ECONOMIC AND FINANCIAL ANALYSIS

A. Overview

1. The additional financing of the State Accountability Revitalization Project seeks to strengthen the accountability of public institutions across Indonesia's decentralized government for delivery of high-quality public services. The project focuses on improving internal control functions to contribute to better use of public resources and improved public financial management (PFM), thereby strengthening public service delivery. The following analysis provides an overview of the country context and a discussion on the economic benefits of the project, focusing on transmission mechanisms through which the project's outputs will contribute to improved governance and broader socioeconomic impacts associated with improved fiscal management and public services. The analysis also provides information to understand and manage recurrent financial costs of project investments and an assessment of the sustainability of the investment to ensure that the improved staff capacity resulting from the investment will properly function to achieve the objectives. As the project is largely focused on building capacity for improved public service delivery through strengthening the systems and skills of government staff and institutions, it is a non-revenue-generating project.[1]

2. **Country context.** Indonesia's gross domestic product (GDP) grew at an average annual rate of 5.0% during 2014–2018, continuing its strong economic expansion since the Asian financial crisis of 1997–1998. Fiscal policy has contributed to Indonesia's economic growth by supporting macroeconomic stability. The government has maintained a prudent fiscal stance, with deficits below the statutory limit of 3.0% of GDP and total government debt below 35% of GDP. Inflation moderated from 6.4% in 2014 to 3.2% in 2018 and is expected to remain subdued.[2] As of 2019, all three major credit rating agencies had affirmed Indonesia's sovereign credit rating at investment grade because of strong growth prospects, a supportive macroeconomic policy, and an enhanced structural reform agenda.

3. **Sector context.** While the central government's fiscal deficit remained below 3.0% of GDP during 2014–2018, there was little improvement in total government revenues and the tax-to-GDP ratio during this period. Table 1 illustrates that with lower revenues, central government expenditures as a share of GDP contracted during 2014–2018, entailing a need for more efficient use of public resources. Efforts to strengthen revenue performance and spending quality are needed, particularly concerning budget execution, spending efficiency, compliance, and audit capability.

Table 1: Central Government Revenues and Expenditures as a Share of Gross Domestic Product, 2014–2018

(%)

Item	2014	2015	2016	2017	2018
Revenues and grants	14.7	13.1	12.5	12.3	13.1
Tax revenues	10.9	10.8	10.4	9.9	10.2

[1] A non-revenue-generating project is a project for which cost recovery is not generally sought. Such projects are usually implemented and operated by public entities that are largely dependent on the government budget. For such agencies, a financial analysis of the executing agency is rarely required. Government auditors are normally responsible for the audit of the executing agencies that implement non-revenue-generating projects. In non-revenue-generating projects, project financing is not related to the future financial performance of the entity. Therefore, the economic and financial benefits of the project cannot be valued in quantitative terms and cost–benefit analysis may not apply as the project primarily focuses on capacity-related interventions. Asian Development Bank (ADB). 2005. *Financial Management and Analysis of Projects*. Manila.

[2] Asian Development Bank. 2019. *Asian Development Outlook Update 2019*. Manila

	2014	2015	2016	2017	2018
Expenditures	16.8	15.7	15.0	14.8	14.9
Fiscal balance	(2.1)	(2.6)	(2.5)	(2.5)	(1.8)

( ) = negative.
Source: Government of Indonesia, Ministry of Finance.

4. Performance challenges related to discrepancies between annual planned and actual revenues and expenditures persist, with midyear budget revisions regularly undertaken to adjust targets. Table 2 illustrates that budget underutilization performance, as represented through differences in planned and actual expenditures, is one factor that has contributed to poor outcomes in public service delivery. Low budget execution affects important services such as health, and it also slows the completion of infrastructure projects. The central government has committed itself to higher levels of spending for capital and social assistance to support development. However, sustained improvements in public expenditure allocations and performance are needed to strengthen delivery of outcomes. Fund allocation for subnational governments has been increasing, with Table 2 illustrating that transfers to regional and village funds now account for approximately one-third of central government spending and that planned and actual expenditure performance has improved over time. However effective implementation relies heavily on local government capacity and the human capital of subnational bureaucracies. Effective public expenditure management also requires efficient and accurate integration of data across the multiple levels of government and feedback to the spending entities. There is a need to strengthen capacity across government, especially at the subnational level, so that all 542 local governments meet minimum service standards and are accountable for the delivery of high-quality public services, particularly to the poor that need them most. Building internal control and financial reporting competencies and establishing compatible systems that are capable of sharing data in the context of decentralization are needed to address these constraints.

Table 2: Selected Central Government Expenditures, 2014–2018

Indicator	2014	2015	2016	2017	2018
Total Central Government Revenues and Grants					
Planned (Rp billion)	1,667,141	1,793,589	1,822,546	1,750,283	1,903,027
Actual (Rp billion)	1,550,491	1,508,020	1,555,934	1,666,376	1,943,675
Actual to planned (%)	93.0	84.1	85.4	95.2	102.1
Tax Revenues					
Planned (Rp billion)	1,280,389	1,379,992	1,546,665	1,498,872	1,548,485
Actual (Rp billion)	1,146,866	1,240,419	1,284,970	1,343,530	1,518,790
Actual to planned (%)	89.6	89.9	83.1	89.6	98.1
Total Central Government Expenditures					
Planned (Rp billion)	1,842,495	2,039,484	2,095,725	2,080,451	2,217,253
Actual (Rp billion)	1,777,183	1,806,515	1,864,275	2,007,352	2,213,118
Actual to planned (%)	96.5	88.6	89.0	96.5	99.8
Capital Spending					
Planned (Rp billion)	160,791	275,788	206,567	200,651	193,685
Actual (Rp billion)	147,348	215,434	169,474	208,657	184,128
Actual to planned (%)	91.6	78.1	82.0	104.0	95.1
Social Assistance Spending[a]					
Planned (Rp billion)	96,655	107,670	53,404	96,675	80,253
Actual (Rp billion)	97,925	97,151	49,614	55,297	84,318
Actual to planned (%)	101.3	90.2	92.9	57.2	105.1
Transfers to Regional and Village Funds					
Planned (Rp billion)	592,552	647,041	770,173	764,925	763,622
Actual (Rp billion)	573,703	623,140	710,257	741,992	757,793
Actual to planned (%)	96.8	96.3	92.2	97.0	99.2

[a] In 2015 the government began implementing Village Law 6/2014, which discontinued social assistance provided to the national program for community empowerment and increased funds classified as "transfers to regional and village funds."
Source: Government of Indonesia, Ministry of Finance.

5. **Progress update.** The quality of the internal control function has improved over the past five years, with support from the current project contributing to these gains. During the period covered by the National Medium-Term Development Plan (RPJMN), 2015–2019, the shares of unqualified audit opinions have reached 91% for the central government, 97% for provincial governments, 72% for district governments, and 86% for city governments.[3] This is a dramatic improvement compared to during 2005–2009 n less than half of audit opinions were recognized as being fairly and appropriately presented.[4] However, there is scope for further improvement. For the period covered by the RPJMN, 2020–2024, the government aims for unqualified audit opinions to improve to 97% for the central government, 97% for provincial governments, 85% for district governments, and 90% for city governments. To meet these targets, the central government's internal audit agency estimates that close to 30,000 trainings and/or certifications will need to be provided to public internal auditors and finance officers. Based on Presidential Regulation No. 95/2018 on e-government, a new-generation financial management system is also to be introduced to support harmonization of data systems in the context of fiscal decentralization. Effective uptake of the new system will require upskilling of government officials.

6. **Proposed intervention and rationale.** The project supports the modernization of systems that, leveraging technological innovations, support human resource upgrading and facility rejuvenation in line with Indonesia's development agenda as stated in the RPJMN, 2015-2019. The project will undertake human resource development related to skills upgrading while simultaneously supporting the development of new skills and reskilling to enable usage of modernized PFM systems. This is in line with the priorities outlined in the RPJMN, 2020–2024, which includes plans to promote bureaucratic institutional reform through several mechanisms, including improving performance accountability and supervision capacities. Focus will be given to the utilization of information and communication technology to improve transparency, accuracy, accountability, and public service delivery. This will involve strengthening the government's goods and services procurement system, as well as upgrading and supporting the rollout of the Government Internal Control System.

7. The government's internal audit agency is responsible for reviewing the information quality and reliability of performance reports prepared by line ministries and other government agencies, and for evaluating the performance of these entities against their respective public service delivery functions.[5] However, the capacity of the internal audit function is still limited and mostly related to financial compliance-related checks.[6] To improve effectiveness, financial compliance auditing should be continued, but the focus should be expanded to understanding the outcomes and performance of public services that are delivered (fulfilling a more advisory role in the process) as well as considering the effectiveness of internal control mechanisms.

B. Economic Benefits

8. In general, the economic benefits of a project should be sustained during a project's implementation period as well as over its economic life. For projects that focus on improving

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[3] An unqualified opinion is an independent auditor's judgment that a company's financial statements are fairly and appropriately presented, without any identified exceptions, and in compliance with generally accepted accounting principles.

[4] ADB. 2012. *Report and Recommendation of the President to the Board of Directors: Proposed Loan to the Republic of Indonesia for the State Accountability Revitalization Project*. Manila.

[5] Presidential Decree No. 29/2014 on Performance Accountability System for Government Institutions.

[6] World Bank. 2018. *Indonesia Public Expenditure and Financial Accountability (PEFA) Assessment Report 2017*. Washington, DC.

systems and capacities, institutional strengthening is an important condition for sustainability. The benefits of the State Accountability Revitalization Project rest largely on promoting good governance through stronger capacity of public internal auditors and finance officers. Good governance will provide efficient and effective use of state funds for better public service delivery, which will improve the well-being of the population and be of development benefit to the nation. Therefore, the economic benefits of the project comprise (i) improved financial management information systems for strengthened audit control and promotion of good governance, and (ii) improved PFM resulting in better service delivery. These benefits should contribute to investor confidence and an improved business climate, as well as support healthy credit ratings and access to lower cost of financing.

9. **Management information systems for strengthened audit function.** The government's financial position has improved, with Indonesia's 2017 Public Expenditure and Financial Accountability (PEFA) Assessment Report pointing to a well-functioning PFM system (Table 3) (footnote 6). The assessment report concluded that Indonesia has a strong legal and regulatory framework, particularly for fiscal management and control of budget execution, with 17 out of 31 indicators scoring above the basic alignment with international good practice. Indicators with particularly good assessment results include transparency of public finance, and accounting and reporting. When compared to the PEFA assessment report of 2011, improvements were identified in 11 out of 31 indicators. Important improvements were recorded in (i) predictability of in-year resource allocation, (ii) parliamentary scrutiny of budget, and (iii) accounting for revenue. However, the comparison also showed deterioration in six indicators, including parliamentary scrutiny of audit reports and revenue outturn.[7]

Table 3: Summary of 2017 Public Expenditure Financial Accountability Assessment Report Performance Indicators

Core of Public Financial Management Performance	Performance Indicators	Score A	Score B/B+	Score C/C+	Score D/D+
Budget reliability	1 to 3			2	1
Comprehensiveness and transparency	4 to 9	3	2	1	
Management of assets and liabilities	10 to 13		2	1	1
Policy-based fiscal strategy and budgeting	14 to 18	2	2	1	
Predictability and control in budget execution	19 to 26	3	1	4	
Accounting, recording, and reporting	27 to 29	1	1	1	
External scrutiny and audit	30 to 31			1	1
Total		**9**	**8**	**11**	**3**

Source: World Bank. 2018. *Indonesia Public Expenditure and Financial Accountability (PEFA) Assessment Report 2017*. Washington, DC.

10. Improvements are needed in the area of external scrutiny and audit. While the internal control function is adequately defined in the legal regulatory framework, its financial management information system is not sufficiently integrated with other PFM systems. In addition, internal audit plans and reports are implemented, but findings are not followed up on in a consistent and effective manner. The 2017 PEFA report highlighted areas for improvement, including conforming with standards outlined in the Institute of Internal Auditors' international professional practices framework. It also stressed a need to (i) address strategic issues relating to governance, risk management, and control processes in cross-sector and government-wide programs; and (ii) build auditors' capabilities and certification efforts in the areas of risk awareness and governance, as well as in financial management information systems. The additional financing responds to these recommendations and, in doing so, supports institutional strengthening and contributes to

[7] The methodology for scoring changed twice from 2011 to 2017, so the results are not directly comparable. Nonetheless, the 2017 PEFA reported noted that "the needle has moved in the right direction" (footnote 6, p. 151).

improved sustainability of PFM in Indonesia. As the investment is focused on strengthening the internal audit control function, state budget leakages should be reduced, thus increasing the efficiency and effectiveness of the government's development expenditures. Improved financial management entails better utilization of public resources and improved PFM, thereby strengthening public service delivery. Benefits from the investment are expected from improved financial and economic management across all levels of government.

11. **Improved public financial management for better service delivery.** The framework for PFM is well established in Indonesia and is supported by systems that cover internal controls, accounting and reporting procedures, internal and external audit systems, centralization of cash balances, and a strengthened accountability and transparency reporting system (footnote 6). Spending units across the government are responsible for budget implementation and are held accountable across various performance criteria. However, the quality of internal audit performance varies across different levels of government, with district governments lagging behind. In the context of decentralization, investing in capacities to facilitate improvements in subnational performance is needed to improve service delivery. This should contribute to improvements in meeting expenditure targets as well as the performance of the government's development programs, particularly those related to universal health coverage, access to finance, enrollment in social security, and education and skills training, among others. Table 4 presents selected socioeconomic indicators, illustrating that access to these services has improved but that further progress is needed. Improved access should contribute to meeting development objectives, including poverty and inequality reduction, job creation, and unemployment reduction. Strengthening PFM should improve accountability and the quality of service delivery for achieving these development goals.

Table 4: Selected Socioeconomic Indicators, 2014–2018

Indicator	2014	2015	2016	2017	2018
Percentage of households with social security (pension) (%)	…	4.6	5.1	5.7	6.7
Percentage of population with health insurance (%)	…	50.6	55.0	59.4	68.6
Percentage of households receiving business credit (%)	9.44	8.60	8.17	12.66	14.10
Percentage of people below the national poverty line (%)	11.96	11.37	11.25	11.22	10.86
Percentage of people unemployed (%)	7.68	6.17	5.94	6.18	5.61
Expenditure inequality	0.410	0.413	0.408	0.408	0.397
Governance effectiveness (percentile rank)	45.5	47.4	53.8	45.7	52.9

… = not available.
Sources: Government of Indonesia, Statistics Indonesia; and World Bank. Worldwide Governance Indicators.

C. Financial Analysis

12. Financial analysis was conducted to assess the level of resources available to the executing agency; these resources were primarily provided by the central government. This analysis will help to understand and manage recurrent costs of project investments that are proposed under the additional financing. It also assesses the sustainability of the investment to ensure that the improved staff capacity resulting from the investment will support development objectives.

13. **Fiscal policy remains prudent.** Total government debt remains below 35% of GDP, more than half of which is in local currency-denominated long-term bonds. The central government's budget deficit has been contained at below 3% of GDP, with financing needs largely met through market sources and official reserves ample enough to cover imports and external debt servicing. All three major credit rating agencies have affirmed Indonesia's sovereign credit rating at investment grade, with Standard & Poor's increasing its rating from BBB– from BBB stable outlook

(May 2019), Fitch Ratings affirming a BBB stable outlook (September 2018), and Moody's Investors Service upgrading its rating from Bbb3 to Bbb2 stable (April 2018). These positive developments are underpinned by Indonesia's growth prospects, its supportive macroeconomic and fiscal policy, and structural reforms to the business climate. At the central level, it is noted that ADB loan funds entail a lower cost and preferable repayment terms compared to funds from local sources. Therefore, the central government's ability to meet its financing needs would not be adversely affected by the project.

14. **Executing agency allocations increased in nominal terms.** Allocations from the central government to the executing agency (the Central Government Internal Auditor or BPKP) have increased consistently in nominal terms from Rp1.1 trillion in 2012 to Rp1.9 trillion in 2020, with the share of the share of government expenditures remaining relatively constant over 2012–2019. Table 5 presents data from the Ministry of Finance on the draft budget request, approved budget, and expenditures disbursed between 2012 and 2020 for the executing agency. The data show that the government systematically allocates budget to cover operation and implementation expenditures, as well as expenditures for capacity building and administration strengthening. Between 2018 and 2020, requests for budget allocation from the executing agency proposed in the annual draft budget have been approved in the budget passed by parliament. This entails that the quality of analysis of the draft budget that is prepared by BPKP and presented to the Ministry of Finance and approved by parliament has improved over time. Capacity strengthening of the executing agency under the original project has also supported improvements budget preparation analysis, which accounts for incremental and recurrent costs required to support the effective and efficient functioning of the executing agency. In 2018 and 2015, the BPKP budget allocation was commensurate with audited expenditure disbursements. In 2012 the executing agency was allocated additional funds in a budget revision. In 2013, 2014, 2016 and 2017, the executing agency disbursed less than their allocated budget. This underspending was related to delays in capacity and administration strengthening, rather than underspending related to incremental and recurrent costs associated with operations and implementation. Based on historical patterns, incremental and recurrent costs for the project's operation, PMU's salaries, and supplies during the project's implementation period and post–project will be adequately maintained through central government public expenditure allocations to the executing agency.

Table 5: Trends in Public Expenditure and Internal Audit, 2012–2020
(IDR billion)

Year	Central Government Internal Audit Agency			Operations and Implementation			Capacity and Administration Strengthening		
	Draft	Budget	Disbursed	Draft	Budget	Disbursed	Draft	Budget	Disbursed
2012	838	933	1,051	…	…	…	…	…	…
2013	…	1,567	1,067	…	…	790	…	…	279
2014	…	1,233	1,209	…	….	899	…	…	312
2015	1,504	1,528	1,528	…	….	1,125	…	…	403
2016	1,679	1,633	1,452	…	….	1,056	…	….	396
2017	1,491	1,440	1,429	1,029	1,051	1,051	462	389	378
2018	1,452	1,452	1,452	1,133	1,133	1,133	319	319	319
2019	1,432	1,432	…	1,141	1,141	…	290	290	…
2020	1,861	1,861	…	…	1,446	…	…	415	…

… = not available.
Source: Government of Indonesia, Ministry of Finance.

15. Table 5 highlights that in 2020 the budget allocation for BPKP was increased to Rp1.9 trillion, with support for the strengthening the internal control program and its administration increased substantially. The increase is for a specific assignment concerned with supervision of the government's 2020 workplan, as well as an increase in allocation for operations and

maintenance (O&M) associated with the project's investments. The assignment is expected to continue in subsequent years and allocations for operations and maintenance are expected to be sustained at higher levels, which would see the budget allocation for the executing maintained at higher levels. Budget allocations are expected to be sufficient to cover expenditures, including those related to operations and maintenance associated with the additional financing of this project. However, due to cost savings associated with the e-learning system implementation, a substantial increase in expenditures is not expected.

16. It is assumed that budget allocations for the executing agency will follow historical patterns of the agency's share of total government expenditure, with an increase in the agency's share of total government expenditure as a result of the proposed project not assumed. Between 2012 and 2020, the executing agency was allocated an average of 0.07% of total government expenditures. It is assumed that annual nominal increases in government revenues and expenditures will gradually improve with tax policy and tax administration reforms, which would increase government revenues to support its expenditures. Table 6 presents projections for the executing agency's budget allocations and expenditures disbursed for 2020–2029, including a breakdown of expenditures for operations and implementation, as well as capacity and administration strengthening. It is assumed that improvements in the quality of BPKP's budget preparation process and expenditure disbursements should be maintained and see both budget allocations and expenditures disbursed commensurate in future. Based on historical trends, the incremental increase in annual budget allocation is expected to adequately cover requirements associated with recurrent costs, including the requirements arising from the proposed project.

Table 6. BPKP's Budget Allocations Projections, 2020–2029
(IDR billion)

	BPKP		Operations and Implementation		Capacity and Administration Strengthening	
Year	Budget	Disbursed	Budget	Disbursed	Budget	Disbursed
2020	1,861	1,861	1,446	1,446	415	415
2021	1,856	1,856	1,417	1,417	439	439
2022	2,056	2,056	1,584	1,584	471	471
2023	2,199	2,199	1,711	1,711	489	489
2024	2,338	2,338	1,817	1,817	521	521
2025	2,484	2,484	1,921	1,921	563	563
2026	2,653	2,653	2,049	2,049	604	604
2027	2,849	2,849	2,206	2,206	643	643
2028	3,042	3,042	2,357	2,357	684	684
2029	3,245	3,245	2,513	2,513	732	732

Source: ADB staff estimates.

17. The executing agency has instituted cost recovery for the training it provides. This means the origin institutions of the civil servants trained will pay certain training fees that will be transferred to the central budget account. Budget for the executing agency's training center is allocated through annual appropriation, which will cover recurrent costs. As such the training facility is not a revenue generating entity. Savings are expected to be generated from e–learning and SPIP implementation. The e–learning system will reduce the training costs, with early experience showing that e–learning resulted in time savings of 30%, which translate into cost savings as well. Online systems are expected to reduce costs associated with report transmission and data entry. The executing agency has judiciously allocated resources to maintain training and accreditation programs, and also has been continuously providing allocations to support the operation and maintenance of training facilities and information systems. A significant increase in incremental recurrent expenditures for operation and maintenance of the executing agency's training centers costs as a result of the project is not assumed. If costs do increase, it is expected

that any shortfall in recurrent expenditures will be covered by nontax revenue from training fees collected by the central government. For illustrative purposes, the expenditures of training centers between 2015 and 2018 are presented in Table 7.

Table 7. Expenditures of BPKP's Training and Education Center, 2015–2018 (Rp. million)

Item	2015	2016	2017	2018
Buildings, machinery, equipment	5,530	5,530	5,530	5,530
Bandwidth	1,620	1,620	1,620	1,620
Software license	…	…	…	510
Total expenditure	61,859	41,539	30,489	55,853

… = not available.
Source: BPKP's Training and Education Center.

18. **Implementation of recommendations from the 2017 Public Expenditure and Financial Accountability Assessment Report.** It is part of the executing agency's mandate to establish standards for internal audit and to provide training in line with those standards. While the project has established centers of excellence in selected universities, particularly for degree and diploma training, the certification of training is mandated to the executing agency as an expert body that is to ensure consistency and quality in outcomes. The project's additional financing supports the government's initiative to upscale support for capacity development and the upgrading of administration systems to enhance the degree of efficiency in the executing agency's operations. This should lead to improvements in the internal audit function and represents a response to areas for improvement that were identified in the PEFA assessment. The ongoing project and proposed additional financing will support the executing agency to raise the standards of internal audit and to move beyond simple compliance checks to identify and address systemic risks for improving the quality of internal control mechanisms. By improving the robustness of audit findings and the quality of audit reports, the project is increasing the likelihood that audit findings will be observed and acted upon.

19. In conclusion, the support provided under the overall project is part of a major push by the government to comprehensively upgrade the capacity of its internal auditors and the public finance officers who prepare reports on financial expenditure, which are the basis for internal audit. Once this one-time upgrade of skills is complete, the resources available for training in the various agencies involved are expected to be sufficient to train new recruits and provide regular in-service training to existing staff without recourse to external assistance. Sustainability for the provision of training in the future will also be promoted by moving the executing agency to a more efficient model of training delivery, including through the widespread adoption of e-learning and closer alignment of training provision and training needs. Provision of new facilities appropriate for the new learning approach, including improved facilities in four regional locations, will also improve efficiency in training provision.