

# Combating Corruption in Indonesia

*Enhancing Accountability for Development*

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**East Asia Poverty Reduction and Economic Management Unit**

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## ABBREVIATIONS AND ACRONYMS

ACA	Anti Corruption Agency	GOI	Government of Indonesia
ADB	Asian Development Bank	IBRA	Indonesian Bank Restructuring Agency
AGO	Attorney General Office		
APBD	Regional Budget	ICW	Indonesian Corruption Watch
APHI	Indonesian Association of Forest Concessionaires	IDA	International Development Association
AWOL	Absent Without Leave	IMF	International Monetary Fund
BAP	Payment Memo	INPRES	Presidential Instruction
BAWASDA	Badan Pengawas Daerah	INT	Institutional Integrity
BCA	Bank Central Asia	IPCOS	Institute for Policy and Community Development Studies
BDNI	Bank Dagang Nasional Indonesia		
BI	Bank Indonesia	IPP	Independent Power Producers
BKN	National Civil Service Agency	JBIC	Japan Bank for International Cooperation
BLBI	Bantuan Likuiditas Bank Indonesia		
BPK	Supreme National Audit Agency	KDP	Kecamatan Development Program
BPKP	Financial and Development Supervisory Board	KKN	Korupsi, Kolusi, Nepotisme
		KKPPI	Acceleration of Infrastructure Development
BPS	Central Bureau of Statistics		
BUN	Bank Umum Nasional	KORPRI	Association of Civil Servants
DAK	Special Allocated Fund	KPPOD	Regional Autonomy Watch
DAU	General Allocation Fund	KPKPN	Commission to Audit the Wealth Of State Officials
DIK	Daftar Isian Kegiatan		
DIP	Daftar Isian Proyek	KPU	Election Commission
DJA	Director General of Budget	LK	Working Paper
DPR	House of Representatives	MENPAN	Ministry of Administrative Reform
DPRD	Regional Parliament	MOF	Ministry of Finance
EMSA	Electricity Market Supervisory Agency	MOHA	Ministry of Home Affairs
		MPR	People's Consultative Assembly
ESC	Energy Sales Contract	NPL	Non-Performing Loans
GAPENSI	National Business Association	NGO	Non-Governmental Organization
GBHN	State Policy Guidelines	NU	Nahdlatul Ulama
GDS	Governance and Decentralization Survey	PAN	State Budget Accountability Statement

GDP	Gross Domestic Product	PDI-P	Partai Demokrasi Indonesia
GGG	Government Guarantee Scheme		Perjuangan
PERDA	Local Regulations	RENSTRA	Strategic Plan
PIMPRO	Project Manager	REPETA	Annual Development Plan
PLN	State Electricity Company	RUU	Draft Law
PO	Operational Guidelines	SIKD	Regional Financial Information
POLRI	National Police		System
PPA	Power Purchase Agreement	SOE	State-Owned Enterprises
PPATK	Center for Financial Transaction	SP3	Instruction to Cease Investigation
	Reporting and Analysis	SPP	Payment Request
PPS	Public Prosecution	SPM	Payment Voucher
PROPENAS	National Development Program	WBI	World Bank Institute
PWC	Price Waterhouse Cooper	WTO	World Trade Organization

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# **Combating Corruption in Indonesia: Enhancing Accountability for Development**

## **Overview**

*“Only Indonesians can overcome corruption in Indonesia. They will do so if persuaded that they must. Careful studies exposing in detail the systems, networks, and social and economic costs of corruption are essential tools in the anti-corruption campaign. Will, as Buddha noted, attends knowledge.”*

-Gary Goodpaster<sup>1</sup>

### **WHY THIS REPORT**

#### ***Fighting corruption is at the heart of Indonesia’s reform agenda***

Indonesia stands at a critical juncture in its post-Independence history. A freely elected government is about to complete a full term in office and the country heads for its second polls under Reformasi. The last five years have seen remarkable changes: a peaceful political transition from an authoritarian regime to an emergent democracy, impressive progress in the development of political institutions, recovery from the financial crisis of the 1990s, and significant institutional changes, which together bring about a major transformation in the rules of the game. An extraordinarily ambitious decentralization effort has been accomplished without the widely feared chaos and confusion. Civil society has been flourishing across the nation, and a newly liberated media is exploring the limits of its freedom. Given steady progress in meeting Barrington Moore’s three criteria for the development of democracy: the establishment of effective checks on arbitrary rulers, the replacement of arbitrary rules with just and honest ones, and the participation of ordinary people in the making of rules<sup>2</sup>, Indonesia could over time emerge as a strong functioning democracy.

And yet, the many accomplishments to date seem fragile, and continued progress towards a full-fledged democracy cannot be taken for granted. Precisely because the transition to an elected government has been a largely peaceful one, it has allowed the powerful interests that dominated the New Order -- the former First Family, the military, and the conglomerates-- to continue to operate, and indeed flourish in this new environment. Although their activities are now subject to a new set of formal rules, close monitoring by civil society and the media, and a degree of transparency, all of which restrain their behavior, they appear to be actively seeking to regain much of their previous power and capacity to influence. Moreover, the informal rules and networks that governed behavior in the past continue to operate (such as upward accountability and low transparency), while the new formal rules must be enforced by a set of agencies, some new but many old, which are weak and corrupt, and easily influenced by these interests. So the foundations on which the edifice

of Indonesia's democracy is being constructed remain weak, and are shaken from time to time by the ghosts of the New Order.

It is in this context that one must view the problem of corruption in Indonesia. Corruption is not unique to Indonesia. Indeed it is prevalent in most countries, developed and developing. And surveys of external perception, in which Indonesia currently ranks among the most corrupt nations of the world, may well be reflecting more the greater transparency about corruption in what is rapidly becoming one of the more open societies in the world, than the actual levels of corruption prevailing. But whether Indonesia is more or less corrupt than other countries is immaterial. Corruption levels by any objective standard appear very high, and cause the vast majority of Indonesians themselves to see corruption as an evil that must be eradicated. Corruption weakens the ability of the state to deliver basic public goods: essential services and the rules that allow societies to function effectively. As such it taxes most the poor and the vulnerable Indonesia's silent majority, creates high macro-economic risks, jeopardizes financial stability, compromises public safety and law and order, and above all, it undermines the legitimacy and credibility of the state in the eyes of the people. Corruption, therefore, represents a significant threat to a successful political and economic transition for Indonesia. By undermining the formal rules and the key organizations which are charged with safeguarding them, and by destroying people's faith in these institutions, democracy itself is threatened.

Why did Soeharto's New Order succeed in delivering high levels of economic growth and substantial poverty reduction despite high levels of corruption? The answer is in two parts (Chapter 1). The first is that the regime was careful to ensure that the scale of corruption did not deter investment and economic activity and kill the goose that lay the golden egg, requiring extraordinarily good management and restraint, neither of which lasted into the 1990s when greed began to assert itself. The second is that this success is overstated since it came at a high cost in terms of weak and corrupt institutions, severe public indebtedness through mismanagement of the financial sector, the rapid depletion of Indonesia's natural resources, and a culture of favors and corruption in the business elite. Research findings now confirm that institutions are crucial to sustainable development. Attempts to estimate through multi-country regressions the contributions of geography, trade and institutions to economic growth in income levels shows that "the quality of institutions trumps everything else"<sup>3</sup>. Thus, the neglect of institutions in Indonesia combined with environmental deterioration and other adverse consequences flowing from the New Order period has had serious negative effects on the sustainability of Indonesia's development efforts.

Has corruption gotten worse since the fall of the New Order? The evidence on this is far from clear. With declining levels of public investment, big ticket corruption may well have fallen in absolute terms, while petty corruption under weaker political management may have increased. Political competition on the other hand may be once again driving up big ticket corruption. What matters, though, is that corruption continues to remain very high and that it hurts the poor and the vulnerable the most. Such persistent corruption causes some people to conclude that it is part of the average Indonesian's mental make up. We beg to disagree. Indonesians are like people everywhere. As surveys show (see Chapter 1), they

deplore corruption, and they are themselves much less corrupt when placed in work environments which reward performance and good behavior and penalize corrupt behavior. A significant number of Indonesians are enraged by what they see and want to do something about it. They are fighting the good fight in every kabupaten and kota, and in every sphere of Indonesian life. This report is a modest contribution to their valiant efforts.

### ***Why another report?***

Much has been written about corruption in Indonesia. Why another report? This report is an initial outcome of an ongoing process of rethinking and learning by the World Bank on issues of accountability and corruption in Indonesia. In the aftermath of the financial crisis and related political upheaval, the World Bank revisited its entire strategy towards Indonesia. To many Indonesians, the Bank was associated with the Soeharto regime, which it had supported for 32 years. It was associated with the accumulation of debt, the most serious of the economic problems inherited from the New Order. And, in particular, it was seen as having failed to take a stand against corruption while lending large sums to a corrupt regime. The Bank has over the last three years confronted these weaknesses. In close consultation with the new Government of Indonesia and reflecting the high level of country indebtedness and fiduciary weaknesses, lending volumes to Indonesia were sharply reduced. The Bank has shifted much of its portfolio towards innovative operations that support poverty reduction through community-driven programs where the beneficiaries actively participate in the determination of investment priorities and oversee the proper use of funds. It has put governance and anti-corruption at the front and center of its development strategy, devoting a significant portion of its analytical work, its lending and its supervision resources to helping improve governance and accountability. It has actively investigated complaints of corruption in its projects and exposed the results of such investigations. And it has taken to heart the criticism of its silence on corruption by speaking out when necessary, as on Bank Bali (see Chapter 4). Reports such as this are part of this effort to be open and transparent about issues of corruption.

This report builds on a comprehensive set of diagnostic assessments and reviews by World Bank staff on some of the main areas where corruption breeds: public expenditure and financial management systems, procurement, inter-governmental fiscal relations, the financial sector, forestry and infrastructure, the justice sector and the civil service. In addition, the Bank has devoted more resources to understanding how corruption takes place in Bank-financed projects. It has worked actively with its development partners through the Partnership for Governance Reform in Indonesia and learned a great deal about governance issues in the process, particularly through the seminal work of the Partnership on this issue. The report attempts to distill from all these studies the key lessons the Bank has learnt about corruption and accountability. It also attempts to better understand how corruption works in particular sectors and processes, drawing on a dozen background papers commissioned for this study. The report is not a comprehensive study of corruption in Indonesia, driven as its contents are by the knowledge and understanding that is readily available to the Bank at this particular point of time.

The central issue examined in this report is why public accountability fails so often and what can be done about it. After analyzing the context in which anti-corruption efforts must operate in Indonesia, the report focuses first on three areas where corruption is rife: the budget, local governments and the government's regulatory functions in selected sectors: banking, electricity and forestry. It then looks at three sets of actors that are part of the problem, and need to be part of the solution: the key players in the justice sector--the police, the prosecutors, the courts, and the Indonesian civil service. It concludes by analyzing how donors are responding to the challenge of corruption, drawing primarily on the World Bank's own experience. Each chapter attempts to explain why accountability breaks down, to review ongoing efforts to strengthen accountability, and to draw some policy lessons. This Overview tries to pull together the common messages and outline a possible strategy for moving forward.

This approach leaves some gaps in our analysis of how corruption works in Indonesia. The biggest are the role of political parties, the military and the private sector, all only briefly touched upon. Other important gaps are corruption in revenue, in state enterprises and in urban and rural land. In many of these areas, reliable information about how corruption works is still difficult to come by, though some of these gaps will be filled as our effort to learn progresses further. This Overview tries to take account of some of these factors as it suggests ways of moving forward to fight corruption.

## **THE ACCOUNTABILITY FRAMEWORK**

### ***Who guards the guardians?***

Corruption, for the purposes of this report, is defined as the use of authority for private gain. This definition is broad, embracing the three elements of corruption as commonly described in the widely used acronym in Indonesia, KKN (korupsi, kollusi, nepotisme). Corruption is more a symptom of the failure of accountability than a disease. Hence, the report focuses on the processes and institutions of accountability and adapts to its purposes a framework developed for the World Bank's World Development Report 2004<sup>4</sup>. Based on this framework, we look at accountability in Indonesia from the perspective of the relationship between citizens in whom sovereignty resides and the politicians/policy makers they elect to represent them as President and in Parliament, between the politicians and policy makers in turn and the implementing agencies/service providers, the Ministries or agencies of government, and between the front-line service providers (those delivering the service, such as a postman, a traffic cop or a municipal sweeper), and citizens/consumers.

Citizens empower their representatives to govern on their behalf, and influence them through voting, political pressure and civil society. The politicians and policy makers in turn develop a compact with service providers, providing them with finance and other resources, and delegating their power and responsibility through laws and presidential decrees in exchange for the services provided. They also require ministries and agencies to provide information on their performance and monitor such performance through financial and performance audits. The compacts are enforced through rewards (salaries and incentives) and penalties, such as administrative sanctions, legal action, etc. Clients in turn can monitor

the performance of the service providers, based on information provided by them and their own experience, and voice their concern about the quality and adequacy of services directly or through non-government organizations or through their elected representatives.

This framework helps us identify the failures at each level of the accountability chain that contribute to corruption. The framework is based on the principal-agent model.<sup>5</sup> At each level of the accountability chain, there is a principal and an agent. Citizens are principals, and the politicians/policy makers they elect are their agents. The politicians/policy makers are principals and their agents are the heads of the ministries/agencies that are the service providers. Within each ministry/agency, the head is the principal and the front line service providers are her agents.

The principal agent problem arises because the interests of the principal and the agent diverge (“divergence of incentives”), and because the principal lacks sufficient information about the agent’s behavior (“asymmetry of information”) and agents have an incentive to hide information. An agent will be corrupt when in his judgment; the benefits of doing so exceed the costs.<sup>6</sup> Costs, here, refers to the risk of discovery and punishment, or the loss of personal reputation and self-respect. As we shall see, a problem with this model is that it assumes that the principal is free of corruption. Who “guards the guardians?” is a question that recurs throughout this report.<sup>7</sup>

### *Accountability is being strengthened...*

Indonesia is putting in place a new accountability framework which has great potential but whose impact on accountability remains weak.

Between citizens and politicians: Free and fair elections, and now direct elections to the Presidency, mark a profound change from the previous system of one-party-one-family rule. These constitutional changes have introduced formal checks and balances. Parliament now exercises oversight of the Executive in a way it could not during the New Order, while the President, after the 2004 elections, will be directly accountable to the public and will no longer be directly beholden to Parliament. Parliament’s ability to remove a President from office, as in the case of President Wahid, has been greatly diluted. The unofficial centers of power, such as the military, have lost their formal place in government, including their seats in the People’s Consultative Assembly, although they remain a powerful force in Indonesian politics. Decentralization is starting to bring government much closer to the final clients of public services. Citizen’s voice has been further enhanced by laws that guarantee press freedom, by the vigorous exercise of that freedom by the newly liberated media, and by the rapid growth of civil society in most parts of the country.

Between the politicians/policy makers and implementing agencies: The legal framework to fight corruption is being strengthened. New organizations have been established to fight corruption, including the Commission to Audit the Wealth of State Officials (KPKPN). An Anti-Corruption Commission and a special Anti-Corruption Court are planned. A new State Finance Law enhances budgetary accountability. The Supreme National Audit Agency (BPK) is freer to audit the state’s accounts and publicize its findings through Parliament.

Between implementing agencies and citizens: The rapidly expanding civil society and a newly free media are helping citizens monitor the performance of implementing agencies and service delivery, and citizens themselves are learning to speak out. Corruption has been a major focus of attention for the media and NGOs.

*...but it remains weak*

But accountability remains weak. The new openness is exposing corruption, but few are being held accountable for their actions. This is because the informal rules, mainly inherited from the New Order regime, still prevail, as do many of the practices, while the new formal rules have yet to be implemented effectively. Why? Because the agencies charged with enforcing the rules are weak, poorly funded and ill-equipped, and riddled with corruption. Politicians/policy makers in Indonesia's young democracy for the most part lack formal experience of government and are learning on the job. Decentralization has almost over night created a whole new class of politicians and policy makers in Indonesia's 400 districts. But many of them and their agents, the civil servants and those entrusted with upholding the law, remain very much a product of the New Order regime, used to ways of behavior that fundamentally undermine accountability. And without an authoritarian figure to control their excesses, they are free to pursue rent seeking unchecked. With billions of dollars of state assets still to redistribute from the aftermath of the financial crisis, the temptation for new and old economic elites to seek to shape the rules of the game to their own advantage through state capture is extraordinarily difficult to check. The media and civil society fight a valiant battle, but their effectiveness is limited, not least by the need to enhance their own accountability.

Between citizens and politicians/policy makers: Newspaper stories documenting corruption in parliament and reporting on political parties building war chests reveal this link in the accountability chain to be not working. Why is there so little commitment to clean government from leaders of a new democracy who need broad public support for their political survival? The answer lies in the current transition. First, many of Indonesia's leaders are conditioned by the corrupt past and set in their old ways. Second, political competition is less strong than it appears. Voters do not believe political parties' claims that that they will be less corrupt than their incumbents, since they lack policy credibility with voters. Third, the proportional representation system combined with the restrictions being placed on eligibility of political parties makes individual politicians heavily dependent on their party bosses for both political survival and success rather than on the support they enjoy from their constituents. They must therefore be responsive to party pressures to collect funds for elections. Finally, the sheer size of Indonesia drives up the cost of elections, and hence the competition for funds.

Between politicians/policy makers and implementing agencies/service providers: The analysis in this report suggests that politicians and policy makers also fail to deliver their end of the bargain in their compact with implementing agencies.

- *Delegation of power* to the agencies through laws and regulations which define accountabilities is part of the problem. While inadequacies of anti-corruption laws are not

the principal problem, despite being weakly drafted and flawed as they sometimes are, there are some important exceptions: the absence of adequate laws on State Audit, procurement, right to information, and whistleblower protection. The principal weakness is in the area of regulation, where laws are passed, but implementing regulations take an inordinately long time to be issued, making the laws ineffective, a common practice in the New Order. When issued, the regulations sometimes defeat the intent of the law, or as in the forestry sector (Chapter 4) they become a tool for rent seeking, since compliance imposes a high cost on those being regulated. Contradictory legislation and regulations also weaken accountabilities. Local governments remain unclear about what precise functions they are accountable for delivering and whether or not they have the authority to determine levels of compensation and employment.

- *Finance and other resources:* Politicians and policy makers undercut the implementing agencies and service providers by failing to provide them with the resources to do their job (Chapter 2). Allocations for operations and maintenance tend to be very low and have declined in real terms. Budget allocations are released late in the year, providing little time to spend it. What gets allocated, service providers often complain, is also “taxed” at source by central ministries as the price for getting the money. Inadequate funding is inherited from New Order practices where agencies were allowed to raise their own resources to meet budgetary gaps. Such survival strategies persist. They range from routinely padding expense accounts to funding recurrent expenditures from the development budget, to levying unauthorized charges for services delivered, to running enterprises and foundations and other resource mobilization ventures. The practice of permitting enterprises to be run by the military and the police is a particularly serious problem leading to allegations of involvement in drug smuggling, protection and prostitution rackets, and, following their formal separation, to open conflicts between the police and the military when their business interests clash. While no one quite knows how much of military and police expenditures are met from allocations in the government budget, guestimates converge around one-third. These practices blur public-private boundaries, weaken accountability for funds and provide a ready excuse for rent-seeking activities.
- *Enforcement:* Compensation plays little role in creating positive incentives for integrity on the part of civil servants (see Chapter 6). While low salaries are commonly viewed in Indonesia as a source of corruption, the evidence suggests that with the large increases in compensation in recent years, civil servants are on average not particularly underpaid relative to their market comparators, although the situation relating to the most senior civil servants needs to be more carefully studied. Pay is however a factor in corruption because of a highly opaque and non-transparent system of compensation administration. Only a small proportion of an official’s income comes from his salary. A range of allowances and payments that are not transparently administered are used to run a patronage system within each organization. In addition, civil servants have access to a host of legal and illegal sources of income ranging from allowances to attend meetings, speed money, kickbacks on contracts, tax avoidance, etc. What they receive depends on their relationships with the power brokers in their organization, and whether they work for a wet or dry agency/department. The threat of withdrawal of such allowances acts as a powerful disincentive to whistleblowers and those reluctant to comply with these

practices, while weak financial management ensures these practices have no consequences for those responsible. Civil servants, therefore, rarely get rewarded for good performance. And they rarely get disciplined for corruption. Survey evidence demonstrates that the few Indonesian organizations that civil servants rate as performance oriented, and that enforce rules and follow good management practices are typically also those in which corruption is lower.

- *Sanctions:* The justice sector (Chapter 5) is responsible for enforcing the rules of accountability. However, widespread corruption in the sector makes it largely dysfunctional, with each arm of the sector, the police, the public prosecutors and the courts deeply flawed in their own accountability, leave alone being able to enforce accountability in others. Thus in the words of an ADB funded study, “those sworn to uphold the law, break the law.”<sup>8</sup> In the absence of an effective justice sector, impunity is widespread and conditions all behavior.
- *Information* is another weak link in the chain of accountability. Politicians and policy makers appear to pay little attention to systematically collecting information on the performance of ministries and agencies that would enhance their accountability. This is reflected in poor record keeping and documentation that undermine financial management, the lack of transparency in key areas such as procurement which restricts competition, and more broadly in a bureaucratic culture of secrecy. Moreover, while Indonesia is not lacking in internal and external auditing, inadequate resources to the Supreme Audit Agency (BPK), the lack of a modern state audit law, and the lack of clear, defined processes for following up on audit findings and the failure to make audits widely available all reduce the effectiveness of audits as a tool for exposing corruption and enhancing accountability.

*Between implementing agencies and citizens:* The ability of ordinary Indonesians who lack influence and access to hold government service providers accountable for their services and provide feedback on their needs is limited. While this is changing as the public’s awareness of its rights grows, thanks to vigorous media and an active civil society, the costs of collective action are high, and it is much more convenient, and often cheaper, to pay a bribe than to demonstrate for your rights.

### ***It takes two to tango***

The focus of this report is on public sector accountability. But the corrupt flourish because there is no shortage of corruptors. For ordinary Indonesians who pay petty bribes, the cost of not bribing is high relative to the cost of the bribe, and this needs to be reduced. But large scale corruption originates in the private sector, both foreign and domestic. Often it is aimed at regulatory capture, influencing policies or regulations that favor certain firms. Collusive procurement practices are equally common. The ownership structure of Indonesian firms is characterized by concentration in one family or controlling shareholders. The business culture of such firms is relationship based rather than rules based. This ownership structure, when combined with a weak regulatory environment promotes practices that lack transparency. Foreign investors typically use domestic partners to facilitate their relations with government. Equity markets are small, with capitalization of less than 15% of GDP in



2002. Most listed companies are either owned by families or by government. Indonesia faces many challenges in reforming its corporate governance. These include the need for greater transparency and reliability of financial reporting, an end to the practice of auditors establishing cozy relationships with the companies they audit – by no means unique to Indonesia, the introduction of genuinely independent directors on company boards and the effective enforcement of company laws and regulations, in part by empowering and strengthening the securities regulator who must fill the void created by a dysfunctional justice sector. These issues are discussed in more detail in a forthcoming World Bank report on Indonesia's corporate governance.

## **REFORM PRIORITIES**

### *Nature of transition limits options*

The nature of Indonesia's current transition limits greatly the options for reform. Indonesia is witnessing the steady breakdown of a highly centralized state once dominated by a powerful ruler. The resultant diffusion of power is seen in the emergence of several competing political forces at the center, both old and new, and a shift in power to the regions where local politicians armed with their new authority under the decentralization laws are beginning to assert themselves against the center. Civil society is growing rapidly and creating a third force independent of the state. The process appears more chaotic than it is in reality. Indonesia's high social capital and the average Indonesian's commitment to the idea of the Indonesian state provide the invisible glue whose strength is easy to underestimate. And the political elite has shown a capacity to come together to push through key institutional and economic reforms that were seen as essential to the country's stability. Nevertheless, the current state of flux allows the informal rules and perverse incentives of the past to flourish without check, while the formal rules still take hold. Over time, as politicians become more experienced, the public more aware and vigilant in protecting its interests, and civil society more effective, accountability could improve. However, most democracies, old and young, are always a work in progress, and it takes strong leadership, the willingness of elites to take an enlightened view of their long term interests, and continuous citizens' vigilance to ensure that accountability improves and the rule of law is applied. It is a continuing struggle with uncertain results and persistent risks of slippage. In the meantime, it is inevitable that the process going forward will appear chaotic and unruly, with progress here, and setbacks there.

The current environment does not appear conducive to a comprehensive and broad-based strategy to strengthen accountability and reduce corruption is likely to work. The vested interests are too powerful, and the ability of the state to implement a broad-based program of reforms is limited. But this could be an environment in which localized solutions will emerge supported by local pressure groups, whether it is in some sectors or sub-sectors or in particular kabupatens and kotas, or in some provinces with reformist governors. It may also well be an environment in which a core reform effort aimed at providing space for such localized solutions could be pushed through at the Center. There are reformers in government who want to change the way things are, and they need support. There are leaders of regional governments who want to make a difference, and there are citizens everywhere

who are asserting their rights and speaking up. The analysis in this report identifies a number of solutions that could be tried in different parts of the system, and readers are encouraged to look at these.

Is it possible to catalyze and stimulate these efforts, involving Indonesians everywhere? A two-track approach is recommended. The first is to help strengthen demand for reforms at the local level. The second is for the central government to pursue a core program of reforms that create an enabling environment for the pursuit of localized initiatives on anti-corruption. Together these steps would allow space for a hundred anticorruption flowers to bloom in different corners of the country that could gradually create enough momentum to begin making a difference to public accountability. Outside of government, all key players involved in accountability should have a key role in this process: civil society, the media, the private sector, and Indonesia's international development partners.

### *Strengthening demand for reforms in the regions and at the grassroots*

The World Bank's experience with the Kecamatan Development Program (KDP) (Chapter 7) shows that empowering local communities to take charge of their own fate brings high returns in terms of strengthening local ownership and social capital, and reducing corruption. Under KDP, project funds are placed under the control of those who benefit from it the most and have a vested interest in the money being well spent. Transparency and publicity, the involvement of local stakeholders and village leaders and of local institutions are central to effective community participation in the fight against corruption. Corruption is not eliminated, but it is reduced and costs are lower for infrastructure. KDP now covers half the poor villages in the country, and when it is successful its popularity attracts districts not covered by the project to allocate their own funds to join the program. The KDP approach can be applied in other areas: involving parents in overseeing funds and monitoring the schools their children attend, empowering patients to monitor health care centers, and allowing NGOs to monitor public procurement in the regions and at the Center. When successful, such programs throw up local leaders and increase awareness of citizens' rights and obligations, and the importance of accountability and transparency, creating over time the social capital for improved governance.

Local governments could also benefit from more active community participation in their decision making and implementation processes, from enhancing information flows to citizens, and carving out partnerships with civil society. Decentralization with enhanced accountability, for instance, may hold the key to resolving rampant corruption in the forestry (and natural) resource sector (Chapter 4). Such accountability must be a two-way process, not only upward to higher levels of government administration -- provincial and national -- but also downward to the local-community. Village-driven accountability consists of both obvious electoral and more immediate dimensions, e.g., an association of villages sharing the same watershed where waterways are polluted by a logging concessionaire's improper road-building. To work, this will require transparency, inclusiveness through genuine consultations, and a rationalization of regulations towards outcome-based regulations the results of which can be monitored by local communities.

New initiatives, through programs funded by international development agencies, directed at assisting rural and urban district governments (kabupatens and kotas), would reward resource-strapped governments with much needed infrastructure funding when they are willing to reform governance in their districts and reduce corruption. Establishing clear and transparent criteria for improvements in accountability and transparency, encouraging communities and NGOs to monitor the performance of local governments, and swift sanctions when criteria are not met, could be guiding principles more widely adopted in central government budgetary transfers to local governments. The program will only work when the criteria for selection of districts is clearly understood and applied, and when benchmarks are monitored and performance rewarded or sanctioned. The resulting competition between districts for central government or donor funding could result in good practices spreading faster than they would otherwise.

The central government can help this process in a number of ways discussed in Chapter 3. These include direct elections to office for bupati and wali-kotas (district heads), following the pattern at the Center, thus making the bupati more accountable to the public, clarification of the precise accountability of local governments resolving the confusion arising from conflicting legislation and regulations, allowing regional governments to experiment with civil service reform within a hard-budget constraint, providing citizens information on the performance of their local governments, and most important of all, expanding the tax base of local governments (particularly property and real estate taxes and local sales taxes) so that citizens know that the taxes they pay are funding the services they receive, and can sanction local governments for their misuse.

### ***Creating an enabling environment for anti-corruption***

The central government also has a key role in creating an enabling environment for anti-corruption efforts. In some cases, this may simply mean stepping out of the way to let things happen. But a core reform effort at the center aimed at creating such an environment would include:

- ***Campaign finance reform:*** Political parties have legitimate financing needs for fighting elections. Unless these needs can be met within the law, the high cost of campaign finance in a country the size of Indonesia could drive the corruption beast. (Chapter 1, and Box 1.2) The success rate in other democracies of controlling money politics has been rather low. What is possible however is to help partially level the playing field. Some countries have found a combination of mechanisms helpful. These include partial budgetary funding for campaign finance, reducing costs of party politics by allocating free time slots of TV and radio with no additional time allowed, banning the use of state resources for political purposes, leaving a paper trail and requiring parties to have their funds audited, ensuring that the civil service is neutral during elections, and ensuring the independence of the election commission.
- ***Strengthening the guardians of accountability:*** Four key institutions dominate the accountability monitoring landscape in Indonesia: the Election Commission (KPU) which helps the people choose their representatives to national and regional governments and parliaments, Bank Indonesia, the country's central bank that guards the nation's money

and financial health (Chapter 4), the Supreme Audit Agency, the government's auditor (Chapter 2), and the Supreme Court that heads the nation's judiciary (Chapter 5). A fifth, the Constitutional Court is about to come into being. The government and parliament need to consider how best to strengthen these institutions and make them independent. Funding them adequately and ensuring that their funds come directly from parliament rather than from the Ministry of Finance will be important. Ensuring they are headed by men and women of the highest integrity and ability is crucial. The autonomy of these institutions, guaranteed by the law, needs to be protected and cherished. But if this autonomy is not to be abused, the leaders of these institutions must be selected by a process that is not subject to corruption or political considerations, and that ensures high quality recruitment.

- ***Funding public services adequately:*** A common refrain throughout this report is that one of the most important factors driving corruption is the failure of the government budget to adequately fund the activities of government and the tolerance of a wide range of practices intended to overcome the insufficiency of budgetary funds (Chapter 2). By blurring the distinction between public and private funding and reducing the accountability of public moneys, this practice creates a bureaucratic culture of corruption. In the case of the military and police, the consequences go beyond corruption and threaten Indonesia's young democracy since the business ventures of these organizations extend to underground illegal activities. This problem cannot be solved overnight and a phased program of work will be needed. The cost of meeting the total needs of the government will be enormous. Before the Ministry of Finance opens its checkbook, government will need to conduct a careful review of all needs and expenditures, as also of the role of the state and of the central government in a decentralized Indonesia with a view to shedding unnecessary activities. This will have to be accompanied by strengthened efforts to stop informal revenue raising measures, shut down foundations and private businesses, improve financial controls, and get better value from the government's procurement rupiah. At the same time, ongoing efforts to reduce corruption in customs and the tax authority that explain Indonesia's current relatively low revenue effort will need to bear results so that the additional allocations required can be funded. Survey data show that citizens and enterprises will be prepared to pay more taxes if they thought they would not have to bribe government providers of services. The government could begin by setting annual targets of increases in provisions for under-funded government activities and finance these from additional resource mobilization and expenditure reduction efforts.
- ***Cleaning up the regulatory jungle:*** The government needs to urgently review the jungle of regulations that attempt to constrain private behavior with a view to rationalizing it and reducing opportunities for rent-seeking and regulatory capture. Fewer and well drafted regulations that focus the goals of regulation to the attainment of medium to long term outcomes (see Chapter 4) would be important as would eliminating regulations that are deliberately framed to impose such arduous or impossible conditions on firms and individuals that they invite corruption. Indonesian law is dependent for its implementation on regulations. Switching to a practice of providing Parliament with the draft regulations together with every draft bill submitted for enactment will enable a

review of such regulations for their consistency with the law and to ensure that the intent of the law is being protected.

- ***Reducing impunity:*** Corruption flourishes in Indonesia because there is little likelihood of being caught and even less of being punished. Reduced tolerance of corruption in the civil service through strong administrative sanctions would be a start, but this is unlikely to happen minus a genuine effort at civil service reform (Chapter 6). Justice sector reforms aimed at effective criminal sanctions for the corrupt are however an essential element of an enabling environment for anti-corruption efforts. There has been modest progress in this direction since the New Order, but given the turbulence of the transition and preoccupation with crisis management, efforts to move more determinedly have come to naught. This will need to be a high priority for the newly elected government after the 2004 elections. This will require strong leadership, the development of a road map for such reforms and the initiation of governance audits leading to action plans (similar to the audit undertaken at the Attorney General's Office on which there has been no follow up action) and needs assessments to determine budgetary requirements for all three branches of the justice sector, the police, the public prosecutors and the courts. Until reforms begin to take hold at the principal justice sector agencies, the new Anti-Corruption Commission will be the only game in town, notwithstanding the unfavorable global experience with such agencies. Government, therefore, needs to ensure that the Commissioners of the Agency are men and women of outstanding integrity, ability and independence, that the Agency is given an adequate budget to do its job and there is strong political support for the work of the Commission even when its activities create difficulties for the government and parliament. The work of the Commission will also be facilitated by an effective law protecting whistleblowers. The Commissioners need to be selective and strategic in developing their work programs if they are not to be overwhelmed by the task. If these conditions are met, the Commission could well help prick the bubble of impunity that surrounds efforts to fight corruption in Indonesia.
- ***Enhancing transparency:*** Accountability cannot be ensured without transparency. The prevailing bureaucratic culture of secrecy creates a veil behind which corruption flourishes. That veil needs to be cast aside as Indonesia continues down the path of democratization. This must begin with the way policies, laws and regulations are made. While the process has opened up greatly thanks to strong civil society pressures and an active media, systematic efforts to make policies, draft legislation and regulations subject to public review and comments need to be incorporated as standard practice in Indonesia's government ministries and agencies. A sunshine law that enshrines transparency into government processes would be an important precondition. A Freedom of Information law has been under consideration for a long time, but has yet to see the light of day. But the government need not wait for this. Existing anti-corruption laws permit greater information disclosure and await implementing regulations. Transparency can also be enhanced in the budget through a number of devices: public expenditure tracking by civil society, making public all government audits and the reports of BPK and BPKP. In procurement, bids need to be opened in public and the results of the bidding process should be immediately disclosed. Judges of the Supreme Court and lower courts should follow the practice of the commercial courts and provide written judgments that can be reviewed by the public. The information revolution now allows the opportunity to

provide the public information about government services, charges and fees so that their ignorance cannot be exploited by unscrupulous civil servants. Indeed, as seen in other parts of the world, E-government offers much potential for reducing corruption and enhancing transparency.

## **THE PLAYERS**

### *Setting the right traditions*

“In the birth of societies, it is leaders of republics who create the institutions; afterwards it is the institutions that form the leaders of the republic” - *Montesquieu*<sup>9</sup>

It is not difficult to achieve greater accountability on paper. As we have argued, Indonesia has already made much progress in that direction. But it is how accountability is upheld in practice that matters. Respect for the key offices of state, for the key institutions that are the pillars of democracy matters. How do politicians view the observance of election laws? Are public officials nervous when they face a parliamentary committee, and do members of parliament see themselves as protecting the interests of the people first before the interests of their party or their personal interests? Does a minister resign if there is a shadow cast on his reputation? What kind of example do ministers set for their civil servants when they submit their expense accounts? It is the traditions that are established in the early stages of a democracy that determine the shape it will take and how accountable its institutions become over time. Much therefore will depend on how the key players in our accountability framework interact and behave. Indonesia does not have the luxury of starting with a clean slate. The prevailing informal rules are those of little or no accountability. They were part of a well oiled machine of corruption. What can be done to shift the norms that have shaped these informal rules and to induce people to adopt the improved formal rules?

### *The politicians:*

Much will depend on the political leadership – the politicians and policy makers in our accountability framework. Strong leaders have a vision of where they want to go, the skill to build consensus around the directions of change, and the courage to take difficult policy measures. They model good accountable behavior. Leaders who are committed to improved accountability will choose carefully the people’s representatives on their party slates and their ministers and heads of agencies. It is the integrity and the ability of these men and women which will shape the future institutions of Indonesia. These men and women will in turn choose teams that move the agenda of accountability forward. This is to expect a lot given an inexperienced leadership, and given the enormity of Indonesia’s problems. Indonesians, like people everywhere, tend to expect too much of their leaders. Yet in a country as large and diverse as Indonesia and one where alternative leadership was suppressed for so long, many people will undoubtedly emerge as potential future leaders. And existing leaders may grow in their jobs and learn to rise to the occasion.

***The civil servants:***

Much will also depend on how the leadership manages the civil service. The civil service needs a huge cultural change as it transitions to a meritocratic rules-based service and one that sees itself as a servant of the people. Surveys of civil servants show that corruption is lower when organizations are well managed, have strong anti-corruption organizational values, have high quality personnel management, and take care to manage procurement well. Managers who observed and set high standards, enforced the rules and motivated their staff by recognizing performance were seen to be much more likely to lower corruption. Management performance was seen by civil servants generally as more important than salaries in explaining corruption. The issue of salaries will, nevertheless, need to be addressed. The first priority is to disentangle the complex and confusing web of pay and employment policies so as to introduce greater transparency, reduce discretion, and eliminate the networks of patronage that now prevail. The second priority is to develop compensation packages based on well designed labor market surveys. It is particularly important to ensure that the top echelons of the service are adequately rewarded. This will then open the door to opening recruitment to all Indonesians and ensuring that the top positions are competitively recruited and filled with the best talent in the country. Well designed and transparent compensation packages will also imply maintaining tight controls over the size of the civil service, eliminating ghost workers and reviewing the status of temporary workers through a proper census of the civil service. Such a comprehensive reform should not delay experimentation with reforms at the decentralized level, as argued above, and the Center should clear the path to such experimentation.

***Civil society:***

As pointed out above, given the difficult nature of Indonesia's transition, relying on top down reforms will be unwise. Moreover, top down reforms are unlikely to occur unless there is bottom up pressure. Civil society will need to make this happen. Civil society in Indonesia is already strong in parts. The two Islamic bodies, the Muhammadiyah and the Nahdlatul-Ulama (NU) are examples of large mass organizations with strong social programs and a commitment to the idea of Indonesia. The secular organizations are newer and less well organized, and competing for the limited pool of donor funding. But they have shown a capacity to come together on key issues and share a strong anti-corruption agenda. Mobilizing people and giving voice particularly to the poor and the vulnerable is a key responsibility for Indonesian civil society. Success for these efforts will depend on the ability of civil society to impose on itself the same discipline it asks of government, by ensuring its own accountability and transparency and by subjecting itself to independent evaluation of its success. Success will also depend on NGOs reducing their dependence on external sources of funding and relying on raising money from within Indonesia, if they are to be genuinely independent organizations.

***The Private Sector:***

The corruptors in the private sector need to change their ways if corruption is to end. This will not be easy. But the world is changing. Globalization and trade liberalization are

increasing competition in all markets, and the Indonesian private sector cannot expect to survive as it once did on the strength of networks and cozy crony relationships. While government needs to change the incentives facing the private sector through improved laws and regulations which ensure competitive markets, including for government procurement, and better enforcement of those laws, the private sector needs to accept its own responsibility for changing the way it does business. There are tentative signs of clean business movements within the private sector and these need the support of all far sighted leaders of the private sector. There is also wider recognition that corporate governance needs to be improved. Further efforts will be required to improve transparency in business practices, promote business ethics and enhance the accountability of managers and boards of public companies.

### ***International Development Partners:***

Indonesia's international development partners also face a difficult challenge. Today they are still perceived by certain constituencies as being part of the problem of corruption rather than being part of the solution. The World Bank's own efforts to reinvent itself in Indonesia have some important initial lessons:

- Partnerships are essential to the fight against corruption: partnerships with beneficiaries, with civil society, and with other donors and multilateral institutions. No one agency can expect to act alone and succeed.
- Transparency and disclosure of information are the most important tools in mobilizing civil society and beneficiaries to help resist corruption, as has been shown in the World Bank's Kecamatan Development Program.
- Corruption thrives when international development agencies appear to tolerate it. While zero tolerance is unrealistic, acting firmly when corruption is found is essential to establish credibility with the corrupt and the corruptors.
- Donor anti-corruption efforts must be based on an understanding of the sectors and institutions within which the particular donor intervention is based, and the incentives faced by the counterparts in government. Such interventions must attempt to shift incentives in favor of greater accountability and transparency.

Development assistance is only a small share of Indonesia's budget and economy. The role of Indonesia's development partners and their impact on what happens in Indonesia should not be overstated. As Prof. Goodpaster notes in the quotation at the beginning of this Overview, only Indonesians can solve the problems of corruption in their country.

## **CONCLUSION**

The choices facing Indonesia's leaders are stark. Failure to act decisively to strengthen accountability and the rule of law could have serious adverse long-term consequences for Indonesia's political and economic stability. On the other hand, a determined and sustained effort at reforms could transform Indonesia's polity and economy, and open the way to a substantial reduction in poverty and vulnerability. What complicates



matters is that reforms in this area will take time to yield results, and will require persistence and patience from both leaders and the led. The alternative of a “too-little-too-late” approach to reforms is no alternative at all.

### *Structure of the report*

As noted above, this report draws on the lessons the Bank has learned since it began to address more systematically issues of corruption in its country assistance program in Indonesia. The rest of this report attempts to do four things. First, it provides an introduction to corruption in Indonesia to set the context for the rest of the report. Second, it looks at corruption in three areas where the Bank has been active in its analytical and advisory work: the Indonesian budget, local governments, and the regulatory function of government. Third, it looks at the role of key players: the guardians of the law in the judicial sector and the civil service, and reviews the role of international development assistance.

- **Chapter 1** sets the overall context of the report. It first looks at international and domestic perceptions of corruption and describes the costs of corruption. It then assesses the inheritance of Indonesia’s young democracy, describing the nature of corruption under the New Order, and examining why Indonesia experienced such strong growth and poverty reduction despite high levels of corruption. The chapter concludes by reviewing the efforts since the collapse of the New Order to enhance accountability and why these have shown so few results.
- **Chapter 2** examines the factors that compromise public accountability in the management of public finances. It reviews how public funds are allocated and spent, how they are managed financially and accounted for, how goods and services are procured, focusing on the key institutions and instruments of public financial accountability. The chapter concludes by looking in detail at ways of strengthening public accountability.
- **Chapter 3** assesses the accountability framework for regional and local governments, identifies its weaknesses, reviews early results of decentralization in terms of quality of service delivery and extent of corruption, and ends with providing some directions for reform that could strengthen local accountability.
- **Chapter 4** looks at accountability in the government’s regulatory role in three key areas: banking, electricity and forestry, reviewing the practices that prevailed under the New Order, and their consequences for current efforts to reform the system and restore accountability. In each of these areas, there was grand corruption during the New Order and shortly after its demise, made possible by the lack of accountability analyzed in Chapter 1. A concluding section looks at what it will take to prevent this from happening again.
- **Chapter 5** examines why accountability is broken in the justice sector and how that might be remedied. It reviews external and domestic perceptions of the justice sector, and why despite changes in formal accountability, accountability continues to break down for each instrument of the law, the police, the public prosecutors service and the courts, and then considers some policy implications.

- **Chapter 6** is devoted to trying to understand why the accountability framework for the civil service produces such negative outcomes. It begins by seeing how public officials and others view corruption and examines if these perceptions hold up to closer scrutiny. It then examines the reasons for failure of accountability and concludes by pointing to ways of going forward.
- **Chapter 7** discusses what it would take for Indonesia's international development partners who are widely seen as part of the problem to become part of the solution. Drawing on lessons learned from the experience of the World Bank, which in recent years, working together with the Government, has put fighting corruption at the core of its country assistance strategy, the chapter looks at issues of project design, disclosure of information, and enforcement, and the implications of these for the Bank's own assistance strategy in Indonesia. It concludes by drawing some lessons that may apply to development assistance to Indonesia.

## 1. Why Corruption Matters<sup>10</sup>

*Indonesia suffers from a very poor international reputation regarding corruption, ranking near the bottom alongside the most corrupt countries in the world. It is also perceived as doing worse over time in controlling corruption. Indonesians agree. They liken corruption to a “disease to combat, denouncing every known case.” While these perceptions may be overly influenced by the new openness of a democratic Indonesia, corruption is high and imposes severe social and economic costs. It also contributes to citizens’ loss of trust in governments.*

*While its origins date from colonial times, corruption became institutionalized under the New Order, when the regime systematically conferred benefits on its friends and allies in return for financial and other favors. The New Order succeeded in delivering rapid economic growth and substantial poverty reduction over three decades despite high levels of corruption because it successfully constrained the scale and unpredictability of corruption such that it did not deter investment and kill off the goose that laid the golden egg. Greed eventually destabilized this careful construct, and the country has paid a heavy price in terms of a sharp accumulation of public debt, a damaged environment and above all, weak and corrupt institutions. Soeharto has gone, but those he favored continue to flourish, exploiting the many new opportunities to re-establish their power in the fluid environment of Indonesia’s simultaneous political and economic transition. Today, the size of the cake on which corruption feeds is smaller, but there are many more players anxious to have their share of the cake.*

*So what has changed? The formal rules are being radically redrawn to enhance accountability. Free and fair elections, formal checks and balances, the reduction in the formal influence of the military, and a vigorous media and civil society are all empowering citizens vis a vis their elected representatives. New laws and a more vigilant parliament are beginning to strengthen the hands of those politicians who wish to control corruption in the ministries and agencies of government. These laws have added new institutions to the government’s anti-corruption arsenal. And implementing agencies are coming under greater public scrutiny. These are all part of the efforts by reformers to move Indonesia from a society based on informal rules and networks to one based on formal rules.*

*But the task is proving difficult. Anti-corruption efforts since Soeharto are a story of considerable promise and creative initiatives dissipated through poor follow up and weak implementation. The political will have been missing reflecting the political parties’ limited credibility when it comes to fighting corruption. Indonesia’s strongly party-orientated political system means that accountability is to party bosses rather than to constituents, and the high cost of campaign finance now drives the corruption beast. This is not an environment in which a comprehensive and broad-based strategy to fight corruption can work. But it may be one in which localized solutions can emerge in regional governments or individual sectors where reformers push the curve. For this to happen, the Central government will have to help create an enabling environment for such reforms. The chapters that follow this one pursue those solutions and the needed enabling environment.*

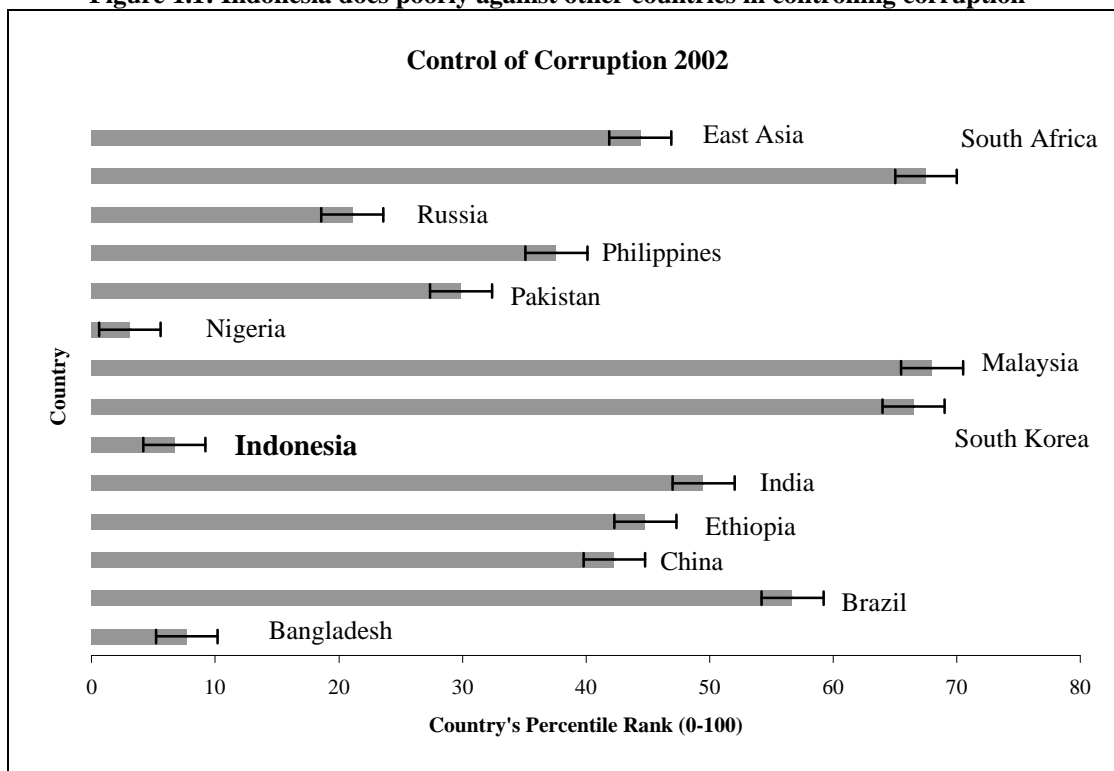
This chapter sets the overall context for this report on corruption, commonly referred to in Indonesia as KKN (*Korupsi, Kolusi dan Nepotisme*). It begins by looking at international and domestic perceptions of corruption. It then describes the costs of corruption, in economic and social terms, noting in particular the burden corruption places on the poor. The chapter examines the inheritance of Indonesia's young democracy, and how changes to the accountability framework are attempting to address the challenges inherited from the past. Finally it looks at why these have so far had little impact on the incentives facing the corrupt.

**PERCEPTIONS OF CORRUPTION**

*Indonesia ranks low on world corruption surveys...*

As is well known, Indonesia suffers from a very poor international reputation regarding corruption. In Transparency International's 2002 Corruption Perceptions Index, Indonesia ranked near the bottom alongside the most corrupt countries of the world.<sup>11</sup> Its absolute score of 1.9 out of 10 (with lower numbers indicating higher corruption) shows a modest improvement over the 2000 Index (1.7), but compares with a regional average of 4.1 and a global average of 4.6. The Political Risk Services Corruption Index, which tracks the evolution of corruption in Indonesia since 1995, indicates that perceptions of corruption in Indonesia worsened from 2.7 to 1.3 on a six-point scale from 1995 to 2001.<sup>12</sup> The World Bank Institute, which synthesizes various data on corruption into one aggregate measure of control of corruption, shows Indonesia doing poorly among the larger developing economies, along with Nigeria and Bangladesh (see Figure 1.1)

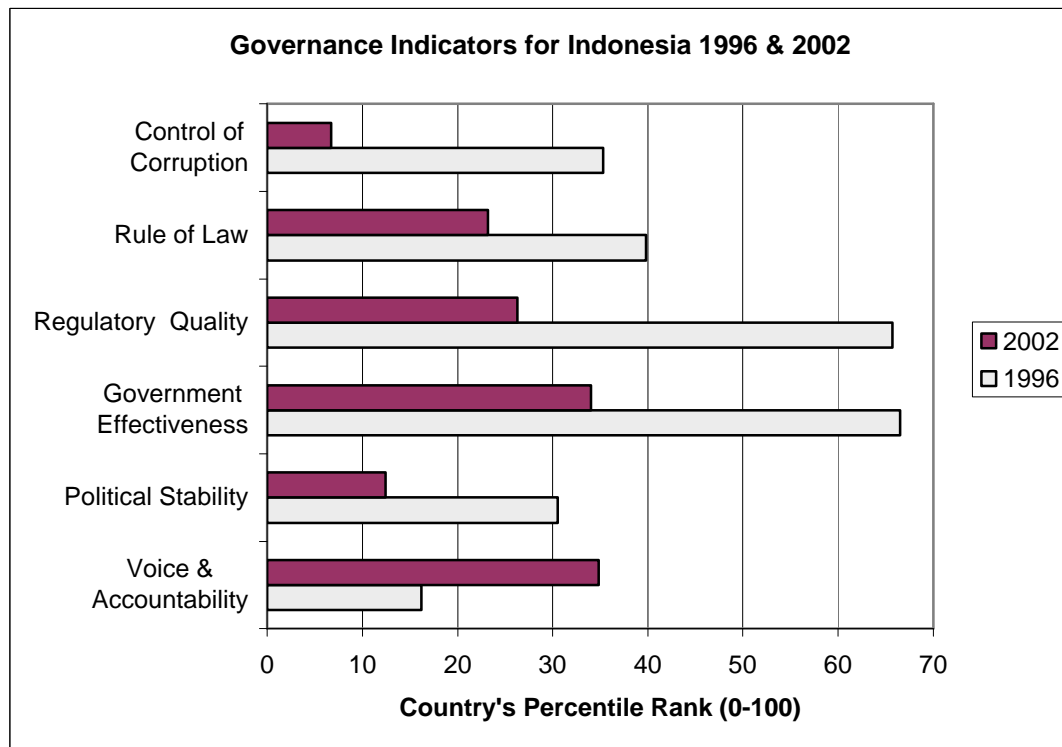
**Figure 1.1: Indonesia does poorly against other countries in controlling corruption<sup>13</sup>**



The World Bank Institute (WBI) also attempts to move beyond aggregated cross-country comparisons by developing indicators for six dimensions of governance. This research concludes

that between 1996 and 2002 Indonesia exhibited improvement in the indicator for ‘voice’ and ‘accountability’, but indicators for government effectiveness, regulatory quality, and control of corruption deteriorated (see Figure 1.2).<sup>14</sup> The improvements reflect the advent of a democratically-elected government and increased media and civil society activity. The declining indicators reflect the shift away from authoritarian rule and centralized government as well as weaknesses in the state’s management capacity.

Figure 1.2: Key Governance Indicators 1996-2002



Source: D. Kaufmann, A. Kraay, and M. Mastruzzi 2003: *Governance Matters III: Governance Indicators for 1996-2002*.

Note: The governance indicators presented here reflect the statistical compilation of responses on the quality of governance given by a large number of enterprise, citizen and expert survey respondents in industrial and developing countries, as reported by a number of survey institutes, think tanks, non-governmental organizations, and international organizations. The aggregate indicators in no way reflect the official position of the World Bank, its Executive Directors, or the countries they represent. As discussed in detail in the accompanying papers, countries' relative positions on these indicators are subject to margins of error that are clearly indicated. Consequently, precise country rankings should not be inferred from this data.

All the above indices are mainly based on the perceptions of business people, country risk experts and household surveys in a variety of countries, which are by definition subjective. Indeed it is entirely possible that perceptions about Indonesia have been affected by the changes in the nature of corruption described below. Greater transparency about corruption since the fall of the New Order, and in particular a vibrant media focused heavily on corruption may have caused people to conclude that the situation is worse than it is. In relative terms, therefore, the actual level of corruption in Indonesia may not be much different from that in some other important developing countries. Resolving these queries about how best to interpret perceptions data requires cross-checking against objective indicators. However, objective indicators are difficult to obtain and may be limited in their relevance when measuring a broad trend.<sup>15</sup> Moreover, to the extent that subjective indicators affect the behavior of individuals and influence decisions by potential investors, financial institutions, and international donors, perceptions

shape the reality. The findings of such perception-based surveys also feed into the self-perceptions of Indonesian society. As President Megawati observed, when reacting to a corruption survey finding on Indonesia, “Whether the survey is valid or not, still the report concerns me and makes me sick. We have to end the [corrupt] condition and uphold the law”.<sup>16</sup>

### *And most Indonesians agree*

That the rest of the world sees Indonesia as corrupt is hardly news to Indonesians, for they are far from being in denial about corruption in their own country. The Partnership for Governance Reform in Indonesia’s National Survey on Corruption in Indonesia,<sup>17</sup> a rich source of information on the perceptions of 2,300 householders, public officials and business people, reveals that 75% of all respondents felt corruption was very common in the public sector. In addition, 65% of households reported having experienced corruption directly, and 70% of all respondents saw corruption as a “disease against which we should all combat, denouncing every case that we know of.” Less than 5% agreed that corruption is a “natural occurrence and part of our daily life, so denouncing it is unnecessary.”<sup>18</sup> The survey also revealed the extent of public anger and disgust at corruption, with over four-fifths of all respondents wanting to see corrupt officials jailed, and their assets seized. A significant minority also wanted such officials to be publicly shamed. There was virtually no support for an amnesty or for forgiving past crimes of corruption.

The survey offers three other significant findings. First, people have little faith in state institutions. Those perceived as the most corrupt include all the key institutions of the justice sector (the police, the courts, the public prosecutor, and the Ministry of Justice) the key revenue agencies (the customs service and the tax authority), the Ministry of Public Works, and Bank Indonesia, the central bank. In contrast, non-state institutions including religious institutions, the news media, and NGOs were ranked among the least corrupt.

Second, the institutions ranked as the most corrupt were also perceived to be the least efficient in terms of delivery of services. In response, citizens appear to be turning to the more trusted non-state institutions as alternative mechanisms for the delivery of some services, particularly the administration of justice and dispute resolution.<sup>19</sup>

Third, the survey offers insights into the actual and perceived causes of corruption in Indonesia. While the results show a strong belief that corruption is attributable to low civil service salaries, individual moral deficiencies, and lack of controls and accountability, a more careful analysis of the data revealed a more complex conclusion. The Partnership study constructed a corruption index using five variables to obtain a scale of perceptions of the level of corruption from high to low. Using multiple regression analysis, researchers found that four variables correlated strongly with perceived low levels of corruption: quality management (the presence of formal rules and their effective implementation, and limited discretion); strong anticorruption organizational values; quality personnel management; and quality procurement management. The morality of civil servants or their salaries correlated weakly with low corruption, as did other factors such as education, age and gender of public officials. These findings suggest that there is no substitute for high quality management in the public sector.

## ECONOMIC AND SOCIAL COSTS OF CORRUPTION

### *Corruption costs a bundle*

Corruption imposes considerable economic and social costs on Indonesia. It involves predominantly unproductive behavior and diminishes incentives to engage in productive behavior. The economic costs include losses in economic efficiency arising from waste or misallocation of resources, declining competitiveness, and high transaction costs. Lost opportunity costs are also evident, with some 35% of enterprises surveyed reporting not making investments in Indonesia because of the high costs related to corruption.<sup>20</sup>

The Partnership for Governance Reform in Indonesia's 2001 survey attempted to quantify some of the economic costs of corruption. For example, public officials reported that almost one-quarter of ministries had suffered budgetary diversions in 2000-2001, due to "fraud, irregular diversion of funds or...other abuse of public office".<sup>21</sup> The survey also indicated that these institutions had to pay to receive their budget allocations. Such diversion of funds causes public losses and detracts from the level of public services provided by ministries. The survey respondents reported that households spent approximately 1% of their monthly income while enterprises spent 5% of monthly company revenue on unofficial payments. However, the impact of corruption on business costs was uneven: small-sized businesses reported allocating a larger percentage of their revenue towards unofficial payments than medium or large enterprises. The cost of corruption for businesses was also reflected in the price enterprises were willing to pay to eliminate corruption. More than half of the survey's business respondents (56%) were willing to pay additional taxes if corruption could be eliminated – and more than half of those willing to do so would pay more than 5% of company revenues towards eliminating unofficial payments.<sup>22</sup>

Corruption also imposes social costs through the proliferation of non-transparent and unregulated patronage networks. These networks weaken the rule of law and government authority, reduce government accountability, and erode the effectiveness of government institutions and public service provision. The involvement of the military, police, and customs agency in smuggling, extortion, and other types of organized crime is associated with a rise in lawlessness by the very institutions that should be protecting citizens. Thus, perhaps the biggest cost of corruption is the loss of trust in government by its citizens.

### *And the poor suffer disproportionately*

While corruption hurts society as a whole, the costs are borne disproportionately by the poor. The poor are often unaware of the official costs of goods and services they need, so they are particularly vulnerable to informal levies imposed by those who control access to goods and services. They are mostly suppliers of bribes and often feel powerless to resist. Because they are often disproportionately dependent on public goods, the poor suffer most from corruption's adverse effects on the economy. This occurs when sub-optimal amounts of public goods are provided as a result of corruption or when its negative impact on economic growth pushes those who are especially vulnerable to economic shocks below the poverty line.<sup>23</sup>

A joint World Bank-Partnership for Governance Reform research project, entitled "Corruption and the Poor",<sup>24</sup> provided people from poor urban communities in Makassar,

Yogyakarta, and Jakarta with an opportunity to speak up for themselves about the impact of corruption on their lives. The participants spoke eloquently of the daily harassment they faced from petty officials and the helplessness, humiliation, and financial pressures involved in paying even the modest amounts (in absolute terms) asked of them. They identified four major costs of corruption: financial costs associated with the way corruption eats into already tight budgets; moral decay, because corruption erodes the rule of law and reinforces a ‘culture of corruption’; loss of social capital, because corruption destroys trust, damages relationships and corrodes community cohesion; and the erosion of human capital, because corruption reduces access to, and the effectiveness of social services.

## THE INHERITANCE

### *A franchise that captured the state*

Corruption is not new to Indonesia. While some historians contend that the Netherlands Indies was relatively free of corruption,<sup>25</sup> this view is not widely shared. Prior to 1800, highly corrupt practices emerged among employees of the Dutch East India Company, who were “underpaid and exposed to every temptation that was offered by the combination of a weak native organization, extraordinary opportunities in trade, and an almost complete absence of checks from home or in Java.”<sup>26</sup> The demise of Company rule and the arrival of the Dutch Governor General at the turn of the 19<sup>th</sup> Century resulted in a worsening of the situation, with both European and local officials indulging in abuses. From this period, Indonesia inherited such practices as paying for positions in government, expecting employees to cover all non-salary costs from their salaries, and a general blurring of lines between public and private resources. Patrimonial value systems in traditional Javanese society easily absorbed these traditions, and they continued into post-independence Indonesia.<sup>27</sup>

While corruption today has its origins in colonial times, it is also in large part a legacy of the first half century of Indonesia’s post-colonial period, and in particular, the three decades of Soeharto’s New Order regime. Under Soeharto, corruption was not an unintended consequence of a highly interventionist state. Rather, as Ross McLeod argues, a system of government intervention was “consciously put in place for the purpose of generating the rents that Soeharto presumably wanted for their own sake, but also needed in order to first attain, and then maintain a position of virtually unchallenged authority.”<sup>28</sup> Thus this was not ‘state capture’ in the sense in which the term has been used in transition economies, i.e., “the capacity of firms to shape and affect the formation of the basic rules of the game (i.e. laws, regulations, and decrees) through private payments to public officials and politicians”.<sup>29</sup> The relation between the state and its corruptors was symbiotic, and in no sense were the conglomerates associated with Soeharto directly capturing the state. Rather, they were part of an elaborate system of franchises. At the center, the chief franchiser, Soeharto expropriated the state’s policy-making role to put policies up for sale, conferring on his cronies monopoly privileges (including the infamous clove monopoly), and protection from imports, awarding them government contracts and rights to natural resources and land, and granting them favorable tax treatment. Presidential decrees were issued providing special facilities to franchisees.<sup>30</sup> And as Robison notes, foreign investors played their role, currying favor with Soeharto’s cronies, and pouring money into projects with First Family connections, showing “a remarkable degree of accommodation to state-led



economic systems and to systems where political power determines access and success in the markets.”<sup>31</sup>

Those given the right to run franchises and benefit from this largesse, in turn are alleged to have paid back the franchiser (Soeharto), and progressively also, his family members, in numerous ways including ownership of shares in their enterprises, contributions to Soeharto-controlled *yayasans* (foundations), loans and contracts on favorable terms to his friends and family, by managing his businesses and assets overseas, and most importantly, by demonstrating loyalty and protecting Soeharto’s interests.<sup>32</sup> Soeharto delegated this right to franchise to his favorite ministers, key bureaucrats, and military officials. This enabled him to grossly under provision the government budget, since under this system, those operating a franchise on behalf of Soeharto could help pay the operational costs of running the government and the military. The large state enterprise sector was a major cash cow in this regime, but also provided an opportunity to keep key people in the military satisfied by giving jobs for the boys.

The franchise metaphor can only be carried so far. The use of the term ‘franchise’ conveys a degree of efficiency and modernism that misses the feudalist origins of these relations. In reality, as Adam Schwarz observes, the problem of corruption was rooted in Soeharto’s patrimonial style of rule. “For Soeharto, the personal dispensing of government largesse falls within the prerogatives of the Javanese ruler. It is quite simply, the spoils of office”.<sup>33</sup>

Despite high level of corruption, over the three decades of the New Order prior to the financial crisis, Indonesia enjoyed high investment levels, rapid economic growth and a substantial reduction in poverty.<sup>34</sup> Indonesia’s sustained record of economic success, along with other East Asian countries with serious corruption problems, led many scholars at the time to argue that poor governance need not be an obstacle to economic growth. Their arguments centered around the idea that a leader with a long time horizon such as Soeharto would inherently recognize that the scale and unpredictability of corruption should not become so high as to deter investment and kill off the goose that lay the golden egg. Their views can be summarized as follows:

- Goodpaster<sup>35</sup> views Soeharto as an example of Mancur Olsen’s ‘*stationary bandit*’ which he contrasts with a ‘*roving bandit*’.<sup>36</sup> the latter shows interest only in plundering and pillaging the territory under his control and when the territory’s resources are exhausted, moves on to richer pastures. In contrast, a ‘*stationary bandit*’ recognizes that settling down in the territory and protecting its residents from other roving bandits could help the territory’s resources grow over the longer term to a much higher level and therefore generate more in tax revenue than could be plundered by the roving bandit in the short run. Soeharto was willing to curb rent seeking policies when they posed serious threats to growth. Thus in the mid-1980s, he embraced the deregulation being advocated by internal reformers and international institutions, ending at one stroke a whole range of monopolies and controls that created rent-seeking opportunities, and instead opting for growth.<sup>37</sup> Over time the forms of corruption shifted along with the policy changes: rents generated by regulatory controls were replaced by skimming from public expenditures, which were subsequently replaced by taxes on private provision of infrastructure. Until the early 1990s, the common factor was a self-restraint in the interests of maintaining power and control. It is argued that Soeharto’s downfall came when, following the death of his wife, who had a restraining influence on the

family, he lost control and was unable to check the excesses of his own children. At this point the once stationary bandit gave way to many roving bandits.

- McLeod believes that Soeharto had an intuitive understanding of the *Laffer Curve*, under which tax revenues increase with the tax rate but at a decreasing rate, and beyond a certain point, revenue begins to decline. Soeharto came down heavily on those who abused their franchise privileges, dismissing excessively corrupt ministers and temporarily privatizing the Customs Service. Deals once made were usually honored. This brought a degree of predictability and reliability to corruption in the Indonesian system, which could easily be factored into investment decisions.
- Andrew McIntyre points out that Soeharto implicitly reduced the risk to investors that the decisions taken could also be reversed by *opening the capital account* in 1970, which constrained domestic policy makers against unpredictable behavior that would trigger capital flight. “Consciously or otherwise, this quickly came to be a strong constraint on future policy action. Because it was such a potent symbol to investors, the costs of reversing the rule became extremely high. Here, then, was a regulatory commitment upon which investors could reasonably begin to plan, since in a fundamental sense, the government was tying its own hands”.<sup>38</sup>

While the Goodpaster-McLeod-McIntyre interpretations offer explanations as to why Indonesia continued to grow rapidly despite high levels of corruption, they also tend to downplay the political and social costs of the New Order regime and its long term implications for political stability. Many Indonesians, however, point out that the same efficiency in managing corruption was used to stifle the emergence of any serious opposition to the ruling elites with important costs for Indonesia’s long term development. These became dramatically visible with the onset of the financial crisis in 1997, which saw the sharp accumulation of public debt and a steep deterioration in the quality of bank assets. Long-term environmental damage is also associated with the systematic depletion of Indonesia’s forest resources.<sup>39</sup> Following the collapse of the New Order regime, Indonesia’s young democracy inherited a weak and corrupt administration, flawed public regulatory bodies, and entrenched corruption in the country’s legal, economic, and political structures. Decades of collusion between business and government had resulted in a distorted economy that protected the economic interests of politically powerful groups even when they were in conflict with the general welfare of society. Indonesia’s business elite came of age and prospered in an environment based on networks and relationships rather than one based on rules.

### ***Franchisees liberated***

Today, Soeharto has gone, but those who ran the franchises largely remain. Their influence continues to lurk behind new laws and policies tipped in favor of the elite or in the quiet reclamation of their old assets at knock-down prices. It is also found in institutions inherited from the Soeharto era, as well as in the behavior and expectations of those who grew up in the New Order period. Furthermore, newspapers report Soeharto cronies and family members continuing to use their wealth and high-level connections to evade justice or avoid paying debts to the state.

These ghosts of the past have found many new opportunities to re-establish their power in the fluid environment of Indonesia's simultaneous political and economic transition. The financial crisis led to a substantial expansion in the role of the state, as the government, through the Indonesian Bank Restructuring Agency, came in possession of a large share of the nation's industrial and financial assets that have been put on the block for resale with inadequate financial controls. The political transition has led to increased competition, forcing political parties to depend on the previous elites for the considerable funds necessary to mount effective campaigns in such a vast country. Decentralization has also opened new avenues for corruption by local elites who may have previously had difficulty getting a fair share of the cake in a tightly centralized Indonesia.

At the same time, it is plausible to argue that big ticket corruption may have declined in dollar terms because the size of the cake has shrunk. Public investment has fallen sharply reflecting the impact of the financial crisis. Private provision of infrastructure has also been, adversely affected by the collapse of many previous deals that were renegotiated in a more populist environment. Political competition has also slowed up large private investment decisions as these are now subject to much greater scrutiny and media exposure.

Petty corruption, however, remains pervasive, and may be increasing as more players enter the fray reflecting the lack of the chief franchiser or enforcer. KKN is still largely seen as systemic and self-reinforcing, and the more citizens engage in it, the more costly it is for those who choose not to play the game. More importantly, it is typically a group effort, with well designed systems that systematically collect rents and distribute these among the group as a whole. Corruption has become a survival mechanism for many, particularly when their superiors demand a proportion of the profits of bribery, when large payments must be made to secure a position or a promotion, or when corruption is used as a means to compensate for official budgets that don't cover the legitimate operating costs of an institution. For many Indonesians, it has become a means of making a living, and the system generates compelling incentives to act corruptly.<sup>40</sup>

## **THE FIGHT AGAINST CORRUPTION**

So what has changed? On paper, at least, the fight against corruption has progressed in three major ways. First, Indonesia's accountability framework is being radically redrawn, which in theory should lay a legal foundation to enable Indonesians to fight corruption, should they wish to do so. Second, new anti-corruption institutions have been created or are in the process of being created that are intended to provide fresh momentum to the fight against corruption. Third, there have been efforts with varying degrees of energy to pursue legal cases against corrupt individuals. These have produced a few major victories, such as the case against President Soeharto's son, Tommy. This section will focus on the first two sets of changes and assess why their impact to date has been so limited. Chapter 5 focuses on the efforts to reform the justice sector and its fight against corruption.

### ***The formal rules are changing***

Indonesia's formal accountability framework is undergoing a remarkable set of changes, which at least on paper fundamentally restructure the rules of the game. These changes have

potentially significant consequences for corruption in the long term, though their impact could be limited in the short to medium term. Indonesia is currently seeing changes in all key aspects of the accountability relationship:<sup>41</sup>

***Between citizens and politicians:*** In the current period of *Reformasi*, the rules by which Indonesia is governed are being fundamentally transformed. The following changes are worth noting:

- *Free and fair elections* are changing the rules dramatically. The President will be directly elected for the first time in 2004, and free elections make the President and Parliament more accountable to the people. It is likely that direct elections of heads of local governments will also be introduced soon, further enhancing accountability at lower levels of the political system. While the long—term consequences of this are only just beginning to be realized, it marks a profound change from what were highly managed elections in Soeharto’s one party dominated system. Today literally hundreds of parties and many presidential contenders are wooing the electorate.
- Indonesia is in transition to a more formal system of *checks and balances*. Under the New Order regime, Parliament and the broader People’s Constituent Assembly (MPR) were fully beholden to the President and served as a rubber stamp for Presidential rule. Following the fall of the New Order, the pendulum swung the other way. A freely elected Parliament discovered its long neglected power, and the MPR went so far as to unseat the first freely elected President Wahid. With the recent passage of the bill for direct election of the President, the power of the legislative branch has been curbed, and politically, the President will be less dependent on Parliament. The MPR itself will now give way to an upper house, a second chamber representing Indonesia’s regions. At the same time, Parliament controls the budget, and the President must work with Parliament. Accountability should be strengthened by this division of labor, although, as we shall see in Chapter 2, there is a blurring of lines of authority on such issues as budget preparation. Moreover, the establishment of a Constitutional Court will enable disputes between the executive and legislative branches and between central and regional governments to be mediated by an independent body.
- The *role of unofficial centers of power* in the formal political process is diminishing. In particular, the military is now nominally under civilian control, and will shortly lose its privileged status as a faction of nominated members in the MPR. It will lose its voice in the election of the country’s president. The police has also been formally separated from the military. In the long run these changes should enhance accountability by making the armed forces subject to Parliamentary and Executive control over their budget and resource management.
- The substantial *decentralization* of functions and budgets to regional governments, particularly at the district level (*kabupaten* and *kota*) is bringing greater authority over local public services to regional officials who may prove more responsive to their local constituencies.
- Under Soeharto’s regime, citizens had difficulty letting their concerns be known to Government. Today their voice has been enhanced in theory, through Parliament’s oversight of the executive, and in reality through a new and more vigorous media and a civil society that is growing rapidly and learning to intermeditate between citizens and implementing

agencies. Direct control of *the media* ended in 1999 when a new press law was enacted. Law 40/1999 states unequivocally that “press freedom is guaranteed as a basic right of citizens”, that “the national press has the right to seek, obtain and disseminate ideas and information,” and that it is not subject to “censorship, bans or prohibition to broadcast.” Together with the press law, the threat of withdrawal of licensing as a tool to curb the media was withdrawn and subsequently, under President Wahid, the Ministry of Information, which had in the past been used to enforce censorship, was dissolved. In 1998-99, the government issued some 730 new press publication licenses, compared to a total of 289 for the entire New Order period.<sup>42</sup> The media has since become a major champion in the fight against corruption. While the key Jakarta-based newspapers have led the fight, their influence is limited compared to television and radio. Radio is doing better, as entry costs are low, but ownership of television is dominated by the old establishment, and although it contributes to a lively media, there are limits beyond which it will not go. Corruption is also a problem with the media, and conscientious editors report difficulties in keeping their staff in line, particularly in the regions. Unfortunately, exposure in the media appears to not guarantee any follow-up action by the police or the attorney general.

- *Civil society* is growing rapidly. NGOs have sought a role in monitoring the effectiveness of anti-corruption efforts in government agencies and have been vigorous in challenging the government on issues of transparency and integrity. Activities range from lobbying parliament to researching corruption and exposing their findings in the media. A law on the right to information is being discussed to facilitate this process. But most NGOs are young organizations and still learning how to operate in this new environment. Typically they are under-resourced and sometimes duplicate each other’s functions.

***Between the State and implementing agencies:*** The formal relation between politicians and government agencies as service providers is also undergoing changes. These are not as major as the changing relations between citizens and the state, but they are significant. Implementing agencies under Soeharto’s regime were given a set of objectives and were subject to a set of laws and regulations, which constrained their behavior. They were provided budgetary funding to undertake these objectives. The government in turn collected information on their performance and could impose legal and administrative sanctions when agencies failed to do their job. These accountability relations remain much the same. But in Soeharto’s time, Parliament had a limited role in overseeing these agencies, while, as argued above, the President, as chief franchiser, had private and implicit compacts with the implementing agency—‘the franchisee’—typically the Minister, the head of a state enterprise or the regional governor. Thus the implementing agency was effectively only accountable to the President. Budgets for operations and maintenance were under funded, and the President implicitly expected his franchisees to find other means of funding the work of the implementing agencies. Legal and administrative sanctions were only applied if the President chose to apply them. Implementing agencies were also subject to an internal audit process by BPKP, which reported directly to the President and was the franchiser’s enforcer. BPK, the Supreme Audit Agency empowered by the Constitution to conduct external audits, lacked power and authority.

In the post-Soeharto period, the more formal structure envisaged in the Constitution is now slowly coming into play. Implementing agencies are currently governed by directives from the MPR State Policy Guidelines and from Parliament. Parliament has become much more

proactive in overseeing central government implementing agencies by discussing budgetary allocations in detail, insisting on much more information from service providers, and gaining a voice on policies and in appointments to key agencies, including through fit-and-proper tests. Financial accountability is also being strengthened with the enactment of the State Finance Law. BPK is beginning to assert its independence. It reports directly to Parliament, and any reports revealing financial improprieties get wide coverage in the press. (See Chapter 2 for a more detailed discussion of financial accountability).

The change in the accountability framework is also reflected in the raft of new legal measures aimed at fighting corruption. These flow from the MPR decree in October 1999 that set as one objective of reform a state apparatus that “functions in providing services to the people that are professional, efficient, productive, transparent and free of corruption, collusion and nepotism”. They include the Clean Government Law (28/1999) requiring public officials to declare their wealth and agree to periodic audits, Law 31/1999 on the Eradication of Criminal Acts of Corruption, which defines criminal corruption and establishes charges and procedures for prosecution, and a recent amendment (Law 20/2001) that places the burden of proof on the accused. An Anti-Money Laundering Law was passed in March 2002, and in December 2002, Parliament passed a law (albeit approximately one and a half years behind schedule) providing for the establishment of a National Anti-Corruption Commission with powers to prosecute and investigate corruption cases.<sup>43</sup> Other new institutions to fight corruption include the Commission to Audit the Wealth of State Officials and the National Ombudsman Commission (see Box 1.1).

***Between implementing agencies and citizens:*** Public officials are slowly learning that they must be accountable to the people. Citizens are also learning to make their voices heard in demanding service from the government. In Jakarta, a lively media and vigorous civil society monitor the performance of individual government departments, and publicize inefficiency and graft, and report on consumer concerns. At the decentralized level, the ability of citizens to express demand for public services and to monitor their provision has been enhanced by the shift in power to the regions. But the quality of both NGOs and the media is weak at the regional level. Also, since local governments have very limited tax authority, citizens cannot as easily hold them accountable for the services they deliver (see Chapter 3).

The formal accountability framework reflects the desire on the part of reformers to transition from a society based on informal rules and networks, where personal loyalties drive private accountabilities, to a society based on a formal set of rules by which everyone operates and which do not favor one set of citizens over another. Informal networks and connections remain powerful and resist the transition to formal rules. The old guard are adapting to the new formal rules and learning to work around them.

### ***Why fighting corruption is so difficult***

Why have the results of these efforts been so modest? Fighting corruption is difficult because it requires challenging strong and well-entrenched vested interests, organized in groupings that generate large mutual gains. As noted above, systemic distortions in incentive structures have allowed KKN to flourish. Tackling corruption in this context requires a complete reordering of incentive structures so that individuals make decisions differently and therefore change their behavior. In a society relatively free of corruption:

- public officials feel accountable for their actions, fear the costs involved in being caught, and are rewarded for being honest;
- people expect rules to be observed and adjust their behavior accordingly;
- contracts are enforceable; and
- people feel they can refuse to pay bribes, knowing that official sanctions will support their right to receive services without paying ‘additional fees.

#### Box 1.1: New Institutions to Fight Corruption

The new anti-corruption legislation has been accompanied by the establishment of a number of state auxiliary bodies with mandates that contribute to the fight against corruption. These include a National Ombudsman Commission, a Commission to Audit the Wealth of State Officials (KPKPN), and a Commission for the Eradication of Money Laundering (PPATK). The planned Anti-Corruption Commission is seen as becoming a major player in the fight against corruption, absorbing KPKPN. However, high hopes for the new anti-corruption institutions have been dampened by the government’s lack of support and inadequate funding.<sup>144</sup>

- The National Ombudsman Commission, established by Presidential Decree in March 2000, receives complaints from the public, makes recommendations to agencies based on information gathered about these complaints, and monitors the compliance of agencies. The Commission has limited powers at its disposal, and cannot coerce government agencies to comply or to provide documents or even to question officials. Nevertheless, following the rush of optimism about *Reformasi*, the Ombudsman received nearly 2,000 complaints in 2000, but despite its efforts to investigate and pass on these complaints, there has been a poor response from the agencies, and as a consequence, complaints received have fallen off sharply to approximately 400 in 2002.<sup>45</sup> Lack of political support, lack of independent authority and powers, and inadequate budgetary resources have all contributed to the disappointing performance.
- The Commission to Audit the Wealth of State Officials (KPKPN) was established in January 2001, through the implementation of Law 28/99 that requires state officials to declare their assets periodically, including at the beginning and end of their term in office. The Commission receives information from officials and complaints from the public, and is empowered to audit the wealth of officials. Despite the fact that the President and Vice President set an example by declaring their assets and the President urged officials to follow suit, compliance was initially poor, with the Commission dogged by a lack of political support, lack of power to sanction non-compliant officials, and a lack of budgetary and staff resources. By June 2003, however, KPKPN data showed that 59% of officials in the executive branch had declared their assets, alongside 87% of legislators, 84% of the judiciary, and 96% of state enterprise managers. The Commission has made this progress through vigorously lobbying high officials to ensure compliance by staff within their institutions, and by savvy use of the media. KPKPN has persisted against all odds with its work, and notable successes include revealing the hidden wealth of judges suspected of corruption and exposing an allegedly false declaration by the Attorney General.
- The 2002 Anti-Money Laundering Law has established a new Center for Financial Transactions Reporting and Analysis (PPATK). This is an independent body reporting directly to the President with the objective of monitoring suspicious transactions relating to financial service providers (FSPs), and reporting transactions of a criminal nature to the Attorney General and the Police. It has no authority to carry out independent investigations and is primarily an information-gathering, analysis and coordination center. The jury is out on this new body since under the Law FSPs are not required to report suspicious transactions until 18 months after the Law came into effect (April 17, 2002). A lot is at stake for Indonesia, which is currently listed as one of nine “non-cooperative countries and territories” by the Financial Action Task Force on Money Laundering, implying that Indonesia demonstrates “critical deficiencies in anti-money laundering systems and a demonstrated unwillingness to cooperate in anti-money laundering efforts”.<sup>46</sup>
- Steps to establish the Anti-Corruption Commission are far behind the timetable set out in the 1999 law, and Parliament’s delayed enactment of the law in December 2002 was not an encouraging sign of the sustained political commitment to make such a commission function effectively. Progress in appointing the Commission remains slow and international experience suggests that the preconditions for successful anti-corruption commissions are very difficult to meet even in much stronger institutional settings than those found in Indonesia (see Box 5.2).

Experience from the industrial countries suggests that such a change in incentives takes a long period of time to bring about and requires strong commitment from leaders and continuous vigilance from the public, civil society, and the media. While much less than in the past, corruption has by no means disappeared in the industrial world, and political corruption is particularly apparent. What distinguishes most industrial countries from developing countries is that ordinary citizens are not exposed to corruption on a daily basis and that when political corruption is brought to light, the institutions of accountability come into play, and those responsible are likely to get punished or exposed. In particular, the political price for corruption per se is higher (voters can more easily sanction corrupt officials), and, even in those cases where it is not, the political price for interfering with the agencies of accountability is high (voters are more likely to sanction politicians who undermine the judicial or prosecutorial initiatives). So to expect a young democracy like Indonesia's to solve its corruption problems in this very short period, given its unenviable inheritance, is to expect too much.

At the same time, as we have seen, the cost of corruption is very high and exposes the country, and its silent and predominantly poor majority that lives on less than \$2 a day, to unusually high risks. Consolidating Indonesia's new democracy requires voters to have faith in public institutions, and corruption destroys that faith. It is therefore important to identify some of the obstacles in the fight against corruption.

Tackling KKN creates winners and losers. Those who lose most are the private and special interest groups including political parties, conglomerates, and the military that benefit disproportionately from the current system and, therefore, have strong incentives to ensure its survival. The losers will also include the well-organized groups within the public sector who systematically collect rents and distribute these between their members. The winners are the majority of Indonesian society, particularly the poor, who find it difficult to organize, have little voice and bear the biggest costs of corruption. To change the system, it is important to identify ways in which Indonesia's poor majority can hold government accountable for actions that damage public welfare in favor of vested interests.

Commitment and leadership from the highest political levels is key to reordering incentive structures, but despite strong rhetoric against corruption such commitment has been weak. Anti-corruption efforts in the post Soeharto era are a story of considerable promise through creative initiatives, new legislation and additions to the state's armory for fighting corruption quickly dissipated through poor follow up and weak implementation. Moreover, there has been reluctance to develop an overall strategy to fight corruption and to appoint a senior official who has authority and resources to take the lead in ensuring its implementation. For a while, Parliament appeared to be a champion of anti-corruption efforts, but the bloom of *Reformasi* appears to have faded in that institution as political realities set in. Indeed, press reports allege that Parliament is now part of the problem (see Box 1.2).

Keefer<sup>47</sup> highlights a number of important reasons why parliamentary accountability is weak. First, as in many other democracies, political parties carry limited policy credibility with voters. This means that "voters cannot believe challengers who claim they will be less corrupt than incumbents. This reduces electoral pressure on incumbents to maintain high levels of integrity".<sup>48</sup> This is in part due to voters' lack of experience with parties other than Golkar in



delivering on any issues that voters care about, be they service delivery or corruption. Voters therefore prefer to trust local leaders whom they know and who influence their vote and become power brokers through a patron client relationship.

**Box 1.2: Spring Song**

“They have a unique joke in the House of Representatives in Senayan about fortune distribution. Legislators may be in a ‘lucrative’ or ‘spring’ commission, a clear reference to a spring as a source of money. Another commission is called the ‘commission of tears’ which is not lucrative and deals with complicated matters: legal and human rights affairs....Each commission reportedly has its own field coordinator, who does not necessarily head the commission as he acts as a mediator for everything outside commission meetings. If a minister or a big boss of a business conglomerate wishes to be safe when dealing with lawmakers, he can simply contact these coordinators.... How is ‘the game’ played? A member of a ‘lucrative’ commission who requested anonymity, told TEMPO the modus operandi (MO) for bribery, a practice now rife in Senayan.... ‘It must be admitted that corruption has now also seeped into the legislative institution....I believe almost every discussion of a bill must involve gift envelopes. Previously, checks were used. However as giving money through a bank account or a check can be easily traced, now the money is given in cash. The MO varies. Sometimes it is put in an envelope. At other times it is put in a plastic carrier or laptop bag. In this way, there is no receipt and therefore the bribery is hard to trace. The more outspoken we are or the more data we have, our price will be higher. Occasions when the government is seeking a strategic approval of the House are usually highly prone to bribery.”

*Source: Tempo Weekly Magazine, October 7, 2002, p.18.*

Lacking ‘issue credibility’, political parties make deals with the patrons or attempt to develop their own patron-client relationships—the so-called “machine politics”. In either case, political competition is reduced, and new parties have difficulty competing with these entrenched patron-client relationships. Voter education will be key to effective political competition, and voter awareness will only grow with experience over several elections.

Second, the current system is strongly party orientated, so legislators’ loyalties are first and foremost to party bosses and they dedicate less effort to delivering benefits to constituents. This is partly due to the rules of Indonesia’s proportional representation system which give voters limited ability to vote for specific candidates rather than parties.<sup>49</sup> Moreover, the high cost of establishing new political parties in a country the size of Indonesia, and the now onerous criteria for party recognition,<sup>50</sup> further compromise accountability since parliamentarians are beholden to party leaders for inclusion in election party lists.

Third, the nature of political coalitions in Indonesia has undermined incentives to fight corruption because coalitions are opaque and change from issue to issue. This allows politicians to minimize their responsibility for persistent KKN and makes it more difficult for the public to discern which parties are responsible for blocking progress on the issue. These factors undercut the role Parliament ought to play in representing their constituents’ demands that the government take action to fight KKN in Indonesia.<sup>51</sup>

The high cost of campaign financing is also now driving the corruption beast, putting pressure on parliamentarians to do their bit to collect money for their party, and to contribute to party funds so they can get a seat. This creates expectations that they will receive a return on their investment through future corruption. High campaign finance costs are driven by the size of

the country, the high cost of advertising, and by the underlying characteristics of electoral competition and the costs of purchasing the support of patrons.

### Box 1.3: Political Party Financing-Experience And Mechanisms

Experience worldwide shows the immense difficulties of installing an effective system of party funding that will not be open to abuse. Many countries have experienced malpractice in public procurement that provided kickbacks for party funding, as well as a plethora of other improper channels involving state-owned enterprises, privatization, and the leverage afforded by appointments and control rights at all levels of government. However, international experience also shows that regulation of party funding can be effective if well-designed, backed by effective sanctions, and accompanied by a parallel diffusion of appropriate ethics and norms. Ultimately it is committed politicians and citizens who have asserted the principles that should govern party financing and have driven through new laws and regulations. These rules need oversight, enforcement, and monitoring. This requires reliable judges or electoral authorities and an active investigative press. In some cases, the shame—and electoral consequences—of political exposure have proved effective. There is no single prescription for success, as party financing rules have to operate in an environment of institutions and degrees of rule-respect that varies across countries, but many countries have found a selection of the following mechanisms to be helpful.

- Leave a paper trail. Ensure that all donations and other sources of party revenue are made public, that donors and the amounts of their donations are identified in the public record, and that candidates disclose links to lobbyists, as well as sources, types, and amounts of support, both before and after elections. Expenditures and their purposes should be similarly published and available for audit.
- Ban the use of state resources for political purposes. Parties in government should not use state funds, postal services, cars, computers, or other assets for political purposes or in election campaigns.
- Limit expenditures. Make party politics as inexpensive as possible. Usually the demand exceeds the supply of funds, leading to a search for funding that may breach legitimate frontiers. There is a lot to be said for reversing this relationship by mechanisms used in a large number of Western European and other countries: (i) allocating free time slots on TV and radio to qualifying political parties, with no additional time allocation permitted; and (ii) imposing legal limits on spending, with actual expenditures subject to audit and to effective sanctions in the case of breaches of the limits.
- Consider public funding. Many countries have established partial public funding, recognizing that political parties play a public interest role: they make an essential contribution to political contestability and the decentralized expression of diverse values and interests. Public funding reduces the scope for private interests to "buy influence" and can also help reinforce limits on spending, because of the electorate's resistance to excessive public expenditure.
- Build public service neutrality. Ensure that the public service is politically neutral and that public servants are neither allowed nor required to make contributions to political parties as a way of obtaining public sector employment. This will contribute to a meritocratic public service that will resist party bias and will encourage decision making in the public interest.
- Ensure oversight. Set up an authoritative and independent Electoral Commission or Court to be responsible for the integrity of all issues regarding party finance and electoral rules. Such commissions have been set up in Canada, India, Ireland, and South Africa.

*Source: "Anti-Corruption in Transition – A Contribution to the Policy Debate," World Bank, 2000*

Unfortunately, campaign finance reform has proved difficult in most parts of the world. Nevertheless Box 1.3 provides some ways Indonesians could check the abuse of campaign finance. In addition, the political transition and the ongoing process of Constitutional change have caused elected officials to have shorter time horizons than those serving under Soeharto, with legislators facing many more possibilities of losing office. This has encouraged a "make hay while the sun shines" attitude. As Keefer points out, "Politicians with short (time) horizons

are less likely to invest in policy reforms with the short run costs and long run pay offs that typically characterize fundamental governance reforms”.<sup>52</sup>

The current environment is not one in which a comprehensive and broad based strategy to strengthen accountability and reduce corruption is likely to work. The vested interests are too powerful, and the ability of the state to implement a broad based program of reforms is limited. But this could be an environment in which localized solutions will emerge supported by local pressure groups, whether it is in some sectors or sub-sectors or in particular *kabupatens* and *kotas*, or in some provinces with reformist governors. In the economic sphere, the central government has shown a resolve and capacity to push through reforms, suggesting there is capacity to undertake reforms, given the political will. There are reformers in government who want to change the way things are done, and they need support. There are leaders of regional governments who want to make a difference, and there are citizens everywhere in communities throughout Indonesia who are asserting their rights and speaking up.

Is it possible to catalyze and stimulate these efforts, involving Indonesians everywhere? A two-track approach is recommended. The first is to help strengthen demand for reforms at the local level. The second is for the central government to create an enabling environment for such reforms to come about. Together these steps would allow space for a hundred anti-corruption flowers to bloom in different corners of the country, gradually creating enough momentum to begin making a difference to public accountability. The chapters that follow explore why accountability breaks down and identify areas for policy interventions that both help strengthen demand and create an enabling environment for anti-corruption reform efforts to succeed. Chapter 2 begins with the important area of public spending.



## 2. Public Spending and the Search for Accountability<sup>53</sup>

*Indonesia's budget is currently a sieve from which public funds routinely leak out. In part this reflects the way budgets are prepared and reviewed. Budgets are not output or outcome based but are driven by bureaucratic needs. Without unified oversight of development and recurrent budgets, there are serious risks of duplication of spending and diversion to unintended purposes. Parliament, which now takes its budget oversight function seriously, is under-resourced and ill equipped to perform this function well.*

*Indonesia's budgets are systematically underfunded, with low operations and maintenance provisions, late release of budget funds, and skimming of allocations at different levels of government by oversight departments. Government agencies are implicitly expected to find other means of meeting their needs, thus blurring the line between public and private expenditures and encouraging rent-seeking behavior. These practices are particularly egregious in the case of the military and the police.*

*Poor financial controls allow such practices to flourish. Lack of a formal comptroller function, weak record keeping, poor cash control, and the lack of a Treasury Single Account all contribute to budgetary leakages. While there is no shortage of auditing, the audit process is flawed, reflecting poor funding of the Supreme Audit Agency, the lack of a modern state audit law, lack of systematic follow up on audit findings, and the inability of audit agencies to successfully prosecute cases of corruption.*

*A flawed procurement system also delivers poor value for the government's purchases of goods and services. An inadequate legal framework, the lack of effective central management of the procurement process, weak incentives to do the job well, and lack of transparency of the process facilitates extensive collusion in government procurement.*

*The new State Finance Law creates an opening for reforms. Policy makers should begin by fixing broken accountability through strengthening parliamentary oversight of the budget, equipping the Supreme Audit Agency to do its job properly, implementing the new State Finance Act's key recommendation that would hold State Treasurers responsible for handling public money, helping civil society track public expenditures, and improving financial controls and cash management, including through a Treasury Single Account. Procurement reforms are long overdue. These should include civil society monitoring of procurement and more competition and transparency in the procurement process. A key medium-term reform will be a complete overhaul of public spending over a five year period, inter alia, by providing adequate funding for all key activities, and eliminating off-budget sources of funds. This will require complementary resource mobilization and expenditure rationalization measures, including reduced corruption in the revenue collection agencies.*

How the state manages its public finances is at the heart of much of the corruption that intrudes on the daily life of the average Indonesian. Such corruption causes poor quality and insufficiency of public services, a deteriorating infrastructure, and significantly higher costs for good procured for the state. Above all, it destroys the public's faith in government. This chapter examines the factors that compromise accountability, reviewing in particular how public funds are allocated and spent, how they are managed financially, and how they are accounted for, focusing on the key instruments and institutions of public financial accountability. The chapter also reviews the problems that plague public procurement and attempts to understand the incentives behind the collusive behavior that leads to a systematic theft of public money.

## **PUBLIC FINANCIAL ACCOUNTABILITY**

### *Indonesia's systems are adequate on paper*

Financial accountability, in a democracy like Indonesia, is a broad concept, and one that adequately emulates other democracies.<sup>54</sup> In the sphere of public spending, it begins with citizens electing the President and members of Parliament, who collectively form the Government to manage on their behalf the resources of the state, including taxing and spending decisions. Every five years, the Constituent Assembly (the MPR)<sup>55</sup> provides State Policy Guidelines (GBHN) to the President on the broad principles and policies that should govern the government's management of the economy. These inform a Five-Year Plan (PROPENAS) formulated by the Government which Parliament (the DPR) votes into law. The executive branch designs the annual plan and the annual budget and organizes itself to spend it (see Box 2.1 for a description of the budget cycle). The legislative branch reviews and approves the budget and then holds the executive accountable for its implementation. The government then delegates this responsibility to individual government agencies, be they ministries or departments, or to lower levels of government, by issuing authority to spend against work plans. (The next chapter looks in more detail at how accountability works at the decentralized levels of government).

The President, through the Ministry of Finance for the recurrent budget, and Bappenas, the National Development Planning agency, for the development budget, determines the amounts the spending agencies will receive and what they will do with the funds. Parliament, representing the people, reviews and approves the budget proposed by the President and monitors its performance and outcomes, requiring progress reports and audits. Thus, the President is accountable to the people, through Parliament, for the proper use of public funds approved by Parliament.

In return for *finance* and *delegated authority*, the Ministries and departments of government procure goods and services, deliver end-use services such as primary health care, schooling, and law and order, and perform functions needed by the state, such as management of external relations with other countries. The government makes arrangements to collect *information* about the performance of these agencies which must report on their activities and be subject to expenditure controls. They also establish incentives to ensure compliance with their objectives through *rewards* (salaries and promotions) and *penalties* (administrative action, dismissal and legal action depending on the nature of the failure to deliver services as required).

**Box 2.1: The budget cycle**

- **Budget Preparation:** On the basis of the Proenas, the National Development Planning agency, Bappenas, prepares the annual Repeta, which includes a broad sectoral allocation of the development budget. The Ministry of Finance (MOF) consults Parliament on the broad fiscal aggregates including the level of development spending. The amount thus determined for development spending is divided among sectors in consultation with the budget committee of Parliament. Line ministries prepare draft budgets with the MOF coordinating the routine budget and transfers to the regions, while the Bappenas coordinates the preparation of the development budget in close consultation with MOF. The budget is based on spending proposals from line ministries which must be consistent with the budget limits agreed with Parliament. The development budget is then reviewed for consistency with the five year-plan (the Proenas) and the annual plan (Repeta). The President presents the budget to Parliament in the August preceding the calendar year, which is now also the fiscal year.
- **Parliamentary Review:** Following a general discussion of the budget, Parliament, together with its Budget Commission, reviews first the underlying macro-economic and policy assumptions, expenditure priorities, and the financing of the deficit. Following this review, the sub-sector and program allocations are reviewed by the various sectoral commissions of Parliament, and then the budget is enacted into law. The Repeta is now an annex to the law, whereas it was previously enacted as a separate law. The annual appropriations act authorizes spending at the sub-sector level. Only after enactment is a detailed review of individual projects undertaken by Parliament.
- **Budget Execution** is in theory straightforward. On the basis of the approved annual budget, MOF issues warrants (DIPs for development spending and DIKs for routine spending) which specify amounts against detailed spending categories for each agency or project. Agencies or project units issue payment requests (SPP) to the State Cash and Treasury Offices (KPKN). KPKN verifies that the request is in order and issues a payment order (SPM), transferring money either to a supplier in the case of direct payments or to a project or unit account from which payments are made.
- **Budget Monitoring and Auditing:** The Director General for the Budget (DJA) issues a progress report mid year to Parliament, and then follows up with a year-end report which forms the basis for the State Budget Accountability statement (PAN), which is submitted to Parliament within 15 months of the end of the budget year (six months under the new law) following an audit by the Supreme Audit Agency (BPK). BPK has a specific Constitutional role spelt out in Article 23E of the 1945 Constitution and Law No. 5 of 1973. BPK submits its reports directly to Parliament, although it does not report to Parliament. BPK has a co-equal status with Parliament, the President and the Supreme Court. BPK's focus is on a compliance with Government regulations in the course of budget execution, but the 1973 Law extended its oversight to government-owned limited companies. In addition to BPK, there are two internal auditors. The first is BPKP, created in 1983 by a Presidential Decree (Keppres 31, 1983) aimed at providing the President an internal audit of the activities of government departments and ministries and selected state owned enterprises. However, BPKP is increasingly acting as an external auditor with functions that overlap with BPK for audits of state-owned enterprises. But unlike BPK, it goes beyond financial compliance audits to performance auditing. The government also uses BPKP as its auditor for projects funded by international development banks. In addition each ministry has its own internal auditor, known as an Inspector, General who reports directly to the Minister. Here again there are overlapping responsibilities with BPKP.
- **Performance Management:** INPRES 7/1999 spells out a performance management process for Government agencies. Among others, it requires a strategic plan (Renstra) for each government organization, with quantifiable indicators of performance. BPKP is supposed to monitor performance. In addition, Ministerial Decree Kep. 195/KET/12/1966 of the State Ministry of Planning spells out a system of evaluation of project implementation. While this performance management system has great potential in the fight against corruption, it remains largely non-operational.

The citizens who receive the services also assess the executive's *performance* based on their own experience and on *information* provided by the press, and by agencies that monitor the executive's performance, such as the Supreme Audit Agency (BPK) and the internal audit agency (BPKP) in Indonesia. If the government fails to deliver services of the quality and

amount that citizens want, citizens' control the executive (*enforcement*) through *voice* (public demonstrations, media criticism, etc.) and when *voice* fails, citizens are free to exercise their right to *exit* by voting the government out of power.

***And efforts are underway to make them work***

With the emergence of its first freely elected government in 1999, the underlying institutions and instruments that constitute Indonesia's accountability framework are now free to exercise the functions they were designed for without looking over their shoulders. Parliament has assumed for the first time an important role in the budgetary preparation, approval and oversight process, and jealously guards its new privileges. It has passed a new State Finance Law (see below) which, if implemented well, will provide the basis for addressing some of the issues identified in this chapter. The budget has become a much more transparent document, with key budget documents available on the internet. With a newly invigorated civil society and media, public scrutiny of the budget and its implementation has improved. The large number of press reports on corruption in public spending are testimony to this new vigilance. The results of the financial audits by BPK and BPKP are now receiving greater public attention.

While this constitutes good progress, it is a modest beginning in the efforts that must be made to rebuild an accountability framework shattered and distorted by years of authoritarian rule. As discussed below, Parliamentary oversight is still a flawed process. The legal and regulatory framework has until now been inadequate. The resources that the Government makes available to its agencies are not closely linked to what the agencies are expected to deliver. Thus, the delegated authority is not always clear, and the finances are inadequate. The Government also fails in its responsibility to provide adequate controls on expenditures and to generate information from its spending agencies through properly audited accounts (see below). The control environment also suffers from a poorly motivated and ethically challenged civil service (see Chapter 6), lacking a highly professional cadre of budget, treasury, accounting and auditing staff to carry out a reform process. The lack of appropriate rewards and penalties for civil servants also impacts on the control environment as does the lack of a functioning justice sector (see Chapter 5). This chapter looks selectively at four factors that compromise public accountability in the management of public money: the budget, the system of financial controls, auditing and public procurement.

**MANAGING THE PUBLIC MONEY**

***A weak control environment***

The World Bank's Country Financial Accountability Assessment for Indonesia,<sup>56</sup> released in April 2001 pronounced the country's control environment<sup>57</sup> as:

“weak, because even though there are several laws and regulations in place, dealing with state financial management, these are not enforced owing to systemic KKN (corruption, collusion and nepotism). Additional factors include (a) poor law enforcement – lack of prosecution or sanctions under the civil service code of conduct – when mishandling of funds is reported; (b) unclear roles, responsibility, and authority of various external and internal auditors; (c) poor personnel policies and practices including the salary and incentive structure in the Civil Service; and (d) inadequate parliamentary oversight including weak follow up on audit findings”.



That judgment is shared by the Government, which in a recent White Paper on the principles and strategy for a reform of public financial management,<sup>58</sup> notes that the current system “falls short” of the key elements of a sound system.

### ***The legal framework is being strengthened***

The legal framework underpinning the system is inadequate, being largely based until recently on a 1925 Dutch Law *Indische Comptabiliteitswet*. The newly passed Law 17/2003 on State Finances, approved in March of 2003, could change that. The Law moves to a unified budget (combining development and recurrent spending) with a performance orientation—requiring line agencies to submit performance indicators and reports to Parliament—and a medium-term framework. The law brings more clarity in the roles and responsibilities of the budget process, and the organization of the budget process itself. A key accountability mechanism is the personal responsibility of the treasurer for losses incurred by the State. The law also announces a move towards common generally accepted accounting standards for central and local government, to be decided by an accounting standards board. Finally, the law specifies the personal responsibility of the treasurer for losses to the state as the core accountability mechanism. The Law defines state finances in a very broad sense, which would include any financial or non-financial asset under control of a state agency. The Supreme Auditor has the right to audit all state finances.

#### **Box 2.2: The Law on State Finances**

As is common in Indonesian Law, much of the detail still needs to be spelled out in the implementing regulations that are yet to be issued. Two areas are of particular interest: the personal responsibility of the treasurer and the comprehensiveness of the definition of state finances. For the personal responsibility of the treasury, relevant clauses have to be included in the draft treasury law. For this accountability principle to have teeth, the treasury law would have to spell out detailed administrative and criminal sanctions on abuse of state money, illegal opening of bank accounts, unauthorized transfers, and the like. A comprehensive interpretation of State Finances is important as well, to avoid abuse through extra-budgetary funds, foundations, and state enterprises. Even though the Supreme Audit Agency (BPK) need not be the sole auditor of such funds, it must have the right to audit any money or assets under the control of state entities.

## **THE BUDGET**

National budgeting systems provide a basic framework for ensuring that *all* public resources are recognized, collected and disbursed in the general public interest. Best practice systems suggest that budgets be prepared and approved in a timely fashion according to prevalent law and made available to the public. Realistic and comprehensive budgets are a key element in the political compact between the state—represented by the executive and the legislative branches of government—and implementing agencies.

In Indonesia, the budgeting system has three serious deficiencies which compromise its effectiveness in the accountability chain:

***The preparation and review process is flawed***

Care in the preparation of budgets by line agencies, with a vetting function by MOF and Bappenas, can be an effective means of preventing misuse or waste of funds. Budgets must fit into the broad fiscal policy stance of the government as well as the fiscal envelope. Parliamentary review of budgets, prior to their approval, is an additional safeguard.

In Indonesia the preparation process leaves much to be desired. It is driven by bureaucratic needs rather than by a policy focus. Budgets are not performance based, with little focus on outputs and outcomes. The Repeta (the annual development plan) attempts to impose some performance indicators, but these are not owned by the line ministries and are typically so vague that they cannot be effectively monitored. Because the routine budget is prepared by the Ministry of Finance and the development budget by Bappenas, there is no unified oversight or control over budget preparation, and there is therefore a considerable risk of duplication of recurrent spending and diversion of budgetary resources to unintended purposes. Moreover, Bappenas no longer vets individual project proposals, but only allocates resources down to the program level. Parliament can change this allocation, and discuss individual projects with the line ministries. While Bappenas and the Ministry of Finance have been trying to coordinate better on such preparation, the government acknowledges in its White Paper that there is a problem needing to be remedied.

Parliament and its Budget Committee take their budget oversight responsibilities seriously. The budget committee together with Government determines the budget aggregates and the sectoral allocation. Subsequently, the sectoral committees review the individual ministry proposals. Individual projects are also discussed, but only after the approval of the budget, which is allocated by program level. Parliament is under-resourced and ill equipped to carry out these functions effectively. Moreover, the effectiveness of its oversight has been compromised by allegations of ministries spending money to buy the support of members of parliament for their programs (see Box 1.2).

***The budget is systematically under-funded***

Under-funding has characterized budget making in Indonesia for a long time. This tends to undermine the efficacy of the contract between the state and implementing agencies. If Governments require a Ministry to deliver a service and do not pay enough to cover the cost of doing so, you can then expect the Ministry to short change the government in the delivery of the service. Under-funding takes a variety of forms:

- Allocations for operations and maintenance budgets are extremely low and have declined in real terms (see Box 2.3).
- Budgets are released late in the year so there is not enough time to spend the allocation.
- Officials in line ministries and project units, and in regional governments complain that release of budgetary funds is subject to a variety of unofficial levies by central ministries to meet unspecified costs or simply as an inducement to expedite the transfer of funds, thus further tightening resources available to spending agencies.
- Allocations are based on an implicit assumption that departments will raise their own funds off-budget. This is particularly serious in the case of the military and police.

**Box 2.3: Budgeting for operations and maintenance**

The government of Indonesia goes through an elaborate process to estimate needs for operations and maintenance expenditures. An interdepartmental Unit Price Index team is established in March of each year to determine unit prices for material expenditure needs. Thus for instance in the 2003 state budget, Rp. 467,000 is allocated for “daily office needs” (office supplies) for one official. Office maintenance is budgeted at Rp. 32,000 per square meter. At the same time, line ministries are asked to submit requests for DUK (*Daftar Usulan Kegiatan*) which includes an estimate for the number of employees, building areas, land area, moveable equipment, office inventories, etc., and MOF also maintains a record of these items. Similarly, Rp. 180,000 is estimated as the cost for a night’s stay in a provincial capital for a junior official, and Rp. 300,000 for a first ranked official. These amounts are stipulated in the Finance Ministry’s decree (No.7 /KMK.02.2003) regarding official travel.

These unit price estimates together with assumed volume data provided in the DUK determine total needs. The trouble begins at this point since the amount this invariably adds up to vastly exceeds the resources available for materials expenditures. The total materials budget for 2003 is Rp. 15.4 trillion, or 4.2% of total expenditures. Comparisons with pre-crisis levels are misleading because a large chunk of what was allocated at the center has now been decentralized. But in 1996/97, the allocation for material expenditures was some Rp. 6.6 trillion or 8.4% of total expenditures. Even allowing for decentralization, this suggests a substantial decline in real terms as well as in US dollar equivalents. So the Ministry of Finance sets ceilings for such expenditures for each sector, sub-sector, and program, while leaving it to line ministries to judge the best way they can use the money. This forces Ministries to ration out the funds allocated. This task is typically managed by senior officials, perpetuating the informal patronage systems and loyalty networks in the civil service that are a source of corruption (see Chapter 6).

Anecdotal evidence suggests that such under-funding results in a number of survival strategies. Civil servants facing unrealistic operations and maintenance positions routinely overstate their expense accounts. When traveling to a place where hotel costs exceed the allowances provided, they claim per diems for more days than actually traveled. Or they rely on project-financed consultants to pick up the costs of their on-site inspection visits. Officials also resort to a number of unofficial levies. In the health sector, doctors make up for low pay by levying fees on patients when they are supposed to provide services free, sometimes by the simple expedient of encouraging the patients to visit them at their private clinic after official working hours. Or drugs that are not needed are sometimes sold in the free market to pay for services provided. These revenue raising efforts lack transparency. Often there may be two sets of tariffs for services: the normal official tariff and one that incorporates a “speed money” component guaranteeing faster service. Indonesia Corruption Watch has documented how this works with driving licenses.<sup>59</sup> Recurrent expenditures are routinely “projectized”, and put into the development budget so that inadequacies in budget provisions can be made up through a second window. This not only makes the distinction between recurrent and development budgets meaningless but creates opportunities for double funding for the same activity. While civil servants see these as strategies that are designed to help them live with inadequate budgets, the formal link between the budget and outcomes is destroyed, and the path is open for corrupt practices. Moreover, when taken together with the relatively low formal salaries of civil servants, it becomes a mechanism to systematically divert budgetary resources to improve incomes.

The late release of the budget also creates perverse incentives for agencies to lock in funds that would be lost at the end of the year, by transferring these funds to other bank accounts outside the control of the central government and generating false documentation on project progress, leaving the door wide open for abuse (see Box 2.4). Interest earned on funds parked in

other bank accounts are usually not accounted for. It also puts pressure on agencies to simply waste funds rather than return them. This incentive is driven by inflexibility in carrying over funds between fiscal years despite carry-over rules, and the improbability of being allocated additional sums to offset unspent funds from the previous year.

**Box 2.4: Year-end moves to protect budgets**

Recent World Bank supervision missions to a development project in one Indonesian city showed that for 16 civil works contracts a majority of the payments to contractors were processed by Government treasury offices in December, just days before the fiscal year-end, and often on the last day of the contracts. The mission also noted the following pattern:

- Minutes were attached to payment vouchers (SPM), duly signed by project managers, stating that work was 100% complete. However, often detailed back-up calculations were not attached, or were attached but independent engineering consultants had failed to certify 100% completion of civil work. When site visits were conducted, it was clear that progress was well below 100%.
- Payments of counterpart (GOI) funding, normally representing 20% of project costs, were transferred to bank accounts in the regional development banks owned by regional governments. The balance of 80% was generally paid out to contractors' bank accounts in private banks.
- During discussions, representatives of KPKN, the treasury office, acknowledged that this practice was often resorted to at fiscal year-ends, where funds were shifted to regional treasuries, to protect unspent but committed balances under centrally budgeted projects. The regional government budget regulations did not contain this unrealistic restriction. It was not clear how these "protected" funds, now outside the central treasury system, were actually used or controlled.
- The same pattern was observed in one other city. Approved national budgets for these cities were received by the project offices as late as July, leaving only 5 months to complete procurement, implementation and payment of the said project packages.

The inflexibility of the budget system seems to provide inappropriate incentives for project staff to falsify documents certifying project progress and exposes government and donor funds to risk of misuse.

***Substantial off-budget funding reduces scope for public scrutiny***

Systematic underprovision based on an implicit assumption that the agencies being underfunded would find other means of raising resources, by no means unique to Indonesia, is particularly deleterious in its consequences for fiscal transparency and accountability. As a result, large amounts of off-budget funding continue to escape public scrutiny despite efforts to bring them into the budget. These include funding through foundations and business enterprises, both legal and illegal,<sup>60</sup> to meet the needs of the military, the numerous foundations maintained by ministries to meet their expenses, and a number of informal levies imposed on consumers of government services. Off-budget funding is subject to very little scrutiny both ex ante and ex post, as even the normal accountability mechanisms such as Parliamentary approval and audits are not applied to such funds. As a result these funding sources provide fertile ground for outright theft.

Military spending financed out of the budget is low by international standards (1.3 percent of GDP). However, it is widely believed that the amount allocated in the budget is only one-third to one-half of total spending by the military funded out of a range of foundations and legal and illegal businesses. Some of these businesses have caused widely publicized clashes with the police, who have their own network of operations, and raise questions about civilian

control over the military. The Supreme Audit Agency has not had much success trying to audit the foundations. Although Law 31/99 explicitly allowed BPK to audit these foundations, the law on foundations of 2001 called for private auditors of the foundations, and initial attempts by BPK to audit the military foundations were aborted. Now, the State Finances Law again allows for audit by means of the wide definition of “State Finances,” but BPK first wants a judicial review of the law and the conflicting Foundations Law before resuming such audits. The government has so far shown no inclination to address the underlying factors that drive such off budget funding.

## **FINANCIAL MANAGEMENT**

### ***Expenditure control or rent redistribution?***

Financial management processes should ensure that disbursed funds reach the intended beneficiaries and that value for money is achieved. These processes should also ensure that there is adequate protection from errors, fraud and corruption, that all financial activities are accounted for and reported in a timely manner, that assets are adequately safeguarded, that organizational resources are being used economically and efficiently and that all existing regulations, policies and procedures are observed. In a well functioning financial management system, all activities set in motion a document trail that follows the money. Such an audit trail is an essential element in a control environment that reinforces the perception that detection of fraud is likely, and hence increases the risk to potential defrauders.

Payment for services is a key stage in the financial management process. This is the last opportunity to view the entire transaction from design to procurement, to implementation, before payment is made and the transaction is consigned to the archives. Finance departments of spending agencies are typically the last checkpoint before the money goes out of the door. Best practice systems would require that all appropriate background documents be checked at this point to ensure that the transaction was properly authorized, that its execution met the agency’s requirements and agreed specifications, that it complied with all policies and procedures, and that its execution did not expose the agency to fraud, theft or avoidable losses of assets. Such a “comptroller” function helps provide oversight of operations and enforces accountability.

In Indonesia, a central comptroller function does not exist. The responsibility for exercising financial controls gets split between the project treasurer at the grass roots, central MOF staff at the treasury offices that disburse money, and the accounting units at different ministries. Project financial staff often lack accounting education and training. Sector ministries lack a central controller function that brings together budgeting, accounting, reporting and payments. As a result, accountability for maintenance of appropriate internal controls are rendered unclear and ineffective. This is one reason why controls fail consistently. This issue is recognized in the recent MOF White Paper and an organizational response is to be developed.

As noted in Box 2.1, KPKN carries out ex-ante reviews of all transactions in its 161 offices spread all over the country employing over 7,000 staff. The SPM (payment order) is issued by KPKN within one working day of receiving the SPP, the payment request, a service standard that is closely monitored. However the system suffers from a heavy dependence on

paper-driven processes and verification processes that are largely ineffective and create opportunities for corruption.

The focus of the verification checks is on consistency with regulations and laws, adequacy of supporting documents and accuracy. Evidence from World Bank supervised projects and BPKP audits suggests that such supporting documentation rarely includes independent verification from third parties confirming the detailed quantities and specifications of goods delivered or works completed. Documentation provided typically includes an internal document called a BAP (*Berita Acara Pembayaran*) giving details of the payment request and confirming its legitimacy. Sometimes contractors' formal invoices are not attached; nor are other relevant third party documents such as transportation documents, certificates of origin, measurement sheets and measurement certificates for civil works. Keeping the more direct evidence of work completion or goods/service delivery separate from payment documents greatly increases the risk of collusion and corruption in the disbursement of project funds. Such documents are the essential document trail needed for expenditure controls and audits. Yet there is apparently little attention to keeping proper documentary records. A recent fiduciary audit of an urban development project in Sulawesi carried out by the World Bank was heavily constrained by inadequate documentation (see Box 2.5).

**Box 2.5: Missing Documentation**

The lack of proper document management was illustrated by a recent World Bank fiduciary review: "The (fiduciary) review..... was hampered by the overwhelming amount of missing documentation from the procurement packets<sup>61</sup>. The missing documentation related to the administration of the procurement process and payments to contractors and other project related financial information. This problem made a more complete analysis by the fiduciary review team impractical. The sample of high-risk contracts could therefore be selected only from a fraction of the total population of procurement packets which were "substantially" complete, as not even a single packet in any of the four cities contained all the required information....about two-thirds and more of the packets listed in each city did not have bid proposals including those of the losing bidders. Similarly, a very large share of the packets did not include contract document details such as bid evaluation reports, bid opening attendance sheets, bid price read-out sheets, Owner's Estimates, bid prices, pre-qualification details, and technical specifications and drawings indicating the scope of work".

*Source: Indonesia: Fiduciary Review of the Second Sulawesi Urban Development Project – Overview Report – World Bank, 2002.*

Verification checks are carried out repetitively within KPKN and by other agencies, once KPKN has issued the SPM. Payrolls are handled in a similar way. Such repetitive checking encourages the low paid clerks doing this to take their tasks rather casually because they know they are doing what someone else has already done or is about to do. So instead of enabling the system to catch mistakes, it may actually perpetuate them. But the principal drawback of the present system is that it absolves project staff or the relevant managers in line ministries from their responsibility to ensure that the expenditures being incurred are in order by placing that responsibility outside the line ministry to the treasury.

**Box 2.6: Draining the Exchequer**

In a provincial capital city in Indonesia, a contract was awarded for over Rp 600 million to widen and deepen drains and provide concrete covers. An aid agency supervision mission noted that the 30% advance payment was released to the contractor in November 2000, within 2 days of signing the contract. Another 65% was released a month later, in December 2000, based on a certified completion of 95% of the work. The back up data sheet to support the 95% completion showed some sub-components to be significantly short of the required level, as much as 50%. Yet other parts appeared to have been overstated to compensate the value, indicating the possibility of a fraudulent payment or an approaching year end deadline.

In another case in a different city, a contract was awarded to improve specific roads at a total cost exceeding Rp 1 billion. The financial management review indicated that disbursements of final payments had been made based on minutes signed by the project staff, without any back-up calculation sheets attached to show actual volumes against contracted ones for each component activity. Back-up data sheets and “as-built” drawings had in fact been prepared by supervision consultants, but were mutually inconsistent. The donor review team determined that volumes for many component activities as calculated based on final engineering drawings were less than the invoiced quantities by as much as 17%. Physical checks conducted by the supervision team showed instances where even the completed engineering drawings overstated the work for some components.

This opens the door once again to corrupt practices, with recipients of government payments able to deal and “negotiate” directly with KPKN officials. In this context the lack of a financial controller position in implementing agencies with a mandate to perform a broad pre-payment control system is a major lacuna in the Indonesian system. The Inspector General in the ministry does perform an internal audit, but usually after the event, and on a sample of transactions.

Accountability is further weakened by the manner in which the Government manages its cash resources. The Government banking operations are characterized by thousands of bank accounts at Bank Indonesia and commercial banks. Individual ministries may also hold their own imprest accounts at commercial banks. Such a proliferation of accounts operated by a large number of government entities when combined with weak financial reporting is a recipe for lack of transparency and corruption. And as noted above, no one seems to have to report the interest earned on such accounts. International best practice calls for a Treasury Single Account regime. In its absence, as noted in Box 2.7, the scope for abuse is high.

**Box 2.7: Cases of blatant diversion**

In a solid waste disposal project outside Java, a contract was issued to a contractor for the procurement of three trucks. During a recent financial management review it was noted from payment records that part of the payment against this contract was made (correctly) to a private bank account in the name of the supplier. However, a part had also been directed to an account in the local branch of a regional development bank owned and operated by the Regional Government. Inquiries revealed that this account was in fact in the name of a project officer, not the supplier. In another case, an authority letter was available at the Project office authorizing that a portion of project payments under a contract be made to an account in the regional development bank in the same city, whereas the loan funded portion could be disbursed to a private bank in Jakarta. Correction fluid had been used to alter the bank account number stated in the letter. Discrete inquiries with the Bank revealed that the recipient bank account was in the name of the regional treasury and not the contractor.

It is easy to see poor administrative procedures as simply reflecting weak discipline in maintaining documents and checking records, reflecting the lack of diligence or education of what are low-paid employees. There is a very fine line, however, between mere administrative lapses and the manipulation of procedures for personal gain. When such lapses develop into a pattern, as they have in Indonesia, alarm bells should start ringing that the risk of collusive corruption is high. For these reasons professional financial managers see good record keeping and administrative procedures as essential tools in ensuring development outcomes. Transparency is achieved by ensuring that decision making processes and the rationale for decisions are adequately documented by the implementing agency. This also promotes confidence in the integrity of the agency and enables the agency to meet requirements for accountability and disclosure of information.

### **AUDITING PUBLIC SPENDING**

Indonesia is not lacking in auditors (see Box 2.3). Yet despite this proliferation of audits, leakages from the budget remain high. In recent years both BPK and BPKP have documented extensive irregularities and leakages. BPK claimed that over the last two years, such irregularities (including lack of supporting evidence for expenditures) in government departments and state enterprises affected some \$60 billion of budgeted funds in these agencies. Yet both agencies have publicly complained that their reports remain ignored and no action is taken against the concerned officials.

The audit process is weakened by a number of factors. First, the resources available to BPK are highly limited. Parliament provides a limited budget, and its staff are reportedly ill qualified for the task: less than 10 percent of the 2,600 staff are qualified accountants. The problem is not so much with the number of auditors as with their ability to perform audits.<sup>62</sup> By contrast, BPKP, the internal auditing agency has over 8,000 staff, with a sizable core group that is better qualified. This reflects a deliberate policy under the New Order to focus attention on the internal auditing agency. In addition, even though BPK is a supreme body recognized explicitly in Indonesia's constitution, BPK has to apply to the Ministry of Finance for a budget, and its personnel policies are determined by MenPan, the Ministry of State Administration. Second, the lack of a modern state audit law leaves many ambiguities, behind which organizations not wishing to be audited can hide. Many organizations, particularly the military, have been known to refuse to be audited by BPK. Third, there are no clearly defined processes for Parliament, the Ministry of Finance and the line ministries to follow up on audit findings and take remedial action, resulting in no systematic follow up of audit findings. Fourth, as noted above, the BPK is not authorized to publish its findings, although nowadays when it gives these to Parliament they are deemed to be in the public domain. There is nothing explicitly stated in the laws that stops BPK from releasing its reports to the press. Finally, if BPK uncovers corruption, it must rely on a corrupt and inefficient Attorney General's Office and the courts to prosecute and try the case (see Chapter 5).

In addition to these weaknesses, there is some duplication of functions between BPK and BPKP, and between BPKP and the Inspector Generals. The Ministry of Finance's White Paper implies that BPK should over time become the sole external audit agency absorbing BPKP,



though the government could retain a small financial inspection unit. BPKP personnel could also be used to strengthen financial management in line ministries.

Finally, the lack of national accounting standards for the public sector is a serious limitation to the proper auditing of accounts. A multiplicity of financial accounting standards co-exists. A Public Sector Accounting Standards Board has recently been constituted to develop such a standard and to align it to international standards of accounting issued by IFAC. This goal is now endorsed by the State Finances law, which requires these standards to be issued by Government Regulation. Obstacles to such a system include the lack of a national computerized accounting environment and a severe shortage of accounting skills.

## **PUBLIC PROCUREMENT**

### ***Why a good procurement system matters***

It is widely believed that the principal source of leakage from the budget occurs through the public procurement system. Corruption and collusion in public procurement contribute significantly to the degradation of services for the poor in Indonesia. It has been estimated that the government and state enterprises taken together procure some \$10 billion annually.<sup>63</sup> This is an estimate based on pre-crisis public expenditure levels. Current levels of development expenditure are about \$7 billion. So procurement levels are probably more modest. Nevertheless, an effective procurement system is at the heart of ensuring that public funds are well spent with the goal of enhancing development effectiveness. When it functions well, it enables goods to be purchased in a competitive and cost-effective manner. Looking ahead to the emergence of an Asian Free Trade Zone and the implementation of future WTO provisions that would require member states to allow access to government procurement for companies from Indonesia's trading partners, it well behooves Indonesia to develop a world class public procurement system rather than one that has a poor global reputation for encouraging corruption.

The characteristics of a well functioning procurement regime include:

- *A clear, comprehensive and transparent legal framework* that allows, inter alia, for wide advertising of bidding opportunities, prior disclosure of all criteria for contract awards, contract awards based on objective criteria to the lowest evaluated bidder, public bid opening, access to a bidder complaints review mechanism, public disclosure of the results of the procurement process, and maintenance of complete records related to the entire process.
- *Clarity on functional responsibilities and accountabilities*, including who is responsible for the procurement process, who is responsible for ensuring the rules are observed and who is responsible for appropriate sanctions in the event of violation of the rules.
- *An organization* that is responsible for procurement policy and for oversight of the proper application of that policy. Such an agency, ideally, should not be responsible for managing the procurement process. It must also have the authority and independence to act without fear or favor in the discharge of its functions.
- *An enforcement mechanism*: Without enforcement, clarity of rules and functions will not matter. The government's audit agency should be trained to audit public procurement and to

initiate action against those who subvert the rules. Complaints review mechanisms, that have the confidence of bidders, need to be established.

- *A well trained procurement staff* is central to ensuring a sound procurement system.

### ***Indonesia's procurement system is dysfunctional***

The World Bank's recent Country Procurement Assessment for Indonesia<sup>64</sup> concluded that Indonesia's procurement system does not function well. "It is not market driven, has been prone to misuse and abuse, and reduces value for money for public funds." A recent fiduciary review of the second Sulawesi Urban project (see Box 2.8)<sup>65</sup> revealed systemic flaws and well entrenched collusion between bidders. Similar collusive practices were found in an ADB-financed urban project in North Sumatra. Investigations into a World Bank text book project following complaints and an investigative report in the weekly news magazine, *Tempo*, also exposed collusive arrangements in the form of a well organized ring of bidders, with substantial losses to the government exchequer.

Typically these collusive arrangements occur with the active involvement of government officials. Such collusion is part of the procurement process and reflects a number of techniques, including restrictive specifications, splitting of contract packages, use of non-competitive bidding procedures, limited advertising, shortened bid submission periods, and breach of confidentiality during the procurement process. During contract implementation, the actors may collude through poor contract administration, unjustified amendments, over-or under-invoicing, fictitious certificates of completion, inaccurate disclosures, etc. The collusive ring appears to be a common occurrence in Indonesia. The price is agreed and fixed up front, with the Owner's Estimate facilitating such price fixing. There may be other bidders who are not part of the ring but nevertheless participate in the bidding to avoid appearances of collusion. These bidders also receive a participation fee from the ring.

#### **Box 2.8: Procurement in the Second Sulawesi Urban Project: fiduciary review findings**

The overall conclusion of the fiduciary review is that the procurement process for the 26 contracts reviewed in detail was manipulated to give the appearance of competition. The winners appear to have been pre-selected in most cases. For example, the findings of the fiduciary review in the four cities, included the following:

- The large number of companies within a single ownership cluster appears to be consistent with the creation of "shell" companies. A "shell" company involves the appointment of nominal directors who are without any real organizational powers or functions, and merely sign documents on behalf of the company.
- The similarities between the bid proposals of the winning and losing bidders is consistent with the possibility of government contracts having pre-arranged winners. The fiduciary review noted that all bidders were members of GAPENSI, and certification from GAPENSI is a condition of participating in the bidding process for government contracts. Furthermore, the similarities between the bid prices is likely to be indicative of the bidders having access to the unit price details of the Owner's Estimate in advance of preparing their bids.
- The inconsistencies noted in the bid documents are indicative that all bidders are not individually represented at the pre-qualification or bid selection meetings. In such circumstances a single representative could be acting for multiple companies, which is consistent with the finding that companies from the same ownership cluster submitted both the winning and losing bids for the same contract.
- Instances were noted where the most competitive bidder was excluded from further evaluation. This is consistent with the possibility that administrative or weak technical grounds could be found to exclude competitive bidders from the selection process.

*Source: Indonesia: Fiduciary Review of the Second Sulawesi Urban Development Project-Overview report, World Bank Office, Jakarta, 2002.*

Contract award mechanisms vary: bidders in the collusion ring may take turns at winning contracts, or they may participate in an auction, where firms offer the percentage cut from the value of the contract they will share with the other firms in the ring. The firm offering the highest cut wins and recovers this sum through an over priced contract or by short-changing the government on the delivery of the contract through poor quality, insufficient quantities and unjustified contract amendments. The bidding process is rigged in favor of the pre-selected firm either by restricting participation in the bidding through the means described above, or through the pre-registration of firms which is common in Indonesia, and is used to eliminate firms that are not playing the game. When an outsider does manage to put in a successful bid, the bid typically gets rejected. The ring leaders are usually powerful local firms who have considerable influence with local officials and the tender committee. Thus pre-registration far from ensuring that firms are qualified to deliver the contract, becomes a mechanism for facilitating collusion among the bidders. Such registration is facilitated by the pressure brought on the process by business associations such as GAPENSI, who have been alleged to play a murky role in the collusive arrangements revealed by recent investigations.

## **ACCOUNTABILITY FRAMEWORK FOR PROCUREMENT**

### ***The legal framework is flawed***

The accountability framework for public procurement in Indonesia is flawed in several respects. First, the executive and legislative branches of government have failed to provide an effective legal framework for public procurement. There is no national procurement law other than the Construction Law 18/1999. The Presidential Keppres 18/2000 that governs procurement policy outside construction, while a significant improvement over past policies, still limits competition by calling for “fair competition” among firms of “equal standing,” thereby allowing leeway to those interpreting the directive as to which firms are of equal standing. The Keppres also attempts to favor local (i.e. belonging to the concerned district or province) Small and Medium Enterprises for contracts below certain values. This violates the principle of ‘one-country-one-market’, and deprives the government of the benefits from nation-wide competition. To implement this provision, firms are required to pre-register to qualify to bid.<sup>66</sup>

Keppres 18/2000 is also weak in a number of other respects. It does not clarify that it supercedes previous Presidential decrees; rather it implies that some of those regulations still apply. It allows considerable discretion for avoiding non-competitive procurement methods through “direct contracting” and “shopping,” it does not require wide publicity to tenders and contract awards, it fails to specify complaints procedures for aggrieved bidders, and it does not require mandatory sanctions against firms found colluding or indulging in other malpractices. The fact that public procurement is guided by a Presidential Decree rather than a Law that emulates international best practice<sup>67</sup> reflects the low importance that the authorities attach to ensuring clean procurement. Presidential Decrees can be passed and revised easily, as was evidenced by successive Decrees in 2000 which established and then abolished a central procurement board for contracts above a certain value.

### ***Government is not organized to handle procurement***

Second, the government has not organized itself to manage public procurement. There is no agency in government that is clearly held responsible for public procurement policy and compliance. By default this responsibility is shared between Bappenas and Kimpraswil (the Ministry of Settlement and Regional Infrastructure), but these organizations lack the mandate to take formal responsibility for procurement policy and oversight of its application. Procurement itself is managed typically by project managers (Pimpros). The Secretary General of the implementing agency appoints on a yearly basis a Pimpro. He or she in turn appoints a Tender Committee to manage the procurement process from its inception to contract award. These are ad hoc committees with 5 or more members, generally chosen from the lower grades of the civil service.<sup>68</sup> The system thus relies on low level officials who are vulnerable to outside and internal pressures for key procurement decisions.

### ***Incentives are distorted***

Third, the incentive framework is skewed to a point where there are no rewards for efficiency and honesty and no penalties for corruption because of a poorly managed civil service and a weak judiciary, both of which are in dire need of reforms (see Chapters 5 and 6). The incentives for project managers and tender committees to participate in corruption and collusion are high:

- Their share of the proceeds from the collusive rings that dominate public procurement is likely to be very high relative to their salaries and allowances.
- Lack of a proper complaints mechanism and lack of any administrative or judicial sanctions for discovery of collusion help perpetuate the system.
- Tender committees lack the training to do their job properly. As a result the review of bids focuses on administrative rather than technical requirements.
- There is no clear career stream for project managers and procurement specialists.
- The government fails to provide the resources to tender committees to do their job properly. Budgets for advertising, typing and printing of bidding documents are typically inadequate if not non-existent, and no fees are levied to pay for the cost of preparing and printing of bidding documents.
- Collusion is facilitated by the lack of clear rules and laws that minimize discretion.

### ***Procurement takes place behind closed doors***

Fourth, perverse incentives are reinforced by limited public disclosure. Much of the procurement process is conducted behind closed doors. Bids are not opened in public and the results of the bidding process are not made publicly available, with appropriate justification for the winning bid. Following a proposal from the World Bank, the government has agreed to allow such information to be made available for all new World Bank projects, and for this to be reflected in the legal agreements with the World Bank (see Chapter 7). Where communities are involved in the oversight of public procurement, procurement results are much more cost effective. NGO monitoring of procurement can also be a source of pressure on civil servants to

conform to laws and not cheat their citizens. Yet NGOs in Indonesia lack the resources and skills to do an effective job.

***Auditing is weak***

Finally, the audit process, the only instrument available for enforcing the rules and regulations, as noted above, is largely ineffective. Its effectiveness is further compromised by the lack of familiarity of government auditors with procurement rules and principles. Even if this were not a constraint, a dysfunctional justice sector ensures that there are no consequences for those who abuse the procurement process. And given the reluctance to apply administrative sanctions against civil servants caught colluding with bidder rings, there is in effect no enforcement mechanism.

**POLICY IMPLICATIONS**

Given the complexity and range of issues identified in this chapter, where should a newly elected government begin in strengthening accountability and fighting corruption in public spending? Many of the issues discussed are inter-related, and there is, in the long run, no escape from a thorough and comprehensive approach to the problem. But a beginning can be made in a few strategic directions. Accountability can be strengthened in a number of ways. This needs to be accompanied by a major overhaul of public spending so as to prepare more realistic budgets and fund them properly.

- Parliament is central to public expenditure accountability. Strengthening Parliament's capacity to review, approve and monitor public spending by providing adequate staff support and by strengthening the working of Parliamentary committees is key. This will require consensus among the country's top political leadership that they will come down heavily against corruption in parliament. It will require the political will to enforce high standards among parliamentarians and impose penalties against those indulging in corrupt activities and failing to cooperate in declaring fully their personal wealth. It will require willingness to encourage independent parliamentary watchdogs to operate. The President can also help by banning the current practice of buying parliamentary support for government legislation (see Box 2.3).
- Information flows are central to enhancing accountability. The audit function needs to be strengthened urgently. A high quality auditing system exposes corruption to full public scrutiny, providing the Government with the information needed to act against corrupt officials. In the short term, this will mean funding BPK adequately to commission private sector auditors even as it builds up its own capacity to audit. A first step in this direction could be to allow BPK to request its budget directly from Parliament. The operations of the Supreme Audit could also be improved by granting it more independence in its personnel management. Finally, it must also mean ensuring a systematic follow up on audit findings by Parliament and the President. Issues of finance, personnel management, and follow up could be legislated through the draft State Audit Law, currently pending in Parliament.
- When key accountability agencies are dysfunctional, such as parliament and the audit, unconventional measures could work. Information can be used to mobilize public participation in the fight against corruption. Empowering beneficiaries by tracking public

expenditures and using the information generated to fight corruption can be a powerful tool, particularly when the normal institutions of accountability are weak. Given the propensity to skim allocations at each bureaucratic level before the funds reach the front line, the experience of Uganda and others with such expenditure tracking mechanisms is highly relevant to Indonesia (see Box 2.9 and Figure 2.1).<sup>69</sup> Early enactment of a Freedom of Information law would help; meanwhile regulations allowing such access to information could be drafted under the existing anti-corruption law (Law 28/1999) which includes provisions on access to information and the right to include outsiders in procurement processes.

**Box 2.9: The Power of Information**

A public expenditure tracking survey of primary schools in Uganda revealed that only 13 percent of the per-student capitation grants made it to the schools in 1991-95. In 1995 for every dollar spent on non-wage education items by the central government, only about 20 cents reached the schools, with local governments (politicians and district officials) capturing most of the funding. Poor students suffered disproportionately, because schools catering to them received even less than others. Indeed, most poor schools received nothing. Case study evidence and other data showed that the school funds were not going to other sectors either. The disbursements were rarely audited or monitored, and most schools and parents had little or no information about their entitlements to the grants. Most funds went to purposes unrelated to education or for private gain, as indicated by numerous newspaper articles about indictments of district education officers after the survey findings went public. To respond to the problem, the central government began publishing data on monthly transfers of capitation grants to districts in newspapers and to broadcast them on the radio. It required primary schools and district administrations to post notices on all inflows of funds. This promoted accountability by giving schools and parents access to information needed to understand and monitor the grant program.

An evaluation of this innovative public information campaign reveals a significant improvement. All schools are still not receiving the entire grant (and there are delays). But the capture by interests along the way has been reduced from 80 percent in 1995 to 20 percent in 2001 (see Figure 2.1). A before-and-after assessment comparing outcomes for the same schools in 1995 and 2001—and taking into account school-specific factors, household income, teachers' education, school size, and supervision—suggests that the information campaign explains at least two-thirds of the massive improvement. In 1995 schools with access to newspapers and those without suffered just as much from the leakages. And from 1995 to 2001 both groups experienced a large drop in leakage. But the reduction in leakage was significantly higher for the schools with access to newspapers, which increased their funding by 12 percentage points more than schools that lacked newspapers.

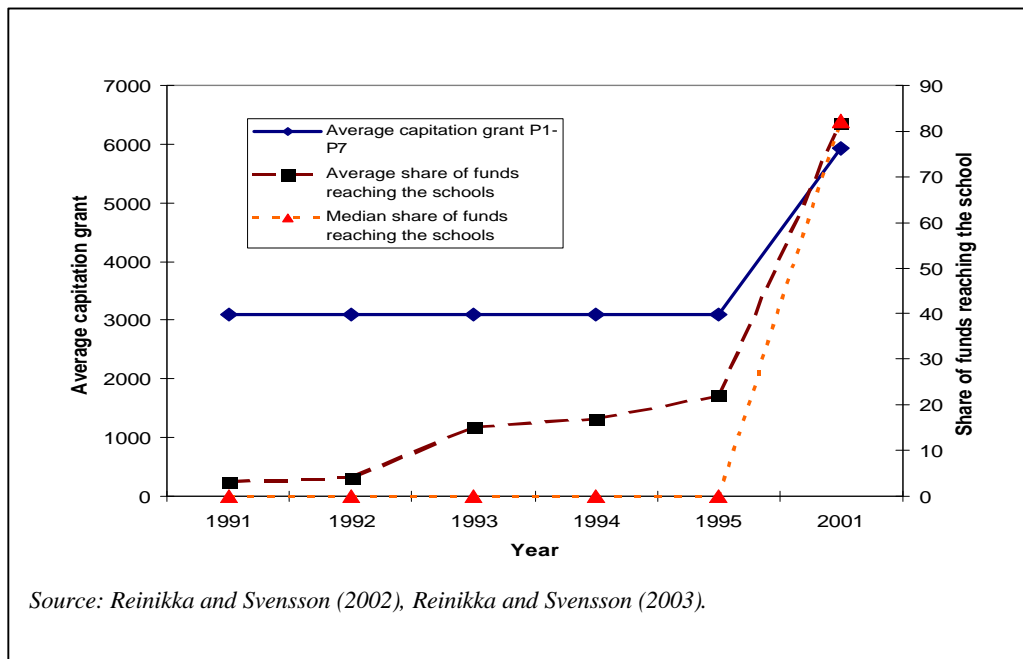
Policymakers in developing countries seldom have information on actual public spending at the level of frontline provider. A public expenditure tracking survey—like the one carried out in Uganda and subsequently in many other countries, tracks the flow of resources through various layers of government, on a sample survey basis, in order to determine how much of the originally allocated resources reach each level. The survey also collects other data to help explain variation in leakage across service providers. With an inexpensive policy action—the provision of mass information—Uganda dramatically reduced the capture of a public program aimed at increasing access to textbooks and other instructional materials. Because poor people were less able than others to claim their entitlement from the district officials before the campaign, they benefited most from it. The extent of corruption and leakages seem to have less to do with conventional audit and supervision mechanisms, and more with the schools' or clinics' opportunity to voice their claims for the funds. Traditionally, it has been left to the government and a country's legal institutions to devise and enforce public accountability. The Uganda experience questions this one-sided approach. As the government's role and services have expanded considerably during the past decades, it has become apparent that conventional mechanisms, such as audit and legislative reviews, are not enough. Collusion, inefficiencies, abuse, and lack of responsiveness to citizens' needs cannot easily be detected and rectified even with the best of supervision. When institutions are weak, the government's potential role as auditor and supervisor is even more constrained. Measures to empower beneficiaries by increasing information are hence an important complement.

*Source: Reinikka and Svensson (2002), Reinikka and Svensson (2003).*

- The new State Finance Law opens the door to holding officials personally responsible for handling public money. Introducing comptrollers in each spending unit, and holding them together with State Treasurers responsible implies specifying in the regulations still to be drafted the precise administrative, financial and criminal sanctions for abuse of state money, for illegal opening of bank accounts, for unauthorized transfers, etc. These must then be widely publicized and enforced. In addition, if criminal sanctions are to apply to abuse of state finances, these must be included in the draft State Treasury Law currently pending in Parliament.
- Financial controls are the essential bread and butter of accountability. The institutional changes to strengthen these will take time. But there are some shortcuts that will help. Closing down the thousands of bank accounts held in the name of the Government of Indonesia and replacing them with a Treasury Single Account will immediately improve cash management and strengthen control over public money. So will proper document maintenance and tracking systems, now made easier by the breakthroughs in information technology. The announced reorganization of the Ministry of Finance and the creation of a separate treasury department are opportunities to create better controls.

**Figure 2.1: Schools Received What They Were Due After an Information Campaign**

*Amount of capitation grant (Uganda shillings) that schools were supposed to receive, and average (mean and median) percent actually received by schools, 1991-2001.*



- Procurement reforms provide a unique opportunity to move decisively on the anti-corruption front. Needed urgently is a sound legal framework that ensures a one-country-one-market principle and reduces discretion. The government needs to organize itself to manage and monitor corruption through an independent body such as the National Public Procurement Office. Introducing sunshine policies on procurement to allow the public to monitor awards will also be key, and enabling communities and beneficiaries to participate in the process will also reduce the risks of collusion. In addition, more

competition in the procurement process could drive out collusion, and with it, corruption. Steps that the Government could take include: mandating wider advertisement for contracts, abolishment of pre-registration and pre-qualification, and abolishment of restrictions on the basis of location or size of firms.

- Central to corruption in Indonesia is the lack of adequate funding for all activities in government and the tolerance of a range of alternative ways in which these activities are funded. Such practices undermine accountability by undercutting the implicit compact between the government and its implementing agencies and expecting the latter to do more with less. A newly elected government has a unique opportunity to commit itself to a total overhaul of public spending within say a five year time span (i) providing adequate funding for all key activities; (ii) eliminating all sources of off-budget funding, including official and unofficial foundations, enterprises, etc.; and (iii) integrating the recurrent and development budgets. This will require a commitment to also clean up the tax and customs departments so that the government generates the resources to pay for the increased level of public spending. It will also require rationalization of public expenditure reflecting the reduced role of the Center in a decentralized environment and the need to shed unnecessary activities.



### 3. Enhancing Local Accountability in a Decentralized Indonesia<sup>70</sup>

*Indonesia is rapidly moving from a highly centralized system of government to a largely decentralized one. Local governments will over time account for nearly half of total government spending, and three fourths of the civil service including teachers and health workers are already assigned to them. Decentralization is improving accountability by bringing citizens closer to their governments, enabling them to better monitor service delivery, and by allowing the central government to supervise and monitor local governments as an agent of citizens. These gains must be set against the risks from decentralization, with regional governments more prone to local elite capture as well as state capture by well organized vested interests. It is widely believed that corruption will increase as a result of decentralization because local elites feel it is their turn to drink at the deep wells of the public exchequer. However, initial results from a nationwide survey by Gadjah Mada University in 177 districts suggest that households perceive corruption to be high, but not much higher than before, while nearly 90% of households believe that services have improved or remain the same.*

*The central government can help enhance accountability in a number of ways. Clarification of the precise functions of local governments would help citizens understand for which services they can hold their local governments to account. Separation of powers between the executive and legislative branches, mirroring changes taking place at the center, would allow for direct elections of bupati and walikotas and greater accountabilities to electorates, and reduced bupati and walikota accountability to local parliamentarians and to party bosses in Jakarta. The center can also help improve citizens' access to information on their local governments, partly by passing laws and regulations that guarantee such access, and partly by providing timely and credible comparative information on regional government performance on a range of service delivery yardsticks. Above all, the center can expand the tax base of local governments. Accountability is weak when citizens know that the taxes they pay are not directly funding the services they receive. When citizens are required to pay for services, directly or indirectly, they will demand high quality services.*

*Local governments do not however need to wait for Jakarta to act. They can, as some governments are beginning to do, enhance information flows, consult citizens on decisions that affect them, and develop partnerships with civil society to intermeditate between citizens and local governments, and to assist citizens in better monitoring service delivery. Regular surveys of citizen satisfaction with service delivery will also increase public accountability. Participatory budget systems, local government, internet websites, and other initiatives that are being tried worldwide could easily be adopted in Indonesia. The challenge is to seize the moment and tap the long neglected talent and skills of local people.*

Indonesia's Jakarta-based elite and senior government officials tend to see the country's recent radical decentralization as one of the principal factors driving increased corruption since the fall of the New Order. Indeed, the newspapers are full of stories of corruption in local governments. Some local elites appear to view decentralization as an opportunity to take "their turn" at drinking from the deep wells of the public exchequer. Yet a well-implemented decentralization is potentially the most promising long-term policy change in the fight against corruption in Indonesia. This chapter assesses Indonesia's accountability framework for regional and local governments. After reviewing the formal framework, it identifies weaknesses in this framework that could undermine accountability. The chapter then reviews early results of decentralization in terms of the quality of service delivery in the regions, and the occurrence of *KKN*. It concludes with some directions for reform that could strengthen local accountability.

## INDONESIA'S DECENTRALIZATION

### *Decentralization creates significant opportunities...*

Indonesia is rapidly moving from a highly centralized system of government to a largely decentralized one.<sup>71</sup> The legal framework which was enacted in 1999, and implemented starting 2001, devolves much of government service delivery to the regions, in particular, the now 416 local governments (districts and cities).<sup>72</sup> It also sets out to increase political accountability of local governments. Regional governments now control about a third of total government spending, up from 17% in 2000. Over time, the regions are likely to manage over half of government spending.<sup>73</sup> Local governments are headed by region heads (*bupatis* or *walikotas*) who will ultimately all be elected by, and accountable to, regional parliaments (DPRDs).<sup>74</sup> About three-fourths of the civil service (including teachers and health workers) is now assigned to local government, as compared to only one-fifth before decentralization.

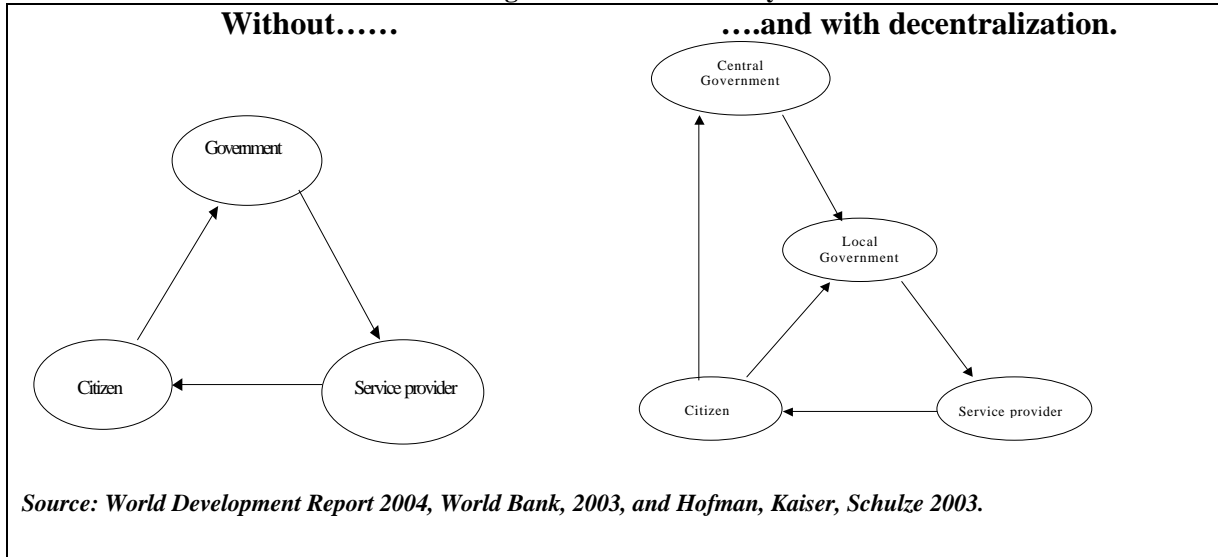
Decentralization is bringing about a fundamental change in the organization and functioning of Indonesia's government. It is significantly changing the nature of accountability, or the compact between citizens and government as discussed in Chapter 1. From a single-tier compact with "government", citizens now have a compact both with the center and the regions (see Figure 3.1). Decentralization could shorten the route from citizens/clients to their governments, enabling them to better monitor government performance. Citizens/clients pay local taxes, in exchange for which they expect local governments to organize the delivery of services. In addition, with decentralization, citizens can compare the performance of their government and service providers with those in other jurisdictions. Local governments, in turn, may be better able to monitor service providers themselves. With the central government no longer responsible for direct provision of services (local government is), it is well positioned to supervise and monitor local governments, as an agent of the citizen. Finally, when voter pressure fails to improve performance, citizens have the option of "voting with their feet"—by leaving the region. All of this could lead over time to more efficient and effective service delivery, and reduce corruption and waste.

### *...but also significant risks*

The potential benefits from decentralization are by no means a given. Information on local government performance is often lacking, hampering constituents in the monitoring of their

local governments. And even if information is available, local constituents may not have the political or legal means to discipline decision makers for bad performance, or corruption. Local governments could be more prone to “elite capture,” domination of a local special interest group that does not have the general interest in mind. They may also be prone to capture by large commercial interests, both donors and foreign. Decision making processes that do not allow for meaningful participation could reinforce such tendencies. Finally, even if accountability is better at the local level, this need not result in better services, as the capacity of local governments may be less than that of the central government.

Figure 3.1: Accountability



## THE LOCAL ACCOUNTABILITY FRAMEWORK

### *Decentralization devolves most functions...*

Law 22 of 1999 on Regional Governance devolves most functions (see Chapter 6) to local government, except those reserved for the center and the province. The local governments have obligatory “sectors” (*bidang pemerintahan wajib*),<sup>75</sup> including health, education, public works, environment, communications, agriculture, industry and trade, capital investment, land, cooperatives, and manpower and infrastructure services. Local governments can hand back functions to the province that they cannot or do not yet choose to perform, but they cannot hand back the obligatory functions.<sup>76</sup> Law 25 of 1999 sets out a revised intergovernmental fiscal framework. Through the introduction of a general allocation grant (*dana alokasi umum*, DAU) and stipulations on shared taxes and local tax bases, the system significantly increases financing for local governments. Among the shared taxes are the natural resource revenues accruing to only a few provinces, and personal income tax. Moreover, the law also moves away from the former system of SDO and INPRES grants characterized by a high degree of earmarking and centralized control.

### *...and changes political accountability*

*Accountability of the Head of Region.* The local legislature, DPRD, elects the head of region for five years. The President must confirm this election. The President confirms

governors, and the governor as representative of the central government in the regions, confirms the head of local governments.<sup>77</sup> The DPRD can dismiss a head of region, for reasons specified in the law, including poor health, lack of belief in one almighty God, death, abuse of his position for personal wealth (Articles 33 and 49). A head of region can also be discharged for reasons of performance (Art. 46), if his annual accountability speech or his special accountability speech is rejected twice by the DPRD. Two-thirds of the DPRD members must be present at the meeting to discharge the head of region, and two-thirds of those present must endorse the discharge. The President endorses the DPRD decision to discharge the head of region. The President can also, in case of a serious crime, discharge the head of region without a decision of the DPRD. The head of region must at least annually report to the President on the execution of regional administration (Art.44 (3) Law 22/99). This report, specified by regulations,<sup>78</sup> is more detailed than that for the annual accountability speech to the DPRD.

*Regional Politics.* The laws on political parties (No.2/99) general elections (No.3/99) and Legislatures (No. 4/99) affect regional autonomy.<sup>79</sup> The law on political parties requires parties to be established in at least one-half of the provinces, and within those provinces in at least half of the electoral districts, preventing regional parties from contesting the regional elections.<sup>80</sup> For local elections, the district or city is the electoral territory.<sup>81</sup> Candidates are registered in each *Kecamatan*, and at least one seat is allocated to each of them, but the overall result of the elections is determined by how well parties do district-wide. The size of the local DPRD's varies from 20 to 45 as per criteria in Law 3/99. Candidates do not need to live in the district that they wish to represent in the DPRD. As with the national Parliament, ten percent of the seats in the DPRD are reserved for the military, an arrangement that will change after the 2004 elections. In 1999, local elections were held at the same time as national elections, within 2 months after Law 22/99 passed.

### ***Financial accountability structures mirror the center***<sup>82</sup>

Regional governments (*provinces, kabupaten, and kota*) each prepare and develop a *Propeda* (regional 5 year development plans), which is supposedly based on the regional interpretation of the goals of the national five-year plan. Based on the *Propeda*, each local government bureau prepares and develops a *Rencana Strategis* (Renstra), a strategic plan with a three-year time horizon. The Renstra is aimed at establishing accountability for the heads of the region and the heads of the bureaus.<sup>83</sup> The report includes some performance indicators, although they are not quantified. Based on the Renstra, the *Repeta* (annual plan) is developed. The *Repeta* is the only planning document that has a linkage with the regions' APBD—the budget. However, the *Repeta* does not include planned budget allocations, but is rather a listing of the programs that are to be funded in the budget. This process is partly mirrored at lower levels of government.<sup>84</sup>

- *Budgeting.* Budgeting in the regions—as in the center—remains largely an administrative exercise. A budget committee, comprising civil servants, is in charge of the process, and the *bupati* and DPRD get into the game relatively late. Budget implementation involves a large number of checks on spending without much concern for results on the ground. Budget evaluation is hardly developed, and there are only incidental independent audits of regional governments' final accounts.

- *Financial Management.* After the DPRD has authorized the budget, the Finance Bureau and each spending unit prepares the budget documents for the apportionment of the budget. Separate warrants are issued for the routine budget (*Daftar Isian Kegiatan* or DIK) and for the development budget (*Daftar Isian Proyek* or DIP). The documentation underlying the warrants include the *Petunjuk Operasional* (operational guidelines – PO) and *Lembaran Kerja* (working paper-LK). The Finance Bureau identifies those budget expenditures (line item starred) for which funding is conditional upon availability of revenues from central government funding within the budget year. Once a warrant has been approved, each spending unit submits quarterly spending plans, and a request for payment (SPP) to the finance bureau. The plans are accompanied by evidence of spending needs (wage bill, contracts signed) and past spending (invoices, etc.).
- *Procurement.* Regional procurement processes remain unchanged from before decentralization.<sup>85</sup> For each public tender, a procurement committee is appointed by the head of region. These tender committees usually consist exclusively of civil servants. Upcoming tenders have to be published in the local newspaper. The result of the tender committee has to be approved by the head of region. The guiding regulations—presidential decree 18/2000—allows for preference for local bidders, and officials in both East Lombok and Sukabumi saw procurement as a means to support local contractors rather than as a way to get the best price for the goods procured.
- *Accounting and Reporting.* Each budget user (*Dinas/Badan*) maintains its own accounting system. The *Bagian Keuangan* (Finance Bureau) under the *Sekretaris Daerah* (Regional Secretary) has the responsibility to keep separate accounts for all spending units' transactions based on *Surat Permintaan Pembayaran* (SPP or Payment Requests) and *Surat Perintah* (SPM or Payment Orders) issued by the Kasda. The regions follow modified cash accounting standards.
- *Auditing.* Audit arrangements at the local level still remain confused. Law 25/99 determined that the audit of local government budget should be done by “prevailing regulations.” At that time, those prevailing regulations assigned the Government's internal auditor (BPKP) the supreme audit authority the Inspectorate General of the Province and the Inspectorate General of Home Affairs a role in audit. Since then, Presidential Decree 74/01 has been issued, changing the audit arrangement. The decree assigns three internal auditors the right to audit local governments' budgets: (i) *Badan Pengawas Daerah (Bawasda) Kabupaten*; (ii) *Badan Pengawas Daerah (Bawasda) Propinsi*; and (iii) Inspectors General of Line Ministries on technical aspect. The Inspector General of MOHA plays a role as coordinator of Bawasda assignment. *Bawasda* submits the audit report to the *bupati* with copies to the auditee unit, *Bawasda Propinsi* and IG MOHA. *Bawasda* audit reports are not available to the public, nor, as a rule, to the DPRD. In the past, the issuance of an audit report was often preceded by a process to “correct” the mistakes found. This process sometimes resulted in negotiation between auditor and auditee. Indonesia's Supreme Audit Agency BPK, the only external auditor in the country, has according to Law 5/1973, the authority to audit all levels of government. It has started to do so since 2001. One problem BPK faces is the limited manpower available to audit the regions. As a result, the BPK only audits a sample of the regions each year. Unlike with the center, it is not obliged to submit its reports to the regional legislature, but starting in 2003, BPK has decided to do so. The regional government has no formal obligation to follow up.

***Regions also enjoy broad autonomy over civil service management***

Law 22/1999 gives the regions the right to “hire and fire” its civil service, but there are conflicting laws and other forms of implementing regulations which appear to circumscribe this autonomy.<sup>86</sup> Articles 75-77 of Law 22/1999 gives regions broad autonomy in civil service management. Government regulation 97/2000 gives the head of region authority to determine the number of civil servants in the region (the establishment). And Presidential decree 159/2000 sets up regional civil service agencies.

The local right to manage the civil service is limited in several ways. In contrast to Law 22/99, the civil service law (Law 43/1999) retains much control at the central level. The central government still determines to a large extent civil service wages: base wage, position allowances, and family and rice allowances are set by Presidential Instruction. In addition, the Ministry of Finance sets limits to honoraria to be received by civil servants for project management, and the like. And BKN, the civil service agency is developing job classifications and accompanying qualification standards, which it wants to see applied to the local civil service as well as the central civil service. Sector ministries such as education, health and agriculture are developing similar standards for teachers, doctors, and agricultural extension workers. Government regulations, which among others require nationwide advertising for certain posts and local advertising for others, further limit hiring procedures.

***And the Center gets to supervise***

The central government supervises the regional governments, through what is termed in Indonesian parlance as repressive and functional supervision. The central government through the Minister of Home Affairs has the right to cancel regional regulations (repressive supervision) when it is deemed that they are in conflict with the public interest or contradict a higher-level legal instrument. The regions can appeal such cancellations to the Supreme Court, according to Law 22/99.<sup>87</sup> The central government has repeatedly cancelled regional regulations on local taxes, which were found to be against Law 34/2000 on regional taxes and charges. The central government also tried to cancel a regulation issued by the West Sumatra legislature on remuneration for the DPRD. The central government felt that this regulation violated Government Regulation 110/2000 on expenses of the DPRD, but the Supreme Court ruled that this regulation was itself not in line with Law 22/99.

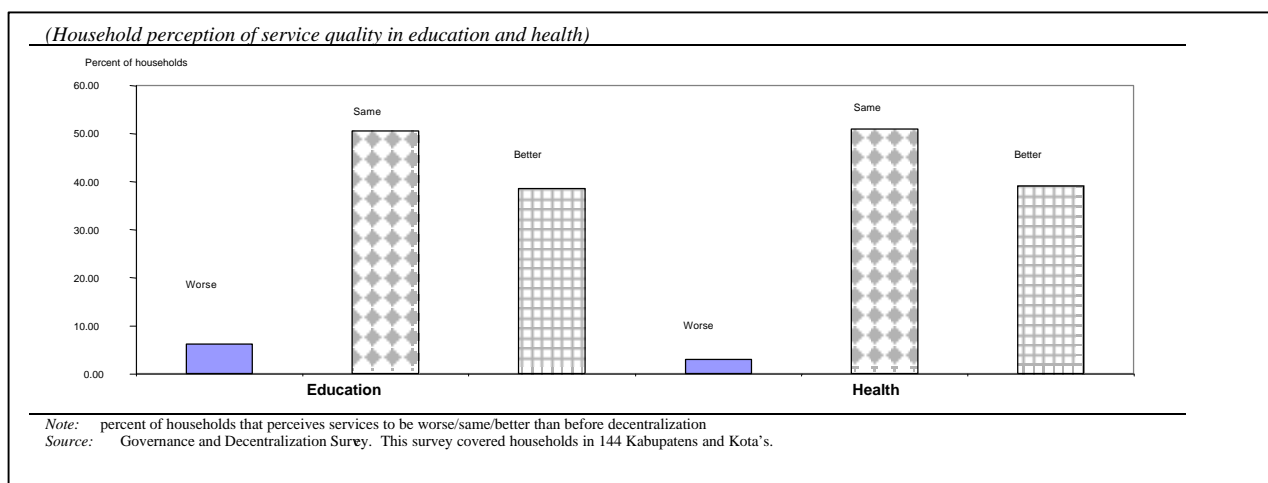
**ACCOUNTABILITY IN PRACTICE**

***Service delivery may have improved***

Indonesia’s decentralization took effect in January 2001 and thus at the time of writing (August 2003), only limited evidence is available on whether the new accountability system is working. The most comprehensive source of data thus far is the *Governance and Decentralization Survey* of Gadjah Mada University,<sup>88</sup> performed in mid-2002. The survey was done in 177 local governments, and interviewed representative samples of households, media, local government officials, and professional groups, focusing on questions of service quality and accountability issues—including corruption and transparency.

The initial results from a nationwide survey on service delivery done in 2002 are encouraging. Some 89 percent of households believe education and health services have improved or remained the same after decentralization compared to before decentralization (see Figure 3.2). On average, only 6 percent of households believe education services have deteriorated and 3 percent that health services have deteriorated after decentralization. Even in the region that performed worse according to the GDS survey, only one-third believed that services had deteriorated.

**Figure 3.2: Improved Perception**



***But corruption has not changed much***

However, there is a widespread perception that there is considerable corruption in the regions (see Figure 3.3). And it appears to be systemic: money politics at the political level, corruption in core government operations such as recruitment, and government procurement, as well as petty corruption at the service delivery level are all seen as common.

Corruption affects the perceived level of services. As noted, on balance, people see an encouraging improvement in core service delivery, but the perceived improvement is negatively correlated with the level of corruption. Yet, a large majority of households believes that the level of “cuts,” illegal levies and bribes are more or less the same as before decentralization. This is in contrast with the headlines in the newspapers, which suggests that corruption has been on the increase since decentralization. One reason for this could be the increased level of transparency in the reform era.

The BPK audits of central and local governments suggest that abuse of government money is the same at the central and the local level (see Table 3.1). The level of “deviations” was somewhat higher at the center in 2001, and higher in the regions in 2002. “Deviation” can imply anything from following the wrong procedures to outright theft.

**Table 3.1: BPK Audit Findings**

(Percentage deviations)		
	2001 Sem II	2002 Sem I
Central	13.6	16.1
Routine	20.5	9.8
Development	6.4	15.6
Province	3.7	27.9
Routine	1.8	8.1
Development	5.1	30.7
District/Cities	12.7	21.8
Routine	13.8	21.6
Development	11.6	22.0

*Source: Chairperson of BPK Welcome Speech at the Presentation of the Audit Results for Semester II of Fiscal Year 2002, Jakarta, February 2003.*

Worrisome in the numbers is the increasing trend in local government deviations: over the first semester of 2001, BPK only found 7 percent of deviations in local government.<sup>89</sup> The jump in irregularities at the provincial level is of concern. Of equal concern is the apparent failure to follow up on the audit findings, even though the BPK submits its findings to the regional legislatures. None of the regions thus far seem to have developed follow up plans on the audit findings. The head of the Jakarta internal auditor even flatly denied there was any issue at all,

after BPK found some \$100 million in spending, or 10 percent of the Jakarta city budget to be tainted by irregularities.<sup>90</sup>

### IMPROVING LOCAL ACCOUNTABILITY

Irrespective of whether it is worse at the center or the regions, or whether it is the same or worse now or before decentralization, the level of corruption should be of concern to policymakers. Corruption threatens to undermine the credibility of the decentralization program itself, and may even lead to a partial re-centralization of powers and responsibilities to the center. Yet, the obvious measures to reduce corruption are largely the central government's responsibility: improving the justice sector and setting up a credible anti-corruption commission as discussed elsewhere in this report.

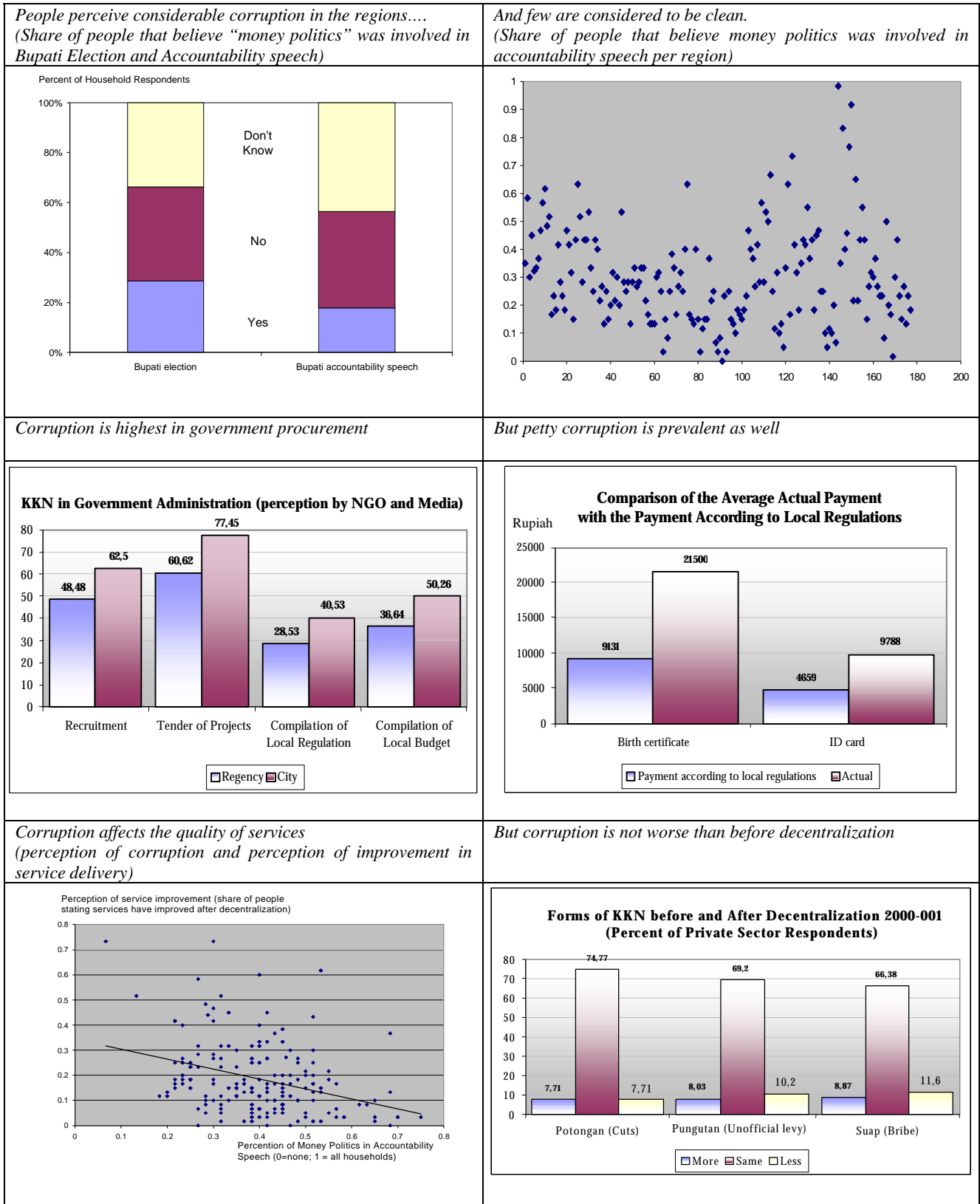
This section focuses on the measures the center can take to reinforce local accountability, including clarifying roles and responsibilities of local governments; empowering the local electorate through political reforms, engagement with civil society and access to information, and by enhancing the local tax base so that citizens can hold local governments accountable for the services their taxes provide.

#### *Increasing clarity of function requires:*

- Changing Law 22/1999 and its implementing regulations to specify which *functions* in the decentralized sectors, rather than entire sectors, are the obligation of local government.
- Phasing out of regulations and decrees that maintain functions already assigned to regional Governments through Law 22/1999—including land, investment approval, and forestry.
- Changes in sectoral laws and regulations to eliminate conflicts with Law 22/1999. A systematic review of existing laws and regulations is required, as well as systematic screening of all draft laws to be submitted to Parliament



**Figure 3.3: Decentralization and Corruption: First Findings**



Source: Governance and Decentralization Survey 2002 and Staff

Apart from the lack of clarity of functions, there is equal lack of clarity on what level of service is expected. The *minimum service standards* required by Government Regulation 25/2000, have not yet been established. This is not surprising, as setting these standards is no easy feat: it requires striking a fine balance between fiscal affordability, regional autonomy, and what Indonesia as a nation considers the minimum service it wants to provide its citizens. First and foremost it requires clarity of functions for local government, and it will be some time before that is achieved.

Beyond clarifying the responsibility of regional governments, the center could require regional governments to be transparent about the services they can expect. Citizen's charters, effectively used in countries as diverse as the UK and China, might be an effective tool for local accountability in Indonesia as well, and the central government could consider making such charters obligatory for key services. Of course, regional governments that want to do so, can go ahead and use such charters without any central requirement already.

***Box 3.1: Many heads of region still lack a popular mandate***

By far, not all heads of regions have a popular mandate. During the 1999 elections, all local legislators were elected, but all incumbent heads of regions retained their job. The incumbent heads were over time replaced by indirectly elected (see Figure 4.2). The implication was that at the time decentralization took off, only 20 percent of the heads of regions had an (indirect) popular mandate. By now, this is a little under 60 percent, but only by the end of 2004 will all heads of regions have been elected according to mechanisms spelled out in Law 22/99. Non-elected heads of regions who have little chance of being re-elected when their time is up may not always have their constituents' interest in mind.

***Empowering the local electorate will increase political accountability***

Law 22/99 stipulates very strong accountability principles of the head of region. However, subsequent regulations have undermined this. Government regulation 108/2000 in the accountability of the head of region further details the mechanisms for discharge on the head of region. It limits the reasons for discharge to the case in which the head of region has committed a crime, requires at least one member of each faction to be present in the session to decide on discharge, and adds the requirement of a review panel appointed by the central government. This regulation therefore curtails the rights of the DPRD to discharge the head of region. The regulation was issued because the central government felt that DPRD's had a tendency to take discharge rather frivolously (see Box 3.2).

Law 22 stipulates an indirect accountability of the head of region, as he is chosen by the local legislature, not directly by the electorate.<sup>91</sup> While such systems work well in other countries, the indirect elections of the head in Indonesia seems to have led to a situation in which the *bupati* or *walikota* focuses on pleasing the local legislature rather than the local electorate. Recognizing this, the amendments to the Constitution call for "democratic election" of the heads of region, which is interpreted to mean direct elections.

Following the third and fourth amendment to the constitution, the political rules for the 2004 elections are currently being debated. Just as in the proposed revisions of Law 22, the government will have to move deftly to understand how modifications and additions to the legal and regulatory framework play out in the political arena, and in the end at the implementation

level. Nevertheless, the constitutional reforms force a change in the political laws, which provides an opportunity to reinforce political accountability at the local level. Direct elections of the head of regions seem to have already been decided upon. As of 2004, the President will be elected by a direct popular vote, and this model is likely to be used at the local level as well. Direct elections could offset the perceived limitations to accountability through the DPRD, although “vote buying” may switch from DPRD to the electorate. If such a step were taken, Law 22 would have to be changed as well, as a directly elected head of region, sits uneasy with the power of the DPRD to dispose of the head of region on political grounds.

**Box 3.2: The Surabaya Mayor—Lessons in Accountability**

The mayor of Surabaya in East Java Province is becoming a textbook case for Indonesia’s new political accountability. Mayor Sunarto Sumoprawiro, popularly known as Cak Narto, went absent from his duties in October 2001, to go to Melbourne for medical treatment. The mayor said he had asked the DPRD for medical leave, but the council members claimed he went AWOL. The departing mayor left a bunch of unresolved problems behind, including a dispute with the garbage collectors and taxi drivers. The DPRD’s anger mounted together with the garbage, and after a failed attempt in December 2001, the council—led by President Megawati’s PDI-P—voted Cak Narto out of office on January 15, 2002, appointing his deputy as replacement. The Minister of Home affairs disagreed with the decision, stating publicly that DPRD’s could not dismiss heads of regions. He refused to confirm the dismissal and the replacement.

After a two-week standoff, the Governor of East Java, acting on the instruction of the Minister, instituted a special team to investigate the case. Their conclusion was the same as the DPRD’s. This did not convince the Minister, and he appointed the Governor as acting mayor. President Megawati ordered the dismissal of the board of the Surabaya branch of PDI-P. She could, however, do nothing against the council members, as there is no right of recall by the party (although this is currently under discussion). The councilors, however, are not off the hook yet, and in a speech at a party meeting in Bandung she said, speaking about councilors breaking party rules: “They are hiding behind their status as the people’s representatives and have forgotten the fact that they represent the party...I have my own way (to teach them a lesson). They won’t be on the list of legislative candidates in the next general elections.” Meanwhile, the former head of the Surabaya PDI-P sued the Secretary General of the central board of executives. Finally, on June 12, 2002, the Governor of East Java appointed the deputy mayor as the new mayor. In August, 2002 the DPRD started impeachment proceedings against him.

*Source: World Bank 2003a*

The accountability of the DPRD members to the local electorate has become an issue as well. Some of the members are not elected, and thus cannot be expected to be very responsive to the electorate. Ten percent of the seats in the local DPRD’s are still “reserved domain” for the military, although this is to change in the 2004 elections once the fourth amendment to the constitution has made its way into the law on the membership of representative bodies. For those that are elected, the party system does not necessarily promote local accountability. Since there are no local parties, and even the local election lists are centrally approved, the elected members do not necessarily feel accountable to the local electorate. Some of the council members do not even live in the region, or have only moved to the region after being elected, and concern for regional issues may well be less strong than that of members residing in the region. Coincidence of national elections with local elections meant that national themes dominated the local elections, and the differences between local and national voting behavior in each region was marginal (Malley, 2002).

Among the reforms that are being discussed are whether the regions should:

- *Determine party lists.* Revisions of the law on political parties could, for example, grant the right to determine candidate lists for regional elections to the regional chapters of national parties.
- *Impose residency requirements:* Candidates resident in the boundaries of their constituency are more likely to be concerned about local issues than other candidates. The benefits of that would need to be weighed against a possible loss in terms of expertise, which would come with limiting the pool of candidates.
- *Have separate election dates from those for national elections.* The coincidence of regional and national elections in 1999 effectively meant that only national issues were actively debated. Separating the dates of national and local elections would allow for local issues to become more prominent in the latter. This advantage would have to be weighed against the additional costs that separate election dates would bring.

### ***Civil society can help enhance accountability***

A boom in civil society organizations since *Reformasi* has increased the demand for participation in government decision making beyond exercising the right to vote. Civil society organizations come in many shapes and sizes ranging from advocacy groups to budget watchdogs, to more traditional organizations such as charities, and other NGOs involved in service delivery. Most, although not all of these organizations are organized as foundations (*Yayasans*) and are subject to the Law on the *Yayasans* of 2001. Decentralization has been a catalyst for participation, as Law 22/1999 requires regional governments to engage the local citizenry in local development.

The multiplicity of civil society actors, exclusive or fractured multiple forums present a problem of representation for local governments. Local governments are placed in the no-win situation of either negotiating with “illegitimate bodies” or not negotiating at all. Local government officials also express confusion as to who represents civil society. For example, the Head of North Sumatra’s planning bureau expressed strong support for civil society participation. However, he argued that the planning bureau lacks the knowledge and information to judge the civil society groups on integrity and accountability to the public. Yet, engagement is taking shape, and in numerous regions around the country this engagement is increasingly formalized through city forums.<sup>92</sup> The search for new mechanisms to involve citizens is a global phenomenon, and a great deal of experimentation is going on with potential lessons for Indonesia (see Box 3.3).

Problems of representation also exist on the Government’s side. Traditional accountability mechanisms would suggest that the legislature would be the primary interlocutor with civil society. But in most Indonesian cities it is the executive rather than the legislator that manages the interaction with and response to civil society organizations. Inexperience of the local legislator and accountability of its members to the party rather than citizens plays a role in the lack of interaction with civil society. The lack of guidance on how community participation should take place weighs in as well. Moreover, the laws only prescribe a role of community

involvement in planning, an activity that largely belongs to the local administration, not the local council.

**Box 3.3: Porto Alegre's Participatory Budget Council**

Porto Alegre, southern Brazil's largest city, has launched a participatory budget system. This instrument attempts to combine direct democracy with the empowerment and promotion of parliamentary representation. The city has established a Participatory Budget Council, comprising two representatives and two alternates for each area who are elected to be responsible for discussing issues relating to municipal revenues and expenses and community concerns, and for establishing criteria for resource distribution. The criteria for resource allocation was based on need (lack of facilities, infrastructure) and local population priorities. Citizens identified and prioritized their needs and evaluated the mayor's program. This created opportunities for participation, accountability and transparency.

*Source: Participatory Budget, Municipal City Hall of Porto Alegre, Municipal Department of Culture, Coordination of Social Communication-CSC. 1995 quoted in Maria Gonzales de Asis, "Reducing Corruption at the Local Level", World Bank Institute, October 2000.*

***Better access to information is key***

Information is the lifeblood of accountability. Increasing citizens' access to local government information is therefore key to increasing local accountability. Indonesia's laws and regulations stipulate access to information. Law 22/99 and Law 25/99 require the local government to publish information on plans and budget. And Law 28/99 on a "Public Administration free of Corruption," gives citizens access to *all* information within the government administration necessary to permit adequate citizens' oversight.

**Box 3.4: Municipalities Worldwide go on the Internet**

Many municipalities all over the world are launching internet websites, allowing citizens to access information on transactions carried out by the municipality and other services. Campo Elias in Venezuela, Limpio in Paraguay and Obnisk in Russia are examples. This allows easy access to information on matters directly affecting citizens. It is also being used to consult citizens on budgets before they are finalized. Campo Elias also allows citizens to track municipal transactions via the internet. All enterprises that provide goods or services to or on behalf of the municipal government above a certain threshold must register and provide a status report on the internet. Failure to do so can result in sanctions. Citizens who do not have access to computers or the internet may come into the Office of Information.

*Source: Maria Gonzales de Asis, "Reducing Corruption at the Local Level," World Bank Institute, October 2000.*

The practice in Indonesia's regions falls far short of these laudable goals. Most local governments have a Local Communication agency (*Dinas Perhubungan*).<sup>93</sup> Local governments are also experimenting with different institutions for physical information access and dissemination. Cities such as Bandung, Blitar and Balikpapan, emulating other cities in the developing world (see Box 3.4) are experimenting with websites, and Kota Medan issues a bulletin published twice a year (but with only 100 copies); and Blitar is also planning to set up a more general public information center. One stop service for licenses and permits is being offered by some local governments (some under World Bank projects), with information on fees

and processing time published and disseminated. But not all regions are as forthcoming as these. Moreover, even when local governments guarantee physical access to information, it is often inaccessible because of the technical nature of the information. Law 28/99, which includes clauses equivalent to a freedom of information act, is hardly known at the center and in the regions alike. The law is not in use because the implementing regulations required to operationalize it have not been issued.

Comparable information on the regions' performance is also a scarce commodity. The Ministry of Finance has set up a web-based regional financial information database with extensive budgetary information for each region, but little analysis is done on these numbers. BPS has started to explore ways of better serving regional governments and citizenry with their information.<sup>94</sup> Traditionally, they published a regional statistical information book in regular intervals, but several of their instruments—including national accounts and household survey, are not significant at the local government level due to sample size. Line ministries such as Health and Education used to have an elaborate information database for their own policy purposes, but little of this is in the public domain.<sup>95</sup> The Monitoring and Evaluation System that the Ministry of Home Affairs has been planning to track decentralization and the performance of the regions has not yet gone beyond the conceptual stage.<sup>96</sup> The information gap is filled in part by others—including universities, NGOs, and donor agencies, but the scale of most efforts is too small to provide significant comparable systematic information. The exception could be KPPOD's information on the business climate and the forthcoming Governance and Decentralization Survey of Gadjah Mada University.<sup>97</sup>

***The central government could help improve access to information in two ways:***

- *Issue regulations for Law 28/99.* Implementing regulations that operationalize the freedom of information clauses of this law are urgently needed. Parliament is currently considering using its right of initiative to pass a freedom of information act, but this may be some time in the making. Moreover, such law may also have to wait for years on its implementing regulation. Thus, Law 28/99 is for now the best hope for better information, and government should issue the regulations soon.
- *Produce comparative information on the regions.* National “inputs” in the competitive process among the regions are essential. Local governments may be tempted to suppress or mold information to their own interests. The center could provide regions timely, credible, and comparable information—and it should already collect such information for its own policy purposes. The Ministry of Finance's *Regional Financial Information System* or SIKD is a good example of such information, and this report has made abundant use of it. In other areas, such as health and education, information already exists, but is hard to access. Even in the financial area, common accounting standards are badly needed to ensure comparable information in the future as well. And finally, published audited accounts are needed for each of the regions—submitted to local legislatures, as well as made available to the general public.

***Local taxes mean local accountability***

Decentralization greatly expands the scope for regional taxes. Law 18 of 1997, the previous law on regional taxes and levies, intended to stop the then-prevailing regional government practice of issuing a plethora of taxes and levies. Many of these had little revenue potential, and high costs to the taxpayer and the economy. Law 18/1997, therefore, restricted regional taxes to a closed list, and made any additional taxes conditional upon approval of the Ministry of Finance. Law 34/00 reverses the burden of proof. The law still gives a list of regional taxes, but regional governments can add taxes through regional regulations approved by the regional parliaments, as long as it abides by the principles mentioned in the law. The regions have made ample use of this option, and have issued numerous new taxes and levies by regional regulation. While this has increased regional own revenues by some 50 percent since the start of decentralization, they remain a modest share of the total. Moreover, many taxes and levies are seen to be damaging the business environment, and are often on traded goods—“imports” and “exports” of the region—in an attempt to minimize the burden on the local constituency. Central government is only weakly supervising the local tax PERDAs.

Accountability would be well served if local constituents bore the burden of decisions made by their local governments. This way, the citizen/voter will in his own interest take a much more active role in monitoring and influencing local governments. This requires first and foremost a better local tax base. The current system of regional taxes and charges allows regions to issue regional taxes as long as they comply with principles stated in the law. This is not working: the regions have strong incentives to impose improper taxes and levies, and the center does not have the capacity to supervise, nor the willingness to enforce cancellation of illegal taxes. The way forward is therefore to restrict regional taxes and levies to a limited, closed list. At the same time, the regions should be granted additional tax bases that are more suited for local governments. Such taxes should ideally generate sufficient revenues, largely burden local beneficiaries, be sufficiently stable over time, and have a base that is not too unequally distributed across the regions.

New local taxes that could be considered, and are currently under debate, include a surcharge on the personal income tax and local business taxes or payroll taxes. While these options are attractive from a revenue point of view, the Government needs to carefully study the economic and other implications of such taxes. The prime candidate for strengthening the local tax base is the land and real estate tax. This tax, which is a local tax in most countries around the world, is in Indonesia still a central tax shared with the regions. Except for administrative considerations, there is little that would prevent giving the authority over the property tax rate to local governments. The Government should, therefore, consider giving the local governments the authority over rates, while continuing to administer the tax on behalf of the local governments.

A further option to increase the regions' own tax revenues is by increasing the maximum rate allowed on existing taxes. Rates for regional taxes such as the motor vehicle tax and the hotel and restaurant tax are limited by central regulation, and almost all regional governments charge the maximum rate allowed. This central limitation on regional rates should probably continue for some time to come, but the center can expand the local tax base by increasing the limits on the rates.

## **POLICY IMPLICATIONS**

- Indonesia's decentralization creates huge opportunities for strengthening accountability and considerable risks of increased corruption. It is too early to tell, whether those risks are sufficiently high to offset the opportunities being created. Some preliminary survey findings suggest that service delivery may have improved, and contrary to the perceptions of Jakarta based analysts, corruption may not have increased very much, if at all. The accountability framework for decentralization is comprehensive, but needs some mid-course corrections to make it work. Some of it is already happening. One such area is how heads of government get selected and removed from office. The proposed direct elections rather than through the DPRD will increase accountability to citizens and reduce accountability to heads of political parties in Jakarta, and to local parliamentarians. Other changes, as discussed above, that increase accountability to citizens of the region are probably desirable. Clarification is probably also needed on whether and in what circumstances a DPRD can remove a bupati or walikota. The changes in the rules at the center for the President could probably usefully be replicated at the local level, so there is a clear division of political authority between the executive and legislative branches.
- In the meantime, the central government needs to move on a number of fronts. A high priority is clarification of the specific functions for which citizens can hold local governments accountable. This will probably involve amending Law 22/1999, as well as cleaning out, amending, and declaring redundant a whole range of government regulations that are inconsistent with the clarifying revisions to Law 22/1999, particularly regulations relating to land, forestry and investment approvals. In making these clarifications, it would be important that this be not seen as an opportunity to roll back decentralization.
- Clarification is also needed on the role of local governments in managing the civil service. The contradictions between the decentralization law and the civil service law, and the center's clear preeminence on civil service issues has eroded the considerable autonomy given to the regions on this issue. Given that a full scale reform of the civil service may take some time (see Chapter 6), the regions could usefully be allowed to exercise the autonomy they have to hire and fire within a hard budget constraint. This may require some key principles to be observed such as non-discrimination against civil servants who are not of local origin, and transparency in rules of hiring and firing. But reformist local governments could use the greater autonomy to hire civil servants of integrity, and establish penalties and rewards that enhance accountability.
- Jakarta also has a key role in empowering citizens in regions by improving their access to information about their local governments. Difficult as this is, sector ministries need to establish minimum service standards and collect and make available comparable performance indicators that allow citizens to judge how their local governments are doing. Financial information on budgetary performance and allocations, and enforcement of common public sector accounting standards will enhance information. Parliament can also ensure that the Supreme Audit Agency is adequately funded to do its job in the regions, and that the results of its audits are made widely available to local parliaments and to citizens. Above all, early passage of a Freedom of Information Act will be a powerful tool in the hands of educated citizens. While such an Act is awaited, the Center can use the existing



anti-corruption law 28/1999 to regulate access to information and to require local governments to make information available.

- Jakarta also needs to ensure that the reforms discussed in Chapter 2 on financial management and procurement are also carried down to the local level. Creating incentives through the DAK grants to regions for such reforms could be an important way to move the agenda forward on anti-corruption reforms at the local level. Indonesia's development assistance partners are also beginning to try to identify and assist reformers in local governments. If done well, this could slowly begin to impact on local government performance by rewarding those who want to help themselves with additional development resources and causing citizens to put pressure on their governments to follow the example of reforming governments.
- Finally, the single most important thing the center can do to enhance local accountability is to expand the tax base of local governments, particularly through the property and real estate taxes, and through appropriate local sales taxes. In exchange, the number of taxes the region can levy should be limited, to avoid the current plethora of taxes, many of which are inefficient, and hamper internal trade. Accountability is weak when citizens know that the taxes they pay are not directly funding the services they receive, or are paid for by people outside the local constituency through "tax exporting." When citizens are required to pay for something, they are more likely to demand that it is delivered in the right quantity and quality. When corruption gets in the way, local governments will hear from their citizens.
- Local governments, however, need not wait for Jakarta to move on all these issues. There is much they can do to enhance local accountability. While the issues discussed in this report when taken together appear overwhelming, reforms at the local level hold the most promise. The scale of problems is more manageable. While capacity is undoubtedly limited, and as noted above, there are several reasons why accountability may deteriorate with decentralization, it is also easy to underestimate the untapped talent and skills of local people and their ability and willingness to contribute to an improvement in their own governance. Reform minded local governments can empower their people by enhancing information flows, by allowing access to decision-making processes and consulting those directly affected by decisions of their government. Key strategic partnerships can be carved out with citizens and NGOs to consult on budget decisions, to monitor the performance of local parliaments and executives, and to help conduct social audits of services delivered by local governments. Civil society can play a key role through surveys of perceptions of local government efficiency, integrity and service delivery and by helping citizens exercise their rights as citizens and monitor the performance of their governments. This chapter has given a number of examples of ways in which this is being done in Indonesia and other parts of the world. The challenge is to seize the moment.



#### 4. Enhancing Accountability of the Government As Regulator<sup>98</sup>

*The previous two chapters reviewed weaknesses in public accountability for the management of budgetary funds at national and regional levels. This chapter looks at the government's regulatory role, focusing illustratively the banking sector, electricity and forestry. Each of these areas saw large scale corruption during the New Order, and the practices and policies pursued then are casting a long shadow over democratic Indonesia. The government has responded to this inheritance by introducing a number of reforms to improve accountability and transparency. Are these enough to prevent a recurrence of the past scale of corruption?*

*Banking deregulation in 1988, together with other policies, created significant moral hazard. This, combined with weak regulatory institutions, and imprudent lending contributed to the financial crisis of the late 1990s. Many of these factors continue to be relevant today, as evidenced by the misuse of liquidity support offered by Bank Indonesia at the height of the crisis and the use of depositors' funds in the 1999 Bank Bali episode in 1999 to fund a political party. Recent sector reforms reduced the risks of such behavior. Fewer banks ease the task of bank supervision, which has been greatly strengthened. Insolvent banks have been recapitalized. The government has begun privatizing recently acquired assets, and the Indonesian Bank Restructuring Agency is shortly to go out of business. However, vulnerability remains, reflecting the large share of weakly managed state banks in total assets, the moral hazard problem from blanket guarantee of banks' liabilities, continued weaknesses in supervision and impunity.*

*Corruption in the electricity sector during the New Order took the form of collusive procurement and sweetheart deals with independent power producers (IPPs) in the 1990s that unraveled following the financial crisis. A new Electricity Law (Law 20/2002) opens the door to competition and the continued unbundling of the state monopoly electricity provider, PLN. New investments and tariff setting are now subject to greater public discussion. But reducing the risk of corruption will require implementing regulations—still to be issued—that do not undermine the new Electricity Law. Moreover the new regulator, the Electricity Market Supervisory Agency will need to be truly competent, credible and independent, and vigilant in ensuring competition.*

*Forestry corruption under the New Order arose out of selling forest exploitation rights to commercial interests, regulatory practices that allowed violation of over-exploitation rules, and mismanagement of reforestation funds. This not only led to severe erosion of the country's forests but also the marginalization of local communities in decisions that affected their lives. Decentralization may be causing corruption to become more fragmented and disorderly, but it could also come to the rescue of the sector. bupatis can no longer deflect criticism to the center. The spotlight on illegal logging is also reducing opportunities for corruption. However, improved accountability will require government commitment to transparency in the sector, inclusiveness in decision making, rationalization of forestry regulations and effective decentralized governance of forestry resources.*

*Common messages from all three sub-sectors are the need for enhanced transparency and inclusiveness in setting policies and regulations, effective management of state enterprises, ensuring that regulations are consistent with new reformist laws, independent and effective regulatory agencies and the need to strengthen the justice sector.*

## **INTRODUCTION**

One of the most important public goods that government produces is the establishment and enforcement of rules governing market behavior. These rules regulate the use of national assets like forests, or ensure that financial markets protect the interests of depositors and borrowers, or enable private providers of infrastructure to obtain an adequate return on their investments while protecting the interests of consumers and meeting the needs of the economy. Under the New Order, the preferences of the head of state played a significant role in determining these rules. In today's democratic polity, Indonesia's citizens rely on their elected representatives to establish broad regulatory policies to protect the nation's assets and ensure the delivery of essential services and to establish and supervise regulatory agencies. The regulators, in turn, must supervise their front line agents who implement these regulations and ensure adherence to them. Such regulations would typically attempt to reflect national priorities and meet social and regional equity considerations. This is a complex task.

Since in an ideal world there should be only one government policy, the views and interests of millions of Indonesians must be reconciled to obtain that one set of decisions – the so called problem of “aggregation of preferences.” This is never easy. In some cases, such as natural resources, the interests of the current generation differ from those of future generations. Higher foreign exchange earnings from forest exports may enable today's Indonesians to pay for imports of essential consumer goods they need for their survival, but may deprive future generations of forest resources and worsen the country's physical environment. Cutting down forests in one region may be seen in the interests of that region, where pressures of population demand land for activities with higher returns than forests, whereas it may be in the national interests to maintain the forest cover. Similarly, most consumers of electricity will want cheap electricity, but a regulator that sets a price for electricity which discourages its production will be failing to do his duty. Equally a regulator must worry about access of electricity or other infrastructure at reasonable prices to remote regions, and build in cross-subsidization in the tariff structure.

As Indonesia transitions to a democratic society, it must not only live with the consequences of past flawed rule setting and enforcement, but must grapple with the inherent complexity of reconciling different interests while setting and enforcing policies, rules and regulations. This Chapter looks at accountability in the government's regulatory role in three key areas: banking, electricity and forestry, reviewing the practices that prevailed under the New Order, and their consequences for current efforts to reform the system and restore accountability. In each of these areas, there was corruption on a significant scale during the New Order and shortly after its demise, made possible by the lack of accountability analyzed in Chapter 1. The choice of these three sub-sectors was driven by the importance of each to sustainable development in Indonesia. A regulatory failure in the banking sector contributed to the financial crisis and to subsequent episodes of corruption and it is important to ensure that such failures are not repeated. A successful transition from the regulatory capture in the electricity sector to an open transparent system of regulation is clearly an important precondition for successful private provision of infrastructure in a resource constrained fiscal situation. Finally, the rapid erosion of Indonesia's forests, and hence its natural resource base, cannot be halted without reducing corruption in the sector.

### *Corruption survives the New Order's demise*

Regulatory policies were a key instrument of abuse under the New Order. The regime's franchisees were granted large business opportunities through trade and import monopolies, protection from competition, access to cheap credit, and privileged rights to the nation's forest and mineral resources. This in turn led to a huge investment boom. But when the regime collapsed, it left an inheritance of a large public debt – a consequence of the effort to rescue banks experiencing capital flight, a looming infrastructure crisis, as many of the past and planned investments based on artificially padded investment costs proved unsustainable and had to be negotiated or cancelled, and a massive depletion of the nation's forest wealth, reflecting regulatory capture by commercial interests.

Five years of *Reformasi* have changed many of the rules of the game. A freely elected parliament has become a much more active player in both changing the rules and in acting as a check on the executive. New laws have been enacted that break the monopoly status enjoyed by infrastructure enterprises and strengthen and make more independent the key regulatory agencies (such as Bank Indonesia). A free press and an active civil society ensure that the voice of citizens is enhanced and that public decisions have access to better information. The forestry sector, in particular, has seen a major campaign to reverse the policies of the past that plundered the nation's natural resource base. Nevertheless the very nature of the Transition increases the risk of state capture given the simultaneity of the efforts to rewrite rules, redistribute assets and create new institutions. New laws to empower the regulators are being put in place while the capacity of the regulators to regulate effectively remains weak. The financial crisis has greatly expanded the state's role in the economy, reflecting the acquisition of banks following the financial crisis, and of the industrial and commercial assets the banks owned following the financial failures of many of their clients. This has created fresh opportunities for corruption. State enterprises remain dominant and continue to enjoy monopolies in particular areas, and are often outside the reach of the arms of regulators.<sup>99</sup> We now review these issues illustratively, in three sub-sectors with a view to understanding why the new efforts to improve accountability are still not working and what can be done about it.

### **THE FINANCIAL SECTOR: BANKING<sup>100</sup>**

In banking, the state, through the Central Bank, plays several key roles: the management of monetary policy to ensure its consistency with policy goals relating to inflation and the balance of payments, regulating and supervising the working of commercial banks to protect the interests of depositors and borrowers and generating information on performance, and ensuring a proper clearing house function. True to the character of the regime, Bank Indonesia has generally managed the monetary policy and clearing house functions efficiently, and indeed, monetary policy has been conservatively managed to ensure low inflation.

### *Deep structural distortions create vulnerability*

However, commercial banks played a key role in the New Order's rent collection machinery. At its center was a network of state-owned banks with a long history of weak lending and collection practices and poor governance. Their portfolio was concentrated in crony

businesses and other state enterprises. The size of loans was increased typically to allow for commissions to bank officials and others. Following banking deregulation in 1988, which removed most barriers to entry, and set low financial thresholds to establish a commercial bank (\$6 million) a large number of private banks were also established, causing their numbers to more than double to 237. This reduced the share of the state-owned banks in total assets from 70% in 1988 to some 40% in 1997. The private banks were typically small, weak and had high loan exposures to their owners and to those with political connections.<sup>101</sup>

In the period leading up to the financial crisis of the late 1990s, there were deep structural distortions, reflecting the perverse incentives facing both corporations and banks, creating major moral hazard problems.<sup>102</sup>

- With financial and industrial policy an instrument of the symbiotic relations between the state and the conglomerates, investors took a rather optimistic view about rates of return and discounted risks to their projects.
- Regulatory institutions were weak. Bank Indonesia (BI), the central bank, was unable to exercise its supervisory role. This was in part because the Ministry of Finance remained actively involved in the regulation and management of state-owned banks which took their cue from their political masters. It was also because private banks were politically well connected and BI could not always openly challenge them. Even if BI were able to operate freely, its staff lacked sufficient expertise to do their job. Supervisory capacity did not increase even with the large increase in number of banks following deregulation. As a consequence, there was poor enforcement of exposure regulations and minimal capital requirements, and even before the financial crisis, the banking sector was riddled with non-performing loans against which adequate provisions had not been set aside. The official data understated bad loans and overstated bank capital, firstly, because loan classification and provisioning rules did not meet international standards, secondly, because enforcement of existing rules was weak, and thirdly because there was a widely prevalent practice of rolling over past due loans and keeping companies afloat, a practice known as “evergreening”. No clear policy existed to deal with problem banks.
- Banks tended to grant credit without due regard to the purpose of the loan, or the borrower’s viability and capacity to generate the cash flow, particularly since the borrower was often either politically important or related to the owner of the bank. Thus, the incentives facing bank officials responsible for credit appraisal, allocation and monitoring, were distorted by the relations between banks and firms. Group lending limits were poorly defined; loan classification and provisioning rules were lax. There was no formal system to record liens on collateral or to make foreclosure and take possession of property.
- With open capital markets, banks were free to borrow low cost funds from abroad. Exchange rate policies aimed at reducing volatility lowered the risk premium on dollar denominated debt. Foreign banks lent large amounts to domestic banks, apparently oblivious of the risks. Thus, a large number of domestic banks had borrowed heavily in foreign exchange and had a currency mismatch on their balance sheets.

These distortions led to a growing share of non-performing loans on banks’ balance sheets, and caused foreign currency liabilities to rise to a third of total liabilities by June 1997.

This left Indonesia extremely vulnerable to external shocks. When the shock came, it led to massive capital flight, partly fuelled by liquidity support from BI. NPLs swelled to 50% of all assets, particularly since banks had taken foreign exchange loans to finance domestic firms that relied heavily on rupiah revenues. These firms suffered severely from the devaluation and were the first to go under, making their banks insolvent. The Government, through the newly created Indonesian Bank Restructuring Agency (IBRA), was forced to take over the insolvent banks and to recapitalize them as well as the state owned banks. The cost to the exchequer was a whopping 50% of GDP, an accurate measure of the real price of the failure of financial sector governance. Two recent banking sector episodes illustrate the nature of this inheritance.

***Emergency liquidity assistance becomes a cash cow***

The extent of elite capture, poor management and lax oversight can be seen in the scandal associated with the emergency liquidity assistance offered by Bank Indonesia at the height of the crisis, known as *Bantuan Likuiditas Bank Indonesia* (BLBI). This assistance was meant to alleviate the severe liquidity crisis facing banks following the financial crisis, and to stem the run on banks. But it ended up financing the run on the banks and the rush out of rupiah-based assets. Despite an injection of some Rp.164.5 trillion over two years, the government found it had to shut some 48 banks.<sup>103</sup> BPK, the supreme national audit agency, initiated a review of the BLBI scheme. Its findings provoked a parliamentary inquiry. Of the Rp. 144.5 trillion disbursed to some 48 private banks, the audit found that 96% was potentially lost or irrecoverable, 59% was misused, providing loans without sufficient collateral, and only Rp. 35 trillion could be accounted for of which about Rp12 trillion had been properly secured.

Roughly a quarter of the amount misused was on account of speculation on foreign exchange markets at a time when the rupiah was in free fall; and a further 24% went to fund loans to affiliates of the bank. Typically the assets pledged were either missing or inadequate or less than the value declared. Three quarters of the assets were in the form of promissory notes from customers or banks without any tangible assets backing them up.

Four banks, Bank Dagang Nasional Indonesia (BDNI), Bank Central Asia (BCA), Bank Danamon and Bank Umum Nasional (BUN), accounted for two thirds of the total BLBI funding, all four allegedly linked to close associates of President Soeharto and his family. These banks already dominated the asset base and were in an advantageous position (see Table 4.1).

**Table 4.1 Pledged versus Actual Commercial Values of Assets (Rp billion)**

<b>Asset Pledged</b>	<b>Value Pledged</b>	<b>Commercial Value</b>	<b>% of Pledged Value</b>	<b>% of Total Collateral Value</b>
<b>Land and Buildings</b>	9,920.87	6,944.60	70.0	8.2
<b>Bonds &amp; Shares</b>	10,631.01	4,480.76	42.1	8.8
<b>Customer Promissory Notes</b>	47,920.19	-		39.8
<b>Bank Promissory Notes</b>	42,977.08	-		35.7
<b>Miscellaneous</b>	8,977.16	3.03	0.0	7.5
<b>Total</b>	<b>120,426.31</b>	<b>11,425.36</b>	<b>9.5</b>	<b>100.0</b>

*Source: Tempo, 11 June 2001 as reproduced in Khouw, op. cit.*

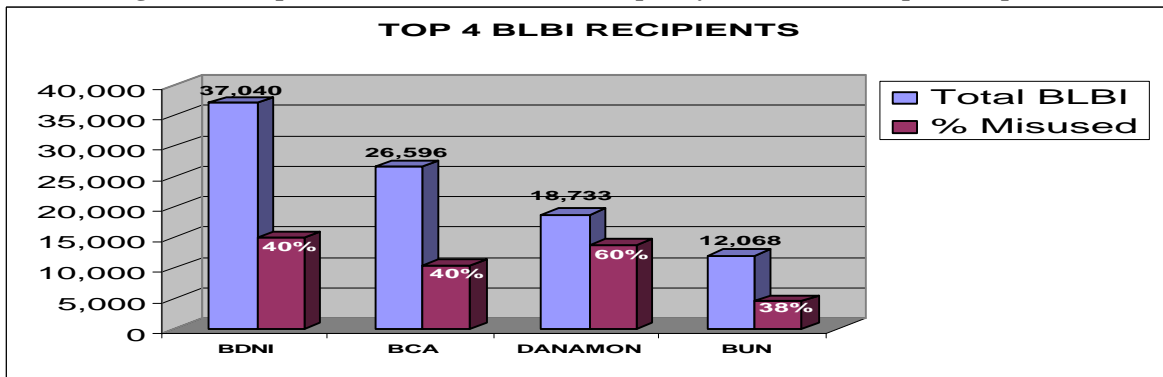
The audit found that this misuse of funds was largely on account of the failure of Bank Indonesia to properly supervise the use of these funds. BI had not only been negligent in not demanding proper collateral to guarantee the recovery of the funds extended<sup>104</sup>, but it had apparently also repeatedly violated its own rules. BI argued, understandably, that it was simply implementing a government decision as the government’s cashier. Nevertheless, BPK recommended investigating the conduct of several BI officials, particularly for illegal support to banks where they had discovered misuse of funds.

Regulators, to be credible, require effective legal institutions that enforce accountability. While going to court is a last resort for an effective regulator, the ability and willingness to do so enhances its credibility and ensures improved compliance. Yet very few people have paid a price to date for the BLBI scandal, with only eight of the 48 BLBI banks facing court action, two cases have been terminated, and there are ongoing investigations in all but five cases where no action has been taken. In total, there have been six BLBI related convictions from four banks, of which all but two of the six defendants are at large. Of those in the country and successfully prosecuted, the losses recovered are a tiny fraction of the amounts owed to the state. The principal reason for ineffective prosecution lies in weaknesses in the justice sector (see Chapter 5) and lack of political will to go after those responsible. Part of the problem is lack of prosecutorial experience in white collar crime and the difficulty of finding evidence that will actually convict someone. As the head of BPK, Dr. Satrio B. Joedono, is quoted as saying “It’s not easy to convert the findings of an audit into criminal charges...because the appropriate rules and procedures that have allegedly been violated must be identified. The requirements of the law of evidence must be met, and that’s not such an easy task”.<sup>105</sup> (see Figure 4.1).

**Tapping the banks for election funding**

Bank Bali provides another glimpse into the flawed accountability in the sector. This scandal came to light in July 1999, following a due diligence acquisition audit conducted by UK based Standard Chartered Bank, which revealed that Bank Bali had paid a private firm a commission of Rp. 546 billion in June 1999 for the recovery of an inter-bank loan from IBRA under the Government Guarantee Scheme (GGS).

**Figure 4.1 Proportion of Misused Funds in Liquidity Assistance to Top 4 Recipients**





The company receiving the commission was controlled by a businessman who was the Deputy Treasurer for the then ruling party. Following a BPK audit carried out by Price Waterhouse Coopers (PWC) requested by IBRA which took over Bank Bali in July 1999, a parliamentary inquiry revealed that the person receiving the commission had links to senior party officials, and indirectly to the then President himself, and that the funds were intended to finance the re-election campaign.

Much of the focus of the Bank Bali scandal has been on what PWC called “fraud, non-compliance, irregularity, misappropriation, undue preferential treatment, concealment, bribery and corruption”. Less has been said, as Khouw notes, about the “failure of the financial supervisory bodies to adhere to their own rules that resulted in Bank Bali receiving special treatment in the settlement of its inter-bank claims,” given that it had been earlier deemed ineligible for settlement by Bank Indonesia under the GGS. Under political pressure both BI and IBRA reversed their earlier positions. BI subsequently defended its action by stating that it was only acting as a cashier of the Government and IBRA, ignoring its supervisory role as Central Bank. The Ministry of Finance claimed that it had no prior knowledge of the cessie agreement, and did not act when it learned that such payments had been made. IBRA on its part failed to prevent the processing of the Bank Bali claims despite evidence that it had prior knowledge of the cessie agreement. As noted below, lack of adherence to rules and pressures to neglect due diligence remain a high risk today.

A related issue is the failure of corporate governance at Bank Bali. As Khouw notes, the outstanding liabilities (foreign exchange swaps) were created by imprudent banking practices. Moreover, since liabilities between related parties were not eligible under the GGS, the claims from the three banks that Bank Bali possessed were considered ineligible by BI. Bank Bali’s management apparently failed to seek legal opinion on the validity of the cessie agreement. It even failed to inform its Board of Directors, IBRA which was supervising it on a limited basis, its shareholders, the securities’ regulators or its auditors of the existence of such an agreement. Such lack of transparency also remains an ongoing risk.

As with BLBI no one has paid a serious price for the Bank Bali case. The only person to be convicted was the Governor of the Central Bank, subsequently acquitted on appeal to the High Court. No other official or private party has been convicted, and the key players, such as the owner of Bank Bali and that of EGP, the company receiving the commission, were acquitted of corruption by the courts.

### ***The banking system remains vulnerable to corruption***

The key question is whether the accountability framework has now improved to a point where the banking system is less prone to the state capture and political interference cited above. There has undoubtedly been progress. The size of the task has diminished somewhat. The number of banks has declined sharply (by about a third from 237 to 141), as a result of takeovers, closures, etc., easing the task of supervision. Bank supervision has been strengthened. Insolvent banks have been recapitalized, and majority share ownership has been sold to private interests in a few key banks.<sup>106</sup> IBRA is about to begin to wind up its affairs. All this contributes to a more stable banking system, but one that remains vulnerable to corruption. Vulnerability comes from five sources.

First, the share of state banks in the total asset base has once again risen. Here the “compact” between the state as owner and the banks is compromised by the failure of the government and parliament to manage these banks in the interests of the citizens whom they represent. Anecdotal evidence suggests these banks continue to face pressure to lend to favored groups from political interests and from their own employees who benefit from the “commissions culture”. Weak management and poor supervision by the Government as owner result in continued lack of incentive to collect loans and to assess lending risks prudently. Data show that non-performing loans have fallen sharply from 48.6% at the height of the crisis to 7.5% in 2002, but ever-greening and restructuring practices make such data of doubtful quality, as in many other countries with large state-owned banks.<sup>107</sup> Stronger management and oversight from the Ministry of State Enterprises without day-to-day interference in the management of state banks will help. Privatization undertaken through a transparent and open process will also help, but only if there is a strong improvement in regulatory capacity to prevent the kind of abuses described above.

Second, Indonesia’s current blanket guarantee of banks’ liabilities creates significant problems of moral hazard, causing private banks to adopt high risk strategies, favor clients who provide “commissions”, and leaving the Government to bail out depositors if the risk materializes. Doing away with the guarantee presents its own risks in terms of loss of public confidence in banks. In Indonesia, such removal needs to be linked to improvements in regulatory capacity and the establishment of a financial safety net in the form of a deposit insurance law.

Third, while the regulatory agencies, which are responsible for protecting the interests of citizens, have improved, much remains to be done to free them from political and financial pressures. The regulatory framework is getting closer to international best practice, but enforcement as everywhere is weak. Enforcement becomes even more problematic in state banks which tend to ignore Bank Indonesia, since they see themselves as directly accountable to the Ministry of Finance. In this context, Bank Indonesia has been granted considerable autonomy. For this to work, the institution will need to continue to strengthen its professional management and replace officials who were responsible for some of the failings of the past. Bank supervisors will have to demonstrate their willingness and ability to take on banks that may have political clout when such banks are not observing the rules. This is easier said than done, since it involves changing the present culture where bank supervisors find it difficult to confront errant commercial bank officials, and are prone to being over-ruled by their managers in the interests of not creating waves. Thus the creation of a new Universal Financial Authority to supervise financial institutions will not solve anything unless the institution is truly independent and based on sound management practices including pay, professional management, and adequate funding for its task. The Government, therefore, would be well advised to not rush into creating such an Authority which might prove highly disruptive, while BI needs to continue to focus its energies on strengthening bank supervision.

Fourth, the organizational providers of services, in this case the banks, are still not generating the kind of sound, transparent, up-to-date and reliable information that imposes market discipline and exposes failures in corporate governance and bank governance information. Accounting is a source of weakness, because although Indonesian accounting standards appear to meet international standards, in practice they fail to do so (see Chapter 2).

There is also lack of transparency in the accounts which are rarely up to date. Anecdotal evidence from World Bank sector work suggests that many bank managers do not appear to use such data as decision tools.

Fifth, there are few rewards for good behavior or penalties for poor behavior. Vigilant bank supervisors do not get publicly acknowledged, and few appear to pay a price for breaking the rules.

Finally, the absence of an adequate legal system to enforce the rules and regulations remains a severe constraint. Contracts cannot always be enforced or property or creditors' rights protected when corruption in the courts is so prevalent. There remain severe weaknesses in the Company Registry, the Fiduciary Registry and Land Registry, which make pledging collateral problematic, further jeopardizing enforcement of contracts.

In sum, while efforts are underway to improve accountability, and while greater citizen vigilance and media freedom subject the players to some degree of scrutiny, much more needs to be done before the sector can begin to function more normally in the interests of depositors and borrowers. Strengthening governance in the regulatory institutions, in state banks and improving corporate governance are all needed, and these will take time to bring about.

#### **INFRASTRUCTURE: THE CASE OF ELECTRICITY**

A rapid expansion of the country's public infrastructure was a cornerstone of economic growth policies during the New Order. The Government consistently accorded high priority to infrastructure provision in successive development plans and allocated substantial budgetary resources for this purpose. Indeed the outcomes in infrastructure development are impressive, given where Indonesia stood at Independence, and the supply of electric power is a case in point.

There are essentially three distinct periods of sector development and organization. Prior to 1990, power investments were principally funded out of government sources (oil revenues) and donor funds. The private sector played a very limited role. When oil revenues dropped precipitously in the mid-to late 1980s and the government faced budgetary shortfalls, the doors swung wide open for private sector involvement which was at its height from 1990 till the financial crisis in 1997. From 1998 onwards there have hardly been any investments in infrastructure. The power sector has been preoccupied with renegotiation of the unsustainable private provision agreements inherited from the New Order, sector reform initiatives, and restructuring of state-owned enterprises (SOEs).

#### ***PLN – the SOE which holds the key to accountability***

Central to the accountability framework for the sector is a powerful ministry, at present named Ministry of Energy and Mineral Resources, which delegates implementation to a number of state enterprises. For electricity the key enterprise is *Perusahaan Listrik Negara* (PLN) which enjoys a monopoly in power generation, transmission and distribution, manages vast assets and plays a major role in the lives of all Indonesians who use electricity.<sup>108</sup>

PLN is a “conventional” public utility enterprise charged with meeting public needs nationwide. Until the new Electricity Law (20/2002) is implemented, PLN continues to be

managed by a Board of technically competent directors recruited from within the utility. The Board Chairman is handpicked by the President. The Board of Directors report to the Minister of State Enterprises, who represents the Government of Indonesia as PLN's sole shareholder, through a Board of Commissioners. The executive, i.e. the Ministry of Energy and Mineral Resources, through its Directorate General of Electricity and Energy Development has the primary responsibility for regulation and licensing, and for sector policy making and planning. In addition the Ministry of State Enterprises, as a shareholder of PLN is now charged with guiding the corporate restructuring and the privatization.

PLN's status was changed from a *perum* (state-owned agency with a social purpose) to a *persero* (a corporation) some years ago. The ambiguity of the status has called for skillful management within PLN. On the one hand, PLN was required to operate as a company and on the other hand it had to meet social and equity objectives and extend services to outlying and non-commercially viable areas. PLN as an implementing agency was given very limited room for maneuver by the executive: the President set the electricity tariff. However, the ministry also set the overall planning parameters, decided how investments would be financed, and reviewed major procurement decisions, functions which fitted better with PLN's role as a cash cow for the regime than to meet rational company objectives. Within these limits, PLN has been, and still is, generally considered a well-managed utility run by professionals, who have indeed been known from time to time to resist and fight the former first family and particular ministers' corrupt business deals.

The combination of the monopoly position of PLN, the mix of commercial and social objectives and the blurred accountability between the executive and the utility were the ingredients that set the stage for big ticket corruption during the New Order. PLN's investment financing pattern, determined by government, created a history of high costs, facilitated large-scale corruption and has indeed had long-term consequences for the post-Soeharto state and for its clients, both in terms of outreach, quality and price.

In the past, the blurred regulatory framework for the sector was ideal to suit those investment sources and modalities, which were most lucrative for short-term rent extraction. Five different sources of power supply financing were used and they helped shape the development of the sector. These are:

- PLN own funds and domestic borrowing
- Government budgetary support
- International donors (WB, ADB, JBIC)
- Export credits (also used in financing of the IPPs)
- Private sector through Independent Power Producers (IPP)

PLN's own funding, domestic borrowing and Government-financed power projects were predominant up to 1990, and corruption in projects was then both predictable and "well-organized" at all stages of the investment cycle. The principal payoffs were in procurement: formal rules were followed on the surface, but bidders and winners were apparently selected beforehand and outcomes of the bidding process were predetermined. As a result, projects tended to be grossly overpriced; some 30% above world market prices for similar investments by some

experts' estimates.<sup>109</sup> Implementation provided further opportunities for rent generation through under delivering on project quality and quantity, the consequences being a lower quality of public service.

Projects funded by foreign donors like the ADB and the World Bank may not have been free from corruption, but the contract packages were large and international competitive bidding was required, which reduced opportunities for corruption. The large leaks and the preferred financing sources were in the form of export credits for the Independent Power Producer projects (IPP), because these were not solicited and financing was tied.

### ***Export credits and IPPs of the 1990s open new chapter***

Export credits and private sector financing through the IPP projects of the 1990s reduced the burden on the budget and opened up new avenues. The 1990s were a gold rush for the “invited elite” and their foreign partners. The exposure of Export Credit Agencies to Indonesia grew by 25% between 1992 and 1996, by which time they held nearly one-fourth of Indonesia's total external debt.<sup>110</sup> The power sector was particularly attractive and export credit agencies were an easy vehicle for rent-generation as funding was tied to the products of a particular country and in many instances there was only one supplier. One example was the “super crash program” of 1994, which saw PLN buy three large new, gas turbine generation plants for Java totaling over 2000MW on export credit financing through a process of so called repeat orders. These orders were processed so rapidly that even underlying gas supply agreements were not in place.

In 1990, Indonesia solicited bids for its first IPP project, Paiton I in East Java. There were two bidders and after lengthy and complicated negotiations, the President intervened and both bidders were ultimately awarded contracts. Subsequently, the Power Purchase Agreement (PPA) for Paiton I was signed in February 1994 and financial closing was achieved some fourteen months later, just days after the signing of the PPA for Paiton II. In the interim, Keppres 37/1992/111 had unleashed a flood of unsolicited project proposals. PLN signed 26 PPAs and Energy Sales Contracts (ESCs) with IPPs by the time the financial crisis struck in mid-1997. The agreements covered an overall capacity of 10,800 MW and a projected investment of around US\$13 billion, with developers securing “support” letters under which Government committed itself to cause PLN to meet its contractual obligations. The lowest tariff negotiated with IPPs was around 5.75 U.S. cents while at the other end of the range, initial period tariffs for Paiton I and most geothermal plants were above 8 U.S. cents. Paiton I tariffs were well above the prevailing average retail tariff and this set the scene for PLN's subsequent financial troubles. The deals struck were of a “take-and-pay” nature, with the risk borne entirely by the utility. Government had a private power team which “directed” negotiations of the unsolicited projects, while PLN was left with the technical parameters and setting up the contracts. The PLN director between 1995 and 1998, Djiteng Marsudi was fired when he complained publicly that “power companies dictated terms to us because they had Indonesia's first family behind them. Resisting them was like suicide”.<sup>112</sup>

The typical modus operandi for setting up a PPA deal called for a linkup between a foreign investor seeking a concession and a well-connected local partner. The “right” local

partners would open doors and secure the needed permits, but were rarely interested in injecting any equity into the project and were not expected to bring in any technical expertise. The local partners would be rewarded for their door-opening skills with “carried interests,” whereby their equity participation was financed by the foreign partner and repaid out of the future dividend stream. This practice is not illegal in Indonesia. Nor does it appear to be in contravention of foreign anti-corruption legislation such as the US Foreign Corrupt Practices Act.

Keppres 1992/37 also resulted in Government pushing PLN into making overly optimistic sales growth projections. PLN was forced to commit capacity to the IPPs prematurely and plants were built in sub-optimal locations in relation to the transmission systems. In the absence of competition, negotiated tariffs were set too high. No standards were established for the award of concessions or for contracts, and for the allocation of risks and the degree of public financial support.

Blurred accountabilities and poor transparency expanded the room for maneuver and created opportunities for sweetheart deals. The Executive had the upper hand in all operations with no public opposition and no public disclosure obligations. The stream of investments signed up by PLN were not given any publicity, both because of the absence of tendering and also because of the “closed” culture of sector operations.

When the Rupiah commenced its sharp decline, the Government postponed or put on hold many major power and other infrastructure projects. Keppres 39/1997, issued in September 1997, allowed 9 power projects to proceed in accordance with their PPAs/ ESCs but caused others, in whole or in part, to be postponed or subject to review.<sup>113</sup> PLN later decided to renegotiate all contracts with IPPs and in the interim make payments at the pre-crisis rate of Rp.2,450 to the US\$. Government established a Ministerial-level team to guide and oversee PLN’s financial rehabilitation and the IPP renegotiations, with PLN being charged with conducting the renegotiations.<sup>114</sup>

### ***While there is ground for hope...***

Five years on, PLN and the Government can, with some legitimacy, claim considerable achievements in changing the sector’s accountability framework.

Renegotiations have been concluded with 26 out of 27 IPPs. Renegotiated tariffs are mostly in the range 4.2 – 4.93 US cents, (with one exception of around 5.5 US cents). These compare with an average retail tariff at the end of 2002 of 5.3 US cents. Following the restructuring process, the average retail tariff is projected to reach 7 US cents by 2005. The conclusion of these agreements allow the Government to wipe the slate clean on past transactions, while allowing the new rules to operate for new investments in the sector that would improve transparency and ensure public scrutiny of decisions. It also contributes to increasing confidence of potential foreign investors, although more will be needed to fully restore such confidence.

Parliament plays an increasing role in the overall policy framework for the sector. Although the President still has the prerogative to set tariffs, such decisions are now based on discussions with the cabinet and consultation with the DPR. The Executive’s understanding of its

accountability to the public was underlined, when large public demonstrations in January 2003, against planned tariff hikes, received an attentive ear from the government.

Sector restructuring was initiated in 1998 in a White Paper, which set the directions for enabling competition, unbundling of PLN, and further inclusion of regional interests and social objectives. The new Electricity Law that followed (Law 20/2002) aims to separate the social and the commercial roles of PLN and attempts to introduce effective competition. A Blueprint Paper (April 2003) sets out the Government's vision, policies and programs for implementation of the law. So far there are no implementing regulations for the law, but these will be drawn up as part of the step-wise approach. The Law provides for progressive competition both within generation and distribution. PLN itself is expected to be split up into a number of operating entities some located at headquarters and some in the regions.<sup>115</sup> Under the law, Regions will be able to invite private operators or local governments to operate the distribution network. The law stipulates that at least one region should be applying competition in power generation within the next five years (Java-Bali). The privatization and decentralization aim to improve services to the population. Government will hold the overall responsibility for sector strategic planning and local governments will prepare regional electrification plans. The regional plans will have inputs from civil society and are expected to reflect local priorities. Area specific tariffs may be applied, and it is assumed there may be more social responsibility to supply outlying and non commercial areas, when local interests come into play. Some areas will not be able to attract competition and the law envisages that the authority for licensing and regulation will be given to the respective layers of regional Government.

The law, if properly implemented will change the accountability framework profoundly. The executive cedes power to an independent regulatory body, the Electricity Market Supervisory Agency (EMSA) by September 2003. EMSA will be accountable to the President, with its members being appointed by the President following the approval of parliament. The legislative branch plays an overall monitoring role. EMSA will be responsible for regulating and supervising power enterprises operating in regions and ensure fair competition where this is introduced.

For the consumer the changes intended to materialize over the next decade should ensure services better suited to local needs. EMSA is charged with ensuring that public consultations really happen and that a public complaints handling procedure becomes operational. EMSA will facilitate dispute resolution, and supervise implementation of business license conditions, and impose administrative sanctions for license violations.

The Government's "Committee for the Policy for the Acceleration of Infrastructure Development (KKPPI)" is in the process of revising Keppres 7/1998, the decree on private participation in infrastructure. It is now envisaged that the new decree will also replace Keppres 81 of 2001 (which established KKPPI) which will give KKPPI an explicit role in guiding and overseeing the implementation of the new policies. It is essential that the new decree reflects international best practice as regards securing private participation, and especially as regards solicitation processes, and dealing with unsolicited bids in order to reduce opportunities for corruption. Efforts are also underway to improve public procurement with a view to getting better value for money (see Chapter 2).

*...but risks of corruption remain*

Whether corruption is reduced will depend on the quality of the implementing regulations. It is important that they fully respect the spirit of the new electricity law. However, a new regulatory framework is not enough. There is a general fear that the well intended legislation will be hijacked, because the regulatory framework will not be adhered to. Will the regulatory body, EMSA, be able to ensure fair competition, when history shows that collusion of business interests is so pervasive and the legal system continues to be so corrupt? Will government desist from export credits that do not insist on competitive international tendering? The establishment of private monopolies instead of a public monopoly could mark up the price on investments and licenses to operate could be bought. Transparency measures and access to information must be ensured, not only for the public to monitor fair play in business, but also to ensure that private interests do not override public concerns of social outreach, equity and environmental concerns.

*Government needs to address investor concerns*

In summary, the overarching challenge facing Government and PLN is to mobilize financing for the massive investments needed to meet present and future power needs while implementing the sector and corporate restructuring needed to cement the new accountability framework, enhance efficiency, address regional and social equity issues, and limit contingent liabilities. Many important building blocks have already been put in place and the April 2003 blueprint outlines the scope, sequencing and timetable of the next steps.

In order to attract financing for the electricity sector it is crucial to implement Law 20/2002. Government's first priority should be to complete the Government Regulations and other subordinate decrees needed to implement Law 20/2002. These must be issued quickly and be fully consistent with the intent and spirit of the law so as to further restore and enhance investor confidence. EMSA's role as the new regulator, will be of critical importance for the sector's accountability framework to work in a democratic and transparent manner.

The mobilization of private financing will be indispensable to meeting the growing power demands of Indonesians. However, PLN payment risk is viewed as the largest impediment for private financing of power generation projects. Given the long lead time required for the implementation of power generation projects—in particular private projects—the government should provide risk mitigation measures to facilitate the financing of private sector generation projects. Private investors' perceptions of political and regulatory risk have been exacerbated in the power sector after the financial crisis and while the resolution of many of the IPPs has improved the climate, there is a need for the government to explicitly address such issues.

**NATURAL RESOURCES FORESTRY**

The state is typically responsible for a nation's forests on behalf of the people. It either owns or regulates the management of land under forests, and regulates the development, exploitation and preservation of forests and forest land. In Indonesia, the Constitution places the government in charge of natural resources. There is a Basic Forestry Law 1999/41 (*Undang-*



*Undang Dasar Kehutanan*) which superceded the 1967 law that governs forest management. The Consensus Forest Boundary-setting or TGHK of 1983 gave the state jurisdiction over three-quarters of the nation's land area. A comprehensive legal and administrative framework for management of Indonesia's vast (143 million hectares) and valuable forest resources was developed in the late 1960s. The Ministry of Forestry, previously a Directorate General in the Ministry of Agriculture, was created in 1983. It was given access to a large extra-budgetary source of funds, called the Reforestation Fund. It also collects royalties and concessions and other fees. The Ministry of Forestry was in effect the regulatory authority for forestry, an awesome responsibility given the size of the land area under its control.

This formal accountability framework broke down consistently because when faced with the conflicting objectives of conserving the national assets and generating rents, Soeharto in this case did not attempt to try to meet both objectives (see Chapter 1) but instead established a franchise system that conferred benefits on a privileged few allowing over the three decades a substantial erosion of the country's forest wealth.<sup>116</sup> The New Order Government moved quickly to increase commercial logging when it came into power, both to boost the economy and to expand the flow of funds through the state apparatus. The system comprised:

- (1) selling forest exploitation rights or their extension or both;
- (2) accepting bribes to ignore rules related to forest over-exploitation and other illegal felling, and industrial overcapacity which were a direct result of (1); and
- (3) mismanaging subsidized reforestation and rehabilitation projects to repair the damage caused by (1) and (2), and by the mismanaged projects themselves.

### ***Plywood exports - an example of state capture***

As Christopher Barr observes, Soeharto recognized that a "system of privately owned logging concessions was well suited to support [his] political objectives (to cultivate and solidify the personal loyalty of the regime's military and bureaucratic power holders) in that it would allow transfer of substantial economic rents".<sup>117</sup> Timber concessions were issued (covering 60 million hectares) to privately owned companies and three state-owned enterprises (*Inhutani*). The rights of exploitation were given out in a highly discretionary and non-transparent fashion. Initially, foreign companies combined with local power interests (the military, cronies et. al.) came to dominate logging in natural production forests. Commercial timber extraction was increased to the extent that by 1980, Indonesia had become the world's largest exporter of tropical timber.

In 1985, the Government strictly enforced a 1980 ban on log exports, in order to support development of a plywood industry and other downstream investments. For good measure, a similar export ban was imposed on sawn timber. Plywood exports increased to a level where Indonesia supplied over 70% of the world's tropical plywood. Squeezed out of investment opportunities in logging operations, almost all foreign companies were reluctant to engage in downstream investments and sold their companies to local partners, and the largest concessions gradually fell into the hands of a small group of Soeharto's business associates, dominated by Bob Hasan and Prayogo Pangestu, often referred to as the "timber tycoons". State banks were instructed to offer concessional loans to a privileged few on a case by case basis.

Barr has documented well the capture of Indonesia's forest industry by these timber tycoons.<sup>118</sup> As he notes, the Indonesian economy was in crisis in the mid 1980s, and the Soeharto-timber tycoon alliance prompted the state leadership to discourage the Central Bank (which had suspended further credit allocations to investors in the plywood industry) from taking 'aggressive' measures to call in outstanding loans.<sup>119</sup> President Soeharto's closest ally, Bob Hasan, had over a number of years organized plywood producers in the Indonesian Wood Panel Association (Apkindo) that was given government recognition as an agency supporting national development. He kept an iron grip on producers in the cartel through mandatory fees for all plywood exports and for membership of Apkindo, as well as through obligations to sell to import marketing bodies he controlled in the major Japanese and South Korean markets, and through pressure to use his ships, his insurance companies and a quality control agency, all in the name of exploiting Indonesia's market advantage and bargaining power in international markets.

Apkindo effectively functioned in lieu of state regulation in the forest products development sector, and its marketing monopoly shaped sector strategies. Together with Bob Hasan's control of the Indonesian Association of Forest Concessionaires (APHI), about a dozen commercial groups gained control of most concessions and through close relationships with President Soeharto, were able to enjoy a range of official privileges for their plywood industries from direct subsidies for vertical integration to export bans on logs and sawn timber that depressed the prices of logs as they raised the world price for plywood from tropical timber. Enjoying similar privileges were the parastatal *Inhutani* companies. The plywood development paradigm shifted Indonesian plywood production from high-grade to high-volume-low-grade plywood which had serious consequences for the forest eco-system. Forestry resource under-valuation as a result of the log and sawn-timber export bans, depressed domestic prices, resulting in more tree species being harvested and wastefully utilized both in the forest and the processing mills. Thus, the artificially low domestic prices for logs did not convey the true scarcity value of the resource.

### ***Regulations to the rescue of the "stick"-holders***

High profits from logging that could ignore externality costs, evade taxes and enjoy a policy-protected, high price margin between raw materials and export of plywood, drew expectations of a share in the spoils among forestry agencies, law enforcers and the military, primarily through bribes to evade forestry resource management regulations. Since the passage of the 1967 Forest Law, some 1000 policies and regulations have been issued, with a questionable impact on deforestation (see Box 4.1).<sup>120</sup> Some regulations are flatly contradictory or impossible to meet. With or without corruption, it is unlikely that any log produced could be in full conformity with all rules and regulations. As national and international concerns grew about the plight of Indonesia's forests, more regulations were issued. This in turn invited more bribes paid to circumvent them; some policies seemed designed with this in mind. Hence, to the abuse of regulations was added the misuse of regulations or so-called policy corruption.

Nor did government have much capacity to enforce such regulations even if it wanted to: the overall ratio of forest civil servants to the number of hectares under public forests is around 1:3,500. But when it comes to forest protection, the ratio is around 1:12,000 hectares. The areas

to be covered are daunting for forest rangers with limited transport and communication and operations and maintenance resources.

The majority of Indonesia's forest policies were issued in connection with concession management, by far the most lucrative part of the forestry domain for both the private sector and forest bureaucracy alike. Local communities were excluded from having any say in the exploitation of land and water resources within their village domains, with devastating consequences for the livelihoods of the poor. Village lands were often arbitrarily classified as state forest land, resulting in destruction by licensed loggers of farmland, cultivated agro-forests, natural forest reserves for extraction and conservation, and water resource systems.<sup>121</sup> Compensation offered was minimal. It was far easier and more profitable to extract bribes from private company officials than from scattered, poor village communities.<sup>122</sup> (such rents would have never percolated upwards to Ministers and Director Generals).

Over time, a large reforestation fund was collected from resource rent taxes collected for every cubic meter of logs harvested, to finance rehabilitation and reforestation that regulatory corruption had allowed. The fund was egregiously mismanaged. Independent auditors<sup>123</sup> estimated that royalty revenues in the late 1990s were under-collected by about 50% due to an underreporting of log production which was made possible through payments of bribes to government inspectors. Revenue from the Reforestation Fund was misallocated to non-forestry investments and wastefully used in reforestation programs that were inadequately audited.<sup>124</sup> Following an independent audit in 1999, the Ministry of Finance took control over the Fund and also oversees the collection of royalties and concession fees.

The consequences for Indonesia's forest ecosystem were ignored, allowing the environmental services of the natural forest to be severely degraded. Landsat remote sensing imagery data show that Indonesia has been losing some 1.7 million hectares of forest cover each year. A conservative estimate of total government revenue losses from forest corruption during the 12 years of the plywood development era (1985 to 1995) would greatly exceed US\$5 billion. The Ernst and Young audit of the Reforestation Fund commissioned by the Ministry of Finance concluded that for the five-year period, 1993/4 to 1997/8, US\$5.252 billion were lost as the result of mismanaged collection and allocation (Ernst & Young, Special Audit of the Reforestation Fund, 27 December 1999).

### ***What undermines sustainable forest management***

In addition to the elite capture of the sector described above, corruption has systematically undermined forest management in Indonesia. Three forces are at work. First, uncertainty of tenure both for large and small-scale enterprises has created "neighborless forests", where forest land users pay little heed to the effects of their exploitation on adjacent areas and where short-term investment time horizons mean that 'taking is favored over making'.<sup>125</sup> The uncertainty is created by secretive and highly-discretionary processes for forest concession granting, extension and cancellation licenses (for less lucrative) community forestry are restricted to temporary permits. Second, undervaluation of forest resources driven by misguided policies directly or indirectly encourages wasteful utilization and raises the opportunity cost of sustainable forest management, in turn encouraging conversion to higher value-added and labor-absorbing agriculture.<sup>126</sup> Third, unregulated externalities further favor

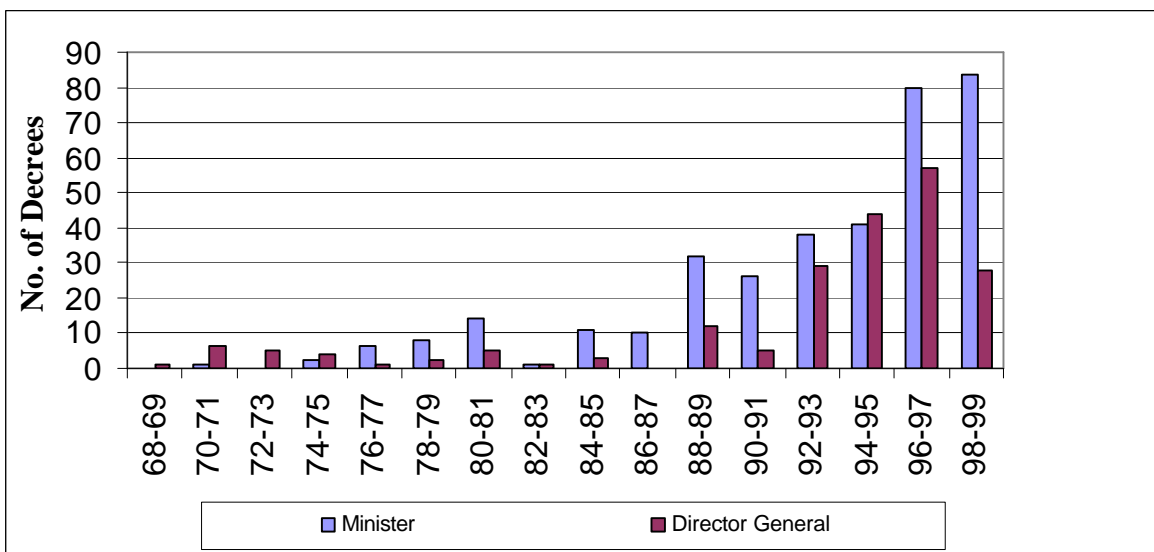
“taking rather than making”. Lack of enforcement of the rule of law in the sector and inappropriate regulations that rely upon the “law of rules,” namely, overly-prescriptive regulations deter site-specific adaptation and innovation, favoring minimalist rule compliance that loses sight of sustainable forest management goals, and invites corruption of the “stick-holders”, i.e., those who make and enforce the rules.

Anecdotal evidence suggests that during *Reformasi*, forestry corruption, like corruption in other sectors, is undergoing a transformation to become more fragmented and disorderly – although guided by the same principles as before: sell forest exploitation rights, accept bribes to ignore exploitation damage, mismanage funds to repair the damage and deflect blame for deforestation and impoverishing outcomes. Forestry corruption is being reshaped by the democratic transition and “messy” decentralization. The bulk of rent-seeking, it would appear, has moved away from the center to the regions despite efforts at re-centralization (driven by concerned, conservative voices as well as those yearning for the re-capture of lost rents).

**Box 4.1: Forestry Policy Development, 1967 to 1999**

Forestry-related Laws & Decrees	Total	In-force	Revised	Revoked
Laws	26	<b>21</b>	3	2
Government Regulation	55	<b>32</b>	2	21
Presidential Decree	53	<b>39</b>	9	5
Ministerial Decree	490	<b>270</b>	94	126
Director General’s Decree	292	<b>166</b>	38	88
Totals	916	<b>528</b>	146	242
%	100%	<b>58%</b>	16%	26%

**Figure 4.2 Ministerial and Director General Decrees for Forest Concession Regulation**



Some upcoming trends:

- the issuance of mini-concession licenses by District Heads in a highly discretionary manner.
- under-reporting of log production by concessionaires takes place alongside a multiplicity of illegal logging and smuggling activities.
- as the Ministry of Forestry reduces the annual allowable cut for Indonesia (halved in 2002 to 12 million m<sup>3</sup>, halved again in 2003), so the wood-based industry makes up the shortfall by relying more on supplies from unlicensed illegal loggers.

### ***Will decentralization come to the rescue?***

There are reasons, however, for cautious optimism. Arguably, the greatest failing of past central control over forest resources, and de facto if not de jure control of districts over forest resources has been the lack of sufficient accountability to stakeholders, particularly local communities. This has its origins in Article 33 of the Indonesian Constitution which assigned the government as steward of natural resources for the greater good of the Indonesian people. Decentralization, with all its “messiness” (see Chapter 4) has brought government closer to the people. Of course populist policies can result in selling natural resources to “buy votes”. On the other hand, it is less easy to accept bribes that allow loggers to destructively harvest in ways which undermine village livelihoods. In the past, bupati could always deflect criticism by claiming to be powerless in the face of decisions made in Jakarta. This is still true for most large scale concession licenses. Some districts are developing local regulations (PERDA) for participatory sustainable forest (and natural) resource management. A draft natural resource management law reflects the spirit of greater transparency and community participation. Across Indonesia, floods, landslides, erosion and sedimentation problems are prompting district and provincial local governments to insist on better managed reforestation projects.

The spotlight on illegal logging that has intensified over the last three years is timely. Anti-corruption forces in government forestry agencies, private industry, NGOs and the media work together against the entrenched and influential interests in government and private institutions who pull in the opposite direction. Solutions are easier to identify over the long-term as the wider political and institutional environment develops, e.g., laws on transparency, conflict resolution, agrarian reform, natural resource management and civil service reform. Four strategic steps would have far-reaching positive effects in the long struggle to eliminate major corruption in the forestry sector, each building greater accountability:

- First and foremost, government commitment to **transparency** in the sector is crucial, particularly in the area of exploitation license issuance, extension, cancellation and also current information on (a) *actual forest cover* (area and quality); (b) *official forest boundaries*, and (c) *reforestation fund planning*, ensuring that each is fully accessible to affected local governments and their local communities. Transparency is a crucial first step where there are entrenched and influential vested interests against reform.
- Second, fostered by the first step, government commitment to greater **inclusiveness** in decision-making about forestry (and natural) resources is needed, so that the voices and

choices of those whose livelihoods are directly impacted are heard, above all in the three focus areas for increased transparency.

- Third, a radical **rationalization of forestry regulations** is required toward an outcome-based system that focuses the goals of regulation to the attainment of medium-to long-term outcomes and thus reduces opportunities for corruption while encouraging innovation and efficiency. This principle would also need to be applied at the local level to preempt a mimicking of the corruptible policy corpus developed at the national level.
- Last, and by no means least, political will nurturing crucial mutual trust is needed to achieve good **decentralized governance of forestry (and natural) resources**.

Decentralization with enhanced accountability holds the key to resolving rampant corruption in the forestry (and natural) resource sector. Given that the nexus of decentralization is the district, it is important to see accountability go both ways, not only upward to higher levels of government administration—provincial and national—but also downward to lower local community levels. Village-driven accountability consists of both obvious electoral and more immediate dimensions, e.g., an association of villages sharing the same watershed where waterways are polluted by a logging concessionaire's improper road-building.<sup>127</sup> The four steps above promote accountability of district governments (who can also hold higher levels of government administration to similar standards) and lay the foundations of corruption control in the forestry sector and the prospect of poverty reduction that comes with reduced corruption. These principles would also apply to combating corruption in the natural resource sector as a whole where there are other “lootable” resources, e.g., mining and coral resources. Indeed, the solution may yet be to approach the forestry corruption problem as a sub-set of the problem of natural resource misgovernance, in the context of the long-promised natural resource management law awaiting parliamentary approval.

## **POLICY IMPLICATIONS**

This chapter has explored how accountability has failed in three key sectors of Indonesia's economy: (1) the failure of regulators and state-owned banks in banking to prevent depositors' funds from being plundered by their owners and by borrowers who have limited interest in repaying loans; (2) the deliberate over-padding of infrastructure costs to finance rent seeking at the expense of consumers and tax payers; and (3) the elite capture of Indonesia's forests at the expense of its environment. Central to each of these stories is the active involvement of the Executive Branch at all levels, leading and managing the process.

Corruption under *Reformasi* is no longer being managed and organized from the top. The political will to fight it is still not sufficiently evident. This is at the heart of the continuing failures of accountability discussed above. The financial sector, infrastructure and forestry were the cash cows of the New Order. In the absence of effective measures to enhance accountability and transparency they could well become major cash cows for a new democracy where political parties are actively competing for scarce funds to fight elections that are highly costly. As noted in Chapter 1, the relatively advanced democracies have not been particularly successful at

solving this problem so one cannot expect Indonesia to do so very easily. This is one of the primary factors driving political attitudes to reforms that would reduce corruption in this area. Thus, while Parliament, for instance, has passed quite far-sighted laws that would remove the monopoly power of the major state-owned enterprises, opening the way for competition, politicians appear reluctant to take measures that might reduce opportunities for raising funds to sustain them in power. Pressure on members of parliament to collect funds for their party is believed to influence the way parliamentarians vote and how they exercise their role as a check on the executive. Only a vigilant and educated electorate can change the incentives politicians face, and that will take time.

Reformers continue, however, to push the envelope, as is evident from their sporadic success such as with the infrastructure laws. Much more still needs to be done to strengthen accountability. The key common policy lessons from all three sub-sectors discussed above for strengthening accountability of the government as regulator are:

- First, policies relating to the regulation of the private sector and banks, particularly in relation to the nation's key assets, are necessarily complex and it is difficult to reconcile competing interests in a society. Capture by vested interests takes place when these policies are prepared by stealth and are not subject to public discussion and scrutiny. Authoritarian regimes have an interest in ensuring lack of transparency. A key requirement will be access to information, and the generation of data that allows the public and regulators to review the effectiveness of government actions. Parliament has a key role that it must learn to play better, but the Executive would also benefit from establishing processes that require public consultations and enable the government to formulate policies that are understood and accepted by all sections of society. This is particularly important in a decentralized context where there is need to be as much accountable to Parliament and the Executive branch as to local communities whose lives are intimately affected by government policies.
- Second, state enterprises continue to play a very large role in the economy and remain a source of weakness. They appear to be accountable to no one, and are generally subject to little oversight. State-owned banks are the weak link in the chain of improvements being made to financial sector accountability following the financial crisis. This is true of state enterprises in other sectors. Better oversight from the government as owner and from regulatory agencies is crucial, as is proper financial auditing. Bank Indonesia should be encouraged to rigorously supervise state-owned banks. Subjecting SOEs to the discipline of improved corporate governance and transparency will also expose these enterprises to greater public scrutiny. Once regulatory authority improves, privatization could be accelerated.
- Third, the laws have improved or are improving. They will, for instance, introduce a significant degree of competition in infrastructure provision if properly implemented. But the proof of the pudding will be in the eating. Laws rely on the issuance of detailed high quality regulations if they are to be implemented. Here, there has been little to no progress in the issuance of regulations in many of the new infrastructure laws. Such delays were quite common in the New Order, allowing politicians and civil servants to pursue their merry ways under the shadows of confusion created by the absence of regulations. Regulations can be deliberately drafted to subvert the intent of the law or as simple rent-creation mechanisms, as in the case of forestry, by creating rules that are difficult to follow so that they attract rents to permit avoidance. Improving the ability to draft regulations and subjecting these to careful

scrutiny to ensure they enhance accountability will be crucial. Government may also want to consider presenting to parliament draft regulations that go with each law to be enacted so that delays in issuing regulations are eliminated and consistency between the laws and regulations can be enforced. A related priority would be to begin to rationalize and simplify the regulatory jungle, a source of much corruption and regulatory capture. Regulations need to be drafted in close consultations with civil society in an open and transparent process.

- Fourth, the regulatory agencies that are being set up, such as in the financial sector or infrastructure, or those that already exist, need to be independent and highly competent, particularly to regulate competition and ensure that there is no abuse of monopoly power. To perform their functions well they will need at their helm men and women of high integrity, who are paid at least as well as those who they regulate, and who are empowered to do their job without looking over their shoulders to their political masters.
- Finally, the lack of an effective justice sector is a common theme throughout this chapter. The failure to enforce contracts, to bring those stealing bank assets to justice, to enforce forestry laws and to hold infrastructure providers to account through public interest litigation all point to the need to reform the justice sector, discussed further in the next chapter.



## 5. Corruption and the Justice Sector<sup>128</sup>

*In a modern democracy, the justice sector helps ensure accountability by enforcing the rule of law and protecting the rights of citizens. In Indonesia, a tragic combination of low professional standards and widespread corruption compromises the sector's ability to deliver on its mandate. Indonesians see the key justice sector agencies as among the most corrupt and least efficient organizations in the country, and NGOs report that corruption dominates each stage of the justice cycle. Indonesians vote with their feet and seek other informal means of resolving disputes or seeking redress. Reformasi has seen the beginnings of efforts to improve the accountability of the sector. New laws govern most agencies, and new agencies have been created to help fight corruption, including an Anti-Corruption Commission. The newly invigorated media and NGOs are actively monitoring the performance of these agencies.*

*Accountability however fails at three levels:*

- *The average Indonesian voter appears not to care enough about reforms in the justice sector to put pressure on his elected representative to reform the system.*
- *Parliament and the Executive do not fulfill their responsibilities to citizens and to the justice sector agencies by failing to lead and coordinate a reform process and by substantially underfunding these agencies. These agencies meet their financing needs through a range of unofficial and illegal activities, and in the case of the police, through formal and informal enterprises and foundations. Some police activities are allegedly criminal in nature (prostitution, drug running, and protection rackets) and this has led to conflicts with the military which is engaged in similar activities. Little has been achieved so far to enhance the professionalism of the police and PPS, or to increase the risks of punishment for corruption. The Supreme Court has initiated an institutional audit that could pave the way for reforms if adequately funded and supported. A new Judicial Commission could also shift incentives in the courts, but there are the inevitable questions about who guards the guardian.*
- *The justice sector agencies do not see themselves as service providers and therefore are not accountable to their clients, lacking both transparency in their procedures and effective complaint resolution mechanisms. Clients are also often ill-served by their lawyers, many of whom are conduits for bribes to judges, public attorneys and the police.*

*Reforming the system will require strong leadership from an official who has the full confidence of the President, and appointment of committed and skilled reformers to head key agencies. It will also require a road map for justice sector reforms that goes beyond the key agencies and covers such issues as legal education and regulation of the legal profession. Each agency needs to develop a governance action plan and be subjected to a comprehensive independent resource needs assessment. Transparency could be facilitated by requiring the publication of court judgments, laws and regulations, and by developing indicators of performance for each agency that can be monitored by the public. The odds are stacked against the new Anti-Corruption Commission given global experience with such agencies and the Government's own poor track record nurturing new organizations. With strong Commissioners, adequate budget support and a strategic and selective work program that does not stretch its capabilities, the new Commission could prick the bubble of impunity that surrounds efforts to fight corruption in Indonesia.*

In a modern democracy, the justice sector plays a key role in ensuring accountability. The executive and legislative branches of government jointly determine a country's constitutional and legal framework, reflecting as best they can the views of citizens. The justice sector safeguards such a framework, enforcing the rule of law and protecting the rights of citizens and minorities. Enforceability is thus central to any system of accountability and the justice sector is responsible for such enforcement. It is particularly important to moving, as Indonesia is attempting to do, from a society based on informal networks, to one based on rules. An effective rules-based society requires effective justice sector institutions that enforce the rules and validate/invalidate private and government actions. The police, the public prosecutors and the judiciary together represent the larger interests of citizens, and not just the government of the day.

In Indonesia, such enforceability is heavily compromised by a dysfunctional justice sector. Widespread corruption in the sector corrodes the rule of law. It also creates virtual impunity for the corrupt. Over time, this corrodes citizens' faith in public institutions and is, therefore, a major potential threat to Indonesia's young democracy. It makes society very vulnerable to those who are intent on destroying the country's social fabric, such as those involved in drug smuggling, prostitution and terrorism. It is also costly for Indonesia's economy. Lack of predictability is now a major concern for investors and partially explains the weak foreign investor response to Indonesia's reform efforts. This chapter examines why accountability is so broken in the justice sector and how that might be remedied. It begins with a brief overview of external and domestic perceptions of corruption in the justice sector, reviews efforts to strengthen accountability in the sector, examines why accountability breaks down in each instrument of the law: the police, the public prosecutor and the courts, and then considers some policy implications.

## **The Extent and Nature of Corruption**

### *The justice sector is widely viewed as dysfunctional*

**Surveys of perceptions on the rule of law show Indonesia ranking low among other countries in its income group, to countries in the East Asia region and among the large developing countries (see Figure 5.1). Foreign investors in the 2000 Business Environment Survey see Indonesia's courts as extremely corrupt and dishonest, compared to other major developing countries (see Figure 5.2).**

This view is shared by the Indonesian public. In the 2001 survey conducted by the Partnership for Governance Reform in Indonesia,<sup>129</sup> the Indonesian judiciary and public prosecution service were ranked among the most corrupt and least efficient institutions in Indonesia, just below the traffic police and Customs, and only slightly higher than the tax authority and the regular police. Business respondents took a slightly dimmer view of the sector than households, since they had more direct experience of the sector (see Table 5.1).

As a consequence, households tend not to use courts to resolve disputes, with eight out of ten households preferring instead to seek informal means including family and friends and religious leaders and local community leaders. Businesses also reported a significant use of

informal means of dispute resolution (two out of three) with the most prevalent formal intervention taking the form of reporting a problem to the police (46%).

**Table 5.1: Perceptions of Legal System Institutions for Honesty and Efficiency**

<b>(Scale of 1 to 5)</b>	<b>HOUSEHOLD</b>	<b>BUSINESS</b>	<b>PUBLIC OFFICIALS</b>
<b>INSTITUTION</b>	<i>Mean Score</i>	<i>Mean Score</i>	<i>Mean Score</i>
<b>Lowest:</b> <b>Traffic Police</b>	2.16	2.13	2.56
<b>Judiciary</b>	2.31	2.29	2.76
<b>Public Prosecution Service</b>	2.36	2.31	2.77
<b>Police, excl. traffic police</b>	2.40	2.37	2.89
<b>Ministry of Justice</b>	2.48	2.48	2.94
<b>Highest:</b> <b>Mosque, Church, Temple.</b>	4.31	4.24	4.55

Source: Partnership for Governance Reform in Indonesia, "A National Survey of Corruption in Indonesia, Final Report December 2001", p.23.

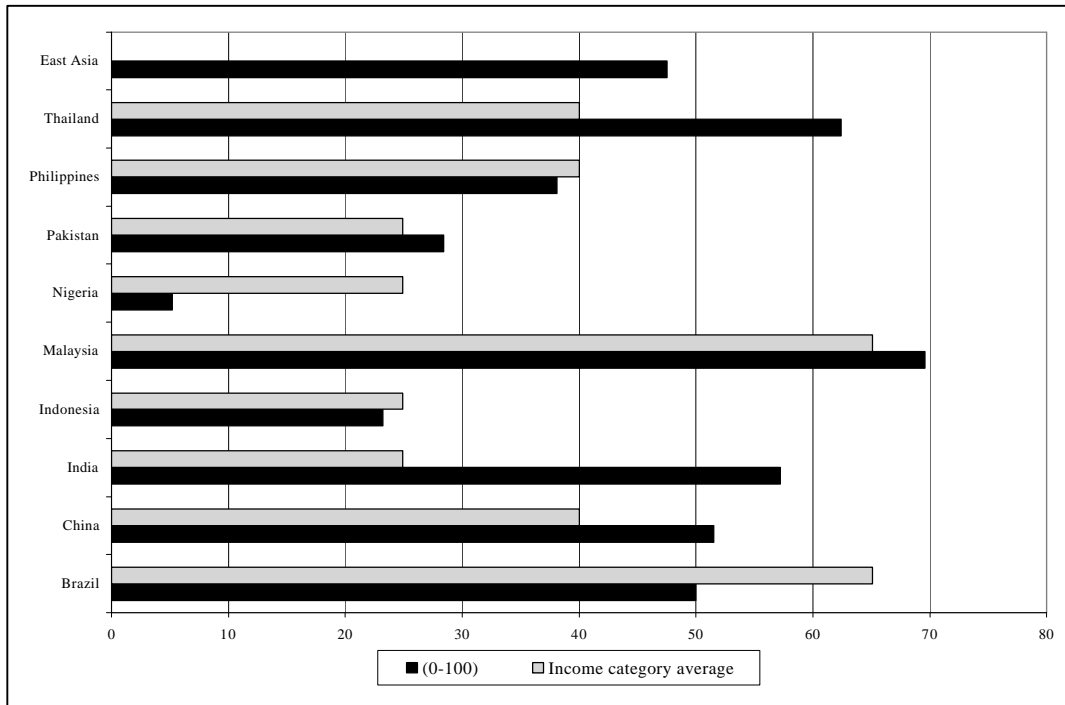
When asked what they saw as obstacles to using the courts, both households and business enterprises cited the likely unfairness of decisions, the length of time it would take to settle the matter, high unofficial costs, and the likelihood that the court decision would not be enforced, and the lack of competence of judges. High official costs were also cited, but since there is little transparency about court charges, it is not clear respondents knew which costs were official and which unofficial costs. An Asia Foundation survey,<sup>130</sup> carried out at the same time, had similar findings. Faced with a justifiable legal dispute (63% of respondents), the majority (57%) pursued informal solutions, a fifth opted for legal action and almost a third chose to do nothing.

### ***Corruption Occurs at each Stage of the Justice Cycle***

Despite the lack of hard evidence, much is known about the nature of corruption in the justice sector. Based on in-depth interviews with informants and by following a number of cases in the Greater Jakarta courts, Indonesian Corruption Watch (ICW) has published its findings on the modus operandi of corruption in Indonesia:<sup>131</sup>

"Judicial corruption is not....considered anything unusual in Indonesia. Many lawyers feel no shame at offering sums of money to judges and attorneys in specific cases...at the same time, there is no sense of shame for judges, attorneys, police and registrars to solicit money from lawyers. Whereas in the past corruption was handled secretly, it is now carried out openly. We need no longer talk about the courts as a place to find justice, but as a place to buy justice. Whoever pays the most will get the "justice" that he/ she wants".<sup>132</sup>

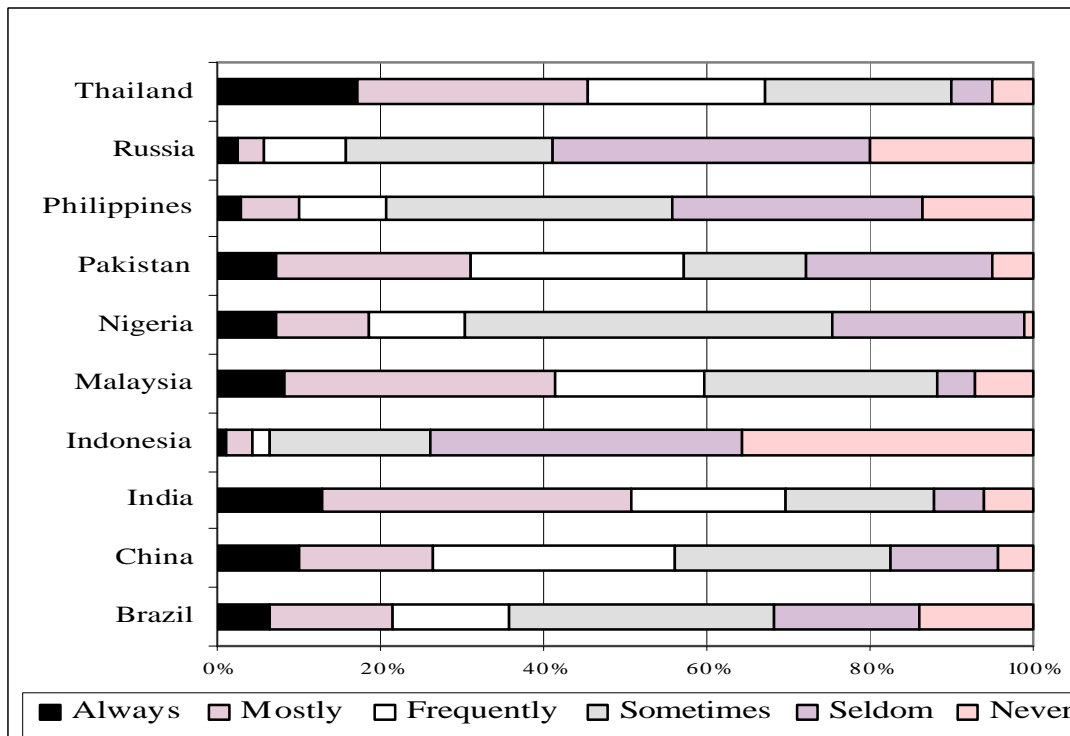
Figure 5.1: Rule of Law



Source: D. Kaufmann, A. Kraay and M. Mastruzzi, 2003: Governance Matters III: Governance Indicators for 1996-2002

Figure 5.2: Honesty of courts in business disputes

How often do you associate the following description with the court system in resolving business disputes?  
"Honest and Uncorrupt"



Source: World Business Environment Survey 2000, World Bank

### Box 5.1: A Guide to Corruption in the Criminal Court System

In criminal cases in Indonesia, money changes hands each step of the way. Indonesia Corruption Watch<sup>133</sup> reports inter alia that:

- Cases can be dropped for lack of sufficient evidence, particularly when the perpetrator has been caught in the act of a crime, by paying the policeman on the spot. A payment can also cause a case to be dropped before anything is noted on paper, or the Investigation Report (*Berita Acara Pemeriksaan*) to be tampered with to reduce the severity of the crime or the public prosecutor to be persuaded to issue an SP3 (*Surat Perintah Penghentian Penyidikan*-Instruction to Cease Investigation).
- Investigations can be dragged out as an inducement to the defendant to pay the public attorney his “processing fee”
- The charges to be brought can be negotiated as can the place of detention.
- When a case comes to trial, a “sympathetic judge” can be arranged through the Court Registrar.
- The verdict can be “arranged” for a fee, through the public attorney, the defendant’s lawyer or by dealing directly with the judge. A postponed verdict is usually an invitation to begin negotiations with the judge. Even if a defendant has a strong case, and good witness, there is no guarantee that justice will be done without paying.
- The verdict can be delayed, or, better still, the sentence need not be implemented. A doctor’s letter saying the defendant is ill, along with an appropriate inducement, is sufficient to prevent the sentence being implemented. Visiting a prisoner in jail also entails a cost from Rp.10,000 (\$1.25) to Rp.50,000 (\$6) for a fee (Rp.500,000-Rp.1,000,000 -\$60-\$120), a prisoner can negotiate a two-day leave from prison.

What becomes clear from this careful documentation is that corruption prevails at every stage of the justice cycle (see Box 5.1) Variations around this theme occur in other courts. In the case of the higher courts including the Supreme Court, there are believed to be long established relations between judges and lawyers. Judges in lower courts are alleged to be in the habit of giving “gifts” to their superiors to ensure that are promoted or not posted to undesirable places. This then creates an appetite for raising funds to meet these costs.<sup>134</sup>

## ACCOUNTABILITY WITHIN THE JUSTICE SECTOR

Accountability issues vary with each key justice sector service provider: the police, the public prosecutor and the courts, and these are reviewed in turn below. Common to each sector is that they all face a substantial change in their mandate from their principals. During the New Order regime, the implicit and sometimes explicit assumption was that the key agencies, and sometimes even the courts, served at the pleasure of the President and worked in the interests of the Regime. Today, these same institutions must make the huge cultural shift to seeing themselves as servants of the people. This will not be easy, since the newly elected leadership, conditioned by years of authoritarian rule, tends to see these institutions as instruments of power.

Nevertheless, important changes are underway. The voice of citizens has been strengthened through a free press, through a vigorous civil society, and through free elections. This in turn has put pressure on the executive and legislative branches to change the rules of the game. New laws now govern most of these institutions. While they are far from perfect, they mark a change in the governance of these institutions. Recognizing the depth of corruption in these institutions, the State has also moved to arm itself with new institutions that it is hoped will be free from some of the problems facing the existing institutions. These include the office of the Ombudsman, the Commission to Audit the Wealth of State Officials and the soon-to-be-

established Anti-Corruption Commission.<sup>135</sup> Finally, there is direct citizen pressure on these institutions, demanding information on the services they provide and a reduction in corruption. This takes the form of lively debates in the press, in policy think tanks, and direct monitoring of behavior of these institutions by NGOs. How these changes in the accountability framework are affecting the key justice sector agencies is now discussed.

### THE NATIONAL POLICE (POLRI)<sup>136</sup>

The National Police (*Polisi Republik Indonesia* or POLRI) has a poor reputation. As seen in Table 5.1, it ranks among the most corrupt and least efficient agencies in Indonesia in the eyes of its citizens. The man on the street –especially in Indonesia’s big cities, does not see the police as being there to serve and protect, but to tax and harass the public. Being flagged down by traffic policeman is an everyday experience for most Indonesians, and one that inevitably leads to a bribe. Most people know how much is expected of them and quietly pay. Senior police officials see such corruption as aberrant behavior on the part of a few individuals and small groups, and will cite as evidence “absence from duty, misuse of operational funds, extortion of money from members of the public, bribery in handling criminal cases, bribery and nepotism in appointments and promotions, protection of gambling and prostitution and acting as debt collectors.”<sup>137</sup>

“It is very difficult to change the perception of the Bintaro (lower rank policemen). They entered the corps because they think being a cop you will be feared and because you can make money. They view police corps as a way of freeing themselves from poverty, and so they cannot understand the concept of civilian police where it is the police who must serve the people, and not the other way around”  
- Slamet Haryono, a policeman in Yogyakarta<sup>138</sup>

The reality is that corruption is institutionalized. This can be seen from the fact that brokers operating outside Jakarta’s motor vehicle and driving license offices charge Rp. 250,000 to facilitate a license versus an official charge of Rp. 52,500, reducing the time it takes to get a license to a couple of hours, versus a full day. The amounts are undoubtedly carefully shared across the large number of officials involved in the relatively smooth and quick process facilitated by the broker. Similarly it is alleged that each of the 600 annual recruits to the police must pay a Rp.30 million bribe.<sup>139</sup> Further, almost any aspect of a criminal procedure can be settled or arranged by a “Markus” (Makelaar Kasus – a broker of cases). Moreover, the police is often alleged to be in the pay of local business interests, or involved in systematic protection rackets.<sup>140</sup>

The accountability framework for the national police under the New Order was governed by Law 28/1997, which saw security as the key objective of the police in serving the public interest. However, since the public interest was seen as the state’s interest, it was the state which was responsible for defining the public interest. It apparently saw the community as the main “source of disorders and disturbances, rather than those for whom order and security is maintained”.<sup>141</sup>

To reflect the new post *Reformasi* reality a new Indonesian Police Law was enacted by Parliament in January 2002 (RUU 2/2002). The law confirmed the separation of the police from the military, and the direct responsibility of the police to the President,<sup>142</sup> although the selection, appointment and dismissal of the Chief of Police must meet the approval of Parliament. It also created a new National Police Commission, which will, inter alia, supervise a complaints

procedure, and a Police Ethics Commission to examine officers suspected of breaching a new Code of Ethics. The law also allows police officers found guilty by the Ethics Commission to be prosecuted as ordinary citizens, a major change from the time the police was part of the military. The new Law does not discuss corruption but the new ethics code is unequivocal: “Asking money from members of the public in return for police services is wrong”.

Until the regulations have been drafted and the implementing mechanisms are ready, it is too early to judge whether the new accountability structure for the police will improve the situation. As noted frequently in this report, regulations can often undermine the intent of legislation. However, public consultations on the draft regulations, facilitated by the Partnership for Governance Reforms may have contributed to ensuring that the majority of members of the Police Commission are not from the Government. The formation of the Ethics Commission is still under discussion.

Despite these attempts at reform, the state fails its chief law and order service provider (as it does most other service providers) by continuing to grossly under-fund the police. The total police budget in 2001 was Rp.5.4 trillion, of which 77% was allocated for salaries for the approximately 250,000 police personnel. Basic salaries and allowances are very low, leaving even the highest paid officers with only around Rp.5 million a month. In a July 2000 survey, 83% of police officers stated that they needed to supplement their income.

Only about 14% of the total police budget is allocated for operational expenditures, including emergency funds. There has been no shortage of emergencies in the post Soeharto era, with the Marriott hotel bombing the latest example of the kind of crises the police have had to face. This leads to the familiar pattern of inadequate provisions for almost everything. Police units are provided cars but limited resources for petrol and none for maintenance. They must cover such expenses from their own pocket. Policemen are not given stationery to write out arrest warrants, and must provide typewriter ribbons, paper and pens themselves.

One “estimate” is that about 30% of actual expenditure on the police is included in the government budget. The rest is financed from a variety of off budget levies, business operations, contributions from the private sector, “operational cooperation,” grants and police-run foundations. This begins with new entrants to the police force who must “buy” their positions. As with other positions in government, this continues throughout a police officer’s career, with training, promotions, and transfers, particularly to “wet” or “dry” positions (referring to the opportunities such positions confer on the individual for corruption) and training all subject to internal levies. There are few hard facts and figures on the extent to which different off budget categories contribute to the police budget, and therefore, it is difficult to estimate the total cost of police operations. It is safe to assume that the police itself do not know.

The police’s business operations are an increasing source of concern. There is significant anecdotal evidence, ranging from the buying of influence, extortion and benefits from the rigid handling of crime procedures, to direct involvement in crimes. The rivalry between the military and police, since they were formally separated in 1999 has now surfaced openly through increasingly violent incidents between rival factions in each force over the control of local drug or prostitution rackets (such as the shootout and burning of a police station in Binjai, North Sumatra in September 2002 leading to some 11 deaths).

“The fights erupting between the military and the police in several areas is often because the military is behind certain individuals and they try to protect this person when police try to catch him for the crime and because of this arrest they will lose a lot.” - A Police Officer<sup>143</sup>

The one positive development is that public concerns have been translated into a great deal of NGO interest in the police, with an umbrella organization called Indonesia Police Watch leading the dialogue with the police. There are a growing number of examples of efforts to increase responsiveness and introduce elements of civil oversight. The Decree to create a new National Police Commission, which will supervise a complaint procedure and may become an accountability mechanism, awaits the President’s signature. Decentralization is also bringing pressures on the police to revisit its highly centralized top down structure.

### **THE PUBLIC PROSECUTION SERVICE (PPS)<sup>144</sup>**

The ADB-financed Price Waterhouse Coopers (PWC) study of the public prosecution service concluded that the public perception of rampant corruption in the service “has a substantial basis in fact”.

“Those who say that the public overstates the issue (of corruption), however, are probably wrong. We consider that the evidence is overwhelming, and not subject to serious dispute. To the extent that it happens, those sworn to uphold the law break the law”.

#### ***Why does the PPS’s accountability framework fail to work for the service?***

The Public Prosecution Service is headed by the Attorney General, who is responsible for ensuring that those accused of a violation of the law are brought to justice. The accountability framework for the Service is derived from Law 5/1991 which lists the functions to be performed by the Attorney General’s Office (AGO), including prosecution of criminal cases, determination of law enforcement and justice policies, coordination of criminal cases with other agencies, determining cases in the public interest, handling appeals to the Supreme Court, and providing advice to the Supreme Court and the President. Having been framed at the height of the New Order’s power, Law 5/1991, not surprisingly, does not establish an independent prosecutorial service. Rather, it is seen as part of the government. In a tradition of independent prosecutorial offices, prosecutors are servants of justice and of the people, rather than of the government of the day. *Even today, prosecutors are expected to prepare a prosecuting plan (rencana tuntutan or rentut for short) to be cleared by their superiors, opening the door to interference in their management of cases and reducing their individual accountability.* This also undermines professionalism in the service. This top-down approach to the management of the AGO is derived from the strong military culture that prevails despite the demise of military rule, underscoring the lack of a professional merit-based culture.

“Officers regularly wear military uniforms, conduct military ceremonies, give ritual salutes, and bring a military shape to every day life. Large group meetings begin with a formal call to attention, a report of readiness to the senior person in command, and an order to stand at ease”.<sup>145</sup>

The lack of independence for prosecutors is compounded by a lack of clarity in the division of responsibility between the police and the AGO in the investigation of cases. This is a source of confusion to both organizations as well as to the public. Until 1981, the prosecutor’s office had substantial authority over the investigation of all cases. The prosecutors effectively



supervised police investigations, and were free to conduct their own further investigation. Law 8/1981 restricted the role of prosecutors to the prosecution of crimes. However, Law 5/1991 once again enabled the AGO to “carry out additional examinations prior to submission of the case dossier to the law court” but stopped short of letting the AGO examine the accused. This lack of clarity has fed the traditional rivalry between the AGO and the police, a situation that is not unusual in other countries. To overcome this, particularly in the prosecution of corruption cases, the then Attorney General Marzuki Darusman established a Joint Team for the Eradication of Criminal Acts pending the establishment of the Anti-Corruption Commission. However, when the Joint Team began making significant progress in the investigation of corruption by a member of the judiciary, the Supreme Court declared that the regulation that established the Joint Team was invalid, resulting in the team having to cease its activities.

The AGO’s ability to function effectively and with integrity is impeded by a number of constraints. The most important is the two budget syndrome: one official budget provided by the state, the other an unofficial budget that is managed by the officers of the PPS and funded from the range of unofficial payments. PWC estimated that this budget is larger than the official budget, but is not subject to any scrutiny or audit process. The comprehensive system of payments, PWC reports, begins for a new entrant to the service with a recruitment fee of up to Rp.1 million, and continues throughout the new recruit’s career with additional payments relating to most career related actions such as promotions, transfers and training. Prosecutors are sometimes expected to pay for their food when on assignment, for work-related transport, for supplies, or to pay court clerks to schedule cases. Since the salaries of members of the PPS are not enough to fund these activities, they participate in a complex system of unofficial payments which leads them down the slippery slope to corruption. The payment typically comes from those seeking advantage for their clients, be they lawyers or brokers, or sometimes even the police. These unofficial payments systematically undermine the system’s integrity. Reform must begin here, as the PWC study notes, by fully funding the work of the PPS. The study also recommends a number of other steps including a more detailed code of conduct that specifically excludes receipt of such payments or gifts, the establishment of a code of disciplinary procedures, annual confirmation from each officer that he or she has complied with the code of conduct and related integrity training.

“I often see prosecutors try to approach judges after a court session. I know what they are up to. Somehow I feel sorry for them. Those who have to do this because their superiors pressured them but sometimes they are just out of line, and even dare to pay judges to obtain a favorable verdict.” - Senior Judge in Central Java<sup>146</sup>

A consequence of the top-down style of management, with excessive hierarchical layers (seven, which are faithfully reproduced in regional offices of the AGO) and nearly 300 structured management positions, is that prosecutors tend to respond to directions from the top and do not see themselves as accountable to the public. NGOs that monitor the PPS’s performance find that it has no case review process, lacks transparency in its procedures and decisions, does not feel it has to report on the progress of the cases under its management, and that it has no mechanism for dealing with public complaints. Such upwards accountability is reinforced by a performance evaluation system that is partly based on the number of cases won, rather than on how the case was fought. This creates incentives for prosecutors to seek light but guaranteed sentences, opening up opportunities for negotiating with defendants on the sentence.

The PWC report recommends measures to enhance transparency and public access to information and suggests that a complaints service should be established.

A determined effort is needed to establish and manage a fully professional prosecution service. The ADB-funded report makes a number of recommendations for improving the management of the PPS. But improvements in management will only occur when professionals respected for their integrity are appointed to senior positions in the service and are given the mandate and the resources needed to reform the institution. That the institution is currently headed by an Attorney General who is subject to an ongoing investigation for failure to declare his assets to the KPKPN, and that he has not been asked to step down until the investigation exonerates him sends a powerful message that the system is not about to change.

## **THE COURTS**

Until the early 1970s, Indonesia's Supreme Court, was seen to be relatively free of corruption.<sup>147</sup> It appeared to attract the brightest Indonesians, many of whom had been educated abroad, and was generally free to exercise the role envisaged in the Constitution. All this changed as the New Order established itself, and as we have seen above, corruption in the courts today is as serious a problem as it is in other branches of the justice sector.

Since the collapse of the New Order, a number of initiatives have been taken to strengthen the accountability of the Court system. This has involved changes in the laws that govern the courts, granting them more autonomy, strengthening the selection process of judges, the establishment of a new commercial court with new operating rules, and increased salaries for judges. While reform of the courts, as in the rest of the sector is a work in progress, the impact of these measures on levels of corruption has been weak. The newly established commercial courts are already showing strong signs of corruption despite the effort made to avoid such an outcome. What has gone wrong?

The accountability framework for the courts begins with Article 24 of the Constitution, which required the establishment of the Supreme Court and the courts under it. Law 14/1970 defines the organization and powers of the courts. Its successor Law 35/1999 envisaged greater autonomy for the courts from the executive branch and a Judges Honor Council was established to handle ethical issues relating to judges. Subsequent amendments to the Constitution call for the establishment of a Judicial Commission that would be responsible for recruitment, dismissal and transfers. Its precise functions are still being debated. The judiciary is reportedly resisting empowering the Commission to play this oversight role. A number of other laws passed in 1985 and 1986 govern the specific courts such as the Supreme Court, and other courts. The new commercial chambers were established under Law 5/1999 to facilitate bankruptcy proceedings; debt restructuring; and intellectual property rights cases.

Law 35/1999 mandated that by 2004, the functions performed by the Ministry of Justice would now be managed under the so called "one roof" of the Supreme Court. However, the Courts remain dependent on Parliament and the Executive branch for budgetary funds. Till recently, Supreme Court justices were appointed by Parliament, based on a short list provided by the President. That function now shifts to the Judicial Commission.

The enhanced autonomy of the Supreme Court comes before the Court has fully established its commitment to integrity, thus giving power to justices who may abuse this new authority. The Judicial Commission will undoubtedly act as a check on such abuse, but who will monitor the Judicial Commission? These issues are currently being reviewed by the Supreme Court as part of an internal institutional audit that is intended to develop a comprehensive reform process.<sup>148</sup>

Will corruption be lower with greater autonomy? The answer appears to be no, unless it is accompanied by a comprehensive reform of the court system. Currently, accountability is weak for a variety of reasons.

First, the courts are still dominated by judges who have grown up in the New Order and who have experienced, in Sebastiaan Pompe's words, "a serious erosion of professional standards, both in terms of professional capabilities and professional identity".<sup>149</sup> This erosion was due to what Pompe believes was "a deliberate process directed at rendering the status of judges and their role less important". This included political marginalization, treating judges as if they were a civil service, and conferring on them the same low pay scales reserved for the civil service, and failing to give judges a high position in society through the deference to their status that only the political class can confer. This led quickly to a loss of interest from bright young lawyers in joining the judiciary and a brain drain out of the profession. A related factor in this erosion of professional standards was the decision after Independence to abolish the indigenous courts and integrate these with the district courts without increasing the number of district courts to undertake this substantial additional work. However, in the early 1980s, fuelled by the oil price boom, Indonesia quickly expanded the number of judges almost twenty-fold from about 160 judges to 3,000; contributed to the general deterioration in quality standards and quality control, and to the failure of the sector to meet societal needs. Individual corruption, which Pompe suggests is the predominant form of corruption in Indonesia's courts, and a corrupt mindset that tolerates the institutionalization of corruption,<sup>150</sup> are symptoms of this erosion of professional standards.

Second, as in the rest of the sector, the courts have always been severely under funded. This is evidenced in the usual range of problems such as the chronic shortage of funds for basic necessities such as electricity, phone bills, postage and paper, and virtually no resources to meet the costs of transfers. This leads to the systemic corruption that prevails throughout the Indonesian public sector. Pompe cites recent reports to estimate that only 30% of institutional needs are met by the budget, but notes that no one really knows what the real gap is between needs and funding. Since the probability of getting adequate funding is low, no one bothers to make a realistic budget. Nor is there any effort to relate funding to deliverables such as case load, and it may well be that the commercial and administrative courts which are experiencing a sharp decline in case load may in fact be over funded. To fund this gap there are a large number of unofficial levies administered by the court clerks. Of those respondents to the Partnership survey who admitted to making unofficial payments, 44% of households and 69% of businesses reported paying at least Rp. 1 million in unofficial payments, with 11% and 20% respectively admitting to paying over Rp. 5 million each time they had a court case.

Third, lack of professionalism and under funding reinforce the system's weak overall human resource management and oversight. Recruitment and promotions are alleged to be

corrupt as elsewhere in the system; although there is no hard evidence on this. Nor is there any effort made to hold judges accountable for their performance. The Supreme Court is the one court in the country with a significant backlog of cases. Lower courts do not have a backlog except in civil or administrative suits, in part because most cases tend to get referred to the Supreme Court. The Justices in the Supreme Court lack the time and the inclination to oversee the lower court judges. So the courts, particularly those in the regions, are left to their own devices. There is little effort to train judges or to mentor young judges. The courts lack key reference materials, such as laws and regulations, previous court decisions etc.

Not surprisingly, the system is erratic and arbitrary and judges are not consistently punished for corruption, although this could change with an effective Judicial Commission. The recent Manulife case is illustrative.<sup>151</sup> When a perverse judgment led to a strong adverse international reaction, the three judges who delivered the judgment were suspended by the Chief Justice, and the Ministry of Justice also temporarily suspended them, causing them much public humiliation. However they were eventually cleared by the Council of Honor appointed by the Jakarta High Court on grounds of lack of evidence. The Court subsequently ordered the suspension to be lifted. But the concerned judges have been transferred out of the Commercial court and out of town.

Finally, transparency of the system is limited, preventing adequate oversight by the public of the quality of court decisions. The requirement that commercial court judges are required to publish written judgments or dissenting opinions has had a favorable impact on that court's performance.<sup>152</sup> The public's right of access to court decisions and the freedom to publish such decisions at will is an important safeguard in many countries. Indonesian courts traditionally provide access to decisions only to the litigating parties. There is also a lack of transparency regarding the payments required for court fees, registration, copies of judgment etc., all of which have illegal unofficial charges. Nor do the Courts publish court schedules. Judges are often late to cases by several hours, delaying hundreds of people. Postponements are common. However, the increased media interest in court corruption and in high profile cases, and more systematic monitoring of court performance by such NGOs as Indonesia Court Monitoring and Leip, has caused judges to realize that they are being watched, and there is anecdotal evidence that this is influencing their judgments.

An important conclusion from Pompe's analysis is that despite the coincidence of structural and institutional corruption with individualized corruption, corruption in the courts "remains a treacherous business to all, including the corruptors themselves" and lacks the sense of an organization with an established hierarchy, loyalty, mutual trust and enforcement that the use of the word "mafia" connotes to describe the judiciary.<sup>153</sup> This implies addressing both the incentives facing judges and the organizational factors that drive corruption.

## **POLICY IMPLICATIONS**

### ***Each rung of the accountability chain is flawed***

Accountability in the justice sector is weak in all three critical relationships: between citizens and their elected representatives and other policy makers, between elected

representatives and organizational service providers, and between service providers as a whole and their clients.

Citizens and elected representatives/policy makers: There is little evidence that the average Indonesian voter cares enough about justice sector reforms to vote out a party that is not committed to pushing such reforms. Legal issues do not rank high among the list of problems Indonesians identify as the most serious. And they do not apparently see the link between the problems they are concerned about, such as security or riots, and the failings of the justice sector.<sup>154</sup> A shockingly high proportion of Indonesians, particularly women, appear unaware of their legal rights under the Constitution.<sup>155</sup> Citizens, moreover, have little faith in the justice sector, and vote with their feet, seeking recourse to informal channels, when absolutely necessary to resolve disputes, and apparently satisfied with the results. This most likely deprives the poor of access to justice since they carry less weight with the local political and religious elites who intermediate the dispensation of justice outside the court system. At the same time, an effectively functioning justice sector may actually be against the interests of many in Indonesia's elite who benefited from the New Order and continue to benefit from corruption today.

Between the executive and legislative branches and the key justice sector agencies: Indonesia's Government collectively fails to ensure that the justice sector agencies perform their role in the interests of the public. While the legal framework is adequate (with the exception of the Attorney General's office where a new accountability law is overdue) autonomy may have been granted a little too prematurely to the courts, without ensuring that they are ready to manage themselves. The government also undercuts the agencies by inadequately financing their needs, which as in other areas, feeds the beast of corruption by implicitly encouraging these agencies to continue past practices inherited from the Soeharto era to raise resources through a range of illegal and legal activities. Efforts by the executive to launch a reform of the sector have been half-hearted and largely a response to donor and civil society pressures. The Attorney General has failed to follow up on the recommendations of the excellent institutional audit. However, the Coordinating Minister for Politics and Security has attempted to lead a dialogue between the key justice sector agencies on a reform process facilitated by the Partnership for Governance Reforms in Indonesia. This has been a slow process with few results to date. The agencies in turn continue to behave as instruments of government and parliament, rather than seeing themselves as responsible to the public for their performance.

Between the justice sector agencies and their clients: Front-line service providers such as policemen on the beat, traffic cops, attorneys in the AGO, and court clerks and judges see themselves as accountable to their seniors rather than to citizens. Clients are seen as a potential source of rents. Clients are often ill-served by their lawyers, who are apparently often the conduit for bribes to judges, prosecutors, and the police. The legal profession is therefore widely seen as part of the problem of corruption instead of being part of the solution. A vigilant media and civil society are beginning to change this a little and making these institutions conscious of their obligations to society, but this is inevitably a slow process.

### ***Reforms must begin with strong leadership***

How is accountability to be established in the justice sector? Any serious effort will, of course take time, maybe even a generation. But laying out a road map of where the reform effort

is headed and key landmarks along the way, and ensuring some effort to deliver initial results will help give momentum to reforms. The following are some of the key elements:

- Managing the reform process will require **strong leadership**. The President needs to empower a senior official who is known for integrity and commitment to move the process forward, and who enjoys the full trust of the President. The President must also ensure that the key agencies of the justice sector other than the courts fully recognize the authority of this official. Ensuring that the agencies themselves are headed by committed and skilled reformers would be an important requirement.
- **A framework and action plan** that constitutes a road map for overall legal reform. The work of the National Law Commission is now complete and this can provide the basis for such a framework. A justice reform agenda will need to go beyond government agencies and cover such issues as legal education, reform of regulation of the private agencies which participate in the justice sector, such as the legal profession, private security agencies, etc. Using a participatory process, the Government needs to go beyond the Law Summits to bring together key stakeholders and empower them to come up with an overall reform strategy.
- **Early establishment of the Anti-Corruption Commission** will allow the government to create an agency that delivers some early results that help build public confidence in the government's commitment to fighting corruption. To succeed, the Commission will need to overcome two hurdles. First, global experience (Box 5.2) on such commissions suggests that they work well only in rather special circumstances and that to be successful they must meet conditions that Indonesia will find difficult to meet. To be successful, anti-corruption work needs to be mainstreamed across the government rather than be concentrated in any one agency. Second, the government's own track record with new agencies has not been good. As the experience with the Ombudsman and the National Law Commission suggests,<sup>156</sup> they languish due to neglect, lack of funding and lack of political support. Nevertheless, given the time it will take to mainstream anti-corruption work, and to reform the police and attorney general's office, the Government has little choice but to try to create the key conditions for the success of this new body. Three of these include the selection of Commissioners of outstanding integrity and independence, an adequate budget to perform its functions, and political support for the work of the Commission, including resisting pressures from the police and the Attorney General's office to undercut its effectiveness. The new Commission will also need to be strategic and selective about the agenda it adopts so that it does not spread itself thin, a common mistake that other agencies have made. Complementary measures would include legislation to protect whistleblowers.
- The principal justice sector agencies need to develop **governance action plans** based on thorough audits of their institutions and begin implementing them. The Attorney General's office is best placed to move fast since much of the findings of the audit conducted two years ago are still relevant. But it appears also to be the least reluctant to reform. The Supreme Court has been moving quietly to develop an agenda for reform.<sup>157</sup> Support to its efforts, both physical and financial, will be critical to moving forward to clean up the courts starting at the top, and cascading down, particularly given that the courts appear from the foregoing analysis to be the most amenable to potential reform efforts.

- The Government also needs to undertake a comprehensive resource **needs assessment** for each of the key agencies, including staffing, pay, and operational and maintenance budgets. It also needs to inventory all foundations and businesses being operated by these agencies and all other sources of revenue. Unless these agencies are adequately funded and unless their private businesses and foundations are shut down, the range of practices that reduce accountability and open the door to corruption will continue.
- Reform cannot come only from the top. The government also needs to ensure that these agencies become accountable to the public and are subject to pressures from their clients, the media and civil society to reform. Transparency is the key to raising public awareness and accountability to clients. The Supreme Court could begin by requiring of itself and key courts under it, that only the Commercial Courts now practice, of making public their written judgments so that they can be scrutinized by others and thus open the door to pressure for better performance by judges. The Courts, the police and the AGO can become more transparent about penalties, fees, and other charges, posting these in public places and on the internet and eroding the role of touts and middlemen. The government can make laws and regulations easily available to the public. The key agencies can be required to publish indicators of performance so the public can assess how these agencies are doing. An effective complaints resolution mechanism, including reactivating the Office of the Ombudsman could help force a change in behavior.
- Reforms will take time to take effect, and the Government will need to manage expectations. This is best done, as noted above, by ensuring that there is a widely accepted road map for reforms, and that Indonesians can see progress along the path to reform. Some quick victories will be crucial. These will come best in the area of transparency and in making the special effort needed to make the Anti-Corruption Commission succeed where others like it have failed (see Box 5.2).

**Box 5.2: What it takes to create a successful anti-corruption agency**

A recent study of comparative experience with anti-corruption agency for the World Bank<sup>1</sup> noted the following factors that drive success of anti-corruption commissions:

- *Establishment:* The success of an ACA depends on its being carefully situated from the start within a set of well-defined supports. These would include a comprehensive anti-corruption strategy, careful planning and performance measurement, realistic expectations and strong enough political backing (across class/party) to make it effective regardless of (political and personal consequences). The agencies that seem to score highest on these measures are those in Hong Kong, Singapore, Malaysia, Uganda and Australia/NSW.
- *Focus:* The ACA needs to be strategic in defining its focus in a way that will maximize its effectiveness. For example, an agency could focus on prevention and monitoring government implementation of anti-corruption policy (foregoing a comprehensive mandate, as in Korea); its jurisdiction could be mainly prospective (only limited concern with past cases, as in Hong Kong); it could choose cases selectively, based on clear standards (as in Argentina and NSW); or it could deal only with the probity and reputation of the public service (as in the US and India)...It appears that clarity of focus is indeed consistently associated with success – except where massive resources are available.
- *Accountability:* This comprises such things as the application of legal standards, the availability of judicial review, systems of public complaints and oversight, a requirement that the agency answer to all branches of government and the public, and precise and comprehensive expenditure accountability. Some commentators also suggest keeping the agency's size, as well as the "free" support given by aid donors to a minimum. Overall, accountability is not uniformly associated with success in terms of ACA goals indeed it is frequently a hindrance, stopping or delaying agencies from taking desired actions. Still, many of the successful ACAs are strongly accountable, but this is probably an outgrowth of the rule of law, which seems to be more consistently associated with success (see below).
- *Independence:* This in some cases arises simply from outside accountability, sometimes from the agency's placement and line of responsibility, the appointment and removal procedures for top officials or some forms of fiscal autonomy. The most important sign of independence is the absence of political intrusion into the agency's operations. De facto autonomy, on the other hand, enables ACAs to operate on a consistent and professional basis with relatively little partisan intrusion – and in most environments, this mode of operation is important to success.
- *Powers:* Observers have suggested that a successful ACA will have strong research and prevention capabilities, along with the authority to do the following: access documents and witnesses, freeze assets and seize passports, protect informants, monitor income and assets, propose administrative and legislative reforms and exercise jurisdiction over the chief of state. ...(many) agencies have most or all of these powers on paper but frequently cannot put them into effect due to lack of coordination, weak capacity in cooperating institutions, and political factors.
- *Resources:* Agencies in this field, as in others, depend on well-trained personnel – including sufficient numbers with highly specialized skills. Staff should also be well-compensated, subject to integrity reviews and quick removal and endowed with strong ethic of professionalism, integrity and high morale...(also important are) sufficient funds, adequate facilities and assets and high level information sharing and coordination with other government bodies.
- *Complementary institutions:* The stated criteria here include adequate laws and procedures, basic features of the rule of law including functioning courts, free and active media, an active community of NGOs, and public interest groups, and other capable institutions such as supreme audit and central bank. ACAs are not successful in the absence of (the basic features of the rule of law). On the other hand, civic factors such as free media and capable non-governmental watchdogs are not as clearly associated with ACA success.

*Patrick Meagher, Anti-corruption agencies: A review of experience. Final Paper. IRIS Center, University of Maryland. August 2, 2002.*



## 6. Corruption and the Civil Service<sup>158</sup>

*The Indonesian civil service is a weak link in the chain of public accountability. Civil servants are the first to admit that corruption amongst their ranks is a serious problem. In recent surveys nearly half of all public officials reported receiving unofficial payments. Most Indonesians believe that low salaries are the principal reason why civil servants are corrupt. But compensation plays little role in creating positive incentives for integrity. A recent World Bank study shows that with the large increases in compensation in recent years, civil servants are on average not particularly underpaid relative to their market comparators, although the situation relating to the most senior civil servants needs to be more carefully studied.*

*Pay is however a factor in corruption because of a highly opaque and non-transparent system of compensation administration. Only a small proportion of an official's income comes from his/her salary. A range of allowances and payments that are not transparently administered are used to run a patronage system within each organization. In addition, civil servants have access to a host of legal and illegal sources of income ranging from allowances to attend meetings, speed money, kickbacks on contracts, tax avoidance and assignments funded under the development budget. What they receive depends on their relationships with the power brokers in their organization, and whether they work for a wet or dry agency/department. The threat of withdrawal of such allowances acts as a powerful disincentive to whistleblowers and those reluctant to comply with these practices, while weak financial management ensures these practices have no consequences for those responsible. Related factors that drive incentives and therefore weaken accountability are a reluctance to punish officials for corruption, a culture of secrecy, a lack of transparency, and a lack of service orientation. The failure to proactively manage the Indonesian civil service does not help.*

*The government needs to begin a civil service reform effort by disentangling the complex and confusing web of pay and employment policies and by introducing greater transparency and reducing discretion on total compensation levels. Merging the recurrent and development budget will help improve transparency. The current elaborate patronage-based system needs to be dismantled and replaced by a simple system that everyone understands. Careful pay comparator studies and labor market analysis are needed to determine an appropriate compensation package for the civil service. This should include a carefully designed analysis of pay for the top echelons of the civil service. This will then pave the way to opening recruitment to all Indonesians and ensuring that the top positions are competitively recruited and filled with the best talent in the country. A similar effort will be needed for the top positions in the regions, including bupati and walikotas.*

Given the size and complexity of the task of reforming the civil service, the central government should allow the regions to exercise the powers they already enjoy under Law 22/1999 and experiment with civil service reform under a hard budget constraint while the groundwork is laid for a national civil service reform effort. Enacting a right to Information law, setting service standards, developing citizens' charters and encouraging civil society to conduct regular surveys of public perceptions of corruption and service delivery will help enhance accountability and improve civil service performance.

Civil servants are a key link in the chain of public accountability. They are responsible for delivering the two types of services that most governments provide: the rules of the game (such as environmental rules and regulations) and essential public goods such as health and education service. The senior civil servants provide the front line workers in their organizations with "assignments and delineated areas of responsibility, equipping them with the resources to act".<sup>159</sup> They must select, train and motivate workers. As service providers, civil servants collectively must respond to the demand for their services, and provide information about their performance to those to whom they are accountable: their clients, and the politicians and policy makers who oversee their work.

Yet Indonesian civil servants are another weak link in this chain of accountability. The Indonesian civil service is at the heart of much of the corruption that is described in previous chapters of this report. Civil servants are the first to admit that corruption is a serious problem. Even "grand corruption" at the political level could not very easily take place without the active complicity of the civil service. This chapter is devoted to trying to understand why the accountability framework for the civil service produces these outcomes. It begins by seeing how public officials and others view corruption. It then discusses prevailing perceptions of what causes corruption. Finally, it reviews the accountability framework to see whether these perceptions are valid and why accountability fails.

The Indonesian civil service, excluding the military and the police, comprises some 4 million civil servants, of whom 1.4% are primary school teachers (1.1 million) and health workers (300,000). By the standards of other countries in Southeast Asia, the civil service represents a relatively small percentage of the population (2%), but it is proportionately the same size as the civil services of the other larger Asian developing countries, India and China.

## **SURVEY FINDINGS**

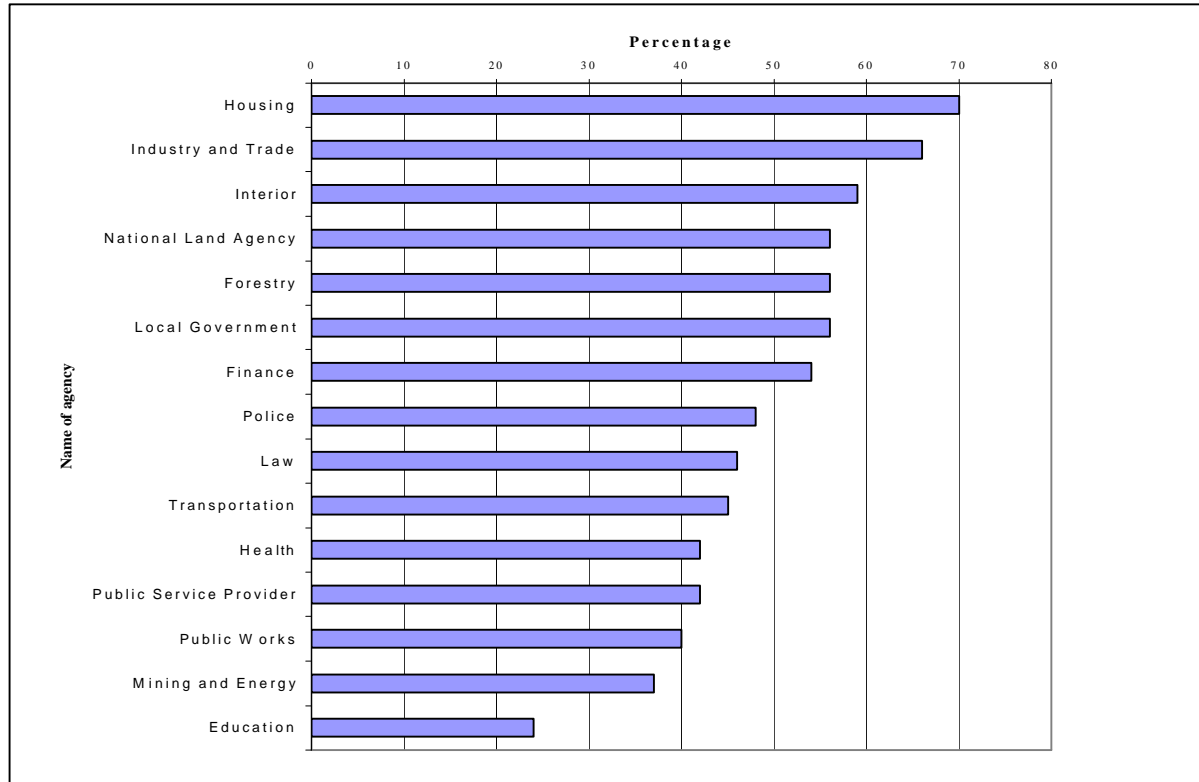
### ***Corruption is a serious problem in the civil service***

Two recent surveys confirm that corruption in the civil service is viewed as a serious problem. In 1999/2000 the Institute for Policy and Community Development Studies (IPCOS), conducted a survey of 692 public officials (52 heads of agencies or departments and 640 officials) from 15 Indonesian agencies.<sup>160</sup> The second survey of households, business enterprises and public officials, conducted in 2001 by the Partnership for Governance Reform,<sup>161</sup> had as its principal goal understanding perceptions and attitudes to corruption. In both surveys, a large majority of public officials viewed corruption as a serious problem—94% of those surveyed in 1999/2000 and 71% of those surveyed in 2001. Further, when asked to rate accountability in

their organizations, officials in the 2000 survey were willing to rate it at only one on a scale of 10.

An interesting measure of the extent of corruption in different agencies as perceived by civil servants was their assessment of the proportion of officials in different agencies who accepted ‘unofficial payments’. The regulatory agencies were seen as the most corrupt, with housing, industry and trade, the interior, and the national land agency topping the list.

**Figure 6.1: Public Officials Perceived to be on the Take (based on self reporting by public officials)**



*Source: Figure D3 in Partnership for Governance Reform in Indonesia, A National Survey of Corruption in Indonesia, Final Report, December 2001*

Between 56 and 70% of all officials in those agencies were seen by their colleagues to be on the take. These are, in Indonesian parlance, the “wet agencies”.<sup>162</sup> On average, nearly half (48%) of all public officials reported receiving unofficial payments. Both heads of agencies and public officials generally regarded regulatory agencies as those in which bribing was most common, with bribes to those handling procurement and those handling service delivery ranking second and third. Payments for tax evasion and for consultants’ contracts came fourth and fifth. In the view of public officials, most bribes were intended to expedite delivery of a service or to seek preferential treatment.

Agencies that were seen as corrupt were also seen as inefficient in the Partnership Survey. This perception is also shared by international businessmen. The Global Competitiveness Index for 2002 ranked Indonesia 67th out of 80 countries assessed, slipping from a ranking of 64 in the previous year.<sup>163</sup> In the same survey, Indonesia’s public institutions

were ranked 77<sup>th</sup> out of 80 in terms of their perceived corruption and the role of contracts and law.

## **WHY THE CIVIL SERVICE IS SEEN AS CORRUPT**

### *Most people think it's about incentives*

Most people in Indonesia, when asked why civil servants are corrupt, will point first to their low salaries, despite the fact that there is little hard evidence to support this view (see below). The Partnership survey found this to be the top reason cited by households (35.5%), business enterprises (36.5%) and public officials (51.4%).<sup>164</sup> Lack of controls and accountability and lack of morals were the second and third most important reasons cited by households. Business enterprises cited poor law enforcement and punishment, and lack of morals, while public officials cited poor law enforcement and punishment as both the second and third most important reason. The 2000 public officials survey confirms this reluctance on the part of senior officials to enforce and punish corruption and poor performance. When asked if staff in their organizations were disciplined for corruption, only 5% reported that they were, while another 8% reported being disciplined for embezzlement. The most common reason for being disciplined was insubordination.

In a recent report on intensification and acceleration of the fight against corruption, the Ministry of Administrative Reform (MenPan) has come up with a long list of causes of corruption.<sup>165</sup> Factors internal to the civil service include weak sanctions, inconsistent law enforcement, inadequate discipline, lack of internal controls, the failure of superiors to set a good example and of those in positions of authority to subject themselves to clear tests of their performance, and low income in relation to what it costs to maintain a decent living standard. External factors include inadequate external controls by the public and by parliament, lack of clarity in regulations, the culture of gift giving, the social norms and permissive behavior of society.

## **THE ACCOUNTABILITY FRAMEWORK**

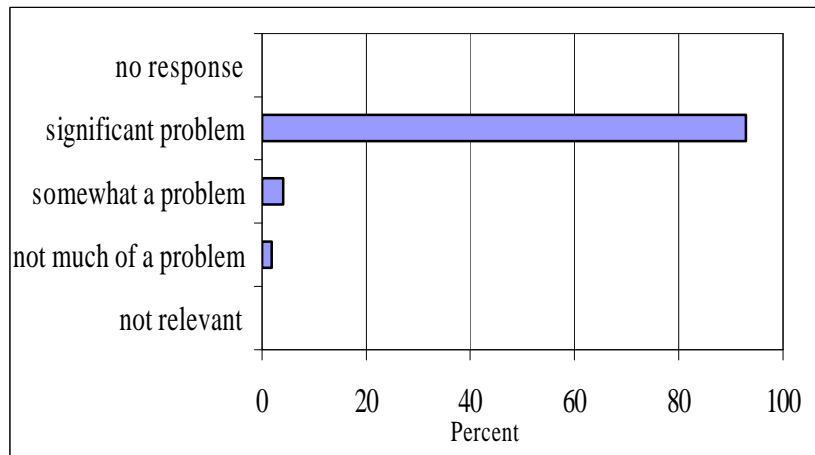
Why does accountability break down? Are the public perceptions correct in their explanations of corruption?

### *Indonesia's accountability framework is sound on paper*

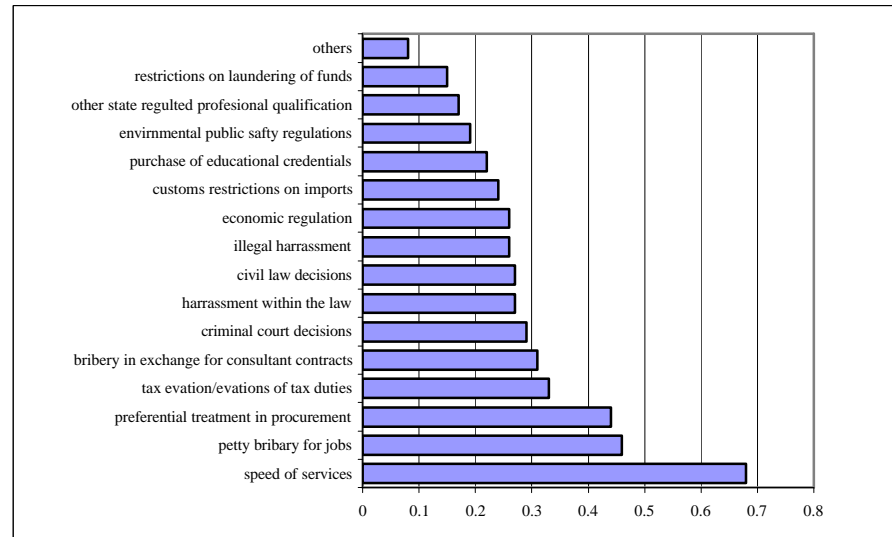
International best practice<sup>166</sup> suggests that a sound legal framework for the civil service should define its responsibilities, accountability, duties and rights and determine the status of civil servants in a country. Any action that an individual civil servant takes must have the sanction of a law or regulation. Such laws must also spell out the accountability of civil servants and establish mechanisms to enforce it. Civil servants should be politically neutral and not be guided in their actions by personal or other interests. Abuse of public funds or position should be subject to disciplinary action and legal remedies. Salaries and allowances should be open and transparent.

Figure 6.2 Civil Servants' Perception of Corruption

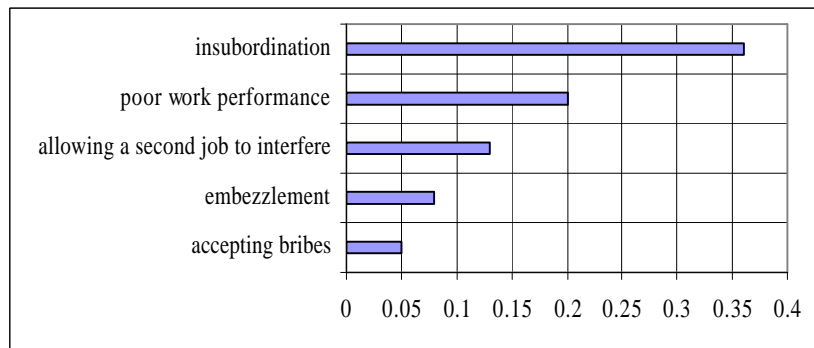
Would you say that corruption is a problem affecting the performance of the government?



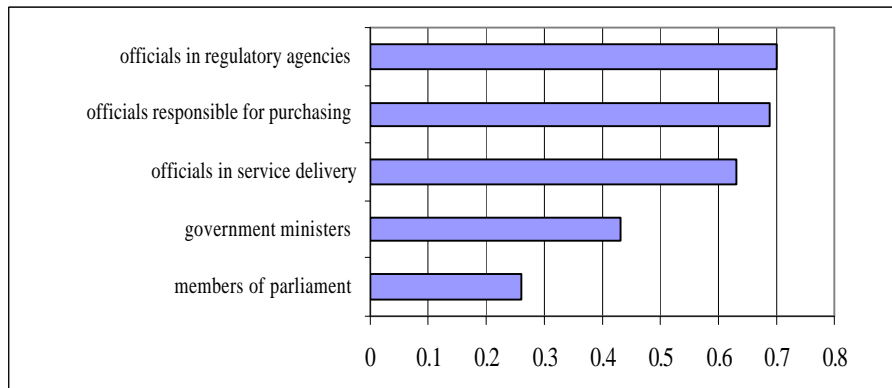
What does corruption help avoid/facilitate



In the past 3 years, have staff in your organization been disciplined?



Which officials are most corrupt?



Source: World Bank, 2000, op. cit.

On paper at least, Indonesian law relating to civil servants is consistent with such best practice. An MPR directive calls for a “clean civil service free from KKN.”<sup>167</sup> Indonesia’s four million civil servants are subject to Law 8/1974, subsequently amended in the post-Soeharto period under Law 43/1999. This law is quite brief and relies on the issuance of regulations that define principles and procedures. The practices of KKN are forbidden, and all appointments and promotions are to be based on an objective evaluation of performance and competence and undertaken through competition. Indonesia has one unified national career civil service despite its current decentralized structure. Law 22/1999 on decentralization allows regional governments to manage their own establishments and staffing provided that they follow centrally defined policies and guidelines. Under President Wahid, Regulations 96-101/2000 were promulgated, covering personnel policy, structural and functional positions.

Civil servants are also now prohibited from being members of political parties. This constitutes a radical change from the Soeharto period when the civil service, represented by the Association of Civil Servants (*Korps Pegawai Republik Indonesia-KORPRI*), was one of the three pillars of the Golkar party of government (derived from *golongan karya* or functional groups), along with a civilian wing and the armed forces, who were clearly in charge. Membership of KORPRI was compulsory and members had to swear allegiance to Pancasila and subscribe to a code of ethics. With the new law, KORPRI is reinventing itself. Membership is no longer compulsory, and its formal links to Golkar have been severed. The new law also commits the government to provide a “just salary in accordance with appropriate standard”. Regulations provide for disciplinary action and disciplinary proceedings, with remedies ranging from verbal warnings to dismissal. Performance is to be evaluated annually.

### ***But accountability breaks down in implementation***

Although the accountability framework for the civil service has been revised, it breaks down at several levels when it comes to implementation. The contract between Indonesia’s elected politicians and the civil service system appears to be adequate in terms of the quality of the rules, i.e., their coherence and relevance, but is somewhat less effective in terms of rule enforcement. The 1999 World Bank civil service mission conducted an institutional diagnostic defining six areas of performance, and devising a set of questions for each area. In the judgment of the mission, the orientation of the civil service, as in many other civil services, is toward following rules rather than achieving results, with minimal room for discretion. The laws that created them and incremental policy changes implicitly determine the work programs of individual ministries and agencies. Mission statements and annual reports are rare. Job descriptions are not in sufficient detail to allow for judgments on competence and performance. Management accountability is seen as accounting for adherence to defined processes, not for meeting objectives within available resources. The main area of weakness, the mission concluded, was in the implementation of pay and employment policy and performance management; the two are not linked, and a focus on results is largely missing.

### ***No one is proactively managing the civil service***

This gap between laws and their implementation and the poor overall performance of the civil service are due in part to the failure to proactively manage the civil service. This function is

split between two bodies that appear to lack political clout. The Ministry of Administrative Reform (MenPan) is responsible for regulations governing the administration of the country. It carries out this function largely through policy pronouncements and ministerial decrees that go largely ignored by the rest of the bureaucracy. BKN (the National Civil Service Agency – *Badan Kepegawaian Nasional*) is formally responsible for implementing Law 8/1974 as amended by Law 43/1999 by issuing guidelines on hiring and firing and promotions, and regulating the size of the civil service. The Ministry of Finance also plays an important role, as its budget allocations in effect determine the size of the civil service. Both MenPan and BKN find that many ministries do not wait to ask them before issuing their own decrees and legislation, even though they are required to ensure that such laws and regulations are consistent with the national policy guidelines. In particular, the Ministry of Home Affairs carries a great deal of weight with decentralized administrations in their management of the civil service. But most important of all, now that regions are authorized under the decentralization law (22/1999) to run their own civil service, it is no longer clear that the one national civil service concept enshrined in Law 43/1999 and PP25/2000 still applies, nor how far the writ of MenPan and BKN extends beyond Jakarta. This lack of clarity about accountability feeds corruption by providing unfettered discretion to those in a position to use it.

The failure to implement the provision in Law 43/1999 requiring the establishment of a Civil Service Commission compounds the problems caused by the lack of proactive civil service management. Several issues are awaiting resolution, including the freeze on new hiring, which while desirable as a tool of fiscal consolidation, results in a number of evasion strategies such as the hiring of staff through the development budget and other informal hiring that is highly vulnerable to corruption. It is believed that there are close to one million people who have informal contractual arrangements with the Government of Indonesia but who are not subject to civil service rules and do not appear on any government payrolls. It is also believed that there are a number of ghost workers on the payroll, some 10% of the total civil service, yet another source of “leakages” from the budget.<sup>168</sup> There has been no recent civil service census, and no effort to match posts to individual staff with unique identification; establishment control is weak, and may be getting weaker with decentralization, again creating further opportunities for rent seeking.

### ***Low salaries are not the reason why the civil service is corrupt***

A second area of concern relating to accountability is the widespread belief that low salaries for Indonesia’s civil servants cause them to abuse their positions and office in order to supplement their incomes. Experience in industrial countries suggests that high earnings do not guarantee probity as recent government financial scandals show. Cross-country studies provide mixed evidence about the association between corruption and civil service pay. Some studies show that when corruption is high and penalties for getting caught are low, the wage at which corruption would be eliminated would be very high, and that it might be better to continue to pay low wages and focus instead on raising penalties. But an IMF study suggests that the “relationship between civil service wages and corruption may be stronger and wages at which no corruption occurs lower than predicted by models postulating self-interested behavior”.<sup>169</sup> In this study, increasing wages from 100% to 200% of the manufacturing wage is associated with an improvement in the corruption index by 1 point on a scale of 5. The authors argue that “to the extent that civil service wages have an indirect effect on corruption, say by improving the quality of the judiciary or society’s policing action, the effects could be larger”. However, the same

study failed to establish a relationship between wages and corruption in the same country over time, leading the authors to warn that cross country results might reflect a “spurious correlation notwithstanding our attempts to control for other factors”. Nor do these correlations imply a causal link between government wages and corruption. But the authors nevertheless argue for a more active wage policy. Low earnings can also result in absenteeism and moonlighting (see Box 6.2), which is also a form of corruption, broadly defined, and can be very costly.

**Box 6.1: Wood Carver Pursues His Craft**

A recent consultant study for the World Bank on recurrent expenditure in health sector institutions in Subang discusses time spent by civil servants on other activities during working hours: “Woodcarving is an art. It is rarely a combination of collective skills in pharmacy management and woodcraft artistry. A pre-arranged field visit to the UPTD Pharmacy was timely enough. Upon arrival of the team, they were told that the chief is busy in the other room. The pharmacy warehouse chief was busy but happily explaining his hobby on woodcarving to two policemen guests. The woodcarving design was almost finished and it looked really stylish and deeply meaningful artwork. Unfortunately, the carving work is done during normal office hours in one of the corners almost behind the pharmacy stockroom. The size of this carving room was even bigger than the office cubicle of the pharmacy head. When asked how many months he has been carving, the proud reply was almost seven months. Again, when asked about the price if he were to sell it, the ready reply was Rp30M (\$3,800). It took about 20 minutes for him to explain why the carving deserved this price before he led the team to his office room and returned to his carving station while another staff attended to the team’s interviews. The warehouse chief came back and answered a few of the questions raised but left again saying that his assistant will do the explaining”.

Given the weak link between corruption and incomes in the literature, the 2001 Partnership survey report investigated the belief that low salaries were the principal cause of corruption. It constructed a corruption index based on five variables<sup>170</sup> and used multiple regression analysis to determine which were statistically significant factors. According to the survey, four indices appear to be strongly correlated to perceived corruption: the quality of management, the strength of anti-corruption organizational values in the internal culture, the quality of personnel management and the quality of procurement management. The income, education level, length of service, age and gender of officials were not found to be statistically significant factors. Managers who observed and set high standards, enforced the rules and motivated their staff were seen as being much more likely to create a low corruption environment. Overall organizational environment was thus perceived to be far more important than factors such as salary. A second regression shed further light on what is perceived to drive a strong anti-corruption internal environment: sound management practices, limited discretion and an emphasis on implementing rules rather than just having them on paper.<sup>171</sup> Similar perceptions emerged from the 2000 World Bank survey of civil servants which found that consistent and clear policies, lack of political interference and rewards for good performance were seen by civil servants to be strongly related to the overall performance of the organization (see Figure 6.2).

A recent World Bank study<sup>172</sup> also questions the assumption that low salaries drive corruption. Its analysis of Sakernas data for 1998 reveals that average workers earned more than their private sector counterparts even before the significant pay increases awarded to public officials in 2000 and 2001. As in most countries, lower skilled government workers earned a positive premium over their private sector counterparts while higher skilled workers earned less. Those with university degrees typically earned some 20% less than their private sector counterparts. Since 1998, real wages rose significantly in the public sector while those in the



private sector declined. The key factor explaining corruption, argues the study is not pay but pay administration:

“While levels of pay may not be germane, the nature of pay administration may be providing possibilities for abuse. The non-transparent nature of civil service remuneration and the opaque system for compensation administration in Indonesia may allow discretion that does not exist in simpler, more streamlined systems. Indeed basic salary and allowances are only part of the compensation currently received by many civil servants. Government officials often have opportunities—both legal and illegal- for additional income”.

#### **Box 6.2: Performance Standards Go Hand in Hand with Reducing Corruption**

The 1999/2000 Indonesian Public Officials Survey was designed to probe performance orientation in the public sector by asking officials what motivated them to join the public service, whether performance standards exist and if performance is evaluated against these, whether incentives reward good performance and punish bad, whether there is a proper system of promotion and mobility in the service, whether officials feel they enjoy sufficient discretion to carry out their duties and whether budget unpredictability impacts performance. Key findings from the survey:

- Most officials cited *job security and benefits* as the most important reasons for joining government; two-thirds of those interviewed had been working in government for over 11 years. The *recruitment system was not transparent*. About 94% of officials reported that vacancies in the positions they occupied were not advertised. Although performance on an examination was reported to be a key recruitment criterion, some 56% of officials said that personal or family connections were a factor in their recruitment decision, while one in eight admitted to payments or gifts as an inducement to get the job.
- *Educational qualifications*: While only 54% of heads of organizations reported having a university degree, 76% of other officials had university degrees, implying that the emphasis on such qualifications was relatively recent. A large proportion of officials received training while employed in the civil service, and two out of five overall and almost all organizational heads received such training overseas.
- *Mobility* across government appeared satisfactory for senior officials, but there was little mobility to and from the private sector.
- Only 9% of officials reported knowing of colleagues receiving *rewards* for outstanding service, while *punishments* were more common, although they were primarily for insubordination and poor performance. Only 13% of officials reported embezzlement and bribes as reasons for punishment (see Figure 6.2).
- Both officials and heads of organizations perceived *corruption* to be a serious problem in their organizations, with heads somewhat more sanguine about corruption. Some 94% of all respondents saw corruption as a problem. When asked to rate accountability in their organizations, officials were willing to rate it at only 1 on a scale of 10.
- *Performance standards* were not implemented successfully. Only 12% of respondents believed performance standards were implemented. On average they rated their organization on implementation of performance standards at 5 on a scale of 10. Those who rated their organizations highly were most concerned about the level of corruption, suggesting the close relationship between performance orientation and discomfort with corruption.
- Implementation of performance standards was most closely correlated with making policies consistent and clear, reducing political interference and rewarding good performance.<sup>1</sup> Discipline was not seen as the answer.

Source: Nick Manning et al., *op cit*.

Salary and official allowances constitute a small portion of an average senior Indonesian civil servant’s take home pay. Lax enforcement of rules governing hours worked on public jobs allows officials to earn a second income. There appears to be considerable discretion over what type of outside employment is permissible. Those working on development projects earn project-associated fees and bonuses, with “projects” defined generously in a poorly managed development budget. The development budget has thus become a major source of abuse, as discussed in Chapter 2. Officials are paid allowances to attend meetings that are beyond the

normal scope of their work. All this is in addition to the range of illegal income described above, such as speed money, kickbacks from government contracts, or for tax avoidance, false expense account statements, etc. The presence of a wide range of regulations, controls and red tape also creates opportunities for corruption.<sup>173</sup> Lack of effective internal and external controls on such practices create an environment of impunity.

The extent to which an official benefits from such a system depends on how well he is plugged into the power networks in his organization, or whether he has had to pay for his job, and has bought his way into the network. The numerous additional sources of income, legal and illegal, allow the senior managers in a public agency to buy the personal loyalties of staff by allocating such allowances and privileges at their discretion to the staff, and encouraging the collection of informal fees and unofficial payments to be shared by the staff as a whole (see Box 6.3). The threat of withdrawal of such allowances acts as a strong disincentive to any potential whistleblower. As seen in Chapter 2, weak financial management allows such practices to take place without any ability to track all the remuneration being received by any one individual, while lack of transparency and independent monitoring of the procurement system also create many opportunities for corruption.

In sum, as noted in the 2001 Bank report, increases in official pay alone do little to change the cost benefit calculation from corruption:

“To the extent that a pay threshold is in any way associated with public probity, it is thus likely to be only one factor in an overall policy package needed to shape civil service ethics. This package will certainly include clear signals of acceptable behavioral rules and the costs or sanctions applied to corrupt practice. The will and capacity to enforce rules and sanctions is also essential”.<sup>174</sup>

### ***The absence of a tradition of meritocracy is a problem***

Patronage systems rely on loyalty and trust. This was a key criterion for appointments in pre-*Reformasi* Indonesia for all wet agencies (see Box 6.3). At its root lies the third factor that explains the breakdown of accountability in Indonesia, which is the lack of any tradition of meritocracy. With a few notable exceptions, such as the key economic positions managed by the so-called Berkeley mafia, appointments to senior civil service positions have been based on almost feudal personal loyalties dating from the colonial era.

The Dutch in their recruitment of natives to the civil service, in contrast to British practice, did not rely on competitive examinations, but instead selected staff based on less than transparent criteria, such as the social influence the individual may have had “over the other natives.” At Independence, Indonesia did not inherit a “workable model of public administration, and [the Dutch] had done little to train Indonesians for responsible positions”.<sup>175</sup>

Quality of civil servants was not at a premium. After independence, senior positions were initially based on the personal background of the individuals, including their participation in the Revolution. Those involved in the war of Independence were seen as being entitled to jobs in the service. With an acute shortage of trained personnel, substantial numbers of poorly qualified officers were also brought into the service. Political party patronage was a common factor during this period. Party loyalty was more important than work performance.<sup>176</sup> Under Soeharto,

key positions often went to the military and to ambitious officers loyal to the President.<sup>177</sup> “In the 1990s, all the top officers were from Soeharto’s inner circle, cynically known as graduates of the University of *Cendan*.”<sup>178</sup> By the late 1990s there were still 6,000 military officers in civilian positions. However, under President Wahid, they had to choose between staying on in the civil service and resigning their military commission, or returning to the military.

“[Recruitment in the Indonesian civil service] ...is often with no standards of needs...It is easy to recruit and I would say we can cut more than half of our civil servants and the work is still going on in Indonesia....[For promotion] ....many other political factors come in...Whether you are belonging to one group or you are friends or you are relatives of the higher ranking positions is necessary to get promoted, so there is not an incentive for the civil servants to prove themselves to perform well to get to a higher ranking”.<sup>179</sup>

### Box 6.3: Informal Patronage Behavior in the Indonesian Civil Service

Opaque arrangements for development budget-financed allowances appear to undergird an informal patronage network through which corrupt practices may occur. Through what many acknowledge to be a semi-formalized system, significant discretionary allowances are distributed by top management in individual agencies to their subordinates in exchange for loyalty and, frequently, collusion in malfeasance. Membership in such personal loyalty networks is reputed to be pervasive, ensuring that officials can accept bribes and kickbacks without fear of reprisal, since their colleagues are likely to be engaged in the same practice. Bribery is, reportedly, closely linked to the purchase of key positions. Indeed, official positions with access to the development budget and control over the discretionary allowances it funds are reportedly a traded good, with a market value based on the estimated returns that might accrue from the access to rents provided by the position. The loyalty network thus makes the job purchase possible, and job purchase in turn creates the demand for corruption since the position purchaser must recoup the costs. In sum, the existence of discretionary allowances locks staff into a loyalty network that enables extra-budgetary transactions to be conducted and shared under protected conditions.

This system of patronage also appears to allow civil servants to reap extra-budgetary rewards from unofficial payments, bribery, graft and returns from rent-seeking. The types of transactions have been outlined in assessments of leakages from Bank-financed projects. Case studies suggest that the system allows management in a “wet” agency (i.e., an agency with access to the development budget and the capacity to purchase access to a project listing, and hence eventual access to donor and counterpart funds) to reap informal benefits through the following representative transactions:

- Payments from contractors and groups of contractors in exchange for selection (this may be recoverable subsequently through the project budget)
- Payments from staff in exchange for hiring on projects
- Loan accounts structured so that interest earned on cash in hand is retained by the agency; this may be in collusion with commercial banks for a share of the returns from the accumulated interest
- Provision of ghost services and/or inflated invoicing in collusion with contractors.

This system appears to be enabled by the significant contribution of the development (non-recurrent) budget to civil service rewards. Requirements for its continued operation include a continued commitment to project financing by donors across a wide spectrum of agencies and the current dysfunctional split between the routine and development budgets, which allows for inadequate project supervision.

*Source: World Bank, “Indonesia: Priorities for Civil Service Reform,” 2001. This box is adapted from “Pay and Patronage in the Core Civil Service in Indonesia,” Nick Manning, PRMPS, World Bank, March 2000, pp. 33-36.*

This lack of meritocracy has continued through to today. Although there are written tests and interviews, there are no “system-wide criteria and standards”<sup>180</sup> and no central personnel agency to enforce such standards. Performance evaluation is superficial and of little consequence. The lack of a meritocratic tradition not only results in poor efficiency outcomes but also creates an environment in which corruption flourishes. On the other hand, as the Partnership Survey on corruption reveals, the few Indonesian institutions that are seen to be well managed,

and where a meritocratic tradition has been established are perceived to enjoy relatively low levels of corruption.

***The reluctance to reward or punish does not help***

Incentives to refrain from corruption depend on rewards (pay and allowances as well as informal incentives that comes with a meritocracy, such as recognition from supervisors and peers), but also on punishment. Indonesia has a comprehensive system of punishment on paper. Disciplinary measures range from verbal or written warnings or written statements of dissatisfaction to demotion, being released from assignment, or dismissal from the service, with and without honor. In reality, however, rewards for integrity and punishments for corruption of any kind are rare. As discussed above, Indonesian managers are very reluctant to discipline officials for corruption, reflecting their likely complicity in the network of corruption in public organizations (see Figure 6.2). Indonesian newspapers commonly report that civil servants who have been accused of being involved in corrupt activities are typically transferred to another position, but rarely sacked. And individuals found to be corrupt are rarely prosecuted in a court of law, and even if they were, the possibility of just punishment under the law would be compromised by the serious deficiencies in the justice system (see Chapter 5).

Theodore Smith, writing over three decades ago, noted that 120 senior regional officials, who were asked in 1969 how often they sacked staff, responded overwhelmingly that while the rules permitted them to do so, they had never exercised this option. “The response requires no interpretation except to point out that the common procedure for dealing with the officials whose corrupt practices became open knowledge is to transfer them to new jobs before their activities gain wide attention”.<sup>181</sup>

***Civil society and public officials***

Finally, a key factor in the weak accountability of the Indonesian civil service is the lack of a service-oriented mindset that allows public officials to accept their role as servants of the people. This situation results from lack of political pressure as well as the failure of civil society to effectively assert pressure and control over those who serve them. Civil society organizations have now developed considerably in the last few years, and corruption watchdogs and consumer associations are emerging which will act as a check on civil service behavior. Decentralization will increasingly bring service providers closer to their clients and force them to face their dissatisfaction. The World Bank’s experience with the *Kecamatan* Development project, discussed in the next chapter, suggests that empowering communities to monitor development performance and facilitating this process through civil society and media coverage has helped moderate civil service corruption. A great deal of scope exists, however for further empowering civil society and the public. The work of the civil service is still shrouded in a culture of secrecy. There is total lack of transparency about rules, the fees and charges that the public is required to pay for services, and the standards it can expect from the civil service. A bill on the right to information has been waiting for parliamentary approval for some time.

## **POLICY IMPLICATIONS**

Fighting corruption in the Indonesian civil service is probably the most difficult of all the challenges discussed in this report. It will require political commitment and time. But the analysis in this chapter suggests a few key policy directions:

First, to the extent that corruption is symptomatic of a failure of the Indonesian state to manage its civil service, there is urgent need for clarity on who would manage a civil service reform process that addresses the incentives that drive corruption. Embarking on a nationally managed reform process that is driven from the center in a country as large and decentralized as Indonesia is almost certainly a recipe for failure. It would be best to accept the logic of Law 22 and allow the regions to experiment with reforms as best they can within certain broad guidelines including a hard budget constraint and discrimination-free hiring and firing. The center's key role then would be to launch reforms for that portion of the civil service that is retained in the central government and reports to it. In either case, some effort is needed to address the rather confused administrative arrangements that now prevail for managing the civil service and for clarifying the responsibilities of the regions for civil service management and reform, with a view to permitting the experimentation suggested above. Establishing a Civil Service Commission, as envisaged under Law 43/1999, staffing it with people of integrity, and providing it broad autonomy to move on a reform agenda may be a way to proceed for civil servants who report to the center.

Second, while determining an appropriate compensation package for the civil service must be an integral part of an anti-corruption program, raising salaries is not where the government should try to begin. The first priority is to disentangle the complex and confusing web of pay and employment policies and introduce greater transparency and reduced discretion. The current elaborate and opaque system of benefits, allowances and extra-salary payments, the product of a strong internal patronage and network system, needs to be dismantled and replaced with a simple and rational system that everyone understands. Merging the recurrent and development budget would contribute to closing a loophole that allows recruitment to positions outside the control of the Ministry of Finance and financed under "projects" included in the development budget, and the payment of a range of project-related allowances that contribute to the lack of transparency on compensation.

Third, a related priority is to develop compensation packages based on well designed labor market surveys. It is particularly important to ensure that the top echelons of the service are adequately rewarded. This will then open the way to recruitment for all Indonesians and help ensure that the top positions are competitively recruited and filled with the best talent in the country. Well designed and transparent compensation packages will also imply maintaining tight controls over the size of the civil service, eliminating ghost workers and reviewing the status of temporary workers through a proper census of the civil service. Such a comprehensive reform should not delay experimentation with reforms at the decentralized level, and since this is permitted under the Decentralization Laws, the Center should clear the path to such experimentation.

Fourth, rationalizing civil service salaries will likely have no effect on corruption unless it is accompanied by the introduction of strong rewards and punishments that significantly shift

incentives in the civil service. This would include establishing clear ethical codes and administering them through an independent ethics commission within the civil service, and ensuring that corrupt behavior is punished severely. Lack of a functioning justice sector need not be a significant barrier since the civil service can enforce its own administrative sanctions and punishment. Our analysis shows that the systems exist on paper and are not implemented and enforced. This needs to change.

Finally, a significant effort is needed to empower the clients of the civil service, the citizens of Indonesia, through transparency and through establishing performance standards. Access to information for the public through a Right to Information Law, will be a crucial first step; and pending the passage of such a bill, issuing regulations that provide access to information under the existing anti-corruption law, as suggested in Chapters 2 and 3, will be important. This will initiate a process of transparency that subjects the civil service to close scrutiny of all its actions. Setting service standards, developing citizens' charters, publishing performance results and surveys of public perceptions of service delivery, and establishing complaints mechanisms are all ways of putting pressure on civil servants to perform better and be less corrupt that have been found to work in other societies.

## 7. Development Assistance: Part of the Problem or Part of the Solution?<sup>182</sup>

*What can development agencies do to reduce opportunities for corruption and strengthen fiduciary oversight in the projects and programs they finance? Criticized for being closely associated with Soeharto, and with debt and corruption inherited from the New Order, the Bank revisited its entire strategy towards Indonesia, agreeing with government to cut lending to a third of past levels, shifting its focus towards community development programs, governance and anti-corruption, and speaking out on issues of corruption.*

*Key changes in the way the World Bank does business in Indonesia have included:*

- **Changes in project design:** *The Bank is attempting to involve communities systematically in the design and implementation of programs it funds with a view to lowering corruption. The Kecamatan Development Project is the best example of this work, aiming to get funds directly in the hands of poor beneficiaries, by-passing governments and empowering communities to prioritize the use of the funds and monitor implementation. Civil society and media help communities monitor performance under the program. This is already showing results in lowering corruption. The Bank is also beginning to involve communities procurement funded under sector-oriented projects, with promising results.*
- **Greater information disclosure:** *Under its enhanced disclosure policy, the Bank has substantially enhanced access to information relating to its projects and programs. The Government of Indonesia has also agreed to make available much more information on new Bank-financed projects, including audit reports, information about corruption, and access of participants in bidding and representatives of end users to key information on the procurement process.*
- **Strengthening controls and supervision:** *The Bank has also greatly strengthened supervision of ongoing projects, conducting random fiduciary audits, more systematic ex-post procurement reviews and prompt follow up on audit findings. Given the complexity of managing a large portfolio, it is adopting a risk management approach to these activities, prioritizing supervision on the basis of the level of perceived risk.*
- **Better enforcement:** *This involves prompt action on complaints and lower tolerance of poor practices. Its Department of Institutional Integrity is currently investigating several complaints – this is itself an achievement because it shows whistleblowers are confident their complaints will be investigated.*

*There are limits to the effectiveness of enhanced supervision and enforcement, And it shifts focus to inputs rather than outcomes. An aid relationship must also be based on trust. More attention is therefore needed on a better understanding of the sectoral and institutional context in which Bank projects operate, and attention at an early stage of the project cycle to addressing the incentives facing the Bank's counterparts. Looking forward, the World Bank is working with its partners to take advantage of the opportunities provided by Indonesia's decentralization to find reform champions in the regions who are committed to addressing weaknesses in governance and accountability and who are seeking access to the Bank's support for provision of pro-poor infrastructure.*

## INTRODUCTION

### *Corruption is endemic, and aid is no exception*

Corruption is endemic in all activities in Indonesia, and activities funded from development assistance are no exception. What can development assistance agencies do to reduce opportunities for corruption and strengthen fiduciary oversight of programs and projects they finance? Is there a way to finance projects that helps to improve Indonesia's governance institutions as opposed to feeding the beast of corruption? This chapter discusses lessons learned from the experience of the World Bank, which in recent years, working together with the Government has put fighting corruption at the core of its country assistance strategy for Indonesia.

Gross disbursements of official development assistance loans provided to Indonesia in 2002 from members of the Consultative Group for Indonesia, net of Paris Club refinancing, totaled \$2.0bn. Some 95% of all disbursements came from three principal sources: the Japan Bank for International Cooperation (JBIC), Japan's principal lending arm, followed by the Asian Development Bank and the World Bank. The lending agencies by definition route their funds through the government budget, since it is the government that is borrowing money from them. Data on grant making are weak. Grant-making bilateral donors often try to avoid routing assistance they provide through Indonesia's budget precisely to reduce risks of corruption. They do this by providing assistance in kind, or financing technical assistance for which they pay directly.<sup>183</sup>

While a lot of NGO and media attention has been devoted to corruption in aid financed projects, corruption is rampant across all public expenditures, and it may be plausible to argue that funds not financed by donors are subject to much less scrutiny and controls. Corruption is equally rampant in activities that have nothing to do with donors such as the collection of taxes and customs duties, which the public already sees as among the most corrupt activities. At the end of the day, the Government of Indonesia is responsible for the effective and efficient use of all expenditure routed through the budget. As was seen in Chapter 2, an accountability framework is in place that is aimed at reducing corruption but it breaks down in implementation. Over the medium term, the government needs to address those flaws and implementation failures. This does not absolve donors and lending agencies of their responsibility for ensuring the proper use of funds that they provide. The experience of the World Bank suggests that there are specific things donors can do to both limit corruption in projects they are financing, but also through projects that begin to improve governance structures.

All donors have policies in place to limit the misuse of their funds. In the case of the World Bank, its Articles of Agreement require the Bank to "make arrangements to ensure that the proceeds of any loans are used only for the purposes for which the loan was granted, with due attention to considerations of economy and efficiency, and without regard to political or other non-economic influences or considerations". The Bank does this in two ways. First, its loan agreements require the Government to follow procedures that are mutually agreed with respect to the procurement of goods and services financed under the project, the disbursement of other expenditures, and regular reporting on project outcomes and expenditures and periodic audits of



expenditures. Second, it “supervises” the activities being funded both with regard to development objectives and to fiduciary controls. Other institutions and donors follow similar procedures. When such supervision reveals the presence of fraud and corruption or simply failure to observe the Bank’s procurement guidelines or to follow the fiduciary safeguards specified in the loan agreement, certain remedies are available to the Bank including cancellation of all or part of the loan in question, or accelerated repayment of loans if these have already been fully disbursed. When corruption is high, aid agencies must weigh carefully whether the benefits accruing for the projects, particularly those to the poor, are outweighed by the risks that part of the funds do not reach the intended beneficiaries. In such cases, lending may be harmful.

## **THE WORLD BANK REVISITS ITS STRATEGY**

In the aftermath of Indonesia’s financial crisis and political remake, the World Bank revisited its entire strategy towards Indonesia. To many Indonesians the Bank was associated with the Soeharto Government, which it had supported for 32 years. The Bank was also associated with debt, perhaps Indonesia’s most visible economic problem in the post crisis years, without being able to contribute to debt rescheduling or debt reduction. And the Bank was associated with corruption because it was perceived to have failed to take a stand against it, while lending large sums of money in a corrupt regime.

Over the last three years, the Bank has actively confronted these weaknesses. In close consultation with the new Government of Indonesia, and reflecting the high level of indebtedness and fiduciary weaknesses, lending volumes were sharply reduced dramatically from an average of \$1.3 billion per year before the crisis, to about \$450 million over the last three years. The Bank shifted its focus (and its reputation) towards a major expansion of its work on community-driven development programs, governance and anti-corruption, and engagement with civil society. The investigation of corruption in its own portfolio, implementation of its revised disclosure policy, and the stance it took on cases such as Bank Bali (see Chapter 4) has begun to shift public perceptions of the Bank.

### ***What the World Bank has learned***

What has the World Bank learned from its experience with fiduciary issues in Indonesia?

- Project design matters: how the flow of funds and procurement are handled and most importantly the extent to which intended project beneficiaries are involved at all stages of the project matter greatly for how well funds are managed.
- Rigorous disclosure of information is critical.
- Project supervision must be aggressive including follow-up on agreements, and complaints must be systematically tracked and evaluated.
- There must be consequences for misuse of funds: serious complaints must be investigated and remedies must be applied.

Looking forward, the Bank and Government will adopt a more programmatic approach, directing Bank funds to local governments that are willing to take on governance reforms.

## **IMPROVING PROJECT DESIGN HELPS**

Over the past few years, the Bank has been trying two parallel approaches to improved project design: greater involvement by project beneficiaries in project design and implementation, including fund flow and procurement; and addressing weaknesses in procurement and financial management and strengthening fiduciary safeguards.

It has long been accepted that involvement of project beneficiaries in the design and implementation of projects is key to better outcomes, including lower corruption. There are few examples of projects that are especially designed to insulate them from a corrupt environment. The *Kecamatan* Development Project (see Box 7.1), a community driven program, launched towards the end of the New Order, is one such example. The project was aimed at trying to reach the poor directly, by-passing government and empowering communities instead to prioritize and monitor implementation of infrastructure schemes of their choice. Villagers are given decision-making power over funds that are used to finance village infrastructure or micro-finance. There is a competition in each village for these funds, which are disbursed through a block grant to each participating *kecamatan* (sub-district), containing some 20 odd villages. Proposals from villagers are verified for technical feasibility, and then submitted to an inter-village meeting where the village collectively decides which projects to choose. All villagers are free to submit proposals, and decisions are democratically made, without outside guidance. Once proposals are successful, funds are released from project accounts. If micro-finance schemes are approved, loans must be made at market rates of interest and the principal and interest is paid into a revolving fund from which others may borrow.

Empowering villagers brings significant benefits. Besides strengthening local ownership and social capital, it helps contain corruption in a project where close supervision would be nearly impossible given that it is spread across more than half the country. This is possible in KDP because those who control the project are those who benefit most from it and have a vested interest in ensuring that the money does not disappear. Villagers are assisted in this effort through a number of features in the project design summarized below (Table 7.1) that are aimed at reducing opportunities for corruption. Andrea Woodhouse, in a background paper for this report,<sup>184</sup> argues that the factors that help the most are transparency and publicity, the involvement of local stakeholders and village leaders, and the involvement of traditional local institutions in the fight against corruption.

These design features do not eliminate corruption. Indeed, the Woodhouse paper demonstrates that corruption is alive and well in KDP and that the incentives created need continuous fine tuning. However, they do raise the risks of corrupt practices motivating villagers to fight them. Indeed, an objective of KDP is to find corruption through community activism, thus changing the social dynamic. The benefits in terms of reduced costs are being studied in some detail by the KDP project team,<sup>185</sup> but preliminary evidence suggests that typical infrastructure costs in KDP projects are significantly cheaper than comparable items in other government projects. Internal rates of return also appear to be consistently higher than standard projects and ex-post maintenance reviews (3-5 years) found maintenance substantially better than through normal public service delivery methods.<sup>186</sup>

**Box 7.1 Empowering the poor and fighting corruption**

The *Kecamatan* Development Projects I and II finance a demand driven program aimed at reducing poverty. The projects are supported by IBRD loans and IDA credits totaling \$590 million. The program started in August 1998. Now in its fifth year, the KDP covers over 21,000 villages in about 1000 relatively poor sub-districts in most of Indonesia's provinces, and is estimated to have benefited some 35 million poor people. About 75% of the funds have been used for village infrastructure projects, such as roads, bridges, and culverts, water supply systems and school repairs, while the remaining 25% has been loaned out through micro-finance schemes operated by village groups to their members for working capital on a revolving fund basis. The use of funds is determined by villagers through a competitive and democratic process facilitated by local facilitators. KDP strengthens accountability of local institutions by keeping all transactions public, and by ensuring independent monitoring by NGOs and journalists. The program also supports capacity development in managing development programs. A third KDP project for a further \$250 million has just been approved by the World Bank's Board. This project extends the scope of coverage of the first two projects. It will focus in particular on helping village governments implement a large training program so that local leaders have the skills to do their jobs more effectively. The project also supports a broad-based program of village capacity development for planning and managing development projects and revolving funds and obtaining services from local governments.

The KDP experience demonstrates that in very corrupt environments, community driven projects can be designed to do a better job of fighting corruption. The Bank has placed its faith in such projects, and of the \$1.376 billion of new loans and credits for Indonesia under the 2001-2003 CAS, over a half are devoted to community driven programs including KDP. Similar approaches are being applied in other projects. In the Java Irrigation Improvement and Water Resource Management Project water users associations were involved in the entire procurement process from the preparation of specifications to checks in the field prior to the handover of the completed work. A study to document the results of such participation showed that this had created a more transparent environment and by 2001, had begun to enhance accountability, improve the quality of the work, and reduce unit costs. This reflected increased involvement of water user associations in the process since late 2000.

As in KDP, the Bank's education projects are also systematically involving communities in small scale construction. Civil works overseen by communities have been proven to be both cheaper and of better quality than where communities have not been involved. If communities are involved in building their own schools or irrigation ditches, they tend to look after them better. Civil works consultants play a crucial role in ensuring this quality.

**Table 7.1: Kecamatan Development Project Design Features**

<b><i>Community control &amp; simplicity</i></b>	<ul style="list-style-type: none"> <li>• Direct transfer of funds</li> <li>• No local government control</li> <li>• Villagers control budgets</li> <li>• Financial formats are simplified so villagers can understand them.</li> </ul>
<b><i>Socialization</i></b>	<ul style="list-style-type: none"> <li>• Villagers learn how the project is supposed to work, what their rights are and what to do if they are unhappy.</li> </ul>
<b><i>Transparency</i></b>	<ul style="list-style-type: none"> <li>• All financial information is made public and publicly displayed in villages</li> <li>• Complaints database will be published in newspapers</li> </ul>
<b><i>Limited monopoly</i></b>	<ul style="list-style-type: none"> <li>• All goods to be procured require at least three quotations</li> </ul>
<b><i>Limited discretion</i></b>	<ul style="list-style-type: none"> <li>• All financial transactions require at least three signatures</li> </ul>
<b><i>Accountability mechanisms</i></b>	<ul style="list-style-type: none"> <li>• Regular village meetings to account for funds. Disbursements can be suspended if misuse of funds is suspected.</li> </ul>
<b><i>Monitoring &amp; follow-up</i></b>	<ul style="list-style-type: none"> <li>• Regular project monitoring, complaints tracking &amp; follow-up</li> <li>• Independent monitoring by civil society groups &amp; journalists</li> </ul>

Source: Andrea Fitri Woodhouse, *The Dynamics of Rural Power in Indonesia: Fighting Corruption in a World Bank Community Development Project*, World Bank mimeo June 2002.

The KDP projects have also attempted to inform the public widely about funding and its uses and have ensured independent civil society and media monitoring of the use of project funds. This now needs to be systematically extended to all projects. For this to succeed, training is needed in financial accounting and development outcomes for both NGOs and the press. Complaints handling processes, surveys of corruption perception, and surveys of firms who participated in the procurement process would also be useful tools.

Procurement as we have seen in Chapter 2 is a major focus for corrupt activity, principally through collusion. Designing projects that reduce opportunities to collude can have beneficial effects. Experience under the Bank's Bali Urban Investment project has shown that enhanced competition combined with empowering honest and capable contractors can reduce procurement costs. This was done by ensuring wide advertising in national newspapers, removal of all geographic and other requirements aimed at restricting competition or favoring local suppliers, opening bidding to all bidders rather than those that have been declared "qualified" to bid in advance; and then having a post qualification process from all those who have bid; establishing an efficient and effective complaints mechanism; and finally declaring misprocurement whenever there is a deviation from policy. In the Bali Urban Investment project, bid prices have been much lower than previously and the spreads were much greater. These practices are now being systematically adopted in all new projects. One reason often cited for failure to advertise widely is budget constraints. There may therefore be a case for financing all costs related to procurement work under the project.

## **OPENNESS EMPOWERS THOSE FIGHTING CORRUPTION**

Closely linked to empowering beneficiaries – the key to better project designs – is the need for rigorous disclosure of information. Indonesia's *Reformasi* has opened the way to *Reformasi* with respect to disclosure of documents. The Bank has substantially enhanced public access to information relating to the projects and programs it funds. Project information documents (short descriptions of projects under preparation) and appraisal reports are available

for anyone wishing to see them. Locally, the Bank opened several public information centers throughout Indonesia, in partnership with Indonesian libraries, reducing one cost of access. More systematic translation of materials into Indonesian would be important to further enhance access.

The World Bank, however, does not control access to Government documents. These documents are typically the most important from the point of view of independent civil society anti-corruption monitoring of projects. Under the Bank's revised disclosure policy, latitude is provided to agree with the Government concerned to go beyond the Bank's disclosure policy and to reach agreements with governments on making documents that belong to governments – such as audit reports and procurement related information – available to the public. The Government of Indonesia has agreed with the Bank to test greater public access to information for selected Bank projects with a view to making such information eventually available for all projects. Indonesia's is one of only a handful of Governments in the world to have taken such a step to date.

Box 7.2 summarizes this agreement.

#### **Box 7.2: Information Disclosure in Projects**

For all new projects funded by the World Bank from 2003, the Government of Indonesia and the World Bank have agreed that they will make available promptly the following documents previously not disclosed to the public.

- “mid-term review” reports for each project
- project audit reports received by the implementing agency
- annual procurement plans and schedules
- bidding documents and “requests for proposals” works or services
- short lists of consultants and, in cases of pre-qualification, lists of pre-qualified contractors and suppliers
- contract award information for all contracts for goods and works above US\$100,000 equivalent and all contracts for consultants above US\$50,000 equivalent

The procurement process is also to be opened up to the public in new World Bank projects:

- After the notification of award to the successful bidder/consultant, the implementing agency will promptly disclose to all bidders and parties submitting proposals for specific contracts the summary of the evaluation of all bids and proposals for such proposed contracts. Information in these summaries will comprise the list of bidders/consultants, all bid prices and financial proposals as read out at public openings for bids and financial proposals, bids and proposals declared non-responsive together with reason for such an assessment, the name of winning bidder/consultant and the contract price.
- If requested, the implementing agency will make available a list of all contracts awarded in a project in the three months preceding the date of the request including the name of the contractor/consultant, the contract amount, the number of bidders/makers of proposals, the procurement method followed and the purpose of the contract.
- Representatives of end users of the goods or works being procured will be allowed to attend the public bid openings.

#### **SETTING THE BANK'S OWN HOUSE IN ORDER**

The World Bank has considerably strengthened supervision of its ongoing projects over the past five years, more than doubling its staff dedicated to fiduciary oversight in the Jakarta office and increasing budgets for supervision. Databases have been set up on complaints relating to corruption, and these are followed up and investigated. Annual procurement and disbursement

plans are now required for projects under a memorandum of understanding reached with the Government at the Country Portfolio Performance Review in October 2001. The Bank is also conducting ex-post procurement reviews more systematically, by outsourcing such reviews. More regular follow up on audit findings is being attempted, but audit reports need to be better analyzed. Here, the fact that audits are conducted by government agencies that have weak auditing capacity and are prone to corruption is a constraint to this process. An Anti-corruption guide and action plan is being prepared for each new project to further protect funds under these projects.

As part of its strategy, the Bank decided to undertake a random fiduciary review for a project selected because fiduciary risks were judged to be high, but which was otherwise being viewed as performing “satisfactorily.” The Second Sulawesi Urban Development Project was approved by the Bank’s Board in November 1996, for US\$155 million. After the financial crisis it was scaled back to \$88 million. The project was aimed at improving the delivery of infrastructure services, strengthening operations and maintenance activities, and improving environmental management in some 41 cities and towns in the island of Sulawesi. The bulk of project funds had been disbursed. The fiduciary review involved a broad overview of procurement implementation and financial management practices, accompanied by an intensive review of a sample of contracts in four cities. Despite much missing documentation, the review found serious problems in all aspects of the project (see Box 2.5 and Box 2.8) including collusive practices, poor contract management, poor performance of the consultants, delays in audits, and poor audit quality.

There is of course no substitute for due diligence in the area of fiduciary controls. This requires low tolerance for the kind of activities found in the Sulawesi fiduciary review. However, staff resource constraints tend to make management of a large portfolio spread over 50 projects difficult, particularly given the progressive change in the nature of projects in the portfolio away from large infrastructure financing to decentralized social and institutional development programs, and from international competitive bidding to national competitive bidding. The newer projects have literally thousands of transactions to monitor. Hence, the Bank is moving towards a risk management approach, rating projects on the degree of fiduciary risk, and giving priority in the use of supervision budgets to projects rated high or medium in terms of their fiduciary risk. Moreover, as the old style projects that did not involve communities sufficiently are phased out, supervision resources can be concentrated more strategically in making the better designed projects work.

#### **LACK OF TOLERANCE OF CORRUPT PRACTICES SENDS A MESSAGE**

For a risk management approach to work, it must be accompanied by enforcement measures that send strong and systematic signals of a lender’s or donor’s lack of tolerance for corrupt practices. The World Bank is taking prompt action on cases brought to its attention or found during supervision. In FY2003, it declared misprocurement totaling \$530,841; in the current year, that amount will rise sharply as it acts on one or two large cases where the investigation is nearly complete. A new Department of Institutional Integrity (INT) at the Bank is required to investigate all cases of potential fraud and corruption in World Bank projects (see Box 7.3). In the case of the Sulawesi project, following the INT investigations and findings of misprocurement, the Bank has declared misprocurement of goods and services totaling \$0.46

million while the Government agreed to cancel the remaining undisbursed amount of \$10 million. The Bank has also begun proceedings to disbar the companies that participated in collusive practices from bidding in new Bank projects. Further, it is working with the concerned Ministry to prepare an action plan that addresses the issues raised by the Sulawesi investigation, prior to any further support to that sector. Finally, the Bank has made public these findings and placed a summary of the report on its web site.<sup>187</sup> It is committed to following this practice for all investigations undertaken by it.

**Box 7.3: The World Bank's Department of Institutional Integrity**

The Department of Institutional Integrity, established in 2001, is responsible for investigating allegations of fraud and corruption in World Bank Group funded projects, investigating allegations of misconduct by World Bank staff, training and educating staff and clients in detecting and reporting fraud and corruption in World Bank Group projects. The Department conducts investigations and submits the results of such investigations to the World Bank's management along with its recommendations which may include debarment of companies that have violated procurement guidelines from bidding in future Bank projects, referring findings to national law enforcement authorities for possible criminal prosecution, and drawing lessons from such investigation for the World Bank's future use. The World Bank is accountable to its 183 member countries, and INT plays an important role in ensuring the effectiveness of the World Bank's lending operations.

There are several complaints currently being investigated by INT in Indonesia. This is in itself an achievement since whistleblowers clearly have confidence that their complaints will be followed up. When misprocurement is found, the relevant amount is cancelled from the total amount of the loan, implying that the government must bear the burden of such misprocurement. If the loan has already been fully disbursed, remedies can include partial or total repayment of the amount misprocured. This can be a harsh remedy for a government struggling to make budgetary ends meet, and so in theory should be a powerful incentive. The other remedy open to the Bank is the debarment of firms. This carries serious consequences for international companies tendering for projects. But in the Indonesian context, there is a risk that companies and individuals reinvent themselves after being disbarred, since it is possible to possess more than one national identity and more than one tax identification number. Adequate due diligence on those who are short-listed for contracts is often missing in project implementing agencies.

Lenders and donors cannot and should not take upon themselves the functions of the Indonesian state. When corruption and fraud are detected in projects, it is up to the Indonesian authorities to prosecute the case and to seek administrative sanctions. There is no evidence from any Bank projects in which the Bank has declared misprocurement, or as in the case of Sulawesi, actually provided evidence of fraud and corruption, of any actions against the concerned responsible officials and no action against the bidders who participated in collusion. This is where civil society can play an important role by bringing to the public attention the lack of action in such cases.

It is important to recognize that there are clear limits to the effectiveness of enhanced supervision and enforcement as vehicles for reducing corruption. An excessive focus on enforcing the rules results in an emphasis on inputs rather than outcomes. More important, if it is to succeed, the aid relationship ultimately must be one of trust. Trust breaks down if one side is continuously looking at each piece of paper with suspicion. If there is a widespread perception of a high risk of abuse of that relationship by one side, that risk needs to be addressed upstream

well before the start of the project cycle. Thus, for example, in the education sector, if teachers are each day abusing their privileged relationship with their pupils by demanding bribes for better grades, that is in some sense a much more serious issue than the diversion of funds from a project. If the senior officials of the ministry are turning a blind eye to or colluding in the production of textbooks that are of poor quality because the procurement process for textbooks has become corrupt, the damage to children's minds from such textbooks is a far more serious problem than the funds diverted from the procurement process, substantial as these are. Sector work that addresses this issue frontally (and well before donors agree to lend in that sector), attempts to understand the incentives that drive such behavior on the part of teachers and education officials and tries to ensure these incentives are changed will enable in the medium to longer term, a better more trusting aid relationship.

Once the incentives have shifted, it will be possible to find honest and committed professionals who will manage projects better and will be just as concerned as donors about the diversion of scarce project funds for illegitimate purposes. In such an environment, where there is mutual trust and shared goals, projects can be designed flexibly. For the kind of institutional changes and community participation that are being emphasized in the new projects the Bank is doing in Indonesia, projects cannot be designed in the way irrigation or dam projects were designed with a high level of certainty on what is to be done. This calls for projects that can be designed even as they are being implemented, reflecting community and local priorities and needs but emphasizing key principles of how things should be managed and done, including how funds should flow, the importance of community involvement, etc. This requires good monitoring and feedback mechanisms and strong local ownership.

#### **LOOKING FORWARD: THE DESIGN OF NEW DELIVERY MECHANISMS**

Two factors – Indonesia's decentralization and the Bank's commitment to improve transparency and effectiveness in the use of its funds – call for new delivery mechanisms. The top-down provision of public services of the New Order regime is no longer an option for Indonesia or the Bank. Decentralization of responsibility to local levels forces, a new way of doing business, poses significant challenges but offers great opportunities for more transparent and responsive service delivery. The challenge will be to find, at each level of government, mechanisms that will ensure transparency of resource use and accountability of service providers to users.

The goal is to use World Bank supported projects to systematically increase standards of governance at each level of government at which it works so that there is a measurable impact on poverty reduction. This would be done through agreeing upon standards—covering information disclosure, participation, financial management, procurement, and expenditure planning, etc. – and allowing local governments to request participation in the project. This approach has already proved highly successful at the community level, and is now particularly important at the district level, where most local government spending authority now lies. It will take some years before the majority of the 400 districts are able to raise their standards adequately. If adequate benefits flow from early investments and capacity building in those districts, showing genuine willingness to change, it is conceivable that a groundswell for reform could develop, for those districts not included in this “early reformers” category, we would continue to provide support through the CDD programs and carefully supervised sectoral programs.



## CONCLUSION

### *Broader lessons for development assistance*

The World Bank's experience in fighting corruption in the projects it finances in Indonesia has four important lessons. The first is that partnerships are central to the fight against corruption. These must begin with partnerships among donors and lenders who have a lot to learn from each other. These partnerships are particularly important if lenders are not to undercut each others' efforts on corruption. When a project that one lender walks away from because of a corrupt environment in the institution managing the project, is picked up by another, it feeds the beast of corruption. A coordinated approach is critical. As the KDP experience has shown, civil society and the media are also important allies in the fight against corruption, and their role needs to be recognized and integrated into project design. Finally, the most important allies in the fight against corruption are those who are the intended beneficiaries of projects. They are the ones who have the most to lose, and a project design that fails to mobilize them is one that is doomed to be plagued by corruption.

The second key message is that transparency and disclosure of information are essential to helping mobilize citizen concerns and NGO and media vigilance. Until Indonesia passes its own sunshine laws, donors can do much to shine a light on all financial transactions so these are subject to public scrutiny. For this to work, it becomes important to engage civil society and the media and provide training on how best to use the information being disclosed. It is easy to bury people with too much information. Making information easy to access and use in a language ordinary people understand is a crucial part of such transparency and disclosure.

Third, corruption has thrived because lenders and donors, like the World Bank, have given the impression that they are willing to look the other way. While zero tolerance is next to impossible in such a high risk environment, a willingness to act firmly and determinedly, albeit strategically, can send a powerful signal to those who have so far not had to pay a price for their corrupt ways.

Finally, it is important that donors acquire a better understanding of the incentives that shape corruption in each sector in which they operate. Anti-corruption efforts must begin with such an understanding. Starting at the project level is starting at the wrong end of the development cycle, where controls and enforcement attack the symptoms rather than the disease. This report is a modest initial contribution towards such an understanding.

<sup>1</sup> Gary Goodpaster,; “Reflections on Corruption in Indonesia”, in *Stealing from the People, 16 Studies on Corruption in Indonesia*, Book 4, pp. 8-28. Richard Holloway (ed.), Aksara Foundation on behalf of the Partnership for Governance Reform in Indonesia, January 2002.

<sup>2</sup> See Barrington Moore’s now classic work, “*Social Origins of Dictatorship and Democracy-Lord and Peasant in the Making of the Modern World*”, Beacon Press, Boston, 1993, p.414, (originally published in 1967.).

<sup>3</sup> Dani Rodrik, Arvind Subramaniam, and Francesco Trebbi, “*Institutions Rule: the Primacy of Institutions over Geography and Integration in Economic Development*”, Harvard University, mimeo. October 2002.

<sup>4</sup> World Bank, “*Making Services Work for the Poor*”, September 2003 (forthcoming).

<sup>5</sup> For a fuller description of this model, see Robert Klitgaard, “*Controlling Corruption*” University of California Press, Berkeley 1988. pp69-74.

<sup>6</sup> In Klitgaard’s stylized equation: CORRUPTION=MONOPOLY+DISCRETION-ACCOUNTABILITY, reducing corruption is a matter of removing monopoly and reducing discretion of agents and enhancing their accountability., *ibid.* p.75

<sup>7</sup> See Mark Philp, ““Why Systems Produce Corruption”, mimeo, undated.

<sup>8</sup> Price Waterhouse Coopers, *Focus on People, The Report of the Governance Audit of the Public Prosecution Service*, a Technical Assistance Project of the Asian Development Bank, March 15, 2001.

<sup>9</sup> Quoted by P.N. Dhar, “*Indira Gandhi, the ‘Emergency’ and Indian Democracy*”, Oxford University Press, New Delhi, 2000, p. 229.

<sup>10</sup> This chapter is based on a draft prepared by Debbie Palmer of the Partnership for Governance Reform in Indonesia.

<sup>11</sup> Indonesia ranked 96<sup>th</sup> (together with Kenya) out of 102 countries listed, only higher than only Angola, Madagascar, Paraguay, Nigeria and Bangladesh. See

[http://www.globalcorruptionreport.org/download/gcr2003/24\\_Data\\_and\\_research.pdf](http://www.globalcorruptionreport.org/download/gcr2003/24_Data_and_research.pdf)

Governance Indicator	Year	Percentile Rank (0-100), in %	Estimate (-2.5 to + 2.5)	Standard Deviation	Number of surveys/polls
Voice and Accountability	2002	34.8	-0.49	0.17	10
	1996	16.2	-1.08	0.21	5
Political Stability	2002	12.4	-1.37	0.2	9
	1996	30.5	-0.34	0.27	6
Government Effectiveness	2002	34	-0.56	0.15	9
	1996	66.5	0.08	0.2	7
Regulatory Quality	2002	26.3	-0.68	0.17	8
	1996	65.7	0.19	0.21	7
Rule of Law	2002	23.2	-0.8	0.13	13
	1996	39.8	-0.34	0.15	9
Control of Corruption	2002	6.7	-1.16	0.15	10
	1996	35.3	-0.44	0.17	7 <sup>11</sup>

<sup>12</sup> Political Risk Services Corruption Index, 1995-2001, reproduced in Keefer, P; *The Political-Economy of Corruption in Indonesia*, 31, July 2002, p3 and p18

<sup>13</sup> Indonesia’s corruption indicators rank it in the bottom 10 percent of all countries included in the index. The thin lines at the top of the bar indicate the statistical margin of error.

<sup>14</sup> Daniel Kaufmann, Aart Kraay and Pablo Zoido-Lobaton; *Aggregating Governance Indicators*, World Bank Institute Governance, Regulation and Finance Division, October 1999 and Daniel Kaufmann, Aart Kraay and Pablo Zoido-Lobaton; *Governance Matters III, Governance Indicators for 1996-2002*, World Bank Institute , May 2003

- <sup>15</sup> Examples of objective indicators include waiting time to obtain a telephone line, the number of procedures required to start a business, the actual cost of building a mile of road compared to what it should cost without corruption, and percentage divergence of funds from the budget. These indicators, however, may not be a very reliable way of measuring broader concepts of governance, and are likely to have as high a margin of error as subjective indicators do. For a discussion on the issue of subjective versus objective indicators, see Kaufmann, Kraay and Mastruzzi, 2003. op.cit.
- <sup>16</sup> Fabiola Desy Unidjaja, "Megawati renews call to combat graft, uphold law", *The Jakarta Post*, March 18, 2002.
- <sup>17</sup> Partnership for Governance Reform in Indonesia; *A National Survey of Corruption in Indonesia, Final Report*, December 2001, pp. x-ix
- <sup>18</sup> Ibid
- <sup>19</sup> See Chapter 5 for a discussion of the views of households and business enterprises and on their use of informal means of resolving disputes.
- <sup>20</sup> Op Cit: Partnership for Governance Reform in Indonesia; *A National Survey*
- <sup>21</sup> Ibid, p.21.
- <sup>22</sup> Ibid, p.20.
- <sup>23</sup> Richard Holloway and Stefanie Teggemann, *Participatory Corruption Appraisal: A Methodology for Assessing How Corruption Affects the Urban Poor*, Partnership for Governance Reform in Indonesia and The World Bank, 2001.
- <sup>24</sup> Hardjono, R and Teggemann, S (eds.) *The Poor Speak Up; 17 Stories of Corruption*, Partnership for Governance Reform in Indonesia, 2002.
- <sup>25</sup> J. S. Furnivall, *Colonial Policy and Practice: A Comparative Study of Burma and Netherlands India*, Cambridge University Press, Cambridge, 1948.
- <sup>26</sup> Clive Day, *The Dutch in Java*, London, Oxford University Press, 1966, as quoted in Theodore M. Smith's unpublished "Corruption, Tradition and Change," 1970.
- <sup>27</sup> Clive Day, *The Dutch in Java*, Oxford University Press, Kuala Lumpur, 1996.
- <sup>28</sup> Ross H. McLeod: *Soeharto's Indonesia: A Better Class of Corruption*, Agenda, Volume 7, Number 2, 2000, pp. 99-112.
- <sup>29</sup> Joel Hellman and Daniel Kaufman: *Confronting the Challenge of State Capture in Transition Economies*. Finance and Development, IMF, September 2001, Volume 38, Number 3. This compares to 'policy capture' defined as "the unscrupulous use of public policies to skew rewards towards a chosen few" with ongoing consequences today. World Bank Office, Jakarta, *Indonesia: The Imperative for Reform - Brief for the Consultative Group on Indonesia*, November 2, 2001, p 3.3.
- <sup>30</sup> Masyarakat Transparansi Indonesia conducted an analysis of such decrees in 1998, and revealed that 79 of the 528 decrees issued between 1993 and 1998 could be interpreted as abuse of presidential power aimed at directing favors to friends or members of the First Family.
- <sup>31</sup> Richard Robison, "Economic and Political Liberalisation in Southeast Asia: Inexorable Force or Red Herring?" paper delivered to the Southern California Workshop on Political and Economic Liberalization at the University of Southern California, 21 March 1995, as quoted in Schwarz, op. cit., p. 316.
- <sup>32</sup> See George Junus Adicondro, "Suharto has gone – but the regime has not changed," in *Stealing from the People, Book 1, Corruption from Top to Bottom*. Ed. Richard Holloway, Partnership for Governance Reform, Aksara Foundation, Jakarta, 2002.
- <sup>33</sup> Adam Schwarz, "A Nation in Waiting," Westview Press, Colorado, USA 2000. (2<sup>nd</sup> edition).
- <sup>34</sup> Growth averaged some 6-7 % over the period, while investment averaged some 25% of GDP. Poverty in the two decades through 1996 fell from 60% of the population to some 12% on the eve of the financial crisis when it rose again.
- <sup>35</sup> Op cit Goodpaster 2002, p7
- <sup>36</sup> Mancur Olson, *Power and Prosperity: Outgrowing Communist and Capitalist Dictatorships*, New York 2000, pp. 6-14.
- <sup>37</sup> William S. Cole, "Roots of Corruption in the Indonesian System of Governance," in *Old Game or New? Corruption in Today's Indonesia*, Asia Program Special Report, Woodrow Wilson International Center for Scholars. December 2001.
- <sup>38</sup> Andrew McIntyre, "Investment, Property Rights and Corruption in Indonesia," in *Corruption: The Boom and Bust of East Asia*, ed. J.Edgardo Campos, Ateneo de Manila University Press, Manila, 2001.

- <sup>39</sup> See Chapter 4 for a fuller discussion of the financial sector and forestry.
- <sup>40</sup> Op cit Goodpaster 2002, p2
- <sup>41</sup> The following analysis and subsequent chapters draws on the analytical framework developed for the forthcoming *World Development Report 2004*, World Bank, 2003.
- <sup>42</sup> K. Sarwar Lateef and Stephen Sherlock, *Fighting Corruption in Indonesia: Obstacles to Developing Investigative Journalism*, draft mimeo, 2002.
- <sup>43</sup> Asian Development Bank; *Governance Assessment 2002*, Asian Development Bank Jakarta.
- <sup>44</sup> The analysis that follows draws, inter alia, on a background paper prepared by Dyan Shinto Nugroho: *Indonesia's New Institutions to Fight Corruption: More Warriors without a Sword?*. World Bank Office Jakarta, draft.
- <sup>45</sup> Antonius Sujata and RM Surachman: *Efektivitas Ombudsman Indonesia; Kajian tindak lanjut kasus-kasus tertentu, Komite Ombudsman Nasional*, Jakarta, 2003, p164
- <sup>46</sup> Financial Action Task Force on Money Laundering website [http://www1.oecd.org/fatf/NCCT\\_en.htm](http://www1.oecd.org/fatf/NCCT_en.htm)
- <sup>47</sup> Keefer, P; *The Political-Economy of Corruption in Indonesia*, July 31, 2002, background paper, World Bank.
- <sup>48</sup> Ibid.
- <sup>49</sup> This will change in the 2004 elections.
- <sup>50</sup> Under the rules governing the 2004 elections, political parties that wish to compete must have boards of administrators in at least two-thirds of the number of regencies/cities with permanent offices, and a minimum membership of 1000 persons or 1/1000<sup>th</sup> of the number of residents in each of the board of administrators' area , i.e., in two-thirds of the number of regencies/cities.
- <sup>51</sup> Keefer, 2002,
- <sup>52</sup> Ibid p19
- <sup>53</sup> This chapter is based principally on two background working papers: *Corruption and Financial Management, Challenges and Opportunities* by Rajiv Sondhi, World Bank Office, Jakarta, (mimeo, 2003) and *Corruption, Collusion and Nepotism in Public Procurement in Indonesia*, by Naseer Ahmad Rana, World Bank Office Jakarta (mimeo, 2003).
- <sup>54</sup> The conceptual framework for accountability used here is adapted from the one developed for the World Bank's forthcoming *World Development Report 2004*, World Bank, 2003. (See Overview).
- <sup>55</sup> The MPR comprises members of parliament, (the DPR) plus a number of nominated groups. The MPR will be replaced in 2004 by a Council of States (corresponding in some ways to the American Senate).
- <sup>56</sup> *Indonesia Country Financial Accountability Assessment*, Report No. 21824-IND, World Bank, Washington, D.C., April 27, 2001, pp. 3
- <sup>57</sup> Defined as including the following: compliance with laws, regulations, policies and procedures, the safeguarding of assets, the prevention and detection of fraud and error, the effectiveness of operations, the accuracy and completeness of accounting records, timely preparation and reporting of financial information.
- <sup>58</sup> *Reform of Public Financial Management System in Indonesia: Principles and Strategy*, Ministry of Finance, The Republic of Indonesia, May 24, 2002 (2002/KPMK/V/MK/001), p. 1.
- <sup>59</sup> Check reference.
- <sup>60</sup> Newspapers have reported a number of such activities including oil smuggling, prostitution and drug and protection rackets.
- <sup>61</sup> Industrial countries typically have far fewer auditors.
- <sup>62</sup> Industrial countries typically have far fewer auditors.
- <sup>63</sup> *Indonesia: Reforming the Public Procurement System*, World Bank, March 27, 2001.
- <sup>64</sup> Ibid
- <sup>65</sup> "Indonesia: Fiduciary Review of the Second Sulawesi Urban Development Project-Overview Report, World Bank Office, Jakarta, 2002.
- <sup>66</sup> *As noted above, this is erroneously described as pre-qualification, a technique normally used to ensure that the firms being pre-qualified are indeed qualified to do the job.*
- <sup>67</sup> *Such as the model procurement law drafted by the United Nations Commission for International Trade Law.*
- <sup>68</sup> *According to a study financed by the ADB, typical salaries of Project Managers, depending on the size of the project, vary between Rp. 1,045,000 and Rp. 1,400,000 per month, and tender committee members who are Section Heads earn between Rp. 790,000 and Rp. 980,000 per month. Salaries of similar positions in the private sector are more than four times higher.*

<sup>69</sup> The box draws on a number of studies by the World Bank and others. For other references see: Ritva Reinikka, "Recovery in Service Delivery: Evidence from Schools and Health Centers." In Ritva Reinikka and Paul Collier, eds., *Uganda's Recovery: The Role of Farms, Firms, and Government*. World Bank Regional and Sectoral Studies. Washington, D.C.: World Bank, 2001; and Ritva Reinikka and Jakob Svensson. "Local Capture and the Political Economy of School Financing." Centre for Economic Policy Research (CEPR) Discussion Paper 3227. London, 2002.

<sup>70</sup> Bert Hofman is the principal author of this chapter, based on contributions from Kai Kaiser, Günther G. Schulze and Andrea Fitri Woodhouse. It draws on World Bank (2003a) "*Decentralizing Indonesia*," Report prepared by the East Asia Poverty Reduction and Economic Management Unit, Washington, D.C: forthcoming; World Bank (2003b) *Indonesia Decentralization Empirical Analysis (IDEA) "Decentralization, Governance, and Public Services: An Assessment of the Indonesian Experience,"* Research Concept Note prepared by Bert Hofman, Kai Kaiser, and Günther G. Schulze, Jakarta, mimeo, and "*Decentralization and Corruption*" by Bert Hofman, Kai Kaiser, and Guenter Schuelze, Paper presented at the Conference on Decentralization and its Impact on Local Economy and Society, May 15-17 2003, Yogyakarta, organized by University Gajah Mada and University Leiden. The authors are grateful to Agus Dwiyanto and his team from the Gadjah Mada University for providing evaluations of the Governance and Decentralization Survey 2002 (See Dwiyanto, Agus et al. (2003) *Governance Practices and Regional Autonomy: Evidence from Governance and Decentralization Survey (GDS) 2002*, Gadjah Mada University, Yogyakarta, mimeo.) and Bambang Suharnoko and Fitria Fitriani for valuable research assistance.

<sup>71</sup> For a detailed account of Indonesian decentralization, see "Decentralizing Indonesia," Worldbank (2003a)

<sup>72</sup> Indonesians use "regions" as a collective term for provinces, districts, and cities.

<sup>73</sup> Many of these provinces and regions are new: after the split with East Timor, Indonesia had 26 provinces, but 4 new ones were added. Since then, numerous local governments have split up, and numerous cities have been separated from their local government of origin. New regions must be created by an Act of Parliament.

<sup>74</sup> The first democratic elections since 1955 were held in Indonesia in 1999. Under the New Order, regional heads were effectively appointed by the center through the Home Affairs ministry to five-year terms. Following the institution of elected and empowered legislatures in 1999, democratically elected officials replace those who were appointed rather than elected when the appointed official's term ends. (See figure 4.2) In 2001, less than half the region heads had been elected.

<sup>75</sup> In early drafts of the law this article read : "...certain obligatory *functions* within the sectors....." As explained below, this change has led to much confusion.

<sup>76</sup> Elucidation of Art. 11, Law 22/99

<sup>77</sup> The appointment of regional heads proceeds according to Government Regulations 151/2000. Following the election, the relevant legislature sends notification (*Berita Acara Pemilihan*, BAP) to the central government and supporting documents (e.g., qualifications of the candidate). The President then issues a letter of appointment for Governors, whereas the Minister of Home Affairs issues letters for local government heads. These are issued as decision letters (*Surat Keputusan*) stating the starting and end date of the appointment. Unlike in the past, the central government has no authority to refuse the appointment of the regional heads. The president refused to issue a letter of appointment for Alzier Dianis Thabranie who was elected as governor by the Lampung provincial legislature in November 2002 as the senior provincial official was involved in several corruption cases, *although this case still appears to be pending*.

<sup>78</sup> Government regulations 56/2001.

<sup>79</sup> See Dwight Y. King (2002) *Political Reforms, Decentralization, and Political Consolidation*, Paper presented at the Conference *Can Decentralization Help Rebuild Indonesia*, a conference sponsored by the Andrew Young School of Policy Studies, Georgia State University, Atlanta May 1-3.

<sup>80</sup> The possible exception to this is the Law on Special Autonomy, which allows for Papuan parties.

<sup>81</sup> ADB, 2002, Draft Country Governance Assessment, July, Jakarta, Processed.

<sup>82</sup> See Chapter 2

<sup>83</sup> PP108 on the accountability of the head of region calls for this.

<sup>84</sup> Each sub-village (*Dusun*) develops a planning program in a Sub-Village Development meeting (*Musbangdus*). This process then feeds into the development of a Village (Desa) Development plan in Village Development Meeting (*Musbangdes*). Based on the village development plans, each Kecamatan (Sub-District) develops a Kecamatan planning program that is integrated into the Kabupaten Planning Program.

<sup>85</sup> The regions visited in preparation for the Bank's decentralization report had yet to determine their own procurement processes—a move which would be allowed under Law 25/2000 and Government regulations 105/2000.

<sup>86</sup> See Chapter 6 for a fuller discussion of civil service issues.

<sup>87</sup> Plans are to create a separate Constitutional Court, which, among others, would take over the review function.

<sup>88</sup> Sponsored by the Partnership for Governance Reforms in Indonesia, the World Bank, and USAID.

<sup>89</sup> Jakarta Post 27 ad 28 November 2001 and Kompas, March 9, 2002

<sup>90</sup> Ibid

<sup>91</sup> Not all heads of government are chosen thus. See Box 4.1.

<sup>92</sup> For instance, in Balikpapan, a city forum is stipulated in a local Mayoral decree no. 188.45-110/2000 as of 21/6/00. In Kota Binjai in North Sumatra, the executive and legislature is preparing an SK that regulates the participation of civil society in the planning process.

<sup>93</sup> Ironically, these bureaus are often staffed with former staff of the abolished ministry for information—a ministry that in good Orwellian tradition existed to control information to the public.

<sup>94</sup> The Central Bureau of Statistics in cooperation with BAPPENAS and UNDP published a very useful pre-decentralization, Human Development Index publication, which presented human development indicators per region based on 1999. There are plans to publish a follow up in 2004.

<sup>95</sup> The limited access to this information can in part be ascribed to the widespread practice in Indonesia's government agencies to sell such information.

<sup>96</sup> In 2003, the Ministry implemented a survey among all regional administrations on implementation of decentralization. The results are not yet available.

<sup>97</sup> KPPOD (*Komite Pemantauan Pelaksan Otonomi Daerah*) (2003) *Daya Tarik Investasi Kabupaten/Kota Di Indonesia*, Jakarta.

<sup>98</sup> This chapter draws heavily on three background papers: Khouw, Merly: *Corruption in the Financial Sector*, Draft Working Paper. 2003; Klausen, Anne-Lise and Hawes, David: *Big Ticket Corruption in Infrastructure*, Draft Working Paper. 2003; WBOJ: *Electric Power*, Draft Working Paper, March 2003, and Bennett, Chris: *Forestry Corruption and the Poor*, Draft Working Paper 2003

<sup>99</sup> For a fuller discussion of the nature of the transition and its inherent risks, see "Chapter 2: Structural Reforms for Growth" in World Bank, *Indonesia-The Imperative for Reform*, Brief for the Consultative Group on Indonesia, November 2, 2001

<sup>100</sup> This section draws on three principle sources: Khouw, op.cit.; Priya Basu, "Bank Restructuring in Indonesia: Process, Outcomes and Preliminary Lessons," World Bank, August 5, 1999, (Internal staff paper); and a recent draft Indonesia Banking Sector Policy Note prepared by World Bank staff.

<sup>101</sup> Priya Basu, *ibid*.

<sup>102</sup> This account is based on Priya Basu, *ibid*.

<sup>103</sup> Khouw, op. cit.

<sup>104</sup> BI, for instance, would be satisfied with obtaining certificates and assignments of title rather than original share certificates and title deeds.

<sup>105</sup> *Tempo*, July 2, 2001, quoted in Khouw, *ibid*.

<sup>106</sup> Rumors continue to persist that such sales have allowed the former owners to buy back their enterprises at heavy discounts.

<sup>107</sup> World Bank, Banking Sector Policy Note, op. cit. p.5.

<sup>108</sup> Power generation has been unbundled and two PLN wholly owned subsidiaries own and manage the Java-Mandura-Bali assets (JAMALI).

<sup>109</sup> The figure of 30% is often quoted as an average mark up for infrastructure investments. The Asian Wall Street Journal, December 24, 1998 quotes Deutsche Bank AG .

<sup>110</sup> [www.ea-watch.com](http://www.ea-watch.com)

<sup>111</sup> The decree stipulated that private entities could be involved in generation, transmission and distribution, and gave preference to build-own-and-operate projects. It was only in 1998 that the Government established cross sectoral rules on private participation in infrastructure – after all the major deals had been struck. This was the regulatory equivalent of closing the stable door after the horse had bolted.

<sup>112</sup> The Asian Wall Street Journal, December 24, 1998. U.S Power Deals in Indonesia draw Flak—Critics Accuse Companies of Using Links with Soeharto to Win contracts.

<sup>113</sup> Some of the affected projects were subsequently cleared to proceed by Keppres 47/1997, but this decree was revoked a couple of months later by Keppres 5/1998.

<sup>114</sup> Established by Keppres 139/1998 and successively amended by Keppres 166/1999 and Keppres 133/2000.

<sup>115</sup> Four portfolio generation businesses; a consolidated system operator, market operator and transmission business; five regional distribution and retail businesses; a single buyer business and an IPP trader business.

<sup>116</sup> Christopher M. Barr, "Bob Hasan, The Rise of Apkindo, and the Shifting Dynamics of Control in Indonesia's Timber Sector." based on his MSc. Thesis, "Discipline and Accumulate: State Practice and Elite Consolidation in Indonesia's Timber Sector", Cornell University, 1998. *Dynamics of Control in Indonesia's Timber Sector*, mimeo, based on the author's MSc Thesis for Cornell University.

<sup>117</sup> Ibid.

<sup>118</sup> See David Brown's report to UK DFID, "Addicted to Rent"

<sup>119</sup> Ibid. p 10

<sup>120</sup> Bennett, Chris (2000) Outcome-based Policies for Reduced Impact Logging. FAO, Seminar Proceedings, Kuching, Malaysia.

<sup>121</sup> World Bank Strategy for Supporting Good Governance of Forest Land in Indonesia, Draft Internal Discussion Paper, June 30, 2003, pp.19-21.

<sup>122</sup> Such rents would never have percolated upwards to Ministers and Director Generals.

<sup>123</sup> The World Bank called for an audit and this became part of the IMF's Letter of Intent in 1999.

<sup>124</sup> Ernst and Young Audit Report.

<sup>125</sup> See draft World Development Report 2004, World Bank, 2003.

<sup>126</sup> There is a complex array of formal and informal taxes from national to regional levels on forest products, exacerbated by corrupt payment processes; narrow interpretation of resource value (focus on timber commodity value) to justify low resource taxes for clear cutting of natural forests, e.g., for pulp and paper industry; and finally log export bans which have been successfully promoted by industry protectionists in the name of conservation, resulting in lower domestic log prices, in turn reducing tree planting as well as incentives for natural forest management.

<sup>127</sup> Bennett (2002a) "Of Responsibility, Accountability and National Unity" in "Which Way Forward: People, Forests, and Policymaking in Indonesia," Colfer, C.J.P. and Resosudarmo, I.A.P. (eds.). Resources for the Future (RFF) & Centre for International Forestry Research (CIFOR), Washington, D.C, Chapter 3.

<sup>128</sup> This chapter draws heavily on World Bank, *Indonesia: Maintaining Stability, Deepening Reforms*, Chapter 3: Reforming the Justice Sector. Report No. 25330-IND, January 2003, and Sebastian Pompe, *Court Corruption in Indonesia: An Anatomy of institutional degradation and strategy for recovery*, draft mimeo, June 2002.

<sup>129</sup> See Chapter 1, Partnership for Governance Reform in Indonesia, Op. cit.

<sup>130</sup> Survey Report on Citizen's Perceptions of the Indonesian Justice Sector, Asia Foundation and A.C. Nielsen, 2001, pp 60-81

<sup>131</sup> Indonesian Corruption Watch, *Lifting the Lid on the Justice Mafia- Research Into Patterns of Corruption within the Justice Sector*, Jakarta June 2001.

<sup>132</sup> Ibid

<sup>133</sup> Ibid.

<sup>134</sup> Mardjono Reksodiputro, Corruption in the Indonesian Legal System, in *Stealing from the People*, Book 2, op.cit.

<sup>135</sup> See Chapter 1 for an overview of these institutions

<sup>136</sup> This section is principally based on a note written by Peter van Tuijl, Advisor to the Partnership for Governance Reforms in Indonesia. An important additional source has been the Asian Development Bank's Governance Assessment, and in particular, Chapter X in that volume on national law enforcement institutions by Dr. Kastorius Sinaga of the University of Indonesia.

<sup>137</sup> Reported by Dr. Kastorius Sinaga (Ibid) in the Asian Development Bank report, as the result of a workshop held in November 2001 by the Association of Commentators on the Police.

<sup>138</sup> Translation of interview notes of Dyan Shinto Ekopuri, a World Bank consultant, participating in a Mapping Reformers study as part of a Justice for the Poor Study.

<sup>139</sup> Seminar on Police Corruption, Indonesian Police Watch, Jakarta, November 2001.

<sup>140</sup> This was recently illustrated in the brazen attack in March 2003 on Tempo Magazine following an article which alleged that arson had been committed to clear an area for redevelopment. Tempo's reporters discovered that they could not count on the neutrality of the police in the dispute.

- <sup>141</sup> Asian Development Bank, *ibid.*
- <sup>142</sup> This also perpetuates the tradition that the police serves the interests of the President, rather than the State.
- <sup>143</sup> Interview notes of Dyan Shinto Ekopuri, *op. cit.*
- <sup>144</sup> This discussion is based in part on the section on the Public Prosecution Service in the Asian Development Bank's Country Governance Assessment Report, which in turn is "substantially" based on a report by Price Waterhouse Coopers, entitled *Focus on People, Report of the Governance Audit of the Public Prosecution Service*, prepared for the Asian Development Bank.
- <sup>145</sup> *Op. cit.* Asian Development Bank, *Focus on People*, p. 8.
- <sup>146</sup> Interview notes of Dyan Shinto Ekopuri, *op. cit.*
- <sup>147</sup> Pompe, *op.cit.*
- <sup>148</sup> For a fuller analysis of the ongoing institutional audit, see World Bank, *Indonesia: Maintaining Stability, Deepening Reforms*, *op.cit.*
- <sup>149</sup> Pompe, *op cit.* The discussion here draws on Pompe's draft paper.
- <sup>150</sup> Pompe argues that corruption is legitimized by trivializing it, leading to such common court parlance as *uang administrasi*, *uang transportasi* (administrative, transport costs), *uang rokok* (cigarette money) and "same day service" (speed money).
- <sup>151</sup> For more on Manulife, see Box 3.2 in Chapter 3 Reforming the Justice Sector, *Indonesia: Maintaining Stability, Deepening Reforms*, World Bank, 2002.
- <sup>152</sup> Commercial court judgments are now accessible on line, together with critical commentaries on [www.hukumonline.com](http://www.hukumonline.com).
- <sup>153</sup> Sebastian Pompe, *op. cit.*, p. 42
- <sup>154</sup> See the Asia Foundation Survey Report on Citizen Perceptions of the Indonesian Justice Sector, *op.cit.*
- <sup>155</sup> *Ibid* pp. 25-31.
- <sup>156</sup> See Chapter 1, Box.1.1
- <sup>157</sup> See World Bank January 2003 *op cit.*
- <sup>158</sup> This chapter draws on three principal sources: *Indonesia: Priorities for Civil Service Reform*, World Bank, 2001, *Pay and Patronage in the Core Civil Service in Indonesia*, World Bank, March 2000 and *Corruption and The Indonesian Civil Service: Some Suggestions for Reform*, John Quah, a background paper for this report. An additional source was the Asian Development Bank's *Country Governance Assessment Report*, June 2002., Chapter VI: The Public Administration and the Civil Service.
- <sup>159</sup> World Development Report 2004, *op. cit.* 3.16.
- <sup>160</sup> See Nick Manning, Ranjana Mukherjee, Omer Gokcekus and Bert Hofman, "Performance Orientation Among Public Officials in Indonesia: Report on a Survey of Public Officials," World Bank, 2001 mimeo. The World Bank-Netherlands Partnership Program financed the Survey which is referred to in this Chapter as the 2000 Survey.
- <sup>161</sup> 650 officials from 19 agencies. *Ibid.*
- <sup>162</sup> Similar results were obtained for these agencies in the 2000 survey of public officials. Nick Manning, et al. *Ibid.*
- <sup>163</sup> World Economic Forum, *Global Competitiveness Report, 2002-2003*, Oxford University Press, 2003.
- <sup>164</sup> Figure G1 in the Partnership Survey.
- <sup>165</sup> No. 37a/M.PAN/2/2002, dated February 8, 2002
- <sup>166</sup> See OECD/Sigma, *Public Management Systems Baselines for Good Governance*, summarized in Box 7, Asian Development Bank, *Country Governance Assessment*.
- <sup>167</sup> *MPR Broad Guidelines of State Policy, 1999-2004*, Chapter 3, B7.
- <sup>168</sup> *Ibid.*
- <sup>169</sup> Caroline Van Rijckeghem and Beatrice Weder, "Corruption and the rate of temptation: Do low wages in the civil service cause corruption?" IMF Working Paper WP/97/73, Washington DC 1997.
- <sup>170</sup> The five variables were "(i) the commonness of bribes, (ii) the percentage of officials receiving bribes, (iii) the percentage reporting budgetary diversion, (iv) the percentage reporting job purchases, and (v) the percentage reporting amount of bribe as a proportion of salary."
- <sup>171</sup> *Ibid*, pages 38-51.
- <sup>172</sup> World Bank 2001, *ibid.*
- <sup>173</sup> See Chapter 4.
- <sup>174</sup> *Op cit.* p.22.



<sup>175</sup> Donald P. Warwick, “*Civil Service Reform in Indonesia, Problems and Possibilities*,” HIID Cambridge, Massachusetts. Unpublished report dated October 1978, quoted in Quah, Op cit.

<sup>176</sup> Ibid.

<sup>177</sup> The military tended to attract the best and the brightest people, given relative career prospects in Indonesia at the time.

<sup>178</sup> Kristiadi, “Indonesia: Redefining Military Possibilities,” p. 102, as quoted in Quah, *ibid*. *Cendana* refers to the name of Soeharto’s family residence in Jakarta.

<sup>179</sup> Check reference

<sup>180</sup> Rainer Rohdewohld, “*Public Administration in Indonesia*,” Melbourne, Montech Pty Ltd., 1995” p. 103, as quoted in Quah, *ibid*.

<sup>181</sup> Theodore M Smith, “Corruption, Tradition and Change,” *Indonesia*, No. 11, April 1971, p.30 as quoted in Quah, 2002.

<sup>182</sup> This chapter benefited from the anti-corruption guide developed by Naseer Ahmad Rana for the World Bank Indonesia Country Team, and from contributions by Jessica Poppele.

<sup>183</sup> This does not necessarily reduce the risks of corruption for such donors, but avoids one level of delegation from principal to agent.

<sup>184</sup> Andrea Fitri Woodhouse, *The Dynamics of Rural Power in Indonesia: Fighting Corruption in a World Bank Community Development Project*, World Bank mimeo June 2002.

<sup>185</sup> xxxxxxxx

<sup>186</sup> See Chapter 3, Box 3.5 in *Indonesia: The Imperative for Reform*, Brief for the Consultative Group Meeting, World Bank, November 2, 2001.

<sup>187</sup> <http://lnweb18.worldbank.org/eap/eap.nsf>