INDONESIA

Public Spending in a Time of Change

The World Bank
East Asia and the Pacific Region
Poverty Reduction and Economic Management Sector Unit
April 2000
CURRENCY EQUIVALENTS
(As of March 27, 2000)
Currency Unit = Rupiah (Rp.)
US$1 = Rp. 7,475

ABBREVIATIONS AND ACRONYMS

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Description</th>
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<tbody>
<tr>
<td>ADB</td>
<td>Asian Development Bank</td>
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<tr>
<td>APBN</td>
<td>State Budget of Income and Spending</td>
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<td>BAKUN</td>
<td>The Government Accounting Agency</td>
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<tr>
<td>BAPPENAS</td>
<td>National Development Planning Board</td>
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<td>BEPEKA</td>
<td>Indonesia's Supreme Audit Board</td>
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<td>BPKP</td>
<td>Indonesia's Internal Audit Agency</td>
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<td>DAPP</td>
<td>District Autonomy Pilot Program</td>
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<td>DG</td>
<td>Director General</td>
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<td>DM</td>
<td>District Magistrate</td>
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<td>DPRD</td>
<td>Dewan Perwakilan Rakyat Daerah</td>
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<td>GFS</td>
<td>Government Financial Statistics</td>
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<td>GTZ</td>
<td>German Technical Agency</td>
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<td>GDP</td>
<td>Gross Domestic Product</td>
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<td>IG</td>
<td>Inspectorate Generals</td>
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<td>IPPs</td>
<td>Independent Power Producers</td>
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<td>IFIs</td>
<td>International Finance Institutions</td>
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<td>IMF</td>
<td>International Monetary Fund</td>
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<tr>
<td>KKN</td>
<td>Korusi, Kollusi, Nepotasi</td>
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<tr>
<td>MoF</td>
<td>Ministry of Finance</td>
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<td>MTEF</td>
<td>Medium-Term Expenditure Framework</td>
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<td>NPC</td>
<td>National Power Corporation</td>
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<td>NGOs</td>
<td>Non-Governmental Organizations</td>
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<td>O&amp;M</td>
<td>Operations and Maintenance</td>
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<tr>
<td>OECD</td>
<td>Organization for Economic Cooperation and Development</td>
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<td>PER</td>
<td>Public Expenditure Review</td>
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<td>PLN</td>
<td>State Electricity Company</td>
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<td>PUMA</td>
<td>OECD Public Management Service</td>
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<td>REPELITA</td>
<td>5-Year Development Plan</td>
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<td>SDO</td>
<td>Subsidy Daerah Otonom</td>
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<tr>
<td>UK</td>
<td>United Kingdom</td>
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<tr>
<td>UNCITRAL</td>
<td>United Nations Commission on International Law</td>
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<td>UU PD</td>
<td>Law on Regional Government (No. 22/1999)</td>
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<td>UU PKPD</td>
<td>Law on Fiscal Balance Between the Central Government and the Regions (No. 25/1999)</td>
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<td>USAID</td>
<td>United States Agency for International Development</td>
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<td>VAT</td>
<td>Value Added Tax</td>
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FISCAL YEAR:

<table>
<thead>
<tr>
<th>Authority</th>
<th>Fiscal Year</th>
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<tr>
<td>Government</td>
<td>April 1 to March 31</td>
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<tr>
<td>Bank of Indonesia</td>
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INDONESIA
PUBLIC SPENDING IN A TIME OF CHANGE

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EXECUTIVE SUMMARY

1. Indonesia’s new government will face a tight fiscal situation throughout its term. The crisis sharply increased debt levels and eroded government revenues, bringing to an end Indonesia’s comfortable pre-crisis fiscal position. But not only has the fiscal situation changed, so has the entire environment for policymaking. Gone are the days when a few technocrats could decide on important fiscal issues and have them implemented without demur. Decisions on fiscal policy will now need to be subjected to the healthy rigors of democratic debate and tailored to the demands of a decentralizing political and government system. Calls for greater transparency and less corruption must be heeded throughout government—including in the design and implementation of the government budget. So, fiscal policy in the future will not just be a question of raising revenues and cutting wasteful spending (although both will be important). It will also require fundamental changes in the way Indonesia manages its public finances.

2. This report identifies the strategic priorities for restoring sound public finances. The three key findings of the report emphasize the need to maintain fiscal sustainability under a constrained budgetary environment and the need to improve the processes for making budgetary allocations and budget implementation towards greater fiscal transparency. These are summarized below:

I. From fiscal stimulus to fiscal sustainability. The fiscal stimulus that was envisaged in the past two years failed to emerge. The fiscal deficits for FY98/99 and FY99/00 have been less than planned.

3. Despite limited budget deficits, government debt exploded in the wake of the banking crisis. As a share of GDP, it is expected to quadruple by the end of FY99/00 compared to pre-crisis levels; the bulk of the increase is from domestic debt to cover the costs of bank restructuring. Meanwhile, the revenue base remains weak because of a fragile economic recovery, and a plethora of tax exemptions and weak administration. Fortunately, the recent recovery in international oil prices will provide some room for budgetary maneuver, but much less than meets the eye because higher oil prices abroad also mean higher energy subsidies at home.

4. The report recommends a shift in fiscal policy focus towards maintaining fiscal sustainability in order to ensure a durable and sustained recovery. For this, of course, primary surpluses must be generated. But medium-term fiscal sustainability is at risk from three sources:

(i) through macroeconomic fluctuations, since inflexible spending items have gone up and budget is now more vulnerable to variations in interest rates, exchange rates and inflation. Inflexible spending on debt service and civil service salaries take up a large proportion of the budget, so the remaining expenditure items in the budget are squeezed. Simulations show that the budget is more vulnerable to interest rate variability (because of its impact on servicing domestic debt) than exchange rate risk (and its consequences for foreign debt service). The reason is that oil and gas revenues provide the Government with a natural hedge against exchange rate fluctuations.

(ii) through contingent liabilities, which pose fiscal risks of becoming actual liabilities suddenly, e.g. banking sector liabilities\(^1\); and

\(^1\) The key contingent liabilities include: (a) guarantees covering domestic banks’ liabilities (excepting equity, of course); (b) implied obligations to private infrastructure providers (mainly in power generation but also in toll roads); (c) obligations of minimum pension payments to civil servants; (d) off-budget credit schemes such as KUT; and (e) a number of guarantee schemes to the private sector (some of which were instituted since the crisis to restore the flow of credit).
(iii) through decentralization. This process would be risky in itself, but the risk is enhanced if the envisaged transfer of resources is not matched by a transfer of expenditure responsibilities. As a result, the center’s deficit could rise further. Also, decentralization poses a further fiscal risk through local government borrowing (under Law No. 25). If not carefully managed, local government debt may end up on central government books, as in many countries around the world.

5. The report recommends that in order to achieve fiscal sustainability over the medium-term, the Government should seek a combination of appropriate domestic revenue generation efforts, spending cuts, accelerated privatization, more aggressive asset recovery from uncooperative loan defaulters, new external finance, and to manage its contingent and other off-budget liabilities as part of an overall national risk management strategy. In addition, efforts to achieve fiscal sustainability should be supported through changes in budget management practices, including more comprehensive budget coverage, preparation of a medium-term budget outlook, and improved debt and risk management.

6. Specifically, the following measures are recommended in this regard:

**Short-term measures**

- Cut wasteful spending such as energy subsidies. These subsidies—which will amount to over 2.5 percent of GDP this year—are still poorly targeted, and mainly enjoyed by the better off.
- Enhance domestic resource mobilization efforts through a combination of measures that include: (a) reducing exemptions on the payment of VAT and certain income taxes; (b) limiting special economic zones to truly bonded areas; and (c) improving tax administration, and reducing corruption.
- Systematically track all the government’s off-budget operations with a view toward better monitoring fiscal risks that stem from contingent liabilities.

**Medium-term measures**

- Adopt a multi-year rolling budgetary plan through a medium-term expenditure framework to track future budgetary consequences of policy decisions, and to make budgets more predictable for public spending entities.
- Create room for parliamentary influence over the budgetary framework early in the budget process.
- Adopt the IMF Code of Good Practices on Fiscal Transparency with a view towards: (a) enhancing clarity in the roles and responsibilities within government; (b) promoting greater information dissemination on government activities to the public; (c) fostering more open-budget preparation, execution, and reporting; and (d) ensuring that fiscal information is subjected to independent assurances of integrity through regular publication of audits of public accounts.
- To limit the growth of contingent liabilities, the Government could consider budgeting guarantees and other contingent liabilities.
- Establish clear and credible rules for regional government borrowing limits. In light of Indonesia’s fragile financial markets, direct or rule-based controls are likely to be more prudent than market-based controls for some time to come.
• Expand the function of the debt management unit in the Ministry of Finance (see above) to include a government risk management strategy that involves three complementary elements:

(a) mitigation of the risk at source through sound microeconomic policies fostering efficient resource allocation and use;
(b) transferring risk to third parties with incentives to manage and ability to bear the risk; and
(c) monitoring and managing any residual risk that cannot be mitigated or transferred.

II. Improving budget allocation. The tighter fiscal conditions that exist today reinforces the need to achieve the best possible allocation of scarce resources.

7. Clearly, budget formulation is a political process. Experience suggests that a participatory process involving both the Parliament and civil society ensures that public spending choices are continuously evaluated. This tends to improve the quality of public expenditures and the efficiency of public services. This priority could be addressed by facilitating adequate information flows between stakeholders and a budget process that allows for political choices without a loss of fiscal discipline. Public resources will have to be allocated efficiently to those areas that will have the maximum intended impact in terms of public service delivery. To this end, institutional measures are recommended in the report to ensure that adequate audit, evaluation and feedback mechanisms are in place so that the mix of spending allocations in the budget is deemed acceptable to a wider spectrum of the public. This also will go a long way in minimizing the observed divergence between budget estimates and budget outcomes.

8. Indonesia’s current budget process is mainly a bureaucratic process. The line ministries submit their bids, and MOF and BAPPENAS cut the bids down to the size required to fulfill the constraint on domestic borrowing. MOF has an elaborate system of expenditure norms, which are used to scrutinize the submitted budgets. Only when the draft budget is submitted to the President, some political decision-making enters the process. Individual ministers do not defend their ministry budget, and appropriations are structured by sector, not by ministry or program. Budgetary decision-making has focused primarily on government investment (i.e. the development budget) and less on decisions regarding the public policy role the government wants to play in any area. Although BAPPENAS has introduced a system for performance evaluation, this has had only limited impact on budget decision-making.

9. In this regard, the report recommends that the development and recurrent spending decisions need to be unified into a single budget and then projected out on a three-five year time horizon. In doing so, the budget appropriations could be structured by line ministry. Each line ministry would then have to provide the rationale for public intervention in that activity as part of the budget formulation process at all levels of government.

10. Specifically, the following measures are recommended in order to facilitate better, more transparent budgetary allocation decisions:

Short-term measures

- Require the line ministries to provide the rationale for public intervention in that activity as part of the budget formulation process. This principle should be applied at all levels of government.
- Structure budget appropriations by ministry, and discuss each line ministry budget separately in Parliament to enhance individual minister’s accountability.
- Agree with parliament on rules for debates and changes to the budget.
Currently, the Fiscal Outlook document is discussed in Parliament at a plenary session that is held about two months prior to the budget debate. This is an important step towards increasing the “buy-in” from parliament. This fiscal outlook should provide the major budget aggregates and sectoral spending limits before detailed budget preparation starts.

- Design earmarked grants for regions to finance national priorities implemented at regional level.
- Design a monitoring system for regional government’s performance on public service delivery.
- With a view towards achieving greater transparency, accountability and fostering anti-corruption measures, make current civil service remuneration transparent by including all salary elements of civil servants in the recurrent budget. The ongoing transition to the adoption of the IMF-GFS Classification System would reinforce this measure.

**Medium-term measures**

- **Unify development and recurrent spending into a single budget and then project this budget out on a three-five year time horizon.** This measure could be tested on a pilot basis in some government agencies or spending entities in the short term. The line ministry appropriations could be ordered by the major programs of the ministry, and the budget documentation should include information on results achieved with spending, and expected results in the future.
- **Increase civil service salaries to become comparable with private sector wages.** At the same time, de-link civil service salaries from development projects. Most of a civil servant’s income should be in the form of base salary, rather than through project-related payments.

11. Democracies require full disclosure of public spending information to all stakeholders. This keeps bureaucrats and politicians honest. It also encourages citizens to pay their taxes, for then they know what their money is buying. Greater transparency also helps communities and NGOs to monitor the quality of public spending programs. There remains the urgent need for greater clarity in the roles of Parliament, Ministry of Finance, BAPPENAS and the line ministries in the budget process. A participatory process involving both the Parliament and civil society ensures that public spending choices are continuously evaluated. This tends to improve the quality of public expenditures and the efficiency of public services. To this end, appropriate guidelines and rules of engagement between the Government and Parliament in the budget formulation process need to be specified.

**III. Improving budget implementation.**

When one turns to the implementation of the public spending decisions, as the government rightly believes, decentralization can indeed be a powerful tool to improve public service delivery and accountability in Indonesia. But, if not well managed, it risks fiscal balance at the center.

12. For fiscal decentralization to be successful, a strong central government is needed to lead and coordinate the process, especially in the short run. It must convey clear policy guidelines for ensuring a balance between revenues and expenditures at the local level, a transition plan to achieve this, and hard budget constraints for local governments to instill fiscal discipline including through clear rules on the issuance, reporting and monitoring of guarantees. To this end, the report recommends measures to improve the adequacy, relevance, timeliness and accessibility of government financial reporting and monitoring systems. In the medium-term, strengthening local accountability is recommended through a larger local tax base, increased transparency, and prudent access to financial markets.

13. There remains the urgent need for better coordination of the process towards implementation of the two fiscal and
administrative decentralization laws (Law No. 22/1999 UU PD and Law No. 25/1999 UU PKPD). Currently, in the Central Government, the Ministry of Finance, the Department of Home Affairs and the Office of the State Minister of Regional Autonomy are involved in this effort, but there was a lack of clarity on who was responsible for what aspect of this implementation process. Clearly, this is a complex task and may need attention from the highest levels in government.

14. Specifically, in the open, democratic, and decentralized era that Indonesia is currently embarking on, the following measures should enhance fiscal transparency and improve public service provision:

**Short-term measures**

- **Strengthen financial management practices in Government** by accelerating the pace of computerization in Government. This will improve the adequacy, relevance, timeliness and accessibility of government financial reporting and monitoring systems. To enhance the efficiency and effectiveness of independent audits of public accounts, there is an urgent need to clarify the mandates, scope, degree of independence and roles of BEPEKA (the Supreme Audit Board), BAKUN (the Government Accounting Agency), BPKP (the government’s internal audit agency) and the Inspectorate Generals (IGs, the internal auditors of each Ministry).

- **Define detailed expenditure assignments across levels of Government.** Design an equalization grants scheme, including transition arrangements. Specify a regional borrowing framework.

**Medium-term measures**

- **Tighten treasury management**, expand regular and timely reporting on budget implementation, independent audits of final accounts, and widely disseminate outcomes of those audits.

- **At each level of government, set up a legislative mechanism** that ensures follow up action on audit findings.

- **Issue uniform accounting standards** for the public sector (including SOEs and sub-national administrations).

- **Draft clear implementing regulations** for sub-national borrowing (external and domestic).