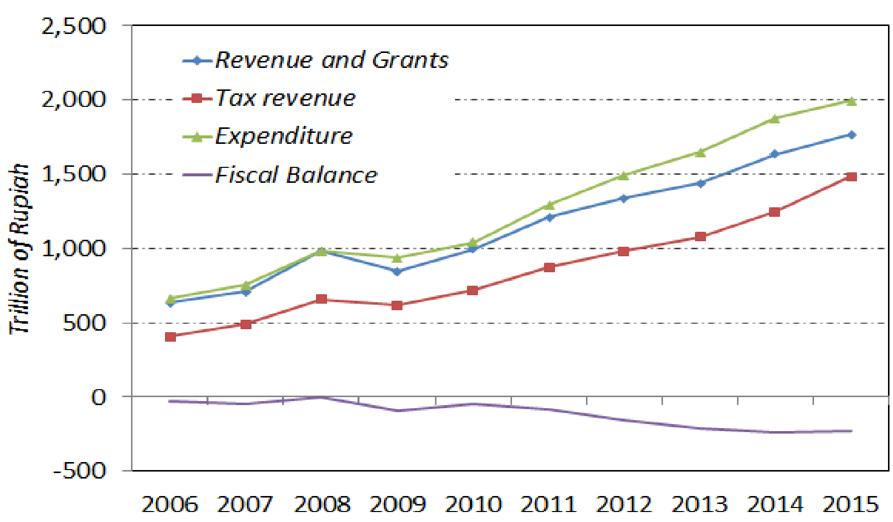
PUBLIC FINANCIAL MANAGEMENT ASSESSMENT

A. Background and fiscal outlook

1. **Rapid economic growth has contributed to significant decline in poverty in Indonesia.** Despite the global economic downturn in recent years, Indonesia's economy has had steady growth since 1999, and has now achieved the status of a middle-income country.[1] The proportion of people living in poverty has declined by half, from 24% in 1999 to 11.3% in 2014, but remains relatively high for a low middle income country. More disconcerting is the uneven nature of growth and rising inequality. One-fourth of the population are vulnerable to shocks such as food price increases, environmental hazards, and ill health, and are likely to slide back into poverty. Despite recent improvements in education and health sectors, public services and health standards still lag behind other middle-income countries. The Gini coefficient, a measure of consumption inequality, has increased from 0.30 in 2000 to approximately 0.41 in 2013. Glaring regional disparities are evident. Poverty is most severe in the remote eastern islands of Indonesia, where 95% of people in rural communities are poor. Eastern Indonesia lags behind other parts of the country in development, notably Java. Consequently, despite its impressive gains in reducing poverty, Indonesia has one of the fastest rising rates of inequality in the East Asia region.

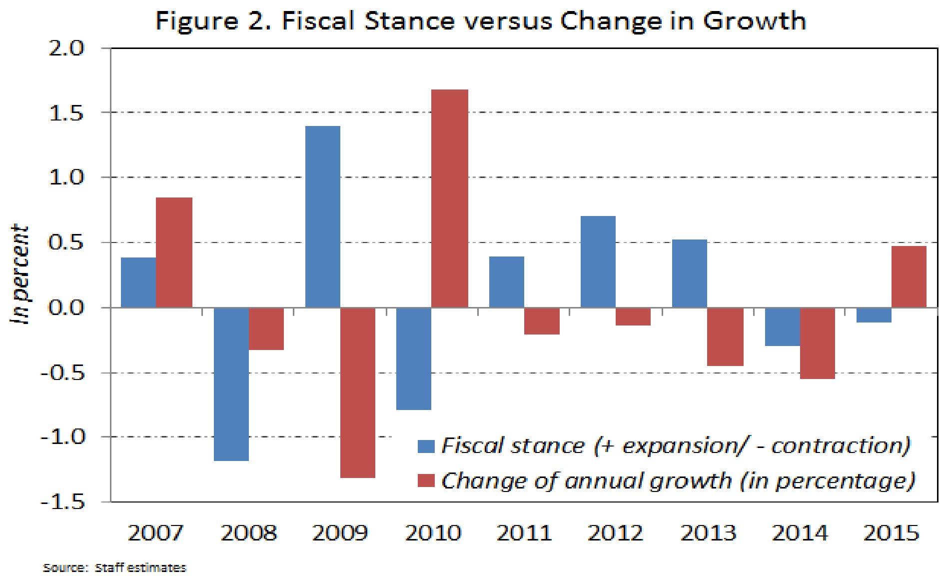
2. **Indonesian's Fiscal Stance.** Post-2008 global financial crisis, aside from 2010, the Indonesia's fiscal deficit has been steadily increasing due to a steady increase in government's expenditure (Figure 1). However, with the exception during 2014 election year, Indonesia's fiscal balanced is fine-tuned with its business cycle. During high growth time, the fiscal stance was contractionary while during low growth time, the fiscal stance was expansionary (Figure 2 next page).

Figure 1. Fiscal Development



Source: Ministry of Finance

[1] Indonesia moderated to 5.1% in 2014 from 5.7% in 2013—in line with staff's expectations and to its slowest pace in five years. A new GDP series, rebased to 2010, was issued in February 2015. It lowered real GDP growth rates by an average of 0.1 percentage points during 2009–14, while recording a slowdown in growth to 5.0% in 2014 from 5.5% in 2013. The new series also raised nominal GDP, marginally affecting key macro indicators such as the current account and fiscal balances, as well as investment and saving ratios. Projections in Figure 2 is based on the old (2000 base) GDP series. Source: Staff Report for the 2014 Article IV Consultation. International Monetary Fund. March 2015.



3. **Fiscal reforms are anchored in a regime of sound expenditure management and revenue increase.** According to IMF, the total subsidy bill had increased from 2.5% of GDP in 2009 to 4.2% of GDP in 2012, while development spending remained at 2.7% of GDP.[2] About 20% of the central government's budget or 282 trillion rupiah ($24.5 billion) was the estimated outgo on energy subsidies during 2014. Elimination of fuel subsidies in late 2014 was one of the major economic policies of the new government, and in the medium-term would create more fiscal space for development spending.[3] Fiscal strategy in the medium-term should be underpinned by reforms to broaden the tax base, reduce fuel subsidies and improve public expenditure efficiencies and budget implementation.

4. **Greater mobilization of tax revenue is of paramount importance.** Government's efforts to increase tax revenue has had limited success, largely due to the narrowness of the tax base, over dependence on the commodity sector, and inefficiencies in tax administration.[4] At present, the tax revenue to GDP ratio is one of the lowest in the G20 (averaging 10.9% of GDP over the past five years) and among emerging market economies (EMEs).[5] Without significant tax reforms, collections are not expected to increase substantially in the medium term. Anticipated decline in oil and gas sector revenues may also render tax projections unrealistic and contribute to revenue shortfall and undermine government efforts to improve the quantity and quality of infrastructure investments, one of government's three priorities, along with education and health.

5. **Containing budget deficit is a priority for Indonesia.** The new government plans to cut its budget deficit to 1% of gross domestic product by 2019, partly by reforming the tax system, as a shortfall in tax revenue estimated at $6.15 billion in 2014 threatened to push the

---

2 Staff Report for the 2013 Article IV Consultation. International Monetary Fund. December 2013.
3 Subsidies on gasoline were effectively discontinued from 1 January 2015 and a fixed-per-liter subsidy scheme of Rp1,000 per lire 9US$0.08) for diesel was adopted. It is expected that energy subsidy bill is expected to decrease to 6% of total expenditure in 2015 from 19% in 2014.
4 In a survey of the ease of paying taxes Indonesia was ranked 126 out of 183 countries in 2010. This put Indonesia behind countries such as Malaysia (24), Cambodia (58), and Lao PDR (113) and the rank has declined from 119 in 2009.
5 Staff Report for the 2013 Article IV Consultation. International Monetary Fund. December 2013.

budget deficit to breach a legally binding limit of 3% of GDP in 2014. [6] Deficit for 2014, however, was below the stipulated level, as government spending was lower than expected, which also included a cut in fuel subsidy costs, was set off against smaller tax collections. The 2015 revised budget is targeting a fiscal deficit target of USD17.8 billion or 1.9% of GDP (Table 1). This target is to be achieved partly through measures to significantly increase tax revenue, including by stronger enforcement of personal income taxes and higher consumption taxes on the wealthy. To finance the deficit, the government plan to raise USD36.1 billion from the issuance of securities and USD3.9 billion from official foreign loans (including USD600 million of program loans). However, with tax revenue collection projected to be weaker than expected, the government is expected to widen the budget deficit by USD6.6 billion to USD24.4 billion or 2.6% of GDP (Table 1) Tax collection in the first quarter of 2015 was down by 10% relative to the first quarter of 2014. While revenue performance is projected to improve in the second half the year, tax outturns for 2015 is expected to be lower than targeted. Going forward, lowering the budget deficit remains the key to fiscal prudence.[7]

Table 1. Financing Plan in 2015 (USD billion)

		2014 revised budget	**2015 revised budget**
1	**Overall deficit**	**20.8**	**17.8**
	% of GDP	*-2.3*	*-1.9*
2	**Gross Financing Needs** (deficit plus debt and non-debt payments)	**42.5**	**40.6**
	o/w debt payments	20.1	17.8
	non debt payments	1.6	5.0
3	**Sources of Financing**		
	Debt	42.0	40.2
	o/w Gross Securities Issuance	37.1	36.1
	Official Foreign Loans	4.7	3.9
	Domestic Loans	0.2	0.2
	Non-Debt	0.6	0.4
4	**Gap**		

6. **Budget spending on priority sector requires significant increase.** Allocations remains heavily skewed towards subsidies. “Indonesia spends 0.5% of GDP on household social assistance, compared to a regional average of 1.0% of GDP and a developing countries' average of 1.5% of GDP. During the period 2000-2009, education spending (including personnel costs) as a share of GDP has averaged around 3%. Though education spending has increased, in line with the constitutional amendment that 20% of the budget goes to the sector, there remain challenges in converting the quantity of spending into quality educational outcomes. Health spending, on the other hand, is considerably lower in Indonesia compared to its peers, averaging only around 0.9% of GDP.”[8] Targeted allocation is 5% for the health sector. Besides, education, and health budgets are mostly allocated for recurrent budget such as

[6] Parliament had passed a law in 2003 limiting the budget deficit to below 3% of GDP in any given year in a bid to prevent a repeat of the financial crisis of 1998.

[7] Anticipating increased deficit, the government has approached development partners for additional budget financing. So far it has received additional financing commitment of USD3.6 billion; including USD1.6 billion program loans from ADB ($800 million), World Bank ($500 million), KFW ($200 million), and AFD ($100 million) and $2 billion disbursable contingent loan from the World Bank. The financing gap of $3 billion is expected to be met by combination of rupiah and foreign-currency denominated bond (Table 1).

[8] Various sources: including ADB, UNESCO, the World Bank, World Health organization, and IMF, Government Finance Accounts.

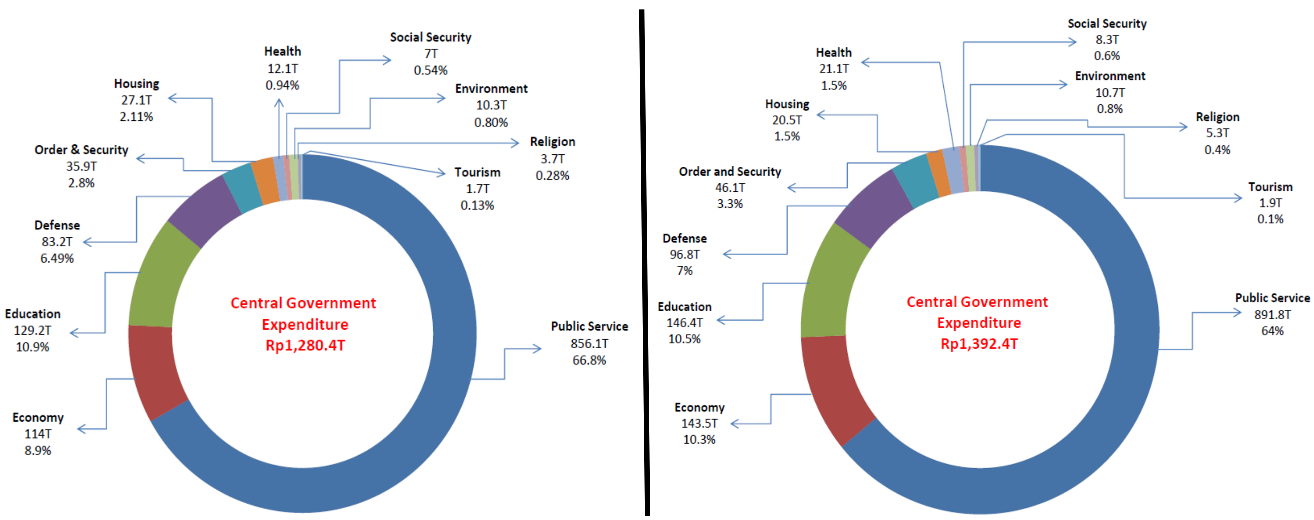
salaries and operational costs than development budget. Even in recent years, the health and education allocation has not been significant (Figure 3).

7. **Expansion of Indonesia's infrastructure has lagged behind its peers.**[9] Lack of quality and quantity of its infrastructure has been a chronic problem. The World Bank estimates that Indonesia has lost more than 1 percentage point of GDP growth between 2001 and 2011 due to underinvestment in infrastructure, chiefly transportation.[10] In the most recent edition of the World Economic Forum global competitiveness index (GCI, 2013–2014), Indonesia ranks 61st out of 148 economies with regard to the state of the country's infrastructure. The new government has, however, put infrastructure as a top priority on its agenda in order to accelerate economic growth.[11] The challenge will be to ensure that the resources are used effectively. In parallel, address the infrastructure gap that is standing in the way of higher growth.[12]

Figure 3

Central Government Expenditure by Function (in Trillion Rupiah)

2014 **2015**



Source: Budget in Brief: APBNP 2015, Indonesia

---

[9] According Center of Logistics and Supply Chain Studies, logistics costs account for around 24% of GDP in Indonesia, compared to Thailand (20%), China (18%), and Malaysia (13%), *State of Logistics Indonesia 2013*; and KPMG, *On the Move in China*, 2011. Further, electricity production per capita is only 20-60% of its peers, implying significant constraints on power generation, and the electrification ratio is at 82%, well below Malaysia, Thailand and China (with each close to 100%) - World Bank, 2014; "Indonesia: Avoiding the Trap," *Development Policy Review 2014.*

[10] Indonesia: Avoiding the Trap, Development Policy Review 2014, World Bank.

[11] Regarding funding for infrastructure projects, the government has set targets in both the National Medium-Term Development Plan 2010–2014 (RPJMN) and the Master plan for the Acceleration and Expansion of Indonesia's Economic Development Plan (MP3EI 2011–2025), approximately 45% of the MP3EI is reserved for infrastructure development. At the national level, direct infrastructure spending is targeted to almost double, reaching 2.2% of gross domestic product (GDP). As much as IDR 290 trillion (USD 22.7 billion) is allocated to spending on infrastructure in 2015, which is spread across ministries and agencies. The funds will be used to construct roads (IDR 57.8 trillion/ USD 4.5 billion), improve water resources (USD 30.5 trillion/ USD 2.4 billion), and to develop regional infrastructure (IDR 500 billion/ USD 38.9 million).

[12] Indonesia keeps lagging behind its regional peers regarding infrastructure and according to research conducted by Morgan Stanley, the ratio of Indonesia's infrastructure spending to its gross domestic product (GDP) is only about 2.3%. In comparison, India spends 6.5%, Thailand spends 3.4%, and Malaysia spends 4.3% of GDP on infrastructure development.

8. **Indonesia experience further underlines the need for faster execution of investment budgets.** In recent years, the development expenditures as budgeted have underperformed against budget targets (approximately 2.7% of GDP), underlying the recurrent problems in budget implementation. During the four-year period 2010–2013, disbursement rate of ministries never achieved 100%, ranging around 90% (absorption rate for key infrastructure ministries such as the Ministry of Transportation, Ministry of Energy and Mineral Resources, Public Works and Public Housing Ministry and agencies– absorption rate was between 75-90%, 55-70% and 70-90% respectively) below 70% in 2011 and 2012 respectively, but reached 90% in 2013. Slow disbursement is attributed largely to cumbersome procurement practices, not so rapid disbursements, and lack of implementation capacity.

9. **Efficient utilization of overall resources through sound public financial management (PFM) continues to be a key priority of the government.** In the aftermath of the Asian financial crisis in the late 1990s, achieving a strong and credible PFM system has been a central governance agenda in Indonesia. It is also fundamental to its poverty reduction efforts. In response to 2001 Country Financial Accountability Assessment of the World Bank that had highlighted a number of deficiencies in Indonesia's public financial management system,[13] the government through a White Paper had set the national PFM reform agenda in 2002/2002 that, among others, sought to improve the results-orientation in state budget planning, modernize budget and treasury management, including the public procurement systems, government accounting and audit functions and regional public financial management.

B. PFM assessment[14]

10. **Over the years, Indonesia has made steady progress in strengthening its PFM.** The Government Financial Management and Revenue Administration Project (GFMRAP), under implementation since 2004 support reforms aimed at strengthening efficiency, governance and accountability in PFM especially in the area of budget execution, together with treasury modernization and revenue administration.[15] In addition, Government's 2012 Medium-Term Strategy Note (MTSN), seeks to improve PFM reform oversight, including strengthening the process of allocating budget resources o priority sectors linking planning and budgeting and strengthen the result orientation of the budget. MTSN also support institutional capacity development, revenue administration, budget execution and reporting and PFM at the sub-national level.[16] PFM reforms are also increasingly aligned with the priorities identified in Indonesia's successive (i) medium term five-year development plan (RPJMN 2010–2014 and 2015–2019), and (ii) strategic development plans of the Ministry of Finance (MoF)'s RENSTRA (for the central level) and the Ministry of Home Affairs (MoHA)'s RENSTRA, which guides the decentralized PFM reforms.

[13] Some of the deficiencies were: (i) an outdated legal framework; (ii) an opaque, and fragmented budget formulation process, including the separation of recurrent and development budgets; (iii) an inefficient payments and cash management system; and (iv) an inadequate and unreliable accounting, reporting and audit oversight arrangements.

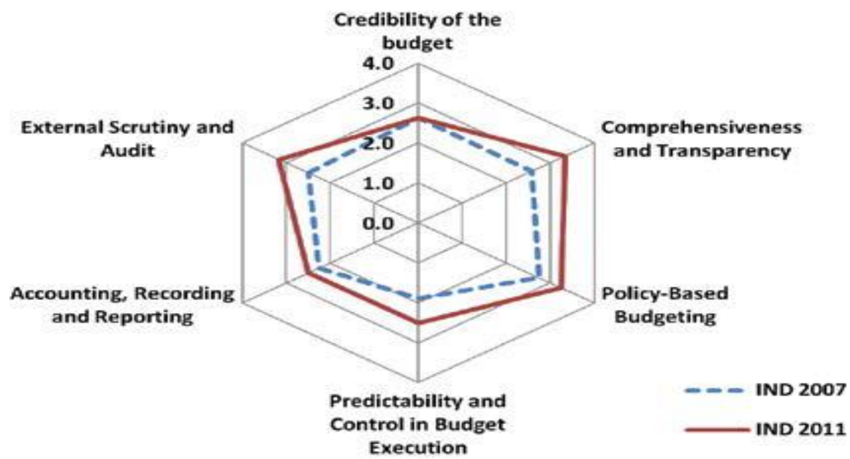
[14] This assessment draws upon: 2012 Repeat PEFA Report and Performance Indicators; PFM updates provided in the 2013 the World Bank's Second Institutional Strengthening for Social Inclusion (Second Institutional, Tax Administration, Social and Investment) Development Policy Loan for Indonesia, and 2012 draft Country Level Governance Risk Assessment and Risk Management Plans for Indonesia (Manila).

[15] GFMRAP implementation has been financially support by the World Bank, Government of Japan and the PFM Multi-Donor Trust Fund (MDTF)

[16] A Trust Fund - Formally "Support to Public Financial Management and Revenue Administration in Indonesia Trust Fund" – provides analytical, advisory service, including technical assistance and capacity building. The trust fund, established in 2006, is currently into its second phase, and is currently supported by the EU, the Netherlands, Switzerland, Canada, USAID and the World Bank (administrator).

11. **The 2012 Public Expenditure and Financial Accountability (PEFA) point to a well-functioning PFM system in Indonesia**. PEFA 2012 repeat assessment, following the first assessment in 2007, demonstrates continuous progress in several aspects, albeit incrementally, resulting in tangible improvements in the quality of its PFM, together with increased transparency and independent oversight of public expenditures.[17] Substantive improvements were identified in five of the six PEFA categories, namely: the comprehensiveness and transparency of the budget, policy based budgeting, predictability and control in budget execution, accounting, recording and reporting, and in external scrutiny and audit for the period from 2007-2011. Figure 2 compares the average PEFA ratings for each of the six main characteristics of the budget cycle. 2012 PEFA findings inform this PFM assessment.[18]

Figure 4



Note: The figure above shows the simple average of the PEFA ratings in each category, with a maximum rating of 4 for an 'A' and 1 for a 'D' and half a point is given for a '+".
Source: Indonesia: Repeat Public Expenditure and Financial Accountability (PEFA) Report & Performance Indicators.

Legal Framework

12. **Legal and regulatory framework for PFM reforms is now largely complete.** New laws, notably the enactment of the laws on State Finance, on State Treasury, and on State Audit in 2003–2004, were adopted by Parliament in the initial phase of reforms, and most of the regulations underpinning the laws have been promulgated.[19] These legislations, regularly under review, have strengthened the quality of budget institutions in formulation of budget, treasury operations and expenditure oversight.

---

[17] The World Bank (2007). Public Expenditure and Financial Accountability: Public Financial Management Performance Reports and Performance Indicators [on line]. Report No. 42098 ID. Indonesia: The World Bank. The World Bank (2012). Indonesia: Repeat Public Expenditure and Financial Accountability (PEFA) Report and Performance Indicators. Jakarta: Public Financial Management Multi Donor Trust Fund for Indonesia.

[18] PFM progress in Indonesia, as assessed in this document, focus primarily on one of the major initiative of the government to strengthen medium-term and performance based budgeting, commensurate with efforts to strengthen budget implementation arrangements. In addition, the assessment discusses PFM at the local government's level, given that around half of total public spending is now under sub-national government control.

[19] Law 17/2003 on State Finance, Law 1/2004 on State Treasury, and Law 15/2004 on State Financial Audit, Presidential Decree of 2010 on Public Procurement; Law No. 32/2004 on Regional Administration, Law No. 33 on Fiscal Balance Arrangements between Central and Local Level, Law 28/2009 on Regional taxes and Fees, Law 25/2004 on State Development Planning; Government Regulation 51/1999 on National Statistics; Government Regulation 23 of 2005 on Public Service Agencies, Government Regulations 58/2005 and 37/2007 and MoHA Regulations 13/2006 and 59/2007 on PFM in RGs.

- The Law on State Finances (2003) established the basic fiscal framework, based on international classification standards for developing the budget. The Law requires a clear budget timetable, and establishing reporting requirements to Parliament, and introducing a medium-term expenditure framework system and performance-based budgeting.
- The National Development Planning System Law (2004) provided the legal basis for the national development planning process, and for linking planning with budgeting.
- The State Treasury Law (2004) provides the basis for modernizing budget execution and reporting, including measures necessary for a centralized cash management and simplified payment systems.
- The State Audit Law (2004) strengthened the legal framework for independent operation of the country's supreme audit institution, BPK, reporting to Parliament.
- The Presidential decree on Procurement (No.80/2003) required improvements in the procurement regime and provided a time table for establishing a national policy formulation and oversight agency. Issuance of Presidential Regulation (54/2010), which follows key principles of sound procurement practices, i.e. efficiency, effectiveness, competitiveness, openness, transparency, non-discrimination, and accountability, further improved the legal and regulatory framework of public procurement in Indonesia.

Policy-Based Budgeting

13. Budget process in Indonesia is orderly, and follows a well sequenced time table and is well coordinated. As the 2012 PEFA notes, "Despite its long standing system of national planning, Indonesia is only just starting to introduce a medium-term expenditure framework (MTEF) and move towards performance-based budgeting (PBB)." "Following the issuance of a joint MoF and planning ministry (Bappenas) manual on PBB and MTEF in June 2009, and pilot projects with six line ministries, the program structure was revised. The new program structure aligns programs with organizational structures and establishes much clearer lines of accountability for performance. Line ministries have also formulated targets and indicators, which provide a better basis for evaluating the performance of programs and activities in the coming years, thus fulfilling a fundamental prerequisite of PBB. The new programs, targets, and indicators have been incorporated in the five-year national plan (RPJM) for 2010–14, and first implemented in the FY2011 budget". These are the initial measures adopted in the planning and budgeting system in Indonesia in its efforts to shift from "input based system to an output and outcome based system".

14. The 2011 budget was also the first year of implementing a detailed MTEF process; and regulations have been put in place to incorporate medium-term budget forecasts and the treatment of new initiatives during the budget preparation process (excluding the local government grants and subsidies which are outside the scope of MTEF). [20]Indicative budget ceilings was first introduced for 2012; taking into account last year's budget realization data, adjusted for inflation, as well as to new government fiscal policies. In the preparation of the 2014 budget, government clearly identified the fiscal changes that impacted the MTEF. In fact, the MoF makes a fiscal capacity assessment for the medium term as the basis for formulating the

[20] According to the World Bank's *Public Expenditure Management Handbook* (1998a: 46), "The MTEF consists of a top-down resource envelope, a bottom-up estimation of the current and medium-term costs of existing policy and, ultimately, the matching of these costs with available resources."

resource envelope and subsequent indicative ceilings at ministry and program-level for the fiscal year and 3 out-years.[21]

15. Importantly, Indonesia since 2008, along with Australia and Brazil, is one of the three countries that provide a comprehensive statement of fiscal risks alongside their budget.[22] The scope and brevity of the fiscal risks statement described in one concise report, includes a broad range of significant risks, not just contingent liabilities. For example, the 2009 Budget Report provided information on sensitivities to macroeconomic assumptions risks associated with government debt, infrastructure development t budget, risk of state-owned enterprises (SOEs), the sensitivities of SOEs to changes in oil prices, exchange rates and interest rates, financial sector, pension plan and old age allowance for civil servants. Fiscal decentralization, legal claims on the government, membership of international financial institutions and natural disasters etc. From the financial year (FY) 2015, in the financial note (nota keuangan) prepared by the Government and presented to the Parliament as the basis to discuss the annual budget proposal, there are information about medium term budget plan in every chapter of the financial note document - Medium term policy on state budget (APBN) in chapter 1; Medium term projection on basic macroeconomic assumption in chapter 2; Medium term projection on revenue in chapter 3; Medium term projection on state expenditure in chapter 4; Medium term projection on central government expenditure in chapter 4; Medium term projection on Transfer funds to the regions and Villages funds to the village in chapter 4; Medium term deficit and financing in chapter 5; and Medium term risk on changing the basic macroeconomic assumption in chapter 5.

16. **Strengthening MTEF process has been the most important and progressive change in Indonesia's budget reforms.** Many positive changes are evident, and as the 2012 PEFA notes, the process has contributed to strengthen efforts in maintaining aggregate fiscal discipline through smaller deficits in the total budget, and more accurate projection of future revenue, together with less spending on unnecessary expenditure. The roles of MTEF, however, in dealing with allocative issues are still challenging due to the devolved process of planning and budgeting system. The MoF is responsible for coordinating budget formulation and specifically considers budget ceilings, deals with recurrent budgets such as routine/operational costs, and Bappenas (Ministry of Development Planning), as the planning agency, prepares priority programmes/activities and deals more with investment/capital budgets. Bappenas also deals with output targets based on RPJMN and Renstra-KLs,[23] and the line ministries have autonomic power to decide what projects they will implement to achieve those output targets subject to the budget constraint. As a result, Indonesia's planning and budgeting system operates a complex mechanism for merging the priorities and planned outputs of the President, Line Ministries, Sub-National Governments, and the Parliament into a set of work plans and budget allocations over the medium and short-term. Both institutions MOF and Bappenas are yet to match fully to the logic of MTEF.

[21] The determination of the resource envelope consists of three key processes: preparation of the Medium-Term Macro-Economic Framework (MTMF), preparation of the Medium-Term Fiscal Policy Framework (MTFF) and preparation of the Medium-Term Budget Framework (MTBF). The MTBF as presented in the financial note is not disaggregated by function, only the main headers (expenditures, revenues, surplus/deficit and financing), but the framework is detailed in subsequent planning and budget documents.

[22] 2014. IMF Policy Paper. *Budget Institutions in G-20 Countries: An Update.* Washington DC.

[23] National Planning document, produced by Bappenas includes an overall strategy for national developments, a macro-economic framework, outcome objectives, and output targets. Renstra-KLs are a series of ministry-level five year strategic plans, which are detailed down to the level of planned activities (in terms of Km of road or dams built) by provinces and indicative budget over five year period.

17. Further, there are some limitations to achieving a full costing of programs and activities in preparing the recurrent budgets, given the staff capacity and magnitude of tasks. In addition, Investments are not consistently selected on the basis of both capital and recurrent cost implications. The government work-plan (RKP), which is the basis of discussions within the government and the Parliament, includes budget numbers and descriptions of investment projects at a general level, but does not include comprehensive information on recurrent cost implications for future years. Issue remains of how much the MTEF data prepared now for the next year is used as the baseline of the next year budget? This is the real challenge for the MOF, as it requires an improved accuracy of the projection, to ensure a balanced budget. Going forward, MOF is planning to introduce a system for monitoring performance indicators called ADIK (Arsitektur Dasar Informasi Kinerja or Basic Architecture on Performance Information) to be managed by DG Budget and will roll out the system in 2016.

18. **Other measures included strengthening budget controls and reporting.** Budget classification system has been streamlined over the years and follows international standards in accordance with the International Monetary Fund government financial statistics. The Government applies national public sector or government accounting standards (SAP) that are broadly consistent with international standards (IPSAS). Since 2004, Indonesia has applied a "cash towards accrual" accounting standard, and moved to accrual-based accounting from January 2015. Transparency of the budget has been enhanced with the key budget documents, including draft budgets, six-monthly budget execution reports, and detailed financial notes, all available on the web. Government's score in the Open Budget Index has increased from 51% in 2010 to 62% in 2012.[24] Audits by the Supreme Audit Board (BPK - the external auditor) show an improvement in the quality of government financial statements. The number of line ministries with statements receiving "unqualified" opinion has increased, while the number of those receiving "disclaimers" has fallen.

19. **Internal Control and Internal Audit strengthened.** Commitment controls are in place that effectively limit commitments to actual cash availability and approved budget allocations, further improved with the implementation of the State Treasury and Budget System (please see para 25 below). The government has also adopted COSO as its control framework in August 2008 and Government Regulation (PP) 60/2008 clarified the role of internal auditors (BPKP) and required all state institutions to implement the Government Internal Control System (GICS) for effective, efficient, and accountable management of state funds, and reliable reporting.[25]

20. **External audit.** Badan Pemeriksa Keuangan (BPK), as the supreme audit institution (SAI) of Indonesia, has made steady progress in its mandate, capacity and practices to strengthen integrity and accountability in government.[26] A peer review conducted by the Dutch Court of Auditors in 2009 had identified some areas for improvement, mainly the need to improve the readability of audit reports and the quality of analysis in the audit. BPK has prepared a new strategic plan for the 2011–15. The new strategic plan reflects both lessons from the peer review and the vision of the new BPK Board. BPK has also prepared a detailed implementation plan to support the execution of the strategic plan. Though BPK has adopted several measures to strengthen auditor professionalism and integrity resulting in significant

[24] International Budget Partnership (undated): "Indonesia, Open Budget Index 2012".

[25] Under the regulation, four types of institutions share the responsibility for conducting the Government's internal audit function, namely, the BPKP, Inspectorates General, provincial inspectorates and district/city inspectorates. Each of these is assigned different roles.

[26] Third amendment of the 1945 Constitution (2001), Law of Audit (2004) and Law on BPK (2006) provide the legal basis for public sector auditing by BPK.

improvement in the quantity and quality of BPK's audit resources, including increases in the number of qualified auditors, representative offices, and in the use of Information Technology (IT), BPK requires more auditors with diverse educational backgrounds in addition to accounting and finance to execute performance audits to enhance the quality of public administration and accountability. ADB had supported the supreme audit body by providing the State Audit Reform Sector Development Program Loan.[27]

21. **Strengthened legislative oversight**. The Parliament's (DPR) role in shaping the state budget and in overseeing budget processes was institutionalized in Law No. 27/2009Under the Law, the former Budget Committee became the Budget Board (Badan Anggaran). It became a permanent entity of DPR responsible for the endorsement of the state budget. Secondly, the State or Public Finance Accountability Board (Badan Akuntabilitas Keuangan Negara) was established as a permanent entity of DPR to review audit results of state financial reports prepared by the State Audit Agency (BPK).

22. **Budget Execution continues to improve.** Slow pace of budget execution pose significant barriers to efficient public service delivery in Indonesia. Back-loaded disbursements and spending patterns skewed towards the end of the financial year remain ongoing challenges, and raise a particular concern over the absorptive capacity and quality of budget implementation, as highlighted by a World Bank Study - "Identifying the Constraints to Budget Execution in the Infrastructure Sector". [28] According to IMF, typically 50-60% of capital spending is disbursed in the last quarter and this contributes to the low level of budget execution in public investment.[29] These constraints are largely attributed to (i) cumbersome and complicated reallocation procedures between spending units and expenditure programs and (ii) severe delays in procurement due to insufficient capacity in spending units.

23. **Measures adopted to accelerate budget execution.** MOF continues to streamline systems/procedures, with a greater focus on performance and flexibility for managers to manage their budgets. Multiyear appointments of budget officers authorized to execute the budget, together with revisions and simplifications in spending rules and new cash management systems are expected to improve budget execution. In addition, finalization of rules to resort to advance procurement on the basis of annual procurement plan before the financial year started will speed up disbursements (Presidential Regulation 54/2010). Other key reforms relate to implementing the State Treasury and Finance System (SPAN) and measures to improve public procurement.[30]

24. **Public procurement reforms have strengthened budget execution.** Procurement reform in Indonesia was initiated in 2003 through a presidential decree (No80/2003), later replaced by Presidential Regulation (Peppres) No. 54/2010. The scope of reforms was extensive, and covered the procurement of goods, services, consulting services and public works regardless of their size or value. Regulations and procedures to facilitate procurement were issues, and made applicable to all levels of government. National Public Procurement Agency (LKPP) was established by a decree to govern the implementation of e-procurement to increase transparency and efficiency in the procurement process. The decreerequired that all

[27] ADB. 2004. *Report and Recommendation of the President to the Board of Directors: Proposed State Audit Reform Sector Development Program to Indonesia*. Manila.
[28] DIPA Tracking Study: Identifying the Constraints to Budget Execution in the Infrastructure Sector.
[29] 2013. Staff Report for the 2013 Article IV Consultation. Indonesia.
[30] A recent ADB country and project level procurement risk assessment that covered 4 big sectors in Indonesia (energy, transport, agriculture and irrigation), indicated that Indonesia's country-wise procurement scored 2.4 out of 3 points, and the assessed sectors are varied from 2.5 to 2.7.

government units and the national and sub-national level adopt e-procurement by 2012 to increase transparency and efficiency in the procurement process. The decree also required procurement Service Units (ULP's) to be established with accredited personnel at all levels of government to standardize the organization of procurement at all levels of government.

25. **E-Procurement has gained momentum.** There is a rapid increase in the number of provinces and local governments using electronic procurement. Most recent data indicate that around 33 provincial governments and 681 regional governments and government institutions have introduced e-procurement.[31] In Indonesia, e-procurement has reduced delays in completion of public work projects.[32] Bidding data suggests that an important channel of influence is selection – regions with e-procurement have a broader distribution of winners, with (better) winning bidders more likely to come from outside the region where the work takes place. On net, the results suggest that e-procurement facilitates entry from higher quality contractors."

26. **Indonesia is committed to further procurement reforms.** The Presidential Regulation 54/2010 does not apply to all state-owned companies, particularly national oil and mining companies. The interaction between the Presidential Regulation and other existing laws applicable to procurement, such as the Construction Services Law (Act No. 18/1999) and the Law on State-Owned Enterprises, is not clear since both these laws also have provisions governing procurement. While the Presidential Regulation allows bidders to file a protest, there is no clear protest handling mechanism and no clear sanctions for violation of the procurement procedures. The Regulation also does not contain provisions specifically authorizing civil society monitoring of procurements. While it requires the signing of an "integrity pact" by bidders and relevant government officials, the scope of that pact consists only of a "vow to prevent and not to engage in collusion, corruption and nepotism in the procurement of goods/services."[33] Most importantly, the Presidential Regulation does not have a sufficiently high legal status to truly standardize the public procurement system throughout Indonesia, as Indonesia has never had a procurement law. Rather, it has had a "plethora of decrees, regulations, and instructions" ranging from Ministers and provincial governors to district officials and municipal mayors "that contain conflicts and inconsistencies."[34] LKPP is now focused on the preparation of a new procurement law, and has carried out a public consultation process on a draft procurement law which included government agencies and international development partners. The draft law proposes a broader scope for coverage which includes concessions and PPP transactions.

27. **The State Treasury and Budget System (SPAN) - An Integrated Financial Management Information System (IFMIS).** SPAN, supported by the World Bank, Government of Japan and the PFM Multi-Donor Trust Fund (MDTF), aims to manage all financial transactions data of the central government in a full cycle from budget appropriation/allotment/execution up to the production of financial statement. This will ensure fiscal data that is timely, robust and reliable. Beginning February 2015, SPAN, as mandated by the Presidential Regulation (54/2010), is under implementation implemented by 179 local Treasury offices (KPPN) of MOF covering the Central Government agencies (+24,000 spending units across Indonesia. With the SPAN in place, all financial transaction data are recorded in one database with real time and online information available at any time required. SPAN permits

---

31 Source: INAPROC-Smart Report LKPP (http://report-lpse.lkpp.go.id/v2/public/index).

32 2014. NBER Working Paper Series. C*an Electronic Procurement improve infrastructure provision? Evidence form Public Works in India and Indonesia.* Sean Lewis-Faupel, Yusuf Neggers, Benjamin A. Olken and Rohini Oande. Working Paper 20344. Cambridge, USA.

33 Ibid., Article 1(13).

34 See *Snapshot Assessment* at 8-9, recommending that Indonesia adopt "an overarching consolidated and comprehensive national public sector procurement law at the highest level."

direct connection with line ministries and other users of treasury resources to access and process financial information, while allowing the Directorate-General of Treasury to meet its obligations for treasury management. SPAN has helped to ensure the budget appropriation data (APBN law and Perpres) is consistent with the budget allotment data (DIPA) as otherwise any inconsistency in data will not be paid/disbursed. SPAN has also put a discipline to both the line ministries and the MOF (DG Budget staff) in ensuring there is no spending beyond the budget ceiling for each individual line item. Moreover, SPAN will record encumbrance or commitment of the contract in the system so it helps to monitor any delay in disbursement. Hence, the implementation of SPAN represents a major milestone in the PFM reform agenda. Major challenges, however, remain to sustain these fundamental changes and will require intensive and dedicated support, including commitment - both human and financial resources - for effective implementation.

28. **PFM at the subnational government level is equally important and the key to successful decentralization in Indonesia.** Indonesia has made significant progress implementing decentralization reforms.[35] Effective devolution of key expenditure and revenue functions to regional governments has taken place. Key reforms have been on enhancing equalization and transparency in fiscal transfers, developing more dynamic sources of local revenue, and strengthening debt management. This has led to a pool of significant resources for the subnational governments (SNGs), and has also vested them with greater responsibilities.

29. At the SNGs level, however, PFM capability is weak, and budget execution is inefficient, together with underspending in scarce resources relating in poor service delivery. In addition, budget reporting is lax, and classification of expenditures is not homogeneous. Regional government follows two different systems of financial management systems and implementation is far from satisfactory, and requires significant capacity strengthening.[36] In addition, fiscal transfer mechanisms[37], too, do not sufficiently provide incentives for PFM improvement at sub-national levels, as (i) fiscal transfers are not linked to improved performance in services delivery and financial management, (ii) increases in own source funds are offset by a decrease in fiscal transfers and (iii) current transfer principles are not adequately need- based, i.e. favor entities with an higher Human Development Index and higher GDP per capita. Strengthening PFM capability of officers at the subnational level should therefore be of continuous importance and should be well coordinated between the main stakeholders, MoF and MoHA.[38]

---

[35] Since 1999, the government has introduced major decentralization reforms to improve the delivery of basic services and infrastructure to local communities across the country. The reforms pursued, which in extent and speed have had few precedents elsewhere in the world, have been referred to as the “big bang” approach to decentralization.

[36] SIKPD (Sistem Informasi Keuangan Pemerintah Daerah or Local Government Financial Management Information System) and SIMDA (Sistem Informasi Manajemen Daerah or Local Information Management System) are the two commonly used system. SIPKD is developed by MOHA, while SIMDA is developed by BPKP. The latest data per January 2014 shows that 364 out of 527 local governments are using SIMDA as their RFIMS.

[37] The Indonesian fiscal transfer system consists of 3 main types of grants: (1) General Allocation Fund (DAU), determined by the amount of spending in personnel plus the "fiscal gap" of the particular district, which takes into account indices such as population and income, (2) Special Allocation Funds (DAK), allocated to districts to focus on particular national priorities set out by central government, (3) Shared Revenue Funds (DBH) related to the generation of revenues from natural resources and taxes in the particular regions.

[38] Under the Law 32/2004 on regional Governments (Decentralization), Ministry of Home Affairs (MoHA) is assigned to supervise and regulate financial management at regional governments; while the role of the MoF is limited to transfer of budget, and setting the limit of cumulative loans and deficits, signing on-lending loan, and setting up regional finance information system. At the strategic level, there must be greater cooperation and coordination between the MoF and the MoHA. The laws which define the roles of both ministries are currently under review.

C. Development Partner Support

30. Development partners have remained engaged with the government, at both central and sub-national level, for strengthening PFM systems in Indonesia, through a broad mix of policy-based operations, projects and TA activities. Since 2004, budget and treasury reforms have remained high on the World Bank agenda through its 8 annual policy-based development policy loans (DPL) to the government, and also supported through parallel co-financing by the Government of Japan and ADB with a series of development policy support program (DPSP). The EU, Netherlands, Switzerland, Canada, JICA, IMF and USA have complemented this work.

31. ADB, particularly through its Local Government Finance and Governance Reform (LGFGR) programs, supported PFM strengthening at the sub-national level, especially in the implementation of a computerized financial management information system (FMIS) at 171 regional locations.[39] Australian Aid (AusAid is very active in the area of PFM at both central and sub-national levels, with focus on tax reform, public procurement, debt management and capacity building at a number of sub-national authorities. GIZ and CIDA were also engaged at the subnational levels through pilot capacity building projects covering specific Indonesian provinces. To strengthen budget transparency, USA supported Open Government initiative is supporting efforts to disclose detailed budget information across all levels of government.[40]

D. Key Lessons

32. PFM reforms in Indonesia, provides several key lessons. First, meaningful reforms require a long time to succeed, together with strong, committed political leadership and legislative momentum. Second, political economy factors are important and complex budget reforms relating to budget allocation, decentralization reforms, and budget execution with focus on IT based financial management system, should be appropriately sequenced, and well aligned with political incentives. This is a key predictor of reforms to succeed in Indonesia. Third, case studies show that TA coupled with investment and policy based loans coupled with TA are crucially important for reforms to succeed in the specific institutional, legal, and cultural country context. Finally, close coordination between different ministries, especially MOF and line ministries, is critical to promote consensus for reforms.

E. Conclusions and Recommendations

33. **Reform agenda, however, is far from complete.** Over the years, Indonesia has achieved progress in PFM. In the first phase of reforms, following the Asian Financial Crisis, Indonesia strengthened its legal and institutional framework for PFM reforms. Second phase of reforms is ongoing, and has have advanced complex reforms that has contributed to strengthen creditability of the budget, its comprehensiveness and transparency, and results orientation.

[39] In addition to the State Audit Reform Sector Development Program (35144-013), PFM support is also provided through Sustainable Capacity Building for Decentralization Project (35261-013), Local Government Finance and Government Reform Sector Development Program (36541-013), and Local Government Finance and Government Reform Sector Development Project (36541-023). The Fourth Development Policy Support Program (43092-013) included outputs for improved PFM and governance as well as for delivery of public services.

[40] At the province level, 73% have disclosed detailed budgets, while at the district level it is still in progress and was planned plan to be completed by end of 2014 (as stipulated in the presidential decree no. 2 /2014). A portal on government institution performance and budget information at national and sub-national level (Portal Satu Pemerintah) is also being developed. • Indonesia's open government action plan for 2014-2015 will also expand to the legislative branch. It is expected that the parliament (DPR) will make publicly available through various on-line media running of on-going meetings, meeting attendance, minutes of meetings, etc. Source: Indonesia OGP Action Plan 2014-15. www.opengovpartnership.org/country/indonesia/action-plan.

Budget processes, and practices have been further streamlined. The development of a fully operational MTEF and PBB, with well-articulated medium-term fiscal targets and detailed indicative revenue and expenditure figures at the line ministry level and sector level, is expected to bolster aggregate fiscal discipline, expenditure prioritization and the efficiency of spending. Implementation of the accrual accounting system, and effective implementation of the integrated financial management system (SPAN) will strengthen the predictability and control in budget execution, including accounting and reporting functions. Faster procurement is sought to be achieved via e-procurement. PFM reforms are always a long-term and complex process, and require continuous support from development partners. Building capacity should go along with the new business processes, and the change in mindset. Going forward, a strong budget system, accompanying the new government's unprecedented overhaul of Indonesia's costly-fuel subsidy regime, and expected tax reforms, will provide the fiscal space to double spending on infrastructure, health and social welfare.