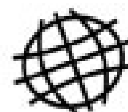
The World Bank Brief for
The Consultative Group on Indonesia
January 19-20, 2005

Indonesia: New Directions



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Report No. 31335-IND

CGI BRIEF

Indonesia: New Directions

CURRENCY EQUIVALENTS
(As of January 14, 2005)
Currency Unit = Rupiah (Rp.)
US$1 = Rupiah 9,160

FISCAL YEAR:
January 1–December 31

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JANUARY 2005

Acknowledgements

This report was prepared by a core team consisting of Yoichiro Ishihara (TTL), Magda Adriani, Blane Lewis, Shobha Shetty and P.S. Srinivas, and undertaken under the direction of William E. Wallace (Lead Economist) and the guidance of Andrew Steer (Country Director). The report was prepared simultaneously with the damage and needs assessment for the Sumatra Earthquake and Tsunami and the unstinting contributions, comments, feedback, review and assistance of both those in Jakarta and Washington were indispensable to its timely completion. Contributions were received from Meltem Aran, Jasmin Chakeri, Aniruddha Dasgupta, Yoko Doi, Wolfgang Fengler, Mitsuhiro Hayashi (Nagoya Gakuin University), Migara Jayawardena, Eka Putra, Sjamsu Rahardja, Kurnya Roesad, Djauhari Sitorus, and Megawati Sulistyo. The report also received valuable comments from Homi Kharas (Sector Director), and Vikram Nehru. Special thanks to Peter Timmer (Center for Global Development), Sudarshan Gooptu and Paul Levy who reviewed the entire report. Peer reviewers were Hadi Soesastro (CSIS) and Odd Per Brekk (IMF). This report was discussed with the Government on January 14th, 2005. Nina Herawati and Indra Irnawan provided logistical and document processing assistance.

ABBREVIATIONS AND ACRONYMS

Abbreviation	Meaning
AAHRD	Agency for Agricultural Human Resource Development
AML	Anti-money Laundering
APBN-P	Revised State Budget
ASDP	Sea Transportation
ASEAN	Association of South East Asian Nations
BAKORNAS	National Coordination Board
Balai PSDAs	Pusat Sumber Daya Air
BAPEPAM	Capital Market Advisory Board
BKPM	Investment Coordinating Board
BPJT	Indonesian Toll Road Authority
BPS	Indonesian Central Statistics Office
BUMD	Regional-owned Enterprises
CAR	Capital Adequacy Ratio
CGI	Consultative Group on Indonesia
COREMAP	Coral Reef Rehabilitation Management Project
CPI	Consumer Price Index
DAMRI	Public Transportation Company
DAU	General Allocation Fund
DIPs	Government Projects' Budget
DPD	Regional Representative Councils
DPL	Development Policy Loan
DPOD	Regional Autonomy Advisory Council
DPR	House of Representatives
DPRD	Regional Legislatures
EDI	Electronic Data Interchange
EFF	Extended Fund Facility
FAO	Food Agriculture Organization
FATF	Financial Action Task Force on Money Laundering
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
GoI	Government of Indonesia
GR	Government Regulations
IAARD	Indonesian Agency for Agricultural Research and Development
IBRA	Indonesian Bank Restructuring Agency
ICP	Indonesia Crude Oil Price
ICT	Information and Communication Technologies
IMF	International Monetary Fund
INPRES	Presidential Instruction
IPPs	Independent Power Producers
SMEs	Small and Medium Enterprises
SOEs	State-owned Enterprises
SRIP	Strategic Roads Infrastructure Project
SUSENAS	National Socio-Economic Survey
IRRs	Implementing Rules and Regulations
ISPS	International Ship and Port Facility Security Code
JAMALI	Jawa, Madura and Bali
JPS	Social Safety Net
KADIN	Indonesia's Chamber of Commerce
KPK	Anti Corruption Commission
LDKP	Rural Credit Institutions
LPG	Liquefied Petroleum Gas
LPKPP	An institution for Development of Public Procurement Policy
LPS	deposit insurance agency
LTO	Large Taxpayer's Office
mbpd	million barrels per day
MOA	Ministry of Agriculture
MOF	Ministry of Finance
MOHA	Ministry of Home Affairs
NBFI	Non-bank Financial Institutions
NCCT	Non-Corporate Countries and Territories
NPL	Non-performing Loan
O&M	Operations and Maintenance
PDAL	Waste Water Utility Company
PDAMs	Local Water Companies
PJM	Medium-term Program
PLN	State Electricity Company
PPA	Asset Management Agency
PPATK	Financial Transaction Reporting and Analysis Center
PPD	Jakarta Transportation Company
PPI	Private Provision on Infrastructure
PPITA	The Private Participation in Infrastructure Technical Assistance
PREM	Poverty Reduction and Economic Management
PRG	Partial Risk Guarantees
PSP	Private Sector Participation
PUSKESMAS	Community Health Center
REER	Real Effective Exchange Rate
Retribusi	Retribution
RPOs	Rural Producers Organizations
Sakernas	Labor Force Survey
SBI	Bank Indonesia Certificate
TFP	Total Factor Productivity
TPA	Final Garbage Collection
UUPK	Basic Forestry Law
V/C	Volume/Capacity
VAT	Value-added Tax

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EXECUTIVE SUMMARY

The past year has witnessed triumph and tragedy in Indonesia. A series of highly successful direct elections marked another historic step in Indonesia's journey towards genuine democracy. The economic crisis that had set back Indonesia's development for the previous six years was finally closed with a highly successful transition from the IMF program. Economic growth picked up, and business confidence and investment demand rose sharply. Most important, poverty rates declined to below pre-Crisis levels for the first time. Sadly, 2004 will also be remembered for the tragic tsunami that claimed at least 104,000 thousand lives in Aceh, and left more than 600,000 homeless. As this report goes to press, the nation is still struggling to come to terms with the enormity of the tragedy, the massive challenge of rebuilding lives and livelihoods, and the longer term task of healing the psychological wounds. Nonetheless, the government has moved quickly to lay out a relief and recovery strategy including efforts to mobilize financial and human resources. The summit in Jakarta on January 6th showed the strong commitment of the international community to assist affected countries. So far, pledged assistance from the international communities for all the countries involved has reached more than US$5 billion, and the Paris Club creditors have offered a debt moratorium.

Total damage of the disaster in Aceh is extensive, including the losses to income, output, and public and private property. Costs of "replacement" (including lost income) are currently estimated in the $4-5 billion range, although the precise costs of a reconstruction plan will only be derived after a detailed process of consultation with the affected Acehnese citizens. A more detailed assessment of the economic and social impact will be available at the CGI meeting. The tragedy's enormous cost is of course in human rather than economic terms, but the economic costs are, nonetheless, substantial. Income and output in Aceh will fall dramatically in the short term, and GDP of the province will fall sharply. For the country as a whole, GDP growth is expected to be reduced in 2005 by 0.1 to 0.4 percent, with the ultimate impact depending significantly on reconstruction activities which have an offsetting impact. Had the disaster come a few years earlier , the economic consequences would have been considerably more serious. But the progress in recovery and macroeconomic stabilization over the last few years, and especially the important political and economic milestones achieved in 2004, have added resilience to the economy and positioned it better to absorb such massive shocks.

Political, Economic and Social Developments (Part 1)

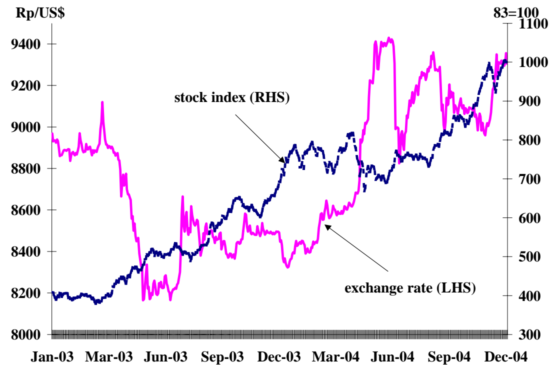
The elections of 2004 were a major milestone in Indonesia's transition. Through three elections in 6 months the Indonesian electorate chose a new Parliament, including an upper house that reflected regional interests, and directly elected the country's President for the first time. The process was universally acknowledged as free and fair, and the logistical arrangements were well handled. Susilo Bambang Yudhoyono (SBY) won a decisive mandate of 61 percent of the popular vote. Direct regional elections will begin in 2005.

The new government took office at the end of October and moved quickly to articulate a reform vision, a 100 day plan and a medium-term framework. The 100 day plan and medium-term framework are organized around three broad objectives: (i) Creating a safe and peaceful Indonesia, (ii) Creating a just and democratic Indonesia and (iii) Creating

a prosperous Indonesia. The government's medium-term plan (Pembangunan Jangka Menengah, or PJM), elaborates on these themes and lays out policies and programs that will help turn the vision into reality over the 2004-2009 period. In this CGI brief we explore some of the implications of these plans. A final version of the PJM will be available on January 20th.

Economic growth rose in 2004, as the economy grew by around 5 percent. The relatively high GDP growth in 2004, a successful election, and the government's articulation of its reform agenda consolidated the momentum that has been building over the past two years and combined to raise market confidence and stock indexes to historic post crisis highs (Figure 1). Indonesia's sovereign rating was upgraded from B to B+ in December 2004, although this is still 4 notches below investment grade. Declining macroeconomic risks are observed in improved debt indicators. The government debt to GDP ratio continued its rapid decline reaching 53 percent in September 2004. Financial sector health improved with both Capital Adequacy Ratios and non-performing loans improving, although risks still remain. Preliminary budget outcomes show the 2004 budget deficit at Rp.27.8 trillion (1.1 percent of GDP), slightly above the target in the revised budget[1]. The government has indicated that they will review the 2005 budget, with latest indications that the budget deficit as a share of GDP will be 1.0 percent and fuel subsidies will be reduced.

Figure 1. Market Sentiment is Strong
(Rupiah exchange rate and JSX stock index (83=100)



Source: CEIC.

Gains in macroeconomic stability and poverty reduction were further consolidated. While the exchange rate weakened, nominal working capital lending rates at around 13.6 percent are now the lowest in more than 10 years. Inflation has stabilized around 6 percent. Consumption demand, especially consumer durables, remained strong, and was augmented by a long awaited turn around in investment growth (over 10 percent in 2004) and with a sharply improved growth in exports (10 percent in 2004 until November)[2]. The Indonesian economy is now operating at close to full capacity in many sectors, paving the way for continued growth in investment and overall growth. Continued growth and relatively low inflation brought the poverty headcount index to 15.1 percent in 2003, now below pre-crisis levels on a consistent basis (Table 1).

Table 1. Change in poverty headcount index from 1996 to 2004

	96	99	02	03
National poverty line	15.7	27.1	16.0	15.1
International poverty line				
1 dollar a day	7.8	12.0	7.2	7.2
2 dollar a day	50.5	65.1	53.5	52.9

Source: World Bank staff estimates, not including Tsunami impact.

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[1] This share is quoted in 2000 base GDP while the government continues to use 1993 base GDP where the deficit would be 1.4 percent.

[2] The interpretation of the export data is still uncertain; see Box 1.2 in Section 1.A.

This encouraging growth in demand has brought with it its own problems. For example, capacity utilization is at an all-time high, straining infrastructure and making the need for high private and public investment a high priority. Overall investment remains around 20 percent of GDP, well below pre-crisis levels of around 30 percent. Government spending, including on infrastructure, health and education has been low, and large capital-intensive investments in mining, oil and gas continue to lag. Lending by banks has increased but is still largely dominated by consumer loans, while long term financing, especially for infrastructure, is growing slowly. Partly responsible for this slow pick-up in investment has been a number of high profile investment disputes and governance problems, especially in the banking system, with new scandals in 2004 (Bank Dagang Bali, Bank Asiatic, and most recently Bank Global). Although exports are climbing, Indonesian export growth is low by regional standards and, Indonesia's share in the important Chinese market fell.

Also of concern to the new Government is that, while income poverty continues to decline, non-income aspects of poverty persist as particularly serious problems, and Indonesia continues to under-perform relative to its neighbors in access to quality health, education and other basic services. Employment growth has been discouraging, adding to pressures on real wages. Indeed, the latest annual figures show that job losses in the formal sector were particularly severe in 2002-2003 with more than a million jobs lost in manufacturing. As a result, the open unemployment rate reached 9.5 percent in 2003[3].

The new Government has recognized that without fundamental reforms to the investment climate, improvements on governance and urgent attention to infrastructure, the current growth performance will not deliver the sustained, quality growth that Indonesia requires. The Indonesian economy is entering a cyclical upturn; three years of consumption led growth, macroeconomic stability and capacity constraints have combined to provide a needed impetus to growth. This opportunity should be used to address problems, and deepen reforms to extend the economic recovery beyond the current phase. The Government's own challenge is to expand public investment while keeping macroeconomic stabilization on track. Options to increase public services include improved allocation of budgetary expenditures, the reallocation and rationalization of existing subsidies, an increase in non-oil and gas tax revenues, and reprofiling public debt.

Medium-Term Prospects (Part 2)

If reforms are successful, and the international environment remains benign Indonesia's income and output should be able to grow by 6 percent per year between 2006 and 2009. In light of the high capacity utilization, current and potential investment demand is high. Improving the investment climate will sustain high investment growth beyond its current cyclical phase. Increasing productivity will be equally challenging and require continuing efforts to reduce costs and increase certainty especially those related to bureaucratic procedures and corruption. Accelerating growth, together with stable prices should push the poverty headcount index to 6-9 percent by 2009. In contrast, given demographics and the composition of this growth, improving the labor market will be more

[3] The first quarter 2004 labor survey indicates a turn around in the unemployment rate, but the small sample size argues against over-interpreting this result.

difficult and open unemployment is only expected to decline from 9.5 percent in 2003 to 8.6 percent in 2009.

In the medium-term fiscal policy will gradually change from fiscal consolidation to support for higher quality growth. Budget deficits of 1 percent of GDP or below for will allow a modest but sustained (and much needed) increase in public spending, while allowing the government debt to GDP ratio to fall from around 50 percent today to 34 percent in 2009. (In comparison, the public debt of the Philippines stands at over 90 percent). Thus Indonesia's stock of debt will continue to be a rapidly shrinking problem. However, its specific profile of debt service payments still creates a heavy burden in terms of financing needs. Gross financing needs will average more than $10 billion per year for the coming five years, of which three-quarters will be needed for amortizing existing debt. With careful management this should not pose a problem, but it will require a judicious use of domestic and foreign borrowing, and a continuation of the reform program, so as to maintain flexible access at good rates in the various markets.

Improving the Investment Climate for Firms and People (Part 3)

Removing Investment Barriers (Chapter 4). Improving the investment climate is Indonesia's key economic priority. Early, decisive action is needed to find the solution to a number of high-profile investment disputes as this is an important litmus test. Firms surveyed by the World Bank indicate that costs associated with corruption, excessive and uncertain regulations and unreliable infrastructure can make up 20 percent of the value of sales. These need to be addressed systematically. Problems are now relatively well understood, and have been well described in the recent "Roadmap" prepared for the new Government by the Indonesian Chamber of Commerce and Industry (KADIN), and in reports of the "Investment Climate Working Group" (comprised of international donors and businesses).

The new Government also has demonstrated a clear understanding that serious problems remain in taxation, customs, decentralization, labor legislation, investment regulations, and the financial sector. The challenge now is to turn this consensus into actions that practically help reduce the cost of doing business. One element would be to begin to shift from an "approval" approach to investment licensing to a "registration" approach. Another fundamental element will be to begin to change the attitudes of middle and lower level civil servants in central and local governments away from a "controlling and exploiting" mindset towards an "enabling and facilitating" mindset. This may take a decade, but there is now a historic opportunity to begin this process immediately, and the pay-off for the country's future be huge.

Averting an Infrastructure Crisis (Chapter 5). The new Government believes strongly that infrastructure remains a serious impediment to growth and a hindrance to poverty reduction. Investment in key infrastructure, now around 3-4 percent of GDP, needs to rise by around 2 percentage points of GDP, or by around $5 billion per year, if it is to enable an economic growth rate of 6 percent. In the years since the crisis a number of important laws (oil and gas, electricity, telecommunications) have been put in place that provide a good platform for moving forward. However, implementation has remained weak and uncertainty was increased when the constitutional court annulled the electricity law in December 2004.

The "Infrastructure Summit", held on January 17-18, is demonstrating the Government's determination to bring all stakeholders to the table to break the current inertia in infrastructure investment. It is laying out 91 investment projects, and committing to a modern regulatory and competitive bidding environment that will enable the private sector to be key partners to the public sector. To be successful this requires not only top-level decision-making to adopt a new approach, but a commitment to a firm process of institution building, that will result in better planning, better regulation, rational pricing, and contract enforcement.

Implementing Decentralization (Chapter 6). The implementation of Indonesia's decentralization laws was carried out more smoothly than observers expected, although a number of problems emerged. In particular unclear expenditure assignments, insufficient decentralization of the tax base, and a near halt to regional public investment in infrastructure contributed to ineffective implementation. With Law 32/2004 and Law 33/2004, the two pillars of decentralization legislation have been amended. These laws move the decentralization process in the right direction, especially by increasing accountability through elections, but progress is uneven especially as regards inter-government fiscal relations. Most importantly, the government needs a clear assignment of responsibility for managing the decentralization process.

Improving Rural Development (Chapter 7). Poverty in Indonesia is mainly rural, and agriculture averages half of rural households income. A meaningful strategy of rural poverty reduction must integrate agriculture as a major element. Both government spending and private investment in agriculture fell in the 1990s as a percentage of agricultural GDP. The Medium Term Plan rightly calls for revitalizing agriculture through the development of agribusiness linkages to improve farmer incomes and greater diversification. To achieve the agricultural growth rate of 3.9 percent will require strong measures to boost agricultural productivity through expenditures on agricultural research, demand-driven approaches to extension, dryland area development, strengthening regulatory capacity, and improving rural infrastructure including rural information and communication technologies (ICT).

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PART 1: THE ECONOMY IN 2004 ON THE REBOUND

Recent improvements in the macroeconomic situation are encouraging. Investment is beginning to support growth acceleration, while private consumption remains strong. Economic momentum together with political stability and high expectations for the new government's economic policies have improved market sentiment. Macroeconomic risks measured by external and government debt to GDP ratios continue to improve. However, the investment climate remains poor. Though recovering, investment growth is low in light of high capacity utilization. In particular, low investment in key sectors such as the oil and gas have led to reduced production. Preliminary 2004 state budget results show a slightly higher deficit, mainly due to lower non-oil and gas tax revenues. Improving tax administration and reallocating inefficient spending are keys to fiscal consolidation and increased public investment.

Aceh and North Sumatra

At 7:58 AM on Boxing Day (December 26th 2004) an earthquake with a magnitude of 9.0 (Richter scale) struck the coast of Sumatra. The resulting "Tsunami" killed over 100,000 people in Aceh and North Sumatra and an estimated 50,000 others in countries bordering the Indian Ocean. Relief operations are still underway, the full extent of the disaster, the loss of life and damage to property remain unclear and an assessment of the relief and rehabilitation needs is underway. The social impact of this event has been devastating; survivors are traumatized, and the social and political support infrastructure badly damaged. Many of those affected were poor. Aceh province has become geographically isolated and the scale of the relief operations has been hampered by bottlenecks and coordination problems among relief agencies. However the scale of the disaster also elicited an outpouring of support worldwide. High-level Summits were held in Jakarta on January 6th and in Geneva on January 11th where billions of dollars were pledged to support the Tsunami-affected countries. The President of Indonesia has asked BAKORNAS (National Coordinating Agency for Natural Disaster and Refugee Relief) to coordinate relief operations and BAPPENAS (The National Development Planning Agency) to develop a National Reconstruction and Recovery Plan. The government also committed to present a damage and needs assessment to the CGI on January 19-20th. Initial results indicate that the impact was very severe for Aceh, in addition to the loss of life and livelihood the loss of public and private property and wealth will have long-lasting impacts. Nevertheless the impact at the level of the overall economy is not expected to exceed 0.4 percent of GDP. An assessment of the economic and social impact of this disaster will be presented in a separate document to the CGI.

Chapter 1. Economic and Social Update

Macroeconomic Stability Turns into Higher Growth. Q3 2004 GDP growth (yoy) accelerated from 4.5 percent in Q2 to 5.0 percent. Q1-Q3 growth reached 4.9 percent (Table 1.1). This growth is in line with, or above, the government's projection for the year of 4.8 percent (revised 2004 budget). Domestic demand (consumption and investment) has driven higher growth, with investment (i.e. gross fixed capital formation) growing by 13.1 percent in Q3. Export growth is also strong at 10.0 percent (yoy) in January-November 2004. Not surprisingly, private consumption growth was dominated by consumer durables, which grew at 8.7 percent in the first three quarters of 2004. On the production side, the pattern of relatively higher growth in the non-tradable sector continued, in fact accelerated, with telecommunications (included in transportation) and construction especially high. However, manufacturing growth also picked up to 5.6 percent, with transportation equipment and cement growing by 6.3 percent (yoy). Still, this was not enough to offset a rapid decline in the mining sector.

Table 1.1. Moderate GDP growth continues (2000 base year, growth in percent compared to same period of the previous year)

	2002	2003	2004 (Q1-3)
GDP	**4.3**	**4.5**	**4.9**
Non-oil and gas GDP	**5.0**	**5.3**	**5.7**
By Expenditure			
Private consumption	3.8	3.9	5.3
Public consumption	13.0	10.0	3.8
Fixed investment	2.2	1.9	11.3
Exports	-1.0	6.6	8.3
Imports	-4.0	2.8	24.2
By Sector			
Tradable	**3.8**	**3.1**	**2.7**
Agriculture	2.8	3.1	3.2
Mining	0.4	-1.6	-5.5
Manufacturing	5.9	5.0	5.6
Non-Tradable	**4.8**	**6.2**	**7.5**
Construction	5.2	6.3	8.1
Finance	5.5	6.9	5.4
Transportation etc.	8.4	11.6	13.6
Utility	7.5	5.9	4.6
Retail trade etc.	3.9	5.3	5.0
Services	3.2	4.1	4.7

Source: BPS.

Solid Signs of Investment Recovery. Until this year, overall investment growth had been dominated by investment in new property (i.e. construction) but 2004 saw a rapid expansion in the output of capital industries and machinery imports, the other elements that make up investment in the national accounts. In 2003, investment growth was a mere 1.9 percent. Property investment, which accounted for about 80 percent of total, grew by 6.3 percent; domestic capital goods output, machinery and transportation, grew by 2.3 percent; and the import of foreign machines actually declined by 20.4 percent. Over the first three quarters of 2004, investment grew by 11.3 percent. Construction grew by 7.5 percent, domestic capital goods grew by 14.7 percent and foreign imports by an amazing 33.6 percent. Other investment indicators also show recovery. For example, capital goods imports (January-November 2004) grew by 44.2 percent (yoy). A caveat is that investment approvals (including domestic and foreign) decreased by 3 percent (yoy) in January-November 2004[1], indicating that the investment climate has not yet fully recovered.

Weak Investment Climate and Low Investment in Oil and Gas. Despite signs of an investment recovery, the investment climate remains weak and investment growth, is lower

[1] Excluding the oil and gas and financial sectors. In January-November 2004, the value of domestic investment approvals declined by 31.8 percent and the value of foreign investment approvals declined by 29.6 percent. However, these declines do not necessary accurately represent the true situation. For example, in 2003, a single investment approval accounted for more than 50 percent of total value of domestic approvals.

than it should be. Regarding the investment climate, for example, it takes 151 days to start up business in Indonesia, much longer than in neighboring countries (Thailand (33 days), Malaysia (30 days) and China (41 days)). The negative consequences of low investment are especially apparent in capital intensive areas (note the decline in mining) and in the oil and gas sector. In 2004, Indonesia's oil production was 1.04 mbpd, 20 percent below the OPEC production quota of (1.3 mbpd) and the value of oil exports is likely to decline by 10 percent in 2004. Uncertainty about tax treatment, laws and regulations, as well as the government's handling of key projects such as Cepu have contributed to a weak investment climate. However, increasing oil and gas production is an item on the government's 100-days program (Improving the Investment Climate and Business Confidence) and its draft-PJM (Issues and Agenda National Development Year 2004-2009). Moreover, in December 2004, the government signed 46 new oil and gas contracts. Although it will take time before the new agreements contribute to actual production, they do show investor confidence returning to this sector. Uncertainty about laws and regulations affect other sectors, as well. For example, the decision of the constitutional court to annul the electricity law (No.20/2002) increases uncertainty in to the power sector and has potential implications for other areas too.

Private Consumption Remains Strong. Private consumption remains strong. Non-food private consumption, such as durables, grew by 8.7 percent in Q1-Q3 2004 (yoy). This is consistent with continuing very strong sales of cars and motorbikes (Figure 1.1). Car sales increased by 31 percent and motorbike sales increased by 39 percent in Jan-Oct 2004. Currently, this growth in private consumption is supported by significant credit growth (Figure 1.2). The credit outstanding to private consumption has continuously increased since 2000 and is now reaching pre-crisis levels. In the short-run, consumer credit supports the growing demand but in the longer term repayment pressures will slow growth.

Box 1.1. Revaluation of GDP – Important Implications for Key Indicators

In May 2004, the Indonesian government updated GDP estimates, as part of an exercise carried out every ten years to capture change in the structure of the economy. The GDP-components have been re-weighted and include new products (e.g. IT sector) as based on the 2000 Input-Output Table. The result is an upward revision in the nominal level and growth of GDP as compared to the previous 1993 base year (box table 1). For example, nominal GDP was almost 10 percent higher in 2000 and 18 percent higher by 2003. This change in nominal GDP affects key macroeconomic indicators, including the tax ratio, budget deficit, and debt to GDP ratio. In some cases, these measures have declined sizably. For example, the government debt to GDP ratio in 2003 was 69 percent in 1993 GDP but only 59 percent in 2000 GDP; the budget deficit ratio improved as well: in 2003 it was 2.1 percent of GDP in 1993 base; and it was 1.8 percent of GDP in 2000 base GDP.

Box Table 1: Change in GDP between base year 1993 and 2000

	Nominal GDP (Rp. Trillion)			Real GDP (growth rate, percent)		
	1993 base	**2000 base**	**Percent change**	**1993 base**	**2000 base**	**Percent change**
2000	**1,265**	**1,390**	**9.9**	**4.9**	**-**	**-**
2001	**1,468**	**1,684**	**14.8**	**3.5**	**3.8**	**0.3**
2002	**1,611**	**1,898**	**17.8**	**3.7**	**4.3**	**0.6**
2003	**1,787**	**2,087**	**16.8**	**4.1**	**4.5**	**0.4**

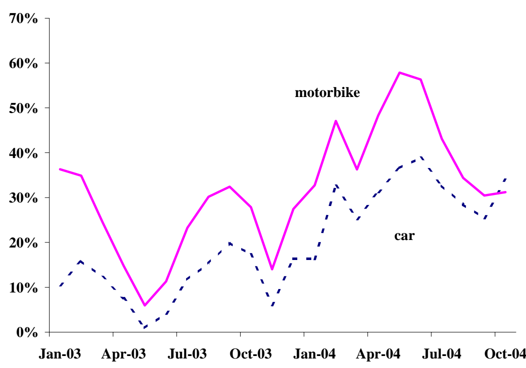
Source : BPS, Staff Calculation.

Given the transition to the new GDP base it is important to highlight the base year for consistency purposes:

- The Government continues to present the 2005 budget in 1993 base GDP but explains the differences using the 2000 base. For consistency, the government continues to use the 1993 convention. In 2005, all government documents will be based on 2000 base GDP; 1993 base GDP is no longer be available.

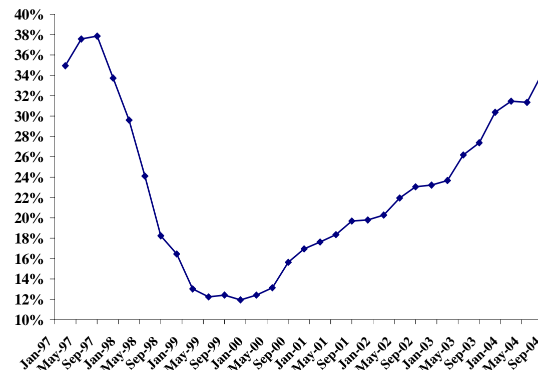
Market Sentiment Improves and Prospects Grow for Higher Ratings. In light of the acceleration in growth, political stability, and positive expectations for the new government, market sentiment has been strong (Figure 1.3). The Jakarta stock exchange composite index reached its all time high of 1,032 in January 2005. The index has increased by a factor of 2.5 in just 2 years. Net purchases by foreign investors have driven the index higher, and are reflected in net positive portfolio investments in the balance of payments. The rupiah exchange rate has traded in the range of Rp.9,000-9,500 against the US dollar in recent months. This recent (real) depreciation of the rupiah measured by REER is contributing to a recovery in price competitiveness and, as such, should have a positive impact on exports. However, compared with regional competitors, Indonesia's REER (Jan 2000=100) is higher, i.e. representing less depreciation at least since 2000, but reflecting in part the level of depreciation at that point (Figure 1.4). These signs of recent progress are reflected in Indonesia's ratings. S&P, one of the leading international rating agencies, raised Indonesia's rating from B to B+ on December 22, 2004, though it remains 4 notches below investment grade.

Figure 1.1. Strong car and motorbike sales
(year-on-year growth, 3 month moving average)



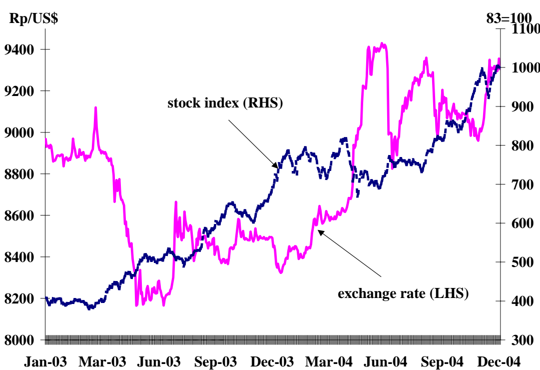
Source: CEIC, staff calculation.

Figure 1.2. Consumer credit supports demand for durables
(The ratio of credit outstanding to private consumption)



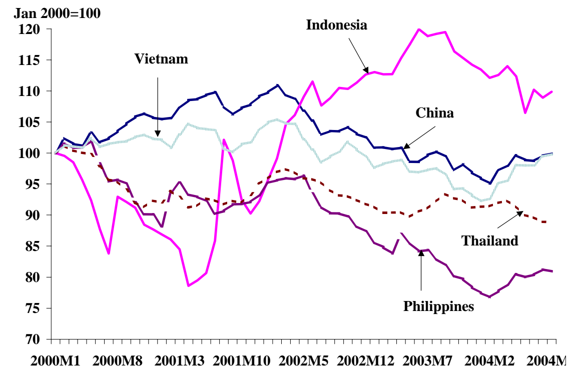
Source: Bank Indonesia, BPS, staff calculation.

Figure 1.3. Improved Market Sentiment
(Rupiah exchange rate and Jakarta Stock Exchange Composite Index (83=100)



Source: CEIC.

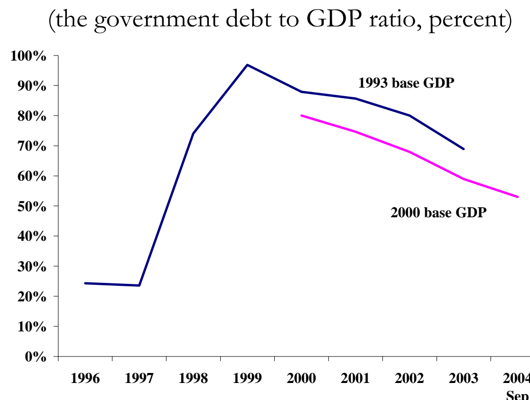
Figure 1.4. REER (Real Effective Exchange Rate)
(January 2000=100)



Source: IMF, staff calculation.

Improving Fiscal and External Risks. Higher growth has reduced fiscal and external risks. The government debt to GDP ratio improved from 59 percent in 2003 to 53 percent in September 2004 (Figure 1.5). The external debt to GDP ratio improved from 56 percent in 2003 to 51 percent by September 2004. The short-term debt to international reserve ratio (excluding non-bank trade credit), an indictor of liquidity risks, had fallen to 38 percent as of June 2004. In 1997, this ratio was well above 200 percent and the current level is comparable with neighbors such as Korea and Malaysia. Nominal levels of external and government debt outstanding have remained essentially the same for the last few years, and reductions in debt indicators has been the result of increasing GDP, a stronger exchange rate and sustained primary surpluses.

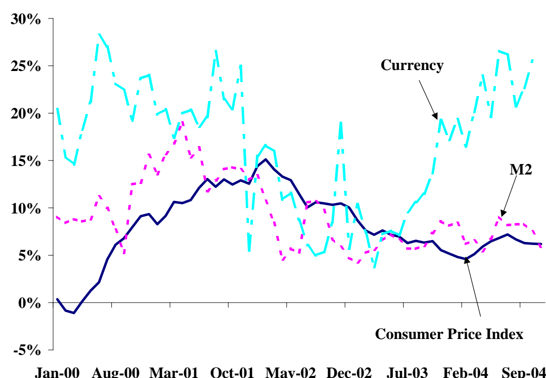
Figure 1.5. Improvement in Macroeconomic Risks
(the government debt to GDP ratio, percent)



Source:: BPS, MOF, staff calculation.

Money and Inflation. Inflation has decelerated in the past few months. Consumer price inflation (CPI) was 6.4 percent (yoy) in December 2004, a decline from its 2004 peak in July of 7.2 percent. Food prices, which make up approximately 25 percent of the index, decelerated from 10 percent in July to 6 percent in December. Inflationary pressure from base money remains small but currency growth greater than 20 percent in January October 2004 (Figure 1.6) could result in increased inflationary pressure in 2005.

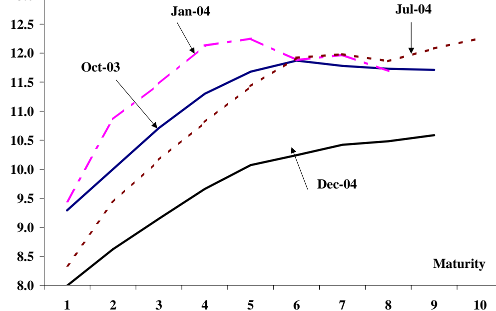
Figure 1.6. Money and Inflation
(year-on-year growth rates, percent)



Source: CEIC, BPS, staff calculation

Government bond interest rates have declined substantially and the yield curve has flattened reflecting perceptions about economic policy formulation and implementation by the new government (e.g. favorable inflation expectations and improving confidence in fiscal policy). Between July and December 2004, the 1-year government bond yield declined from 8.3 to 8.0 percent, whereas the 9-year government bond yield declined from 12.1 to 10.6 percent (Figure 1.7). The flattened yield curve reflects the improvement in long-term risk assessments among investors, which in turn should assist the government medium-term financing prospects (Chapter 3).

Figure 1.7. Declining and Flattening Yield Curve
(government bonds yield)



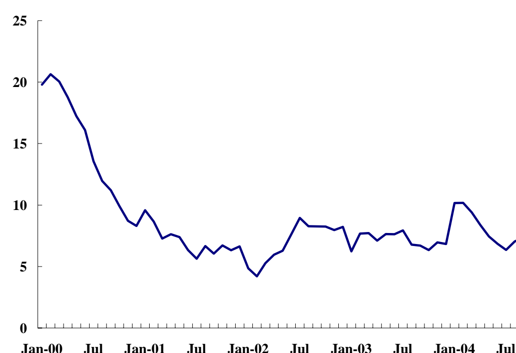
Source: CEIC, World Bank staff

Financial Sector Developments. Banks have also benefited from the acceleration of economic

activity. The profitability of commercial banks—as measured by rates of return to assets and equity—has improved substantially. Average risk-weighted capital adequacy ratios have remained above the 8 percent BIS norm for several years, while non-performing loan (NPL) ratios have continued to decline, reflecting continued restructuring efforts, improved capacity of borrowers to repay, and new loan growth. The CAR improved from 19.4 percent in December 2003 to 20.8 percent in September 2004. The NPL ratio declined from 6.8 percent in December 2003 to 5.6 percent in September 2004. Bank lending to firms, especially those in the manufacturing sector, accelerated in 2004, after a long period of stagnation.

Real interest rates continue to decline (Figure 1.8), and the availability of credit is improving. At the same time, there has been continued progress in corporate debt restructuring, which, combined with the lower interest rates, has resulted in sharply lower interest expenses for firms. At the same time, stock prices surged in 2003-04 with strengthening growth, the improving financial health of corporations in the country, and the return of foreign portfolio capital inflows. This helped reduce the equity cost of capital. Firms' profitability and balance sheets are thus improving, and this should also be supportive of new investment.

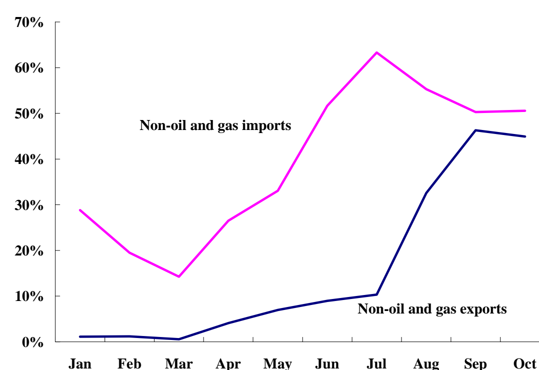
Figure 1.8. Real Interest Rate Declines
(Real Interest Rate=Lending Rate – CPI)



Source: Bank Indonesia, staff calculation

International Trade and Balance of Payments. In 2004, both exports and imports increased sharply, although changes in data collection methods (Box 1.2) may have affected the figures (Figure 1.9). In January-November 2004, total exports increased by 10.0 percent (yoy). Oil and gas exports grew by 14.3 percent, while non-oil and gas exports grew by 8.8 percent. Non-oil and gas exports started to surge in August. In the January-July period, the average year-on-year growth rate was 4.8 percent, but was 26.9 percent by August-November. In January-November, total imports grew by 40.0 percent (yoy). Oil and gas imports increased by 47.4 percent and non-oil and gas imports increased by 37.7 percent. Capital good imports increased by 44.2 percent; especially important were imports of electrical equipment and transportation equipment, which increased by 58.6 percent and 43.6 percent, respectively.

Figure 1.9. Surge in International Trade
(year-on-year growth, percent)



Source:: BPS, staff calculation

Box 1.2. Change in Trade Data Collection Methodology

In 2004, the export and import data collection method was changed. Through 2003, all Indonesia's custom offices sent data on trade transactions by hardcopy. In January 2004, custom offices began to send import data electronically through an EDI (electronic data interchange) system. In May 2004, the 11 largest custom offices also started to send export data electronically, while the remaining 108 smaller offices continued to submit data by hardcopy. Although the 11 largest custom offices now send export data electronically, the system used is different than the EDI system used for import data. Anecdotal evidence indicates that coverage (both import and export) may have increased substantially in 2004 but that the quality of export data may deteriorated. Part of the reason is the usage of "," and "." where Indonesian and English practices differ. While the Indonesian central statistics office (BPS) is checking data accuracy and making adjustments, the consistency of the series is uncertain. Japanese trade data imply that exports to Indonesia increased by 27 percent, while Indonesia trade data suggest that imports (non-oil and gas) from Japan increased by 39 percent, a discrepancy of some 12 percentage points.

As regards the balance of payments, in Q1-Q3 2004, the trade balance reached US$15.9 billion, while the service balance was –US$12.8 billion. As a result, the current account balance was US$3.2 billion, significantly lower than the US$5.6 billion in Q1-Q3 2003. The oil balance was negative until Q3 2004, although the oil and gas balance was surplus. While oil export volume declined by about 10 percent (yoy), mainly due to lower production, import volume increased due to strong domestic demand for fuel products such as gasoline and kerosene. For the first time since the crisis, net private capital flows turned positive in Q1-Q3 2004, reaching US$2.8 billion. Not only was portfolio investment positive, not surprising in light of the buoyant stock market, but foreign direct investment (FDI) finally turned positive as well. In contrast, the public sector balance (excluding IMF) turned negative at –US$1.8 billion. In addition to the expiration of the Paris Club rescheduling at end-2003, public inflows are were limited to project loans and the proceeds from the international bond. However, in Q4 2004, World Bank and Asian Development Bank disbursed program loans worth US$0.6 billion.

Fiscal Policy (table 1.2)

Budget Deficit Slightly above target in 2004. The preliminary 2004 state budget outcome indicates that the budget deficit was Rp.27.8 trillion (1.2 percent of GDP), slightly higher than Rp.26.3 trillion (1.1 percent of GDP) envisioned in the revised budget (APBN-P). In mid-December 2004, gasoline (Pertamax and Pertamax plus) and LPG prices were hiked. These prices are not regulated by the government and the price hikes were decided by Pertamina. As

Table 1.2. Snapshot of State Budget
(As a percent of GDP)

	2003 pre. actual	2004 APBN-P	2004 pre. actual	2005 APBN	2005 APBN-R 1/
Revenues	**16.3**	**17.2**	**17.4**	**14.5**	**16.6**
o/w oil and gas	3.9	4.7	4.6	2.3	4.4
o/w non-oil and gas domestic tax	10.1	10.4	10.5	10.3	10.3
Expenditures	**18.2**	**18.4**	**18.6**	**15.1**	**17.6**
o/w fuel subsidies	1.4	2.5	2.9	1.2	1.8
o/w development expenditures	3.2	3.1	2.9	-	3.6
Budgetary balance	**-1.8**	**-1.1**	**-1.2**	**-0.6**	**-1.0**

Note: 2000 base GDP, Not including Tsunami impacts.
1/ 2005 budget being reviewed, staff estimates.
Source: Ministry of Finance, staff calculation.

such, the price hikes do not have a direct impact on the state budget (i.e. oil and gas revenues and fuel subsidies). However, a possible improvement in Pertamina's cash flows would positively affect the state budget, indirectly, through profit transfers and/or settlement of past arrears.

The Budget Deficit in 2005 adjusted but still reflects fiscal consolidation. The previous government and parliament approved the 2005 budget (APBN) in September 2004. However, drafting a revised 2005 budget (APBN-P) is one of the items in the government's '100-days program'[2]. The budget deficit target was revised from Rp17.4 trillion to Rp.26.2 trillion up from 0.8 percent to 1.0 percent[3] of GDP. The increase in gross financing of Rp.10 trillion would be covered by additional government bonds. In the approved 2005 budget, gross government bond issues were Rp.43 trillion, but the figure was revised up to Rp.49 trillion. According to the latest information, the oil price assumption (ICP) is likely to be increased from US$24/bbl to US$35/bbl with fuel prices expected to be increased in February or March 2005 by 35 percent[4].

External Financing Needs in 2005. Gross financing needs in 2005 are expected to be quite similar to those in 2004. The projected budget deficit in 2005 is US$2.9 billion and amortization is US$7.9 billion. Therefore, the government has to raise US$10.9 billion in financing. The government plans to raise US$1.0 billion from bank financing, and US$5.9 billion from (domestic and foreign) bond issuance. Sales of the remaining assets of PPA (asset management agency) and privatization should raise another US$0.8 billion. Other non-CGI sources, such as export credits, could finance about US$0.3 billion[5]. This implies a financing need from CGI of approximately US$2.9 billion. Given the general uncertainty surrounding these numbers, the projected amount being requested from CGI is in the range of US$2.5-3.0 billion (Table 1.3), the same as last year.

Table 1.3. Financing needs and CGI disbursement request

	US$ billion
1. Gross financing needs (=2+3)	**10.9**
2. Budget deficits 1/	3.0
3. Amortization	7.8
o/w domestic 2/	2.4
o/w external	5.4
4. Sources of financing (=5+6+7+8+9)	**10.9**
5. Bank financing 3/	1.0
6. Government bond issuance 4/	5.9
7. Privatization and PPA asset sales	0.8
8. Non-CGI foreign financing 5/	0.3
9. Total CGI financing requested	**2.5-3.0**

1/ including grants in revenue
2/ scheduled amortization and debt buyback
3/ draw down of deposits
4/ including domestic and external bonds
5/ including export credits
Note: Not including Tsunami Impact.
Source: World Bank staff estimates.

[2] The official revised budget would normally be submitted to parliament in the second half of a year, as it is based on the results in the first half.
[3] If 1993 GDP were used (as was the case in the original 2005 budget) the budget deficit would be 1.2 percent.
[4] Prices of household kerosene and transportation diesel will not be changed.
[5] Actual disbursement of export credits in 2003 was US$0.2 billion.

Steady decline in Poverty Indicators. Preliminary results from the 2003 SUSENAS household survey suggest that poverty levels have continued to decline. The poverty headcount index dropped to 15.1 percent in 2003 (Table 1.4). Although the 2004 poverty headcount index is not available. steady growth as well as low inflation in February 2004 are both likely to have helped further reduce poverty[6].

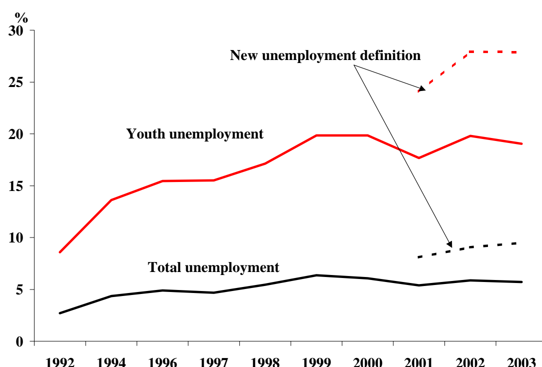
Table 1.4. Change in poverty headcount index from 1996 to 2003

	96	99	02	03
National poverty line	15.7	27.1	16.0	15.1
International poverty line				
1 dollar a day	7.8	12.0	7.2	7.2
2 dollar a day	50.5	65.1	53.5	52.9

Source: World Bank staff estimates, not including Tsunami impact.

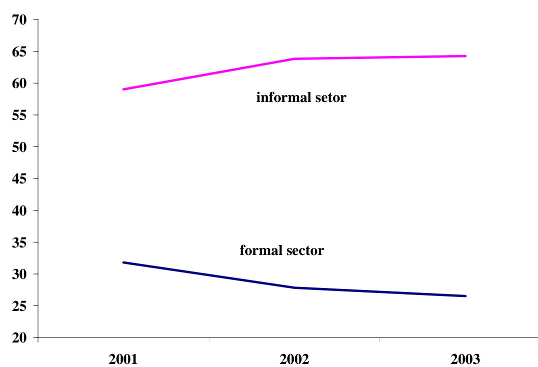
An improving employment picture. *Quarterly* labor statistics show that the unemployment rate declined from 8.5 percent in August 2003 to 7.4 percent in May 2004, with the labor participation rate increasing from 65.5 percent to 66.2 percent. This is the first sign of improvement in the labor market, although validation of this trend will require more reliable annual data[7]. The survey also indicates continued slow formal sector growth, with the share of informal sector edging up slightly from 64.4 percent to 64.6 percent. The formal sector employment declined by 12.5 percent in 2002 and 4.7 percent in 2003 (Figure 1.11).

Figure 1.10. Unemployment Rate on the Rise
(overall and youth unemployment rates)



Source: BPS, staff calculation.

Figure 1.11. Formal sector employment declines
(million)



Source: BPS, staff calculation.

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[6] SUSENAS (household survey) is done in February. As such, the poverty headcount index is sensitive to the inflation rate at that point. In February 2004, CPI inflation rate (yoy) reached its low point of 4.6 percent, much lower than 7.6 percent in February 2003 and below the level later in 2004. Food price inflation rate was 2.4 percent (yoy) in February.

[7] The annual labor force survey (Sakernas) and the quarterly survey (Indikator Ketenegakerjaan) are not entirely comparable. The quarterly survey focuses on a fewer number of indicators, employs smaller sample sizes, and covers less geographic territory (provinces) than the annual labor force survey.

Chapter 2. Politics, Policies and Pro-Poor Growth

POLITICAL DEVELOPMENTS AND IMPACTS

The elections of 2004 were a major milestone in Indonesia's transition and an important achievement for the entire region. With three rounds of elections in less then 6 months for four different institutions – the Presidency, the DPR, the DPD, and regional legislatures (DPRDs) – across 600 thousand polling stations, Indonesia's election process was one of the largest and most logistically complex ever undertaken in the world. More people voted in one day in Indonesia's presidential election than any other presidential election in history. The process was universally acknowledged as free and fair and the logistical arrangements were remarkably well handled.

The results represent a strong mandate for change in Indonesia. Dr. Susilo Bambang Yudhoyono won a decisive mandate of nearly 61 percent of the popular vote – the largest number of votes for any directly elected president in history. The legislative results returned a very broad range of political parties to the DPR, anchored by Golkar and former President Megawati Sukarnoputri's PDI-P, but with an unexpectedly strong performance from two new parties – the Partai Demokrat of President Yudhoyono and the renamed Partai Keadilan Sejahtera – both of which emphasized governance and anti-corruption in their campaigns. President Yudhoyono selected a coalition cabinet with representatives from a wide range of political parties including a large share of non-partisan figures. Initial concerns that the elections had produced a divided government were allayed when Vice President Jusuf Kalla won the leadership of Golkar, the largest party in the DPR, effectively bringing it into the governing coalition. The new upper house of the legislature, the DPD, composed entirely of non-party members directly elected at the provincial level, has taken up its post and is working to define its internal procedures and political role as a representative voice of the regions.

Direct elections for regional leaders are about to begin. Recent revisions to the legal framework for decentralization have introduced direct elections for regional leaders, including governors, bupatis and walikotas (previously they were elected by regional legislatures). In 2005, direct elections are scheduled to be held in 172 districts (out of 440) and 5 provinces (out of 33). This is a further important milestone in Indonesia's democratic transition and should considerably strengthen executive accountability at the local level.

POLICY PROGRESS IN 2004

Almost forgotten in the post-election political shift was Indonesia's successful exit from its IMF program. In 2003 the government ended its Extended Fund Facility (EFF) with the IMF and gave up access to Paris Club debt rescheduling. To address potential policy and financing credibility issues during the transition the government issued an *Economic Reform Package Pre and Post IMF (Inpres No.5/2004)*. The White Paper, as it became known, signaled the continuation of prudent macroeconomic policies and economic reforms through end-2004.

- ***Macroeconomic fundamentals improved markedly.*** Monetary and fiscal policy combined to bring down inflation and the debt burden with the debt to GDP ratio falling below 60 percent as mandated in the State Finance Law No.17/2003.
- ***Banking sector reform continued***. The bank restructuring agency IBRA, set up during the crisis, sold-off most of the major assets and was closed in February 2004. The remaining un-sold assets were turned over to a new Asset Management agency (PPA) which completed the sale of the last "IBRA" bank, Permata, in December 2004. The authorities issued a blueprint for the financial sector safety net and began implementation: a Deposit Insurance Law was passed by Parliament and the Central Bank Law was amended to allow for a lender of last resort. Minority Government shareholdings in two state owned banks – Bank Mandiri and BRI – were sold to the public.
- ***Public financial management reform accelerated.*** Indonesia made headway in the difficult area of financial management. Parliament enacted the State Finance Law in 2003, followed by the State Treasury and Audit laws in 2004. The reorganization of the Ministry of Finance began in September 2004 and should be completed by January 2005. With the law and reorganization, budgeting and treasury functions will be clearly separated, a reform critical to improving checks and balances.
- ***The foundations for a better judicial system were established***. Management of the entire judicial system was shifted from the Ministry of Justice to the Supreme Court according to a "one roof" model. The Supreme Court, in close collaboration with civil society, designed a "blueprint" to guide reforms in all major aspects of the court system and established an office to implement the blueprints and coordinate donor assistance. Specialized courts were set up to handle commercial cases and corruption cases. After a long delay, an Anti-corruption Commission was set up with the appointment of five commissioners. The commission has sweeping powers to investigate and prosecute allegations and to undertake preventive and community outreach measures to tackle the roots of corruption.

However, amendments to decentralization Laws 22 and 25 (Laws 32/2004 and 33/2004) respectively are mixed. They improve the status quo in some cases but not consistently; further changes are needed to make decentralization work effectively. First, Law 32/2004 establishes reasonable criteria for the decentralization of responsibilities across levels of government. Second, Law 33/2004 is positive in indicating that the government will gradually reduce deconcentrated spending by shifting the funds to conditional regional transfers. Third, provisions in the new decentralization laws suggest that sub-national government borrowing will remain restricted to the central government, at least in the near-term. This means that the problems with central lending, in particular on-lending, will have to be addressed in forthcoming new and revised government regulations. However, the intention to pay for all regional civil servant salaries from the DAU (General Allocation Fund) represents a definite setback; if implemented, this would create incentives to unnecessarily increase staff levels and reduce the scope for equalizing fiscal capacities across regional governments.

Despite the progress in other areas investment climate reforms were slow. Although 2004 was again designated the year of investment there was little follow-through. The high profile National Investment and Export Team was established but never gained the traction

needed to deal with cross-cutting policy issues and coordination failures. Trade policy was mixed, focusing on limited barter deals and inconsistent protectionist measures. Special import licenses were issued to selected importers/producers, a rice harvest import ban was put in place and then extended after the rice harvest was complete, and a rattan export ban imposed that clearly hurt large numbers of rattan growers. A series of seemingly erratic court decisions in high profile cases hurt investor confidence that was already impacted by ongoing security and election concerns.

THE NEW GOVERNMENT'S INITIAL STEPS

The new government moved quickly to articulate a reform vision, a "100 day plan" and a medium term framework. In his inaugural speech on October 20, 2004, the new President Dr. Susilo Bambang Yudhoyono articulated his vision to reduce poverty. He emphasized that *"…the greatest challenge is to free our people from poverty, ignorance, backwardness, and all problems that prevent the growth of our people's abilities. … the challenge of our era is to consolidate our democracy and accomplish our reform agenda…".* More specifically, he stressed that his administration would adopt policies which would attract investment and that he would personally lead the anticorruption program.

On October 28, the new Cabinet discussed a "100-day plan", a process that should begin to implement the vision outlined in the inaugural speech. This 100-day plan and the Medium Term Plan are organized around three broad objectives: (i) Creating a safe and peaceful Indonesia (ii) Creating a just and democratic Indonesia, and (iii) Creating a prosperous Indonesia. Some of the actions listed build on existing reform efforts while others emphasize new areas, such as resolving the conflicts in Aceh and Papua (Table 1.5).

Table 1.5. Selected Measures from the "100-day plan"

Objectives	Actions
Creating a safe and peaceful Indonesia	• Expedite resolution of conflicts in Aceh and Papua, Prevent conflict escalation in Poso, Maluku, and North Maluku (e.g. rehabilitate infrastructure). • Increase measures to control illegal logging and fishing.
Creating a just and democratic Indonesia	• Provide full support to the Anti-Corruption Court in terms of providing authority, personnel, and finance. • Accelerate the prosecution of a few high profile corruption cases. • Create an independent oversight body and advisory staff to spur reform of the Attorney General's office. • Improve regulations related to recruitment, wages, lay-offs and separation pay.
Creating a prosperous Indonesia	• Secure the 2004 budget – including intensification of tax collection and divest remaining shareholdings in ex-IBRA banks. • Review 2005 budget – while ensuring continued trend decline in the fiscal deficit. • Create a more individual and business friendly tax system (eliminate luxury taxes on non-alcohol drinks, raise the income subject to tax threshold, accelerate the depreciation schedule, investment allowances, extended loss carry-forward, reduce dividend tax). • Complete a poverty reduction strategy. • Increase access to education (books scholarships, teacher competence) and health (increase staffing at Puskesmas, Medical practitioners law, free service for poor at Puskesmas).

Source: Summarized by World Bank Staff.

Most of the measures in the 100-day plan were well received by investors. There were a few exceptions such as efforts to use State Owned Banks and Enterprises to assist Small and Medium Enterprises and some tax measures create concern. The proposal to assist SMEs by permitting state banks to restructure existing SME non-performing loans needs careful implementation to ensure that moral hazard is not perpetuated. The proposed tax changes also need to be carefully designed so as to allow the government to continue to deliver on its commitment to fiscal stability.

On December 9 the President issued a Presidential instruction (INPRES 5/2004) picking up the focus on corruption from the 100 day plan. The document lays out key principles of how to work with integrity directed towards a wide range of central and local government institutions. It requires all state officials to report their wealth for review by the KPK. It calls for a more transparent framework for identifying service standards and fees, as well as feasibility studies of e-procurement systems, to reduce bureaucratic discretion in the delivery of public services. It directs state institutions to cooperate with the Commission to Eradicate Corruption to improve the investigation and prosecution of corruption cases and takes a tough stance against corruption within law enforcement institutions. Finally, the INPRES assigns Bappenas the task of drafting a National Anti-Corruption Action plan to guide the administration's efforts in this area through 2009. The INPRES and the President's strong public statements on anticorruption, combined with the initial high-profile efforts to accelerate ongoing corruption cases against regional officials, are intended to demonstrate the new administration's commitment to anti-corruption efforts and to set a new tone for public service standards.

By mid December initial drafts of the President's Medium Term Plan were becoming available. The Medium Term Plan (or PJM in Indonesian) focuses on four broad areas, the three indicated above; a people who are "Safe and Peaceful", "Just and Democratic", and "Prosperous" as well as a macroeconomic framework for development. Generally the plan indicates that with macroeconomic stability in place, the medium-term strategy should focus on the quality of growth and increased efforts to fulfill basic social rights.

A Safe and Peaceful Indonesia includes goals and policies designed to improve social cohesion and harmony and those designed to assure territorial integrity. An additional focus is on strengthening the role of ASEAN and on raising the capacity and welfare of the armed forces.

A Just and Democratic Indonesia requires strengthening the legal system and ensuring respect for human rights. The second focus is on governance and especially on reducing corruption through increased public input to the policy making process. The government also underlines the importance of strengthening the decentralization process by clarifying the authority between central and regional governments, strengthening the capacity of local bureaucratic apparatus and re-structuring regional financial capacities.

There is an extensive agenda designed to create a **Prosperous Indonesia**. A highlight is the focus on improving the investment climate by speeding up business start-up procedures, simplifying tax and customs, legal certainty and security. Specific targets are included:

- Increasing the efficiency of export/import services (port, customs and tax) to the level of Thailand or Malaysia at this time. Within three years the goal is to close half the difference.
- Achieve the start-up and business operation measures in Thailand and Malaysia at this time. Again the goal is to close half the distance within three years.

Improving the employment and workforce conditions focuses on creating a flexible labor market and an industrial relations system guided by concerns about equity and productivity. More balance on employment-friendly regulations is featured in the PJM.

The President's electoral emphasis on rural development is reflected in the PJM with a focus on the rural investment climate including diversification and industrialization, increased access for farmers to capital and making rural marketing and distribution more effective.

Accelerating infrastructure provision focuses explicitly on increasing the access of the poor. This includes re-constructing damaged infrastructure in rural and conflict-ridden areas and expanding investment in remote and neglected areas. Infrastructure development should focus on the poor. Finally, the document indicates that the government will encourage private participation in the provision of infrastructure, especially in regions with high economic potential.

PENDING ISSUES AND RECENT SURPRISES

In the waning moments of the last Parliament a controversial National Social Security System Law was passed. The new law is designed to establish basic guarantees for health, work place accidents, old age pensions, retirement, and death benefits, essentially a safety net. Unfortunately the law (and the underlying analysis) lacked actuarially based cost estimates and appears to substantially underestimate the cost of delivering the services implied, thus creating large contingent liabilities for the State. Further, proposed increases to formal sector labor costs (conservatively estimated to be in the range of 15-20 percent) will slow growth in employment and tax revenues both, other key government priorities as well; perhaps even jeopardizing investment and exports. Prior to passage employer and labor groups addressed Parliament to express their concerns but there were not sufficient to delay passage or amend provisions. In addition to sustainability and employment concerns another problem is the perpetuation of the institutional, management and incentive structures at the State Enterprises responsible for current programs. Un-funded liabilities, poor governance and inefficient service characterize Taspen, Asabri and Jamsostek, the institutions that will be responsible for managing the enlarged system. At a moment when social security systems worldwide face sustainability problems and are moving toward defined contribution and increased competition the Indonesian proposal is moving in the opposite direction. The public mandatory defined benefit schemes that this Bill proposes have a poor record around the world. Despite these weaknesses he new Law is already being implemented and its review is urgent. Government and legislators should reassess the implications of this law for the budget, pension security, and capital market development before the entitlement become locked in politically. This would require first, assessing the costs (contingent liabilities) of the existing schemes and placing them on a sustainable

footing through appropriate policy reforms. Following this, the implementation of a broader social security scheme in a sustainable manner should be considered.

Box 1.3. The Quality of Disclosure in Indonesian Banks

On 8 April 2004 Bank Indonesia closed two small private national banks namely Bank Dagang Bali (BDB) and Bank Asiatic, cited the unresolved problems in the banks' solvency and liquidity positions. The closure of these banks caught the market and depositors by surprise as prior to the closure there was no indication that these banks were in trouble nor had it been announced that they were under Special Supervision. Both banks had consistently disclosed sound financial performance back to 2000. Both banks were recording profits on the back of steady increases in deposits and strong loan growth. Comparing to peer banks, these banks had above average financial performances. Subsequent Bank Indonesia investigations found irregularities which included fictitious transactions in loan, marketable securities and others that violated the Legal Lending Limit. These facts suggested that the banks' published financial reports did not provide reliable information which reflected the true financial condition of the banks. The reports appear to have understated the risk, overstated financial performance and thus, provides an example of low quality disclosure of financial information. Although the ultimate responsibility to provide reliable financial reports rests on the management of the banks and external auditors. Bank Indonesia as the supervisor and regulator of banks has an important role to minimize the disclosure of unreliable financial information to the public and to improve the quality of publicly disclosed information in the banking sector.

The overall banking system continued to improve but periodic banking scandals have continued. Bank non-performing loans and capital adequacy improved markedly in 2004, lending picked up (Chapter 1) and Bank Indonesia produced a blueprint for the reform of the banking sector. However, end 2003 and 2004 continued to witness banking scandals and failures. At the time of last year's CGI the BNI scandal was breaking. In this case a failure of internal controls allowed US$200 million in fictitious export credits to be issued and stolen through the collusion of bank employees at a branch in Jakarta. In early 2004 problems with Bank Dagang Bali and Bank Asiatic unfolded with the banks again using depositor funds to breach legal lending limits and create fraud (Box 1.3). More telling were the delays and problems closing these banks and retrieving the assets needed to reimburse depositors. Flaws in the banking law allowed the owners to resist the process through the requirement of a share-holders meeting. Finally, and most recently, in December 2004 Bank Global faced imminent closure. Again fictitious lending and fraud were complicated by a slow response on the part of Banking Supervisors to compound governance problems. The problems are compounded by a bond issued by Bank Global and held by a number of State Owned Enterprises who are likely to lose these funds, triggering a special audit of their involvement. While most of these scandals remain relatively small, the concerns are that that bank supervision and especially the willingness to take action are not yet sufficient to secure the safety of the financial system. More resolve to enforce powers of regulation and supervision rapidly and effectively is needed. Coordination between various financial sector regulators also needs to be improved to ensure that early detection is followed by action.

Infrastructure finance and "idle cash" in the banking system. Financing infrastructure investment is a priority to improve the investment climate (Chapter 4). In order to meet this need, some suggest that financing would be available from the liquid assets in commercial banks especially the sale of through the sale of Bank Indonesia instruments (SBIs) and recap bonds they hold. However, the sale of an SBI by one bank to another bank does not increase liquidity in banks. If the SBI were sold to an individual, who did not want to reduce their own cash balances, they would have to draw down their account at the bank effectively eliminating the excess liquidity in the banking system. The situation is similar with the recap

bonds. If recap bonds are sold by one bank to another there is no change in liquidity in the banking system. If they are sold to an individual the most likely event is that there would be a draw down in the deposits in the banking system. In all it is difficult to arrive at the conclusion that there is any substantial amount of "idle cash" in the banking system. For example, net liquid assets are estimated to be about Rp.14 trillion, 0.6 percent of GDP (Table 1.6).

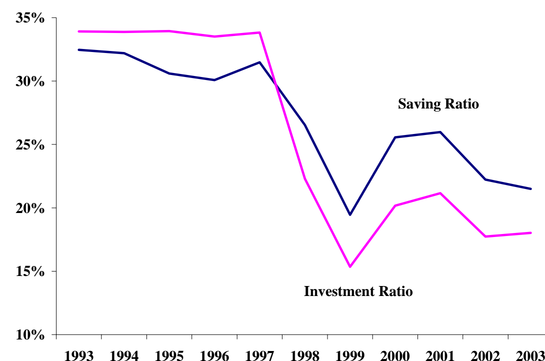
Table 1.6. Net Excess Liquidity

A. LIABILITIES AND COMMITMENTS	**290**
Deposits (primary & secondary reserves at BI)	139
Committed (Undisbursed) loans	130
Others	21
B. LIQUID ASSETS AVAILABLE	**304**
Lending in the Interbank markets	100
Placement at BI (e.g. Current account reserve, SBI)	195
Marketable securities (non gov't bonds)	9
C. ESTIMATED EXCESS LIQUIDITY (B-A)	**14**

Based on data as of September 2004.
Source: Bank Indonesia, World Bank staff estimates.

How can Indonesia finance infrastructure? First by reallocating expenditures in the state budget (Chapter 3). In 2004, the government spent 3 percent of GDP on fuel subsidies alone. If the government increases fuel prices and reallocates the financial resources to public investment infrastructure investment would increase. In addition, there is new financing available each year from national savings, with a higher savings rate more would be available for investment, including for infrastructure. In particular this financing should flow through bond markets and other non-bank financial institutions (NBFI) who are able to better match the long maturities needed for infrastructure finance with savings instruments. During the pre-crisis period, Indonesia's saving ratio was well above 30 percent, but it fell to 22 percent in 2003[1] (Figure 1.12). The increase in the saving ratio would assist infrastructure finance in the medium-term.

Figure 1.12. Saving and Investment Ratio
(percent of GDP, nominal, 1993 base GDP)



Source. BPS, World Bank staff estimates.

Tax reform and tax laws—an update. The last year saw continued, but slow progress on tax reform. The tax department extended the Large Taxpayer Office to including most foreign taxpayers and state owned enterprises as part of the transformation of the tax department from a focus on taxes to taxpayers. This has generally been considered to be an effective strategy as it coupled higher paid tax officials with more and better IT support and faster refunds. In the White Paper the Government included measures to revitalize the tax court and strengthen the Inspector General at the Ministry of Finance, but these have yet to play a major role. A final aspect in the reform agenda includes an extensive rework of the tax laws. Over the course of a number of meetings between the Ministry of Finance and the private sector the proposed tax laws were extensively discussed. However, at the end of the discussions significant differences remained and the laws were not submitted to Parliament. A suggestion of the CGI Investment Working Group is that they be reviewed by an independent panel with an additional law (on tax collection) added to the income tax, value

[1] Based on 1993 base GDP.

added tax and tax administration laws[2]. If so, the dialogue over the last year combined with such a group could provide the kind of foundation needed to develop an improved the tax system. The CGI Investment Climate Working Group and Kadin provided a number of suggestions including suggestions on how to improve the appeals processes, increase transparency in audits and assessments and speed up VAT and other refunds. Other longer-term suggestions, besides the establishment of an independent panel, include revising the tax code to reinforce the self-assessment system, along with suitable penalties and better enforcement of the code of conduct and taxpayer bill of rights. At the end of this process it is important that there be an acknowledgement of the right of taxpayers to "clear and fair process" but equally of the tax department to insist on appropriate compliance. Finally it is important that the Indonesia's underlying fiscal strategy be an important consideration and that the sum of the measures be broadly revenue neutral.

Tax Amnesties – on the table? The government's initial 100 day plan was reported by newspapers to include a tax amnesty. This was removed from subsequent versions but still appears to be under active consideration. Most experience with tax amnesties has not been positive. Amnesties in addition to conferring immunity from sanctions potentially defer taxes or lower penalties; allow the laundering of tax-evaded money; and are a signal of future enforcement (negative as well as positive). A number of countries including Argentina, and the Philippines are known for repeated amnesties and reduced tax credibility. If such an amnesty is imposed it should be preceded by more effective enforcement, including additional auditors and access to information and should be once and for all.

Constitutional challenge to the electricity and oil and gas laws – In possibly contradictory decisions in December the electricity law was overruled while the oil and gas law was upheld by the constitutional court. The Constitutional court held that electricity is a basic service and, as such, subject to state oversight at all stages of production under the constitution. An electricity regulatory authority as proposed did not constitute sufficient state oversight. Independent Power Producers (IPPs) status would be legal as they sell to PLN the electricity company who then sell to the customer[3]. The government has subsequently indicated that it would rewrite the electricity law in such a way that competition would be fostered while basic services were delivered in line with the constitution. After a week marked by alarm among investors, the court ruled that fuel products were not basic services and that deregulation of the oil & gas sector could proceed.

PRO-POOR GROWTH[4]

The Indonesia of 2005 and beyond also needs fresh ideas and approaches to cope with problems that are far more complex than just removing the impediments to growth and rehabilitating the market economy. Wise, pragmatic, and effective leadership—at all levels of government—is essential if rapid growth is to be re-established in a way that continues to

[2] The law on tax collections should have been part of the initial tax reform effort, as it is responsible for some of the most controversial provisions of Indonesian taxes, including the requirement to prepay assessments.

[3] The legal status of these companies was created under the previous law.

[4] This section draws from the Policy Briefs prepared by the World Bank office in Jakarta for the new government, and on an extensive study on "Operationalizing Pro-Poor Growth in Indonesia," prepared by C. Peter Timmer for PREM (December, 2004, pp. 108).

improve the lives of the poor. Indonesia's success from 1967 to 1997 in connecting the poor to rapid growth did not just happen as the accident of market forces. It was planned, nurtured, and largely financed by a government intent on reducing poverty as rapidly as possible.

The economic and political environments have obviously changed, but a new government with similar commitment can do the same. This CGI Brief focuses on the three essential components needed to restart rapid, pro-poor growth: (1) improving the investment climate, especially for labor-intensive manufactures; (2) solving infrastructure bottlenecks, especially in electricity generation, efficient transportation, and port facilities and procedures; and (3) developing a rural development strategy that will diversify agriculture into higher value-added activities and stimulate rapid growth in the rural non-farm economy. This Brief devotes separate chapters to each of these topics.

As always, there is a tension between helping the poor directly in the short run and helping them participate in a rapidly growing economy in the long run. When there were large oil revenues and substantial support from the donor community, it was possible to do both in visible and substantial ways. Now the Government was set clear priorities for restarting rapid growth and for alleviating poverty, and it must raise the productivity with which it uses resources. Both tasks require clear leadership and political commitment. Fortunately, both are on the table with the new Government.

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CHAPTER 3 MEDIUM-TERM PROSPECTS

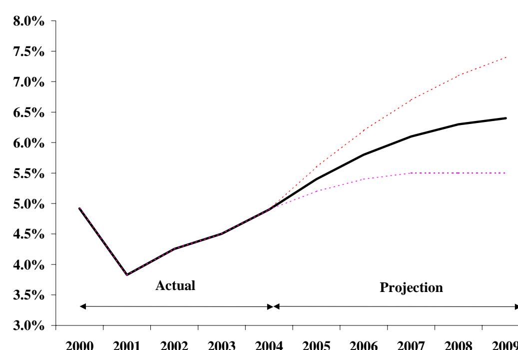
With macroeconomic stability at hand, the new government is well positioned to focus on medium-term development targets: macroeconomic, fiscal and social. Acceleration of the economic growth rate is a prerequisite for achieving these medium-term development targets. Growth rate acceleration should focus not only on the *quantity* of economic growth but also the *quality* of growth. There are at least three important features of quality economic growth. First, **efficiency** - growth should be achieved through not only a high *quantity* of investment but also a high *quality of* investment. Second, **sustainability** - future growth should not be jeopardized by efforts to accelerate the current strong recovery , through an unsustainable fiscal stimulus. And third, growth should be **pro-poor and pro-employment;** that is**,** higher growth should be accompanied by poverty alleviation and job creation.

1. Macroeconomic Target

Bright Short-Term Outlook and Medium-Term Challenges. Current economic and investment momentum, together with a supportive external economic environment, are expected to deliver higher growth in 2005-2006. The real challenge is to sustain this higher growth through the 2007-2009 period. The Bank foresees that economic growth could average 6 percent from 2006 to 2009 (Figure 2.1). The government foresees higher growth beyond 2007. The government's projection of real GDP growth in 2009 is 7.6 percent, for example, the highest rate since 1996 when growth was 7.8 percent.

Investment and Productivity Are Key to Medium-Term Growth. For the past few years, consumption, supported by a rapid growth in consumer credit, has driven economic growth. The Bank expects that continued macroeconomic stability and reforms to the investment climate will lift investment and that GDP growth. A standard growth accounting exercise[1] (Table 2.1) suggests that further increases in investment and TFP (total factor productivity–a rough measure of efficiency) would be required to sustain a growth rate of 6 percent.

Figure 2.1. Economic Growth Rate Projection
(annual constant GDP growth rate, percent)



Source: Bappenas, World Bank staff.

The growth accounting exercise in 2004-2009 suggests that an average growth of 5.9 percent in 2004-2009 would require annual investment growth around 11 percent and average TFP growth around 2 percent[2]. Historically, Indonesia achieved high TFP

[1] The growth accounting exercise is based on estimation of a Cobb-Douglas production function. The contributing factors to the growth of output are (i) capital (i.e. investment), (ii) labor, (iii) quality of labor (years of schooling are a proxy) and (iv) TFP (total factor productivity). TFP is calculated as a residual.

[2] In this calculation, the labor force growth rate and average years of schooling are exogenous. The annual labor force growth rate is assumed to be 2.1 percent and average years of schooling year is assumed to increase by 0.4 years every 5 years.

Table 2.1. Growth Accounting Exercise (annual average 1/)

	1970-1980	1980-1990	1990-2000	1990-1997	2000-2004	2004-2009 (projection)
GDP growth	**7.9**	**4.3**	**4.3**	**7.4**	**4.7**	**5.9**
Capital Stock	2.0	2.8	2.0	3.0	0.2	1.4
Labor Force	1.9	2.1	1.7	1.8	1.5	1.5
Years of Schooling	1.7	0.5	1.6	1.8	1.1	1.0
TFP	**2.2**	**0.9**	**-1.0**	**0.9**	**1.9**	**2.0**

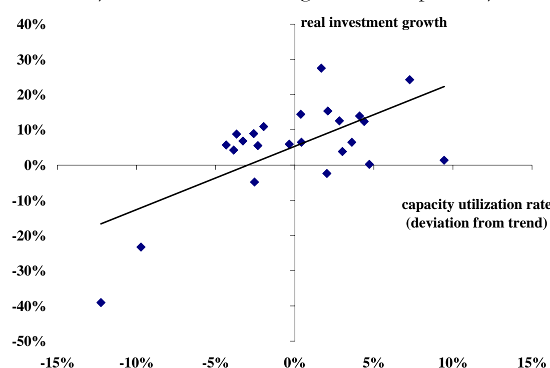
Note: 2004 is based on the actual data in Q1- Q3.
1/ geometrical average.
Source: World Bank staff estimates.

growth in two periods: 1970-1980 and 2000-2004. A comparison of growth in 1970-1980 with that in 1990-1997 shows a change in sources of growth. In 1970-1980, the contribution from capital stock was 2.0 percent, labor force 1.9 percent, labor quality 1.7 percent and TFP 2.2 percent. In 1990-1997, the contribution from capital stock was 3.0 percent, labor force 1.8 percent, labor quality 1.8 percent and TFP 0.9 percent. These results indicate that high growth in 1990-1997 was achieved by an increasing *quantity* of investment rather than by an improvement in productivity (efficiency). In 2000-2004, contribution from capital stock (0.2 percent) was marginal in light of low investment after the crisis and the contribution from TFP was high at 1.9 percent due to high capacity utilization rates.

Averaging 5.9 percent growth in 2004-2009 is challenging. Even if average real investment growth rate is 11 percent, an expected contribution from capital stock is only 1.4 percent due to the depreciation of the past investments. As such, TFP would need to be 2 percent, historically high. In order to achieve the high TFP growth rate in , (i) implementing *efficient* and *productive* investments, and (ii) improving the investment climate are required.

Potential Investment Demand Is High. A projected average annual investment growth of 11 percent in 2005-2009 looks achievable in light of high potential investment demand in Indonesia and neighboring countries' experiences. The Bank estimates that capacity utilization in 2003 was the highest in 20 years. Based on historical patterns real investment should now be growing 15-20 percent a year given the very high capacity utilization rates (Figure 2.2). Also, neighboring countries' experience also shows that Indonesia has room for high investment growth in the coming years (Table 2.2). Indonesia's average annual investment growth in 2000-2003 was 3.5 percent. In contrast, in Thailand investment growth averaged 6.5 percent and Korea 14.9 percent. With a sustained improvement in Indonesia's investment climate in the coming years, real investment growth could average 11 percent annually.

Figure 2.2. High Potential Investment Demands
(capacity utilization rate (deviation from long-term trend line) and real investment growth rate, percent)



Source: World Bank Staff.

Table 2.2. Regional Comparison of Real Investment Growth Rate (percent)

	Indonesia	Korea	Malaysia	Philippines	Thailand
1998	-33.0	-22.9	-43.0	-11.2	-44.3
1999	-18.2	8.3	-6.5	-2.3	-3.2
2000	16.7	12.2	25.7	19.9	5.4
2001	6.5	-0.2	-2.8	-13.0	1.2
2002	2.2	6.6	0.3	1.4	6.5
2003	1.9	3.6	2.7	2.9	11.7
2004 (Q1-Q3)	11.3	3.2	3.4	6.5	14.1
2001-2003 ave	3.5	10.0	0.1	-2.9	6.5

Indonesia: 1998-2000: 1993 base GDP, 2001-2004: 2000 base GDP.
Source: CEIC, World Bank staff calculation.

Productivity and Investment Climate. Accelerating TFP represents another challenge. Accelerating of TFP would require, for example, more efficient use of existing capital stock, more *productive* and *efficient* investment, and reductions in Indonesia's high-cost economy. The high TFP in 2000-2004 (Table 2.1) reflects, to some extent, low investment and intense use of the existing capital stock. Given this high capacity utilization rate, maintaining the same TFP through greater use of existing capital is not an option. Improvement in the investment climate are the key to increasing not only the quantity of investment but also productivity. A forthcoming World Bank document analyzes how improvements in the investment climate positively affect productivity, investment and employment[3].

Improvements in the investment climate would increase productivity as production factors are better used (Table 2.3). For example, survey results indicate that currently, managers average 12.7 percent of his/her time (about 6.3 hours/week) complying with regulations. Firms where managers spend only 10.3 percent of his/her time on compliance, have productivity 1 percent higher. If improvements to the regulatory environment could deliver this increases in productivity would reduce costs, raise profits and positively affect investment. Such a firm would also hire more people to meet increases in output. Thus continuing with this example, a 1 percent increase in productivity results in an additional 0.3

Table 2.3. Selected Examples of Impacts of Improving Investment Climate on Firms' Productivity, Investment and Employment

Variables	Current Situation (average)	Productivity	Investment	Employment
Percent of total time per week spent dealing with local and national regulations	12.7 percent (6.3 hours a week)	If time is reduced to 10.3 percent, productivity increases by 0.96 percent	Investment would increase by 0.3 percent	Employment would increase by 0.2 percent
Frequency of power outrage	4.4 days a year	By reducing the frequency by 1 day, productivity increases by 0.7 percent	Investment would be increased by 0.2 percent	Employment would increase by 0.2 percent

Source: World Bank (2005 forthcoming) Raising Investment in Indonesia: A Second Generation of Reforms.

percentage points in investment and an additional 0.2 percentage points in employment.

Table 2.4. Growth Accounting Exercise for Government Growth Projection

	2004-2009 (projection)
GDP growth	**6.6**
Capital Stock	1.6
Labor Force	1.4
Years of Schooling	1.0
TFP	**2.6**

Source: Bappenas, World Bank staff estimates.

Growth Projections in the PJM. The government projects growth rate at 7.6 percent in 2009 or 6.6 percent on average in 2005-2009. An application of the same growth accounting exercise suggests that an average TFP contribution of 2.6 percent would be required. The government assumes real investment growth of 14 percent and annual labor force growth rate of 1.9 percent (Table 2.4).

The government assumes agriculture growth of 3.2-3.8 percent, manufacturing growth of 6.6-10.2 percent, and other sector growth of 5.9-7.6 percent. This implies further increases to the share of manufacturing in total output, consistent with Indonesia's experience in the last 20 years (Appendix 2). However, from an historical perspective, (Table 2.5) the government's projection regarding agriculture growth seems optimistic; achieving this level of growth would require a clear strategy for the sector. (Chapter 7 on Rural Development).

Table 2.5. Historical Real Growth Rates

	1961-2003	1961-2003 (excl.98-99)	1971-1980	1981-1990	1991-1997	2001-2003
GDP	5.2%	5.5%	7.5%	5.5%	6.9%	4.4%
Agriculture	3.0%	3.0%	3.5%	3.5%	2.7%	2.9%
Manufacturing	8.3%	8.4%	12.6%	10.0%	9.9%	5.0%
Others	6.1%	6.6%	10.1%	5.2%	7.0%	4.5%

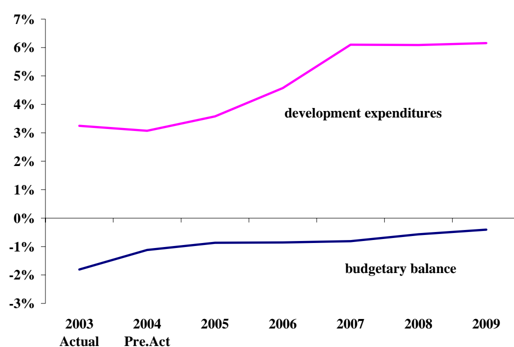
Source: CEIC, World Bank Staff Calculation.

[3] World Bank: Raising Investment in Indonesia: A Second Generation of Reforms (2005). This analysis is based on approximately 700 manufacturing firms.

2. Fiscal Target

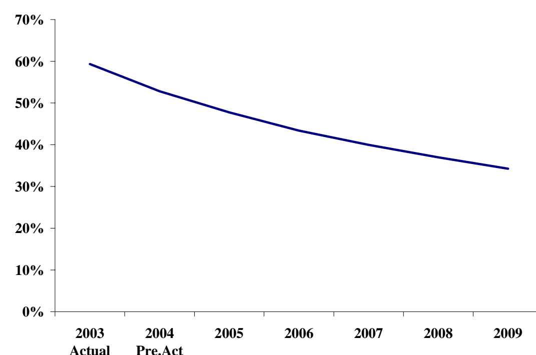
Changing Role of Fiscal Policy. In the medium-term, the role of fiscal policy is likely to change from 'the guardian of macroeconomic stability through fiscal consolidation' to 'supporter of high quality growth'. In order for this to happen, fiscal consolidation must be balanced with a rise in public investment in key infrastructure and social sectors (i.e. health and education). Currently, the Bank's base line projection foresees the Government continuing to focus on fiscal consolidation, with deficits projected at no more than 1 percent of GDP (Figure 2.3). This scenario results in a substantial decline in the debt to GDP ratio to 34 percent in 2009 (Figure 2.4). Central government development spending would increase by about 3 percentage points to 6.2 percent of GDP in 2009 (Figure 2.3). With regional governments estimated to spend another 3 percent of GDP, total development spending would be back to pre-crisis levels of approximately 9 percentage points. This increase in development spending is largely due to an expected reallocation of fuel subsidies (Box 2.1), a decline in domestic interest rates, and an increase in non-oil and gas tax revenues.

Figure 2.3. Fiscal Consolidation and Rise in Public Investment
(as a share of GDP)



Source: World Bank staff.

Figure 2.4. Government Debt on the Decline
(Government debt to GDP ratio, percent)



Source: World Bank staff.

Box 2.1. Fuel Subsidies

Currently, international fuel prices are higher than Indonesian prices by 50-350 percent (the latter for household kerosene). Fuel prices have been fixed since January 2003 at a weighted average price of US$22-24/bbl. As a consequence, preliminary results from the 2004 budget show that fuel subsidies reached Rp.69 trillion, an amount equivalent to total central government development spending. An increase in fuel prices has historically had a neutral impact on the budgetary balance, as revenues (tax and non-tax oil and gas revenue) and expenditures (fuel subsidies and revenue sharing with regions) increase by approximately the same amount. However, only 24 percent of fuel subsidy goes to the poor (i.e. bottom two quintiles) in 2002; subsidies assist smugglers more than the poor; they breed corruption and; they are bad for the environment. Perhaps most importantly these resources can be used better and more efficiently and, fuel subsidies should be reduced. If fuel prices were hiked by 20 percent a year in 2005-2007, fuel subsidies would be reduced to almost zero. Several issues are critical to this process: (i) timing and extent of fuel subsidy reduction, (ii) compensation mechanisms for the poor, (iii) socialization, and (iv) use of the saved money. Roughly, a 20 percent increase in fuel prices would free up US$2 billion (1 percent of GDP) and increase in the rate of inflation of 0.5-1 percent. The impact on growth depends on how the saved money is used; but if it were used efficiently, the net impact on growth would be positive.

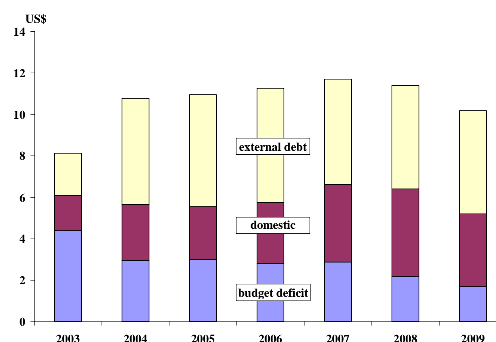
Domestic fuel prices are projected to reach international prices by 2007, with international oil prices at an assumed US$35/bbl for ICP (Indonesian Crude Oil). Two key factors supporting this scenario are (i) an increase in non-oil and gas tax revenues and (ii) the availability of sufficient financing.

Increase in Non-Oil and Gas Tax Revenues. Non-oil and gas tax revenues accounted for more than 90 percent of total domestic tax revenues in 2004. Bank projections indicate that the ratio of non-oil and gas tax revenues to GDP could increase by 0.3 percentage points of GDP a year, offsetting a decline in oil revenues of approximately 0.15 percent per year. The increase in taxes is slightly higher than the 0.2 percentage point per year gain between 2000 and 2003, but is consistent with the President's strong commitment to tax reform and higher compliance. The projection is also based on an assumption of higher economic growth and structural change (increased manufacturing and investment and a turnaround in formal sector employment), which would result in higher tax revenues. Finally, improvements in tax administration, building on ongoing tax office modernization (converting from a tax to a taxpayer orientation) and other administrative reforms are assumed to contribute to increased revenues.

High Financing Needs Continue in the Medium-Term. Despite projected fiscal consolidation, in the medium-term financing requirements remain high (Figure 2.5). Gross financing needs[4] will remain in the 3-4 percent of GDP (US$11-12 billion) range until 2009. For the past few years, both debt and non-debt financing (including privatization, IBRA asset sales and deposit withdrawals) have been used to meet around half of total financing needs each. From 2006-2009, contributions from non-debt financing are expected to be more modest. IBRA's unsold assets were transferred to PPA (asset management unit), but the quality of remaining assets is low. Debt financing concerns point to the importance of continued, reliable low-cost financing. The scenario assumes that gross external financing needs (including export credits) will average US$4 billion per year. This leaves gross domestic bond issuance as the residual, at averaging Rp.60 trillion, or about US$6.5 billion per year from 2006-2008. However, net issuance of domestic debt would be much smaller at Rp.25 trillion (or approximately US$3 billion). At these levels of borrowing, total debt to GDP would fall rapidly (Figure 2.4)[5].

There are a couple of measures that the new administration could consider in order to reduce refinancing risks and the debt servicing costs. One of the most obvious ones is to maintain macroeconomic stability. A 1 percent increase in the domestic interest rate would impose a cost about Rp.2 trillion (0.1 percent of GDP) on the state budget. The recent decline and flattening of the government bond yield curve (Figure 1.7 in Chapter 1) is an illustration of the kind of payoff that results from good government

Figure 2.5. Indonesia's Gross Financing Profile

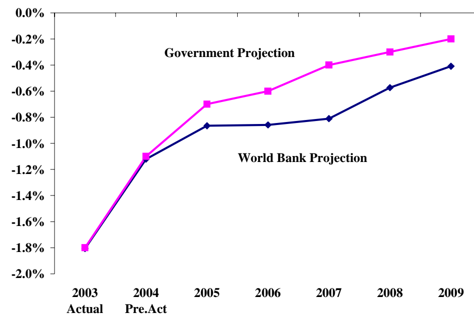


Source: Bank Indonesia, MOF, World Bank staff est.

[4] Sum of budget balance (deficit) plus foreign and domestic debt amortization.
[5] This analysis does not take the fiscal impact of the earthquake and tsunami into account.

economic management. Also, a regular issuance of domestic bonds, as the government achieved in 2004, reduce risk and associated costs as the secondary market develops and provides more predictability to investors.

Figure 2.6. Budgetary Balance Projection
(Budgetary balance as a share of GDP)



Source: Bappenas, World Bank staff.

Fiscal Projection in PJM. In the reviewed draft, the government projection foresees that the budget deficit as a share of GDP would reach 0.2 percent in 2002, almost in line with the Bank's projection (Figure 2.6). The projection is well below the minimum requirement of 3 percent as stipulated in the State Finance Law (No.17/2003)[6]. Underpinning this projection is an increase in non-oil and gas revenues. Non-oil and gas income tax and VAT are projected to increase from 8.6 percent of GDP in 2003 to 10.8 percent in 2009. Given lower than expected (preliminary) realizations in the 2004 state budget, achieving this target would require extra efforts in improving tax administration or possibly adjustments to tax policy.

3. Social Target

Further Decline in Poverty. The poverty headcount index improved to 15.1 percent in 2003, lower than pre-crisis level of 15.7 percent (1996). Under the current macroeconomic framework, which envisages real growth rate at 6.0 percent and inflation rate at 3.0 percent in 2009, the Bank foresees that the poverty headcount index would further improve to 6-9 percent in 2009.

The substantial reduction in poverty stems from both income growth and reduced inflation, especially for food prices. Historically, every 10 percent *increase* in real per capita incomes has *reduced* the poverty headcount index by 1.3 percent. At the same time, every 10 percent *increase* in the real price of rice has caused a 3.2 percent *increase* in the headcount poverty index.[7] As noted in the chapter on rural development, increases in rice prices are no longer poverty reducing, as they probably were in the 1970s and early 1980s. Now, because so few households are net suppliers of rice to the market, higher rice prices are unambiguously bad for the poor, including the rural poor.

…And Job Creation. In the PJM, the government foresees substantial improvement in labor markets. The open unemployment rate is expected to improve from 9.5 percent to 5.1 percent in 2009 (Table 2.6). The total labor force is projected to increase by 1.9 percent annually, while employment is projected to increase by 2.9 percent annually in 2004-2009. At the sector level, agriculture employment growth is projected to be 2 percent a year, manufacturing is 3.9 percent and others are 3.7 percent. Underpinning this scenario is an assumed acceleration of economic growth and moderate labor productivity growth. In

[6] State Finance Law requires that budget deficit shall not be more than 3 percent of GDP (Elucidation of Article 12 Paragraph 3).
[7] C. Peter Timmer, "Operationalizing Pro-Poor Growth in Indonesia," prepared for the World Bank, December, 2004, p. 29.

Table 2.6. Government's Labor Market Projection in PJM

	2003 Actual	2004 Pre.Act	2005	2006	2007	2008	2009	Average Growth (04-09)
			<--------------------		Projection		-------------------->	
Employment (million) (1)	90.8	92.3	94.2	96.7	99.7	103.0	106.6	2.9%
Unemployment (million) (2)	9.5	9.9	9.9	9.4	8.5	7.3	5.7	-10.5%
Total labor force (million) (3)	100.3	102.2	104.1	106.1	108.2	110.3	112.3	1.9%
Unemployment Rate (4)=(2)/(3)	9.5%	9.7%	9.5%	8.9%	7.9%	6.6%	5.1%	-
real GDP growth (2000 base, %)	4.5%	5.0%	5.5%	6.1%	6.7%	7.2%	7.6%	-
GDP (2000 base, Rp.trillion) (5)	1,572	1,651	1,742	1,848	1,972	2,114	2,274	6.6%
Labor Productivity (5)/(1) (Rp.mln)	17.3	17.9	18.5	19.1	19.8	20.5	21.3	3.6%

Source: Bappenas, World Bank Staff Calculation.

2004-2009, real GDP growth rate is projected at 6.6 percent a year, while labor productivity growth rate is projected at 3.6 percent. These two projections result in an employment growth rate projection of 2.9 percent[8].

The World Bank also foresees an improvement in the labor market (i.e. the improvement in the unemployment rate), but one that is less substantial than the government perceives. The Bank projections suggest that real GDP growth in 2004-2009 would be slightly lower than 6 percent and labor productivity growth is projected to be 3.7 percent –almost same as the actual growth in 2000-2003 of 3.8 percent. As a result, the employment growth rate would be at 2.1 percent. Since labor force growth is assumed to be 1.9 percent annually, the open unemployment rate in 2009 would still be 8.6 percent. Although the Bank's projection is somewhat less bright compared to the government's, it still represents a dramatic turnaround from the past, given the fact that the unemployment rate increased by 1.4 percentage points between 2001-2003 at a time when average economic growth rate was 4.2 percent.

4. Factors Affecting Medium-Term Targets

Both external and domestic factors could affect these medium-term targets. Externally, a possible slowdown in global economic growth and trade would have severe impacts. More generally, the economic performance of key trading partners such as the United States, Japan and China is critical. Also, possible higher international interest rates would have a negative impact.

However, given the size of its domestic economy, as well as the relatively small share of external trade, Indonesia's achievement of medium-term targets depend most importantly on Indonesian policy, especially reforms outlined in the PJM.

Among reform programs discussed in the PJM, the Bank would highlight areas such as poverty, rural development, governance and civil service reforms, investment climate, infrastructure and decentralization as being especially important. These topics are discussed in the rest of CGI brief paper.

[8] The higher economic growth rate becomes and the lower labor productivity growth rate becomes, the more employment would be created.

Appendix 1. Medium-Term Macroeconomic and Fiscal Targets

A. Macroeconomic Framework

	2003	2004	2005	2006	2007	2008	2009
	Actual	Pre. Actual	<--------- World Bank Projection---------->				
Nominal GDP	2,087	2,342	2,629	2,954	3,304	3,642	3,976
Real GDP Growth Rate	4.5%	4.9%	5.4%	6.0%	6.0%	6.0%	6.0%
o/w investmetn growth rate	1.9%	11.0%	16.0%	12.0%	10.0%	9.5%	8.0%
GDP Deflator Growth Rate	5.2%	7.0%	6.5%	6.0%	5.5%	4.0%	3.0%
Investment to GDP ratio (%, nominal)	17.8%	18.8%	20.7%	21.9%	22.7%	23.4%	23.9%
Current Account Balance (US$ billion, % of GDP)	7.3 (3.0%)	4.5 (1.7%)	3.3 (1.2%)	2.5 (0.9%)	2.2 (0.7%)	1.8 (0.5%)	1.0 (0.2%)
Non-oil and gas exports 1/							
Non-oil and gas imports 1/							
Oil Prices (ICP, US$/bbl)	29	36	35	35	35	35	35

1/ data collection method was changed in 2004. As such, data are not directly compared between 2003 and 2004 onward

B. Fiscal Framework

	2003	2004	2005	2006	2007	2008	2009
I. Revenues	**16.3%**	**17.2%**	**16.6%**	**16.8%**	**17.1%**	**17.1%**	**17.2%**
o/w Non-Oil and Gas Tax	10.1%	10.4%	10.3%	10.6%	10.9%	11.2%	11.5%
o/w Oil and Gas	3.9%	4.7%	4.4%	4.3%	4.3%	4.0%	3.8%
II. Expenditures	**18.2%**	**18.4%**	**17.6%**	**17.7%**	**17.9%**	**17.7%**	**17.6%**
o/w Development Expenditures	3.2%	3.1%	3.7%	4.6%	6.1%	6.1%	6.2%
III. Primary Balance	**1.5%**	**1.6%**	**1.5%**	**1.4%**	**1.3%**	**1.3%**	**1.4%**
IV. Overall Balance	**-1.8%**	**-1.1%**	**-1.0%**	**-0.9%**	**-0.8%**	**-0.6%**	**-0.4%**
V. Financing (1+2)	**1.7%**	**1.1%**	**1.0%**	**0.9%**	**0.8%**	**0.6%**	**0.4%**
1. Domestic ((1)+(2))	1.7%	2.1%	1.8%	1.4%	1.0%	0.6%	0.5%
(1) domestic bank financing	0.5%	1.0%	0.0%	0.0%	0.0%	0.0%	0.0%
(2) domestic non-bank financing	1.1%	1.1%	1.8%	1.4%	1.0%	0.6%	0.5%
a. Asset sales for budget financing	1.3%	0.8%	0.2%	0.2%	0.2%	0.2%	0.2%
b. Domestic bond	-0.1%	0.4%	1.6%	1.2%	0.8%	0.4%	0.3%
- New Issues	0.5%	1.4%	2.4%	2.1%	1.9%	1.5%	1.1%
- Amortization	-0.7%	-1.0%	-0.8%	-0.9%	-1.1%	-1.1%	-0.8%
2. Foreign ((1)+(2))	0.1%	-1.0%	-0.8%	-0.5%	-0.2%	-0.1%	0.0%
(1) Gross Disbursement	0.9%	0.9%	0.9%	1.2%	1.2%	1.3%	1.2%
(2) Amortization	-0.8%	-1.9%	-1.8%	-1.7%	-1.4%	-1.3%	-1.2%
Gross financing needs (US$ billion)	8.1	10.8	10.9	11.3	11.7	11.4	10.2
Gross financing needs (% of GDP)	3.3%	4.1%	3.6%	3.4%	3.3%	3.0%	2.5%
Government Debt to GDP ratio (%)	59%	53%	47%	43%	40%	37%	34%

Note: 2003 and 2004 Preliminary Actual, 2005-2009: staff projection.

Development expenditures- central government development expenditures. Regional governments also contribute to development expenditures, most of which come from central government's transfers.

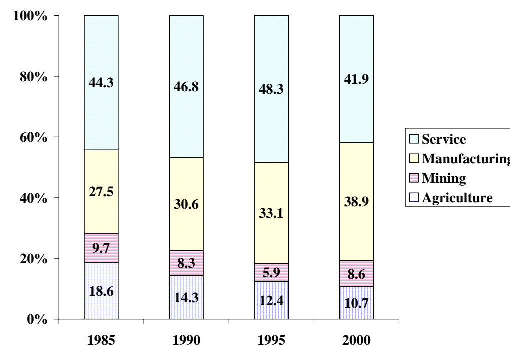
Source: Various government agencies, World Bank staff estimates.

Appendix 2. Structural Change in the Economy
From De-Industrialization to Re-Industrialization

In the past 20 years, Indonesia's economy has experienced significant structural change. The Input-Output Table (I/O) table is a useful analytical device in this context, since it captures the economic structure better than national accounts[9]. By using the I/O tables for 1985, 1990, 1995 and 2000, Hayashi (2004)[10] analyzes the structural change of Indonesia's economy. Although Indonesia's economy has experienced further structural change since 2001, the analysis indicates some important trends. For several years after the crisis, we, including the Bank, have discussed de-industrialization, in which the share of manufacturing declined. However, this analysis –using the more comprehensive I/O data- shows the opposite story. The share of manufacturing has been increasing even after the crisis.

Increased Share in Manufacturing. The share of manufacturing increased across the period (Figure 1). In 1985, the share of manufacturing was 27.5 percent and reached 38.9 percent in 2000. In contrast the previous 1993 base national accounts, indicate that the share of manufacturing increased only slightly from 24.1 percent in 1995 to 24.9 percent in 2000, but afterwards declined to 24.7 percent in 2003. Why the gap? In addition to underestimating overall GDP and especially manufacturing the 1993 base GDP did not capture developments in new manufacturing industries such as Information Technology Between 2000 and 2003, according to 2000 base GDP, which better captures this new manufacturing, the manufacturing share increased By way of comparison the share of agriculture declined from 18.6 percent in 1985 to 10.7 percent in 2000.

Figure 1. Increase share in manufacturing
(share of major sector, percent, I/O table)



Source: BPS, Hayashi (2004)

The Decline in Labor Intensive Manufacturing. The share of labor intensive industries declined from 16.9 percent in 1995 to 13.4 percent in 2000[11]. Among these industries, the share of the textile industry in manufacturing, declined from 4.2 percent in 1995 to 2.8 percent in 2000 continued to decline from 2000 and 2004 (until Q3). In contrast, the share of machinery increased from 16 percent to 20.8 percent, and that of oil and gas manufacturing increased from 6.0 percent to 12.9 percent between 1995 and 2000.

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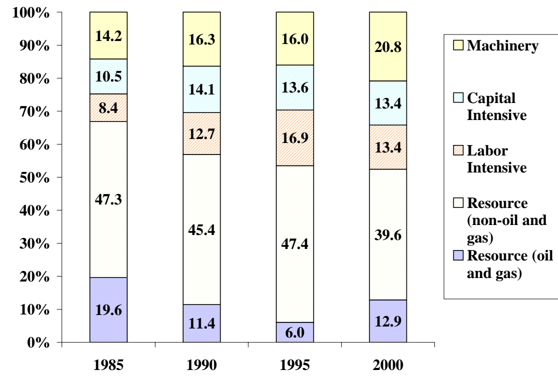
[9] While the national accounts reflect final demands, I/O table take intermediate goods into account, and thus better reflect the "complexity" and linkages in the economy.

[10] Hayashi (2004) "Industrialization and Structural Change of the Indonesian Economy: Analysis of the Input-Output Table in 1985-2000" in Sato (2004) Eds. "Indonesia's Economic Restructuring" (Japanese), figures are adjusted to 1993 constant prices.

[11] Labor intensive industry includes, for example, textile, apparel, footwear, and printing.

The change in production shares in manufacturing are consistent with the employment story. Despite increases in manufacturing, manufacturing employment did not increase in the share in total employment or even in absolute numbers. Manufacturing employment was 11.2 million, 12.9 percent of total in 1997. It increased slightly to 11.6 million (13.0 percent) in 2000, but declined to 10.9 million (12.0 percent) in 2003. This is partly due to the decline in share in labor intensive industries.

Figure 2. Shrinking Labor Intensive Industry
(Share in total manufacturing, percent, I/O table)



Source: BPS, Hayashi (2004).

PART 3. IMPROVING THE INVESTMENT CLIMATE FOR FIRMS AND PEOPLE

Chapter 4. Removing Investment Barriers

Introduction. *Achieving macroeconomic and political stability was the focus of policy in the last few years, and these objectives have largely been accomplished. Looking ahead, improving Indonesia's investment climate is arguably the most important economic challenge for the Government. President Susilo Bambang Yudhoyono (SBY) focused on the importance of improving the investment climate in his inauguration speech, and the government medium-term plan (PJM) puts it as one of the central issues. Improving the investment climate is especially important because the economic outlook for Indonesia has substantially improved over the course of 2004, after a long period of modest growth and stagnating investment. In this promising environment, the key question now facing policymakers is how to strengthen and extend this rebound into a strong, multi-year expansion that creates jobs and reduces poverty.*

Promising Environments. After stagnating in 2001-2003, investment grew by 11.3 percent in the first three quarters of 2004. Other indicators also signal a recovery in investment. For example, capital goods imports increased by 44.2 percent in January-November 2004. The government signed 46 new oil and gas contracts in mid-December 2004. Until recently, the economic recovery has been led by stronger consumer spending, which has improved the market outlook for firms. The moderate increase in growth, combined with low investment over the past seven years, raised firms' capacity utilization, which has now reached much higher levels than historical averages. Given the current high capacity utilization, continued growth and improvements in the investment climate suggest potential demand for investment is high.

The financial sector is ready to support investment. Real lending rates continue to decline, and the availability of credit is improving. At the same time, there has been continued progress in corporate debt restructuring, which, combined with the lower interest rates, has resulted in sharply lower interest expenses for firms Stock prices surged in 2003-2004 with strengthening growth, the improving financial health of corporations in the country, and the return of foreign portfolio capital inflows. This helped reduce the equity cost of capital. Firms' profitability and balance sheets are thus improving and this should also support new investment.

But a Challenging Agenda Remains

Early, decisive action by the new government is critical to anchor and sustain the recent investment recovery. As with any recovery, cyclical factors have played a role in the current investment recovery and investment growth is lower than it should be given high capacity utilization. Building on this upswing, the government can ensure a higher and more sustainable path for growth in investment. Further structural and institutional reform efforts are needed to improve the investment climate, build on the gains already achieved, and extend the investment recovery beyond the current upswing.

Box 3.1. Kadin (Indonesia's Chamber of Commerce)
Recommendation: Revitalization of Industry and Investment

Kadin submitted a roadmap on how to revitalize industry and investment in October 2004. The roadmap has 5 necessary macro preconditions and 6 critical sector factors. The five preconditions are: (i) macroeconomic stability, (ii) security and political stability, (iii) positive work ethics, national discipline, providing services and care to improve performance, (iv) trust and spirit of togetherness, (v) clean, transparent and effective administration (good public governance). Six critical cross sector factors are: (i) law, (ii) tax, (iii) manpower, (iv) infrastructure, (v) regional autonomy and (vi) industrial strategies and policies. Five macro preconditions and six critical sector factors are selected based on the business experience survey by the International Chamber in August 2004 (Box table 1).

Box Table 1. Identification of Issues Faced by Business Community
(percentage of respondents with negative experience)

Issues	Percentage
Law enforcement	91%
Corruption	88%
Tax	84%
Bureaucracy and inconsistency in policies / regulations	82%
Manpower	64%
Crimes and security	58%
Infrastructure	51%
Regional autonomy	51%

The 5 macro preconditions and 6 critical sector factors are consistent with the government PJM and CGI investment climate working group recommendations. Policy recommendations for each critical cross sector factor are divided into a program for the first 100 days and that for 1-5 years. Further, Kadin compiled recommendations for 12 important industrial sectors in light of the view that a specific sector has specific problems and as such requires a specific action plan and reform agenda .

Source: Summarized by World Bank staff based on Kadin's Roadmap.

The donor community as well as Indonesia's Chamber of Commerce (Kadin) (Box 3.1) have proposed measures to improve the investment climate[1]. Although improving the investment climate requires medium-term structural changes, three key principles are put forward: (i) safeguard key accomplishments to date, (ii) take early, decisive action, and (iii) develop a comprehensive medium-term roadmap.

Early, Decisive Action. The new Administration has a historic opportunity to take decisive action to improve the investment climate. Recent public statements demonstrate to investors that the Administration understands the gravity of the situation and is committed to improving the investment climate, and this is a good start. Announcing a bold package of measures early in the Administration's tenure could change investors' perception of Indonesia and help set off a positive dynamic where investment begins to expand and spur higher economic growth. This would in turn win Government political support and build support across society for further reforms. Formally establishing a regular dialogue between the Government and domestic and international business communities on investment climate reform would also provide the signal to the market[2] and the proposed Infrastructure Summit in mid-January is also a step in this direction. The Government needs to

[1] CGI Investment Climate World Group (October 2004) "Creating Jobs Through Investment", Kadin (November 2004) "Revitalization of the Industry and Investment".

[2] For example, Indonesia and Japanese government launched a joint forum on investment in mid-December 2004.

Box 3.2. Investment Climate Test Case- Managing Disputes

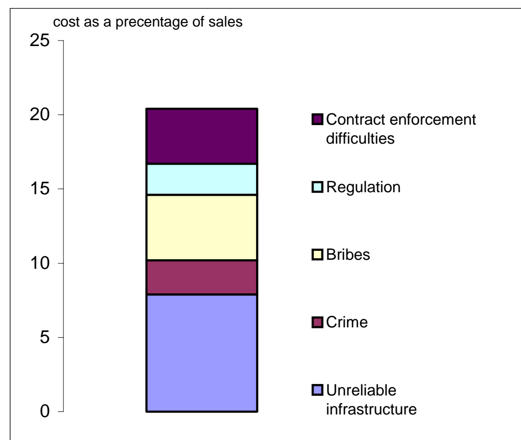
Commercial disputes are an unavoidable occurrence in any country's investment climate, but the frequency of incidence, speed and ways they get resolved differentiates credibility among governments. It is unfortunate that the new Administration inherits a number of long-standing disputes, some dating as far back as 1998, unresolved by the past government(s), but it also represents an opportunity to demonstrate achievement if resolutions are found and deemed satisfactory by observers. At present, there are four high profile disputes involving the government or state-owned enterprises and foreign investors. The roots of these cases vary from cancellation of a project (Karaha Bodas vs. Pertamina), renegotiations over previous deals (Cemex vs. Semen Gresik and ExxonMobil vs. Pertamina) to the more recent one concerning environmental impact (Newmont Mining). Each of these cases is complex and puts the Indonesian government in a difficult position of having to balance the interests of many parties including: the local community and local government where the investments are located, parliamentarians, foreign governments and prospective investors. Furthermore, the government needs to consider the country's fiscal constraints in paying out litigation charges while, regrettably, internal issues have hindered genuine legal defense with corruption and collusion indications. To its credit, the new Administration has made noticeable efforts to settle these cases as the investment climate is not only macroeconomics but the handling of individual cases . Recently the government has announced that it has prepared six options to offer Cemex, and a comprehensive review of the Cepu oil bloc with ExxonMobil. However, at some point in the near future, decisions need to be made, as it is important for the government to reach closure in each of these cases and not to let them stretch to on.

significantly strengthen the institutional mechanisms for driving investment climate reforms through the bureaucracy and coordinating policies and regulations that affect investors. In contrast, the constitutional court annulled the electricity law (Law No.20/2002) in mid-December 2004. Despite the government intention to submit a revised law, the rejection had a negative impact on the investment climate. Investors in the power sector and others may have become skeptical about legal certainty, since other key laws might be annulled (Chapter 2). Also, there are several major investment disputes that remain unsolved (Box 3.2).

Comprehensive Medium-Term Roadmap. A medium-term plan is crucial because it provides benchmarks against which to measure the Government's performance and give investors confidence that conditions will continue to improve. After initial steps at reassuring investors, a key step for the Government is the formulation of a medium term agenda of investment climate reforms. But what really matters to businesses in terms of investment climate? The Productivity and Investment Climate Survey [3] identified two overarching areas of concern to investors with regard to Indonesia. *First,* investors said they were concerned with *risks* arising from political and social insecurity, macroeconomic instability, and policy and regulatory uncertainty. Political and macroeconomic stability have greatly improved in the past two years, thus reducing the most severe constraints to

Figure 3.1. Extra Cost of Production are High

(cost as a percentage of sales)



Source: PICS.

[3] PICS—a survey of about 700 firms undertaken in 2003 by the Asian Development Bank and the World Bank

investors—and this is starting to be reflected in the recent investment recovery. Policy and regulatory uncertainty remain, however. *Second,* investors were concerned about their *cost* of production, such as power shortages, taxes, cost of financing, and labor regulations. For example, the costs associated with crime, corruption, regulation, unreliable infrastructure, and poor contract enforcement amount to 20 percent of firms' sales (compared with 8 percent in Poland and 13 percent in China) (Figure 3.1). These extra costs are typically more than what firms pay in taxes.

In the PJM, the Government reveals a medium-term plan to "Create Healthy Business Environment" in chapter 14. Table 3.1 summarizes the chapter. The purpose of "Create Healthy Business Environment" is "increase in investment, exports and economic competition as well as benefits to expand work opportunities…".

The main issues that need to be addressed to ensure sustained growth going forward fall into several broad and at times overlapping categories (Figure 3.2): (i) policy and regulatory uncertainty, including corruption; (ii) legal, judicial, and security issues; financial sector issues; (iii) tax and customs administration; (iv) labor regulations and labor disruptions; (v) infrastructure bottlenecks; (vi) the changing role of local government; (vii) need for coordination, and (vii) financial sector issues. The majority of firms perceived these issues as

Table 3.1. Policy on "Creating A Healthy Business Environment" in Draft PJM

Category	Key Items
Issues	- Healthy business environment for investment, exports, competitive power and job opportunity. - Starting up business takes 151 days. - Uncertainty of law, bad infrastructure condition. - Current growth is not able to create enough job opportunities.
Suggestions	- Minimize high costs by reforming government organizations in different levels. - Improve ports, customs and excise, and tax administration to levels in Thailand or Malaysia for efficient export-import services. - Increase competition to enhance productivity of workers.
Policy Objectives	- Decrease transaction and high economic cost. - Improve law enforcement (property rights, land ownership and fair regulation). - Improve investment policy (investment law). - Develop manpower climate. - Increase infrastructure service capacity. - Improve harmony of laws between central and regional governments. - Develop policy formulation mechanism being prioritized by export potentials, fulfill domestic needs, manage natural resources, job creation. - Export product competitiveness. - Strong domestic trade. - Promoting tourism.
Development Programs	- Tax and customs reform. - Investment climate improvement. - Create job opportunities. - Develop science and technology. - Develop infrastructure. - National standard development. - Industry development. - Trade development. - Tourism development.

Note: Based on November 27th version.
Source: Bappenas, summarized by World Bank Staff.

Table 3.2. Indonesia's Investment Climate in International Comparison
(percentage of firms reporting constraint to be severe or very severe)

	Policy Uncertainty	Corruption	Tax rates	Tax administration	Finance	Electricity	Labor regulation
Indonesia	48.2	41.5	29.5	23	23	22.3	25.9
China	32.9	27.3	36.8	26.7	22.3	29.7	20.7
Malaysia	22.4	14.5	21.7	13.3	17.8	14.8	14.5
Philippines	29.5	35.2	30.4	25.1	18.2	33.4	24.7

Source: World Development Report 2005.

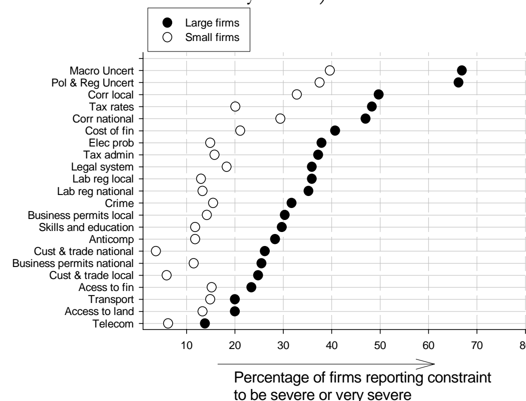
constraints. As macroeconomic and political stability is now largely achieved, the Government can move into improving second-level problems.

International Comparison of the Investment Climate. Indonesia's investment climate is weak in an international comparison in major categories (Table 3.2)[4]. For example, in Indonesia at 41.5 percent, the percentage of firms reporting corruption is a severe constraint is about three times as high as Malaysia (14.5 percent).

- **Policy and Regulatory Environment**. Firms report making informal payments of around 4.6 percent of annual sales, and exporters report paying close to 5 percent of annual sales. Under the old regime, corruption was contained and predictable, and thus easily figured into the cost of doing business. With decentralization, however, about a third of the surveyed firms (and 40 percent of large firms) think that corruption has increased, with many more government officials at different levels demanding bribes for business transactions. This unpredictability raises firms' transactions costs, reduces productivity, and acts as a disincentive for investment.

  With the new Government now in place, some short-terms measures can signal its seriousness about corruption. These measures include: (i) holding a series of televised public hearings on corruption in different sectors; (ii) creating a high-level Presidential Council of Governance Advisors to ensure that the anti-corruption momentum continues; (iii) creating a nationwide "yellow card" campaign for public complaints about corruption; (iv) launching a pilot top-to-bottom reform plan for one institution perceived as corrupt; (v) setting clear performance targets for key institutions in charge of dealing with corruption (such as the Committee to Audit the Wealth of State Officials, the Attorney General's Office, and the Anti-Corruption Commission); and (vi) completing the legal framework to deal with corruption.

Figure 3.2. Constraint to Investment
(percentage of firms reporting constraint to be severe or very severe)



Source: PICS.

- **Legal, Judicial, and Security Issues.** About 25 percent of firms rate the

[4] Surveys were conducted in 2002-2004, and the number of sample companies are different.

functioning of the legal and judiciary system as a major or severe constraint; close to half believe that the courts are unfair and corrupt; and about 40 percent believe the courts are unable to enforce firms' contractual and property rights. These numbers are significantly higher than in other countries surveyed. Security and law and order are also of concern, as measured by the amount firms spend on security measures (equipment, personnel, professional security service), and on protection payments to organized crime. Improving security and law and order would significantly raise the firms' willingness to invest, which in turn would raise employment.

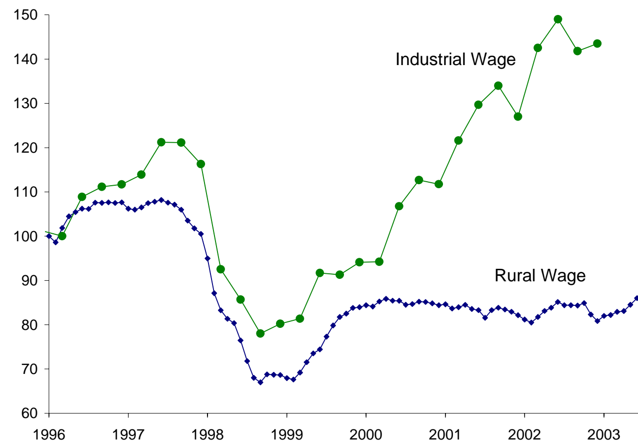
- **Tax and Customs Administration.** Tax and customs administration needs strengthening, and local taxation needs simplification. The value-added tax (VAT) that has become overly complicated and forms need simplification. The tax administration needs to be more efficient in the areas of enforcement, collections, and VAT rebates, since current inefficiencies add to investors' costs. So do predatory local taxes, which have proliferated due to the lack of a tax base for local governments. About 30 percent of firms in Indonesia say that taxes are a major or very severe constraint to doing business—broadly in line with the Philippines and China.

  Specific issues that need to be addressed in the tax area include procedural issues in assessments of taxes, excessive delays in VAT and corporate income tax audits and refunds and long periods resolving tax assessment appeals; arbitrary implementation of tax regulations by tax officials that leads to the prevalence of additional charges, luxury tax that encourages smuggling and creates unfair competition for legitimate producers, and depreciation schedules that can provide disincentives for investment in equipment renewal.

  Custom reform is one of the government development programs in the draft PJM and one of the customs reform programs is "*Increase eradication of crimes such as smuggling and undervaluation*". Currently the government is planning to revise laws on customs and excise relating to smuggling including tighter inspections (Jakarta Post on December 21, 2004).

- **Labor Regulations**. The new labor regulations are a problem to a quarter of the firms (35-40 percent of large firms), and have had the unintended consequence of reducing the growth of formal sector jobs. Labor has long been a key element in Indonesia's comparative advantage for investors, but this perception changed in 2003 with the passage of the Labor Protection Law (No.13/2003), which has decreased the flexibility of firms with regard to layoffs and dismissals, temporary hiring and contract workers, and the salary scale for skilled workers. The irony is that labor issues were not of concern to prospective foreign investors before 2003, but they now rank high in terms of constraints to investment. Labor disruptions are one of the most important factors affecting firms' efficiency, and are leading firms to revert to more capital-intensive production methods. The regulations have the potential to raise the costs of doing business and have drawn widespread criticism from employers. It is essential that implementing regulations take into account their effects on the level of employment, particularly of the poor.

Figure 3.3. Real Wage Development 1996-2003
(Quarterly Index, 1996 Q1=100)



Source: BPS, staff calculations.
Note: Industrial wage as a good proxy for formal wages, whereas rural agricultural wage is one for informal sector wages.

In order to promote pro-poor growth and poverty reduction, labor policies should support employment creation and an integrated labor market. The wedge that has developed in wage rates between industrial and rural wages is one indicator that recent labor legislation has provided greater protection for one segment of the labor market at the cost of excluding new entrants into the industrial wage sector.

In addition, the lack of clarity on the Social Security Bills adds to the policy uncertainty faced by investors, and could negatively affect hiring decisions. It is important to note that the bill may harm the poor by increasing labor market rigidity, raising the costs of doing business in Indonesia, thereby reducing employment prospects and damaging the already uncertain investment climate. Improvements to the law will have to be made in the implementing regulations, follow-up laws and Presidential Decrees. Implementing regulations of the labor laws and the Social Security Bill will need careful preparation and a wider public debate.

Further reform of the Labor Law could do much to improve the functioning of Indonesia's labor market. Developing the legal framework and policies in which quality employment can grow requires careful and thoughtful decision making, as well as consultations with representatives of labor, business, and Government. Job information centers, enhanced skills training, and a national skills accreditation or licensing system are

also important measures that could lead to higher productivity and help expand employment.

- **Infrastructure** **(see also Chapter 5 on Averting an Infrastructure Crisis).** Indonesia's infrastructure has deteriorated since the onset of the financial crisis. Firms lose about 4 percent of their sales to transportation problems and 6 percent to power outages; and nearly 40 percent of firms rely on their own generators. Indonesia has undertaken some ambitious reforms in infrastructure, but despite their significance, the impact of these reforms on investor confidence has been limited, due to the lack of an overall strategy, predictable policies, and implementing regulations. An effective infrastructure strategy must be based on three pillars: (i) *improving public management and planning of infrastructure* to improve service provision; (ii) *restoring private sector participation* to provide expertise, foster competition, improve efficiency, and ease finance constraints; (iii) *mobilizing finance for infrastructure* through greater efficiency in implementing public projects, including improved transparency, competitive bidding, and an end to corrupt practices.

  Improving infrastructure is key to attracting new investment, maintaining Indonesia's international competitiveness, increasing productivity and generating employment. The Government's fiscal constraints will require Indonesia to attract substantial private financing to improve the quality and quantity of its infrastructure while maintaining fiscal consolidation and avoiding inappropriate contingent liabilities. The Government will also need to use its budget more efficiently and effectively and perform rigorous cost-benefit analysis for projects.

  Important considerations include:
  (i) Improving public management of infrastructure by creating a medium-term strategy for infrastructure development.
  (ii) Creating or empowering independent regulatory authorities in key infrastructure sectors.
  (iii) Establishing a transparent and viable framework for private participation in infrastructure development by revising Keppres 7/1998 on Public-Private Cooperation in Infrastructure Provision.
  (iv) Reforming the regulatory basis for competition and price setting, to achieve appropriate prices of public services that balance project sustainability / profitability with competitive pricing to support user industry competitiveness.
  (v) Establishing an independent review and oversight system for infrastructure projects in order to prevent corruption.
  (vi) Exploring innovative ways to finance infrastructure development, including strengthening non-bank financial institutions, mobilizing domestic savings and increasing government spending where appropriate and feasible.

- **Issues Involving the Changes in Role of Local Government.** (see also Chapter 6 on Implementing Decentralization). Decentralization exacerbated investors' concerns, particularly among large firms, about corruption, policy uncertainty, and business licensing. Lack of revenue sources in the post-decentralization period has provided strong incentives to introduce new forms of taxation and *retribusi*. The proliferation of

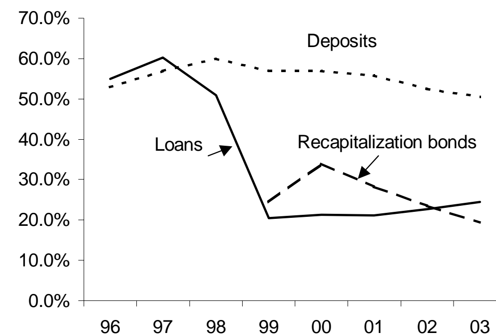
inappropriate local taxes and regulations has become a menace for businesses. Many of these restrict or tax trade within or between *kabupaten* and provinces as they are easy to implement (by positioning officials at key strategic locations, such as city boundaries, weigh stations, ports, or bridges). These taxes and restrictions interfere in domestic trade and undermine internal market efficiency. This makes them illegal according to law 34/2000 on regional taxes, but supervision remains weak. Local business people complain about the high cost of location permits which give the right to the investor to use the land for specified purposes. Setting the costs of such permits too high discourages investment and encourages corruption. To ensure no local taxes and fees that damage the investment climate are introduced, the current approval mechanism for local perdas could be replaced with a closed list of allowable revenue instruments to local governments; such list would need to include instruments that can substantially increase revenue at the local level, and be augmented by control over the property tax. At the same time, the capacity of the central government to review local regulations needs to be strengthened.

Strengthening local governments is essential to enable them to undertake new responsibilities, including investments in areas such as roads and education, which are critical for attracting business to underdeveloped regions. To support local governments' ability to carry out these and other functions, the Government needs to address several key issues related to decentralization. In particular, the Government must: (i) expand the legitimate revenue-raising authority of local government, while banning nuisance taxes that drive away business; (ii) strengthen its supervision of local business regulations; (iii) clarify functional assignments across government levels; and (iv) improve the distribution of transfers.

- **Need for Coordination.** In sum, a crucial task facing Indonesia today is to ensure that the present rebound in the economy is consolidated into an extended multi-year period of strong growth. This requires further improvements in the investment climate. Some of the most critical obstacles to investment—political and macroeconomic instability—have been largely dealt with. Reforms that need to be tackled in the next stage range from legal and judicial reforms, to financial sector, tax administration, labor regulations, infrastructure, and local government policies—areas that are the responsibility of many different ministries. To achieve cohesion and momentum in the reform program, it will therefore be necessary to coordinate across key responsible ministries, and to monitor the progress. The new Government comes at an opportune time to engage in further reforms that can be implemented in a reasonable period of time, while achieving the biggest bang for the buck.

- **Financial Sector Issues.** Indonesia's banking sector is much healthier now than it was when the crisis hit. This is a prerequisite for new investment. But much remains to be done. There is still a large unfinished agenda before the financial sector can move from being part of the problem to being part of the development solution: (i) Bank lending has yet to recover, and needs to shift its focus from consumption to investment (Figure 3.4); (ii) The governance of state banks remains weak; (iii) Non-bank financial institutions remain small, they make up less than 20 per cent of Indonesia's financial system.

Figure 3.4. Lackluster lending
(Bank financial indicators, 1997-2003)



Source: Bank Indonesia, staff estimates.

A three-pronged strategic approach for financial sector policy. It is time to focus on building a financial sector that can contribute to the long-term developmental needs of Indonesia. A sound well-regulated financial sector, consisting of strong banks, capital markets, non-bank financial institutions, and institutional investors such as pension funds, is key to unlocking the potential of Indonesia's economy. Indonesia needs to adopt a three-pronged approach towards the financial sector going forward.

- First, further *strengthen* the financial sector to minimize the possibility of another crisis.
- Second, *diversify* the financial sector so that it becomes less vulnerable to shocks, and becomes a source of long-term domestic financial resources.
- Third, *improve access* of the poor to formal financial sector services so that the financial sector supports poverty reduction efforts.

(i) Strengthen the Financial Sector

- **Clarify the role of state banks**: State banks account for 35 percent of Indonesia's banking system and they continue to pose a risk to the banking system. The government should consider completion of privatization, renewing and enforcing performance contracts, and examine options to downsize the state banks.
- **Establish the financial sector safety net:** A sound financial sector safety net is critical for creating the incentives to protect depositors from bank failures, while avoiding the risks of future bailouts. Construction of the safety net is well underway. The government needs to set up the deposit insurance agency (LPS) and adequately resource it. A formal coordinationg mechanism should be established between BI, the MOF and the LPS.
- **Further strengthen banking regulation and supervision:** Although significant improvement of BI's regulation and supervision has been recognized, the perception of weaknesses still remains.
- **Provide an enabling environment for improving skills and infrastructure:** Credit assessment, risk management, and technology skills are of critical importance. The government and BI need to encourage the banking sector to invest in human resources and training.

- **Fully implement anti-money laundering (AML) reforms:** Getting Indonesia off the Non-Cooperative Countries and Territories (NCCT) list should be a priority for the Government, though some progress such as creation of PPATK has been made more work on implementation is needed. Remaining on the list means Indonesia is contributing to the vulnerability of the international financial system and the Government needs to fully implement the recommendations of the FATF.

(ii) Diversify the Financial Sector: Non-bank finanical institutions in Indonesia are small. Having a more diversified financial sector would reduce the vulnerability of the current bank-dominant financial sector and improve the environment for greater investment. Pension funds, insurance companies, mutual funds, capital markets need to play greater role.

- **Strengthen capital and money markets**: Despite good performance in the last two years, further efforts need to focus on fundamental structural and institutional issues to strengthen these markets. Sound capital and money markets reduce the vulnerability of the economy to stresses in the banking sector. The government should see that the regulator (BAPEPAM) undertakes a program to improve disclosure requirements of the listed companies, and protect the rights of minority shareholiders.
- **Develop the government bond market:** The government bond markets are nascent, but face high demands. Especially, the secondary market needs further development. For this purpose, the government should develop a liquid, benchmark government bonds issue; and promote adoption of standardized repurchase agreements (repos) among market parties.
- **Strengthen institutional investors:** Insurance firms, pension funds and mutual funds are important institutional investors that provide long-term domestic resources. In addition to providing risk management mechanisms, they also mobilize long-term domestic resources critically needed in Indonesia.
  - **Insurance sector:** The sector is small and concentrated. Although the government has introduced stricter capital requirements, the regulatory and supervisory regimes as well as institutional capacity of the regulator needs to be upgraded.
  - **Pension sector**: The sector is also small but set to expand. Pension schemes as well as its state-run pension funds have been problematic. The first step in reforming the schemes would be to appoint a task force to assess their governance and preformance.
  - **Social security law.** The recently passed law should be reviewed by the government. The implications of the law for the budget, pension security, and capital market development should be reviewed. With the assessment of the existing scheme in hand, a more sustainable social security scheme can be implemented.
  - **Mutual funds.** The sector has grown extremely well but the fundamentals are weak. Many mutual funds do not follow international valuation norms and risk losing investor confidence, and damaging the economy at large. BAPEPAM's regulations and supervision of this industry need to be tightened and brought into line with international practice.

(iii) Improve Access of the Poor to the Financial Sector: The government is committed to improve the access to finance for the poor, and subsidizes many credit schemes for small business operators. However, these schemes are not delivering for various reasons, such as bad program design and inadequate incentives. These subsidy

schemes may also affect negatively the non-bank microfinance providers who are all struggling to operate in a weak legal framework.

- **Change the focus of public expenditures:** The focus should shift from direct capital transfers and interest rate subsidies to building the capacity of microfinance providers. Under the leadership of MOF together with line ministries a national strategy should be developed to provide support for sustainable microfinance services (see also Chapter 7 on Improving Rural Development).
- **Finalize the Microfinance Law:** The government needs to finalize and submit to parliament a draft microfinance law. Links between the non-bank microfinance providers and the formal banking sector should be facilitated and proper supervision of non-bank microfinance providers needs to be arranged while evaluating the existing experiences. The revised draft Cooperatives Law should be implemented to provide a better framework for microcredit; accelerating land titling would also facilitate the availability of collateral.

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Chapter 5. Averting an Infrastructure Crisis

The Problem

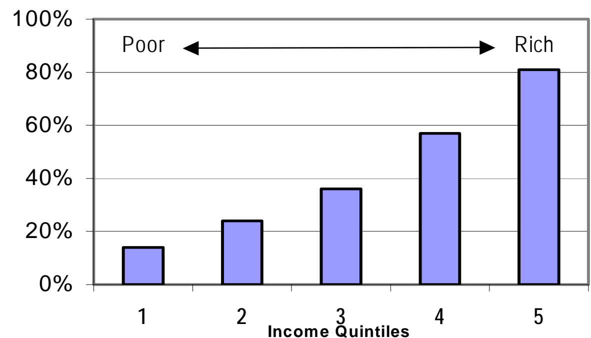
Table 3.3. Infrastructure Performance

Indicator	Indonesia (in year 2000)	ASEAN Regional Ranking
Electrification Rates (%)	53	11 out of 12
Fixed Telephone lines (%)	4	12 out of 12
Mobile Subscribers (%)	6	9 out of 12
Access to Improved Sanitation (%)	55	7 out of 11
Access to Improved Water (%)	78	7 out of 11
Road Network (Km per 1,000 pop)	1.7	8 out of 12

Poor infrastructure is hurting growth. Investment in infrastructure must increase before Indonesia can achieve the 6 percent growth rate needed to create jobs. Several business surveys have identified poor infrastructure as a key barrier to investment, and Indonesia ranks below most of its neighbors on key infrastructure indicators (Table 3.3). The *Global Competitiveness Report* captures Indonesia's slide over the last decade: in 1996 Indonesia's infrastructure was better than that of Thailand, Taiwan, China, and Sri Lanka. By 2002, these countries had all overtaken Indonesia in the quality of infrastructure. Power outages are imminent in Java, while outer regions already suffer regular black-outs. Lack of fixed-line telephones reduces Indonesia's competitiveness by limiting Internet and data access. Road congestion has increased and is pushing up costs for exporters. And maintenance of existing roads is neglected: almost half the district roads are in poor or bad condition, leading to increases in transport costs and lower prices for farm produce.

The poor have the worst access to services. The poor have a limited choice of services and they pay more to providers. For example, when it comes to safe drinking water the poorest of the poor have less than one quarter the access of the rich (Figure 3.5). The poor pay water vendors up to five-times more than the rich who use piped water. The range of services is generally lower in rural areas, where most poor people live. More than 6,000 villages, mostly in rural areas outside Java and in Bali, have no electricity - that's 90 million people without electricity. The lower rural coverage in phones, power, and other infrastructure services has increased regional disparities in development.

Figure 3.5. Access to 'Safe Water' by Income level



Source: Susenas 2002

Poor infrastructure has reduced the quality of life and the environment. The lack of sewerage systems and solid waste facilities has caused widespread contamination of surface and ground water, as well as destroying sensitive eco-systems. Only 14 percent of the population is serviced through water utilities and just 1.3 percent has access to a sewerage network. These conditions explain why Indonesia has the highest incidence of typhoid in East Asia. Lack of water and sanitation is costly

Table 3.4. Sector Challenges

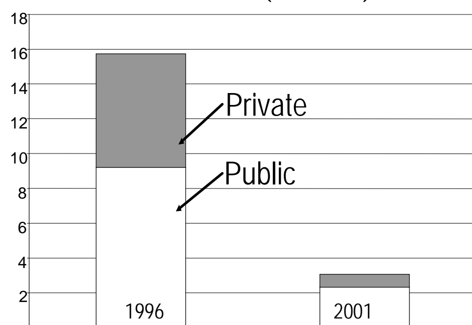
Water and Sanitation	Telecommunications
• Water access is low – 22 percent of the population do not have access to "improved" water, and only 14 percent are connected to PDAMs. • Sanitation service is lacking – only 1.3 percent of the population are reached by a sewerage network. • PDAMs are struggling – over 2/3 are loss-making, unaccounted for water is over 40 percent, and tariffs are well below costs.	• Fixed line access is the lowest in the region – only 4 percent of the population. • Massive investment is needed, but funding is a challenge – raising teledensity 1 percent will cost US$330 million. • The mobile sector continues to expand, averaging 77 percent annual growth since 1995.
Power	**Roads and Road Transport**
• Access is low – Currently, 43 percent of population are without power (roughly 90 million people, including many of the poorest people in Indonesia). • Connection costs are 33 percent higher in rural areas. • Investment needs are high – an estimated US$15-17 billion are required before 2012 for an additional 9,700 MW of capacity, expanded transmission, and distribution for 1.6 million connections annually.	• Spending has declined – from 22 percent of the national development budget in 1993, to 11 percent in 2000. • Maintenance is lacking – the proportion of road budget for maintenance has been reduced from 30 percent to below 10 percent from 1985 to 2000. • Congestion is a problem – significant capacity expansion is needed, but little has been added, and urbanization trends will only increase the problem.

the annual social and economic costs of sanitation-related health problems are estimated at US$4.7 billion (2.4 percent of GDP), or Rp. 100,000 per household per month.

The Causes

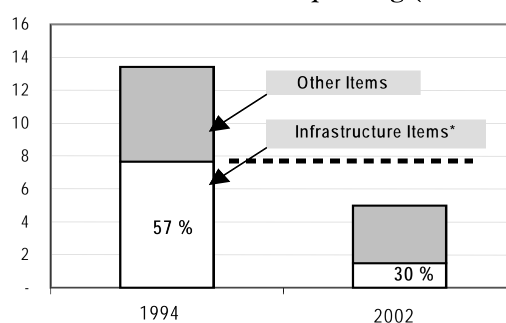
The economic crisis plunged the infrastructure sector deeper. The economic crisis forced the suspension of many planned private and public infrastructure projects, and the financial viability of private projects under construction was eroded by the Rupiah's plunge. In 1996 Indonesia invested 7 percent of GDP in infrastructure, and by 2001 that was just 3 percent (Figure 3.6). Public spending on infrastructure fell by 80 percent from pre-crisis levels. In 1994, the central government spent almost US$14 billion on development, 57 percent of this for infrastructure. By 2002 development spending had plunged to less than US$5 billion; just 30 percent of this went toward infrastructure (Figure 3.7). Private investment in infrastructure dropped by a massive 90 percent from 1996 to 2000.

Figure 3.6. Total infrastructure spending ($ billion)



Source: World Bank

Figure 3.7 Central government development spending, and infrastructure spending ($ billion)



Source: World Bank

But infrastructure was in trouble long before. The infrastructure sector has had long-standing weaknesses that were not properly addressed up to the economic crisis. The relative prosperity and robust economic growth that preceded the Crisis obscured the need and urgency for reforms. In fact, the Crisis revealed this frailty, as the fundamentals of the sector were not resilient enough to withstand most of the difficulties. Before the crisis hit, services such as water, electricity, roads and telecommunications suffered from poor institutional and regulatory frameworks, and corruption went unchecked.

Decentralization complicated matters. While local governments were given control over local infrastructure, they were not provided with adequate funds for infrastructure development. The central government was also slow to develop the financial resources such as earmarked grants (DAK) to leverage local budgets and local access to borrowing. A lack of clarity regarding the roles of various levels of governments for infrastructure service provision made the problem worse. The central government also had to adjust to their new role of coordinating autonomous levels of government rather than having the function of the sole provider of infrastructure services. Unfortunately, provincial governments are unable to assist in coordinating many regional efforts, since the decentralization laws have given them very little authority for such engagements.

Towards a Solution

Government has been responding. In the past few years, infrastructure has featured more prominently on the government's reform agenda, resulting in the following initiatives:

- A modern Electricity Law was adopted in 2002, implementing regulations have been prepared, electricity tariffs have been increased substantially, and contentious issues with the Independent Power Producers have been settled;
- A new Oil and Natural Gas law was passed, introducing downstream competition and market pricing;
- The water sector has seen progress in implementing a debt relief program to strengthen PDAMs' finances; and
- A new Telecommunications Law adopted in 1999 has paved the way for the progressive introduction of competition in all markets, and dramatic growth in the number mobile subscribers since 1997 has been accompanied by increased fixed line services, public payphones, teleshops, and internet shops.

But a comprehensive strategy is needed. Despite their significance, the impact of these reforms has been limited. The main impediment is the lack of an overall strategy and predictable policies. For example, most of the laws regarding infrastructure do not have implementing regulations. Therefore private investors do not see these policies as credible.

There are no simple solutions, but for strategies to be effective they must be based on three pillars:

- First, better public management, planning and consistent policies for infrastructure development are important to reestablish credibility, service provision and impact on the population. Efficiency in implementing public projects is needed to improve impacts, which will require improved transparency, competitive bidding, and an end to corrupt practices.
- Second, while the public sector is likely to remain dominant in infrastructure, the private sector must return to provide expertise, foster competition, improve efficiency, and ease finance constraints.

- Finally, a comprehensive plan to mobilize financing for infrastructure is needed, since reforms will take time and a substantial funding gap will exist. The Government, for its part, will need to contribute more funding towards infrastructure, while also taking steps to mobilize more domestic savings for infrastructure investment, and better target public resources towards the poor

Pillar I: Improving Public Management of Infrastructure

Most of Indonesia's infrastructure is still managed by the public sector, and this will remain the case for some time to come. The role played by the public sector will need to change in three ways.

Rethinking the Role of Central Authorities. The central government needs to adjust its role from service provider to facilitator. Emphasis is needed on policy formulation and support to local authorities. These new functions need to be defined for each of the main ministries, with organizational structures and staffing needs reviewed accordingly.

Indonesia must improve the coordination and strategy for infrastructure development. Responsibilities for infrastructure provision and operating decisions are now widely dispersed through many special purpose coordination committees, some with overlapping roles. In the past, Bappenas prepared the national five-year development plan and, with the Coordinating Ministry for the Economy, directed policy development and reform initiatives. Currently, Bappenas functions as a planning advisor for the various committees, and the Coordinating Ministry of Economic Affairs focuses more on short-term implementation matters. Stronger coordination between these agencies and the line ministries in charge of implementing policies is a must.

Taking action – on Public Management

- The government needs to expand its efforts to operate the infrastructure sector on a commercial basis. Road transport, as well as other forms of transport such as the railway sector would benefit by commercialization. Local water companies (PDAMs) would also significantly enhance their services by gaining more autonomy from local governments and being more transparent in their operations.
- In order to support a more commercial business environment, the Ministry of State Owned Enterprises can strengthen their shareholder capacity while working to further strengthen the professional capacities of SOE Boards of Commissioners.
- The role, organization and staffing of main sector ministries need to reflect the new decentralized environment. Overall policy planning and coordination functions need to be strengthened and implementing responsibilities cut back.
- Help develop the capacity of local governments and entities to better provide infrastructure services through joint ventures, partnerships, twinning arrangements and investments, with experts in central ministries playing a key role.
- The provinces need to be empowered to play a much stronger coordinating role vis-à-vis municipalities.
- Procedures for on-lending of foreign loans need to be streamlined by amending KMK 35 (the policy that governs local borrowing). The current bottom-up process is complex and has the potential to impede the channeling of funds for urgent and justified infrastructure at the sub-national level.
- Better utilize the DAK as a means to develop infrastructure development at the regional level and promote efficiency in infrastructure management. Options include channeling funds being used by sector departments that are properly intended for regional government functions, and also financing investments that have benefits that spillover to neighboring regions.
- Prevent proliferation of various taxes and charges by regional governments that are inconsistent with sound public policy.

Making Decentralization Work. The legislative and regulatory provisions governing decentralization are incomplete. This is exacerbated by the fact that local and national regulations are inconsistent and often contradictory. Local governments need help to provide effective services. And provincial governments will need to play a greater role in coordinating the 400 local governments and municipalities.

The central government needs to rethink the transfer of financial resources to decentralized authorities.

- First, the distribution of resources should be more equitable. Modifying the current allocation of resources is politically sensitive and therefore difficult, but many poorer regions receive just enough to pay wages and have little funding for infrastructure.
- Second, the central government should encourage local authorities to accept national objectives. Funds available for matching grant schemes should be increased and the two matching grant mechanisms could be consolidated.
- The recently passed legislation relating to for regional government borrowing requires further development at the regulatory level and will generate the need for modern financial management within the local institutions.

Tackling Corruption. Infrastructure presents opportunities for rent seekers at every stage, from project identification and negotiation to implementation and operation. Significant amounts of public funds are lost annually through corrupt procurement practices in Indonesia. Eliminating corruption requires changes to the accountability framework that will take time to design and implement, but there are ways to reduce corruption immediately. These require limiting rent-seeking opportunities, improving detection, increasing deterrents, and creating incentives for non-corrupt behavior. Indeed, such measures have been shown to pay off – in a recent World Bank infrastructure project in Bali, mechanisms to increase competition, and improve complaint mechanisms and advertising cut almost 20 percent from the overall project costs .

Taking action – on Tackling Corruption

1. Considerable effort has gone into improved procurement regulations for central and regional government by replacing Keppres 18/2000 with Keppres 80/2003. The new law establishes an Institution for Development of Public Procurement Policy (LPKPP), requires procurement certification for bid committees, removes pre-qualification for contracts below US$6 million, and introduces 'integrity pacts' for suppliers and contractors. Keppres 80/2003 is a positive step – but the government needs to work out the many unresolved details to ensure implementation and enforcement are carried through.
2. The revision to Kepress 7/1998 on Public Private Partnerships for Infrastructure Provision is overdue. This is needed to improve guidelines for project identification and more transparent and competitive solicitation of private partners.
3. Require expanded information disclosure for infrastructure activities along with increased public participation and improved financial compliance and technical and performance auditing.
4. Apply tough sanctions for those who have been found to have engaged in corrupt practices.

Pillar II: Restoring Private Participation

Indonesia needs private sector participation in infrastructure because they bring vital resources and expertise that will improve service coverage, maintain international competitiveness, and support the expanding economy. In addition, it is more likely that conditions for effective service provision will be met with private providers, because the government will have to credibly commit to reforms in

order to attract them. Indonesia could make infrastructure projects more attractive to private industry by: ensuring the use of commercial principles in publicly managed projects; improving the financial sustainability of infrastructure services; enhancing competition between operators; implementing regulations to balance public and private interests; and optimizing the allocation of risk among stakeholders.

Commercializing, Corporatizing and Privatizing. Increasing commercial discipline – by transforming infrastructure agencies into state-owned corporations or limited liability companies – has produced significant performance gains. A few examples are Telkom and Indosat (telecom), PLN and PGN (power), and Jasa Marga (roads). Requiring compliance with stock disclosure and auditing procedures, as well as appointing more professionally qualified and independent commissioners, have all had positive impacts. But not all service providers have improved. PDAMs function with little autonomy, often relinquishing dividends to local governments who keep tariffs artificially low. Commercial principles are also lacking in the road sector, where studies suggest that standards are declining, while collusion in contract awards is increasing.

Ensuring Financial Sustainability of Service Provision. Cost-covering tariffs are important to attract private sector investment in infrastructure. Tariff increases are politically difficult, but required to revamp infrastructure investment. Increases should be explained through extensive public information campaigns and protection for the poor (see below) to make them acceptable. Tariff increases cannot be avoided. The government has supported increases in the power sector from below 2.5 cents per kWh in 1997 to the current rate of 7 cents, and achieved significant improvements in the financial viability of the sector, and notably of PLN. Progress could be made through infrastructure that uses more gas in generation and by improving PLN's operational efficiency.

By contrast, the water sector is in disarray, as low tariffs discourage local water companies from expansion and adequate maintenance. The transport sector also needs to improve its financial viability to fund expansion works and cover the cost of maintenance. Removing subsidies on gasoline and diesel, and restructuring road user charges to reflect actual usage could generate funds to cover sector expenditures. The price of local telephone calls is currently below cost and will have to rise in the future.

Maximizing Competition. Competitive pressure on suppliers helps to boost the performance of infrastructure providers. Indonesia's mobile phone market is the best example of competition at work, allowing consumers to benefit from better technology, greater choice, and lower prices. To replicate this success in other areas of infrastructure, three options exist:

- There is scope for ***competition in the market*** – where consumers can choose their supplier and suppliers compete to serve the consumer. In telecommunication, where there may be the largest potential for early competition, plans have been postponed. Similarly in power, Indonesia Power and PLN continue to operate more as partners than as head-to-head competitors. Consequently, power costs more than it should. Indonesia's new 2002 electric power law, struck down by the constitutional court, did, however, recognize the potential for competition in generation and supply, and provided for its progressive introduction on a regional basis.

- ***Competition for the market*** (e.g. franchise bidding) can be used to select operators. Numerous opportunities have been lost: water supply concessions have been awarded through direct negotiations; unsolicited Independent Power Producers' (IPP) projects have been negotiated quickly and non-transparently; similar practices are widespread in the toll-road sector and in the new Jakarta monorail project. The cost for the Indonesian economy has been enormous; when IPP projects have been competitively tendered, the offered tariff has been well below the previous rates.

- Finally, ***yardstick competition*** can also result in competitive pressure. Regulators can use comparative performance data to regulate monopoly network industries. This tool has been used by various countries, and some efforts have been made in Indonesia to introduce yardstick competition in the water sector. Yardstick competition has been found to be viable, but challenging to implement.

Establishing and Enforcing Adequate Regulation. Sound regulation is needed for private participation as it helps to promote economic efficiency, fosters innovation, and creates incentives for system expansion. Laws have been passed in the telecommunication and energy sectors to create regulatory entities. A credible regulatory body, however, needs adequate technical expertise and the independence to perform its function, and its regulators should have statutory authority, be appointed for fixed-terms, be protected from removal except in predefined circumstances, and be funded through levies on the regulated industry.

More effort is needed to develop strong, independent regulatory bodies in Indonesia. To achieve this the government must appoint and fund regulators whose powers are backed by legislation. Until there is an effective regulatory function, regulation by contract is likely to remain the next-best option for a number of sectors.

Allocating and Managing Risk. Rewards for investors are supposed to be commensurate with risks – but Indonesia's reputation for red-tape, a weak judicial system, arbitrary taxes, and corruption has made many investors reluctant to invest. This reluctance also stems from political and economic events beyond their control. But if infrastructure were to be provided by the public sector instead, the government would, implicitly bear all of the risks. Therefore, the government should develop a framework for identifying and assessing investment risks, and a means to determine the level of acceptable risk. Involving the Ministry of Finance in this process would better ensure that the fiscal exposure of risk sharing arrangements is properly evaluated and financially feasible.

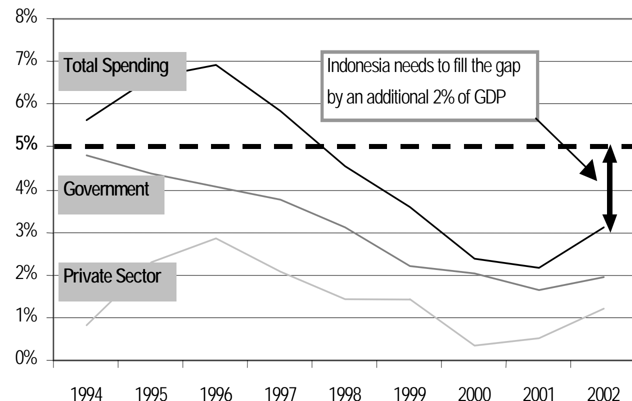
Taking action – on Restoring Private Participation

1. Define, publish and socialize basic goals and policies for private participation.
2. Amendments to Keppres 7/1998 (or a similar regulation) need to be completed and supplemented with a sound policy framework on public support for private projects, including a framework for realistic risk allocation between public and private sector.
3. Complete the process of sector law revision, accelerating the issue of implementing regulations, and moving ahead with establishing and empowering non-ministerial regulatory agencies.
4. Develop a comprehensive plan to restore tariffs to cost-reflective levels and improve the socialization of tariff changes to the public.
5. Develop sector-by-sector plans for restructuring and promoting competition – with the adoption of competitive tendering as the norm for all PPI projects and benchmarking mainstreamed as a means to pressure local monopolies.
6. Invest in building capacity as part of the process of empowering government agencies to respond to the challenge of dealing efficiently with private infrastructure developers, and communicating effectively with the public regarding PPI issues.

Pillar III: Mobilizing Finance for Infrastructure

Figure 3.8 – Filling the Financing Gap - Infrastructure Spending (% of GDP)

Indonesia needs to increase infrastructure spending an additional 2% of GDP ($5 billion) annually to sustain 6% medium-term growth



Financing needs are great. Annual investments of $2-3 billion until 2010 are needed to meet a modest growth in electricity demand; the road sector could easily absorb $700-750 million more each year for maintenance and expansion; investments of $600 million a year are considered a conservative estimate of what is needed to meet the *Millennium Development Goals* in the water and sanitation sector; and raising telecommunication density by one percentage point will cost about US$300 million.

At the macro level, the government projects a growth rate of 6 percent or above for the year 2006 (GOI PJM 2005-09). To sustain such growth, estimated infrastructure investment should be around 5 percent of GDP. In 2002, overall spending on infrastructure amounted to only 3 percent of GDP (Figure 3.8) was low compared to Indonesia's past infrastructure spending levels.

Increasing Government Spending. Local government spending in infrastructure increased significantly in the years following decentralization. Today local governments spend almost as much as the central government on infrastructure. The most promising avenue for increasing local governments' contributions to infrastructure is through borrowing. However, the financial institutions that could lend to municipalities are severely underdeveloped in Indonesia, and lending from central government to local government is only starting to take off.

In the short term, more public spending on infrastructure will have to come from central government. This has been recognized by the authorities: from 2002 to 2003, infrastructure allocation by the central Government, has been increased by US$0.75 billion, taking spending to

US$2.5 billion. This figure is still low when compared to 1994 spending levels. A combination of the following measures could address the problem in the medium term.

- First, the central government needs to increase revenue, especially through higher tax compliance.
- Second, spending should be reallocated from untargeted subsidies like fuel subsidies towards infrastructure.

Mobilizing Domestic Finance. Domestic funds are an important source of long-term infrastructure finance. Three large retirement funds, several hundred individual employer funds set up for their workers and the life insurance sector have combined assets of about Rp. 100 trillion. International experience shows that contractual savings institutions, notably pension funds, are essential instruments to channel domestic savings into infrastructure financing. Pension funds and insurance companies have long-lived liabilities denominated in local currency, making them particularly suited for long-term investment in local infrastructure projects. The Indonesian government should consider modifying investment regulations for pension funds and insurance to allow investment in infrastructure securities. It is absolutely crucial that fund managers make investment decisions on the basis of commercial, rather than political, considerations.

The central government could consider improving the regulatory environment and strengthening the institutions and capacities of local governments so as to stimulate more sub-national borrowing in domestic markets. The government of Colombia, for example, created a municipal finance institution (Findeter) to promote long term lending from commercial banks to municipalities. A bank that makes a loan to a municipality can refinance up to 85 percent of the loan at Findeter. This facilitates municipalities' access to commercial loans while relying on the project appraisal skills of commercial banks. Where possible government schemes for municipal finance should involve the financial sector in allocating credit and sharing risk. Municipal finance schemes can only be viable if municipalities have a positive and roughly predictable revenue stream through taxes and service charges.

The government should focus on improving financial market infrastructure. Establishing a sound government bond market is an important aspect of market infrastructure. A well functioning government debt-market allows for the creation of benchmark bond prices for infrastructure bonds. Credible rating institutions capable of providing an independent assessment of the risks and returns

Taking action on – Mobilizing Finance for Infrastructure Development

1. Indonesia needs to increase investments in infrastructure by about 2 percent of GDP. In the short/medium term, increased spending by the central government will be required to bridge this gap. This would be possible through a combination of: improved tax collection, and re-allocation of unproductive spending (such as the fuel subsidies).
2. Steps should be taken to tap domestic savings for infrastructure investments through, for example modifying investment regulations for pension funds and insurance to allow institutional investors to acquire infrastructure securities.
3. Strengthen capacity of sub-national entities ability to borrow in local markets so they may fund priority investments.
4. Create or upgrade certain aspects of financial market infrastructure, including: setting up sound and credible credit rating institutions; developing a sound government bond market; and establishing credible dispute resolution mechanisms.
5. Implement a risk management framework that can attract private financing towards infrastructure.
6. To the extent that cross-subsidy schemes remain necessary in the short term to enable the poor to have access to infrastructure, they should be more limited and better targeted at the truly poor.

offered by the bonds are important players in this process. Lastly, a sound legal framework and dispute resolution mechanisms are key to attracting long-term investments from private sources.

Protecting the Poor. Cross-subsidization for users of infrastructure services is very common in Indonesia, but these schemes present major drawbacks:

- They are not targeted to the poor who often have little or no access to services, instead subsidies go towards the already low consumption costs of existing users.
- They entail large resource transfers and so introduce important allocation distortions.
- They force a service provider to operate transfers among its own users so that monopolistic arrangements are maintained to prevent new entrants from "stealing" their customers. These customers, who are currently over-charged, provide the source of the cross-subsidies.

Output-based subsidies can be better targeted at poor users. Output-based schemes link the payment of the subsidies to effective service provision. Since service providers receive the subsidy after delivery, such schemes enhance incentives to perform. Indonesia has started to explore such schemes in the power sector. It could also design such measures to maximize competition between operators. This can be done through competitive bidding processes to identify, on the basis of the lowest subsidy required, the best operator to provide the subsidized services. The government could also establish a system of "portable subsidies," where operators compete for customers, and providers that deliver good service are paid a pre-determined subsidy. In setting-up subsidy schemes, it is important, however, to ensure transparency and apply incentives for disciplined administration of funds.

The Way Forward

Indonesia has already undertaken some ambitious reforms in infrastructure. At the same time, the reform agenda is huge and no government can address all of the issues simultaneously. Sudden tariff increases, for example, would strain household budgets. So the government should set clear priorities and a strategy to implement them.

Over the short to medium term, additional financing of more spending on infrastructure is needed to support higher growth, and expand the provision of basic infrastructure services to all people. This is within reach with appropriate policies and improved efficiency. While increased public spending will be key, especially to reach the poor and backward areas, this should complement, not replace, policy reform. In addition, this should also provide a good platform for mobilizing long term funding from domestic financing sources. Without downplaying the challenges ahead, there are reasons to be optimistic: a feasible path exists, and the government is aware of what needs to be done.

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Appendix 3. Sectoral Issues and Government Programs on Infrastructure in PJM

1. Raw Water and Irrigation

Issues	Government Program
1. Unbalance between supply and demand (geographically and time of the year) a. Java with 65% population only carry 4.5% of total national water supply b. 80% of water is available for only 5 months 2. Increasing threat on sustainability of water resources a. Increase number of damaged watershed (22 out of 470 in year 1984 to 62 in year 1999) 3. Land use transformation 4. Increasing demand a. In year 2003 national water usage was 112.3 billion m3, in year 2009 it's predicted that the demand will increase to 117 billion m3. 5. The irrigation system level of service is not optimal a. In year 2002, the system could irrigate up to 6.77 ha (47% in Java, 25% in Sumatra) – about 25% of this system was not in operation 6. The land transformation was 35 thousand hectare per year (agriculture to non-agriculture land) 7. Coordination, institutional and regulatory reform a. IRRs for the new Water Law (Law No. 7/2004) b. Lack of community participation 8. Low quality data and information system	1. Development, Management, and Conservation of Rivers, Lakes and other Water Resources 2. Development and Management of Irrigation Network, Swaps and other irrigation system 3. Provision and Management of Water Supply 4. Flood Control and Coast Protection 5. Institutional and Regulatory Framework

2. Water Supply and Sanitation

Issues	Government Program
Water Supply: 1. Low piped water supply service coverage (18.3% of urban population was served by PDAM in year 2002; 6% of rural communities were served by piped water) 2. Low PDAMs level of service 3. High leakage and illegal connections 4. Too many PDAMs (lack economy of scale) 5. Tariff setting 6. Low sanitation and sewerage coverage	Programs- Water Supply: 1. Community empowerment (public campaign, community participation); 2. Institutional Reform (PSP in water supply, revision of water supply-BUMD regulations, water supply and waste water funds, GR regarding obligation by BUMD) 3. Improvement on level of service (including restructuring PDAM and PDAL, capacity building, tariff structure)
Drainage: 1. Low service coverage (Since 1992 – 2002 the drainage only served around 2.51 Million people; solid waste service for 18.15 Million people 2. Environmental issues 3. TPA low management quality 4. Drainage system is not effective	Programs – Drainage and Solid Waste Management: 1. Community empowerment (campaign, construction of community-based recycle center); 2. Institutional reform 3. Improvement of level of service

3. Transportation Sector

Issues	Government Program
1. Road condition is deteriorating a. In year 2002, from total length of 330,500 km the road in bad condition was 12% of national road, 35% of provincial road, 48% of kabupaten road and 4% of kota road; b. V/C ratio more than 0.6 in North Java corridor was almost 900 km in 2003 c. Road user cost national was Rp. 1.5 Trillion / day (National) and Rp. 700 Billion / day (Java) 2. The financing need is high a. The investment need for road rehabilitation, maintenance, betterment and construction has been increased from Rp. 2.5 Trillion (2001), Rp. 4.15 Trillion (2002), Rp. 4.6 Trillion (2003) and Rp. 5.9 Trillion in year 2004; 3. Government will commit more funding to the sector a. Rp. 1.1 Trillion in 2001 from Rupiah budget to Rp. 5.1 Trillion in year 2004 4. Railway sector: infrastructure backlog, lack of grade separation, lack of improved capacity, no blueprint and investment plan, no clear role of PTKA – separation of regulator and operator, lack of private participation (monopoly by PKTA), improvement on level of service / performance, and the implementation of railway sector restructuring; 5. River, Lakes and Ferry Transport: the service level and coverage is bad, limited role of local government and private sector; 6. Sea transport: low domestic service coverage (50% for domestic shipping, and only 3.6% for international shipping), no clear role of central and local governments on port operation and management business 7. Air transport: low financial performance and level of services of SOEs (Angkasa Pura I, II)	1. Road rehabilitation and maintenance (151,000 km of national road; 180,000 km of provincial road; 722,000 km of kabupaten/kota road 2. Road improvement and construction 3. Construction of 1,593 km of toll road: a. 257 km of toll road in Jabodetabek area; b. 5.4 km of bridge from Surabaya – Madura c. 40 km of toll road Cikampek – Padalarang d. 1,290 of high grade road/Trans Java Toll Road and some sections in Sumatra (Medan-Binjai) and Sulawesi (Makassar) e. IRRs of Road Law, technical assistance, etc f. Study and preparation of construction of high grade road / Trans Java Toll Road 4. Road traffic, public transport: a. Improvement of national and local transportation system (e.g bus terminal management, traffic engineering and management for national roads, etc) b. Improvement of road transport safety c. Sustainable transportation d. Service improvement for public transport and freight transport e. Technical assistance to local governments (including restructuring DAMRI and PPD) f. Management of overloading 5. Railway: a. Maintenance, optimization and improvement of railway infrastructure b. Improvement of railway support to logistics business (railway access to port, dry ports, etc) c. Improvement of railway safety and grade separation d. Institutional, legal reform and restructuring i. Revision to law no. 13 / 1992 ii. Market structure – vertical and horizontal un-bundling iii. Spin-off Jabotabek railway iv. Implementation of PT. Kereta Api restructuring e. Improvement of SOE's performance and PSP in railway sector 6. River, Lakes and Ferry transport: a. Rehabilitation of river, lakes and ferry ports (23 locations) b. Construction of river, lakes and ferry ports (Trans Kalimantan, 6 lakes transport facilities) c. Improvement of PT. ASDP services (additional 14 ships for pioneer routes, operation subsidy for ASDP for pioneer routes d. Restructuring and institutional reform

	e. Improvement of SOE’s performance, the role of local government and private sector; 7. Sea Transport: a. Rehabilitation and improvement of infrastructure (including 27,000 m of ports belong to SOEs) b. Construction of sea transport infrastructure (Bojonegoro, Muara Sabak, Surabaya) c. Restructuring and institutional reform (Revision of Law No. 21 Year 1992 on Shipping, implementation of International Ship and Port Facility Security Code (ISPS) 8.Air transport: a. Rehabilitation and maintenance (31 airports) b. Construction of air transport infrastructure (runway in Makassar, Medan, Ternate and Sorong, terminal passenger in Lombok, Makassar, Medan, Sorong and Lombok and 5 unit of air navigation system) c. Restructuring and institutional reform (Revision of Law No. 15 Year 1992)

4. Energy Sector

Issues	Government Program
1. Unbalance demand and supply 2. Low energy diversification (energy mix policy) 3. Energy efficiency 4. No clear policy on energy pricing 5. Tax, uncertainty of regulation, and the role of local government Electricity: 1. Low electrification ratio; 2. Low investment for rural electrification; 3. Unbalance demand and supply, unbalance JAMALI and outside JAMALI grid 4. Electricity tariff uneconomic 5. Renewable energy potential is not fully utilized 6. Low efficiency (PLN losses 12%)	Policies: 1. Exploration intensification 2. Energy pricing 3. Energy diversification 4. Energy conservation 5. Energy mix policy 6. Environmental aspect 7. Others (reform, standardization, information system, etc) Energy Programs: 1. Improvement of level of service and energy infrastructure (including fuel switch, gas pipe transmission, Blue Sky program); 2. Restructuring and reform (including IRRs for oil and gas law, energy industry structure, tax incentive policies, unbundling, third party access); 3. Energy access for local government, cooperative and community (sub national borrowing in energy, PSP); 4. Application of energy technology 5. Infrastructure development (gas pipeline, coal ports, geothermal, railway double tracking, and oil refinery) Electricity Programs: (Note: due to recent Constitutional Court's decision to revoke the electricity law, much of the program should be revised accordingly with the old law UU 15/1985) 1. Improvement electricity infrastructure level of service; 2. Electricity access for local government and communities; 3. Application of IT in electricity sector

Chapter 6. Implementing Decentralization

Background: Early Decentralization Experience

The hurried implementation of Indonesia's two decentralization laws—Law 22/1999 and Law 25/1999—was carried out more smoothly than many observers expected might be the case. Two million central civil servants were transferred to sub-national governments without great incident and regional public service delivery did not, at least, break down. Still, a number of problems with the new decentralization framework soon became apparent.

Table 3.5: Sub-National Shares of Public Expenditure and Revenue

	Sub-National Expenditure Share	Sub-National Revenue Share
Developing Countries	13.78	9.27
Transition Countries	26.12	16.59
OECD Countries	32.41	19.13
Indonesia	**33.24**	**6.65**

Note: Figures for Indonesia are for provinces and kabupaten/kota combined and are from 2002. All other figures are averages, for sub-national governments across the indicated group of countries, for the 1990s.

Source: World Bank staff estimates.

The assignment of expenditures across levels of government was not clearly laid out in law. Among other things, this ambiguity led to conflict and confusion among central departments and sub-national governments regarding responsibility for service delivery in many sectors. Lack of clarity regarding expenditure assignment notwithstanding, sub-national governments have assumed significant spending responsibilities. As of 2002, about one-third of total public expenditure was carried out by regions (Table 3.5).

The new decentralization legislation did not devolve appropriate local tax bases to sub-national governments. Inadequate decentralization of taxes has constrained sub-national governments' ability to gauge demand for local services and has weakened accountability linkages. In Indonesia, regions contribute significantly less to total domestic revenue generation—just less than seven percent—relative to sub-national governments elsewhere in the world (Table 3.6). Instead of decentralizing typically local taxes (such as the property tax), the center allowed sub-national governments to create their own new taxes (kabupaten/kota only) and charges (provinces and kabupaten/kota), under certain conditions. In the run-up to and during the first year of decentralization, regions authorized nearly 1,000 new revenue instruments. Most of these new taxes and charges appear, in practice, to be either nuisances or economically harmful. Only around 40 percent of new taxes and charges created by the regions were sent to the central government for review, as required by law (Table 3.6). Regions' authorization of new revenues instruments seems not to have slowed much in more recent years.

Table 3.6. New Taxes and Charges Authorized by Sub-National Governments, FY 2000-2001

	Provinces	Kab/Kota	Total
Authorized by region (no.)	55	942	997
Reviewed by Center (no.)	27	406	433
Cancelled by Center (no.)	10	113	123
Reviewed of Authorized (%)	49.1	43.1	43.4
Cancelled of Reviewed (%)	37.0	27.8	28.4

Source: World Bank staff estimates.

Sub-national governments gained access to significant shared revenues

from natural resources and the personal income tax under the new decentralization framework. But given the unequal geographic distribution of these resource bases, the allocation of attendant revenues across regional governments proved very unequal. In the early years of decentralization, for example, around one-half of the personal income tax shared with sub-national governments was allocated to Jakarta alone. And about three-quarters of the total natural resource revenue shared with kabupaten/kota was distributed to about 35 places (in 2002) on Aceh, Riau, Kalimantan Timur, and Papua.

Table 3.7. Distribution of District Government Per Capita Revenue

	Coefficient of Variation
Before Decentralization	0.674
After Decentralization	0.819

Note: The coefficients of variation (standard deviation divided by the mean) before and after decentralization are based on average real per capita kabupaten/kota revenue for 1997/98-1999/00 and 2001-2002, respectively.

Source: World Bank staff estimates.

Absent significant own-source revenues, the vast bulk of funding for most sub-national governments derived from the new general allocation fund (DAU). The DAU was intended, among other things, to equalize fiscal capacities across sub-national governments. But the prior inequitable distribution of shared revenue, a number of faulty design features of the DAU itself, and parliament's insistence on instituting a "hold harmless" provision prohibited it from doing so very effectively. As a result, fiscal inequalities among regional governments were exacerbated under decentralization (Table 3.7).

Sub-national borrowing came to a near halt during the initial years of decentralization. For the most part, this was due to the collapse of the government's traditional on-lending mechanism, which resulted from uncertainty regarding its legal status as outlined in Law 25/1999. In any case, regional public investment in basic infrastructure waned.

A factor underlying many of the problems related to the initial implementation of decentralization was the dearth of a common perspective and a lack of coordination among central agencies. While some ministries appeared to go along with the general idea of decentralization, others simply ignored the more inconvenient aspects of the regional autonomy program, and some departments seemed to actively work against the policy. A range of ministries and institutions competed to manage the decentralization process. Both DPOD (Regional Autonomy Advisory Council) and Tim Keppres 157 were set up to coordinate decentralization policy, but neither had sufficient power to make important decisions. The end result was inter-departmental conflict and inconsistent policy implementation at the national level, confusion at the regional level, and the needless duplication of resources and effort.

Other reasons for some of the early undesirable outcomes of decentralization include the center's inability to adequately monitor sub-national activities and its lack of capacity to hold regions responsible for their actions, insufficient regional management and implementation capacity, and weak sub-national government accountability to constituents.

Revised Decentralization Legislation: A Brief Assessment

With the recent promulgation of Law 32/2004 (revised Law 22/1999) and Law 33/2004 (revised Law 25/1999), the two main pillars of decentralization legislation have now been amended (Box 3.3).

The modified legislation moves the decentralization process in the right direction in some instances but the progress of reform is uneven and inconsistent.

Box 3.3. Summary Highlights of Decentralization Legislation, 1999 and 2004

	Law 22/99 and Law 25/99	Law 32/04 and Law 33/04
Selection of Regional Government Head	Elected by DPRD members.	Elected by popular vote.
Regional Civil Service Management	Regions responsible for all decisions regarding sub-national civil service.	Some sub-national civil service decisions (e.g. regarding staff transfers) require central approval.
Regional Budget Authority	Regional budgets approved by regional parliaments and authorized through regional by-laws.	Provincial budgets require ex-ante approval of center and district budgets require ex-ante approval of province before authorization.
Expenditure Assignment	Central and provincial functions outlined in law. Districts responsible for all services not delivered by center and provinces. Broad areas under the (obligatory) authority of districts outlined in legislation.	Central functions outlined in law. Explicit distinction made between sub-national obligatory and non-obligatory functions. Enumerated areas of obligatory responsibility nearly identical for provinces and kabupaten. Details regarding sub-national responsibilities to be provided in forthcoming legislation.
Tax Assignment	Positive list of taxes for both provinces and districts. Districts may create new taxes and charges; ex-post approval of center required.	Positive list of taxes for provinces and districts unchanged. Districts may create new taxes and charges; ex-ante approval of center required.
Revenue Sharing	Shared sources of revenue include those derived from: property taxes, forestry, mining, fisheries, oil and gas, and personal income tax. Shared amounts based on fixed percentages of realized national revenue. Distributions made (mostly) by derivation.	Shared sources same as before plus geothermal mining. Shared amounts same as before, except oil and gas, which increase by 0.5 % (starting in 2009). Shared amounts based on national realizations as before, except oil and gas. Distribution by derivation, except oil and gas. Allocation of oil/gas shares back to point of origin, up to 130% of planned national revenue; thereafter through equalization transfer.
Equalization Transfer	Pool of finance minimum of 25 % of domestic revenue. Provincial and district portions 10% and 90% of total, respectively. Formula allocations based on lump sum, civil servant, and fiscal gap components. Hold harmless rule applied.	Pool of finance minimum of 26 % of domestic revenue (starting in 2008, 25.5% until then). Provincial and district portions to be determined later, as a function of new expenditure assignments. In short-run, allocations to fully fund regional civil servant wages; remaining funds distributed based on fiscal gap. Hold harmless rule to be removed in 2008.
Special Purpose Transfer	Matching grant for regional capital development. Pool of funds derived from national domestic revenue and financing and distributed by center based on proposals from regions.	Matching grant no longer restricted to regional capital development. Pool of funds derived from national domestic revenue (only) and distributed by center based on national priorities. Central department deconcentrated spending on regional tasks to be turned into funding for special purpose grant.
Borrowing	Borrowing allowed for short- and long-term purposes. Long-term borrowing restricted to creation of revenue generating infrastructure. Borrowing from foreign sources made through the center. Borrowing restrictions based on sub-national conditions.	Borrowing for short-, medium-, and long-term purposes. Long-term borrowing restricted to creation of revenue generating infrastructure. Issuance of revenue bonds prescribed. Borrowing from foreign sources made through central on-lending mechanism. Borrowing restrictions based on central and sub-national conditions.

Source: World Bank staff.

Most positively, the new legislation provides for the direct election of sub-national government executives. This will surely help support the development of greater accountability at the local level in the long run. While this is a necessary and very welcome development, it will be insufficient by itself to insure accountability, even if implemented under the best of circumstances, as the experience of countries across the world has shown.

Some unfortunate recentralization is also apparent in the two new laws. Sub-national governments must now obtain the center's authorization before making certain civil service decisions, for example. And annual sub-national government budgets must now be reviewed and approved by the center before implementation.

The new decentralization laws have only recently come into effect. As such, it is too early to make firm judgments on many important matters. A number of issues integral to the revisions are at least worthy of note, however.

Law 32/2004 enumerates some sensible standards for eventual use in determining obligatory service responsibilities across levels of government: efficiency, spillovers, and accountability. But until those norms are actually used to determine specific provincial and local responsibilities for public service delivery, sub-national expenditure assignment will remain ambiguous. For now, Law 32/2004 only outlines broad areas of obligatory regional government service responsibility. Confusingly, the general expenditure assignments for provinces and kabupaten/kota indicated in the law are nearly identical.

Sub-national governments have not been granted any authority over additional local tax bases under the new decentralization legislation. As a result, regions' dependence on transfers from the center—along with attendant weak demand response and inadequate accountability—will continue, at least in the short term.

In an attempt to curtail the proliferation of nuisance and harmful taxes and charges, Law 33/2004 insists that regions should not employ revenue instruments that cause a "high cost economy" and/or that constrain the mobility of goods and factors between regions. But the center's ability to monitor and enforce such broad conditions is uncertain. In addition, Law 32/2004 stipulates that regions will now be required to obtain approval from the center before authorizing new revenues, although, again, the government's capability to implement this control nationwide can be questioned.

Law 33/2004 extends revenue sharing somewhat, by adding a new source of shared revenue—geothermal mining—and by setting slightly higher regional shares for oil and gas revenues. More positively, the government has developed a mechanism to distribute windfall gains in the gas and oil sectors across all sub-national governments, as opposed to just allocating those revenues to producing regions.

The new laws provide for the possibility of a more equalizing DAU, by making provisions for removing the hold harmless condition, for example. But this and other envisioned improvements to the distribution mechanism are not slated to be carried out until 2008. In the meantime, the DAU will, first and foremost, be used to fund the full regional wage bill, thereby creating unfortunate incentives for overstaffing and leaving little space for fiscal equalization.

Table 3.8. Consolidated Development Expenditure in Regions

	2001		2002	
	Rp billion	%	Rp billion	%
Regions	24,872	60.7	39,552	64.7
Center	16,071	39.3	21,597	35.3
Total	40,943	100.0	61,149	100.0

Note: Regions' development spending includes that for both provinces and kabupaten/kota. Central spending in the regions is based on the amount of funds disbursed through regional KPKNs (outside Jakarta).

Source: World Bank staff estimates based on MoF data.

Law 33/2004 prohibits the use of donor finance to fund the DAK, thus unnecessarily limiting the pool of funds for the special purpose grant. More constructively, the new legislation stipulates that current sectoral department development spending on sub-national tasks will be turned into increased DAK funding. Central spending in the regions is, in fact, noteworthy (Table 3.8). The extent to which Ministry of Finance (MoF) will be able to claw back central department developing spending on regional tasks, however, is unclear. As the law itself intimates, progress on this issue is likely to be gradual.

Law 33/2004 lays the groundwork for regional governments to borrow from a wide range of domestic sources, including via the issuance of revenue bonds, thereby potentially reducing sub-national governments' dependence on the center to finance capital development, at least in the long run. However, borrowing policy and regulatory issues have yet to be addressed in detail. Given this and the lack of supporting institutional infrastructure, widespread regional government access to capital markets is probably still a long way off. The issuance of revenue bonds may never be a realistic option for many sub-national governments, given basic demand (e.g. creditworthiness) and supply (e.g. costs and capacity) concerns. In the meantime, regional borrowing is likely to remain restricted to that from the central government and, in particular, the center's on-lending mechanism.

Law 32/2004 appears, in general, to vest more power over a wide range of decentralization policies in the Ministry of Home Affairs (MoHA). In addition, the law stipulates that the President may set up a new body, led by the MoHA, to manage the implementation of decentralization. The extent to which other important central ministries and regional governments will go along with this new setup is very uncertain, however. The problems with central management of decentralization, as briefly discussed above, are likely to remain unresolved unless other actions are taken.

Government's Medium Term Plan for Decentralization: PJM

The government's PJM develops an agenda for revitalizing decentralization. Its assessment of current challenges in decentralization overlaps, at least in part, with the brief overview provided above. The PJM highlights, in particular, problems related to differing perceptions of decentralization at central and regional levels, unclear responsibilities of various levels of government, weak management capacity at sub-national level, limited role of provinces in coordinating decentralization, and poor regional cooperation in service delivery. The PJM also identifies policy targets, suggests broad policy directions, and enumerates specific programs of action to tackle recognized problems. The focus of the government's indicated corrective policies and programs is on developing required legislation, building regional institutional and human resource capacity, enhancing regional management of fiscal and other resources, and improving inter-governmental relations and linkages at sub-national level.

Some additional policy recommendations for improving decentralization follow. The proposals offered below concur in large measure with government's agenda, although they differ somewhat in scope as well as in detail in certain instances.

The Way Forward: Policy Recommendations

The lack of a central authority to oversee decentralization is a pressing matter. Putting one of the concerned parties in charge of decentralization, as Law 32/2004 suggests, is likely to exacerbate coordination problems and conflict at the central level. It would be more effective to locate the central management of decentralization at a level above ministries and coordinating ministries, say, in the Office of the President or the Office of the Vice President, for example.

Improving decentralization in the years ahead will require many legal, regulatory, and organizational changes, and spelling these out in a comprehensive blueprint or "roadmap" would facilitate implementation of the government's complex and comprehensive regional autonomy program. Such a roadmap could help manage the delicate balance between central oversight and local autonomy, and between equity and efficiency. If the plan were developed in close consultation with sub-national governments, parliament, DPD, civil society groups, and other interested parties, it could help develop a shared national vision for decentralization in Indonesia, as well as outline an operational approach to implementation.

As noted above, the new legislation provides some useful standards for assigning responsibilities across levels of government. These principles must now be fleshed out in significantly more detail and carefully applied in forthcoming regulations in order to make expenditure assignment sensible and clear to government and citizens alike. And then, many sector laws would need to be revised in order to make them compatible with the new assignment of functions. The PJM explicitly recognizes the necessity of both actions.

Law 32/2004 stipulates that minimum standards should be developed for each obligatory function and the PJM reiterates the importance of such standards. The development of minimum standards might well assist citizens in clarifying what they can expect from their government. The standards must, however, be realistic and affordable. As a first step, it might be preferable for regional governments to develop and set their own indicative standards, within the framework provided by the new law. Then, national standards could be developed in a more gradual manner from the locally derived norms.

Kabupaten/kota should be given more control over locally generated revenue. Such authority would improve local government's ability to discern genuine demand for services that they provide and at the same time encourage citizens to hold their representatives more accountable for their actions, as the PJM stresses should happen. In this regard it might finally be time for the government to devolve some tariff control over property taxes, as exists in the vast majority of countries in the world. In addition, local government authority to create new taxes should be rescinded. Local governments would retain the right to levy and collect only those taxes on a "closed list" of revenue instruments.

Given the PJM's stated concern with inequality among regions, the government should revisit the design of its major policy instrument of fiscal equalization—the DAU. The central government should reconsider the current notion of paying for all regional civil servants out of the DAU. This

provision directly restricts the government's scope to redress fiscal imbalances, among other things. At the same time, the government should return full power to the regions (in the context of national guidelines) over staffing decisions. In addition, the government might consider moving more quickly than intended on some of the sensible fiscal equalization ideas embodied in Law 33/2004, such as the elimination of the "hold harmless" condition.

To ensure the realization of national priorities, including those related to poverty reduction and income inequality, as outlined in the PJM, government should expand the pool of finance for the DAK, and may wish to consider providing incentives for improved performance of regions, something the PJM recognizes as a priority. The growth of the DAK could be financed, for the most part, by cutting back central department spending on regional tasks, as Law 33/2004 stipulates. Given the general difficulty of reducing central department regional development funds, in the context of annual budget negotiations, this issue will require the attention and support of the highest levels of government. The government might also allow itself the flexibility of channeling donor finance through the DAK, as need arises.

Given that most regions will probably remain dependent on the center for their capital financing needs, at least in the medium term, the center will need to redouble its efforts to improve its on-lending operations. A first step would be for the government to revise KMK 35/2003, with a view to increasing the volume of bankable projects financed. Second, the government should act quickly to operationalize the regional borrowing limits recently codified in legislation (Law 17/2003). More broadly, over the medium term, the government might consider developing a more comprehensive regulatory framework for sub-national borrowing.

Besides implementing direct elections of sub-national executives, the government might consider supplementary local accountability measures. Such actions might include requiring regions to provide more comprehensive and timely information to citizens regarding planned and implemented budgets, for example. Even better, regions might be required to solicit input of their citizens in preparing budgets by holding participatory, consultative meetings. And, as the PJM notes, the role of local non-governmental organizations as mechanisms of accountability should be strengthened.

Accountability of regions to the center must also be reinforced. But repressive measures such as central control over regional government staffing decisions and central approval of budgets before they can be implemented are not useful in this regard if, indeed, they are even possible. The government should seek alternative measures of insuring sub-national government accountability. At a minimum, the central government must enhance its own capacity to monitor regional activities. One idea along these lines would be to devolve more responsibility for oversight of local governments to provinces, in their capacity as autonomous regional governments, as the PJM advocates. In addition, the center must demonstrate a readiness to use some of the sensible sanctions that it has at its disposal (e.g. the DAU intercept for non-repayment of government loans), as conditions warrant. Finally, the government might improve its ability to hold regions accountable by limiting the creation of new regions to originally intended purposes, as stressed by the PJM. In this regard, the government might even consider instituting a temporary moratorium on the creation of new provinces and kabupaten/kota.

Some of the above policy recommendations could be implemented more or less immediately while others would require more time to develop. The table below summarizes policy recommendations in the short- and medium-term.

Box 3.4. Policy Recommendation Matrix

	Short-Term	Medium-Term
Decentralization Management	- Assign management of decentralization to high-level authority. - Develop a concrete plan or road-map for medium term.	- Enhance regions' capacity to manage and implement decentralization through provision of performance incentives.
Intergovernmental Fiscal Structure	- Clarify assignment of functions across levels of government. - Rescind regional government authority to authorize new revenue instruments and institute "closed list". - Devolve tariff control over rural and urban property tax to local governments. - Cancel plans to pay for entire regional wage bill from DAU. - Allow donor finance to contribute to DAK pool of funds or specify alternative mechanism for allocating donor finance as grants to regions. - Re-operationalize central on-lending mechanism and implement regional borrowing limits codified in law.	- Harmonize sectoral laws with expenditure assignment. - Develop guidelines for regional governments to set their own minimum service standards. - Implement envisaged fiscal equalization improvements to DAU more quickly than planned. - Move more rapidly to exchange departmental regional DIPs for DAK. - Develop regional infrastructure fund with donor support. - Develop more comprehensive regulatory framework for sub-national borrowing.
Accountability Mechanisms	- Hold regional government elections in near-term as suggested by new legislation. - Cancel plans for central government involvement in regional staffing decisions. - Rescind requirement of central approval of sub-national budgets. - Employ use of central sanctions on regions as currently allowed by law and as conditions warrant. - Put in place a moratorium on the creation of new regions.	- Develop and implement additional accountability mechanisms at regional level. - Build central capacity for more comprehensive monitoring of regional activities.

Source: World Bank Staff.

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Chapter 7. Improving Rural Development

Agriculture averages half of rural households incomes, with the rest coming from rural non-agricultural activities, petty trading and seasonal construction work. There are important regional variations between Java and off-Java. Despite this regional diversity and agriculture's secular decline as part of Indonesia's structural transformation, the sector remains the core for rural household incomes. The sector[1] employs the largest share, 45 percent, of Indonesia's labor and contributes the second largest share, 17.5 percent, of GDP.

A meaningful strategy of rural poverty reduction must integrate agriculture as a major element, and the PJM is correct in making this a key focus. However, tackling rural development will require a multi-faceted response from several line Ministries, including Public Works, Agriculture, Home Affairs, Health, Communication, Education and so on, which will deal with both on-farm and off-farm initiatives to improve productivity and empowerment of rural communities as recommended in the PJM.

Improving the productivity of the rural poor and increasing the productive value of the assets owned by the poor are key aspects of poverty reduction for Indonesia. The government can support increased productivity of the poor through its agricultural research and extension service. Although agricultural productivity is quite high in Indonesia, there remains a large gap between Indonesia's agricultural productivity and that of the best performers in East Asia. One reason for this is that agricultural research expenditure as a share of sectoral value-added is significantly lower than in regional competitors, and highly dependent on donor-financed projects. The systems that the central government needs now for public agricultural research and extension are quite different from the past and include a greater role for private provision, an increased reliance on rural producer organizations, and decentralization of authority and budget responsibility. Developing new agricultural research and extension systems capable of generating, adapting and disseminating technology relevant to small-scale producers is crucial for rural poverty alleviation.

While increasing agricultural productivity is crucial to a renewal of rapid, pro-poor growth, raising productivity in other sectors of the economy where the poor are employed is equally important. Knowledge about new techniques and new technology are often efficiently transmitted through private sector networks. It is important that government supports existing knowledge networks and bears the transaction and coordination costs associated with creating and disseminating knowledge as a "public good" with large positive externalities. There are many activities which serve this purpose including: trade fairs, industrial exchange programs, encouraging joint ventures, improving technology transfer from FDI, supporting business services, and funding broadly applicable research. Thus the government needs to carefully devise a strategy for enhancing productivity, especially the productivity of the poor.

[1] Agriculture is defined here to encompass forestry and fisheries, consistent with GOI statistical conventions.

Diversification as the conceptual framework for raising productivity and reducing rural poverty[2]

A sequence of progressively broader diversification defines a successful agricultural transformation. In Indonesia, farm sizes are small and likely to remain that way for decades because of population pressures and insecure property rights. Diversification out of staple grains, especially rice, to higher-valued commodities will be the first step in this process. The next step will be to move beyond basic commodity production in order to access value-added supply chains for the modern retail sector, especially supermarkets, where the value-added comes in the form of quality, timeliness, food safety, and labor standards in production.

The next step is the diversification of the rural economy itself, from being primarily driven by its agricultural base to the industrial and service sectors as the base for rural economic growth. This step seems feasible only when population densities permit substantial clusters of activities that feed on themselves for inputs and demand for output. Thus the effectiveness of the model of labor-intensive, rural non-tradable production as the vehicle for pro-poor growth, driven by agricultural profitability and wages from labor-intensive exports is conditional on good rural infrastructure and human capital. In Indonesia, these requirements may limit the model to Java, Sumatra and Sulawesi, with poorer, more sparsely settled regions lacking the necessary incentives for these investments. At the same time, good rural infrastructure reduces the relative importance of non-tradables in local economies and increases competitive pressures from world markets.

Where rural diversification is not economically feasible, the final step in diversification out of agricultural commodity production will be the transition of economic activity from rural to urban areas. In this transition, the importance of migration (and remittances) will be critical. One of the main justifications for investing in rural schools and public health facilities is to improve the competitiveness of rural migrants to urban areas.

Whatever the stage of rural diversification, it must be driven by market demand. Since the 1970s, the development profession has identified "market demand" with border prices and international trade. This focus on international trade has allowed a revolution in food marketing in developing countries to go virtually unnoticed until several years ago. The consolidation of the food retail sector and the rapid rise of supermarkets are now being felt in Indonesia. The revolution creates a challenge to higher rural incomes because high standards for quality, safety, hygiene and farm labor practices exclude many of a country's farmers from the supply chains that provision their consumers, even poor consumers.

In the ultimate stage of rural diversification, globalization permits procurement officers to source food supplies from anywhere in the world, so local farmers compete not just against each other for local consumers; they compete against the global market. But farmers also have access to the global market if they are the low-cost producer meeting global standards. The future of agricultural development depends on putting productive new technologies in

[2] This section is drawn from "Agriculture and Pro-Poor Growth: Reviewing the Issues," a paper prepared for ARD/PREM by C. Peter Timmer, December, 2004, pp. 28.

the hands of farmers and creating an open market environment to make the resulting production as profitable to farmers as employment opportunities in other sectors.

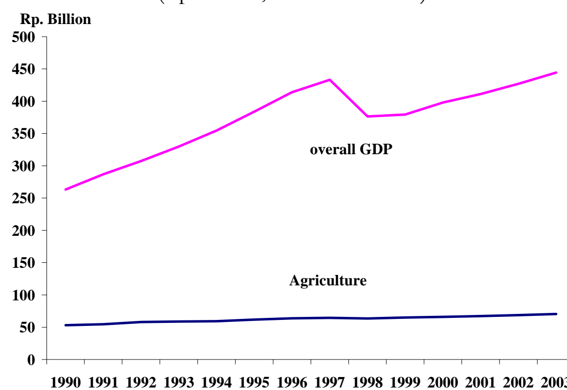
Where the strategy does work, diversifying the rural economy will be the key to increasing income opportunities and raising productivity. Placing rural diversification at the center of agricultural and rural development means there are two quite different tasks that need to be managed simultaneously: (a) raising the productivity of staple food crops for those farmers who continue to grow them; and (b) using the low costs of these staple foods as "fuel" for the agricultural diversification effort, including as feed for livestock. In Indonesia, diversification will depend on continued availability of low-cost rice, especially in rural markets. Low-cost staple foods are also important to the poor directly, because they devote such a large share of their budget to them. Making substantial progress on both of these "rural" tasks will be among the most "pro-poor" things Indonesia can hope to accomplish between now and the target date for the Millennium Development Goals in 2015.

Role of Agriculture

Between 1968 and 1992, Indonesia sustained rapid growth in both crop and animal production, with annual output growth averaging nearly 4 percent. "Green revolution" technologies brought large increases in rice yields, and the area under non-food crops grew rapidly outside of Java. However, growth began to slow during the end of this period, and by the 1990s appeared to have stagnated. In the third period, between 1993-2000, output growth averaged only 0.9 percent/year. (Table 3.9, Figure 3.9). Part of the slowdown was a natural result of slowing growth in demand for food products by Indonesian consumers, as population growth slowed and adequacy of food energy intake was achieved. But a major cause of the agricultural slowdown has been the relative decline in public and private investments in the agricultural sector. Both government spending and private investment in agriculture in Indonesia fell in the 1990s as a percentage of agricultural GDP.

The agricultural growth rate of 3.9 percent called for in the PJM is very high by Indonesia's own historical record and judging from rates achieved in other Southeast Asian countries. To achieve such a rate, stronger measures will be needed to boost agricultural productivity through increased expenditures on agricultural research, promoting more demand-driven approaches to extension, dryland area development, strengthening regulatory capacity, and improving rural infrastructure including rural information and communication technologies (ICT).

Figure 3.9. GDP and Agriculture
(Rp. billion, 1993 base GDP)



Source: BPS, World Bank staff calculation

Table 3.9. Level and composition of agricultural output in Indonesia

	Average annual growth rate during period 1961-67	1968-92	1993-2000
Crop and animal outputs, total	1.2	4.8	1.0
Food crops, all	1.3	5.1	-0.1
Risse, paddy	1.7	5.5	0.7
Cassava	-0.5	1.9	0.2
Maize	11.3	7.8	1.6
Horticultural crops, all	2.7	3.3	3.9
Fruits, all	3.0	3.7	4.3
Vegetables, all	2.9	4.0	3.9
Non-food crops, all	0.8	5.3	2.9
Cane sugar	1.4	5.6	-4.1
Rubber	0.4	2.8	0.8
Animal products, all	1.4	5.7	0.9
Meat	1.5	6.0	0.8
Milk	-0.6	5.1	2.9
Fish products, all	4.6	4.4	4.3
Forest products, all	-1.5	0.7	-3.5
TOTAL FACTOR PRODUCTIVITY	0.7	2.6	-0.1

Source: Fuglie and Piggott (2003) cited in ADB/IFPRI 2004[1].

Increase Public Expenditures on Agricultural Research. The broad-based growth in rural productivity that is an essential ingredient to rural poverty alleviation needs effective systems for generating, adapting and disseminating technology relevant to small-scale producers. High-quality agricultural research and extension systems will be critical to getting productivity onto a higher growth path. Indonesian agricultural research expenditures have declined dramatically since the early 1990s compared to its neighbors. Real expenditure on public agricultural research in 2001 was no greater than in the 1995; and presently, it ranks near the bottom as compared to other Asian countries, relative to agricultural GDP and total government expenditure on agriculture. Indonesia provides less than 0.1 percent of agricultural GDP to support agricultural research in the country (less than Bangladesh, and well below the recommended level of 1 percent). The immediate challenges for the agricultural research system are to: (i) increase the overall level of national research expenditure; (ii) clarify the public funding responsibility; (iii) counter the effect of decentralization of increasing the administrative overhead costs; (iv) replace the significant proportion of senior researchers nearing retirement; (v) integrate private sector agricultural research capacity; (vi) strengthen capacity in biotechnology research and (vii) and reinvigorate rice variety and system research. These are all major tasks and will require time and resources to accomplish.

Support New Approaches to Agricultural Extension. Like public extension systems in many countries, Indonesia faces a major challenge to develop an effective institutional mechanism for disseminating technology relevant for small-scale producers. While the PJM does indicate the need for improving extension, new approaches will be required in the context of the changed institutional environment. There is growing evidence of significant

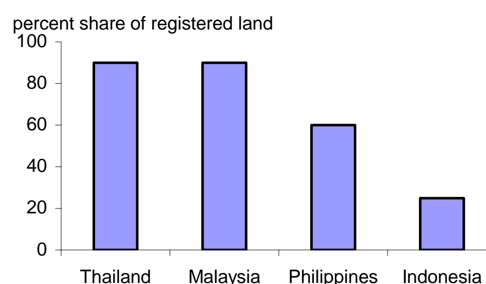
benefits to decentralized extension systems that involve the private sector and civil society which need to be replicated nation-wide and strengthened. Governments, specifically local governments, need a paradigm shift from (i) top-down to participatory approaches, (ii) input and technology dissemination to dissemination of market and upstream information and technology, and (iii) from centrally managed extension services to decentralized services, and some movement toward privatization of extension.

Privatized extension services will assume greater importance in the dryland cash cropping sub sector in Eastern Indonesia since exportable commodity production is being increasingly supported by the private sector. The present political climate of Indonesia also provides a more conducive environment for a range of rural producers organizations (RPOs) than was possible in the past. In all of these initiatives, it is important that measures are put in place which better link agricultural research and extension; the separation of these functions within MOA has militated against ensuring focus on farmer's problems when setting the research agenda.

Securing land ownership. Land conflicts and disputes, concentrated ownership and tenure of land, and lack of legal protection of poor people's rights over land adversely affect income and opportunities for the poor. Less than 25 percent of holders of rural land parcels have a formal land certificate, compared to almost universal possession of land use certificates by farmers in China and Vietnam. The low share of land owners that possess a formal certificate of ownership is also a constraint to access to credit. Although alternatives exist to the use of land certificates as collateral for loans Indonesia's underperformance on land administration is a major constraint to expansion of commercial microfinance. Analysis demonstrates that rural recipients of land certificates borrow more, invest more, and earn more from their land-based economic activities (SMERU, 2002).[3]

Moreover, around 64 percent of Indonesian land is classified by the Ministry of Forestry as forest land and is therefore administered under the Basic Forestry Law of 1967 (UUPK). UUPK precludes individual land tenure despite the fact there are private dwellings, farms, and even cities on this land. Moreover, some forest land overlaps with land that previously enjoyed traditional land rights (adat) adding further complexity. The Government has titled over a million parcels of land since 1997, increased capacity at the National Land Agency, and carried out a comprehensive review of the policy and legal reforms needed to modernize the land system under democratic, pro-poor principles. However, titling of non-forest land has been slow. Only about 25 percent of the nation's estimated 80 million land parcels have been registered in the 40 years since land registration began (Figure 3.10). If the current pace of registration continues, it would be difficult for land registration to catch up with the growing number of

Figure 3.10. Low Land Registration in Indonesia



Source: World Bank

[3] SMERU (2002) "An Impact Evaluation of Systematic Land Tilting under the Land Administration Project", SMERU Research report, Jakarta.

parcels. Moreover, a large share of land off-Java is communal land and private titling of this land may work against the poor and increase conflict. Therefore it is important that the process of titling is closely supervised in terms of the costs and benefits it accrues to the poor.

Enhancing diversification and strengthening regulatory capacity. The PJM recognizes the importance of diversification to improving efficiency and farmer welfare and the growing importance of globalization in agricultural competitiveness. However, measures are called for that go beyond just the PJM's focus on diversification in consumption away from rice. The latter is already happening. Between 1996 and 2002, despite the economic crisis, per capita food consumption in Indonesia increased by 8 percent in real terms. All of this growth took place in high value foods such as animal products, fruit, vegetables, fish, fats and oils, and prepared food. Per capita consumption of low value grains and tubers actually declined. These changes have induced rapid growth in supermarkets, which have further influenced the agricultural production structure, processing, handling and marketing. Diversification is key in the estimated 24 million hectares of dryland areas where measures which encourage livestock, vegetable intercropping, reforestation of small areas with high-value wood species, diversification into cashew or fruit, could all contribute to more stable incomes and poverty reduction.

Indonesia's agricultural product regulatory framework is quite developed but attention is needed on capacity building, maintaining the integrity of national systems with decentralization, and focusing on assisting small holders to meet trade specification requirements. Private markets depend on an effective and streamlined regulatory environment, including grades and standards, food safety, bio-safety and environmental regulation, to lower transaction costs. Regulations alone are not enough, however. They must be matched by a partnership with traders, processors and producers in a system of effective (and transparent) self regulation. This will be important not just for domestic consumer protection and safety, but also to gain and maintain access to international markets. Importing countries are increasingly tightening the quality/safety requirements for food products, including measures that permit "traceability" of the product all the way back to the farm level. Without attention here, a focus on productivity gains for farmers could fail to translate into welfare gains if market outlets are limited.

Securing sustainable water resources management. The PJM recommends an increase in public investments in irrigation infrastructure and management. Tackling this key issue will require a cross-sectoral effort between the concerned line Ministries, as growing water scarcity is projected to slow irrigated crop yield growth. The scarcity of water is heightened by the increasing costs of developing new water sources, soil degradation in irrigated areas, groundwater depletion, water pollution and degradation of water-related ecosystems, and wasteful use of already developed water supplies. Neglect of maintenance because of the systematic under-funding of O&M has led to at least one third of the 3 million hectares of government designed irrigation schemes being rehabilitated twice in the last 25 years, and the unsustainable use of the resource.

The PJM rightly calls for increased participation by water users. In recent years GoI has developed a localized water-management model that places the Water User Associations at a central place of decision-making, and in close cooperation with the local government. The

experience shows that such associations are effective in enhancing good water use, leading to higher productivity; innovative water uses (crop diversification, fisheries development, etc.); better income generating opportunities; sustained preventive maintenance; and a more positive partnership between local government, its farmers constituency and national line agencies. In addition, securing protection and equity for existing non-formalized customary rights to water resources will be a prerequisite to establish an orderly, equitable and transparent processes of water re-allocation to be able to continuously meet communities' changing needs. This would require strengthening the nascent basin organizations (Balai PSDAs) approach to water resources management in order to better manage scarce water resources and to optimize their allocation.

Improving Rural Infrastructure: While the PJM emphasizes the rehabilitation/construction of primary arterial road development as a priority, a concomitant thrust for expanding and improving the rural road network is urgently needed. In particular, village to market access roads are critical for the rural poor, and for supporting the intensification and diversification of agriculture. Kabupaten roads make up 72 percent of the classified road network; almost half of this network is in poor or bad condition, and only 19 percent is in good condition. Evidence from Indonesia and other developing countries indicates that in rural areas, higher non-farm incomes prevail in areas with good rural infrastructure due to strengthened linkages between farm-non-farm, rural-urban, and development of SMEs.[4] Moreover, studies have indicated that high transaction costs in Indonesia, caused by various factors including poor rural infrastructure, result in the farmer's share being as low as 25 to 30 percent of the gross value of high value products.

Increasing access of rural communities to information and communication technologies (ICT). The PJM is to be commended for identifying the poor status of rural ICT development as a significant barrier to increasing rural productivity and incomes. Rural communities need up-to-date information on sources, availability and cost of inputs for production, also on the potential of different techniques and technologies used for production, processing and marketing. However, the information that is often most relevant to improving livelihoods is non-technical, including the role and responsibilities of different institutions in the provision of key services, including agricultural extension, credit, health and education, and where to go and who to ask for more specific information. Rural communities increasingly need information about off-farm activities, about rural development projects and policies, and how to participate in and influence government processes.

It is important that this information be available in an appropriate format and language, and that rural communities have the capacity to access, analyze and act on it. With decentralization and the new political and institutional environment in Indonesia, there is an opportunity to use ICTs to support the rural development agenda and improve the delivery of government services in innovative ways. The Government of Indonesia does not yet have a coherent set of policies and strategies for strategically using ICT as a development tool. Currently there is no forum for such coordination, either at the national or the regional level. This can result in poorly coordinated policies hampering progress. The creation of a

[4] Rosegrant, M.W and Hazell, P.B 2000. Transforming the Rural Asian Economy: The Unfinished Revolution, Asian Development Bank. Oxford University Press.

Presidential Council on rural development could help to coordinate rural ICT and other cross-sectoral policies relating to rural development from all ministries in order to maximize the impact of government initiatives in these areas.

Improving Natural Resource Management. The PJM rightly identifies the increasing degradation of upper watersheds as one of the prime natural resource management problems in Indonesia. Deforestation and poor land management practices in upper river catchments have resulted in major economic damage to livelihoods and ecology in the upper catchments, and to the downstream areas. There has been a disproportionate impact on the poor, since they are the majority of the upland dwellers. With 70% of the land classified as forest (public) land, under population pressure, natural forest areas in protected forests in the upper catchment area are often encroached upon by farmers, who do not invest in proper soil conservation and tree planting because of the risk of future eviction.

Many reforestation programs implemented in the past failed because of top-down management and the use of inflexible prescriptions poorly adapted to conditions. Experience in Indonesia and elsewhere is now showing that reforestation programs that are targeted to watershed conservation and management can be more effective and widespread if small-holder cultivators of sustainable agro-forests are given secure and long-term access to degraded state land resources in the upper catchments areas of river basins to foster a real sense of stewardship of the land.

The PJM also rightly points to the dangers of the poverty-coastal environment nexus which has contributed to increasing pressures on the coastal resource base. The PJM is to be commended for its calls for expanding the joint management of coastal zones, irrigation schemes, and upper catchment areas. For this to be realized in practice, poor farmers and fishers need to be given *real* decision-making and economic opportunities, to serve as an asset for natural resource management rather than as a liability (assets for the poor, the poor as assets). Experience has shown that a legally defined partnership between local government and resource users in managing and defining sustainable use of coastal ecosystems has proven effective in reaching consensus among communities and multiple resource users with competing interests and objectives for a rational and sustainable use of the coastal ecosystems.

Increasing rural employment and incomes through the provision of micro-finance: The PJM correctly points to the need for development of micro-enterprises, and in that context, the importance of supporting the enhancement of institutional capacity to deliver micro-finance services in the rural areas. However, it does not specify how the government proposes to help develop such services. Indonesia is rich in micro-finance providers. However, despite the range of micro-finance providers, many Indonesians do not have access to micro-credit. A recent survey reveals that 50 percent of households may lack effective access to micro-credit, and less than 40 percent have savings accounts, a number that is even lower in rural areas. For the poor to have better access to finance the government needs to: (i) reduce the amount of public contributions to subsidized schemes, while increasing attention to capacity building of micro-finance providers; (ii) redirect public resources saved into building capacity of formal and community-based informal micro-finance providers, (iii) arrange for proper supervision of non-bank micro-finance providers. Existing experience with delegated supervision of these providers (BKD by BRI, and LDKP

and rural BPR by Provincial-owned Development Banks, BPD) should be evaluated, so that once a micro-finance law is in place and an overall supervisory authority is established, focused testing and scale-up can be pursued; (iv) establish, under the leadership of MOF, a national strategy of support for sustainable micro-finance services provision; (v) promote links between non-bank micro-finance providers and the formal banking sector, and; (vi) accelerate land titling as a basis for collateral.

Maintaining food security through openness. The Government is right to place high importance on the maintenance of food security. Both Indonesian and international experience have shown that achieving food security and achieving self-sufficiency in food are different things. Food security is the combination of the availability of food and the affordability of food. The latter component is determined by the prices of food and by household incomes. Thus ensuring food security is best achieved by measures to promote household incomes while avoiding artificial increases in food prices such as those caused by tariff increases or licensing restrictions.

In Indonesia, recent years have seen a protectionist trend in policymaking with a variety of ad hoc forms of protection imposed on agricultural products. Of particular importance to the poor is the recent Ministerial decree imposing a seasonal ban on the import of rice from two months before the harvest season until one month thereafter, but which has now been in effect for a full year, with another six month's ban just announced. Moreover, only designated registered rice importers or importer producers approved by the Ministry of Industry and Trade will be allowed to import and rice import verification or a technical investigation should be conducted in the origin country before the rice is imported. This will benefit households who are net producers of rice. However, over 90 percent of urban households are net consumers of rice and are therefore likely to suffer as a consequence of an increase in the price of rice – and over 70 percent of rural households are also net consumers and so likely to lose. Increases in the price of rice only benefit 20 percent of the population overall – predominantly medium and large farmers who tend not be amongst the poorest.

The Way Forward

With support from DfID and the Dutch Trust Fund, the World Bank is carrying out an extensive research and advisory project that will lead to an understanding of constraints to improving the rural investment climate. Although this project concentrates on the rural non-farm economy, the research plan specifically uses a framework designed to understand linkages among agricultural productivity, farm household incomes, and the dynamics of the rural non-farm economy. Consequently, the research is designed to address the current debate over rice prices, the role of agriculture in poverty alleviation, and the scope for expansion of micro, small, and medium enterprises in rural areas. There is much evidence from Indonesia and elsewhere that these enterprises are the "ladder" out of rural poverty. But little is known about how to speed the development of these enterprises, make them more productive, and help them transition into the formal economy.

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