

Working Paper #1

Current Issues on the DAK Grants

The DAK (*Dana Alokasi Khusus*, Special Allocation Fund) is designed as a conditional matching grant that is aimed at addressing strategic need for local development. Of the total national grants, the DAK accounted for about 8.5%. It is an important part of fiscal decentralization arrangement regulated under the law on fiscal balance (Law 33/2004) and all the ancillary regulations such as Government Regulation No.55/2005 and the MoF Decree No.124/2005. The concept for DAK was introduced in 1999, and it was originally intended to provide additional funding for regions whose special characteristics could not be quantified as a factor for the block grant of the DAU (*Dana Alokasi Umum*, General Allocation Fund) allocations. For example, it was designed to provide funding for remote regions, small regions, those with chronic food deficiencies, those that located on international borders, those that prone to natural disasters, and those that require special services to cater to the tourist industry.

Law 33/2004 gives an emphasis that the DAK is an instrument for central government priorities while maintaining the need to account for special characteristics of particular regions. Together with the DAU block-grant, the DAK grant is an essential instrument for ameliorating vertical imbalance in the Indonesian public finance system, in which the local governments are mostly (up to 80 percent) depended upon the central government grants.

Given the fact that there is a declining relationships between the DAU funding and the local government development objectives (poverty reduction, human development index, overall economic welfare, etc.), the DAK grant is increasingly important. There has been unproductive financial allocation at the provincial and local government levels due to the negative sides of decentralization such as the creation of new administrative jurisdictions (*pemekaran*), the high cost gubernational and regency elections, and lack of planning and budgeting capacity among the sub-national authorities. Therefore, it is fundamental to find the most efficient and effective ways for allocating the DAK grant, which is mostly used for education and health.

On education, the use of DAK funding in the regions has been quite remarkable. Since the implementation of fiscal decentralization in 2001, the DAK funding for education has been focused on rehabilitating primary schoolrooms, accounted for about 530,000 nationwide. However, considering the needs of basic education in the country, many aspects of the school infrastructures were not adequately funded.

In 2006, as it was considered that many functions have been devolved and the sub-national governments fiscal capacity were improved, the Ministry of National Education (MONE) started to foster a co-financing system. The planned works and the allocations of DAK funds are discussed with the sub-national stake-holders (education Dinas officials). The policy on DAK was defined to help local governments to overcome a backlog of maintenance of primary school

assets inherited from the central government, which was transferred in 2001. The introduction of DAK as a conditional matching grant has contributed to strengthen ownership of the program by local beneficiaries and, as the works are labor intensive, helped local job creation.

However, not all local governments are committed to providing a counterpart contribution. The data showed that in 19 out of 32 provinces, the local government contributions only ranged from 0% to 4%. The provinces seemed to have better contributed to the DAK projects. Some of highest levels of co-funding came from fiscally-poor regions. The significant cost-sharing occurred on big three provinces in Java, South Sumatra, Maluku, Gorontalo and Riau. More analysis would be needed to understand the lack of commitment.

There are still rooms for policy changes on the DAK for education. For example, unless regulations allow local government to not contribute, the 10% minimum matching contribution could be enforced. There is also possibility to improve DAK grants for accelerating the completion and rehabilitation of classrooms. It might require to shift DAK funds from resource-rich regions to resource-poor regencies where the needs are the greatest and fiscal capacity per capita is the lowest.

On health, an effort to improve policies on DAK grants is less significant than that on education due to the nature of complexity in designing the program. Nevertheless, one of the important policy in health is the opening up of free third-class services in hospitals for the poor. The government compensates the hospitals through the Jamkesmas, the health insurance scheme for the poor. But as the access to the fund is still limited because of under-funded Ministry of Health, many of the poor are still uncovered. Meanwhile, in the regions, investments in the health sector often focus on building new hospitals although they are not appropriately staffed and limited in facilities.

The current approach taken by the MoH is to identify the types of equipment needed by health facilities that could usefully be procured with limited DAK grants without significant MoH support to implement a procurement program. As the local governments are more capable of building their inventory of health equipment to overcome backlogs, this approach might be sensible. But the long-term policy challenge to improve health services for the poor remain unaddressed.

There are still issues of efficiency in the local government investments on health sector. Some policy options to convert Class C hospitals into BLUD (Badan Layanan Umum Daerah) and the improvement of government service provision on health must be explored. The use of non-tax revenues and government subsidies for health is another option that should be considered and analyzed appropriately.

In the meantime, there is some inherent problem with the current DAK grants due to political pressure in the regions. There is a demand to broaden the legal definition of "special" regions, to include regions prone to natural disasters and/or with significant tourism potentials. Under these broad definition, almost all of regions would qualify as "special" regions. Also, many

policy makers are considering to increase the total available DAK funding. The larger the funding pool, however, the more likely resource-rich regions will get the DAK funding. Another emerging issue is the pressure to put a limit of funding for individual local governments to a maximum entitlement, without considering the scope of public services provided by the regions. This would ensure that funding is available for all local governments, but it definitely distorted the nature of special funding.

To sum up, the followings are some of the fundamental issues concerning the DAK grants:

- a. The DAK grant is continually expanding in terms of sectors and numbers of projects. This tendency should be reconsidered to ensure that DAK would not become a top-down instrument for development planning like the Inpres funds in the past. The number of sectors that benefit from the DAK grant has increased from 5 in 2003 to 13 in 2009. The numbers of project are almost quadrupled from 1,132 in 2003 to 4,012 in 2008. Yet there is no pattern as to why it is expanded as it is not really linked to the needs expressed by local governments. Therefore, a thorough analysis is needed whether the DAK is a good instrument to overcome the failures of the DAU grants and to address the problem of decentralized development in the country.
- b. Due to its small size compared to the overall central government subsidies, the DAK might not be able to attain the equalization objectives. However, if the DAK allocation is appropriately targeted for fundamental objectives, e.g. poverty alleviation, improving school enrollment, capital formation for the SMEs, it would have an important political ramifications. As a "specific" grant, the DAK grant entitlement is not specific enough and there are still misperceptions among central and local government authorities. These are the reasons why DAK allocations have not been able to attain fundamental development objectives.
- c. According to current regulations, the DAK allocations are restricted to funding physical works in various sectors (education, health, transports, marine and fishery, agriculture, local government facilities, and environment) and cannot be used for administrative activities. There might be a strong argument for this restriction as the DAK fund is allocated with other schemes such as BOS for education or Jamkesmas for health. Nevertheless, in the long run it would also hampering the DAK effectiveness for investment, weakening its linkage to local government development planning and creating rigid criteria for projects which might be fundamental for local development.
- d. Aside from the imposed restriction, the DAK fundings are frequently limited for a single fiscal year. There are also many cases where local government proposals for DAK fundings can only be allocated in the next local budget, making it less effective for addressing specific development issue at the local level. Therefore, a robust local financial management system that would allow MTEF (Medium Term Expenditure Framework) arrangement is urgently needed. The strengthened role of the Governor

to create multi-year DAK arrangements and cooperative development projects involving neighboring districts is equally important.

- e. As the DAK grant is not officially recorded in the local budgets (APBD), there is a lack of comprehensive information on its performance and accountability. The general rule for the DAK as a conditional matching grant is also weak. Therefore, policy options to improve its monitoring and evaluation should be elaborated and implemented accordingly. A possibility for the MoF treasury units to ensure DAK compliance, a system of sanctions for non-performance, and a tracking system for DAK matching funds, for example, are among the policy options that should be analyzed appropriately.

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