PUBLIC FINANCIAL MANAGEMENT ASSESSMENT

I. Summary

1. Indonesia has an impressive track record of growth and poverty reduction and has made significant achievements in several global indexes measuring governance and competitiveness. Indonesia has undergone steady growth over the past five years, weathering a global slowdown and maintaining sound macro-economic policies while exhibiting fiscal prudence. In 2017, the economy grew by 5.1 percent, with an accelerating trend towards year's latter quarters. In line with this trend, growth is forecasted to increase to 5.3 percent in 2018. In just a few years, Indonesia's rankings in the World Bank's Ease of Doing Business index have improved by 42 places, from 114^{6h} in 2015 to 72nd in 2018, reflecting significant improvements in the regulatory environment and governance framework. Poverty has also declined significantly, falling by more than half from 24% in 1999 to 10.6%% in 2017.

II. Background

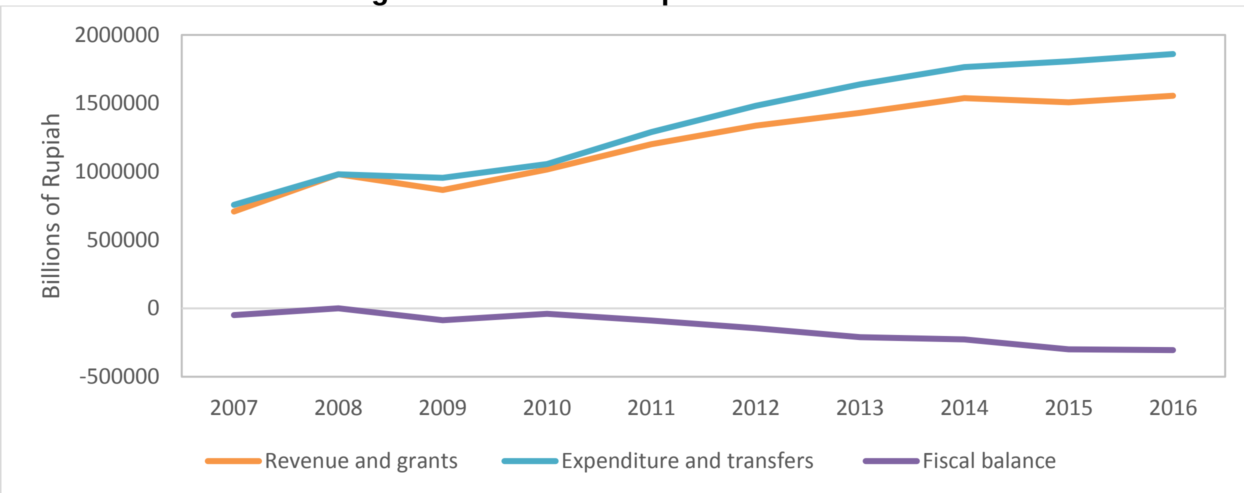
2. **Steady economic growth, significant poverty reduction, persistent inequality.** Indonesia has recorded steady economic growth over last decade. From an average rate of approximately 7 percent in the mid-late 1990s, growth recovered to 4.9 percent in 2000 following the Asian financial crisis. It continued to accelerate through the 2000s to a peak of 6.4 percent in 2010, before moderating to approximately 5.0 percent in 2013. The economy has remained relatively constant over the past five years, with a growth rate of 5.1 percent in 2017, but now shows signs of moderate acceleration. Growth is projected to be 7.3 percent in 2018.The proportion of people living in poverty has declined by more than half, from 24% in 1999 to 10.6%% in 2017. However, overall poverty levels remain relatively high for a low middle income country. More disconcerting is the uneven nature of growth and rising inequality. The bottom 40% of the population are vulnerable to shocks such as food price increases, environmental hazards, and ill health, and are at risk of sliding back into poverty. Despite recent improvements in education and health sectors, public services and health standards still lag other middle-income countries. The Gini coefficient, a measure of consumption inequality, has increased at a faster pace than in neighboring Southeast Asia countries, from 0.30 in 2000 to 0.39 in 2017. Indonesia has made strong commitments in pursuing an agenda of inclusive growth and sustainable development. Strong economic and fiscal performance is required for making progress towards these commitments, with weaknesses in public expenditure management and service delivery constraining factors in making progress towards inclusive growth. Reducing poverty to single digitals and reversing the situation of high inequality require measures to improve the quality of service delivery, increase access to finance, and address labor market entry barriers that limit access to quality jobs.

3. **Indonesia's fiscal strategy.** The government's fiscal strategy can be divided into long-term and short-term. For the long-term, the government strategy is to create sustainable and equitable economic growth through optimizing revenue, improving spending quality, and sustainable financing. Indonesia seeks to increase its tax-to-GDP ratio from 10.4% in 2016 to 11.5% in 2018 and to between 12.7% and 13.3% by 2021.[1] In addition, the government is now preparing a comprehensive medium-term revenue strategy that includes both tax and additional tax administration reforms. For the short-term, the strategy is to safely navigate the economy through global uncertainties. The crux of the short-term strategy is fiscal stimulus, resulting in a

[1] Republik Indonesia (2017) Buku II: Nota Keuangan – Beserta Rancangan Angaran Pendapatan dan Pelanja Negara 2018, Republik Indonesia, Jakarta.

modest budget deficit in recent years (Figure 1). The government has also created fiscal space via revenue mobilization, including a tax amnesty, and energy subsidy reform. After taking office in 2014, the Joko Widodo administration announced that it would reduce energy subsidies and allocate the savings to increased public spending on infrastructure and social services. It has done so in 2015, 2016 and 2017 budgets.

Figure 1: Fiscal development 2007–2016

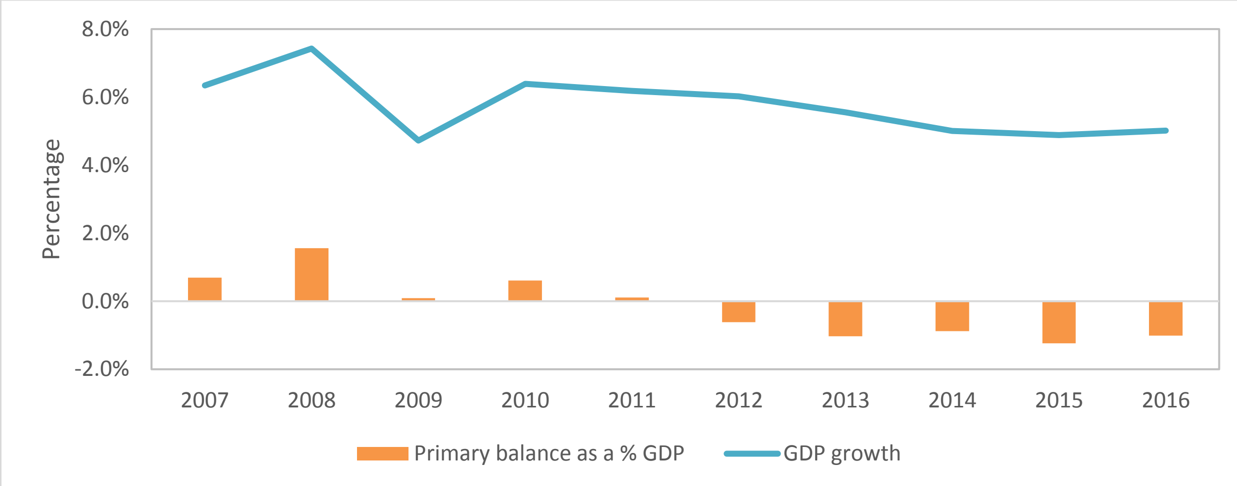


Source: Ministry of Finance

4. **Prudent fiscal stance.** Indonesia's fiscal deficit is manageable. The government deficit was capped by law at 3% of GDP since 2003 and this rule has been consistently applied. The threshold for each level of government is determined annually and was set at 2.7% for the central government and 0.3% for the sub-national governments in recent years. The fiscal stance has been mildly expansionary in recent years, with the primary balance moving to deficit in 2012 as GDP growth began to decline (Figure 2). This was driven initially by expenditure pressures, notably from energy subsidies. In a major policy shift in January 2015, energies subsidies were reformed, which reduced fuel subsidy costs from 2.3% of GDP in 2014 to 0.5% of GDP in 2015. Indonesia's government debt-to-GDP ratio reached at 27.9% of GDP in 2016 and has increased from a low of 23.0% in 2012, reflecting a larger primary deficit.

5. **Tax reforms and revenue strategy.** The most prominent budget initiative in 2016 was the 9-month tax amnesty program, which commenced in July 2016 and sort to accelerate growth, widen the tax base, and increase revenues. After the successful implementation of the tax amnesty program, which brought in $10.2 billion in additional revenues, the government plans to deepen tax policy and tax administration reforms, with expectations to improve the tax-to-GDP ratio considerably. In line with this, Indonesia will join the Automatic Exchange of Information in 2018, which enhances cross-border cooperation between tax authorities, with a regulation was released in May 2017 which provides the tax office with access to the banking industry's financial data for tax purposes. In addition, the government is currently preparing a comprehensive medium-term revenue strategy promising significant reform to tax policy and administration. Meanwhile, the upgrading of Indonesia's sovereign rating to investment grade by Standard & Poor's and Fitch's in 2017 should have a positive impact on investment and control the cost of government debt.

Figure 2: GDP growth and the primary balance 2007–2016



Source: Ministry of Finance

6. **A more credible fiscal framework.** Revenue shortfalls flagged in mid-2016 led the government to cut planned spending by $11.3 billion and widen the budget deficit target from 2.2% in the original budget to 2.4% of GDP in the revised budget. The 2016 fiscal deficit came in at 2.5% of GDP, the was roughly in line with the government's revised target 2016. Revenue in 2016, excluding income garnered through the tax amnesty, came in 3.7% lower than in 2015. Expenditure cuts saw capital spending decline by 23% and social spending by 49% from 2015. Consequently, a focus of the 2017 budget has been fiscal consolidation, with the 2017 budget setting a slightly lower limit on total government expenditure than the revised 2016 budget – but with a higher allocation for infrastructure spending. A more realistic revenue mobilization target was another feature of the 2017 budget. However, overall revenues were lower than expected for 2017. Revenues grew 4.4 percent y/y by October, compared with the 16.7 percent y/y envisaged in the budget,[2] resulting in the deficit approaching statutory levels for 2017.

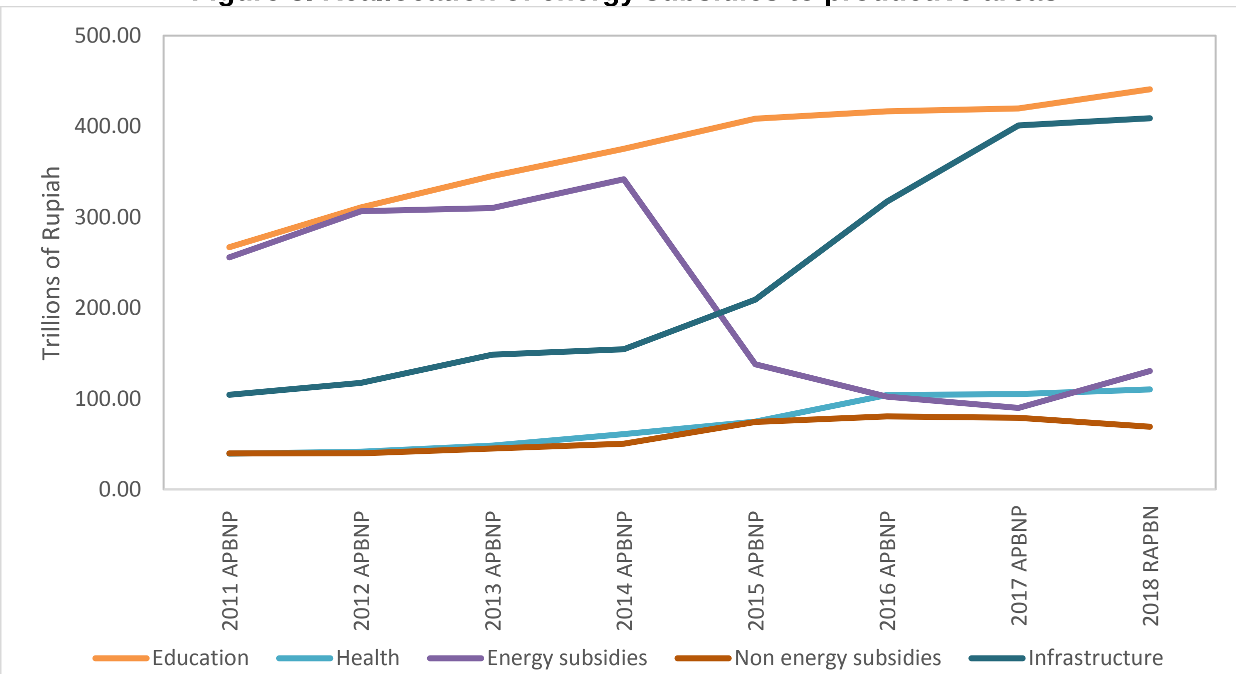
7. **Fiscal policy continues to support growth.** The revised budget for 2017, approved by the legislature in July, raises the budget deficit to the equivalent of 2.9% of GDP from 2.4%. As tax revenues excluding petroleum grew slightly slower than envisaged in the original budget, total revenues are likely to be lower by 0.3% of GDP. Meanwhile, the revised budget foresees total expenditures somewhat higher, notably with higher allocations for public infrastructure, health care, and education. The government expects that the actual deficit will be near 2.7% of GDP due to the traditional underperformance of spending. The 2017 budget made further progress with subsidy reforms, including better targeting of electricity subsidies and shifts from price subsidies to direct transfers for foodstuffs. However, the revised budget puts on hold the policy of rebuilding fiscal buffers and makes use of most of the available fiscal space, although there are no imminent risks to confidence or fiscal sustainability from the shift.

8. **Strategy in 2018.** In 2018 the government is to focus on improving fiscal management to support equitable growth through expanding productive spending, improving subsidy schemes, and fiscal decentralization in 2018. The reallocation of energy subsidy to productive sectors has provided an opportunity for the government to expand education, health, and infrastructure (figure 3). The reduction in energy subsidies has provided ample fiscal room for the government to accelerate development of priority infrastructure projects, which should help to reduce regional

[2] IMF. 2018. *Article IV.*

disparities and strengthen basic service delivery. Further reforms to subsidies are underway, with the policy of transferring subsidies on the price of goods to a beneficiary family-based subsidy. Meanwhile, the government has fulfilled its commitments on mandatory spending in education at 20% and health at 5% of total expenditure. Social protection has also improved somewhat in recent years, including with the launch of universal health insurance. However, allocations are still considered low when the GDP share is compared to international benchmarks and other countries in the region, with public spending on education, infrastructure and health expected to reach 3.0%, 2.7% and 0.7% and of GDP in 2018 respectively.

Figure 3. Reallocation of energy subsidies to productive areas



Source: Ministry of Finance

9. **Mobilization of revenue paramount for infrastructure focus.** In line with efforts to reduce regional disparities and strengthen growth, infrastructure investment has accelerated. The government has increased ministerial / institutional allocations for infrastructure and subnational governments are now required to invest at least 25% of the resources they receive from the general allocation fund and revenue sharing in infrastructure. It has also addressed land acquisition issues and strengthened cooperation with the private sector. The infrastructure budget in the draft 2018 state budget amounted to Rp. 409.0 trillion, an increase from the previous year due, with increased allocations for transport infrastructure, the Special Allocation Fund (DAK) and land acquisition. However, there is a general risk associated with realizing capital-expenditure targets related to the ability of the government to collect revenue as planned. With a fiscal deficit for 2017 approaching a legal limit equal to 3.0% of GDP, any further slippage in revenue collection would require lower government expenditure, including development expenditure. That could hurt growth, employment, and wages. To finance the 2017 deficit the government needs to raise $29.9 billion, with $2.8 coming from bilateral and multilateral development partners (Table 1). In 2018 it needs to raise $24.1 billion, with $2.8 coming from bilateral and multilateral development partners.

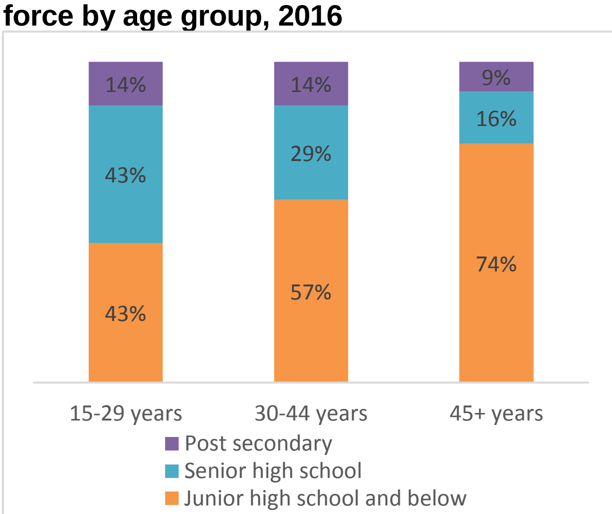
Table 1. Financing Plan (Rp. billion)

	2016 actual	2017 Outlook	2018 Draft budget
Total revenue	117.0	128.9	139.1
Total expenditure	140.2	158.9	163.3
Overall deficit	-23.2	-29.9	-24.1
% of GDP	*-2.5*	*-2.9*	*-2.2*
Sources of Financing			
- Bilateral and multilateral loans	2.1	2.8	2.8

Source: Ministry of Finance

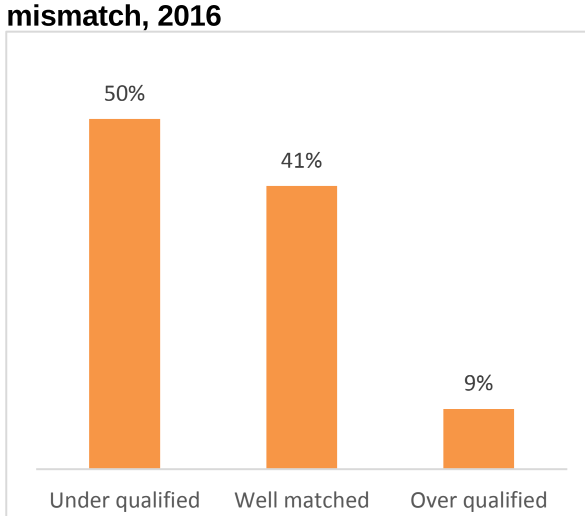
10. **Investments for inclusive growth.** Recent policy initiatives to increase public investment in infrastructure should help to make Indonesia more competitive and support economic growth. They will need to be complemented, however, by measures to address labor market entry barriers that are increasingly a factor constraining the country from its inclusive growth agenda. These entry barriers include skills gaps and inadequate labor market activation programs. Indonesia's workforce has improved its educational attainment in recent years. Still, almost 60% of workers, especially older ones, have not completed high school (Figure 4). Since 2002, the government has committed to education 20% of its budget. While this investment has helped to improve educational attainment, education spending still lags that of other major economies in the region, with public spending on education in Malaysia and Viet Nam at 6% of GDP in recent years. A reflection of low educational attainment is that half of employed people today can be considered underqualified for their jobs (Figure 5).

Figure 4. Education attainment of the labor force by age group, 2016



Source: Statistics Indonesia, Jakarta.

Figure 5. Education and occupational mismatch, 2016

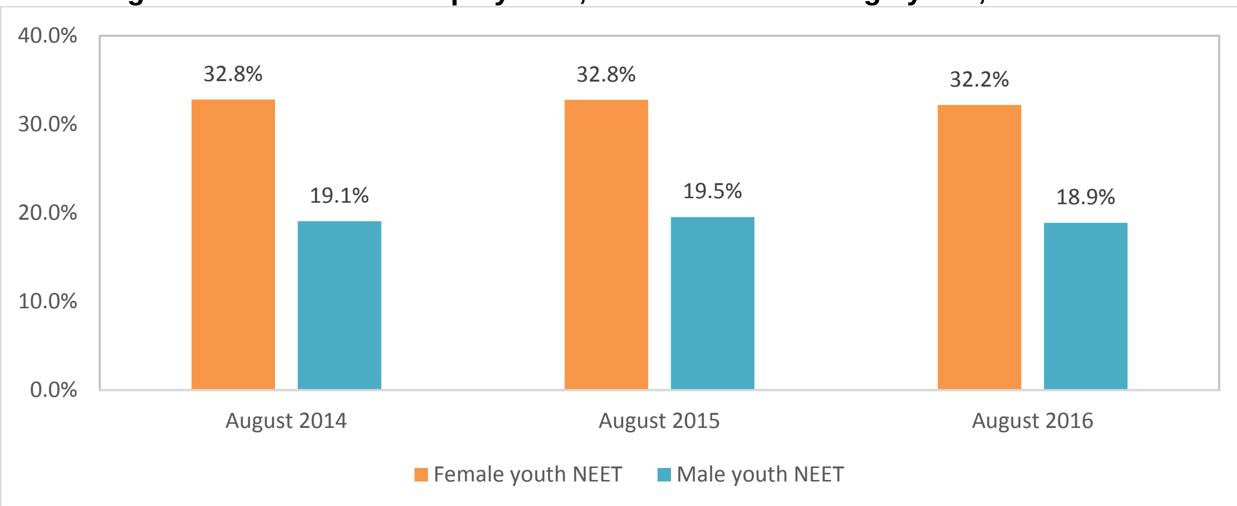


Source: Statistics Indonesia, Jakarta.

11. **Labor market entry barriers are high for youth.** While most of Indonesia's young people aged 15–24 years have now completed 9 years of schooling, one in four has not completed the full 12-year cycle before university. Moreover, the quality of education is a matter of continuing concern. Results from the Program for International Student Assessment of the Organisation for Economic Co-operation and Development indicate that, although Indonesia's performance has improved over time, on average Indonesia's 15-yearolds underperform their peers in other middle-income countries in Southeast Asia. Meanwhile, the World Economic Forum's Executive Opinion Survey identifies a mismatch between the skills that graduates possess and those that employers require. The combination of these factors results in high rates of youth are not in employment, education or

training (NEET) (Figure 6). As many as one in four youth are considered as NEET. Young women are even more at risk, with 32.2% of females aged between 15 and 24 classified as NEET. Many youth NEET come from low-income families and the entry barriers that they face often allow cycles of poverty and inequality to perpetuate. These observations underscore the need to close the skills gap and address labor market entry barriers in Indonesia.

Figure 6. Youth not in employment, education or training by sex, 2014–2016



Source: Badan Pusat Statistik

A. PFM assessment[3]

12. **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,[4] 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.

13. **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.[5] Substantive improvements were identified in

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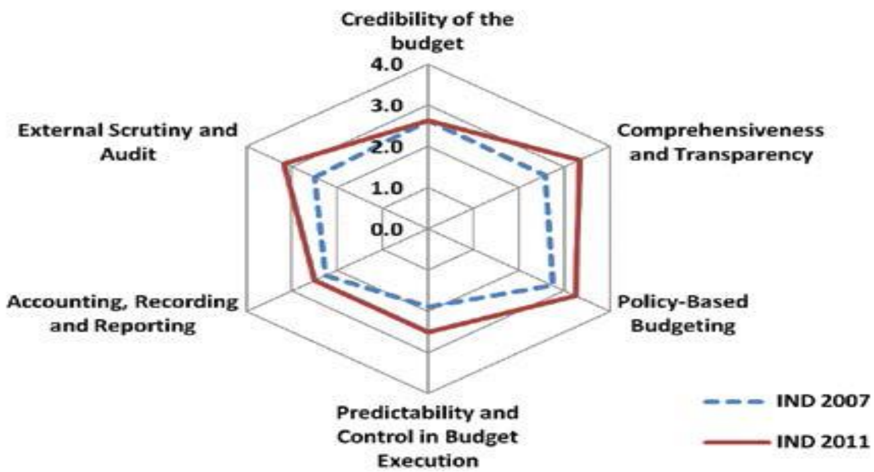
[3] This assessment draws upon: 2012 Repeat PEFA Report and Performance Indicators; PFM updates provided in the 2013 the World Bank's Second Institutional Strengthening for Social Inclusion (Second Institutional, Tax Administration, Social and Investment) Development Policy Loan for Indonesia, and 2012 draft Country Level Governance Risk Assessment and Risk Management Plans for Indonesia (Manila). A 2016 PEFA Assessment is currently under preparation by Government of Indonesia, but has not yet been released to the public.

[4] 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.

[5] 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

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 4 compares the average PEFA ratings for each of the six main characteristics of the budget cycle. 2012 PEFA findings inform this PFM assessment.[6] A 2017 update to the PEFA has not been released yet, but excerpts from the IMF's 2018 Article IV claim: " PEFA documents an overall improvement in the core PFM systems across the budget cycle and finds Indonesia has a strong legal and regulatory framework, and a PFM system largely aligned with international standards".[7]

Figure 7: PEFA Rating Comparison 2007 and 2011



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

14. **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.[8] These legislations, regularly under review, have strengthened the quality of budget institutions in formulation of budget, treasury operations and expenditure oversight.

(2012). Indonesia: Repeat Public Expenditure and Financial Accountability (PEFA) Report and Performance Indicators. Jakarta: Public Financial Management Multi Donor Trust Fund for Indonesia.

[6] 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.

[7] 2018. IMF. *Article IV.*

[8] 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.
- The Presidential Decree on Procurement (No. 4/2015) mandates the usage of electronic transactions for all government procurement, with a view towards improving the efficiency, transparency and quality of procurement, and ensuring accurate and timely recording and reporting.

15. **Foundations for performance-based budgeting.** Indonesia has also taken steps to move towards performance-oriented budgeting. A new special budget module (KRISNA) was jointly developed between MoF and BAPPENAS, with a view towards integrated planning and budgeting under a single, unified results framework which could be jointly tracked and monitored. Under KRISNA, line ministries are required to formulate targets and performance indicators for various spending programs, which are then reviewed and approved by BAPPENAS and MoF. During budget execution, performance against these indicators is reported on within the system by line agencies, and is tracked by MoF and BAPPENAS. Acchievements and challenges are used to inform budget negotations in the subsequent fiscal year. This provides a better basis for evaluating the performance of programs and activities thus fulfilling a fundamental prerequisite of PBB. Programs, targets, and indicators are incorporated in the five-year national plan (RPJM) for 2015–19.

16. Since 2008, Indonesia has provided a comprehensive statement of fiscal risks alongside their budget, one of a relatively small group of countries which does so.[9] The scope and breadth of the fiscal risks statement are described in one concise report, which goes beyond simple contingent liabilities to include a broad range of significant risks across various dimensions. For example, the 2009 Budget Report provided information on sensitivities to macroeconomic assumptions risks associated with government debt, infrastructure development as a share of the 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. The Financial Note of National Budget for 2016

[9] 2014. IMF Policy Paper. *Budget Institutions in G-20 Countries: An Update.* Washington, DC.

provides information about medium term budget plan, fiscal risk, and fiscal development. It is worth to note that for the first time the Financial Note for 2016 Budget includes a sole chapter on fiscal risk, indicating government's commitment to lay out contingent liabilities issue with specific details on how to manage those liabilities.

Medium-term perspectives in public financial management

17. **Transparency improved by publishing the Medium Term Fiscal Framework.** Since 2011, MoF has incorporated 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).[10] 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. Since 2014, the government also identified the fiscal changes that impacted the MTEF in the financial note. In 2015, the financial incorporated macro sensitivity test for better fiscal risk management including external factors. In 2017, the government improved transparency by beginning to publish a medium term fiscal framework in the Macroeconomic and Fiscal Policy Framework document, including background analysis, forward challenges and reforms to strengthen budget functions.

18. **Improvements in the integration of budget and planning.** The MoF is responsible for coordinating budget formulation and specifically considers budget ceilings, deals with recurrent budgets such as routine/operational costs, and BAPPENAS (National Development Planning Agency), 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 Annual ministry-specific work plans (or Renstra-KLs),[11] 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, subnational governments, and the Parliament into a set of work plans and budget allocations over the medium and short-term. Recognizing these constraints, Government Regulation No. 17, 2017 on the Synchronization of National Development Planning and Budgeting Processes was released recently to improve the policy orientation of budgeting. Furthermore, MoF and BAPPENAS have worked to jointly develop a new system (KRISNA), a specialized budget module which links to the integrated financial management system, which integrates planning, budgeting execution and performance monitoring of public expenditure. KRISNA was implemented for the 2018 budget. This system improves the policy orientation of budgeting and provides a concrete, shared framework to ensure clear vertical linkages exist between the national development plan and the annual budget. In 2017, the government also synchronized national development priorities with budget preparation, execution, monitoring and reporting under a unified results framework.

19. **Multi-year contracting reforms improve execution of public investments.** Since 2015, a MoF decree empowered line ministries to propose and sign multi-year contracts with

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[10] 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."

[11] 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.

service providers. This improves the ability of agencies to execute on public investment programs, particularly those with large commitments which should be managed with disbursement in tranches over multiple years. This reform addresses the previous misalignment of multi-year public investment programs against annual budgeting, while also expanding the range of public goods and services providers, increasing competitiveness.

Budget reporting

20. **Budget reporting has been improved.** Since 2015, MOF implemented Government Finance Statistics (GFS) standard in national budget through Budget Law and Presidential Decree to provide more autonomy and control to budget owners (line ministries). Budget reporting in national and subnational has also applied a "cash towards accrual" accounting standard, and in the process of moving accrual-based accounting since 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 64% in 2017.[12] 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. The government has also increased transparency by publishing budget data in a dedicated portal and by providing additional functional disaggregation of spending into thematic areas, such as climate change and gender responsive budgeting.

Budget control and oversight

21. **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.[13]

22. **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.[14] 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 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

[12] International Budget Partnership (undated): "Indonesia, Open Budget Index 2017".

[13] 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.

[14] 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.

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 through the State Audit Reform Sector Development Program.[15]

23. **Strengthened legislative oversight**. The Parliament's (DPR) role in shaping the state budget and in overseeing budget processes was institutionalized in Law No. 27/2009. Under 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).

Budget execution

24. **Budget execution rates have improved, but more remains to be done.** Indonesia has improved the timeliness and quality of budget execution. By the end of November 2017, more than 80% of the 2017 Revised budget had been disbursed.[16] Bunching of expenditures has improved slightly, from 50%-60% in the last quarter in 2013,[17] to 40% in the last quarter in 2017. However, development expenditures as budgeted have underperformed against budget targets (approximately 2.7% of GDP) in recent years, highlighting recurrent problems in budget implementation. During the four-year period 2010–2013, disbursement rate of ministries never achieved 100%. The 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 was between 75-90%, 55-70% and 70-90% respectively. Slow disbursement is attributed largely to cumbersome procurement practices and lack of implementation capacity. At subnational level, the problem is more attenuated given lack of capacity. In response to slow budget disbursement, the government has established a Budget Realization Evaluation and Monitoring Team (TEPRA). The new unit name is headed by the Minister of Finance. Per data from TEPRA, public spending disbursement varied across line ministries. Strengthening disbursement is also emphasized in the SDGs, with goal 16 on institutional strengthening targeting the development of more effective, accountable and transparent institutions at all levels, with the indicator as primary government expenditures as a proportion of original approved budget. In line with this, the government commits to increase its performance on audits.

25. **Main issues with slow budget execution.** Slow pace of budget execution poses 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".[18] 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.

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[15] ADB. 2004. *Report and Recommendation of the President to the Board of Directors: Proposed State Audit Reform Sector Development Program to Indonesia*. Manila.
[16] World Bank. 2017. *Indonesia Economic Quarterly.*
[17] 2013. Staff Report for the 2013 Article IV Consultation. Indonesia.
[18] DIPA Tracking Study: Identifying the Constraints to Budget Execution in the Infrastructure Sector.

26. **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). These early procurement initiatives have shown recent signs of capital spending execution improving. Other key reforms relate to implementing the State Treasury and Finance System (SPAN) and measures to improve public procurement.[19]

Cash management

27. **Automating cash management process.** MOF has implemented 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 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. MOF has also implemented online monitoring of SPAN (OM-SPAN) to monitor budget execution on real time basis. In the future, the SPAN application could be linked with government systems on planning, budgeting, and financial transactions.

Public Procurement

28. **Public procurement reforms.** 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

[19] 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.

process. The decree required that all 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. LKPP continues to work to improve budget execution through regulatory reform aimed at streamlining and simplifying public procurement. New regulations empower line ministries to undertake advance procurement and multi-year contracting, and new capacity building efforts and e-learning modules help to strengthen the ability of procurement officers to execute planned spending.

29. **Almost all government procurement undertaken through electronic platforms.** Beginning in 2010, the government made e-procurement mandatory for certain goods and services, spurring a rapid increase in the number of provinces and local governments using electronic procurement. Then, in 2015, a Presidential Decree mandated that all public procurement of goods and services was to be undertaken through electronic platforms. Most importantly, 100 percent of procurement for the Ministry of Public Works is undertaken electronically. Amongst other line ministries, an estimated 90 percent of procurement now takes place through electronic channels, improving the transparency, accuracy, and efficiency of government spending on goods and services.

PFM at subnational level

30. **Some improvements in the legal framework.** A comprehensive reform of the policy and regulatory framework for the system of intergovernmental fiscal relations in Indonesia is still underway. The review includes a revision of all the system's main elements: (i) expenditure and revenue assignments, (ii) intergovernmental fiscal grants, and (iii) local government's borrowing powers. The reforms include amendments to the main fiscal decentralization laws (i.e., Law 33 Year 2010 on fiscal balance) and associated government regulations, and a reconsideration of the mechanisms for new local government formation. Recent improvements include a new Memorandum of Understanding between CMEA, PT SMI, MoF and MoHA to improve coordination and processing of financing requests, along with an accompanying set of SOPs. As a result of these efforts, borrowing time has shrunk from more than 6 months to less than 40 days. Despite this progress, more clarity is still needed on expenditure assignments, the institutional framework for policy coordination at the central government level, and the processing of applications for new regions. There has been progress on the later issue with the new Law on Regional Government, i.e. Law 23/2014, which replaces Law 32 Year 2010.

31. **Lack of revenue collection capacity by local governments.** Successful fiscal decentralization requires the assignment of adequate sources of own-source revenues to local governments. Indonesia has recently taken critical steps in this direction. Gradual devolution of the property taxes started in January 2014 upon enactment of Law 34 on regional government revenues and charges. However, progress on the ground is difficult due to lack of capacity of local government in administering the local tax, high initial cost to improve fiscal cadastre, and issues of accrual tax on property tax. Only around 10% of total government revenue is raised at the sub-national level, mostly from nuisance levies and user charges, which is low by international comparison.[20] Thus, institutional strengthening of revenue collection agencies will be needed. Administering land and property taxes is cumbersome, involving sometimes complex mapping and valuation and collection techniques, which are increasingly managed by sophisticated computer applications.

[20] OECD (2016) Economic surveys: Indonesia 2016, OECD Publishing, Paris.

32. **Need for enhanced equalization, predictability, and transparency in the release of fiscal transfers and shared revenue**. Despite progress, substantial flaws remain in the design and coordination of the different elements of the system of intergovernmental grants. The formula used for the allocation of the largest unconditional grant to local governments, the DAU, 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 favour of regions with small populations. The DAK, the transfer devoted to cover 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.[21] These local transfer policies were developed to address concerns about high allocations to Java, with fiscal transfers skewed towards small, rural districts. Importantly, the different elements of the system of transfers are not properly coordinated, resulting in inefficiencies in resource allocation across local governments. Lastly, none of the major grant mechanisms have adequate performance incentives incorporated in their design, thereby limiting their effectiveness.

33. **Lack of Qualified Staff And Poor Public Financial Management Skills In Local Governments.** One systemic liability in the public finance setting of Indonesia is the lack of skilled civil servants, especially in accounting and financial management at the lower levels of government (sub-districts, villages, and neighborhoods). The decentralization, which started in 2000, transferred more than 30 functions and two million civil servants from the central government to the sub-national level. Today 73% of government employees are located at the regency/city level, and with 1.8 civil servants per 100 residents, the wage bill for accounted for 28% of total general government outlays in 2014.[22] However, the new intergovernmental setting inherited a large administrative and institutional burden, multitude of public agencies, lack of professional civil servants, uncertified accountants, weak public management systems, graft and corruption. The latest data from the State Ministry for Administrative Reforms in 2008 shows that 50% of the country's four million civil servants were not sufficiently qualified. At the Ministry of Finance, 48% of its staff was found to be unqualified for their jobs. The situation in the local tiers of government might even be worse in some of them.

34. **Different financial management information level at subnational level.** Budget reporting at subnational level has been inconsistent. The different options of regional financial management information systems (RFIMS) created the inconsistency. There are currently two main RFMIS which is being used by local governments: SIKPD (Sistem Informasi Keuangan Pemerintah Daerah or Local Government Financial Management Information System) and SIMDA (Sistem Informasi Manajemen Daerah or Local Information Management 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.

B. Development Partner Support

35. 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 supported through parallel co-financing by the Government

[21] World Bank (2017) Indonesia economic quarterly: January 2017, World Bank, Jakarta.
[22] OECD (2016) Economic surveys: Indonesia 2016, OECD Publishing, Paris.

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.

36. The World Bank Group has been assisting the government in improving PFM at national level through the Government Financial Management and Revenue Administration Project (GFMRAP) since 2004. GFMRAP support reforms aimed at strengthening efficiency, governance and accountability in PFM especially in budget execution, together with treasury modernization and revenue administration.[23] At subnational level, ADB is the lead development partners. ADB's 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.[24] The Government of Australia is also active in PFM at sub-national levels with focus on capacity building at several 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, United States of America supported Open Government initiative is supporting efforts to disclose detailed budget information across all levels of government.[25]

D. Key Lessons

37. 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

38. **Consistent progress has generally brought Indonesia's PFM system in line with international good practice, but further efforts will deliver additional benefits.** As stated in the IMF's 2018 Article IV release, "PEFA documents an overall improvement in the core PFM system across the budget cycle and finds Indonesia has a strong legal and regulatory framework, and a PFM system largely aligned with international standards".[26] This reflects sustained effort by

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

[24] 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.

[25] 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.

[26] IMF. 2018. *Article IV.*

Indonesia to improve PFM systems. In the first phase of reforms, following the Asian Financial Crisis, Indonesia strengthened its legal and institutional framework for PFM reforms. The second phase of reforms is ongoing, and focuses on reforms which have contributed to strengthening creditability of the budget, its comprehensiveness and transparency, and results orientation. Budget processes, and practices have been further streamlined. Significant steps towards operationalizing a functional 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, are helping to bolster aggregate fiscal discipline, expenditure prioritization and the efficiency of spending. These improvements in fiscal discipline have contributed to Indonesia's sovereign credit rating being elevated to investment grade by both Standard and Poor's and Fitch's in 2017. implementation of the integrated financial management system (SPAN) has helped strengthen the predictability and control in budget execution, including accounting and reporting functions. Procurement has improved the roll out of e-procurement and accompanying reforms. 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.

39. **At subnational level challenges remain**. Access to basic services remains uneven across the country. Many local governments do not have the means to meet their service mandates due to low revenue-generating capacity and inefficient distribution of fiscal transfers. In areas where central and local governments have shared responsibilities, there is a great deal of overlap and confusion. The intergovernmental coordination institutions remain underdeveloped and ineffective. Consequently, local government lacks the incentive to implement prudent fiscal management, resulting in poor local government performance.