I. Introduction

Since 2000, the Government of Indonesia has adopted a number of new policies and regulations on local government financial management aimed at promoting improved systems and greater accountability over public resources managed by local and regional governments. For more than two years, USAID’s Local Governance Support Program (LGSP) has assisted more than 60 local and regional governments to implement these reforms by providing training and technical assistance in financial management. While the intent of these new policies and regulations is good, significant challenges exist for local government officials attempting to implement financial management reforms in the post-New Order decentralization era.

Of particular significance in the area of budgetary and financial management for local governments was the recent introduction of two new regulations, Peraturan Pemerintah 24/2005 (PP24), introducing new government accounting standards, and Permendagri 13/2006 (PM13), introducing new performance-based budgeting standards. Implementation of these regulations has been slow and inconsistent across local governments, and officials and staff are overwhelmed and confused by many of the innovations and regulations prescribed. Inconsistent and sometimes conflicting policies issued by the Ministry of Home Affairs (MoHA) and the Ministry of Finance (MoF) to regulate financial and accounting issues further complicate efforts to implement robust financial systems and transparent accounting practices in local governments. In addition to the complexity of the national regulations affecting budget and financial management, there are a variety of human resource issues that impede progress toward the development of sound financial management systems that support good local governance.

The implementation of Permendagri 13 has presented the most challenges to local governments. In addition, there are also several problematic areas related to PP24. LGSP held a one-day workshop and focus group discussion titled “Challenges to Implementation of Local Government Financial Reforms” in May 2007 in Jakarta. The forum was intended to identify, discuss and develop possible recommendations for easing implementation of Permendagri 13. This policy brief describes the various challenges confronting the Government of Indonesia and local governments in implementing Permendagri 13 and presents the conclusions of that workshop.

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1 See Annex 2 for full names and description of the laws and regulations referenced in this brief.
II. Policy Challenges at the National Level

The primary challenges at the national level include a conflicting, inconsistent and overlapping legal framework and a lack of coordination between implementing ministries.

Legal Framework

The two legal pillars of regional autonomy are: (i) Law 32/2004 on Regional Governance, which focuses on administrative and political decentralization and includes the guiding references to the devolution of expenditure responsibilities; and (ii) Law 33/2004 on Fiscal Balance governing the distribution of resources across regions. In addition, there are four organic laws which govern planning and budgeting, accounting and financial reporting, treasury and audit for local governments in the decentralization era: Law 17/2003 on State Finances provides the legal framework for a unified budget; Law 1/2004 on State Treasury prescribes a variety of financial management functions; Law 15/2004 provides for the audit of all governmental units; and Law 25/2004 on developmental planning sets out the authorities and responsibilities for various local government officials related to planning. In all, there are at least 5 laws, 9 government regulations, 5 presidential decrees, and 22 ministerial decrees that impact more or less directly on issues of planning, budgeting, accounting, financial reporting and accountability for local governments in Indonesia.

However, most important to the day-to-day operations of local governments is Peraturan Pemerintah 58/2005 (PP58) on the Management of Local Government Finance, which derives from Law 33. Its implementing regulation is Permendagri 13, issued by the Ministry of Home Affairs in 2006, which introduces new performance-based budgeting standards. For Law 17/2003, the Ministry of Finance in 2005 issued PP24, which introduces new government accounting standards.

The ministries of Finance and Home Affairs jointly developed PP58, which brought comprehensive changes to regional planning, budgeting, accounting and financial reporting. The intent of PP58 was to integrate these functions into a more coherent system of regional financial management. It brought under one comprehensive legal framework the principles and authority for: regional monetary management; the integration of the annual budget with both medium- and long-term planning processes; the structure for the preparation and adoption of the annual budget; the execution and administration of the annual budget; management of regional assets; management of public service institutions; and management of regional finance. However, implementing PP58 requires the adoption of a number of other ministerial degrees to provide detailed guidance and instructions to local governments: Permendagri 13 is such a regulation.

Permendagri 13 addresses five primary areas of local government budgetary and financial management: planning and budgeting, revenues, budget execution, accounting and reporting, and budget administration. The most significant impact of PM13 is that it devolves these responsibilities from specialized units in the local government to the budget units.
While Permendagri 13 deals with the planning and budgeting processes, PP24 represents a significant effort to create transparency and accountability in the management of state finances through the presentation of financial reports and audits that meet the standards of generally accepted accounting principles. Of significance is that PP24 is based on international government accounting standards. Under PP24, local governments will move from a cash basis of accounting to accrual, which will show a local government’s true financial position and improve the quality of financial statements.

Ministerial Overlap and Lack of Coordination

Inconsistency and confusion deriving from the complex legal situation manifests itself mainly in relation to: (a) respective authorities and responsibilities of central and local governments; (b) delegated authorities and functions provided to MoHA, the national development planning agency (Bappenas) and the MoF; and (c) authorities to develop common accounting and reporting standards for all levels of government, including instruments relating to the development of the regional financial management information system (SIKD). A fundamental conflict exists in Law 33 regarding the fiscal balance between the central and regional governments. While the Ministry of Home Affairs determines how local government funds will be used to finance essential functions, the Ministry of Finance determines how the funds will be raised to finance those expenditures. With the laws affecting local governments drafted primarily by different ministries (MoHA and MoF), a clear definition of the roles and functions of different levels of government has not yet been established, and coordination between central and regional governments (e.g., conflicting sectoral laws, authority over civil service and rules on financial management) has been weak. Regulations that clearly delineate expenditure responsibilities have not been issued. In addition, some new regulations are issued before local governments have completely implemented a previous regulation. For example, PP58/2005 superseded PP105/2000. PP105’s implementing regulation was Keputusan Menteri 29/2002. Some local governments were still putting in place that regulation from 2002 when Permendagri 13, the implementing regulation for PP58, was issued. This created a great deal of confusion among not only the local governments but the national audit agencies, as the audit regulations still had not been amended to be congruent with PP58. Moreover, implementers of Permendagri 13 consider it significantly more complex than KepMen 29.

The issuance of PP24 and Permendagri 13 are good examples of the lack of coordination between the Ministry of Finance and Ministry of Home Affairs, which creates a challenge not only for the local government but for the central government as well. Each agency’s regulation calls for reporting the same information but in differing formats and on a different accounting basis. Even the chart of accounts that local governments are required to use is different. Permendagri 13 requires reporting at the program and activity level, while PP24 requires reporting at the organizational level. There are also differences in the treatment of certain transactions. For example, short-term investment transactions under Permendagri 13 are treated as budgetary transactions while under PP24 they are balance-sheet transactions. These differences create the burden of conversion by the local government officials to prepare the reports in a way to comply with both MoHA and MoF.

III. Implementation Challenges for Local Governments

There are a variety of challenges local governments face when attempting to implement fiscal and financial reforms based on laws and regulations, above and beyond the conflicts in the regulations issued by different national ministries cited above. The entire fiscal cycle of local governments, from budget adoption to financial reporting, face difficulties caused by complex regulations, a lack of qualified human resources, poor coordination and inadequate use of technology. The major challenges at various stages of budget preparation and implementation are described below.

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2LGSP’s experience in addressing some of these issues as well as other fine points arising from successfully executing a capacity-building program in this area are described in Annex 1.
Integration of Planning and Budgeting. Linkages, among Law 25/1999, Law 17/2003 and Law 32/2004 in how to prepare the mid-term expenditure framework, annual planning, budget policy (KUA/PPAS) and the annual budget, remain unclear. The purpose of PP58 and Permendagri 13 is to link planning and budgeting. Under Permendagri 13, certain planning and budget documents are to be prepared by the work unit (SKPD) which has created difficulties for local governments due to a lack of technical competency at that level. There are no indicators defined for the achievement of service delivery targets used in planning, nor are there links with existing target indicators in the annual performance-based budget.

Budget Preparation and Adoption. Under KepMen 29, the legislative council (DPRD) establishes its General Budget Policy, or AKU, which serves as a broad policy guideline for the executive to prepare the draft budget. However, under Permendagri 13, the DPRD should instead issue a different guideline which is similar to the AKU but stipulates significantly more details about programs and activities. It constrains the executive in the preparation of the draft budget because it requires a greater level of detail than may be realistic or practical. As a result, the draft budget presented may be quite different from the DPRD guideline, thus causing conflict between the DPRD and the executive.

It is not uncommon to find delays in adopting the annual budget as the process often falls behind the established budget timeline. Some steps that are supposed to be sequential, such as the development of the general budget policy and budget instructions to departments, are in actuality developed in parallel. Sometimes the draft budget is being reviewed while the general budget policy has yet to be approved. Although the budget is supposed to be adopted by the end of December for the fiscal year beginning in January, sometimes the executive delivers the draft budget to the DPRD as late as February, and the DPRD needs at least two months to review the draft and to make sure that it reflects public needs and priorities. The consequences of not adopting the budget on schedule means the local government cannot fund any projects outside of routine expenditures, such as the salaries for public servants, before the local government budget, the APBD, is formally issued. The quality of certain projects is diminished if a late budget does not provide sufficient time to plan and execute. To accelerate the budget adoption process, both the local legislative and executive branches of government will need to take a disciplined approach to establishing the necessary steps to complete the APBD process efficiently and in a timely manner.

Budget Execution. Permendagri 13 mandates that the budget approved by the DPRD be specific down to the activity level and “shall give details of functions, government affairs, organizations, programs, activities, types, objects, and details of expenditure objects” (Article 23 (2)). One consequence of prescribing appropriations at an activity level (one level below program) is that the DPRD must approve the budget at the level of the working unit rather than at the higher departmental level. Approval at this level of detail makes the budget inflexible in execution and significantly diffuses accountability for budget execution. Under KepMen 29, the accountability hierarchy was clear; under Permendagri 13, this authority is unclear; no regulations related to internal control have been issued. And, as noted above, the late adoption of the budget often precludes a workplan from being completed by fiscal year end as it requires advance planning and mobilization of resources. Finally, while a cash basis of budgeting is simple, it often means that the working unit must wait until the cash is available to execute their work. Balancing funds from the central government are often transferred late in the year, resulting in delays in work and the compression of activities into just a
Budget Reporting. Expenditures of all local governments in Indonesia accounted for about 30 percent of total general government expenditure in 2004/2005. Although required by law, local governments do not normally provide their approved budgets and budget execution reports to the central government in a timely manner. Limited capacity, particularly in the more remote regions, is an important factor, but there have also been weaknesses in coordination between MoF and MoHA in establishing consistent standards for reporting. At the beginning of 2006, the central government had only received 90 percent of local governments’ budget reports for fiscal year 2004, a lag of more than 12 months. The Ministry of Finance has issued an instruction to all local governments to submit their 2007 budgets by March 2007 or risk a decrease in their general allocation from the central government.

Accounting. The new government accounting system, while maintaining transaction records on a cash basis, has been adapted to deliver financial statements in formats used for accrual based accounts. Full accrual accounting will be in place by 2008. Currently reports on budget realization are compiled from transaction records. Unfortunately, to convert cash-based transactions to accrual reporting is time consuming, requiring an examination of all revenue and expenditure transactions, which for a normal government can amount to thousands of transactions. Some examples of the confusion in the way transactions are treated differently between Permendagri 13 and PP24 include the classification of certain types of income, recording of asset acquisition costs, treatment of short-term investments and refunds from overpaid taxes and fees. The various financial reports required by PP24 do not follow the budget structure defined in Permendagri 13. As a result, the mayors in some local governments have not issued their Accounting Policy as mandated, complicating the task of preparing financial reports.

Human Resource Constraints. The limited number of college graduates in the civil service and particularly in the technical areas of budgeting, accounting and financial management creates difficult challenges, particularly when implementing regulations based on such complex principles for good governance as performance-based budgeting and accrual accounting. For example, among LGSP’s 57 local government partners, there is only one local government finance department with a staff member holding a degree in accounting. Under Permendagri 13 the devolution of responsibility to working units for planning, budgeting, accounting and reporting has created enormous technical challenges. Attempting to explain the concepts of accrual accounting to staff with little or no training in accounting is extremely difficult. Furthermore, staff in the internal auditor’s unit do not possess the necessary competency in accounting to give advice on implementing the new government accounting standards.

The ability of local governments to deal with the above issues varies greatly by district. Some have made considerable advances in applying the principles of good financial management. Kebumen and Sleman in Central Java, Parepare and Takalar in South Sulawesi, and Banda Aceh and Aceh Besar in Nanggroe Aceh Darussalam are examples of districts that are relatively advanced in improving fiscal transparency. They have adopted a comprehensive approach and are simultaneously undertaking reforms in organizational arrangements and financial and human resource management. Results so far include: the participation of civil society organizations in local budget discussions, publication of financial statements that include balance sheets, a significant reduction in public administration staff, and the provision of relatively comprehensive information to the public. Other districts have been making progress adopting such practices. However, a large number of districts continue to struggle to address the above issues.

IV. Recommendations for Improving Implementation

To address the above challenges, a workshop and focus group discussion was held in Jakarta on May 22, 2007. It was attended by 58 participants: 8 officials from the Government of Indonesia (GOI), 17 officials from local governments and the remainder from the academic community, the press, LGSP and other donor
organizations. The workshop benefited by remarks from Prof. Dr. Mardiasmo, Director General of Financial Equilibrium at the Ministry of Finance, and Bambang Pamungkas, Director of Local Financial Monitoring and Accountability Facility at the Ministry of Home Affairs. Both the Ministry of Finance and Ministry of Home Affairs indicated their desire to receive input from local governments on issues related to the implementation of national regulations.

Workshop participants confirmed most of the issues identified in the policy brief, highlighting the lack of consistency between regulations issued by the Ministry of Finance and Ministry of Home Affairs; differing perceptions among regulators, implementers and auditors, as well as between the executive and legislative branches; and limited quality and quantity of human resources which resulted in a lack of readiness to implement the regulations.

The following recommendations to the national ministries developed out of this workshop, in response to the issues raised:

**General**

- The Ministry of Home Affairs and Ministry of Finance should agree on a common understanding and approach before issuing regulations related to budget and finance, thereby minimizing the perception of independent approaches toward local governments.
- MoHA and MoF should limit the frequency of issuing new regulations given the weak capacity of local governments to comprehend them, let alone implement them.
- Technical guidelines for local financial management should be as specific and final as possible to avoid giving the LGs the opportunity to interpret these guidelines themselves, creating in turn difficulties for auditors.
- MoHA should consider local capability in the context of regional autonomy when issuing regulations related to the obligatory and optional functions of local governments. MoHA should not try to regulate local optional functions too often. MoHA should give an opportunity for local governments to determine their own optional functions.
- MoHA should conduct regular monitoring and evaluation of local governments to obtain feedback on the implementation of policies issued by central government.
- The Supreme Audit Authority (BPK) should clarify which basic regulations apply when auditing local governments’ financial reports. In addition, audits of local government need to be more consistent across local governments in their provision of audit findings.

**PM 13/2006**

- The Ministry of Home Affairs should revise PM13/2006 to synchronize it with other regulations, particularly with the provisions of PP58/2005, which are directly and indirectly related to finance, taking into consideration the issues discussed in the workshop.
- Regulations related to local government budget and finance issued prior to PM 13/2006 need to be reviewed and amended to conform to PM13/2006.
- MoHA should refer to the recommendations of various university studies which provide valuable specific guidance on strengthening the implementation of PM13/2006 and PP24/2005.

**Performance Indicators**

- MoHA should develop Performance Indicators Standards that are simple and easy to understand by local governments in developing programs and activities. Too many indicators at too low a level of detail are not productive in achieving the government’s policy goals.
- MoHA should issue guidance for the annual LG work plan, the RKPD, which gives clear examples of performance indicators to be used consistently throughout the budgeting process.
PM 13/2006 creates performance indicator targets at the program and activity levels. With thousands of activities in a typical local government, it is difficult to determine what the real performance indicators are. Performance indicators should be established at a level no lower than the program level, not the activity level.

While there are certainly many other areas, such as general strengthening of human resources that would enhance effective implementation of financial management reform at the local level, the above recommendations provide a platform for further dialogue and consideration. They, along with some of the more detailed commentary from the workshop proceedings which amplify the above recommendations, will be communicated to both the Ministry of Finance and Ministry of Home Affairs to carry forward such a dialogue in a spirit of cooperation and broader reflection.
Annex 1: LGSP’s Experience and Challenges

LGSP conducted diagnostic reviews for an initial group of 30 local governments in 2005 and a second group of 27 in 2006. These reviews revealed that local governments lacked the basic knowledge of the regulations to implement planning, budgeting and accounting reforms. They also generally lack qualified human resources in the financial management positions needed to strengthen financial management systems to improve performance and implement effective internal controls to curb corruption.

In addition to the challenges cited above as a result of the diagnostic reviews, LGSP’s experience in delivering capacity building revealed a number of issues related to effective training:

• Many local governments do not have proper training facilities, lacking proper lighting, tables and chairs, audio-visual equipment, air conditioning, etc;
• Training activities conducted on site are often interrupted by daily official activities;
• When activities are conducted in government facilities, the number of participants often exceeds the recommended number;
• The standard rotation policy within the civil service system precludes the development of skills and knowledge on the job;
• There is no lack of willingness to learn; almost all staff ask us to assist them on how to do their job.

In response to LGSP’s diagnostic results, training materials were revised to assume little or no knowledge of the subject matter. We also modified our training approach to eliminate as many barriers to learning as we could. For example, we found that when we conduct the training off-site, participants are subject to fewer distractions and learning transfer improves. To ensure that knowledge transfer is effective, a significant feature of LGSP’s approach to technical assistance and workshops is to require participants to complete certain deliverables that are due after each workshop—to formulate a performance-based budget or to implement a new accounting practice—before they can progress to the next workshop in the series. LGSP also offers technical assistance to help participants complete each level of the module series. LGSP aims to deliver training in parallel with the actual planning and fiscal cycle and includes specialized seminars for elected officials and councils to put training results to immediate use. This “just-in-time” training approach has proven extremely successful and highlights the need for and effectiveness of linking donor program assistance to government cycles and processes.

There are positive signs that progress is being made. Because LGSP is a demand-driven program, we know that our local government partners are willing participants in reform. Positive developments which may be attributable to LGSP assistance include the following:

• Participation in the planning and budget processes by various stakeholders in the community is becoming more accessible and transparent;
• The budget calendar, previously unpublicized, is increasingly published in local media and posted in government offices and other public places;
• Budget hearings, previously unpublicized, are advertised and open to the public and opportunities provided for citizens to provide input to the budget;
• The local councils, particularly those that are newly elected, are enthusiastic to improve their evaluation of the executive’s budget and oversight of the executive;
• Financial statements, previously not made public or issued late, are issued in a timely manner and made available to the public;
• CSOs and NGOs are increasing their awareness of the budget process and their role as advocates;
• Female civil servants in LGSP’s training activities are demonstrably willing to learn, participate actively and have become increasingly enthusiastic as they to apply what they have learned. To date, approximately 30 per cent of participants in our training have been women, mostly in the accounting area.

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<tr>
<th>Law/Regulation</th>
<th>Full Title</th>
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<th>Level</th>
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<tr>
<td>Permendagri 13/2006</td>
<td>Guidelines on Local Financial Management (Pedoman Pengelolaan Keuangan Daerah)</td>
<td>Revises Kepmendagri 29/2002 and follows on PP 58/2005. It provides the chart of accounts with program and activity codes, and divides the expenditure side into direct and indirect categories. There is no longer any distinction between public services and local apparatus in the budget main group as in previous regulations, while the obligatory and selected functions are introduced in this regulation. This regulation also gives details about the chart of accounts, forms and procedures for implementing it.</td>
<td>Ministry of Home Affairs Regulation</td>
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<tr>
<td>PP 58/2005</td>
<td>Local Financial Management (Pengelolaan Keuangan Daerah)</td>
<td>An omnibus regulation that describes public finance as set out in laws 1 and 17/2003, laws 22 and 13/2003 and Law 25/2003. It determines in general the planning, budget, budget administration as well as reporting and accountability process and procedures. It also defines how they are interrelated.</td>
<td>Government Regulation</td>
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<tr>
<td>PP 24/2005</td>
<td>Government Accounting Standards (Standar Akuntansi Pemerintahan)</td>
<td>Establishes the first standard for government accounting consisting of eleven main accounting statements. Also calls for the implementation of double-entry bookkeeping standards and a modified accrual basis for the transaction record. This regulation serves as guidance for central and local governments in administering and reporting on their financial transactions within any given accounting period.</td>
<td>Government Regulation</td>
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<td>Law 25/2005</td>
<td>National Development Planning System (Sistem Perencanaan Pengelolaan dan Tanggung Jawab Keuangan Negara)</td>
<td>Determines the system for national development planning describing planning procedures from the local stakeholder’s forum (musrenbang) through to the preparation of the central government’s annual work plan. The role of the planning agency is key in this planning process.</td>
<td>National Law</td>
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<td>Law 32/2004</td>
<td>Regional Governance (Pemerintahan Daerah)</td>
<td>Revises Law 22/1999 on local governance. Reduces the power given to the local council and sets a higher role for the provincial governor. Determines that the district manager or mayor will be elected directly by citizens and that the draft budget of the city and or district must be verified first by the province.</td>
<td>National Law</td>
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<td>Law 15/2004</td>
<td>State Audit (Pemeriksaan Pengelolaan dan Tanggung Jawab Keuangan Negara)</td>
<td>Determines the audit function and mechanism for financial audit, performance audit and specific audit in the government area. Implemented by the National Supreme Audit (BPK) and working with internal auditor of government, ensuring audits empower government to follow up if any action needed.</td>
<td>National Law</td>
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<td>Law 1/2004</td>
<td>State Treasury (Perbendaharaan Negara)</td>
<td>Lays out the management of the state treasury both in the central and local governments. It also initiates the establishment of the finance directorate within local government as a local treasurer. The finance directorate merges the former finance division, procurement/asset division and revenue collection department.</td>
<td>National Law</td>
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<td>Law 17/2003</td>
<td>State Finance (Keuangan Negara)</td>
<td>Establishes Department of Public Finance that manages the new financial system based on performance, transparency, and accountability, replacing the former system under Dutch regulation. Defines the budget as consisting of revenue, expenditure and financing, and based on performance. This law also indicates that accounting systems will be regulated under new government accounting standards.</td>
<td>National Law</td>
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<td>Kepmendagri 29/2002</td>
<td>Guideline on Monitoring of Local Budgets and Budget Calculation (Pedoman Pengurusan, PTJ dan Pengawasan Keuangan Daerah dan Penyusunan Perhitungan APBD)</td>
<td>Provides guidance on how to prepare, implement, and report using performance-based budgeting and double-entry bookkeeping. This is a revolution in the local government budget and accounting system. This decree provides general guidelines with little detailed information on how to prepare performance-based budgets, how to administer the budget using double-entry bookkeeping. When this regulation was issued, there was still no accounting standards set out by the government.</td>
<td>Ministry of Home Affairs Decree</td>
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<td>Law 25/1999</td>
<td>Fiscal Balance between the Central Government and the Regional Governments (Perimbangan Keuangan antara Pemerintah Pusat dan Pemerintahan Daerah)</td>
<td>Defines the distribution of resources across the regions, following on Law 22/1999. It restructures some revenue sources for local government, especially the revenue-sharing from central government. Under previous regulations 7 and 8 issued by MoHA decree in 1974, revenue-sharing derived from natural resources was limited, and most transfers were done through specific grants allocated as one-time allocation via a presidential instruction. With the 1999 amendment, revenue sharing from tax, non-tax and natural resources funds for local government are described in detail. This law also determines that the use of this general allocation fund (DAU) falls fully under local policy.</td>
<td>National Law</td>
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<td>Law 22/1999</td>
<td>Local Government Autonomy (Otonomi Pemerintahan Daerah)</td>
<td>Determines the structural changes for local government autonomy, especially in the municipality and district. This law determines that the highest authority within local government is the legislative council. Council members are elected directly by citizens, and have authority to select, monitor, and fire the district manager or mayor. They also have extensive budgeting authority. This law also implies that local government budgets must be participative, transparent and accountable.</td>
<td>National Law</td>
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