SECTOR ASSESSMENT (SUMMARY): PUBLIC SECTOR MANAGEMENT (PUBLIC EXPENDITURE AND FISCAL MANAGEMENT)[1]

A.   Sector Performance, Problems, and Opportunities

1.   Since 2000, Indonesia has experienced one of the largest increases in inequality of all Southeast Asian economies. The Gini coefficient, used to measure household income inequality, surged from 0.30 in 2000 to 0.40 in 2015 partly because of unequal access to education and jobs. Underlying this rise is the relatively limited impact of social programs and policies on the Gini coefficient compared with other member economies of the Association of Southeast Asian Nations. This is primarily because of inadequate spending, weaknesses in public expenditure management (PEM), and poor targeting of social protection programs. Therefore, with regard to mitigating high inequality in Indonesia, the key development problem is insufficient and weak targeting of spending on infrastructure and the social sector.

2.   The government recognizes the importance of tackling inequality and is committed to reducing the Gini coefficient to 0.36 by 2019. After mapping out Sustainable Development Goal (SDG) targets against the National Medium-Term Development Plan (RPJMN) 2015–2019, the government is aligning public expenditure spending for education, health, social assistance, and infrastructure spending as key conduits for reducing income inequality. The table below summarizes some key RPJMN targets and baselines on health, education, and infrastructure. This government's alignment also needs to be complemented by strong national PEM and effective public service delivery by subnational governments.

Health, Education, and Infrastructure Targets: National Medium-Term Development Plan, 2015–2019

Health		
Indicator	**Baseline**	**Targets (2019)**
Maternal mortality ratio per 100,000 live births	359 (2012)	306
Infant mortality rate per 1,000 live births	32 (2012)	24
Percentage of districts or cities that completed 80% of primary immunization of infants (%)	71.2 (2013)	95
Education		
Net enrollment rate in primary education (%)	91.3 (2014)	94.8
Net enrollment rate in senior secondary education (%)	55.3 (2014)	67.5
Gross enrollment rate in colleges and universities (%)	28.5 (2014)	36.7
Infrastructure		
Population with access to national roads (%)	94 (2014)	100

Source: Indonesia National Statistics Office.

3.   **Planning and budgeting needs to be strengthened.** The role of the medium-term expenditure framework (MTEF) in dealing with allocative issues is still a work in progress because of the devolved planning and budgeting system. The Ministry of Finance (MOF) is responsible for coordinating budget formulation and specifically considers budget ceilings and deals with recurrent budget items such as routine and operational costs. The National Development Planning Agency (BAPPENAS) prepares priority programs and activities and deals with investment and capital budgets. BAPPENAS also deals with output targets based on the RPJMN

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[1] This assessment draws upon prior analyses related to public expenditure and fiscal management carried out by the Asian Development Bank (ADB) and the government.

and annual ministry-specific work plans. The line ministries have the power to decide what projects they will implement to achieve output targets subject to budget constraints. As a result, Indonesia's planning and budgeting system is a complex mechanism that merges the priorities and planned outputs of the President, line ministries, subnational governments, and Parliament into a set of work plans and budget allocations over the medium and short terms. Both the MOF and BAPPENAS have yet to fully implement the MTEF and synchronize planning with the budget cycle. Recognizing these coordination challenges, Government Regulation No. 17/2017 on synchronizing national development planning and budgeting processes was issued to improve the coordination between planning and budgeting under a unified results framework. policy orientation of budgeting. Significant capacity building for the government will be required to implement the regulation.

4.   Given the capacity of government staff and magnitude of tasks, there are limitations to achieving a full costing of programs and activities in preparing the recurrent budgets. Investments are not consistently selected on the basis of both capital and recurrent cost implications. The government annual work plan, which is the basis of discussions with 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. The issue remains of how much the MTEF data prepared for the next year is used as the baseline for next year's budget. This is a challenge for the MOF, as the baseline projections need to be accurate to ensure a balanced budget and impacts on the credibility of the government's budget system.

5.   **Slow budget disbursement.** From 2012 to 2015, the budgeted development expenditures have underperformed against budget targets, underlying the recurrent problems in budget implementation. During 2010–2013, the disbursement rate of government ministries did not reach 100%, and the absorption rate for key infrastructure ministries was as follows: Ministry of Transportation (75%–90%), Ministry of Energy and Mineral Resources (55%–70%), and the Ministry of Public Works and Public Housing and its agencies (70%–90%). Slow disbursement is attributed largely to cumbersome procurement practices and lack of implementation capacity. At the subnational level, the problem is more accentuated given a lack of implementation capacity. In response to slow budget disbursement, the government established a budget realization evaluation and monitoring team headed by the minister of finance, which issued data indicating that public spending disbursement varies across line ministries. Strengthening disbursement is also emphasized in the SDGs. SDG 16 (peace, justice, and strong institutions) targets the development of more effective, accountable, and transparent institutions at all levels, with primary government expenditures as a proportion of originally approved budgets as an indicator. In line with this, the government is committed to increasing its audit performance.

6.   **The fiscal transfer system needs improvement.** Despite progress, the design and coordination of the different elements of the intergovernmental fiscal transfer system can be improved. The formula used for the allocation of the largest unconditional grant to local governments (through the General Allocation Fund) fails to properly estimate both the expenditure needs and fiscal capacity of local governments and does not distinguish between type and size of local administrations. The emphasis for equalization is between places, not between people, with bias in favor of regions with small populations. The Specific Allocation Fund (DAK), which covers the capital expenditure needs of local governments, suffers from poor targeting at the sector and jurisdictional levels. The DAK formula provides transfers based on absolute (not per capita) fiscal capacity, with regions that raise the largest absolute amounts of revenue considered richer and less in need of DAK support.[2] These local transfer policies were developed to address

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[2]   World Bank. 2017. *Indonesia Economic Quarterly: Sustaining Reform Momentum*. January 2017. Jakarta.

concerns about high allocations to Java, with fiscal transfers skewed toward small rural districts. The different elements of the fiscal transfer system are not properly coordinated, resulting in inefficiencies in resource allocation across local governments.

B.   Government Sector Strategy

7.   **Aligning public expenditure with overarching targets.** The government aims to stimulate the economy through fiscal policy to achieve a long-term development impact on infrastructure and the social sector. The fiscal strategy rests on two pillars. As an immediate measure, the government reduced general subsidies (such as for energy) for the non-poor and increased pro-poor spending in critical social and infrastructure areas. Over the medium term, the government is aligning its expenditures with RPJMN and SDG targets, which will make spending more efficient and better targeted. The presidential regulations on implementing the SDGs issued in 2017 laid out implementation plans in a sequential manner. The first step, completed in 2016, was to map out the SDG targets against those in the RPJMN, with the targets relevant to the RPJMN given priority. The government has set up a national coordination body to monitor implementation of the SDGs chaired by the President. The Presidential regulations require the government to develop action plans at the national and subnational levels.

8.   **Reforms to the subsidy program.** In improving budget efficiency and allocation, the government in 2015 eliminated the energy subsidy and thus moved away from a general subsidy to a more targeted subsidy. The focus is to promote more productive spending. This is needed to develop priority infrastructure projects, ensure more efficient spending, improve targeted subsidy schemes by expanding social protection programs, and fulfill mandatory spending on education (20% of total expenditure) and health (5% of total expenditure). In addition to the unified poverty database, the government is leveraging information and communication technology to register beneficiaries and monitor disbursements. The noncash social assistance program piloted in 2016 that replaced the rice subsidy program has now been extended to 1.4 million households. In 2018, there has also been a significant increase in the conditional cash transfer program reaching 10 million households. Progress toward the achievement of the SDGs has been particularly encouraging in relation to SDG 3 (good health and well-being). Indonesia's health insurance system now covers 172 million people (with 92.4 million of the poor receiving subsidy), making it one of the largest health insurance systems in the world. Based on calculations by the Asian Development Bank (ADB) as shown in the figure 1 below, the government's realignment of universal subsidy programs and its focus on social assistance programs had a significant impact in reducing the Gini coefficient from 0.41 in 2014 to 0.39 in 2016.

Figure 1: The Effect of Social Spending on Indonesia's Gini Coefficient, 2016
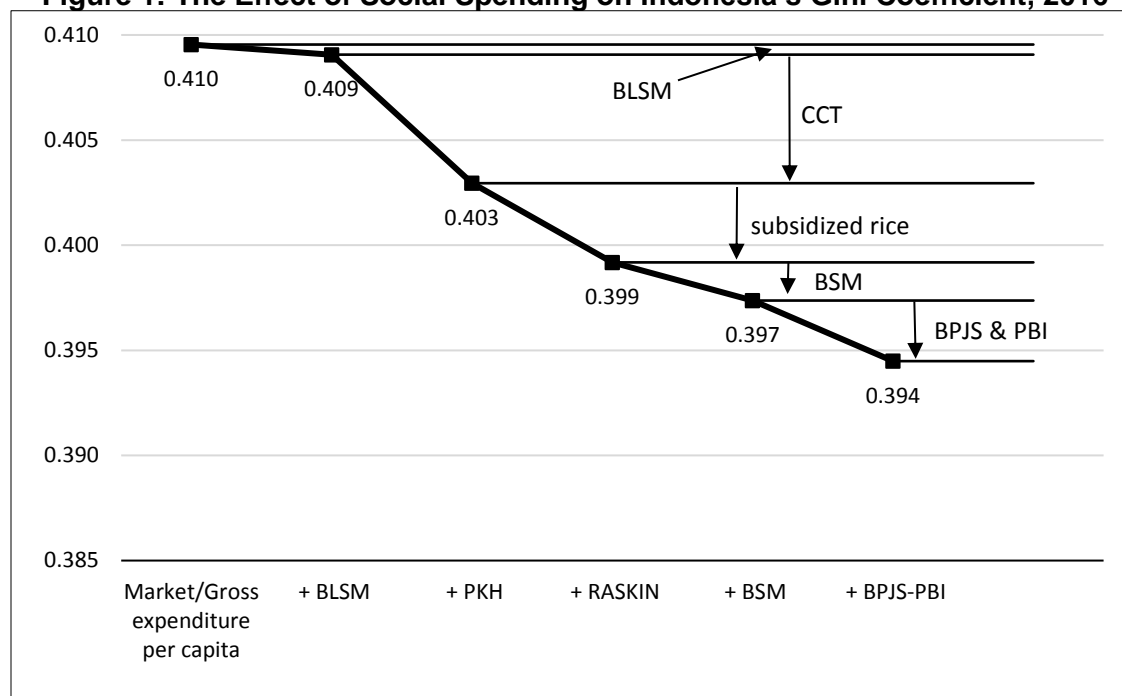
BLSM = Bantuan Langsung Sementara Masyatakat (Temporary Direct Assistance); BSM = Bantuan Siswa Miskin (Cash Transfer for Poor Students); BPJS = Badan Penyellengara Jaminan Sosial (National Health Insurance); PBI = (Subsidized Health Insurance for the Poor).
Source: ADB study (unpublished)

C.   ADB Sector Experience and Assistance Program

9.   ADB has long supported reforms in PEM and social protection. As early as 2002, ADB provided significant technical assistance (TA) to set up the public financial management (PFM) and PEM framework at the national and subnational levels. This was followed by ADB's support in 2005 for the government's efforts to build a modern national PFM system including a public debt management office. In the second phase beginning in 2008, ADB provided support to introduce financial management information systems within 147 local governments and to decentralize the tax framework. Since 2012, ADB has provided TA to improve the fiscal sustainability of social security, strengthen the fiscal decentralization framework, and improve the fiscal risk management of contingent liabilities arising from accelerated infrastructure investment. The Fiscal and Public Expenditure Management Program continues ADB's engagement with the government in the areas of fiscal policy and PFM by supporting the PEM framework at the national government level and fiscal transfers to subnational governments for efficient service delivery.

10.   Specific to the reforms in the Fiscal and Public Expenditure Management Program, ADB provided TA to support the implementation of the SDGs by helping the government undertake fiscal gap analysis for social assistance programs. At the subnational level, ADB provided capacity development to four districts in East Java province to deliver effective, safe, and good-quality education and health services by promoting governance principles. ADB has included a TA in the 2018 pipeline to develop a financing strategy for implementing the SDGs, support capacity building to MOF and BAPPENAS for efficient coordination between the planning and budgeting processes, and pilot labor market activation programs based on ADB's experience in the Philippines.

Problem Tree for Public Sector Management

EFFECTS

Increased household income inequality

SUB-EFFECTS

Constrained scope for local government involvement in development	Low value of money in public spending	Decreased spending effectiveness	Increased unemployment and poverty due to poor services

CORE PROBLEM

Insufficient and weak targeting of spending on social sectors and infrastructure

CAUSES

Weak public expenditure management at central level	Weak public expenditure management at local level	Non-sustained medium-term spending in critical sectors	Insufficient public spending accountability	Weak regulatory framework at central and local levels

SUB-CAUSES

Inability to fully ascertain effects of exogenous factors on macroeconomy	Ineffective performance-based grant system for local governments	Inadequate capability to systematically maintain targeted levels of investments	Low capacity of local government officials and agencies on financial management	Inconsistent, conflicting, and incomplete laws, rules and regulations

Poor coordination at central level of macro policies and programs

Non-specific expenditure assignments to priority sectors for local governments

Weakness in social health insurance coverage for disadvantaged population

Weak audit laws

Performance-based budgeting not rigorously applied

Poor monitoring and evaluation system for budget implementation at local level

Low level of resource availability for urban and rural infrastructure services

Vertical and horizontal spending inequities

Existing performance monitoring system not adequate

Lack of proper operation and maintenance and inventory asset management system

Shaded boxes are causes addressed by the program