



Executive Summary

Indonesia Public Expenditure Review 2007

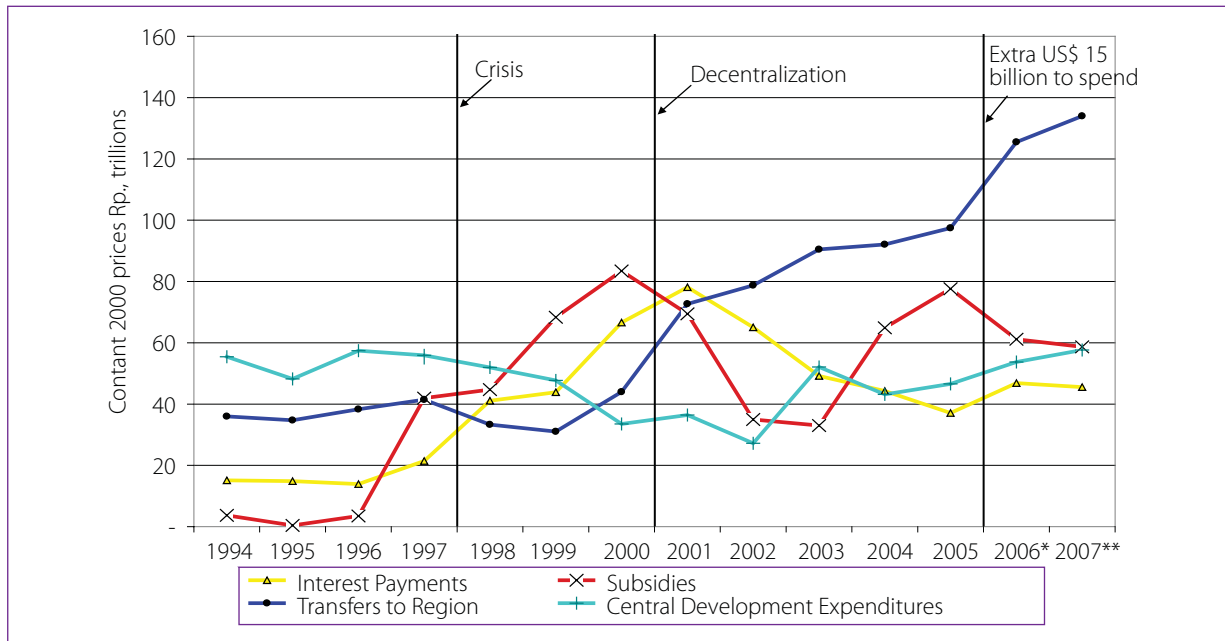
A Unique Opportunity

Indonesia's post-crisis period is over: the country now has sufficient financial resources to address its development needs. Prudent macroeconomic policies, particularly extremely low budget deficits, were instrumental in this recovery. Now is the time to build on the achievements of the past few years and to spend Indonesia's financial resources effectively and efficiently to improve the quality of education, expand healthcare, and close critical infrastructure gaps in order to reduce poverty and build a competitive economy.

Over the past 10 years, there has been a remarkable transformation in the way public resources are managed and allocated. Three defining moments stand out:

- i. **1997-98 – The economic crisis.** The economy contracted and public spending fell. Debt and subsidies increased while development spending declined.
- ii. **2001 – ‘Big bang’ decentralization.** One-third of central government expenditure was transferred to the regions.
- iii. **2006 – An extra US\$15 billion to spend.** The reduction in fuel subsidies in 2005 opened up space for additional spending, debt levels dropped to 41 percent of GDP, aggregate expenditure increased by 20 percent and transfers to sub-national governments grew by 32 percent.

Figure 1 Defining years in Indonesia's public expenditure allocation



Source: World Bank staff estimates.

Note: *2006 preliminary results, 2007** budget (APBN).

Indonesia can expect to have significant additional fiscal resources, or a “fiscal space”—almost of the magnitude of the revenue windfall seen during the oil-boom of the mid-1970s. Since the reduction in fuel subsidies in 2005, Indonesia has freed up US\$10 billion to spend on development programs. An additional US\$5 billion is available due to a combination of increasing revenues and declining debt service. Similar amounts will be available in 2007 and beyond. Indonesia's fiscal position could be further improved by removing subsidies that still place a heavy burden on its budget. Despite the reduction in fuel subsidies, total subsidies still account for US\$12 billion of the budget (15 percent of total expenditures in 2006).

Fiscal space will remain significant even if global oil prices drop sharply. The combination of increasing revenues and reduced subsidies will ensure large additional fiscal resources in the future. International oil prices and the country's fiscal space have been effectively de-linked because of the sharp decline in oil production of almost 40 percent since

1996. Indonesia now consumes roughly the same amount of oil as it produces, so changes in international oil prices are relatively unimportant in terms of the budget.

About half of these additional resources will be spent by district and provincial governments. In terms of spending, Indonesia is already one of the most decentralized countries in the world. The current transfer system will guarantee that this remains the case for years to come. The 2006 increase in transfers to sub-national governments is as great as during the “big bang” decentralization of 2001. Indonesia’s provinces and districts now spend a record 37 percent of total public funds (Box 1). This represents a level of fiscal decentralization higher than the OECD average and higher than any other East Asian country except China.

Box 1 Public finance in Indonesia – key facts

- Provincial and district governments now manage 37 percent of total public expenditures and carry out more than 50 percent of public investment
- Total government debt fell to 41 percent of GDP by the end of 2006.
- Spending on subsidies and administration accounts for a third of total expenditures. Subsidies still consume roughly 15 percent of the budget and remain at the 2004 level.
- Public investment has recovered and returned to the pre-crisis level of 7 percent; sub-national governments now manage half of Indonesia’s public investment.
- Spending on education is now 17.2 percent of total spending, the highest share of any sector and comparable to that of many other low and middle-income countries. Education spending reached 3.8 percent of GDP in 2006, up from 2.4 percent in 2001.
- Total public health spending is still below 1 percent of GDP, despite steep increases since 2002.
- Public infrastructure investment has still not recovered from its post-crisis low and remains only 3.4 percent of GDP.

Why this Report?

Analyzing public expenditures can be a powerful tool. Indeed, such analysis and monitoring of public spending should be a natural and routine process. Many governments around the world, often with support from the World Bank, conduct such Public Expenditure Reviews (PERs) every couple of years. Indonesia and the World Bank conducted the last national PER in 2003 and in the interim several further in-depth analyses of sectoral and regional expenditures have been undertaken.¹

This report tries to establish the facts about Indonesia’s public expenditures, presenting trends over time and analyzing the composition across sectors and levels of government. The report presents comprehensive information on key sectors, including sub-national governments and state-owned enterprises in key infrastructure sectors. Based on these facts, the report asks: Who benefits from these substantial amounts of public resources? Where are the gaps? Which regions are well-endowed? Which regions are lagging behind? In addition to these questions, this report also tries to respond to key concerns that are in the minds of many ordinary Indonesians and friends of Indonesia, such as:

- Can Indonesia afford to spend more?
- Is the current level of education and health spending sufficient?
- How to revitalize infrastructure investment, and which sectors are the priorities?
- Why is it so difficult to disburse funds through the government budget system?
- How unequal is Indonesia and how should fiscal transfers be structured to equalize disparities?

Fighting corruption is one of the government’s most important priorities and curbing corruption involving public funds remains one key area. Corruption both distorts spending decisions and budget execution at the

¹ For instance: Decentralizing Indonesia (2003); Papua Public Expenditure Analysis – Regional Finance and Service Delivery in Indonesia’s Most Remote Region (2005), Spending for Reconstruction and Development – Aceh Public Expenditure Analysis (2006), Investing in Indonesia’s education (2007).

same time. While this report argues that Indonesia should increase its public investment, the degree of corruption will determine if these investments will produce lasting results for the people of Indonesia. With the massive shift of resources to lower levels of government, fighting corruption at the sub-national level is now as critical as tackling it at the central level.

This report focuses on the technical dimensions of corruption: the budget process, and procurement and audit systems. These fiduciary systems typically determine the degree of corruption in public expenditures and the quality of spending. Based on the analysis of the fiduciary environment at the central and sub-national levels, the report highlights areas where corruption risks are highest, particularly in the public financial management system.

This report addresses seven critical expenditure areas. The first two chapters (Chapter 1 on fiscal space and Chapter 2 on cross-sectoral allocations) discuss how much money is available to the government and how it is allocated across sectors and levels of government. The following three chapters on education, health, and infrastructure analyze how resources are currently allocated within these critical sectors and how effectively they are used. The final two chapters (Chapter 6 on public financial management and Chapter 7 on decentralization) highlight institutional and cross-cutting issues in effective public expenditure management.

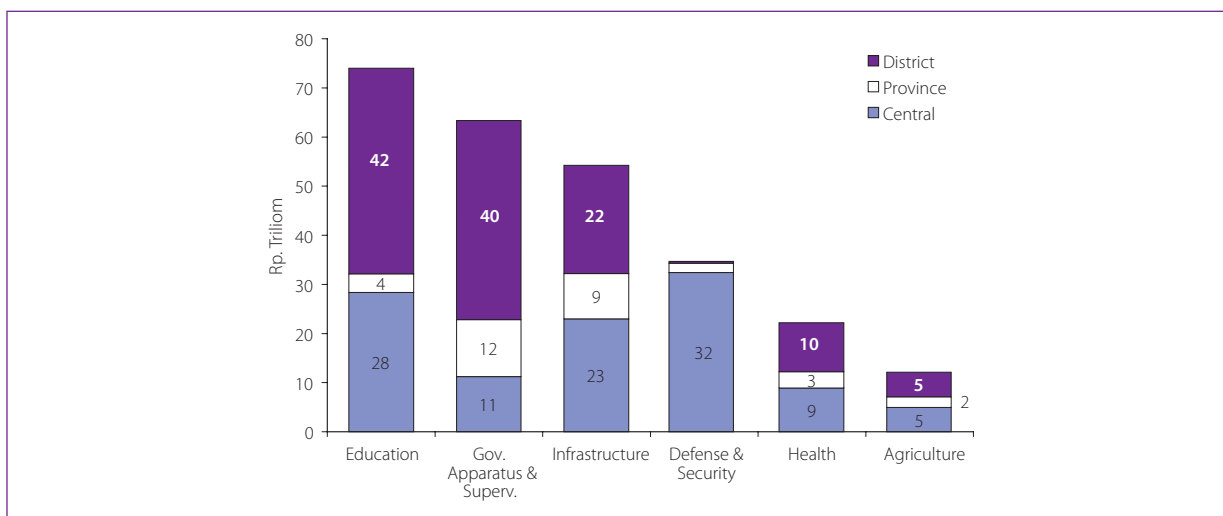
Trends in Sectoral Spending and Public Investment

While the poverty headcount dropped significantly after 1999—even considering the reversal in 2005—service delivery indicators show a mixed picture. Some indicators have improved, such as the primary school enrollment rate, but many others have only improved slightly since 1999 and some not at all. Indonesia still ranks poorly in areas such as maternal mortality, infant and under-five child nutrition and junior secondary enrollments, particularly among its poorest citizens. In addition, Indonesia faces new challenges such as increasing rates of cardiovascular disease and epidemics such as HIV/AIDS and avian influenza.

The government has a unique opportunity to upgrade Indonesia's public services. During the oil windfall in the mid-1970s, the government focused on supplying basic needs, particularly primary education and health. These efforts contributed to dramatic improvements in these sectors although some remote areas, particularly in eastern Indonesia, are still lagging behind. Today, the main challenge is to move into the next generation of reforms, with a focus on the quality of public services and targeted infrastructure provision. In order to keep Indonesia's economy competitive in the long run, secondary and tertiary education, an upgraded health system and better infrastructure services are equally important.

However, the current spending mix is less than optimal in addressing Indonesia's development challenges. While very good progress has been made over the past two years in reallocating spending (from inefficient subsidies) towards pro-poor programs, Indonesia is still under-spending in key sectors, such as infrastructure and health. Impressive gains have been made in allocating additional funds to education, which is now the sector with the largest public spending (in 2005, education spending accounted for 13.9 percent of total national expenditures). Spending on core government administration (excluding salaries for teachers, doctors and nurses) constitutes the second-largest sectoral spending item representing as much as 11.9 percent of the total (Figure 2). This is high compared with the level of spending on government administration observed in other similar countries, which range from 5 to 10 percent. Meanwhile, the level of spending on the infrastructure and health sectors (10.2 percent and 4.2 percent of total expenditures, respectively) is rather low by most international standards. In 2005, the government also spent 22.6 percent of its budget on mainly pro-rich subsidies (reported under the Trade, National Business Development, Finance and Cooperative Sector). This means that taken together, spending on core government administration and subsidies accounts for as much as 35 percent of total government spending.

Figure 2 Sectoral spending in Indonesia: education and government apparatus dominate

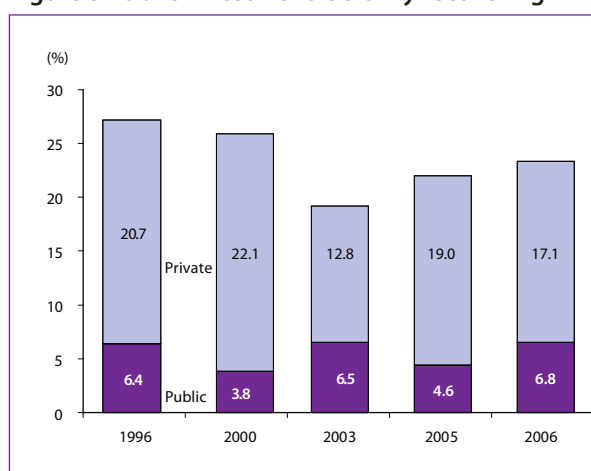


Source: World Bank staff estimates, 2005.

After the economic crisis, the Indonesian government failed to invest sufficiently in its economy and the public investment rate became one of the lowest among middle-income countries. Total investment, both public and private, declined from 27 percent of GDP in 1996 to less than 20 percent in 1999. But public development spending—a proxy for public investment—declined even more sharply, from 6.5 percent of GDP in 1996 to around 4 percent in 2000.

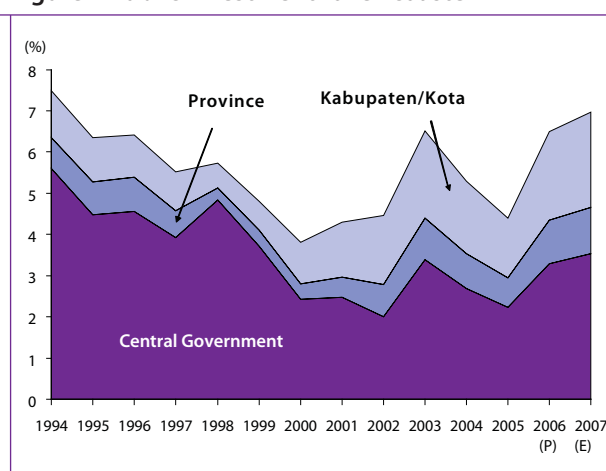
Public investment is starting to recover from its post-crisis contraction and this constitutes an opportunity to address the weaknesses in service delivery. After 2002, public investment started to recover and by 2003 had reached pre-crisis levels. In 2004 and 2005, it dropped again when the fuel subsidy ballooned. Following the reallocation of fuel subsidies in 2005, public investment returned to its pre-crisis level of 6.0 percent of GDP. However, the public investment rate in Indonesia is still one of the lowest among middle-income countries. With its bold reallocation of resources, Indonesia is now at a point where investment can and must rise above pre-crisis levels in order to compensate for the low investment levels from 1999 to 2002 (Figure 3 and 4). (As noted and seen in Figure 3, private investment still lags behind pre-crisis levels.)

Figure 3 Public investment is slowly recovering



Source: BPS, MoF, World Bank staff estimates.
Note: Figures are the percent of GDP.

Figure 4 Public investment roller-coaster



Source: BPS, MoF, World Bank staff estimates.
Note: Figures are the percent of GDP.

The composition of public investment has changed substantially since decentralization. When Indonesia decentralized, sub-national governments increased their share of resources. Sub-national governments now manage half of total public investment (Figure 4). At the same time, the sectoral composition of expenditures changed as well. The overall shares of education and administrative expenditures have increased substantially, while infrastructure has declined, particularly since 2003.

Education

Indonesia has achieved very high primary enrollment rates. Hence, getting children into primary school is no longer the main development challenge, although additional efforts will be needed to target the remaining 8 percent of children still not enrolled. The government is rightly addressing the investment gaps in primary education but, going forward, more emphasis should be put on improving the quality of education throughout the system and increasing enrollment rates for junior secondary education.

Indonesia is now allocating 17.2 percent of total public expenditures to education. This level is almost on a par with other developing countries, even with OECD countries. However, some of the countries in the immediate region (Malaysia, Thailand and the Philippines) spend more—up to 28 percent of their budgets. In addition, there remains a backlog of urgently needed investment in school buildings and other assets that have deteriorated badly over the years.

There is a structural inconsistency in the central-local spending composition. Local governments spend the bulk of total government expenditures (70 percent), but these funds are almost entirely devoted to teacher salaries, which are still set by the center. In contrast, the center is the largest spender on education investments, although local governments are in charge of running, building and rehabilitating schools. The center's dominance in education investments may be in conflict with the stated objective of decentralizing most education functions to sub-national governments.

If the constitutional 20 percent education mandate is defined as omitting teachers' salaries, then this will prove unrealistic and problematic. It will be close to impossible to reach the requirement that 20 percent of all public expenditure be allocated to education if teachers' salaries are excluded. Sub-national governments will need to increase their education spending by another 17 percentage points to 45 percent in order to reach the 20 percent benchmark within this definition. The central government will also need to double existing spending levels and allocate the increment to non-salary expenditures. However, increasing resources at the central level to 20 percent goes against the logic of decentralization; inevitably, a large share of additional central spending goes to decentralized functions. The current definition of the rule, which classifies salary top-ups as non-current expenditures, also amounts to a further fragmentation of teacher salaries.

Teachers are very unevenly distributed across Indonesia. Indonesia has enough teachers to achieve a student-teacher ratio of 20:1 but many teachers work part-time and are concentrated in the better-off areas of the country. As a result, about 55 percent of schools have an oversupply of teachers, while 34 percent are understaffed. Most urban and a large share of rural schools have too many teachers, while 66 percent of remote schools have serious shortages. The government's new policy of providing additional financial incentives for teachers working in *remote* schools is a first step in the right direction, but this will only improve the quality of services if strong, ideally community-based, monitoring systems are in place.

The current salary structure does not provide strong incentives for teachers to teach in secondary schools and in remote regions. The new teacher certification program addresses some of these problems by upgrading teachers' qualifications and providing financial incentives for regional redistribution. But the teacher salary payroll will become unsustainable unless measures are actively pursued to combat absenteeism and these measures are used as an entry point to modernize the sector. The financial implications of the increased allowance pay proposed in Teacher Law No. 14/2005 can only be mitigated if the number of teachers on the payroll (full and part-time) is also reduced.

Health

Indonesia is still lagging behind its neighbors on major health outcome indicators such as infant and under-five mortality, and maternal mortality rates. There are three major reasons that explain this: poor quality of basic healthcare, low utilization rates of secondary healthcare by the lowest poverty quintiles, and low levels of preventative care.

- **Poor quality of basic healthcare.** Local health clinics (Puskesmas) lack adequate infrastructure, such as clean water and regular access to electricity, as well as sufficient stocks of basic medicines. Spending efficiency could be improved by re-allocating funds to primary public healthcare services for the poor and focusing on interventions that improve the quality of basic services.
- **Low utilization of secondary healthcare by the poor.** The poor have low utilization rates for secondary (hospital) healthcare. Consequently, there is significant potential for investing in demand-side approaches that would increase access to emergency in-patient care for the poor. Pro-poor financing for hospital care could be implemented through targeted vouchers (health cards) that allow free care for the poor on a fee-for-service basis.
- **Low levels of preventative care.** Indonesia's disappointing health indicators can also be improved by strengthening preventive care, and intensifying programs and national campaigns that tackle communicable diseases, particularly in remote and less developed areas of Indonesia.

Although expenditures on health have increased substantially since 2000, aggregate spending is still below 1 percent of GDP. Despite the low aggregate spending on health, Indonesia can still achieve major improvements within the current spending envelope if resources are distributed more evenly across income groups and districts. Government policies in the sector have not been properly reflected in the budgetary allocation, with more resources going to services predominantly used by richer income quintiles (secondary care). Therefore, it is important to better allocate the existing resources before substantially increasing health spending. For instance, all subsidies to secondary care facilities should be channeled into primary care. There may also be particular merit in subsidizing ambulatory care, especially in remote regions. The current PKPS-BBM program shows promise in improving the poor's access to primary and secondary in-patient care.

There are significant regional discrepancies in per capita public health spending, translating into inequalities in service provision across districts. Public health spending at the district level (combining sub-national, central government deconcentrated allocations) tends to benefit richer districts. This inequality is predominantly driven by the regressive impact of deconcentrated spending.

While Indonesia has adequate numbers of midwives, it has too few doctors, pharmacists and nurses. Indonesia has sufficient midwives who are well distributed across the country. However, most of them serve small clienteles and have little opportunity to upgrade their skills. For all other medical practitioners, the challenge is the opposite. For example, there is a severe shortage of doctors in health clinics (Puskesmas), particularly in remote areas. Absenteeism is also high at 40 percent because most public doctors also manage their own private practices.

Infrastructure

Indonesia has fallen behind most other countries in the region with some of the lowest rates of access to water, energy and sanitation services in the region. Only 40 percent of Indonesians have access to piped water and one third of Indonesians (over 70 million) do not have access to electricity. These rates have not significantly improved in recent years.

Indonesia is investing too little in infrastructure. Public infrastructure investment fell dramatically after the crisis, to about 1 percent of GDP in 2000. Currently, total public infrastructure investment—public, state-owned enterprises and private sector combined—stands at 3.4 percent of GDP, which is still significantly below pre-crisis levels of around 5 to 6 percent of GDP.

Four reasons account for this performance:

- **Capital intensity.** Infrastructure sectors tend to have a higher share of capital spending than social sectors (particularly education). After the economic crisis, Indonesia, similar to most other post-crisis countries, cut its capital budget, which disproportionately hurt infrastructure investments.
- **Private sector caution.** The vacuum left by the sharp fall in public infrastructure investment was never filled by private infrastructure investment. This remains an issue today: not only is increased public investment in infrastructure sorely needed, but so is progress in encouraging private investment through improvements in the investment climate, together with a clearer framework for joint projects involving both the public and private sectors.
- **Decentralization.** Local governments spend mainly on social sectors and their own administrations. The center continues to spend substantial amounts on local functions, particularly in health and education and, as a result, allocates fewer resources for large-scale infrastructure projects. In addition, public enterprises that have been transferred to local governments, particularly local water-supply utilities (PDAMs), have become insolvent.
- **Budget process.** Most capital budgets tend to be spent in the second half of the fiscal year, which provides too little time to complete large investment projects. The current budget process provides too many uncertainties and interruptions for rolling out complex multi-year infrastructure projects.

Scaling up infrastructure investment will require at least 2 percent of GDP, or US\$6 billion per year. However, while this would amount to a return to pre-crisis investment levels, it would still not make up for the 'lost decade' in infrastructure investments since then. The government's growth and poverty reduction strategy made infrastructure one of its priorities, but recent policy changes have not yet been translated into practice and the public sector will be hard pressed to fill the financing gap. A significant share of the future increases in investment will need to come from the private sector.

Public Financial Management

Indonesia has made progress in reforming its public finances and increasing transparency but the reform agenda remains large. In almost all key areas of public financial management (PFM)—budget formulation, budget execution, procurement and audit—Indonesia has a sound legal framework already in place. Future challenges include, first, the appropriate implementation of laws and regulations in areas as diverse as moving to performance-based budgeting, establishing a Medium-Term Expenditure Framework, initiating electronic procurement processes and strengthening the external audit body. Second, the current budgetary system lacks flexibility, which slows down implementation.

Advancing the PFM reform agenda is critical to ensure that new fiscal resources are allocated and then spent efficiently. The greatest implementation problems lie in disbursing public investment budgets. They are typically disbursed slowly and consequently a disproportionately large share of the funds is spent near the end of the fiscal year. There is also consistent under-spending on capital expenditure compared with the initial budget—this despite the fact that aggregate budgets are often revised upwards substantially during mid-year. In addition to issues of implementation there is also the issue of corruption in public spending. Significant additional financial resources are now flowing to sub-national governments, so tackling corruption at the sub-national level becomes that much more urgent.

The Indonesian budget system is inflexible. Indonesia's budget documents are excessively detailed, require considerable time to prepare and deliberate upon, and add to the complications of implementation. Parliament's discussions and hearings focus on details, not on the links between policy and broad budget allocations, and consume a disproportionate amount of time. In 2006, although the central government approved the budget authorization documents at the beginning of year, disbursement remained slow due to implementation bottlenecks. Because of the large amount of detail, budgets for individual projects often need to undergo lengthy revision processes.

The legal and regulatory framework for public procurement has been improved, but the capacity to implement procurement in a timely and transparent manner has not kept pace. The National Procurement Policy Office within Bappenas is preparing nationwide standard procurement procedures, including standardized bidding documents, but the capacity to enforce them across all levels of government is limited. Pilot initiatives to implement e-procurement are underway, but a scaling-up strategy to leverage e-procurement to enhance market transparency across the entire government procurement system is not yet in place. The introduction of basic-level training and the certification of procurement practitioners are important initiatives but most public officials lack adequate career stream or remuneration incentives to take up procurement responsibilities. All of these initiatives are of the utmost importance if Indonesian citizens are to receive the full benefit of the re-allocation of resources from the center. Failing this, collusive practices will not only continue but increase in their relative and adverse impact.

The state audit law has strengthened the role of the external audit institution, the State Audit Agency (BPK) and there is now an opportunity to establish greater budget flexibility while ensuring high fiduciary standards. The BPK is now clearly in charge of the external audit of all government institutions, while the State Development Audit Agency (BPKP), together with the Inspector General of each ministry, coordinates the internal audits of the central government, and the Bawasda offices manage the internal audits in the regions. But while it is now critical to implement the State Audit Law, staffing and resources at the BPK and the BPKP are not commensurate with their redefined respective roles. The BPK, despite its expanded mandate, has less than half the number of certified auditors of the BPKP, which now has a more limited role. Furthermore, without rigorous enforcement of the BPK's audit findings, which to date has been conspicuous only by its absence, the increased capacity and performance of the BPK are unlikely to be translated into improved fiduciary standards.

Fiscal Decentralization and Regional Inequality

Indonesia is one of the most diverse countries in the world, with living standards that range from developed country standards to entrenched poverty. Population density also varies greatly: Java is one of the most densely populated islands in the world, while Papua is one of the least densely populated. Poverty rates range from less than three percent in some cities (Denpasar, Bali; Bekasi, West Java) to more than 50 percent in West Papua and Papua (Manokwari and Puncak Jaya, respectively).

When Indonesia decentralized in 2001, the government allocated a large amount of resources to poorer regions in an effort to balance the country's disparities. Although intergovernmental fiscal transfers could be even more equalizing, the poorest and most remote parts of Indonesia have received very substantial transfers since 2001. The General Allocation Fund (Dana Alokasi Umum, or DAU) is the most important tool of the transfer system, financing about 70 percent of all sub-national expenditures (provinces and districts) and more than 80 percent of district expenditures.

In 2006, total government transfers increased nominally by 47 percent mainly to the benefit of the poorest regions of Indonesia, which experienced a disproportionate increase in their revenues. The DAU even increased by 64 percent, with important implications for the structure of the transfer system and its equalization impact. Remote provinces with high levels of poverty, including Aceh, Papua and Maluku have seen their allocations increase by more than 100 percent, compared with 2005 levels. Transfers will continue to dominate sub-national finances, particularly in local governments, because the base for own-source revenues is low while transfers have been covering more than 80 percent of sub-national revenues and are even increasing further. The DAU itself is likely to become even more dominant because revenues from oil and gas are expected to decline due to lower oil and gas production, at least for the next few years.

Today, Indonesia's main development challenge is not to transfer significant additional resources to poor areas, but to make sure that existing resources are spent effectively. Many local governments have difficulty spending these additional resources. Their unspent reserves have been rising rapidly and reached a record 3.1 percent of GDP by November 2006. Most regions have enough financial resources to make a difference to the lives of their citizens. Even poor regions with comparatively low fiscal resources (particularly in NTB, NTT) have seen their DAU

transfers increase by an average of 75 percent in 2006. Despite these large surpluses, resources are often channeled to the wrong places. For instance, while local government funds remain unspent, many PDAMs have become insolvent and are unable to provide water services.

An Agenda for Implementation

This is a moment of great opportunity. With a stable macroeconomic environment and sufficient fiscal resources, the Indonesian government can further reduce poverty and improve the quality of and access to basic services. Allocating and managing resources are now at least as important as mobilizing them. Spending money well is a particular skill—one that has been partially lost in the aftermath of the crisis, when the government focused rightly on stabilizing the macroeconomy and restraining spending.

The reform agenda remains large. Many of the needed reforms will entail difficult and lengthy processes. The government has already started implementing an ambitious agenda. What matters most is to stay the course and to demonstrate consistent progress in difficult and lengthy reforms. There are six critical expenditure areas: fiscal space, education, health, infrastructure, public financial management and decentralization. The key steps towards achieving better management, allocation and impact of public spending for improved service delivery and reduced poverty are outlined below.²

1. Enlarge fiscal space and maintain macroeconomic stability by reducing and reallocating subsidies and reducing aggregate debt. Fuel and electricity subsidies are still a significant portion of the budget and largely benefit better-off citizens (Box 2). Middle-income countries such as Indonesia are still vulnerable to shocks and debt levels above 30 percent are considered unsafe.

- Despite the drastic reduction in fuel subsidies in 2005, total subsidies remain high at close to US\$10 billion. A reduction of these subsidies would free up significant additional resources. The lower the international oil price, the easier it becomes to liberalize fuel prices. However, if the price adjustment were to be significant, it would once again be critical to design compensatory programs to ensure that subsidy reduction did not have an overall negative welfare impact on the poor.
- Further improve debt management within the recently established new debt unit, advance the implementation of the Treasury Single Account and proactively manage contingent liabilities. Debt levels exploded during the crisis not because of excessive borrowing but because of contingent liabilities in the banking sector.

2. Maximize the benefits of increased education spending by investing more in junior secondary education, redefining the 20 percent spending target and reallocating teachers to under-served schools. Transition rates from primary school to junior secondary school are low; the 20 percent spending rule, using its current definition, places unrealistic demands on the education budget; and teachers are not equally distributed among schools.

- Promote higher transition rates to and retention rates in junior secondary schools by providing targeted transfers to poor students to ensure that they can afford to attend school, as well as engaging in targeted construction of new schools in under-served areas.
- Adjust the definition of the 20 percent spending target to include teacher salaries and combine regional and central spending. Without these adjustments, education spending will have to rise so much that it will crowd out spending for other basic services such as health and water services.
- Reallocate teachers to under-served schools. While there is no shortage of teachers in the aggregate, remote areas and specific schools are under-served. Offering more attractive financial incentives to teachers to serve in remote schools, as well as allocating teachers to schools based on the number of students (not the number of classes) will promote a more equal and efficient distribution of teachers throughout the country.

² See Annex A in the main report for a full compilation of the report's recommendations.

3. Address inequalities in access to health services by better targeting under-served regions. Improve the quality of healthcare by regulating private service providers and increasing the service area for and training of midwives. The initial priority should not be to raise overall health spending, but first to spend existing funds more efficiently and effectively.

- To address inequities in health provision, the Special Allocation Fund (Dana Alokasi Khusus, or DAK) could be utilized to increase the supply of health services to under-served regions, while demand-side interventions such as vouchers could be used to increase demand from poor clients. The most immediate challenge lies in channeling existing spending to where it would most benefit the poor—in primary care and in rural and/or under-served areas.
- To harness the potential of the private sector, better regulation of private service providers is necessary. Almost 40 percent of the poor satisfy their healthcare needs through private providers, but there is no comprehensive information on the types and quality of services they provide. A systematic effort to regulate, license and accredit private providers would enhance the quality of care available to the poor.
- Midwives currently operate in relatively small service areas and therefore deliver relatively few children each year. It would be more efficient to expand midwives' service areas and improve the quality of their training, with a stronger focus on practical delivery skills.

4. Invest in infrastructure by expanding the supply of electricity and reducing subsidies that benefit better-off clients, providing fiscal incentives to encourage sub-national governments to better maintain roads and creating a framework for PDAMs to function better. Currently, electricity subsidies account for 28 percent of all subsidy costs and largely benefit better-off Indonesians. Local roads are often poorly maintained and the vast majority of Indonesians do not benefit from high-quality water services.

- Reduce subsidies for all electricity voltages above 450VA. Higher voltage levels are used disproportionately by the better-off, so the subsidy savings would be pro-poor.
- Local governments have few incentives to properly maintain roads although in the long run maintenance is much cheaper than reconstruction. The central government could offer direct incentives to local governments based on the year-on-year quality of road maintenance that they undertake.
- Current impediments to long-term borrowing by PDAMs could be removed and incentives provided to local governments that improve PDAM services. Under the current system, most PDAMs cannot borrow in credit markets. A process of debt restructuring should be undertaken to give the most credit-worthy PDAMs incentives to raise tariffs and lower costs, thereby improving their ability to borrow money commercially. In addition, the central government could create a pool of funds to be used to reward those local governments that make the most progress in improving the financial position and operational performance of their PDAMs.

5. Make the flow of public expenditures more predictable and transparent by creating performance-based budgeting systems, linking budgets to planning processes and strengthening procurement and auditing functions. While there are formal links among policy objectives, budgeting, disbursement and auditing, the process often does not work effectively in practice.

- Performance-based budgets assess results according to outputs achieved and not financial inputs. Currently, input controls are the predominant method of assessing the quality of public spending, but a shift to greater ex post control, including audits of expenditures, as well as assessments of outputs produced, would result in more effective spending efforts.
- Linking budgets more effectively to planning processes is a priority. While the five-year plan (Repanas) outlines medium-term objectives, budgeting cycles operate on an annual basis. Implementation of the Medium-Term Expenditure Framework (MTEF) would allow multi-year budgeting and the carry-over of funds, and enable policy-makers to budget medium-term resources with greater levels of certainty.
- Strengthen procurement and auditing systems by focusing on efficiency. While procurement rules have recently been tightened, this has resulted in slower procurement of goods and services. Improved training of procurement professionals is required to address these bottlenecks. In addition, efficiency gains could

be obtained by combining the three main internal audit bodies into one unified organization, as well as employing more and better-trained staff at the BPK. Likewise, significant efficiency gains would come with the lowers levels of corruption that would result from the tightening of these systems.

6. Help local governments to better spend their resources by removing full coverage of the civil service wage bill from the DAU, reducing spending on administration and building capacity. Local governments

now have significant authority over planning and budgets, but they do not yet have clear incentives to use these funds to maximize economic development and service delivery outputs for local citizens.

- Current transfer rules create incentives for local governments to increase the size of their civil service and create disincentives for them to allocate local expenditures more strategically to achieve their objectives. Elimination of the DAU's automatic coverage of all civil service wages would create incentives for local governments to allocate their budgets more efficiently.
- Significant savings could also be achieved by reducing spending on core administrative services, the largest spending item of sub-national governments. Disproportionate spending on administrative services has crowded out capital investments and spending on front-line service providers, both of which would generate more output for each rupiah spent.
- With far larger resources now flowing to the regions, more effective local government administrations are required. Therefore, it becomes crucial to invest in capacity-building with the aim of improving project development and implementation skills. This is especially crucial if local governments are to effectively manage the additional funds needed to tackle low investment in public infrastructure.

A small number of high-impact reforms could produce rapid results. The reform agenda above is indeed a challenging one and is broken down into a summary matrix of 62 specific recommendations in the main report. However, there are specifically seven reforms that will achieve a high impact and could be implemented within a 12- to 18-month timeframe. These reforms either address service delivery, Indonesia's fiscal position or its budget processes (Box 2).

Box 2 Seven high-impact quick wins

Impact on service delivery and personnel management

- *Remove complete coverage of civil service salaries from the DAU.* DAU payments currently cover 100 percent of local civil servant salaries, penalizing local reformist governments that want to reform their civil service and reallocate funds to priority sectors.
- *Adjust the definition of the "20 percent mandate" to include teacher salaries and combine central and regional government spending.* This would allow focusing on aggregate spending and performance of the sector. Such aggregate definition would further reduce distortions in the teacher salary structure and decentralization framework.
- *Allocate teachers to schools based on the number of students, not on the number of classes,* with a weighting for smaller schools. This would result in a more rational allocation of teachers within and among school districts and would result in a more even distribution of teachers to students.

Fiscal impact

- *Reduce inefficient and pro-rich fuel subsidies (US\$5 billion).* Despite fuel price increases in 2005, the fuel subsidy remains one of the largest spending items in the budget.
- *Reallocate inefficient and pro-rich electricity subsidies (US\$3 billion).* Subsidies could be reallocated from consumption (all but 450VA) towards connection to encourage expansion of the electricity network.

Impact on budget processes

- *Establish a Medium-Term Expenditure Framework and allow for authorization of multi-year budget appropriations.* This would be particularly useful for larger infrastructure projects in order to increase predictability and efficiency of medium-term fiscal priorities.
- *Further strengthen both the capacity and regional presence of the BPK. Redefine the role of the BPKP and consolidate the functions of the various internal audit agencies.*