.<sup>9</sup>

In keeping with these policy objectives, a wide variety of decentralization initiatives have been undertaken by various ministries. The most prominent is the Integrated Urban Infrastructure Development Program (IUIDP), which was launched by the Ministry of Public Works in 1985. A principal goal of IUIDP is to shift the emphasis gradually away from the delivery of single, sector-specific infrastructure projects to the integrated management and organization of the urban development process as a whole.<sup>10</sup> Moreover, in contrast to the traditional "top-down" approach, the IUIDP is intended to empower local governments to determine, plan and implement their own service priorities.<sup>11</sup>

Preceding and parallel to IUIDP, a series of initiatives have been undertaken, mostly under the Ministry of Home Affairs, to strengthen the capacities of local governments in technical matters, including capital investment programming, revenue administration, service operation, maintenance management, financial planning and accounting. Although these efforts have been largely independent of IUIDP and poorly coordinated,<sup>12</sup> a proposed Ministry of Home Affairs project to be funded by the World Bank is expected to consolidate many of them.<sup>13</sup>

Another major decentralization initiative is the Urban Development Coordination Team (TKPP — Tim Koordinasi Pembangunan Perkotaan), which was established in 1987 by joint decree of the State Minister of Bappenas and the Ministers of Finance, Home Affairs and Public Works to coordinate the formulation of integrated urban development policies.<sup>14</sup> Because of TKPP's formal status as a medium for interdepartmental consultation, international development agencies and technical departments used TKPP as the principal forum for discussing and approving development project proposals. More recently, the IUIDP Management Group (IMG) was created under the leadership of Bappenas to coordinate the implementation of IUIDP.

In the area of local government finance, the Ministry of Finance enacted a new land and building tax (Pajak Bumi dan Bangunan — PBB) through Law No. 12 of 1985.<sup>15</sup> In addition, a lending facility known as the Regional Development Account (RDA) began operations in the Ministry of Finance in 1988.<sup>16</sup> The RDA is mandating the use of formal appraisal techniques for evaluating projects, standardizing interest rates on the loans it disburses, enforcing stricter repayment of loans, and consolidating major sources of loan finance for urban and regional development.<sup>17</sup>

A variety of other related efforts to reform decentralized government finance have been planned or undertaken in recent years. A comprehensive attempt to reform the system of central-local fiscal transfers was initiated during 1988 and 1989. The proposed system would have consolidated several existing grant programs and revised the block grant allocation formula to take better account of both need and resource capacity. This particular program of reforms proved controversial and was not adopted, but debate surrounding it raised awareness on grant reform issues and prepared the way for other efforts.<sup>18</sup>

### (c) *Factors underlying recent decentralization efforts*

What accounts for this reemergence of the interest in decentralization, and why should it be seen as any more genuine than previous official stances on this issue? It must be acknowledged that most recent decentralization efforts have been heavily influenced by the international donor community, as discussed below; nevertheless, there are good reasons to believe that the present efforts are far more serious from the government's perspective than anything undertaken in the past. First, as noted above, the government has actually implemented numerous decentralization initiatives, which, although deficient in many respects (discussed below), have begun to build the capacity of local governments to function more independently of the center.

Second, during the 1980s, manufacturing-led economic growth accelerated urbanization and generated a steady rise in real disposable incomes.<sup>19</sup> These trends, which have continued into the 1990s, led to a substantial increase in demand for public services in Indonesia's cities and towns, exacerbating an already serious backlog in infrastructure investment. The central government has simply been unable to keep up with the rapidly growing demand for infrastructure. This situation has serious consequences for some regions in terms of hindering economic growth and generating the political dissatisfaction that comes with the failure of the center to provide basic services.

Third, rapidly changing central fiscal conditions in recent years have more sharply focused attention on the massive budgetary implications of centralization. Current decentralization efforts have developed in the context of a steep decline in state revenue caused by the drop in oil prices in the mid-1980s, which raised serious concerns about the capacity of the central government to continue financing the major share of local infrastructure investment.<sup>20</sup> The burden on the central government is exacerbated by its standard practice of disbursing most donor loans for local infrastructure as grants, even to local governments with sufficient fis-

cal capacity to repay loans, and even for projects that should be self-financing. If debt service obligations are not met from direct returns to investment projects, they have to be covered by general revenues derived from central government taxes and export earnings.

Fourth, there has been considerable publicity regarding problems associated with the high degree of fiscal centralization in Indonesia.<sup>21</sup> These include: widespread delays in loan-financed infrastructure projects administered by overburdened central government technical departments<sup>22</sup>; reduction of the quality of many development projects<sup>23</sup>; poor fiscal accountability of weak local governments, which compromises incentives for efficient service provision and cost recovery<sup>24</sup>; failure of central agencies to take adequate account of project complementarities, preventing the public sector from responding effectively to the integrated needs of many areas<sup>25</sup>; and, persistence of a problematic, redundant administrative structure that plans and implements development projects.<sup>26</sup>

Finally, the emergence of an organized and visible opposition in Indonesia during the 1990s appears to have the current regime concerned about its image and its performance.<sup>27</sup> Although there is probably no immediate threat to the ruling party, allegations of corruption, regional bias in fund allocation, human rights abuses and generally poor service delivery have placed the government in an increasingly defensive position.

Collectively, these five considerations suggest that the present decentralization efforts of the government are serious, but they should not be seen as a genuine interest in significant political decentralization. Rather, the central government has come to realize that it cannot effectively provide and finance all public services in a country so physically large and geographically and ethnically heterogeneous. In addition, there seems to be an emerging recognition among senior politicians and bureaucrats that more fiscally effective local governments need not pose a substantial and immediate threat to the central government. On the contrary, limited measures to strengthen the local governments could be seen as decisive action to correct a growing service delivery problem that widely affects the quality of life in many parts of the country. If effective, such efforts could reflect favorably on the government at a time when some Indonesians are beginning to question its legitimacy more openly.

#### 4. PROGRESS IN DECENTRALIZATION EFFORTS

The brief catalog of initiatives provided above can leave little doubt that the Indonesian government recognizes — at least officially — the potential gains

involved in improving and decentralizing the regional development process. Although the resources devoted to such purposes continue to grow and new donor projects to assist this process continue to come on line, these efforts have yielded relatively modest results in terms of infrastructure development and the role that local governments play in it.

##### (a) *Infrastructure provision*

The most obvious problem is that infrastructure development is lagging well behind Repelita V (1989–94) targets, an issue that plagued Bappenas as it prepared the five-year development plan that took effect in 1995. There are also indications that projects being developed in many areas are inappropriately tailored to local priorities and needs, at least in part because the center continues to dominate the process of service planning and implementation.<sup>28</sup>

##### (b) *Local responsibility and central control*

The pace of decentralization has largely been left to the central government sectoral ministries involved in service provision, and most of them have had a working policy of interpreting the 1974 decentralization legislation discussed above conservatively, allowing decentralized governments to provide services only if explicitly sanctioned by subsequent official decrees and regulations. In many instances they fail to empower decentralized governments to establish service departments for specific tasks devolved to them or to provide adequate staff and access to funds for this purpose.<sup>29</sup> The result is that, except in a few large cities, such as Jakarta, Surabaya, Bandung and Medan, central government technical departments retain primary responsibility for development of many services that are formally under provincial or local government jurisdiction.

Although local participation is slowly increasing in some areas, there has generally been inadequate effort to build local capacity in project planning and implementation. The majority of documents for IUIDP and related programs have been prepared fully or largely by outside consultants appointed, controlled and paid by central government technocrats. As a result, decentralized government officials often perceive these plans to be essentially external, and, therefore, fail to identify with them and strongly support their implementation.

Another widely recognized concern is that the emphasis on infrastructure decentralization programs has focused on services under the Ministry of Public Works, where IUIDP originated.<sup>30</sup> Although it makes sense to start with a limited number of sectors when beginning a complex decentralization process, the

program was not explicitly designed for the eventual-ity of including additional services of considerable importance to other ministries and decentralized governments, such as transportation, irrigation and health care.<sup>31</sup>

Even the performance of the highly favored IUIDP sectors has been mixed. Infrastructure investment plans and strategies to enhance own-source revenues and to build local capacity have already been drafted for more than 100 local governments, and newly funded IUIDP initiatives continue to come on line each year. The timing and pace in the implementation of major projects, however, has been highly erratic, with long delays in loan negotiations and disbursement of funds.<sup>32</sup> Moreover, in spite of IUIDP's stated objectives and a directive from the Minister of Public Works to strengthen the Ministry's district offices and deconcentrate the infrastructure development process, many of the IUIDP sectors have continued to operate under strong central control.<sup>33</sup>

#### (c) *Intergovernmental fiscal relations*

Intergovernmental fiscal relations have also failed to follow expected trends in recent years. Despite pronouncements in the National Urban Development Strategy and the Repelita V emphasis on decentralizing regional finance, there has been only very modest and irregular movement towards releasing central control over the use of grants to decentralized governments. In fiscal year 1987–88, for example, general purpose (unconditional) grants accounted for 17.2% of total intergovernmental grants. By fiscal year 1990–92, this figure had increased to 18.3%, but not before falling to as low as 14.7% in fiscal year 1989–90.<sup>34</sup> Although the annual average growth rate of unconditional grants during the past decade has been slightly higher than the growth rate for specific purpose transfers, there is clearly no strong trend toward increasing local fiscal autonomy.<sup>35</sup> This situation is made more serious by the slow progress in improving the productivity and buoyancy of local own-source revenue and ensuring that potentially self-financing services more fully recover costs.<sup>36</sup>

On the loan front, the establishment of the RDA to lend to decentralized governments has yielded mixed results. On the positive side, standardized project analysis criteria and a uniform interest rate were adopted, but these have not been consistently employed, and it has been necessary to make major compromises. The RDA was established as a Ministry of Finance account rather than a semi-autonomous, demand-responsive institution, thereby leaving it somewhat vulnerable to misuse as a quasi-grant agency and undermining its accountability.<sup>37</sup> Political pressure also prevented the standardized interest rate from being set at a level consistent with establishing a

sustainable revolving fund, and there has been no attempt to link the RDA to the grant system.<sup>38</sup>

More generally, the central government has persistently failed to think systematically about local revenue generation in a broader framework of economic development and service needs. Little is understood about equity and efficiency consequences of using different sources of revenue (own-source, grants, loans) for service development, and there have been few explicit efforts to create linkages across sources, e.g., to make grants conditional on local tax capacity and effort, to make loans only to regional authorities with demonstrated capacity to repay them, etc.

#### (d) *Coordination at the central level*

There is a widespread impression among both government officials and outside analysts that mechanisms for coordinating infrastructure and decentralization policy development, particularly the TKPP, have been largely ineffective. Although the TKPP had a promising start, its efforts to coordinate infrastructure-related activities have deteriorated over time. Moreover, these activities remain poorly harmonized with and somewhat duplicative of more general decentralization and capacity-building efforts being undertaken by the government, such as the various programs under the Ministry of Home Affairs mentioned above.<sup>39</sup>

After the IUIDP Management Group (IMG) began meeting, in part to deal with the ineffectiveness of TKPP in supporting and monitoring the implementation of urban development activities, the roles of the two coordinating bodies became somewhat confused. In recent years, the TKPP has become fairly inactive, and coordination, to the extent that it occurs, is largely handled by the IMG.

#### (e) *Targeting of donor funding and technical assistance*

Partly as a result of the poor coordination discussed above, the distribution of development funds and technical assistance across ministries has been neither rationally determined nor well balanced. Although funding to other agencies has clearly increased substantially in recent years, by far the greatest share has gone to the Ministry of Public Works. This imbalance has contributed to the ability of this ministry to encroach on the substantive territory of other ministries. The capacity of ministries to absorb and manage funds and technical assistance is an important issue, and there is little doubt that the Ministry of Public Works has used such support effectively to develop IUIDP, but only on its own terms. Critics often argue that short-term expediency

in project implementation should be balanced with efforts to bring about longer term development of a rational and effective system that harmonizes and develops the expertise of the various relevant actors.

The problems caused by the skewed targeting of technical assistance are exacerbated by the inadequate coordination of technical assistance projects discussed above. Although the situation has been improving,<sup>40</sup> technical assistance project proposals have often failed to link with and build on ongoing projects. This has led to some nontrivial duplication of effort in technical assistance, particularly at the central government level.<sup>41</sup> While redundancy appears to have been less prevalent in the field, there does seem to be a problem of poorly specified terms of reference for advisers to local governments.

Although extensive delays and difficulties are to be expected in the early stages of a complex and multifaceted agenda that involves a politically and bureaucratically sensitive goal, it is very clear that the design of many Indonesian decentralization efforts failed to account for — and in some cases created or exacerbated — a number of complex and interrelated problems that should have been expected to hinder progress. We now turn to a brief examination of how this situation developed.

## 5. DEVELOPMENT OF THE PRESENT SITUATION

The complex problems discussed above raise questions about whether Indonesia's decentralization efforts might have proceeded more smoothly and if it is possible to turn the situation around. A useful starting point for considering these questions is a closer examination of the institutional origins of key reform efforts and the nature of the relationships among the key actors involved in the regional development process.

### (a) *Initiation of recent decentralization efforts*

The seeds of the Indonesian government's main problems with integrated decentralized development policies and programs were planted in their origins, which were largely donor driven and hastily developed. Faced with a steep decline in oil revenue after the mid-1980s, the government urgently needed foreign exchange. During negotiations for the First Urban Sector Loan (USLI), the World Bank persuaded government officials to agree to develop the TKPP and the RDA. It is not at all clear that Indonesian officials would have supported such efforts, at least in the form that emerged, in the absence of external pressure during a difficult period.<sup>42</sup>

### (b) *Complexity of the institutional framework*

A key reason for the deficient performance of the infrastructure development process is that the overall central government institutional framework in which it must operate is highly fragmented and complex, and no clear coordinating institution has been designated or emerged from the agencies involved. Although several reform initiatives were designed to alleviate this problem, as discussed earlier, unclearly specified ministerial portfolios and poor coordination persist because there have never been serious negotiations on how to assign responsibilities for local development across ministries.

Resolving this problem is no simple matter because some ambiguity in responsibility is inherent in particular tasks. For example, improving infrastructure project implementation requires local training and institutional development, which are in the portfolio of the Ministry of Home Affairs. It is also clear, however, that the Ministries of Public Works and Finance have important roles to play in technical training. Such overlapping jurisdiction of multifaceted projects is common, both within and across ministries.

In addition to the ambiguities regarding horizontal responsibilities at the central level, the role of decentralized levels of government and their relationship to central agencies are also not clearly and consistently defined. In some areas, local governments play a significant role in planning and implementing major infrastructure development projects. In many other areas, they have only minimal input. Such differences might be justifiable if they were based on rational grounds, e.g., varying economic resource bases, expenditure needs and administrative capacities of particular local governments, but they are in practice largely determined on a sector-by-sector basis through subjective and uncoordinated assessment of local capacity by various ministries.

### (c) *Interministerial competition*

Although the complexity of the institutional environment alone helps to explain the difficulties in decentralizing Indonesia's infrastructure provision mechanism, it is also clear that there are few, if any, incentives for the many institutions involved to work toward better coordination, either horizontally or vertically. Individual ministries and their directorates should be expected to protect their own interests first, unless there is a mechanism backed by sufficient power to enforce coordination. Similarly, central agencies should not be expected of their own accord to decentralize significant responsibilities, thereby undermining their own control over infrastructure resources.

To the extent that there is any interest in decentralization, it seems to be defined in different ways across ministries. Bappenas largely focuses on taking better account of different regional needs in central government projects, rather than handing over those projects to sub-national governments. The Ministry of Finance is primarily concerned with fiscal decentralization: strengthening local revenue sources, increasing the importance of loans relative to grants for capital financing, and restructuring grant programs to give decentralized governments more discretion. For the Ministry of Home Affairs the core goal of decentralization appears to be strengthening local institutional and manpower capacity to assume tasks currently undertaken by central sectoral ministries, but not necessarily reducing Home Affairs control over decentralized government activities. Finally, for the Ministry of Public Works, decentralization seems to mean a conventional type of deconcentration: reinforcing the power and capacity of the Ministry's field offices while limiting the decentralized government role to that of project partner.

The 1988 attempt to reform the intergovernmental transfer system mentioned above illustrates the problems that different ministerial perspectives can generate. This proposal, which originated in the Ministry of Finance, met with strong resistance from other agencies involved in allocation of regional development funds because the changes did not correspond to their vision of decentralization and reduced their independent power over fiscal flows to the regions. It is not uncommon for ministries involved in regional development to view reform initiatives proposed by "competitors" with suspicion and to withhold genuine support.

(d) *Competing donor interests*

In spite of current trends in donor rhetoric, their interests are also not well served by sectoral coordination and decentralization, and they behave accordingly. Such efforts are time consuming and difficult, and, therefore, likely to affect donors negatively by causing substantial delays in their efforts to bring new projects on line and to move funds. There are also clear indications that particular donors — who to some extent are in competition with each other to make loans and enhance their individual reputations — have tended to establish client relationships with specific ministries or divisions within ministries. These client ministries can be relied on to further objectives they share with their patron donors, such as particular sectoral or geographic interests. Such relationships can reinforce tendencies for ministries to specialize and compete with each other. Integrated decentralized planning is very difficult to implement in an environment in which key projects are indepen-

dently initiated by various donor agencies rather than developed in response to well-coordinated government policies.

(e) *Central mistrust of local governments and lack of incentives*

Central government officials — even many of those who are outspoken advocates of decentralization — have a very cautious attitude about the degree of responsibility that local governments can handle. Some of this hesitation undoubtedly derives from the perpetuation of decentralized government stereotypes in common wisdom about the way the public sector functions, and some of it relates to their self-interest in preserving the power of their ministries, as discussed above. It is also true, however, that many decentralized governments are plagued by poorly developed technical capacity and are more in need of increased technical assistance than greater autonomous responsibilities.

Even more important, the current system provides little motivation for local governments to perform well. There is no true accountability to a local constituency because decentralized level parliaments do not possess genuine political independence. Moreover, senior provincial and local officials feel that they are primarily accountable to the center, in particular to the Ministry of Home Affairs. Their deference to the center is reinforced by their dual role as decentralized government officials and regional representatives of the central agencies.<sup>43</sup> Finally, and most immediately critical, there are no real rewards and penalties in the present administrative system to encourage good performance.

(f) *Summary of obstacles to decentralization*

Although progress has been made on a number of fronts during the past few years, we paint a pessimistic picture of a system caught in a complex web of forces that constrain reform. First, glaring deficiencies abound in the institutional framework for infrastructure development. There is no clear consensus on the role of key agencies, coordination among competing agencies is lacking, and operating procedures and staff are inadequately developed.

Second, these difficult institutional problems are reinforced by the interests of donors. Donors create relationships with ministries which share their sectoral and geographical interests and have the capacity to move projects and money rapidly, fostering largely unproductive competition — not only across donor agencies, but also among their client ministries. Furthermore, there are few reasons for either donors or ministries to be interested in authentic decentraliza-

tion, which requires gradual institution building and reduces donor and central government control over resource allocation.

Finally, there are few incentives that encourage local officials to meet their responsibilities effectively and few mechanisms that allow local constituencies to exert pressure for their own needs to be met. Without such accountability — and sufficient local technical, financial and administrative capacity to give it practical meaning — the main benefits of decentralization cannot be realized.

## 6. REFORM OF THE PRESENT SYSTEM

Over the longer term, comprehensive institutional reforms will be required to make decentralized governments more efficient and accountable and to reduce interregional inequities. In the interim, a less ambitious program of reforms of both the central government institutional framework and central-local fiscal relations could greatly improve the current situation.

The critical “textbook” actions required at the central level — intended to result in the “products” of a normatively desirable system — are obvious. First, clearer decisions need to be taken regarding appropriate institutional responsibilities for activities related to regional service development and finance. Once jurisdictional issues are clarified, the government would need to ensure that a viable and properly empowered mechanism is in place to take the lead on the design and coordination of service planning and implementation. Finally, a clear mandate and schedule for at least some degree of fiscal decentralization — enforceable by a designated coordinating agency — are required.

On the central-local relations front, the steps that need to be taken are also straightforward, at least to enumerate. First, appropriate functions should be devolved to decentralized governments as per existing central government legislation. Second, powers to raise revenues from appropriate sources sufficient to cover an increasing portion of both capital and recurrent expenditures should be extended to local governments — along with adequate enforcement authority and deterrents to administrative and political interference in local revenue generation. Third, transfers should be distributed according to more rational and consistent criteria, such as service needs relative to broader development goals and fiscal capacity. This can only be done through a more explicitly coordinated system of intergovernmental grants and technical assistance. Finally, incentives to improve local resource mobilization should be incorporated into the transfer system.

We demonstrate above that many attempts have already been made to undertake some of the basic tasks included in this succinct outline of reforms. The

success of these efforts has been fairly limited, in part because some initiatives have been unworkably comprehensive, while other less ambitious efforts have focused on specific technical activities that did not deal much with fundamental institutional bottlenecks. Both comprehensive and limited decentralization initiatives have been greatly frustrated by the technical and bureaucratic complexities detailed earlier. Since genuine interdepartmental consensus and coordination seem to be the key missing elements in decentralization programs to date, we argue that future efforts should focus more strategically and pragmatically on simple but significant, cumulative steps in the right direction that are accepted by all concerned parties. Below we describe one such recent effort, an experiment with the development of a process for rating the capacity and performance of local governments. This process has begun to break down or create dialogue about some of the major problems enumerated above.

## 7. RATING LOCAL GOVERNMENT

We begin our discussion by reviewing the basic rationale behind the rating exercise. Next, we describe the most important institutional and methodological features of the undertaking. Finally, we examine how some important bureaucratic obstacles to decentralization were reduced in the course of developing and implementing the rating methodology.

### (a) *Rationale*

We argued in the preceding sections that the Indonesian government has made only modest progress in strengthening decentralized authorities and that slow progress is not surprising because extensive decentralization requires difficult fundamental changes in the way the public sector functions and the way all relevant actors perceive the system. In this context, it seems both sensible and possible to phase in greater degrees of autonomy gradually and selectively, beginning with the simpler tasks that subnational officials would most likely be able to manage successfully and with those decentralized governments identified as particularly capable. This would allow progress to be made in clearly defined ways that would not unduly and immediately threaten central bureaucracies or overwhelm the capacities of decentralized governments. With this in mind, the government decided to experiment with developing an interdepartmental process to rate local performance as a proxy for ability to assume more fiscal autonomy. The focus was on local governments rather than provincial governments because the former are, in general, considerably weaker and have more fundamental service responsibilities.

The immediate objectives of developing a system for rating local government capacity were twofold. The first purpose was to produce a workable methodology that could be used to evaluate, at least in approximate orders of magnitude, local government performance. This was necessary in order to generate evidence to counter the argument, frequently made by central officials, that local authorities were generally incompetent and unable to handle new responsibilities. The fact that common sense and experience suggested that local governments varied widely in fiscal and managerial capacity and that the best among them were perfectly capable of assuming more responsibility was insufficient to persuade these "anti-decentralization" officials. This group demanded some type of "hard" evidence of local government capability, which could only be derived from a more formal evaluative methodology.<sup>44</sup>

The second, and more innovative, intention was to use the local government rating exercise to help alleviate some of the difficult institutional obstacles to decentralization outlined above. The remainder of this section discusses more specifically how the rating exercise attempted to begin to do this.

#### (b) *Institutional description*

An interministerial task force comprised of officials from Bappenas and from the Ministries of Finance, Home Affairs, and Public Works, was created to develop a program for furthering decentralization.<sup>45</sup> Such interministerial task forces on decentralization are common — and notorious for their ineffectiveness<sup>46</sup>; moreover, systems for rating local governments have been experimented with in many countries.<sup>47</sup> As noted above, Indonesia had already tried to decentralize through various interministerial coordination committees, and a number of attempts to evaluate local governments along various dimensions had already been developed. The current experiment, however, has a number of features that distinguish it from earlier attempts that may on the surface seem similar.

First, the Institute for National Administration (LAN) was selected to chair the task force because of its perceived neutrality, that is, because it was not directly involved in planning and implementing regional development programs, and is therefore not a beneficiary of donor funds for this purpose. Most interministerial efforts in Indonesia and elsewhere have been based in a ministry that is perceived as a rival by other agencies whose cooperation is required for success. The choice of LAN was also strategic: its credibility as the lead institution was enhanced by the fact that its director served as the secretary to DPOD, a presidentially appointed Committee to Evaluate Regional Autonomy.<sup>48</sup> The idea to base the evaluation

effort in LAN emerged in discussions among members of the DPOD, whose deliberations exposed the reasons why other interministerial coordination efforts had failed.

Second, the members of the task force were chosen for their obvious interest and expertise in urban development and local government matters. The substantive areas of local government performance were also strategically defined to coincide with the interests of the key institutional players, so as to significantly involve all of the competing ministries in a cooperative way: Bappenas for overall development planning and programming capacity at the local level; the Ministry of Finance for resource mobilization capabilities of local governments; the Ministry of Home Affairs for local authority budgeting and management effectiveness; and the Ministry of Public Works for local government project design and implementation ability.<sup>49</sup>

Setting up the system in this logical and balanced way was possible because the ministers of all key participating agencies were on the DPOD, the entity that empowered the LAN task force. After the rationale for using a neutral lead institution was accepted as a way to break the impasse encountered with numerous past efforts, the ministers understood that none of their agencies could easily get a clear upper hand over the others. Under such circumstances, there were considerable pressures to devise a system in which each agency played a strong equal role. Discussion of how to do this resulted in a policy of allowing each member agency to define performance in its own way, provided that substantive justification could be provided to the task force as a whole. The technical requirements of the process and the stake that each agency had in playing a significant role thus necessitated the appointment of senior, knowledgeable persons to the task force.

As discussions regarding the role of the task force proceeded, a general feeling emerged that, as long as each key player was satisfied that their input was significant and agreed to go along with "majority opinion" in designing and implementing decentralization initiatives, the exercise would serve its intended purpose. All of the parties seemed to realize and accept that they would probably win some battles and lose others.

Third, although local government evaluation systems have been used for many purposes in both industrialized and developing countries, including credit rating and determining eligibility for participation in central government sectoral programs, we could find no examples of cases in which such systems have been used with the intention of differentiating the scope and pace of the decentralization of fiscal responsibilities to local governments.<sup>50</sup>

Finally, there was no international donor involvement in the process. There was limited foreign

technical assistance, but this was financed entirely by the Indonesian government. Although the advisors occasionally made efforts to move the process more rapidly during relatively slow periods, the overall impetus and direction for the exercise came from government officials.<sup>51</sup>

### (c) *Methodological description*

The methodology developed for rating local governments was based on a simple numerical index that covered the four substantive functions outlined above: development planning and programming; resource mobilization; budgeting and management; and project design and implementation.<sup>52</sup> The substantive work was done largely by ministerial representatives to the LAN task force and their staff, with some expatriate technical assistance provided by LAN.

The constructed index incorporates both readily available quantitative data on selected performance variables as well as provincial officials' qualitative assessments of the performance of a local authority relative to its comparable peers in the same region. The quantitative indicators included in the index are based on various standard public finance and administration considerations, such as: the adequacy of local development expenditures relative to needs, local government fiscal effort relative to capacity, local authority revenue collection performance and budgeting accuracy, and the performance of local authorities in designing and implementing development projects. The qualitative appraisals were captured through detailed structured interviews with relevant "experts" at the provincial level.<sup>53</sup> These experts were drawn from the provincial *kanwil* and *dinas* (respectively, deconcentrated offices of central government ministries and local government offices) whose work closely corresponded to the substantive areas of the LAN task force mentioned above.

The rating procedures were implemented on a trial basis in the provinces of Nusa Tenggara Barat (the western-most group of the islands east of Bali, headquartered on Lombok), Sulawesi Utara (North Sulawesi), and Jawa Timur (East Java). A province-specific composite index score was calculated for each of the local governments, which were then ranked according to their respective scores. It was considered strategically important to compare local governments within rather than across provinces and to identify some "good" local governments from each province. This was done to prevent biasing the overall results in favor of the highly developed western provinces, thereby undermining the broad ministerial and parliamentary support required for the exercise.

Local government capacity is in general a notoriously difficult concept to operationalize.<sup>54</sup> In this case, there were indeed definitional and technical difficul-

ties, as well as some disagreement among interested observers about the precise ranking of individual governments after the exercise was completed.<sup>55</sup> The method for ranking local authorities and its results, however, was broadly accepted as credible by task force participants and other interested parties. Even if the methodology itself left room for considerable improvement, the participants in the process were confident that they could use the index scores and rankings to identify local governments capable of assuming more responsibility in managing their fiscal affairs.<sup>56</sup> This consensus provided a solid basis for progress and the refinement of evaluation instruments in future rounds of the process.

## 8. DECENTRALIZATION PROBLEMS CONFRONTED

The rating exercise helped to break down some of the bureaucratic obstacles to decentralization discussed earlier in two ways. First, the newly created institutional mechanism of the LAN task force provided a direct means to attack some of the more difficult problems by producing, for the first time, a regular forum, under neutral leadership, at which concerned parties could discuss and debate their respective points of view. Second, the well-accepted analytical principles for developing the evaluation methodology themselves helped to govern discussion and mediate conflict among the members by serving as the "rules of the game" for participation on the task force. To illustrate how these two mechanisms worked in practice, we discuss their operation below *vis-à-vis* four of the most important obstacles to decentralization: lack of coordination among the main central government agencies, central-local government conflict, poor incentives for local and central government performance, and counterproductive donor organization behavior.

### (a) *Lack of coordination among central government agencies*

As already noted, one of the main obstacles to decentralization in Indonesia has been the difficulty of getting central government agencies to coordinate their activities in any common area of policy. While the formation of the LAN task force does not immediately simplify the complex institutional framework, it does provide a formal mechanism for concerned central agencies to coordinate their efforts regarding an important issue of decentralization. The task force performed its coordinating function quite well, in the sense of bringing heretofore opposed parties at the center together on a regular basis, and, more important, on an equal footing, to discuss both policy and

operational issues of concern to the decentralization agenda. Even though the lines of communication had been opened, there remained, of course, a great deal of disagreement on the nature and pace of decentralization.

In terms of the specifics of the rating exercise, early disagreements concerned the question of how best to operationalize the rather elusive concept of local government capacity. Each agency had its own particular view of how to define performance of local authorities, of course, and the initial tendency was for each group to try and force its preferred definition onto the other parties. Progress quickly became blocked. One thing the key players did agree on, however, was the general need to use "rigorous analytical methods" in evaluating local government performance, regardless of how it was eventually defined. Moreover, the participants' enthusiasm for a "scientific approach" to the question was such that they proved willing to let the well-established rules of index construction guide discussion and mediate any conflict.

These "rules of the game" had both theoretical and empirical components. At the theoretical level, the guidelines of index construction suggest that variables chosen to serve as proxies for a particular concept must be logically valid representations of the concept, such that operational variables and concepts are well matched. Moreover, if several variables are well matched to a given concept it is expected that those variables should be empirically associated with one another. That is, empirical association among well-chosen operational variables suggests, at least, the possibility of logical validity.<sup>57</sup> These general guidelines, which were of course fleshed out in much greater detail, became accepted operating principles which helped to govern debate among the participants and to produce rather quickly a list of candidate variables to be included in the operationalization of the concept of local government capacity. In the end, each agency appeared satisfied that its own particular idea of what constituted important evaluative criteria would be included in the overall methodology.

The second area of contention at the technical level concerned how to combine the chosen operational variables into a meaningful indicator of local government capacity. Much as before, each participant began by arguing for weighting his or her own favored variable more heavily relative to the variables of others in forming the final index. Normal guidelines of index construction, however, suggest the use of equal weights in averaging variables unless a clear and strong argument can be made for the adoption of another weighting scheme. Task force members found it difficult to argue logically for differential weighting procedures and, in the end, variables were weighted equally in the index. Again, the simple rules of index construction served to facilitate reaching a consensus.

The real significance of these and other rather lim-

ited technical achievements in consensus-building is their impact on the broader policy dialogue. Most importantly, these small successes helped to create an environment that was conducive to cooperation on some of the larger issues of decentralization. Alongside discussions about the rating exercise, for example, exchanges began to take place concerning how to improve the system of fiscal transfers to local governments. This contentious area of concern, long recognized as vital to improving capacity at the local level, had been on the back burner of policy making in Indonesia since earlier reform efforts discussed above became embroiled in irreconcilable conflict; the accomplishments of the rating exercise helped, in part, to move it to the fore again. One particular idea that emerged concerning central-local transfers was to assign local governments with higher scores in the evaluation exercise greater discretion over how to spend central government grants. Indeed this seems to have been adopted as one of the operating principles of the new decentralization agenda.

#### (b) *Central-local government conflict*<sup>58</sup>

A second major obstacle to decentralization in Indonesia mentioned earlier is the significant tension among different levels of government. This is, at least in part, due to the negative attitude many central officials have toward their colleagues at the provincial and local level; input from outside Jakarta is not particularly valued by central officials, and is, therefore, not usually solicited. LAN hoped that this problem might be confronted by encouraging the participation of decentralized government officials on the LAN task force. Noncentral personnel did occasionally take part, but mostly on an *ad hoc* basis. This was largely a problem of logistics: officials from outside Jakarta just could not regularly attend meetings in the capital city. Central administrators were thus able, at least initially, to continue to disregard official input from decentralized levels.

At the technical level of the rating exercise, getting many central government officials to accept the idea of incorporating provincial level input *vis-à-vis* evaluating local government performance proved difficult. Central government critics of the so-called expert assessment of local government capacity generally expressed three concerns. First, it was often asserted that provincial administrators, due to cultural conventions, would be unwilling to pass judgement on local capabilities.

Second, it was frequently claimed that, even if provincial officials were willing, they would simply be unable to assess the capacity of local governments correctly. In this regard, critics asserted that provincial officials were not skilled enough to make such judgements and/or that they would be unduly influ-

enced by inappropriate criteria (political, cultural etc.).

Third, and partly as a result of the second, it was sometimes contended that any local government evaluation methodology should be based primarily on objective, quantifiable variables. At the limit, observers maintained that an analysis of quantitative indicators would, in fact, be sufficient to rate capacity of local authorities. This would make the expert assessment redundant.

In the end, the inability of the task force to assemble rapidly the data required to generate a complete set of adequate quantitative indicators and the realization that there would undoubtedly be some interpretation problems with the quantitative variables broke down the initial opposition to the use of objective criteria. After this was accepted, it quickly became clear that the best way to get reliable subjective evaluations was through provincial government officials, who were in a much better position than their central government counterparts to evaluate local governments comparatively.

Actual experiments with the rating process indicated that provincial experts were quite willing to make relative evaluations of local government capacity, given assurances of confidentiality and appropriate authorization from the provincial governor's office. In Jawa Timur, for example, 30 out of 33 questionnaires were satisfactorily completed, a 91% response rate. The three delinquent officials all had seemingly unobjectionable reasons for failing to carry out the request.

Provincial officials also proved very able to evaluate local government performance. A statistical analysis of the results from Jawa Timur revealed that the various expert assessments of local government capacity were quite strongly correlated with one another.<sup>59</sup> The consistency of opinion suggested, at least, the possibility of valid measurement by the experts and underscored one of the key premises of the rating exercise: that there is substantial agreement on which local governments are more capable, and thus, no reason to delay the implementation of decentralization. Moreover, the expert assessments were also shown to be highly correlated with the quantitative indicators chosen earlier by central level officials. It was this fact that particularly helped to convince central personnel that provincial officials were capable of evaluating local capacity.

Finally, an empirical test was conducted in Jawa Timur of the assertion that the quantitative indicators used in the exercise should be sufficient to evaluate local governments.<sup>60</sup> The results demonstrated that these indicators could not, in fact, adequately substitute for provincial qualitative assessments, i.e., provincial official judgements clearly added something important to the overall evaluation. This rather standard application of index construction principles

helped to convince LAN task force participants that the "objective" indicators chosen by central government personnel would not, in fact, suffice in rating local governments.

Again the derived "rules of the game" proved useful in surmounting bureaucratic obstacles. In this instance, the methodological rules of index construction helped central government officials to overcome their reluctance to cooperate with those at the provincial level, at least in terms of rating local authorities. The immediate result was the construction of an index for rating capacity of local governments that incorporated both quantitative indicators and expert provincial opinion. The more important outcome was that central government bureaucrats gained a new-found appreciation for provincial government officials' general capability. This has helped to improve the lines of communication between center and region, at the very least.

#### (c) *Poor government performance incentives*

As discussed at length above, the lack of accountability to a local constituency and the high degree of control of local government activities by central agencies undermines incentives for local governments to perform their assigned tasks efficiently. While the rating system does not deal with the politically sensitive constituency problem, it does begin to provide some incentives for local governments to improve their performance.

The evaluation process is designed in such a way that those local governments with relatively higher ratings in the exercise are expected to be treated favorably in a variety of ways over time as they meet an increasingly stringent set of performance criteria. In addition, the exercise is designed to be repeated on a regular basis. Local authorities, therefore, know exactly what they have to do to upgrade their rating in future exercises, and they understand the positive consequences of doing so. This progressive, transparent process provides incentives to improve performance noticeably absent from the present system.

On the central government side, the existence of the LAN Task Force provided a forum in which representatives of the key central agencies involved in local and regional development met regularly about progress with the local evaluation exercise. Although there were no formal sanctions if a particular ministry failed to undertake some task it agreed to, there was considerable informal collective peer pressure on representatives from delinquent ministries to meet the obligations determined through task force deliberations. Thus, regular meetings of the group served as an informal enforcement mechanism to make sure that each ministry acted responsibly in carrying out its part of the negotiated process. Compliance was reinforced

by the oversight of the DPOD, which is composed of the top officials of the ministries from which the LAN task force membership is drawn. Although the informal monitoring mechanism has to date only occurred in the development of the rating exercise, it seems reasonable to assume that a similar situation could be developed during the implementation of decentralization measures at a later stage.

#### (d) *Counterproductive donor organization behavior*

The final major obstacle to decentralization discussed above concerns the sometimes counterproductive behavior of donor organizations. To minimize the possibility of undue donor influence, the LAN task force limited its membership to Indonesian government officials. This restriction was largely successful in combatting donor interference in the process, although the accomplishment was not as automatic as it might have been.

Some donors reacted to their exclusion by initiating their own, similar efforts inside other central government agencies. These endeavors have, so far at least, proved unsuccessful, largely because they appear to have ignored important institutional questions discussed above. Other donors lobbied for a more indirect involvement in the LAN endeavor. The World Bank, for example, expressed quite strong interest in assisting with some of the methodological aspects of the local government rating exercise. In this regard, the Bank favored a scheme based on the idea of a "representative tax system" (RTS). While the method was recognized by central government officials as conceptually attractive, some task force participants feared that the Bank, or perhaps its counterpart agency (Bappenas), might eventually grow to dominate the entire process if it were allowed to take part. In the end, the Bank was not taken up on its offer of methodological assistance, the stated (if not the real) reason being that data requirements of the RTS were unmanageable.

Perhaps most importantly, if the task force continues to operate over time, a greater government consensus on the meaning of decentralization is likely to emerge gradually. This raises the likelihood that government can take more complete and better directed control over decentralization, explicitly defining and coordinating the directions they want donor projects to take, rather than accepting projects designed largely on the basis of independent donor agendas.

## 9. THE FUTURE OF THE RATING EXERCISE

It is too soon to be certain about the future of Indonesia's experimental local government rating exercise and how it might be used over time to define

and implement decentralization measures. As noted above, the pilot exercise took more than two years to develop and was only tested in three of the country's 27 provinces. In spite of the slow progress and uncertainty, however, there are various hopeful signs that the exercise will have a lasting impact, even if its structure and functions change over time.

First, there is general recognition among government officials that the exercise helps to reduce the long-standing institutional obstacles to decentralization. Reference to the exercise is common in central government policy circles. More important, a new regulation was issued during the development of the exercise which officially established the government's intention to use a local government rating system as a basis for selective, systematic and gradual decentralization.<sup>61</sup> The new national development plan, Repelita VI, also states that gradual and selective decentralization will be undertaken during the five-year plan period that began in 1995.

Second, after reviewing the encouraging results of the trial rating exercise, the government has provided the LAN task force with funds to evaluate the exercise and to extend it to additional provinces. The extension is being done entirely internally, without even the limited foreign technical assistance provided through LAN for the initial trial. This more firmly establishes the exercise as a government-owned policy experiment.

Third, discussion is continuing on how to use the results of a rating exercise once it is in place for all provinces, and some intentions have already been announced. At the time of this writing, the official in charge of the Inpres block grant program in Bappenas publicly indicated that he plans to use the results of the LAN rating exercise to reform the grant allocation formula. A number of senior central government officials in other ministries have indicated their interest in decentralizing some service functions according to the capacity of local governments.

Fourth, various other recent steps not directly related to the rating exercise — above and beyond the activities discussed earlier — indicate a growing willingness on the part of the government to push forward with decentralization. For example, certain provincial government offices operating at the local level, which establish considerable control by the provincial governors over local governments, are being abolished, thus reducing one higher level constraint on local government operations. In addition, a number of new efforts to improve local managerial capacity are being funded entirely out of the central government's own budget and designed by its own staff. Perhaps most significantly, the government is planning to issue new regulations that allow local governments to enter into direct, independent contracts with foreign entities. This means that external development funds for local government projects and enterprises (definitely from

private firms and perhaps even from some donors whose regulations allow this) will no longer have to flow entirely through the central government.

None of these developments guarantee that the LAN local government rating process will survive to become a major vehicle for decentralization, but there can be little doubt that it has already had a major impact on the decentralization debate and has facilitated the emerging momentum in the development of related policies. Analysts who insist on measuring the success of public policies in terms of rapid, full achievement of the high standards of an idealized model may consider the rating system approach unsatisfactory. They should be reminded that decentralization — even in the most industrialized countries that have tried to implement it — takes a long time and requires massive reforms of bureaucracies and people's attitudes. In the Indonesia case, this is a formidable task: central government officials are used to having all the power and making all major decisions; local governments are used to being heavily subsidized and not being held very accountable to anyone; and individual citizens are neither accustomed to paying for most public services nor to expecting much from local governments.

Breaking these patterns of behavior is not going to happen overnight, but the consensus-based approach embodied in the local government rating exercise provides a mechanism for implementing change in a rational and incremental fashion and in ways and places that maximize the probability of success. Clear achievements early on, even if quite modest, will provide justification for taking additional steps toward decentralization and are likely to generate further support for doing so.

The broader reality is that the Indonesian government's urgent need to make better use of available resources and to improve its image will slowly propel it to continue to adopt and to implement appropriate policies for institutional reform and decentralization. Concurrently, technocrats and politicians at both central and decentralized levels will gradually grow accustomed to new ways of thinking about the role of decentralized levels of government. With careful definition and planning of the stages of the decentralization process, those involved in this reform effort can steadily push the system in the right direction.

## 10. CONCLUSIONS

Many developing countries face severe constraints on decentralization quite similar to those documented in the Indonesia case.<sup>62</sup> Decentralization and local government reform efforts have often been donor driven, have been plagued by complex institutional environments in which key ministries compete for power and donor funds; have commonly treated local gov-

ernments as if they were homogeneous entities; have often been hampered by dismissive, self-serving central mistrust of local government capabilities; and have rarely provided significant incentives for appropriate behavior by local governments.

The most binding constraint in many cases has been the fragmentation of responsibility at the central level and the inability or unwillingness of the central government to improve coordination. This has often prevented efforts to take even modest initial steps towards decentralization. Attempts to get around this problem, often in the form of interministerial coordinating committees, have typically failed because the institutions leading these efforts were seen as furthering their own interests rather than seeking genuine cooperation among relevant ministries.

Given the common obstacles to decentralization, Indonesia's experience with the local government rating exercise suggests several lessons and concerns of potential importance for other countries struggling with the difficult task of initiating and designing a decentralization program.

*First*, the Indonesian process establishes that it is possible to devise a relatively simple methodology, using well-accepted practices, to rate the capacity and performance of local governments. This provides a way of better understanding which functions local governments can realistically manage before embarking on a decentralization program.

*Second*, a trial application of the Indonesian process indicates that there is, as expected, substantial variation in the capabilities of local governments. It also validates the belief that certain local authorities, despite general central dismissal of local officials as incompetent, are widely considered capable of assuming greater fiscal responsibilities. Such recognition provides a solid basis for selective decentralization and for more effectively targeting limited technical assistance to places that need it most.

*Third*, the Indonesian experience demonstrates that a task-oriented institutional mechanism, together with certain methods-derived "rules of the game," can be used to help overcome a number of bureaucratic obstacles to furthering decentralization. Most important, the exercise stimulated a better understanding of the meaning of and possibilities for decentralization; provided a fresh starting point for more effective interministerial and intergovernmental cooperation; and began the process of the government reclaiming the momentum for and terms of the decentralization process from competing donor agencies.

*Fourth*, if Indonesia follows through on the intention to repeat the evaluation exercise periodically and to use it as the basis for decentralizing specific rights and responsibilities, there would be clear

incentives for local governments to improve their performance in providing services to their constituents.

*Fifth*, The Indonesia experience underscores the fact that a broad understanding of and support for decentralization take a long time to cultivate. The trial evaluation exercise took more than two years of slow, painstaking work to develop, and it will clearly be at least a few more years before the index could be fully operational according to the goals of its developers. Although this may seem like a long time, it underscores the critical importance of negotiating broad support on such a sensitive matter. Without adequate consensus on the nature and scope of decentralization in a given context, decentralization activities are unlikely to get very far or to be sustainable.<sup>63</sup>

*Sixth*, the slow pace and the labor-intensive nature of the Indonesian initiative raise issues about the future role of donors in decentralization reform. On the one hand, many countries will continue to require substantial donor assistance for the foreseeable future. On the other hand, slow institution building is incompatible with the large-scale, capital-intensive, quick-disbursement type of projects traditionally favored by multilateral development banks and many bilateral aid agencies, which have been the primary funders of decentralization efforts in developing countries. It remains to be seen whether the donors can adapt to a different way of doing business, which the recent prolifera-

tion of a new generation of "institution-building" projects suggests they are trying to do — within the limits of their own institutional constraints.<sup>64</sup>

As economic pressures for decentralization continue to escalate and forces driving democratization continue to develop, many countries will feel an increasing urgency to formulate decentralization policies that produce results. Although the Indonesian approach is still in its early stages and its exact future is uncertain, policy makers in other countries may profit by considering how they might replicate some of the considerable initial benefits in reducing bureaucratic obstacles realized under this approach, as well as how they might adapt or expand the approach to bring about decentralization strategically.

More generally, developing countries considering decentralization should understand the critical importance of going beyond the typical donor-driven decentralization approach based on applying the normative prescriptions of conventional models of public administration and finance. These models, if properly interpreted in the context where they are being used, provide considerable direction regarding the form a desirable multilevel public sector should ultimately take, but they offer little guidance on how to get there. The type of process-oriented approach to the design and implementation of decentralization examined here, if widely accepted by major relevant parties and tailored to the political and institutional realities of a particular country, has great potential to help achieve more realistic and sustainable results.

## NOTES

1. Much of this literature is reviewed in Olowu and Smoke (1992); Smoke (1993); Smoke (1994); and Cohen and Peterson (1995). Some recent successful cases and innovations are discussed in Olowu and Smoke (1992); Tendler and Freedheim (1994); Cohen and Peterson (1995); and Tendler (1996).

2. More detailed discussions of this system can be found in: Davey (1979); Devas (1989); Galbraith (1989); Walker (1991); Leigland (1993); and Smoke and Bastin (1993).

3. These figures mask significant variations, but only a small number of large urban governments are more fiscally self-reliant. The Indonesian system of decentralized government finance is explored more fully in Kelly, Bastin and Suryowibowo (1993), Smoke and Bastin (1993) and Shah and Quereshi (1994).

4. During the Repelita IV plan period (1985–89), regional government (nonenterprise) borrowing represented less than 5% of the total expenditures on regional development from all sources. For urban governments alone, investment credit played a more important role during the same period, accounting for more than 15% of total urban development expenditure. In recent years, the total volume of

loans contracted by regional governments and their enterprises has more than doubled, mainly because of a surge in foreign loans to Indonesia for urban development and a new national policy to require decentralized governments to repay an increasing share of investment funds acquired through foreign loans. Some "loans" to regional governments, however, are essentially forced borrowing through donor projects that reflects central government policy rather than regional demand. Bastin (1990) and Johnson (1994) discuss borrowing trends and needs among Indonesian regional governments.

5. The evolution of the government system is described in Devas (1989) and Bastin and Azis (1992).

6. See Davey (1979); Devas (1989); Galbraith (1989); Bastin and Smoke (1991); and Walker (1991) for further discussion of these issues.

7. Davey (1979) and Devas (1989) discuss this legislation and the context in which it was implemented.

8. These include strengthening local resource mobilization capability, improvement of the system for financing urban infrastructure, development of decentralized institu-

tional, manpower and procedural capacity, and enhanced coordination among the various agencies and levels of government involved in the development of urban services.

9. Repelita V (1990–94) and Repelita VI (1995–99).

10. Bastin (1987) discusses the rationale for IUIDP in greater detail. IUIDP guidelines are detailed in Republic of Indonesia (1989a).

11. Local governments participating in IUIDP receive technical assistance from the central government to prepare and implement comprehensive five-year investment plans as well as plans to enhance own-source revenues and to strengthen administrative and technical capacity.

12. These programs are briefly reviewed in Smoke and Bastin (1993).

13. As the project is still in its formative stages, it is not yet clear what form this consolidation will take.

14. A number of responsibilities fall under the official jurisdiction of TKPP, including the organization of the institutional framework for urban development; coordination of integrated urban development policies and programs; coordination of institutional development through training and technical assistance; initiation, preparation, approval and implementation of infrastructure projects; and, project monitoring and evaluation.

15. This legislation simplified the previous property tax system by consolidating various land-related taxes under the Directorate General of Taxation and applying a uniform rate to all classes of property. It also substantially broadened the tax base by reducing exemptions and changing from a rental value to a capital value base, at the same time introducing measures to ensure greater equity. Finally, strict deadlines and penalties were introduced to ensure better registration and payment. These reforms have dramatically increased the yield of this important regional revenue source. More details on the 1985 property tax reforms and their early results are found in Kelly (1989) and Kelly (1992).

16. Although it started making loans to regional governments and their enterprises in 1989, the RDA was not formally established through a decree of the Minister of Finance until September 1991.

17. More information on the Regional Development Account is found in Bastin (1990); Johnson (1994); and Ichsan (1995).

18. During the past several years, new laws on the reform of central-local fiscal relations and local revenue systems have been drafted under the leadership of the Ministry of Finance. Although it is likely to be some time before the difficult work of building a broad consensus on inter-governmental fiscal matters is complete and new legislation is in place, the process helps to provide a foundation for reform.

19. Bastin and Azis (1992) examine macroeconomic trends and their effect on regional development in Indonesia.

20. The underlying fiscal trends are discussed in Bastin and Azis (1992).

21. These problems are discussed more fully in Smoke and Bastin (1993).

22. A large volume of foreign loan resources remain unspent, and the government must pay commitment fees on loans which have been signed but not yet used. Enhancing the capacity of local governments to implement investment projects would add to the country's loan absorption capacity and reduce idle loan resources.

23. This is true because central control is often exercised with inadequate flexibility in the selection and design of projects. As a result, insufficient consideration is given to unique local conditions, a serious concern in a country as physically large and geographically and ethnically heterogeneous as Indonesia.

24. Since many local infrastructure projects are financed from central government grants and implemented by central technical departments, there is no compelling reason for local officials to attempt to mobilize resources for capital expenditures and the operation of completed facilities.

25. This occurs because responsibility for the full range of infrastructure required to support economic development is fragmented across various central government sectoral ministries subject to little formal coordination.

26. Deconcentrated sectoral ministry offices often function parallel to regional government agencies devoted to the same services. Rarely are both active enough to justify operating two offices.

27. The ruling party retained a majority in the 1993 elections, but its margin was significantly reduced. During the election period, opposition parties openly criticized government policies.

28. Various related issues are reviewed in more detail in Bastin and Smoke (1991) and Bastin and Azis (1992).

29. PT Hasfarm Dian and DHV Consulting Engineers (1989).

30. IUIDP is based in the Directorate General of Human Settlements.

31. Recently, urban transport has been formally incorporated into the IUIDP, but it remains to be seen if existing procedures can be easily transferred to other sectors under different agencies.

32. Preparation for the East Java-Bali IUIDP under World Bank funding, for example, began in early 1986, but preparation and negotiations were lengthy, and the loan was not signed until March 1991. The Asian Development Bank's West Java-Sumatra IUIDP, in contrast, was able to conclude a loan agreement in September 1989 after a rapid appraisal and negotiation process, but not a single project had been started two years later. While the planning and implementation problems were being slowly worked out, the Indonesian

government had to pay substantial commitment fees after the loan was signed.

33. The sectoral directorates in the Ministry of Public Works, which have responsibility for services such as water supplies, irrigation and sanitation, are often accused of giving little consideration to proposals brought up from the local government level, instead favoring projects identified by their own office. One arguable exception to this is the Directorate General of Highway Development (Bina Marga), which has established a network of field offices at the local level that work closely with regional governments in developing plans for road construction and improvement.

34. These data are taken from a regional finance database in the Ministry of Finance and from Shah and Quereshi (1994).

35. The central government issues guidelines for the use of general purpose grants, and these are often enforced. Thus, even Indonesia's general purpose grants cannot be considered truly unconditional.

36. The most recent comprehensive analysis of decentralized government own-source revenue is in Shah and Quereshi (1994). Although the growth of local own-source revenues has been quite significant in some areas, the growth rates are typically below those of central government revenue sources, and they are uneven across regions; moreover, yields are typically far below their potential. Even in the case of the successful land and building tax reforms discussed earlier, the overall effective tax rate is among the lowest in the world. User charges are particularly problematic; although charges account for a major share of total provincial and local revenues, they cover less than 10% of the outlay on decentralized public services.

37. Bastin (1990) discusses the process of developing the RDA in more detail.

38. This would help to ensure that provincial and local governments that can afford to borrow are forced to do so, thereby releasing grant resources for regional governments with limited fiscal capacity. Smoke (1996) explores how to create linkages between grant and loan systems.

39. Perhaps the most important reason for the weakening of the policy coordination capacity of the TKPP was its growing direct involvement in operational issues. Because of this increasing concern with managerial details, senior officials representing most participating ministries began delegating subordinate staff to take part in TKPP meetings, thereby diminishing TKPP's stature and ability to perform as an influential policy-making body. This development may have been inevitable, however, given the lack of a suitable forum for working out implementation problems until the UIDP Management Group (IMG) was established.

40. The situation has been particularly helped by the development of a USAID-funded Municipal Finance Project that works simultaneously with all key ministries involved in urban development.

41. Some might argue that introducing competition across

projects and ministries could produce better results. The costs of such competition, however, both in terms of real resources and the creation of institutional problems, are unlikely to be offset by the benefits generated. There is certainly no indication to date that this competition has been productive.

42. See Bastin and Smoke (1991) for more discussion of this process.

43. For example, a provincial governor simultaneously serves as appointed deputy of the President in the district and possesses certain autonomous powers as head of the region. Similar responsibilities are charged to the mayor at the city level and the regent at the regency level. In some instances, heads of district sectoral offices are also in charge of counterpart local government sectoral departments, and the staff of the offices often overlap to a considerable degree.

44. A subgroup of the anti-decentralization faction argued against the feasibility of developing a workable evaluation methodology, largely as a means to forestall the decentralization process. This group eventually acquiesced, however, with the announcement of Government Regulation No. 45 of 1992, which explicitly called for some means of identifying capable local governments so that the decentralization of fiscal responsibility could proceed.

45. Other sectoral ministries involved in local service provision, such as the Ministry of Health and the Ministry of Education, also participated in the task force when their input was required, but they were not part of the core membership.

46. See, for example, Rondinelli (1990) and Cohen and Peterson (1995).

47. Fiszbain (1995) provides a discussion of rating and a detailed case study of Colombia.

48. DPOD is a conference of senior government officials, drawn from a variety of ministries, charged with considering all issues relating to decentralization.

49. The fact that there was some overlap among these areas of performance was considered less important than the fact that key institutional players would be permitted to define good performance in a way acceptable to them.

50. See Bastin and Smoke (1991) and Fiszbain (1995).

51. The technical advisors worked for an urban development project undertaken at the request of the Indonesian government by the Harvard Institute for International Development, which has been working in Indonesia for nearly three decades.

52. Babbie (1979) provides a thorough introduction to index construction methods. Numerous examples of indexes used in social science research can be found in Miller (1991).

53. An extensive description and analysis of the rating process appears in Harvard Institute for International Development (1993) and Lewis (1994).

54. For more information on capacity building and measurement at the local level, see Cochrane (1983); Davey (1989); World Bank (1989); Olowu and Smoke (1992); Silverman (1992); Smoke and Olowu (1993); Therkildsen (1993); and Fiszbein (1995).
55. See Lewis (1994).
56. For more information concerning the methodology developed for rating local governments and results of the trial implementation, see Harvard Institute for International Development (1993).
57. At the same time, the variables should not be too strongly empirically related, or else there would be redundancy among the proxies. The redundancy of a variable suggests that it should be excluded from the index.
58. This discussion is further developed in Lewis (1994).
59. Lewis (1994) discusses this in greater detail.
60. The test was made by regressing a variable representing the results from the expert assessment against the relevant set of quantitative indicators chosen by the central government officials. The results indicated that just over one-quarter of the variance in the expert assessment index was accounted for by the quantitative proxies taken together. For more information see Lewis (1994).
61. Government Regulation No. 45 of 1992 on "The Implementation of Regional Autonomy with the Emphasis on Second Level Regions".
62. Cochrane (1983); Rondinelli (1990); Olowu and Smoke (1992); Cohen and Peterson (1995); Dillinger (1995).
63. The benefits of selective and incremental reform are receiving increasing attention in the decentralization literature. Examples include: Cochrane (1983); Bahl, Miner and Schroeder (1984); Rondinelli, Nellis and Cheema (1983); Rondinelli and Nellis (1986); Davey (1989); Guarda (1989); Rondinelli, McCullough and Johnson (1989); World Bank (1989); Rondinelli (1990); Olowu and Smoke (1992); Smoke (1993); Smoke and Olowu (1993); Smoke and Evans (1993); Dillinger (1994); Dillinger (1995); Cohen and Peterson (1995).
64. Recent documents outlining the new donor focus on building institutional capacity for decentralization include: Rondinelli (1990); The World Bank (1991); United Nations Development Program (1992).

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