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INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

PROGRAM DOCUMENT

FOR A PROPOSED

INSTITUTIONAL, TAX ADMINISTRATION, SOCIAL AND INVESTMENT DEVELOPMENT POLICY LOAN (INSTANSI--DPL)

IN THE AMOUNT OF USD$300 MILLION

TO

THE REPUBLIC OF INDONESIA

DECEMBER 6, 2012

Poverty Reduction and Economic Management Unit
Indonesia Country Department
East Asia and Pacific Region

REPUBLIC OF INDONESIA - GOVERNMENT FISCAL YEAR

January 1 – December 31

CURRENCY EQUIVALENTS

(Exchange Rate Effective as October 3, 2012)
Currency Unit Rupiah (IDR)
USD 1.00 = IDR 9,590

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ABBREVIATIONS AND ACRONYMS

AAA	Analytical and Advisory Activities	KL	*Kementerian Lembaga* (Line Ministries)
ADB	Asian Development Bank		
AFD	Applicationi Functional Designs	KMK	*Keputusan Menteri Keuangan* (Decree of the Minister of Finance)
AGO	Attorney General's Office	KN	*Kekayaan Negara* (State Assets)
ALM	Assets and Liability Management		
AMDAL	*Analisa Mengenai Dampak Lingkungan* (Environmental Impact Assessment)	KPI	Key Performance Indicators
APBD	*Anggaran Pendapatan dan Belanja Daerah (Sub-national budget)*	KPK	*Komisi Pemberantasan Korupsi* (Corruption Eradication Commission)
APBN	*Anggaran Pendapatan dan Belanja Negara* (State Budget)	KPKNL	*Kantor Pelayanan Kekayaan Negara dan Lelang* (State Auction Service Offices)
AusAID	Australian Agency for International Development	KPPN	*Kantor Pelayanan Perbendaharaan Negara* (State Treasury Services Offices)
Bappenas	*Badan Perencanaan Pembangunan Nasional* (National Development Planning Agency)	KPU	*Komisi Pemilihan Umum* (General Election Commission)
Bawasda	*Badan Pengawas Daerah* (Supervisory Board)	LG	Local Government
BI	Bank Indonesia	LIBOR	London Interbank Offered Rate
BKPM	*Badan Koordinasi Penanaman Modal* (Indonesia Investment Coordinating Board)	LKPP	*Lembaga Kebijakan Pengadaan Barang/Jasa Pemerintah* (National Public Procurement Office)
BLI	Base-Line Indicator	M&E	Monitoring and Evaluation
BLT	*Bantuan Langsung Tunai* (cash transfer)	MDTF	Multi Donor Trust Funds
BOS	*Bantuan Operasional Sekolah* (School Operational Assistance)	MenPAN	*Kementerian Pemberdayagunaan Aparatur Negara* (State Ministry of State Administrative Reforms)
BPJS	*Badan Pelaksana Jaminan Sosial* (Implementing Agency for Social Safety)	MIS	Management Information System
BPK	*Badan Pemeriksa Keuangan* (State Audit Agency)	MoF	Ministry of Finance
BPKP	*Badan Pengawasan Keuangan dan Pembangunan* (Financial and Development Audit Agency)	MoH	Ministry of Health
BPN	*Badan Pertanahan Nasional* (National Land Agency)	MoHA	Ministry of Home Affairs
BPS	*Badan Pusat Statistik* (Central Bureau of Statistics)	MoPW	Ministry of Public Works
BR BRI	Bureaucratic Reform Bureaucracy Reform Initiative	MP3EI	Masterplan for Acceleration and Expansion of Indonesia's Economic Development
BSC	Balanced Score Card	MTEF	Medium-Term Expenditure Framework
BSM	*Beasiswa Siswa Miskin* (scholarship for poor students)	Musrenbang	*Musyawarah Rencana Pembangunan* (Multi stakeholders consultation forum)
CMEA	Coordinating Ministry for Economic Affairs	MW	Mega Watt
COA	Chart of Accounts	NGO	Non-Governmental Organization
COSO	Committee of Sponsoring Organization	NPPKP	*Nomor Pengukuhan Pengusaha Kena Pajak* (VAT collector number)
CPI	Consumer Price Index	NPPO	National Public Procurement Office
CPS	Country Partnership Strategy	NPWP	*Nomor Pokok Wajib Pajak* (Tax Payer Identification Registration Number)
CPSPR	Country Partnership Strategy Progress Report	NTS	National Targeting System
CRP	Conference Room Pilot	OECD	Organization for Economic Co-operation and Development
CSA	Control Self Assessment	OJK	*Otoritas Jasa Keuangan* (Financial Services Authority)
CY	Calendar Year	PBB	Performance Based Budgeting
DAK	*Dana Alokasi Khusus* (Special Allocation Funds)	PBO	Parliamentary Budget Office
DG	Director General	PEACH	Public Expenditure Analysis and Capacity Harmonization
DGB	Director General Budget	PEFA	Public Expenditure and Financial Accountability
DGH	Directorate General of Highways	PEMDA	*Pemerintah Daerah* (Local Government Entity)
DGT	Director General Taxes	PER	Public Expenditure Review
DIPA	*Daftar Isian Pelaksanaan Anggaran* (Approved Budget Allocation)	PERISAI DPL-DDO	Program for Economic Resilience, Investment and Social Assistance in Indonesia Development Policy Loan- Deferred Drawdown Option
DPL	Development Policy Loan	PESF DPL-DDO	Public Expenditure Support FacilityDevelopment Policy Loan- Deferred Drawdown Option

DPR	*Dewan Perwakilan Rakyat Daerah* (People's Consultative Assembly)	PP	*Peraturan Pemerintah* (Government Regulation)
DSF	Decentralization Support Facility	PPP	Purchasing Power Parity
DTT	Directorate of Treasury and Transformation	PREM	Poverty Reduction and Economic Management
FDI	Foreign Direct Investment	PLN	*Perusahaan Listrik Negara* (State Electricity Company)
FPO	Fiscal Policy Office	PMK	*Peraturan Menteri Keuangan* (Minister of Finance Regulation)
FHH	Female Headed Households	PMT	Proxy Means Testing
FIRM DPL	Financial Sector and Investment Climate Reform and Modernization Development Policy Loan	PNPM	*Program Nasional Pemberdayaan Masyarakat* (National Program for Community Empowerment)
FX	Foreign Exchange	PNS	*Pegawai Negeri Sipil* (Civil Servants)
FY	Fiscal Year	POM	Project Operation Manual
GDP	Gross Domestic Product	PPLS	*Pendataan Program Pelayanan Sosial* (Social service data collection program)
GFMRAP	Government Financial Management and Revenue Administration Project	Pusintek	*Pusat Sistem Informasi dan Teknologi Keuangan* (Center of Information System and Technology)
GFMIS	Government Financial Management Information System	RASKIN	*Beras Miskin* (Rice for the Poor Program)
GL	General Ledger	R&D	Research and Development
GNI	Gross National Income	Renja-KL	*Rencana Kerja Kementerian Lembaga* (Line Ministies' Work Plan)
GOI	Government of Indonesia	RKA-KL	*Rencana Kerja dan Anggaran Kementerian/Lembaga* (Ministry/Institutional Budget and Work Plan)
GOJ	Government of Japan	RKP	*Rencana Kerja Pemerintah* (Government Work Plan)
HR	Human Resources	ROSC	Report on the Observance of Standards and Codes
HRD	Human Resources Development	SD	Sustainable Development
HRIS	Human Resources Information Services	RPJMN	*Rencana Pembangunan Jangka Menengah National* (National Medium Term Development Plan)
IBRD	International Bank for Reconstruction and Development	SAKTI	*Sistem Aplikasi Keuangan Terpadu Instansi* (Agency Integrated Financial Application System)
ICR	Implementation Completion and Results	Satker	*Satuan Kerja* (Working Unit)
ICT	Information and Communication Technology	SMS	Short Message Service
IDPL	Infrastructure Development Policy Loan	SPAN	*Sistem Perbendaharaan dan Anggaran Negara* (Integrated Financial Management System)
IMF	International Monetary Fund	SUN	Rupiah-denominated tradable Government securities
JICA	Japan International Cooperation Agency	TNP2K	*Tim Nasional Percepatan Penanggulanan Kemiskinan* (National Team on Accelerating Poverty Alleviation)
JPS	*Jaring Pengaman Sosial* (Social Safety Net)	TSA	Treasury Single Account
JSEI	Jakarta Stock Exchange Indonesia	UAT	User Acceptance Test
Kanwil	*Kantor Wilayah* (Regional Offices)	UKP4	*Unit Kerja Presiden Bidang Pengawasan dan Pengendalian Pembangunan* (The Presidential Working Unit for Supervision and Management of Development)
KDP	*Kecamatan* Development Program	ULP	*Unit Layanan Pengadaan* (Procurement Service Unit)
Keppres	*Keputusan President* (Presidential Decree)	USDRP	Urban Sector Development and Reform Project
PFM	Public Financial Management	VAT	Value Added Tax
PFM-MDTF	Public Financial Management-Multi Donor Trust Funds	VP	Vice-President
PINTAR	Project for Indonesian Tax Administration Reform	VSL	Variable Spread Loan
PKH	*Program Keluarga Harapan* (Conditional Cash Transfer)	WBG	World Bank Group

REPUBLIC OF INDONESIA

INSTITUTIONAL, TAX ADMINISTRATION, SOCIAL AND INVESTMENT

DEVELOPMENT POLICY LOAN (INSTANSI—DPL)

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Loan Program Summary

Borrower	Republic of Indonesia
Implementing Agency	Coordinating Ministry for Economic Affairs and the Ministry of Finance
Financing Data	IBRD Variable Spread Loan, USD300 million
Operation Type	The first single tranche operation of a two-year programmatic DPL series.
Main Policy Areas	Public Financial Management, Poverty Reduction and Public Service Delivery
Key Outcome Indicators	Since 2004, the three previous DPL series (DPLs 1-4, 5-6 and 7-8) have helped the Government of Indonesia (GoI) towards achieving its medium-term growth and poverty reduction objectives. This new INSTANSI DPL series is expected to contribute to the achievement of the following targeted outcomes by 2014: • Greater integrity and more effective use and management of public funds (continued improvements in Central Government ministries and agencies [K/Ls] receiving an 'unqualified' audit opinion from 63 percent for FY2010 to 84 percent for FY2013; and with the percentage of total capital expenditure disbursed by end of Q2 increased from 18 percent in 2012 to 22 percent in FY2014); • Strengthened GoI efforts to reduce poverty and vulnerability, through better informed and evidence-based policy and program decisions (with the percentage of social assistance programs in Central Government expenditure increasing from 3.3 percent in FY2011 to 4.5 percent in FY2013). As discussed in the following sections, the proposed Institutional, Tax Administration, Social and Investment (INSTANSI) DPL is a beginning of a new series of two-year DPLs, which continues the reform efforts supported by the three previous DPL series that have been implemented since 2004. The Investment Climate pillar of the previous DPL series has been moved to two separate DPLs that will also be presented in 2012, i.e. Connectivity (Connectivity DPL) and Financial Sector and Investment Climate Reform and Modernization (FIRM DPL).
Program Development Objective(s) and Contribution to CPS	The overall goal of the DPL program is to assist the GOI achieve its medium-term growth and poverty reduction objectives through strengthened public finance management, and poverty alleviation and service delivery efforts. Policy reforms supported by this operation will focus on the following pillars: (i) **strengthening public financial management (PFM)** through improvements in the medium-term results orientation of the budget process, the introduction of an enhanced automated budget and treasury system (SPAN) and ICT services, improved budget execution within Central Government, strengthened state assets management, improved Government accounting and audit functions, as well as improved tax administration; and (ii) **enhancing poverty alleviation and service delivery efforts** through improved governance and institutional accountability, better measurement and targeting of the poor in social assistance programs, improved household-targeted poverty reduction programs, i.e. Jamkesmas, and community-based poverty reduction programs, i.e. the National Program for Community Empowerment (PNPM). As highlighted in the 2009-2012 Country Partnership Strategy Progress Report (CPSPR) issued in February 2011, the DPL series continues to be at the center of the WBG support in strengthening Indonesia's Central Government institutions and systems, a key cross-sectoral engagement theme under the 2009-2012 CPS. The CPSPR recognizes that the DPLs have helped the GOI's efforts to improve the effectiveness and accountability of Central Government institutions and systems under the long-term objective to enhance public financial management and governance to increase the development impact of priority budget expenditures.

Risks and Risk Mitigation	• *High and volatile energy subsidy costs could significantly reduce fiscal space for other priority programs and undermine medium-term plans*. The 2012 Budget was revised to provide for the possibility of increasing subsidized fuel prices, if international oil prices were 15 percent above the level assumed in the budget, combined with compensatory cash transfers to the poor. However, with international oil prices falling, this condition is unlikely to be met in 2012. Nontheless, fuel subsidy spending is projected to rise significantly in 2013, reflecting increased consumption. This imposes a substantial budget rigidity and opportunity cost in terms of spending on key development priorities. In the run-up to the presidential election in 2014, it is unlikely that the GOI will implement a relatively unpopular fuel price hike, unless costs escalate more significantly. The DPL seeks to partially mitigate this risk by promoting more transparent medium-term and performance based budgeting (PBB), which should better highlight some of the policy trade-offs, as well as strengthening the ability of compensatory programs to better target the poor and vulnerable groups. • *The initial focus of PFM reforms, on enhancingexpenditure controls and oversight, is likely to make budget spending more difficult in the short-term, potentially undermining support for the reforms.* Indonesia has made significant strides in PFM with increasing transparency, expenditure controls, and independent oversight (as shown by the 2011 PEFA update). However, the tightening of controls has exacerbated existing problems of budget execution, particularly for capital spending, and increased the risk aversion of Government officials, potentially delaying much needed spending. To mitigate this risk, the DPL seeks to balance the further strengthening of expenditure controls and compliance, with efforts to streamline procedures and improve the quality of spending (e.g. with the MTEF, PBB or better targeting for poverty spending) as policy makers look for more rapid results. • *Some recent policy outcomes have tended to be protectionist, generating concerns about the increasing risk of political pressure by vested interests.* Recent policy moves in investment, trade and mineral sector regulation could be viewed as moving away from efficiency and favoring special interests. The risk is that such lobbying could undermine progress in other key reform areas, such as taxes where the compliance rates are already low, especially as political tensions build in the run-up to the 2014 elections. The DPL program is expected to help put in place a mechanism for stronger GoI coordination and consultation on key reform areas, thereby providing more regulatory certainty. • *The multiplicity of implementing agencies and their varying institutional capacities create a challenge in coordinating and implementing the reform efforts.* The reforms supported by the INSTANSI DPL are driven by priorities that were developed and articulated formally through dialogue and consensus within the Government; hence their implementation helps to further enhance coordination between various ministries and agencies. The overall commitment to and ownership of reforms remain strong, and the Coordinating Ministry for Economic Affairs has performed well in ensuring consistent and effective cross-ministerial coordination. The DPL program has also helped strengthen the capacity of the various institutions involved, which is complemented by other Bank instruments, including investment projects, technical assistance and AAA and trust fund support. • *The external environment is fraught with uncertainty and shocks could offset some of the recent benefits from strong growth and divert attention from longer-term reforms.* Shifts in market sentiment could result in sudden, large and a potentially disruptive reversal of capital inflows, while the external accounts, and growth outlook, remain sensitive to global commodity prices and demand, particularly from China. Similarly, increases in domestic and international food prices would negatively impact poor and vunerable groups. However, the Government has developed a track record in precautionary and proactive measures during the recent global financial turmoil, which should help limit the impact of such turbulence on Indonesia. These include a sound macroeconomic and fiscal framework, the use of trade measures, as in 2008, to mitigate the impact of rising food prices; the use of budgetary sources to expand social protection programs and to intervene in stabilizing food prices; and Presidential Decree No. 5/2011 aimed at safeguarding domestic rice production against extreme weather. Furthermore, the recent PERISAI DPL, approved in May 2012, along with parallel facilities from other development partners, explicitly aim to mitigate GoI financing concerns in the face of a crisis. In addition, by supporting improvements in the targeting of social protection and the quality of public spending, notably for capital spending, this DPL could help to enhance the effectiveness of the Government's response to future shocks.
Operation ID	P126162

I. INTRODUCTION

1. **The proposed Institutional, Tax Administration, Social and Investment Development Policy Loan (INSTANSI DPL) to Indonesia, for USD 300 million, marks the beginning of a new series of annual single-tranche DPLs.** The proposed operation is deeply rooted on the previous DPL series that consisted of: (i) first DPL series (DPLs 1-4), which was implemented from 2004 to 2007 and anchored to the FY04-08 Country Assistance Strategy (CAS): (ii) second DPL series (DPLs 5-6) that was implemented from 2008-2009; and (iii) third DPL series, which was initially set out as a three-year DPL series (DPLs 7-9) to be implemented from 2010-2012. Initially focused on supporting the GoI's macroeconomic stabilization efforts, the previous DPL series covered a broad range of reform efforts aimed at improving the investment climate, strengthening public financial management and enhancing poverty alleviation and service delivery. Given that the reform agenda is far from finished and an extension of the reforms is needed, the GoI has requested to terminate the ongoing third DPL series (DPLs 7-9) a year earlier and present the INSTANSI DPL as a new, two-year series. This new DPL series is still anchored under the FY09-12 Country Partnership Strategy, and continues to deepen the reforms supported under the previous DPL series.

2. **The INSTANSI DPL continues to support the GoI's policy and institutional reforms that are aimed towards strengthening its public finance management and enhancing its poverty alleviation and service delivery efforts.** The INSTANSI DPL policy actions continue to be aligned with the Government's development priorities, as outlined in the latest five year plan (RPJMN 2010-2014), surrounding the following pillars**:**

i) **strengthening public financial management** through improved results orientation in the budget process, linking budget formulation and execution to the Integrated Financial Management System (Sistem Perbendaharaan dan Anggaran Negara or SPAN) with improved provision of IT services, streamlined budget execution and management of budget authority within the Central Government, strengthened management of state assets, improved Government accounting and audit functions, as well as improved tax administration; and

ii) **enhancing poverty alleviation and service delivery efforts** through improving governance and institutional accountability, improving poverty measurements and targeting of the poor, improving poverty reduction programs at the household and community levels, i.e. Jamkesmas and the National Program for Community Empowerment (PNPM).

3. **In developing the operation, the Bank and the Government considered several design alternatives, including the possibility of supporting such reforms through a single multisectoral DPL.** The INSTANSI DPL stems from the result of these discussions. The GoI has requested that the overall DPL series that has been implemented since 2004 be restructured to allow for broader Bank engagement on priority sectors in line with the GoI's own strategic plans, particularly those related to public financial management and poverty, connectivity and financial and private sector. The sectoral approach aims to maximize synergies across the Bank's program in Indonesia, increase ownership of the reforms by the relevant institutions, and improve targeting of complementary technical assistance programs. As a result of the DPL restructuring, this year the Bank will support the following three sectoral DPLs for a total amount of about USD 500 million. These include:

- *The Institutional, Tax Administration, Social and Investment Development Policy Loan (INSTANSI-DPL, formerly named "DPL 9").* This operation will focus on strengthening public financial management and enhancing poverty alleviation efforts to improve the quality of fiscal spending.

- *The Financial Sector and Investment Climate Reform and Modernization (FIRM) DPL.* This operation aims to promote the development of a sound, efficient and inclusive financial sector and accelerate investment in order to support GOI in achieving its economic expansion and poverty reduction goals, by supporting reforms to improve financial system stability, promote financial sector diversification, enhance financial inclusion and support investment climate regulatory reform.

- *The Connectivity DPL*. This operation supports reforms to reduce domestic logistics costs and strengthen inclusive development, by: (i) strengthening national coordination and regulation; (ii) strengthening intra-island connectivity; (iii) improving inter-island connectivity; and (iv) improving international connectivity.

4. The overall focus of the INSTANSI DPL, Connectivity DPL and FIRM DPL is consistent with the World Bank's Development Policy Review (2008), and are fully aligned with the 2009-2012 Country Partnership Strategy Progress Report (CPSPR). Both of these strategic Bank documents highlight that Indonesia's main challenge is not so much the design of appropriate policies or programs or the raising of financing, but rather strengthening the institutions in charge of implementing those policies and programs so that their developmental impact is enhanced. This is indeed the ultimate objective of the three proposed DPL operations, within the areas of public financial management and poverty alleviation, financial inclusion and investment climate, and connectivity.

5. With the restructuring of the DPL series, the proposed INSTANSI DPL becomes more streamlined, focusing on two core policy areas: strengthening public financial management and enhancing poverty alleviation to improve the quality of fiscal spending. The INSTANSI DPL no longer focuses on improving the investment climate, the policy actions of which have been incorporated into the new Connectivity and FIRM DPLs, while actions related to reducing the tax burden and improving tax administration have shifted to the strengthening public financial management pillar. Actions under the poverty pillar that are aimed at enhancing financial inclusion are addressed under the FIRM DPL.

6. The Government's ongoing policy and institutional reform priorities cut across the three different DPLs. For example, in the area of connectivity, the Connectivity DPL supports policy and institutional reform efforts that are aimed at reducing domestic logistics costs and improving trade facilitation. In the area of public financial management, the INSTANSI DPL continues to support important institutional changes to help ensure that Government plans, budgets and tax administration are more results-oriented and therefore achieve better development outcomes. And in the area of poverty and social services, the GoI continues its ambitious reform to improve the implementation of its anti-poverty programs by extracting program beneficiary lists for priority Cluster 1 programs (PKH and Jamkesmas) from the unified database, which should help enhance their targeting and ultimately increase their impact on the poor. Whereas in financial sector, the FIRM DPL supports policy and institutional reforms that aim to reinforce financial system stability, promote financial sector diversification, enhance financial inclusion and strengthen the investment climate.

7. Indonesia has made remarkable progress over the past decade in terms of macroeconomic and political stability, which supports the proposed INSTANSI DPL operation. Output growth has been strong and consistent, averaging 5.5 percent per year over 2002 to 2011, grounded on increasing private sector investment, strong domestic consumption and generally sustainable external surpluses. Although financial markets remain vulnerable to changes in international investor sentiment, external imbalances have declined rapidly as corporate and financial sector balance sheets were repaired. Increasing revenues, combined with restrained expenditures, have contributed to low fiscal deficits. In an environment of controlled inflation and rising incomes, Indonesian citizens' living standards have improved and poverty levels have fallen, although many remain close to the poverty line. In addition, as the result of a decade of relatively successful political and institutional reforms, Indonesia in 2012 is a highly competitive, decentralized electoral democracy. A system of checks and balances between legislative, judicial, and executive branches is increasingly in place, with no one branch of Government able to dominate, and few institutional outcomes 'guaranteed'. The overall macroeconomic situation and policy framework, as well as prospects for both growth and continued prudent fiscal policy, warrant continued support for Indonesia's structural and institutional reforms through the INSTANSI DPL.

8. **The INSTANSI DPL is expected to further enhance coordination and implementation of GoI reforms in key policy areas, which is critical for accelerating growth to 7 percent and beyond, and continuing improvements in social outcomes over the medium term.** For planned increases in fiscal expenditures to lead to improvements in public services, Indonesia will need more effective and accountable institutions that can translate available resources into better development outcomes. This will be particularly important as Indonesia embarks on a period of second generation reforms to provide, for example, more sophisticated services in infrastructure, better education, and a sustainable health system. Improvements in the public financial management and poverty alleviation, supported by the INSTANSI DPL, are expected to not only improve the quality of fiscal spending, but also the quality of social outcomes overall.

9. **Overall progress achieved under the DPL program continues to be satisfactory.** The DPL program has established a good track record in advancing key policy and institutional reforms. These reforms have supported Indonesia's achievement in terms of accelerated economic growth and poverty reduction. Supporting Indonesia's relatively ambitious policy reforms is at the core of the World Bank's program in Indonesia.[1] Over the past few years, in addition to the core DPL series, the World Bank has also been supporting policy reforms in the infrastructure sector (through the Infrastructure DPL, closed in FY11), the Public Expenditure Support Facility (PESF DDO) and the PERISAI DPL-DDO, both of which provide critical support to Indonesia during periods of heightened global financial uncertainty. The proposed INSTANSI DPL also continues to complement the World Bank assistance to Indonesia, which is provided through a variety of instruments (i.e. investment projects, technical assistance, and advisory services).

10. **The INSTANSI DPL continues to be led by and based on GoI priorities.** In addition to the continuous policy dialogue that takes place between the different GoI counterparts and the World Bank, a series of formal dialogues took place and will continue throughout the preparation of the INSTANSI DPL, in order to formulate the supported policy actions and to assess their progress. The Japan International Cooperation Agency/ Government of Japan, which is also providing program support, along with other development partners, participate actively in the consultation process. Technical assistance is often provided by different development partners in support of the policy actions identified by the Government. The INSTANSI DPL was negotiated with the GOI in October 2012 and is scheduled to be presented to the World Bank Board in November 2012. All policy actions have been completed.

II. COUNTRY CONTEXT

11. **Indonesia has made remarkable progress over the past decade in terms of macroeconomic and political stability.** Output growth has been strong and consistent, averaging 5.5 percent per year over 2002 to 2011. This has been grounded on increasing private sector investment, strong domestic consumption and generally sustainable external surpluses. International commodity demand has been supportive, but the non-tradable sectors have accounted for the majority of output growth. External imbalances have declined rapidly as corporate and financial sector balance sheets were repaired, although financial markets remain vulnerable to changes in international investor sentiment. Increasing revenues, combined with restrained expenditures, have contributed to low fiscal deficits. In an environment of controlled inflation and rising incomes, Indonesian citizens' living standards have improved and poverty levels have fallen, although many

[1] The World Bank program in Indonesia is split approximately equal between program support (DPL), investment loans and results based operations (such as the 'Local Government and Decentralization' programs).

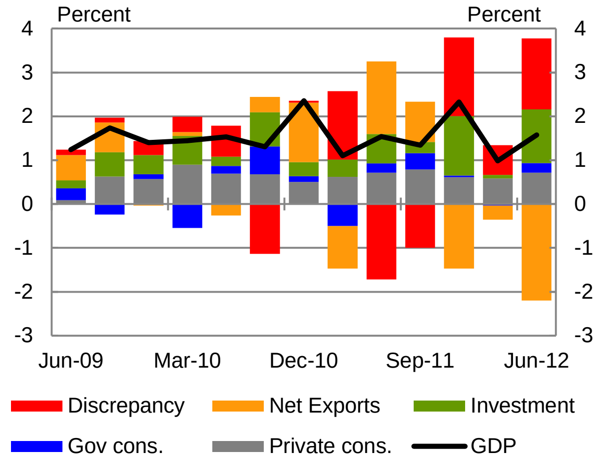
remain close to the poverty line. In addition, as the result of a decade of relatively successful political and institutional reforms, Indonesia in 2012 is a highly competitive, decentralized electoral democracy. A system of checks and balances between legislative, judicial, and executive branches is increasingly in place.

12. Compared with other countries in the region, Indonesia was less affected by the global economic downturn of 2008-09 and growth has since moved back to, and above, pre-crisis levels. GDP growth declined from 6 percent in 2008 to 4.6 percent in 2009 but subsequently recovered to 6.1 percent over 2010 and 6.5 percent in 2011. The social impact of the crisis was also limited, there were few reports of layoffs, poverty and unemployment rates continued to fall and households' spending power was supported by inflation slowing to decade lows. This relatively strong performance was supported by the health of public and financial sector balance sheets and the strength of domestic demand, particularly private consumption. Indonesia's export mix, focused on commodities, benefited from international price rises and demand for raw materials from China and other emerging economies. Policymakers also took proactive measures during the crisis, including a fiscal stimulus package, supportive monetary policy and a significant contingent support package from development partners in the event of a worsening of the crisis. Nevertheless, the fiscal deficit came in below target in 2009, 2010 and 2011 which, combined with strong GDP growth, supported the downward trajectory of Government debt to just below 25 percent of GDP, down from over 90 percent in 2000. Indonesia's sovereign ratings have been upgraded and in late 2011 and early 2012 were moved back to investment grade by Fitch and Moody's for the first time since 1997/1998. The improved creditworthiness, along with high relative yields and the levels of liquidity in some developed economies, contributed to the strong portfolio inflows into Indonesia over 2010 and the first half of 2011.

A. The Current State of the Indonesian Economy

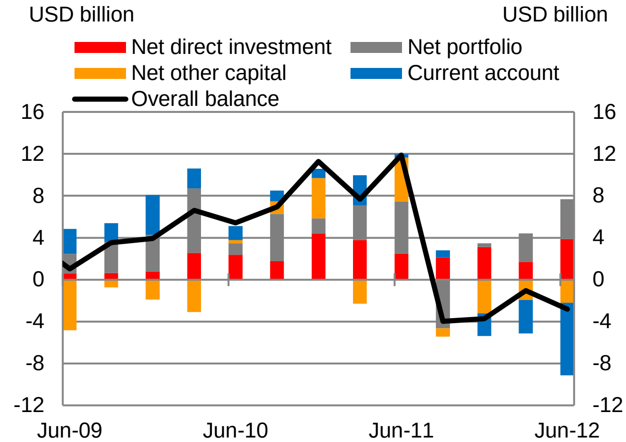
13. Supported by domestic demand, Indonesia's recent growth performance has remained robust although, as in other countries in the region, there have been spillovers from the deterioration in the global economy and volatility in international financial markets. Growth in 2011 moved up to 6.5 percent year-on-year, the highest annual growth rate since 1996, from 6.1 percent in 2010 (Figure 1). In the first half of 2012 growth remained solid, at 6.3 percent and 6.4 percent in the first two quarters, despite the weakness in the external environment. Domestic demand, particularly private consumption and investment, has continued to drive growth. However, weakening external demand has subtracted from growth since late 2011, in line with the deterioration in the trade and current account balances discussed below. Recent growth has also been broad-based across sectors, as the strength of domestic demand continues to support growth in key services sectors, such as trade, transport and communications. Within the tradable sectors, non-oil and gas manufacturing has also performed relatively strongly.

Figure 1: With the external demand weakening, private domestic demand has supported Indonesia's recent robust growth
(percentage point contribution to quarter-on-quarter seasonally adjusted growth)



Sources: BPS and World Bank
Note: Contributions may not sum to GDP due to seasonal adjustment

Figure 2: The widening current account deficit in Q2 2012 contributed to the fourth consecutive overall balance of payment deficit
(USD billion)



Sources: BPS and World Bank

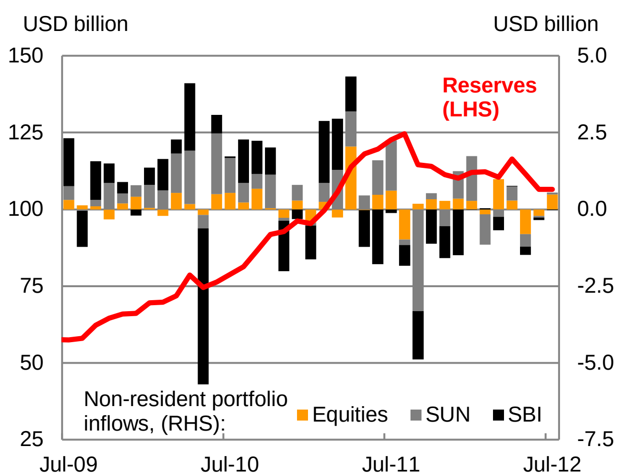
14. Inflation has remained relatively stable over the past year as food price spikes have unwound and the likelihood of subsidized fuel price hikes has decreased. Sharp increases in food prices contributed to rising headline CPI inflation in late 2010. But, as these shocks unwound, inflation declined over 2011 and reached a two-year low of 3.6 percent year-on-year in February 2012. Since then inflation has moved up gradually, to 4.6 percent year-on-year in July 2012, due mainly to higher food prices. Core inflation has also remained low at 4.3 percent in July. Expectations of higher prices associated with a potential adjustment of subsidized fuel prices have also subsided with the reduced likelihood of such a policy change (see discussion below).

15. Following strong inflows over 2010 and 2011, overall balance of payments outflows have been seen since Q3 2011 (Figure 2). These represent the first quarterly deficits since the end of 2008. Initially, in the second half of 2011, outflows were due primarily to the reversal of inflows on the volatile capital account. Subsequently, the main driver of the net balance of payments outflow has been the diminishing current account balance, moving into deficit in the fourth quarter of 2011 and hitting a record low since the Asian crisis in the second quarter of 2012. As a result of of these trends, and with BI taking measures to stabilize the exchange rate, international reserves have also fallen over 2012, moving to USD109.0 billion at end-August 2012, around 2.2 times the level of recorded short-term external debt by remaining maturity.

16. In recent years, as in other emerging markets, portfolio capital flows to Indonesia have been affected by the swings in international investor risk aversion and concern over global growth prospects. Periods of heightened international risk aversion have contributed to portfolio capital outflows from Indonesia, primarily of local currency fixed income securities (Figure 3). Non-resident investor holdings of local assets are relatively high, for example, their holdings of rupiah-denominated tradable Government securities (SUNs), at USD23.7 billion at end-July 2012, accounted for 28.4 percent of the outstanding stock. As discussed below Bank Indonesia has introduced a number of measures in recent years to address the risks of short-term portfolio outflows. Direct investment inflows, attracted by Indonesia's large and growing domestic market, its natural resources and relatively low manufacturing labor costs, has been rising gradually since 2010. Inflows moderated in the second half of 2011 but remained relatively strong, moving total inflows up to USD18.9 billion in 2011 from USD13.8 billion in 2010. FDI continued to be solid at USD 8.2 billion in the first half of 2012 despite slowing from USD10.3 billion in the same period 2011.

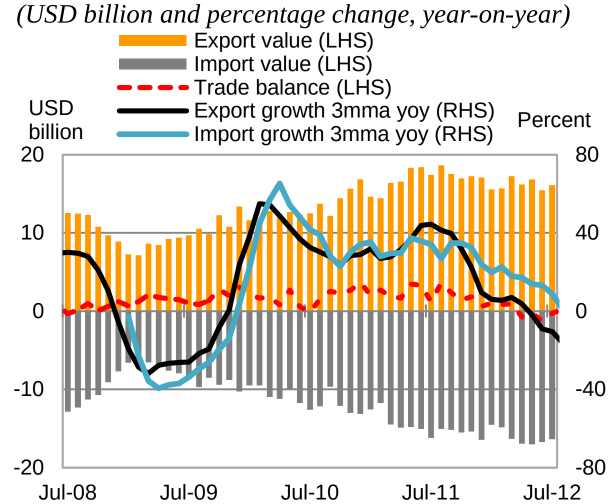
17. The trend move into a current account deficit reflects to a large extent the strength of Indonesia's domestic demand set against weakening external demand. These factors have contributed to a decline in the goods trade surplus while there has been a continuation of the large services deficit and rising outflows on the income balance (in line with strong FDI). Both declining commodity prices and volumes have also contributed to falling export growth as the monthly trade balance moved into deficit from April to July 2012. Imports have also come down, with a lag as in 2009, in part likely because a capital and intermediate goods imports are related to exports. External debt-to-GDP has been on a downward trend (moving to 27.3 percent at end-June 2012 from 35.9 percent at end-2006) and is likely to remain stable despite a higher current account deficit (see IMF 2012 Article IV external debt sustainability assessment). There is, though, the risk that, in the current fragile external environment, a further widening of the deficit raises concerns over external financing needs. Should weaker export demand persist, this risk should be mitigated by a reduction in imports used to produce exports and the impacts of price adjustment through the weakening of the exchange rate. On the capital account side, it is encouraging that, as discussed above, FDI has, to date, remained solid (accounting for a rising share of capital inflows).

Figure 3: Reserves have declined on weaker portfolio, and trade balance, inflows
(USD billion)



Sources: Bank Indonesia, CEIC, JSEI, World Bank

Figure 4: The goods trade balance has narrowed over 2012
(USD billion and percentage change, year-on-year)



Source: BPS and World Bank

18. The volatility in international capital markets has been transmitted to local asset prices, although domestic banking sector performance remains solid. As in international markets, over the past year Indonesian equities have seen sharp swings in prices. The rupiah has also come under pressure, depreciating 12.9 percent against the US dollar to Rp 9,573 per USD from the beginning of August 2011 to 30 August 2012. Local currency government bond yields have risen gradually over 2012 as a mixed consequence of the expectation on higher future inflation, related to the potential hike in the subsidized fuel price, and then rising international risk aversion. However, they remain at relatively low levels historically (with the five-year yields at around 5.5 percent). Overall banking sector indicators have remained solid. The capital adequacy ratio, while down slightly, remains at 17 percent. Non-performing loans were down half a percentage point over the year to 2.2 percent. (For further details on recent performance and policy challenges in the sector see the Financial Sector and Investment Climate Reform And Modernization DPL program document).

19. Strong growth over the past five years is reflected in a significant improvement in Indonesia's poverty and employment numbers. Indonesia's poverty rate, measured at the national poverty line, fell from 16.6 percent in March 2007 to 12.0 percent in March 2012. Both urban and rural poverty rates have been declining and the decline was spatially uniform. However, the 0.5 percentage point decline since March 2011 is the lowest drop in ten years, reflecting the slowing rate of poverty reduction evident in the last four years The poverty rates over this period for male-headed and female-headed households are similar (although female-headed household poverty experienced considerably more volatility earlier in the decade). Despite this positive progress, nearly 40 percent of Indonesians live on 1.5 times poverty-line expenditure (or less), meaning there are many who remain vulnerable to impoverishment. There remains the challenge of ensuring that GDP growth translates into sufficient creation of quality jobs. Employment growth of 3.2 percent year-on-year was seen in August 2010, falling to 1.4 percent in February 2012. There were changes in the weighting series between August 2010 and February 2011 which makes employment growth comparisons for February 2010 and August 2011 difficult. The official open unemployment rate has continued to trend downwards, falling to 6.3 percent in February 2012 from 6.6 percent in August a year before (or 6.8 percent on February 2011).

B. The Macroeconomic Policy Framwork

20. Bank Indonesia has shifted its monetary policy stance in line with international developments and the prospects for the path of administered fuel prices. In anticipation of a worsening external environment, and with inflation declining, Bank Indonesia loosened monetary policy at the end of 2011 and beginning of 2012. Rate cuts in October, one of the earliest policy responses in the region, were followed by further reductions in November 2011 and February 2012 respectively. Furthermore, the lower bound of Bank Indonesia's operational corridor (the overnight deposit facility rate) was also widened in September 2011 and January 2012, moving it to 200 basis points below the policy rate. With the proposal to raise subsidized fuel prices, inflation expectations picked up and BI indicated it was ready to shift its stance, including through measures to manage short-term liquidity. Although inflation expectations have since receded, in August 2012 BI increased the overnight deposit facility rate by 25 basis points, in part to support the exchange rate in the face of the current account outflows. As in other economies, the central bank has also made increasing use of a range of macroprudential tools. For example, in the context of strong credit growth (above 25 percent year-on-year) it has imposed maximum loan-to-value ratios for housing loans and minimum down payment on vehicle purchases.

21. In terms of exchange rate policy, the Rupiah has depreciated gradually over the year with interventions to manage volatility. In early May 2012 there were reports of shortages in onshore US dollar liquidity and BI has responded through a number of measures to support FX liquidity, for example introducing a foreign currency "Term Deposit Instrument". These measures follow earlier policy actions aimed at preventing disruptive capital outflows, such as example, reinstating limits on short-term offshore borrowing of banks and raising holding periods on SBIs. With the rising demand for dollars given the overall balance of payment outflows, there has been a gradual depreciation in the exchange rate over the year with the authorities underscoring their commitment to exchange rate flexibility in the 2012 IMF Article IV.

22. Fiscal deficits and debt continue to be conservative but the allocation of spending could be improved and, with subsidy spending increasing, the deficit is projected to rise in 2012. The realized (audited) 2011 Government deficit of Rp 84.4 trillion (1.1 percent of GDP) came in well below the revised Budget level of Rp 151 trillion (2.1 percent of GDP), as under-spending in core Government programs more than offset high spending on energy subsidies. The revised 2012 Budget increased the deficit for the year to 2.2 percent of GDP, up from 1.5 percent of GDP in the original budget. The upward revisions to the 2012 revenue and expenditure numbers were both driven by the increase in the assumed oil price. In light of the likely higher spending on energy subsidies the Government proposed a one-third increase in the subsidized fuel price in its draft revised Budget. However, the approved revised Budget authorized the Government to make such an increase, but only if the six-month average Indonesia crude oil price was 15 percent higher than the USD105 assumed in the Budget. The revised Budget also included additional spending on temporary compensating programs in the event of a fuel price increase, including a cash transfer to the poor combined with anti-poverty programs at the community level and public transport subsidies while infrastructure spending also received a boost. As in most previous years, realization of expenditures on core programs is likely to come in below budget and revenues continue to grow strongly, although oil and gas non-tax revenue are lower than initially projected due to lower oil lifting. Latest Government projections are for the 2012 Budget deficit to come in Rp 179 trillion, slightly below the revised Budget level in nominal terms but still 2.2 percent of GDP. In terms of budget transparency, the central Government publishes its annual Budget in a timely manner. It is usually posted on the Ministry of Finance website within one week after the Budget has been passed.

23. For 2013, the Government's recently proposed budget projects a narrowing of the deficit to 1.6 percent of GDP, or Rp 150.2 trillion. The reduced deficit reflects the Government's intention to increase revenue to GDP (from 15.9 percent to 16.2 percent) as efforts continue to broaden the tax base, while at the same time reducing nominal spending relative to GDP (to 17.9 percent of GDP vs. 18.2 percent in 2012). Despite this conservative overall spending stance, and an oil price assumption in 2013 of USD100 per barrel, USD5 lower than the 2012 assumption, there is a significant increase in energy subsidy spending, driven by growing consumption and a weaker exchange rate; the energy subsidy allocation is 62.9 (35.8) percent higher than the level in the original (revised) 2012 Budget. Total subsidies (rising 29 percent on revised 2012 levels to Rp 316.1 trillion) along with personnel spending (rising 13.6 percent from 2012 to Rp 241.1 trillion) thus continue to account for the lion's share of total public expenditure. Capital spending, while projected to rise a further 15 percent in 2013, continues to run into implementation constraints and will likely lag infrastructure development needs.

24. The decision not to increase subsidized fuel prices on 1 April in the approved 2012 Budget was as a missed opportunity and there remains the need to redirect this spending to more pressing development needs to support medium-term growth and development and to address the distortions and inefficiencies of the current subsidies. The fall in international oil prices since early May 2012 made it highly unlikely that the condition for a hike in subsidized fuel prices will be met. An electricity price hike planned for 2012 that would have limited spending on electricity subsidies has also been postponed. In the proposed 2013 Budget, there is no indication of a fuel price adjustment although it is proposed that electricity tariffs be increased by 15 percent on average for higher wattage customers (although details of this mechanism are to be decided and the proposal is subject to Parliamentary approval). From the perspective of fiscal sustainability a higher deficit is manageable given Indonesia's strong initial debt position and conservative deficits-to-GDP. However, in the case that oil prices move up sharply, the risk of hitting Indonesia's three percent of GDP deficit limit could prompt a tightening in spending in key development areas. Furthermore, it is the opportunity cost of the current spending on subsidies that is of particular concern given other pressing development needs, along with the fact the fuel subsidies are an ineffective and poorly-targeted method of assisting the poor (with the vast majority of the benefits going to richer households who own cars and motorbikes).

Table 1: The revised Budget deficit target for 2012 is 2.2 percent of GDP

(Rp trillion, unless otherwise indicated)

	2011 Actual	*Share of GDP*	2012 Budget	*Share of GDP*	2012 Revised Budget	*Share of GDP*	2013 Proposed Budget	*Share of GDP*
A. State Revenues and Grants	**1,210.6**	***16.3%***	**1,311.4**	***16.2%***	**1,358.2**	***15.9%***	**1,507.7**	***16.3%***
i. Tax Revenues, of which	873.9	*11.8%*	1,032.6	*12.7%*	1,016.2	*11.9%*	1,178.9	*12.7%*
Income Tax	431.1	*5.8%*	520.0	*6.4%*	513.7	*6.0%*	574.3	*6.2%*
Sales tax (VAT)	277.8	*3.7%*	352.9	*4.3%*	336.1	*3.9%*	423.7	*4.6%*
Excises	77.0	*1.0%*	75.4	*0.9%*	83.3	*1.0%*	89.0	*1.0%*
Export taxes	28.9	*0.4%*	19.2	*0.2%*	23.2	*0.3%*	31.7	*0.3%*
ii. Non Tax revenues, of which	331.5	*4.5%*	278.0	*3.4%*	341.1	*4.0%*	324.3	*3.5%*
Natural resources	213.8	*2.9%*	177.3	*2.2%*	217.2	*2.5%*	190.7	*2.1%*
B. Expenditures	**1,295.0**	***17.4%***	**1,435.4**	***17.7%***	**1,548.3**	***18.2%***	**1,657.9**	***17.9%***
i. Central Government Expenditures, of which	883.7	*11.9%*	965.0	*11.9%*	1,069.5	*12.5%*	1,139.0	*12.3%*
Personnel	175.7	*2.4%*	215.9	*2.7%*	212.3	*2.5%*	241.1	*2.6%*
Materials	124.6	*1.7%*	188.0	*2.3%*	186.6	*2.2%*	159.2	*1.7%*
Capital	117.9	*1.6%*	152.0	*1.9%*	168.7	*2.0%*	193.8	*2.1%*
Social	71.1	*1.0%*	47.8	*0.6%*	55.4	*0.6%*	59.0	*0.6%*
Subsidies	295.4	*4.0%*	208.9	*2.6%*	245.1	*2.9%*	316.1	*3.4%*
Fuel subsidies	165.2	*2.2%*	123.6	*1.5%*	137.4	*1.6%*	193.8	*2.1%*
Electricity subsidies	90.4	*1.2%*	45.0	*0.6%*	65.0	*0.8%*	80.9	*0.9%*
Interest payments	93.3	*1.3%*	122.2	*1.5%*	117.8	*1.4%*	113.2	*1.2%*
ii Transfer to Regions	411.3	*5.5%*	470.4	*5.8%*	478.8	*5.6%*	518.9	*5.6%*
C. Primary Balance	**8.9**	***0.1%***	**-1.8**	***0.0%***	**-72.3**	***-0.8%***	**-37.0**	***-0.4%***
D. Fiscal Balance	**-84.4**	***-1.1%***	**-124.0**	***-1.5%***	**-190.1**	***-2.2%***	**-150.2**	***-1.6%***

Source: MoF and World Bank staff calculations

Table 2: Bond sales account for the majority of net financing sources

(Rp trillion, unless otherwise indicated)

	2011 Actual	*Share of GDP*	2012 Budget	*Share of GDP*	2012 Revised Budget	*Share of GDP*	2013 Proposed Budget	*Share of GDP*
A. Net financing needs	**130.9**	***1.8%***	**124**	***1.5%***	**190.1**	***2.2%***	**150.2**	**130.9**
B. Net financing sources, of which	**130.9**	***1.8%***	**124**	***1.5%***	**190.1**	***2.2%***	**150.2**	**130.9**
Domestic Banking	40.3	*0.5%*	8.9	*0.1%*	60.6	*0.7%*	14.3	40.3
Non-domestic Banking, of which	108.4	*1.5%*	117	*1.4%*	134	*1.6%*	155.3	108.4
Bond sales	119.9	*1.6%*	134.6	*1.7%*	159.6	*1.9%*	177.3	119.9
Foreign Official Loans	-17.8	*-0.2%*	-1.9	*0.0%*	-4.4	*-0.1%*	-19.5	-17.8

Source: MoF and World Bank staff calculations

25. Low deficits, budget discipline, prudent fiscal policy and high nominal GDP growth have enabled Indonesia to reduce its public debt burden significantly. In the past ten years, Indonesia's public debt-to-GDP ratio has fallen to slightly below 25 percent in 2011, from around 90 percent in 2000. This improvement in Indonesia's debt position stands out among other economies in the region and has been possible through a combination of fiscal conservatism and high nominal GDP growth. Indonesia's Government debt-to-GDP ratio is likely to continue falling in the years ahead and the downward debt dynamics appear to be robust to a plausible range of macroeconomic shocks, in line with those suffered over the past 10 years (see Annex 5). This relatively positive picture focuses on solvency issues rather than liquidity and roll-over risks, which may occur even if solvency is solid. Indonesia's financing position is supported by cash reserves from previous over-financing and the still conservative fiscal deficits. However, as highlighted above, a sharp tightening in global and domestic financial markets, as seen in 2008, would potentially limit the Government's ability to meet gross financing needs on reasonable terms. Recognizing this risk the Government has raised a sizeable share of financing early in the year (with gross securities issuance at end-August at 73.4 percent of the full-year target under the revised Budget) and has put in place contingent financing from donor partners, including the World Bank's PERISAI operation.

26. In response to the deterioration in the current account deficit in Q2 2012, Bank Indonesia and the Government also announced a number of policy responses. These policies were designed to adjust the current account deficit to "a sustainable level to support the momentum of the national economy". For example, Bank Indonesia will focus on stabilizing the Rupiah "in accordance with its fundamental conditions" while the measures announced by the Government include support for boosting exports but appear to be aimed mainly at limiting dependence on imports and supporting domestic production. It is unclear whether such policies are likely to be effective, and they could introduce distortions over the medium-term. Furthermore, it is important not to over-react to the recent current account deficit numbers or make policy missteps that could adversely impact investor sentiment, thereby actually putting more pressure on external balances. Allowing for a gradual weakening of the exchange rate, as has been seen recently, could also facilitate an improvement in the trade balance.

27. ***In summary, the overall macroeconomic situation and policy framework warrant continued support for Indonesia's structural and institutional reforms through the INSTANSI DPL.***

C. Indonesia's Economic Outlook

28. Risks to the outlook for the Indonesian economy remain weighted to the downside, and are likely to remain high in 2013. Global financial markets and portfolio flows to Indonesia remain volatile, with the global economic outlook highly uncertain, with weaker growth in high income economies, moderating commodity prices and continued financial market turbulence. The direct impact of lower growth in the EU on Indonesia's economy is likely to be limited, as Indonesia's exports are relatively diversified by export destination direct linkages. However, a further deterioration in international financing conditions or in commodity prices and demand relative to the baseline scenario would be of particular concern. A seizing up of global US dollar liquidity could have important implications for Indonesia's financial sector, and potentially have spillovers to the real economy, through investment and trade financing, and to Government financing costs. Lower international commodity prices or demand could affect Indonesia's GDP growth via their impact not only on trade (with commodity exports accounting for around two-thirds of the value of exports) but through domestic consumption and investment, as well as lower fiscal revenues. However, a sharp recovery in oil prices, for example due to supply shocks, could also refocus attention on the cost of Indonesia's fuel subsidies.

29. In a baseline scenario of international financial market fragility combined with relatively weak external, but continued solid, domestic demand, growth of 6.0 percent is forecast for 2012, moving up to 6.4 percent in 2013. The underlying macro assumptions for this baseline include a continued weakness in external demand with overall international commodity prices also projected to moderate.

Table 3: Baseline macro economic outlook

	2009	2010	2011	2012 (p)	2013 (p)	2014 (p)
Growth						
Real GDP (% change)	4.6	6.1	6.5	6.0	6.4	6.6
Real investment (% change)	3.3	8.5	8.8	9.6	10.0	10.5
Real private consumption (% change)	6.2	4.6	4.7	4.5	4.8	4.9
Real exports (% change)	-9.7	14.9	13.6	6.3	7.6	11.0
Real imports (% change)	-15.0	17.3	13.3	7.7	8.1	11.8
Current account balance (% of GDP)	1.9	0.8	0.2	-1.8	-1.7	-1.7
Fiscal variables						
Central Government balance (% of GDP) [1]	-1.6	-0.6	-1.1	-2.2	-1.6	-1.4
Central Government debt (% of GDP)	28.4	26.0	24.3	23.0	21.2	19.5
Prices						
GDP deflator (% change)[2]	8.4	8.0	8.4	7.2	8.1	8.7
CPI inflation (%)[2]	4.8	5.1	5.4	4.4	5.1	5.0

Note: [1] 2011 is actual audited, 2012 is revised Budget deficit and deficit from 2013 to 2014 is based on Government 2013 Budget Financial Note. [2] Period averages.
Source: BPS, Bank Indonesia, Ministry of Finance and World Bank staff projections.

30. **Under more adverse but plausible scenarios framed around the above external risks, growth in 2013 could decline to around 4 percent of GDP, the lowest in a decade.** Taking the above downside risks into account, different scenarios can be considered to simulate the impact of external shocks on Indonesia's economy (see Table below). The main impact would be felt in 2013 given the strong performance in 2012 to date. Under a scenario similar to 2009 which assumes a greater growth slowdown due to the real impact of the financial crisis and credit tightness, as well as a moderate decline in commodity prices leading to a sharp contraction in the terms of trade, GDP growth is cut to 4.7 percent in 2013 (down 1.7 percentage points on the baseline scenario), reflecting lower investment and exports. If a financial crisis precipitates, or accompanies, a significant growth slowdown also in emerging economies as well as a sharp drop in global commodity prices, growth could fall even further in 2012, down to just under 4 percent.

31. **The outlook for China is of particular importance for Indonesia**. A drop in China's growth down to 7 percent would directly cut Indonesia's major trading partner growth by 0.17 pp (given a weight in Indonesia's exports of 11 percent in 2011). The second round effects via global and regional trading partner growth would also clearly be important. However, the real concern with a relatively marked slowdown in growth would be if China's growth leads to a sharp fall in global commodity prices - particularly coal and minerals that form a sizeable share of Indonesia's exports. If significant commodity price declines were sustained then this would spill over to domestic consumption and investment in Indonesia as household incomes and corporate investment, and fiscal revenues would also decline. Estimates of the spillovers vary across studies but, estimates in the September 2012 IMF Article IV report on Indonesia, incorporating direct and indirect trade effects and global commodity price impacts, suggest that a 1 percentage point reduction in China's growth could lower Indonesia's GDP by up to half a percentage point. The IMF report also highlights there would also be spillovers through the commodity channel from a shift in the composition of China's growth from investment to consumption.

32. **Growth could also move substantially lower if the impact of adverse external shocks is amplified domestically.** Growth would still be above 4 percent in the international scenarios discussed in the previous paragraphs. This is similar to that seen in 2009, when growth dropped during the height of the global financial crisis but remained at 4.6 percent. However, it is important to note that these GDP

projections combine the external scenarios with moderations in the underlying domestic drivers of growth, i.e. private consumption and investment. In the event that there was a major dislocation to these drivers, for example due to domestic policy miss-steps or problems in the domestic financial sector, then the downside risks to growth could be much greater, and hence the importance of crisis preparedness measures.

Table 4: Different scenarios for the international environment and their potential impact on growth in Indonesia

Scenarios	**International scenario 1:** Continuing turmoil		**International scenario 2:** Return to 2009		**International scenario 3:** Severe global slowdown		Memo: Outcomes			
	2012f	**2013f**	**2012f**	**2013f**	**2012f**	**2013f**	**2008**	**2009**	**2010**	**2011**
Indonesian GDP growth (percent)	6.0	6.4	5.8	4.7	5.7	3.8	6.0	4.6	6.2	6.5
Scenario assumptions										
Investment/GDP ratio (percent)	25.3	26.1	25.1	25.1	25.0	24.1	23.7	23.4	23.9	24.4
Major trading partner GDP growth (percent)	3.3	3.7	2.3	0.1	1.9	-1.8	2.0	-0.7	7.2	3.6
Terms of trade growth (percent)	2.0	9.0	0.0	-15.0	0.0	-30.0	-18.1	-4.2	5.7	10.2

Source: CEIC and World Bank staff projections
Note: Investment/GDP ratio is real and terms of trade series is constructed by World Bank from monthly trade data

D. Policy Challenges

D. 1. Macro-economic policy

33. There remain a number of challengs for the macro fiscal and monetary policy framework. Bank Indonesia will need to remain vigilant to potential rising inflation and any financial sector risks if domestic demand remains robust. The 2012 IMF Article IV report notes that this will require the usage of traditional monetary policy tools given that macroprudential measures on certain sectors will “not tackle the underlying condition of easy money”. Indonesia’s fiscal position is in a strong starting position at the aggregate level and the deficit is likely to remain conservative. However, flexibility to respond to a downturn in growth is limited by the disbursement issues in infrastructure and the efficiency of spending is limited by the continued burden of energy spending. More generally, there is a need to improve further the quality of the allocation and efficiency of spending, although in the run up to the elections in 2014 the near-term political environment may limit the likelihood of addressing fuel spending expenditures or limiting the growth of personnel expenditures. Failure to make such improvements in the medium-term could lower the growth outlook going forward and ability of the Government to meet its development objectives, notwithstanding the level of resources allocated.

34. Although Indonesia is relatively well placed to weather external shocks, it is also important to further improve preparation for a potential crisis through enhancing the range of instruments and policies available to deal with increased volatility and improving the resilience of its economy and public finances. Risks in the global environment remain high both from developments in the Eurozone, the fiscal cliff in the US and the uncertain impact of recent quantitative easing on commodity and emerging market capital flows. Indonesia remains well-positioned to withstand external real and financial shocks due to its continued strong economic performance and policies, low Government debt levels and significant reserves. Importantly, the 2013 proposed Budget retains a number of measures to deal with any future crisis situation that had been introduced in the 2012 Budget. Other elements of the Government's crisis preparedness has been the establishment of crisis management protocols and continent financing facilities with development partners to support financing of critical public expenditures in the event of an increase in market financing pressures. The World Bank PERISAI DPL-DDO operation, in addition to supporting short-term policy measures aimed at enhancing crisis preparedness, provides contingent budget support, which the Government intends to draw down only in the event of a significant worsening of the financing conditions. The Government has also secured additional contingent financing of around USD3 billion from the Government of Japan (Yen 120 billion), Australian Treasury (AUD$1 billion) and the Asian Development Bank (USD500 million).

D. 2. Structural challenges

35. Sustained progress on structural reforms can also play an important role in not only enhancing medium-term growth prospects but also in supporting the confidence of investors in the economy in the near term. A number of recent trade and investment policy measures or proposals have created a sense of rising protectionist policy making. The measures include, for example, restrictions on imported horticulture products, an export tax and new divestment regulations in the mining sector and proposals to limit single ownership in the banking sector. The objectives of these policies, such as moving up the value chain domestically and creating quality jobs, are not necessarily the concern but rather whether these policies are likely to achieve these objectives (and whether they may introduce distortions into the economy which, in the long-term, could be a drag on growth). In addition, the presentation of these policies, which is often changing and inconsistent, highlights coordination difficulties across ministries and limited consultation with stakeholders. In addition to their uncertain effectiveness, there is a risk that the continuation of such policies, or other perceived "policy missteps" could weaken some of the confidence of investors in domestic policy making (particularly in the run up to the 2014 presidential elections). Limiting further such missteps, along with a continuation of the Government's ongoing work on crisis preparedness will be important to maintain investor confidence in a fragile global environment.

36. Looking towards the medium-term, continued progress on policy reforms and key investments in infrastructure and skills development will be required if Indonesia is to move its potential growth rate up towards 7 percent and beyond. The continuation of recent growth rates of around 6.5 percent appear sustainable over the next few years, supported on the demand-side by rising incomes and domestic consumption, and on the supply side by Indonesia's demographic dividend and strong investment growth rates reflecting the attractiveness of the domestic market, commodity endowment and relatively low labor costs. However, sustaining such growth rates over the medium-term, or moving them higher, will require investments in infrastructure and addressing regulatory and investment climate constraints on businesses. For example, for 2014-2016 the 2011 IMF Article IV baseline potential growth rate is 7.1 percent, rising to 7.9 percent in an upside scenario in which infrastructure and structural reforms proceed faster than in the baseline but declining to 6 percent in a downside scenario in which infrastructure development proceeds slowly and there is little progress on structural reform. Private and public investment in infrastructure as a share of GDP, at around 4 percent in 2009, is still significantly lower than prior to the 1997/98 crisis. Infrastructure has been identified by the Government as a key constraint for growth, leading to large increases in budgetary allocations to the infrastructure sector as well as efforts to attract more private sector investment.

E. The Political and Social Context

37. From 2001 to 2010, Indonesia experienced a deepening and entrenching of democracy and a return to stable and strong economic growth. The beginning of the current administration's second tenure saw widespread public disenchantment with weak law enforcement and high-profile scandals involving the police and the attorney general's office. Yet despite political tensions within the Parliament, the coalition structure and consensus-oriented approach of the ministerial cabinet have been maintained. Policy-making continues to benefit from the reform-orientation and technocratic background of several key cabinet members as well as leadership from the President and Vice President. A cabinet reshuffle in the second half of 2011 saw some significant changes, including in the economic ministries, but the overall reform orientation of the cabinet has remained.

38. Political positioning can be expected to rise in 2012. Given that parliamentary and presidential elections are planned for April and July 2014, political tensions and positioning can be expected to rise again next year. This is likely to give rise to distractions that will make the Government's task of implementing institutional reform more challenging, particularly as coalition members may seek to disassociate themselves from controversial or popular reforms.

39. Some recent policymaking outcomes from the administration have tended to be protectionist, generating concerns over Indonesia's overall investment climate and commitment to reforms. For example, the issuance of a decree that will eventually eliminate foreign majority ownership of mines could increase the risk of regulatory capture by special interests, which in turn could undermine economic efficiency. Other controversial policy moves include: the banning of rattan exports to protect domestic furniture makers; restrictions on imports of horticultural products; and the tighter rules on establishing retail and restaurant franchises, in a bid to promote domestic businesses. This protectionist trend and the regulatory uncertainty that it creates could potentially expand to other sectors, especially if economic growth slows as a result of the accelerating global slowdown and also as political tensions build in the run-up to 2014.

40. Nevertheless, there have also been some notable successes in other policymaking. For example, very sound candidates have been appointed to the new leadership teams in the KPK and the General Election Commission (KPU), in addition to the commissioners appointed to the new Financial Services Authority (OJK). The administration also succeeded in passing a new Law on Land Acquisition Procedures for Public Interest Developments, along with the implementing Presidential regulation, which bode well for smoothing the way forward for land purchases for important infrastructure projects.

41. Progress in reforming the judicial and law-enforcement agencies continued to be slow. Recent cases of corruption highlighted the vast challenges in reforming the judicial and law-enforcement systems in Indonesia. These included allegations of corruption affecting most political parties, investigators conspiring with a corrupt tax auditor, senior police and Attorney General Office (AGO) personnel fabricating evidence against two Anti Corruption Committee (KPK) deputy-chairs, and police officials conducting suspicious financial transactions. Thus far, progress towards the resolution of these cases remains to be slow.

42. Instances of sectarian violence against minority groups highlight the need for the Government to strengthen efforts in upholding the laws concerning the freedom of religion. The past year has seen an increase in the number of instances of religious violence and intolerance.

43. Although the risks of terrorist attacks have much reduced in recent years, the threat remains. Following the spate of terrorist bombing and loss of life, mainly on Bali and Java since 2002, the authorities have made solid progress in neutering the terrorist networks in Indonesia.

44. Over the past decade there has been considerable progress toward gender equality in Indonesia, particularly in the area of education. However, persistent gender disparities remain. Maternal mortality rates remain relatively high for Indonesia's income level, and as in other countries, women's voices in the public domain remains weak. While Indonesia's female labor force participation rate increased from around 45 percent in 1980 to about 55 percent in 2008, it still remained below the 70 percent average for the region. Furthermore, women still earn less than men in all sectors, are more likely to work in the informal sector and are the majority of unskilled migrant laborers. Gender gaps in wages in the service, industry and agriculture sectors in Indonesia are among the largest in the region. The important socioeconomic variations in Indonesia are that urban educated women have higher returns than men with the same education, while women at the bottom end of the wage distribution (i.e. among the lowest educated individuals) face the biggest wage gap. Enterprise surveys also suggest that, within the same firms, women are more likely than men to be temporary workers – around 25 and 17.5 percent of women workers in exporting and non-exporting firms compared to less than 10 percent of male workers are on temporary contracts in Indonesia. While female-owned and managed enterprises are not inherently less productive, they tend to be less capitalized and operate in less remunerative sectors.

III. THE GOVERNMENT'S REFORM PROGRAM AND BANK SUPPORT

45. The proposed INSTANSI DPL is designed to support the Indonesian authorities' reforms to strengthen public financial management and enhance poverty alleviation and service delivery efforts, in light of the Government's ongoing program of wide-ranging structural and institutional reforms. The INSTANSI DPL focuses on a set of medium-term policy measures underpinned by a wide-ranging program of longer-term reforms that the Government has been implementing over the past decade. The World Bank has supported these longer term reforms through a range of programs, particularly through the ongoing DPL program since its inception in 2004. Key elements of the Government's longer-term institutional and structural reform program are outlined below, while the proposed INSTANSI DPL program is described in Section V.

A. Indonesia's Overall Development Agenda

46. Since the 1998 Asian financial crisis, Indonesia has come a long way in reinforcing economic stability and initiating structural reforms. Within the first five years after the crisis, overall stability was restored on both the macroeconomic and political front. Lacking the finances to undertake many needed investments, at that time the Government's initial focus was on fiscal consolidation and putting in place the basic legislative framework for the new Indonesian political setting. On the economic front, the focus was on restructuring the banking sector, which had collapsed as a result of the crisis, and on restoring the fiscal position of the Government. By the end of the first five years post-crisis, macroeconomic stability had been restored and the political arena had been stabilized. Thereafter, to prepare for the end of its IMF program, the Government issued a White Paper in September 2003 that outlined plans for macroeconomic and fiscal consolidation and a series of structural reforms to restore confidence in the Indonesian economy and boost investment. These plans were broadly maintained by the Government led by President S.B. Yudhoyono who came to power in late 2004, with the plans incorporated into the Medium-Term Development Plan RPJMN 2004-2009. Indeed, the history of fiscal prudence then provided the Government with the fiscal space needed to meet Indonesia's rising development challenges.

47. Upon taking office, the second Cabinet led by President S.B. Yudhoyono moved rapidly to announce its first 100-day action plan in early November 2009. The action plan included 15 priority program areas, 45 detailed programs and 131 specific action plans. The 15 priority areas were a mixture of reformist initiatives and conventional policy goals. In descending order of priority, these included combating legal mafias, revitalizing the defense industry, combating terrorism, electricity, increasing food production, production of fertilizer and sugar, land-use and spatial planning, infrastructure development, and climate change and the environment. Responsibility for monitoring progress rested with the head of the new Presidential Delivery Unit (UKP4). Although the 100-day action plan was relatively un-ambitious in terms of economic or institutional reforms, it appears to have been successful in achieving its objectives, with the monitoring unit UKP4 closely following progress on key Government priorities.

48. Also in February 2010, the Government unveiled its Medium-Term Development Plan (RPJMN) 2010-2014, which outlines the GOI's development programs and reform initiatives towards a more inclusive and equitable development. The new RPJMN lays out 11 national priorities including: (i) bureaucracy and governance reform; (ii) education; (iii) health; (iv) poverty reduction; (v) food security; (vi) infrastructure; (vii) investment and business climate; (viii) energy; (ix) environment and disaster management; (x) least developed, frontier, outer, and post-conflict areas; and (xi) culture, creativity, and technological innovation. Most programs under poverty reduction, education, and health are a continuation or expansion of the existing development programs, such as the integrated social assistance program including the national insurance system (Jamkesmas), scholarships for the poor, cash transfers (BLT), conditional grant assistance for poor households (PKH), School Operational Assistance (BOS), and the expansion of rural community development programs (PNPM Mandiri). Some new program priorities include constructing 19,000 km of highway across the five largest islands, increasing electricity generation capacity by 3,000 MW per annum, building transportation infrastructure based on the National Transportation System and Transportation Blueprint, introducing a single identity number to be applied by 2011, reducing the number of least developed areas by 50 districts by 2014, developing a national logistic system, and implementing an electronic investment license and information system. These new priorities reflect the Government's focus on infrastructure for the next five years.

49. With the target of increasing economic growth to 7 percent and reduction in poverty rate to 8-10 percent by 2014, the RPJMN 2010-2014 highlights the need for growth with equity and a range of cross-cutting policies to ensure that development is both sustainable and inclusive. Private consumption is projected to grow by 5.3-5.4 percent annually, while investment and exports are projected to rise annually by 9.1-10.8 percent and 10.7-11.6 percent, respectively. The emphasis of the RPJMN is on a strategy that is pro-growth, pro-jobs and pro-poor, with particular relevance for increasing investments in infrastructure and strengthening the pro-poor agenda.

50. Addressing gender issues has become a Government priority. The issuance of INPRES No. 3/2010, together with some ministerial regulations on gender budgeting and mainstreaming[2], signify the Government's serious efforts toward a more equitable development, involving women and children.

51. In May 2011, the Government launched its Masterplan for the Acceleration and Expansion of Indonesia's Economic Development 2011-2025 (MP3EI or "the Masterplan") as Indonesia's new, longer-term strategy to become an industrialized economy. The Masterplan goes beyond the five-year development plan and aims to boost Indonesia's economic growth to 7-9 percent during the coming decades, aimed at becoming one of the 10 largest economies in the world by 2025. It argues that such high growth levels can only be attained by structurally transforming the economy through higher levels of investments in priority sectors and especially infrastructure. The new MP3EI is based on three strategies: (i) *the development of six economic corridors*[3] aimed at fostering centers of growth by developing leading resource-based industrial clusters in each major island group.; (ii) *the strengthening of national connectivity*, strengthening connectivity and synergies between those centers of growth, including international connectivity; and (iii) *the acceleration of technological and R&D capacity*, to complement connectivity by improving human resources capabilities and increasing investments in research and development. According to the new MP3EI, these strategies will need to be supported by an improvement of Indonesia's investment climate, including its trade and investment policies.

B. Key Reform Directions Supported by the DPL

52. The proposed INSTANSI DPL continues to support the Government's development agenda. The overall goal of the DPL program is to help the Government achieve its development objectives, as outlined in the RPJMN 2010-2014. In particular, INSTANSI DPL supports the GoI's reform efforts in: i) strengthening public financial management; and ii) enhancing poverty alleviation and service delivery efforts. As explained in the introduction section of this program document, the INSTANSI DPL no longer covers the area of improving investment climate, which is being shifted to the Connectivity and FIRM

[2] These include MoF Regulation No. 93/ 2011 on ministry/agency work planning and budgeting that requires the provision of gender budget statement; Ministry of Home Affairs Regulation No. 67/2012 for gender mainstreaming; and Bappenas decree No.19/ 2012 on Steering and Technical Teams that are mandated with institutionalizing and accelerating gender mainstreaming in Bappenas.

[3] The six regional corridors are Sumatra, Java, Kalimantan, Sulawesi, Bali-Nusa Tenggara Timur (NTT), and Papua and Maluku.

DPLs. This section describes the key Government reform achievements and directions under the two pillars supported under the INSTANSI DPL.

B. 1. Public Finance Management

53. Since the *White Paper* in 2002, the Government has shown strong, persistent commitment towards building a modern public financial management (PFM) system. A new regulatory framework has largely been established.[4] Remarkable efforts have been made to improve business processes and systems throughout the entire budget cycle, including audit, legislative oversight and supportive civil service reforms. It has thereby addressed a multitude of risks related to capacity constraints, poor infrastructure, and weak governance across the PFM institutional and stakeholder landscape. In the medium to long term, it is expected that improvements in Indonesia's PFM systems will lead to better targeted and more flexible allocations of public funds to priority development needs and more efficient, transparent and accountable spending. This is fundamental to improving public service delivery and desired development outcomes.

54. The breadth and depth of PFM reforms over the relatively short period are commendable. Most notable include: the introduction of performance-based budgeting (PBB) and a medium-term expenditure framework (MTEF); the strengthening of monitoring and evaluation (M&E) systems; the development of an integrated budget and treasury system (SPAN); full implementation of a Treasury Single Account (TSA); strengthening of cash and debt management functions; development of accounting standards to provide for a 'full accrual' framework; an inventory and appraisal of Government assets and the introduction of a state asset management information system; the introduction of e-procurement systems and establishment of a new procurement agency (LKPP); and adoption of the COSO control framework and strengthening of external audit.

55. While progress has been substantial, and reforms are generally moving in the right direction, considerable challenges remains. Among others, reforms of Central Government budgetary systems to improve the policy orientation in budget formulation and execution need to be strengthened. The new budget and treasury system (SPAN) is expected to commence roll-out in 2013, which will necessitate some fine tuning of procedures and the underlying business processes at spending agencies need to be reengineered. Reform of the regulatory framework and implementation of e-Government procurement will continue in 2012, including the development of a permanent procurement management function in implementing agencies. Relevant and reliable financial reporting needs to be strengthened along with human resources in Government accounting and reporting. The COSO control framework needs to be fully implemented and the internal audit function strengthened. The Government's M&E capacity needs to be further enhanced to support the focus on getting better results, including with the move towards PBB.

56. Improving the performance of the tax system also remains a key part of the medium-term reform objectives. The Government's medium-term plan is to further increase tax revenue from its current low level of around 12 percent of GDP, to around 15 percent (closer to the non-OECD regional average).[5] This is well within the estimate of an additional 2-5 percentage point of GDP that could be collected through better coverage and improved compliance.[6] Given that tax policy has already been simplified and rates are broadly in line with regional comparators, this is to be achieved through the implementation of the next stage in the reform of tax systems and administration. The first phase of tax reform—which focused on modernizing tax offices, improving governance, and strengthening the legal framework—was largely completed by 2009. The Directorate General of Taxes (DGT) has restructured, moving from a "tax type" to a functional organization with a field office network targeted to specific taxpayer segments—i.e. large,

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[4] The most noteworthy laws issued include the State Finance Law No. 17/2003, the State Treasury Law No. 1/2004 the State Financial Audit Law No. 15/2004 and the Procurement law (54/2010).

[5] The MOF has a more ambitious medium-term target of 18 percent of GDP for tax revenues.

[6] International Monetary Fund, 2011, Indonesia: Selected Issues, *Revenue Mobilization in Indonesia*, September 2011.

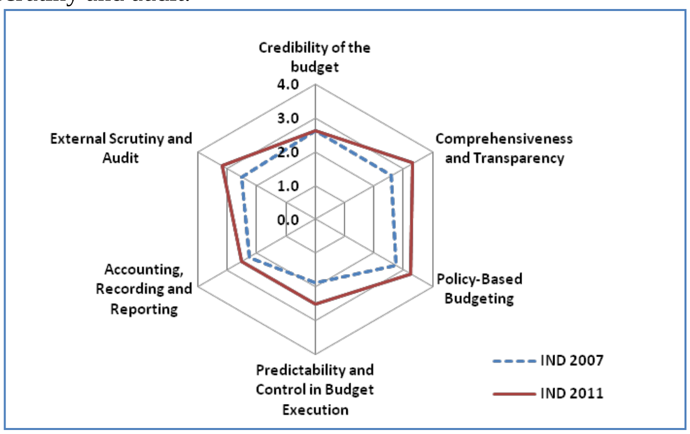
medium, and small taxpayer offices in addition to one High Wealth Individuals unit. To improve governance, DGT introduced new corporate values, a code of conduct, a whistleblower system and established an internal compliance unit. Key achievements also include strengthening the legal framework for taxation through amendments of the three main tax laws.[7] These have improved the balance between taxpayer rights and the authority of the tax administration, reduced corporate and personal income tax rates, and revised the list of exempt and zero-rated goods and services for VAT.

57. Overall, public financial management reforms are technically complex and involve enormous amounts of data, new procedures an ICT systems and people. The sheer size of Indonesia, the scope of its Central Government PFM systems (covering 29,000 spending units), the number of involved stakeholders, and the ambitious nature of its envisaged reform agenda make PFM reforms a particularly challenging undertaking that will continue to require significant amounts of expertise, coordination, capacity building and sequencing. However, the Government has shown continued commitment to complete the planned reforms, through the development of annual and medium-term plans and strategies that ensure the proper phasing and coherence of reforms — for example, the Government produces an Annual Strategy Note that coordinates support for the GoI's reform program, in part through a Bank administered multi-donor trust fund for PFM. The Government's strategy is also informed, and adjusted, by considerable analytic work that helps to prioritize and sequence the reforms (see Box 1).

[7] These include the enactment of the amended General Taxation Provisions and Procedures Law No. 28/2007, which strikes a better balance between the rights and obligations of taxpayers and the powers of tax officials, an issue of longstanding concern to the business community; the Income Tax Law No. 36/2008, which reduces corporate and personal rates, simplifies administration and increases legal certainty; and a law recognizing electronic signatures, which clears the way for initiatives such as electronic registration and filing of tax returns.

Box 1: Analytical Underpinnings for PFM Reform Support

Indonesia's proposed public finance reforms address the findings and recommendations of recent assessments, including those of the World Bank. Starting in 2001, the Country Financial Accountability Assessment identified weaknesses in the country's accounting standards and systems as significant hurdles in the improvement of the governance and accountability environment in the country. New accounting standards have been implemented across the Government agencies since 2003, involving the development of new accounting systems and procedures, a move from single entry to double-entry accounting and the adoption of a new chart of accounts. A repeat assessment of the Public Expenditure and Financial Accountability (PEFA) was also conducted in 2011, following a first assessment in 2007. The results showed that Indonesia has made steady progress in strengthening the quality of its Public Financial Management (PFM) systems and processes, and continues to inform the prioritization of ongoing reforms. The chart below compares the average PEFA ratings for each of the six main categories of the budget cycle. Substantive improvements were made in five of the six categories, namely: the comprehensiveness and transparency of the budget, policy based budgeting, predictability and control in budget execution, in accounting, recording and reporting, and in external scrutiny and audit.



Note: The Chart shows the simple average of the PEFA ratings in each category, with a maximum rating of 4 for an 'A' and 1 for a 'D' and half a point is given for a '+".

The self-diagnostic assessment conducted by the National Public Procurement Office (NPPO) in 2007 using the Base-Line Indicators (BLIs) tool, presented a "snapshot" comparison of the actual system against the international standards. The baseline benchmarking of Indonesia's procurement system showed it scored 62.5 percent for the "Legislative and Regulatory Framework" (PILLAR I*)*, 55 percent for the "Institutional Framework and Management Capacity" (PILLAR II), 59.3 percent for the "Procurement Operations and Market Practices" (PILLAR III) and 69 percent for the "Integrity and Transparency of the Public Procurement System" (PILLAR IV), in comparison with recognized international standards. Since 2007, it is expected that there will be improvements on some of the indicators of Pillars I and II with the establishment of LKPP and ongoing reforms. In 2012, the Bank is also conducting a survey of procurement at the subnational level, to identify weaknesses and constraints.

The first phase of the tax administration reform effort has also generated tangible results. The IMF estimated that administrative improvements accounted for over half of the 1.1 percentage points of GDP increase in tax collection over the period 2002–2006 (Brondolo et al. IMF WP/08/129, 2008). Investment climate surveys conducted by the University of Indonesia reveal that the compliance costs for filing returns, obtaining VAT refunds, and customs clearance have improved since 2005–2007 (though not on the "Doing Business" surveys). The Tax Office has also shown consistent improvement in the Corruption Perception Index score, measured by Transparency International Indonesia (TII) every two years. In 2010, the TII's Bribery Index, which measures corrupt interaction with the public service, placed the national tax administration as the lowest (best) among all government institutions. Nonetheless, the IMF recently estimated that an additional 2-5 percentage points of GDP could be collected "based on broadening the tax bases and increasing compliance" (IMF, 2011, Indonesia: Selected Issues).

58. The World Bank uses a number of instruments to support the Government's PFM reform agenda. The DPL helps to reinforce the Government's ownership of and commitment towards the achievement of reform milestones. Through the Government Financial Management and Revenue Administration Project (GFMRAP), the Bank is also providing support to design and implement the aforementioned IFMIS solution, SPAN, which has involved a comprehensive reengineering of business processes, institutional reform and change management. Implementation of SPAN is expected to significantly improve the timeliness, reliability, integrity and transparency of budget spending and reporting. As a cross-cutting reform, it should also enhance the capability of managers to efficiently manage service delivery. The Public Financial Management - Multi Donor Trust Fund (PFM-MDTF) provides additional resources to support critical activities to keep the reform agenda on track together key development partners — the European Commission, the Governments of the Netherlands and of Switzerland, USAID and the World Bank. The Bank also supports the tax reform agenda through the Project for Indonesian Tax Administration Reform (PINTAR) that aims to increase the efficiency of taxpayer data collection and management, improve tax administration human resource management, strengthen tax audit and collection functions and implement a comprehensive change management process.

B.2. Poverty Reduction

59. Despite strong economic growth and falling poverty in the last decade, many households that continue to live on the edge of poverty. The last decade in Indonesia has seen a return to strong economic growth, and the poverty rate has fallen from 23.4 percent in 1999 to 12.5 in 2011. Sustained economic growth contributed to this success by creating more jobs and increasing public expenditures for health, education and infrastructure. Not seen in the falling overall poverty rate, however, is the persisting high degree of vulnerability. Much of the Indonesian population is clustered just above this line; around 25 percent live below the official near-poor line of 1.2 times the poverty line, and 40 percent below 1.5 times the poverty line. Living standards remain low for many Indonesians not in poverty, and relatively small shocks to their income and consumption can send them into poverty. Consequently, around half of the poor this year will not have been poor last year; that is, they are newly poor. [8]

60. Female-headed households (FHH) in particular experienced much more volatile poverty rates than the male-headed households (MHH). While poverty rates for female-headed households (FHH) and male-headed ones (MHH) experienced a similar reduction over the 2000s, the FHH poverty rate was much more volatile than the MHH rate over the first half of the decade. This suggests that FHH interact with labor markets differently to MHH, face different risks to income and consumption, or have differential access to coping mechanisms and are less able to smooth consumption when shocks occur. Despite tangible progress (e.g., gender parity in enrollment rates at all levels of education), persistent gender disparities also remain. Maternal mortality rates remain relatively high for Indonesia's income level and women's voices in the public domain remains relatively weak. While Indonesia's female labor force participation rate increased from around 45 percent in 1980 to about 55 percent in 2008, it still remained below the 70 percent average for the region. Furthermore, women still earn less than men in all sectors, are more likely to work in the informal sector and are the majority of unskilled migrant laborers. Further, Indonesian women are disproportionally more excluded from formal financial services than men. The World Bank Access to Finance Survey 2010 and Migrant Worker Survey found that women are less likely to borrow, and when they do so, they are more likely to borrow informally.

61. Indonesia introduced a range of national poverty reduction programs to protect poor and vulnerable households from shocks. In response to the East Asian financial crisis, the Government

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[8] Further analysis and discussion on the nature of poverty and vulnerability in Indonesia, and the effectiveness of social assistance programs in addressing them, can be found in recent World Bank's major reports (2012), *Targeting the Poor and Vulnerable in Indonesia*, and *Protecting the Poor and Vulnerable in Indonesia*..

established a broad safety net (*Jaringan Pengaman Sosial*, JPS) and introduced large commodity price subsidies (*Operasi Pasar Khusus*, OPK). The JPS consisted of temporary, short-term programs including public works (*Padat Karya,* PK), scholarships and funding for health services. A second generation of social assistance programs was then introduced following the partial removal of regressive fuel subsidies in 2005. A portion of the savings from the subsidy cuts were reallocated to four programs: operational aid to schools (*Bantuan Operasional Sekolah*, BOS), health insurance for the poor (*Asuransi Kesehatan Miskin*, Askeskin), village infrastructure (*Infrastruktur Pedesaan*, IP) and rice for the poor (*Beras Miskin*, Raskin). Later, the Government also introduced a temporary unconditional cash transfer (*Bantuan Langsung Tunai*, BLT) to help poor and near-poor households cope with the inflationary shock caused by the fuel subsidy removal.

1. These programs evolved into the current range of national programs that are part of the Government's poverty reduction strategy. The strategy is articulated around the following three main clusters:

- *Cluster I* consists of household-based social assistance programs that target poor and vulnerable households and individuals. This collection of programs includes: Jamkesmas (Jaminan Kesehatan Masyarakat), health service fee waivers: Raskin, a subsidized rice distribution; and Beasiswa untuk Siswa Miskin (BSM), a collection of programs that provide cash transfers for poor students. It also includes a newly piloted conditional cash transfer program (Program Keluarga Harapan, or PKH).
- *Cluster II* covers poverty-reduction interventions at the community level. This cluster predominantly consists of the National Community Empowerment Program (Program Nasional Pemberdayaan Masyarakat Mandiri, or PNPM-Mandiri), which was scaled up nationally between 2007 and 2010, providing block grants to rural and urban sub-districts that support community-level development projects.
- *Cluster III* includes initiatives that aim to expand economic opportunities for low-income households by improving access to credit for micro- and small- and medium-sized enterprises, such as the development of a National Strategy for Financial Inclusion and scaling up the Kredit Usaha Rakyat (KUR) program.

62. The Government is committed to accelerating the pace of poverty reduction over the upcoming five years. Since the 2009 elections, there has been renewed commitment by the Government to intensify policy reforms that support poverty reduction and improve the effectiveness of national poverty reduction programs. The President declared poverty reduction to be one of the highest development priorities for Indonesia. The RPJMN 2010-2014 highlights the Government's aim to lower the poverty rate to 8-10 percent by 2014. The President's triple-track development strategy (pro-growth, pro-jobs and pro-poor) will reduce poverty by strengthening economic growth, stimulating job creation, and deepening investments in its poverty reduction strategy.

63. To improve the effectiveness of the national poverty reduction strategy, overall oversight and coordination responsibilities have been elevated to a cabinet-level team led by the Vice President. The Government has taken its first step to implement the national poverty reduction programs across all clusters by elevating the overall oversight and coordination to a newly created National Team for the Acceleration of Poverty Reduction (*Tim Nasional Percepatan Penanggulangan Kemiskinan*, or TNP2K). The Vice-President chairs the TNP2K, which includes all Government agencies responsible for the planning, financing and implementation of poverty reduction programs. It is responsible for implementing the main poverty reduction strategies outlined in the RPJMN 2010-2014, which include: (i) integrating the family-based programs into the family-based social assistance system and expanding coverage for main social assistance programs; (ii) scaling-up the PNPM-Mandiri from Rp 9.3 trillion in 2009 to Rp 11.9 trillion in 2012; and (iii) expanding the coverage of KUR and improving its distribution mechanism. To support these strategies, the Government is identifying reforms that will enhance the delivery and effectiveness of its poverty reductions programs and maximize the impact of increased funding on the most vulnerable segments of society. These include institutionalizing program assessment and improved governance accountability, developing good systems to measure poverty and target poor households and regions, and empowering Local Governments, communities and service providers to deliver quality services.

Box 2: Analytical Underpinnings for Service Delivery Reform Support

World Bank analytical reports, including *Making the New Indonesia Work for the Poor*, have found that even though Indonesia has made progress in reducing poverty many people remain poor and vulnerable. Sustained economic growth has helped more Indonesians escape poverty, by creating more jobs and increasing public expenditures for health, education and infrastructure. Indeed, the poverty headcount has fallen from 16.7 percent in 2004 to 13.3 percent in 2010. Yet despite these gains, there are still 32.5 million Indonesians who currently live below the poverty line and approximately half of all households remain clustered around the national poverty line (Rp 200,262 per month). The gap between the poor and non-poor is also widening. The Gini coefficient, a measure of consumption inequality, has increased from 0.32 percent in 1999 to about 0.37 percent in 2009 and regional disparities also persist with eastern Indonesia lagging behind other parts of the country, notably Java.

The reduction in poverty rate has been slower than expected, partly because there are not enough opportunities for poor workers to move into better jobs in the formal and non-agricultural sectors. The Bank recently completed the *Indonesia Jobs Report*, a comprehensive analytical overview of the labor market over the past 20 years. The report finds that the majority of Indonesia's working population of 104.5 million is concentrated in the agricultural and informal sector. Formal employment grew at an impressive rate of 1.2 percentage points per year from 2003 until 2007. Formal sector employment for the poor increased by only 0.8 percentage points and remained roughly constant for the near-poor. Those who entered the formal sector faced dropping wages.

Household-based social assistance programs play an important role in the Government's strategy to reduce poverty. In 2012 the Bank released *Protecting Poor and Vulnerable Households in Indonesia*, a comprehensive household social assistance public expenditure and program review, to provide an evidence base for program and policy reforms. The report provides three key conclusions. First, spend better to achieve a more optimal mix of welfare-improving programs, by scaling up or institutionalizing cost-effective programs, rationalizing those that deliver too little at too high a cost, and re-engineering programs that are struggling to deliver benefits to those most in need, as well as improving access to services. Second, as reforms are implemented, spend more on cost-effective programs and remaining gaps. Indonesia's strong fiscal position makes this increase affordable**.** Finally, develop a long-term reform roadmap to establish and sustain a comprehensive social safety net. This may involve consolidating programs under a single system and transforming agencies to accelerate poverty reduction and protect the vulnerable.

The Bank also released an analytical report on *Targeting Poor and Vulnerable Households in Indonesia*. The research found that while the poorest households are most likely to receive program benefits, many are excluded while many non-poor households participate. Less than half of the poorest 40 percent of households receive BLT and Jamkesmas (1st and 2nd quintile), while many non-poor also benefit from programs, with a quarter to a fifth of total benefits going to the richest 40 percent. While over 70 percent of the poorest 40 percent receive Raskin, high population coverage levels are due to sharing the rice among many non-poor households as well as poor, resulting in a substantial dilution in benefits to each household. The report recommends that Indonesia develop a National Targeting System (NTS), featuring a beneficiary registry, which could improve targeting effectiveness and ensure program satisfaction and acceptance.

64. The Bank uses a number of instruments to support the Government's poverty reduction goals. Starting in 2010, a multi donor trust fund initially supported by AusAID was established to support the Government in making informed and evidence-based decisions about poverty reduction policies and for programs, as well as to build the analytical capacity of local universities and think tanks for research and assessing poverty-related issues. This Partnership for Knowledge-based Poverty Reduction (PKPR) uses a three-pronged strategy in its engagement with the Government that focuses on: (i) providing poverty analytics and building analytical capacity to inform poverty and social protection policies, programs and strategies; (ii) supporting the Government in the design, implementation and evaluation of key poverty and social protection programs; and (iii) improving the quality and accessibility of data needed for poverty analysis and policymaking. Since 2005, the Bank has also been using the DPL series to support Government reforms aimed at improving poverty reduction outcomes.

65. The Bank also manages a multi donor support facility that provides technical assistance and strategic oversight for the National Community Empowerment Program (PNPM-Mandiri). The facility pools together grants provided by the Governments of Australia, Denmark, the Netherlands, the United Kingdom, the United States of America and the European Commission, to help the Government to achieve its goal of providing PNPM block grants to all 70,000 villages in the country, at a cost of USD1 billion a year. Grant funding provided through the PNPM Support Facility is used to build Indonesian capacity for large-scale poverty reduction, with the aim of making the program a sustainable operation. Capacity building programs supported by the facility engage a broad range of partners, including national and Local Governments, universities and research centers, civil society organizations and grassroots initiatives. The facility supports a number of pilot operations to test innovative ways to support communities in reaching MDGs, to make community projects more environmentally sustainable, or to work through civil society organizations (CSOs) to reach the most vulnerable.

C. Other Related Reform Priorities and Areas of Development

66. Outside of the main pillars of reform covered by the DPL, there are two major areas of reform in which the World Bank is also involved that are relevant to the success of this DPL series. These are civil service/bureaucracy reform and decentralization. The Government is actively addressing the challenges of reform in these areas, with support from development partners.

C. 1. Civil Service/ Bureaucracy Reform

67. Strengthened PFM systems and poverty alleviation programs will not by themselves resolve the weaknesses in the implementation of public policies. Delivery also depends on improving the institutional capacity and capability of the public sector, and in recognition of this the Government placed Bureaucracy Reform as the first priority of the RPJM 2010-14. The MoF has been at the forefront of such reforms for some years. More generally, the President approved a Grand Design and Roadmap for Bureaucracy Reform (BR) in late 2010 and the President's Monitoring Unit (UKP4) and a BR Steering Committee, chaired by the Vice-President, are closely monitoring progress. By 2012, some 52 ministries and central agencies (K/Ls) are anticipated to be implementing BR, with the goal of all 76 K/Ls implementing BR by 2014.[9] A new M&E self-assessment system for BR has been rolled out in 2012, under the Ministry of State Administration Reorm (MenPan) that will include a public dashboard measuring the BR progress of all K/Ls. The Government also announced a moratorium of the (net) recruitment of civil servants nationally, from September 2011 to December 2012, and a draft Civil Service Law (ASN) has been endorsed by the Parliament, which could lay the foundations for modernizing the civil service.

C.2. Improvement of the Decentralization Framework

68. With the 'big-bang' decentralization of 2001, Indonesia went from being one of the most centralized countries in the world in administrative, fiscal and political terms, to one of the most decentralized; but the transition is far from complete. While some surveys show an improvement in satisfaction with local service delivery, significant challenges remain. Overlapping responsibilities without a coordinated decentralization framework prevent effective service delivery, and Sub-national Government accountability and transparency mechanisms are weak. Much central funding devolved to the sub-national entities — at around 30 percent of budgets — is spent on personnel's salary and other administrative costs, reducing the incentive to address civil service costs. While the Special Allocation Fund (DAK) has been growing rapidly, the Government's strategy for using this important instrument is unclear. Unlike most decentralized countries, Indonesia has just started transferring very limited tax powers to Local Governments, which in general still distorts incentives and creates unhealthy dependence on transfers from

[9] The Government has also announced the first pilot and then role out the BR to all 33 provincial and 491 city/district authorities.

the center. Meanwhile, many Local Governments misuse revenue-raising authority that constrains business development and trade compromising the investment climate. Given the important role of Sub-national Governments in public investment, particularly in the infrastructure sector where the needs are great, amending the law on sub-national government taxes and fees, as well as reforming on-lending and on-granting regulations, is urgent. Most regions also need to improve technical capacity to implement reforms.

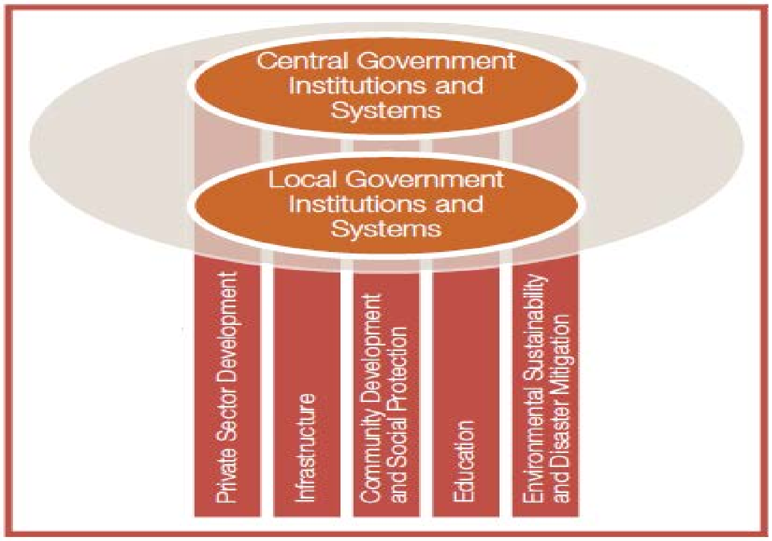
69. To support the decentralization reform and Local Government agenda, the Bank, together with development partners, will continue to improve the environment within which Local Governments operates. After the closing of Decentralization Support Facility (DSF) in early 2012, the Bank has continued its on-going support by providing resources and coordination for both central level agencies and Local Governments around analysis and critical capacity building through various programs and activities. Beginning in 2010, the Bank has provided resources and assistance to improve the special assistance grants (DAK), with an initial emphasis on enhancing accountability and reporting of grants to infrastructure sub-sectors within pilot Local Governments. World Bank programs also work directly with Local Governments to enhance capacity and improve financing in districts across Indonesia, including through the Initiative for Local Government Reform (ILGR) and the Urban Sector Development and Reform Project (USDRP). Both aim at changing governance behavior in the context of decentralized public service delivery by targeting reform minded Local Governments and encouraging increased accountability through citizen participation. In addition, the Public Expenditure Analysis and Capacity Harmonization (PEACH) program carries out Public Expenditure Reviews designed to better inform spending decisions at the local level. PERs have been completed in 10 provinces with Local Governments working closely with local academic institutions and local stakeholders to improve policy and analytical capacity, , including on gender analysis in expenditure review.

IV. BANK SUPPORT TO THE GOVERNMENT REFORM PROGRAM

A. Links to the 2009-2012 Country Partnership Strategy

70. The proposed INSTANSI DPL supports the emphasis of the CPS on strengthening Indonesia's institutions and systems, a key cross-sectoral engagement theme (Figure 5). As highlighted in the 2009-2012 Country Partnership Strategy Progress Report (CPSPR), issued in February 2011, the DPL series continue to be at the center of the Bank's support for strengthening Indonesia's Central Government institutions and systems. The CPSPR recognizes that the DPLs have helped the Government's efforts to improve the effectiveness and accountability of Central Government institutions and systems under the long term objective of enhancing public financial management and governance to increase the development impact of priority budget expenditures. Underpinned by advisory and monitoring work, as well as institutional capacity-building in collaboration with other development partners, DPLs have also supported key reforms in the areas of private sector development, community development and poverty alleviation. According to the CPS, this current generation of DPLs is expected to build on strong relationships with the reform-minded economic ministries and continue to support the Central Government in strengthening effectiveness of its institutions and systems. This includes efforts to promote more efficient public expenditures, strengthen tax administration, enhance the overall business climate and strengthen poverty alleviation and service delivery.

Figure 5: 2009-2014 CPS core engagements



B. Relationship to Other Bank Operations

71. The Bank is supporting the Government's reform agenda using mutually supportive instruments. While with the DPL series the Bank supports the Government's ownership and commitment towards the achievement of reform milestones, with other technical assistance and financing instruments it supplements that support through the necessary advisory, human and financial capacity to carry out the reforms. Projects such as the GFMRAP and PINTAR, directly reinforce changes to the underlying institutional, incentive and organizational frameworks for core functions of the MoF and other related institutions, including fiscal-policy formulation, budgeting, treasury, internal audit, procurement, revenue dispute resolution and legislative oversight.

72. The DPL series support to the reform of Government institutions and systems directly contributes to the effective implementation of the other investment lending operations in the country. The reform of PFM systems seeks to address some of the core problems faced in the delivery of key investment in social sectors. Examples include the unpredictable release of funds and cumbersome budget adjustments. The DPL will also complement efforts being undertaken through the Connectivity and FIRM DPLs, by increasing the transparency and efficiency of the Government's spending and strengthening inter-governmental fiscal relations and reforms that foster accountability.

C. Collaboration with Other Development Partners and the IMF

73. The proposed INSTANSI DPL is being prepared in collaboration with the Government of Japan (GoJ) / the Japan International Cooperation Agency (JICA). The Asian Development Bank had in the past provided parallel financing to the DPL. Harmonization around the DPL has allowed the World Bank, the ADB and the GoJ/JICA to build upon the natural synergies and complementarities that exists across their respective portfolios. The DPL program has also provided a solid foundation to deepen the harmonization agenda in Indonesia with other development partners around this or other initiatives and programs.

Table 5: Development Partner Contributions to DPL Operations

Operation	World Bank	Government of Japan / JICA	Asian Development Bank	Total
DPL 1	300	100	–	400
DPL 2	400	100	200	700
DPL 3	600	100	200	900
DPL 4	600	200	200	1,000
DPL5	750	100	200	1,050
DPL6	750	100	200	1,050
DPL7	600	100	200	900
DPL8	400	100	-	500
INSTANSI	300	TBD*	-	TBD*
Total	**4,700**	**TBD**	**1,200**	**TBD**

**To be determined*

74. The collaboration extends well beyond the co-financing arrangements. Japan provided USD100 million for the first three operations, and last four operations and USD200 million for the fourth. A further contribution from the GoJ/JICA, is expected for INSTANSI DPL. The Asian Development Bank (ADB) also provided parallel financing of USD200 million for each of DPLs 2-7. Both development partners have worked with the Bank on joint preparatory work, the drawing up of common policy stances and reaching common agreement on the fulfillment of triggers, monitoring progress on overall program implementation, achievement of medium-term objectives and the selection of policy actions in collaboration with the GoI.

75. The contribution of the GoJ/JICA has intensified in the PFM area. The technical assistance and support that JICA has provided over the years to Indonesia, as well as numerous Japanese companies, has provided a rich source of analytic information and substantive direction to the reform agenda in the PFM, tax, and investment climate areas. JICA currently provides technical assistance support to Bappenas and DGT, on the development of a performance-based budgeting system and HR in tax administration respectively. The DPL process also provides a forum for discussions between the GoJ/JICA and the GoI.

76. Other development partners were also engaged in policy dialogue on different areas of the INSTANSI DPL. Other development partners such as the European Commission and the Australian Government have participated as observers during the joint consultation session with the GoI. This has helped ensure that the various reforms supported through the policy dialogue of the DPL series complement and are reinforced by other development partners' programs. Underpinning the policy dialogue is advisory technical assistance (TA) that the Government has drawn upon. Further, there continues to be synergies between the DPL and bilateral support provided by donors through trust funds. For instance, the PFM MDTF complements the DPL policy dialogue, supports some of the PFM-related institutional reforms and closely complements the ongoing GFMRAP and PINTAR projects.

77. The Government continues to welcome the development partners' harmonized approach. GoI counterparts have appreciated the donor harmonization, which led to a notable reduction in the transaction cost of policy dialogue. Moreover, donor harmonization around the Government's own program has bolstered country ownership of the reform process and has helped change the nature of the relationship with these donors to one of a reliable partnership.

78. The IMF has also been closely involved with the overall operation. The IMF and the World Bank in Indonesia continue to consult regularly on macro and sectoral issues, and the Bank coordinates closely with the Fund in its missions. In addition, the Bank, the Fund and development partners have worked closely on the PFM agenda and the DPL's indicative triggers have been developed in close coordination. The DPL has thus provided a platform to push the reform agenda in these crucial areas where both institutions are working.

D. Lessons Learned from the previous Development Policy Loan (DPL) Series

79. Important lessons have been learned over the course of the core DPL and IDPL series, which are relevant for the INSTANSI DPL. These lessons stem from the nature and evolution of the relationship between the Bank and the Government, and also from the characteristics of the DPL program as a means of offering policy support, together with the changing policy environment on the ground. Some of the lessons may be particular to the Indonesian case because of the broad scope and depth of the Bank's engagement with the Government, supported by a range of resources that include significant donor trust funds. As highlighted in the Implementation Completion and Results (ICR) Report for DPLs (7-8), Indonesian DPLs benefit from a large field team presence that is actively engaged with the Government through various other instruments in addition to the DPL. The socialization on both sides is deep and the processing has become standard. As a result, although the task team leaders for the DPLs change, the lessons learned from previous DPLs are seamlessly incorporated into future operations, and the series has become more mature and efficient. The following lessons are particularly worth highlighting:

- **Lesson 1: The application of a set of basic principles has contributed greatly to the successful implementation of the Indonesian DPL series.** Based on earlier experiences processing the DPL series, the Bank team had outlined a few principles to guide them when selecting policy areas and prior actions. First, there has to be a robust engagement and relationship with key high-ranking counterparts who were "champions" of reform, had reasonably well-defined agendas, and the authority to advance their agenda, thereby ensuring strong government ownership and execution of the reforms. Second, the GoI counterpart has to see some value to adding some element of their reform agenda or work program into the DPL process and would therefore make the time and reform commitment to participating process. Third, there also had to be a champion on the WB side for including the reform in the DPL process, which incentivized staff to engage in the DPL if it was in parallel support to their work program. These three basic principles ensured that the prior actions would be actively monitored by both sides for completion in a timely way.

- **Lesson 2: For a mature DPL series, a broad program scope limits the breadth of the reforms that can be taken.** Given the coordinating nature of the DPL program across the three distinct pillars, in order to keep it operational, the number of implementing agencies engaged has to be kept limited. This in turn affects the policy areas and actions that can be selected. Also, as the key value of the DPL process is in elevating reforms — a broad DPL is kept manageable by limiting the number of reforms selected. Therefore to deepen the reform agenda it makes sense to move to a sectoral DPL, which will allow involving a broader set of institutions and increase the number of reforms in the policy area. This approach will maximize synergies across the Bank's program in Indonesia, increase ownership of the related policy reforms by the relevant institutions, and improve targeting of complementary technical assistance programs. A similar action was done in the first DPL series, when the infrastructure component was spun out into its own DPL series, this allowed the management of the DPL for PREM related actions to be set in the core DPL and the infrastructure-related items to rest with the SD team.

- **Lesson 3: The splitting of the DPL series is a positive reflection that the value of the DPL series extends beyond the financial disbursements**. Although the new DPL series will provide a combined financing similar to the core DPL series, the government's willingness to invest more of their time to process three DPL highlights the benefits gained from the DPL process. DPLs have provided a convening forum for the various units within the government, but also within the Bank, to discuss reform priorities, progress, and cross-agency issues, e.g. M&E. Development partners, even with no financial involvement in the DPL, have attended the DPL meetings as a useful means of gauging the priorities and issues in the Government's reform agenda.

- **Lesson 4: The DPL series can serve as a useful incubator to test out new reform agendas and counterparts.** The DPL has served as a tool to test out reform agendas, like the connectivity, education and finance agendas, to test whether or not a counterpart champion would be able to drive future reforms through the DPL process. In these cases one or two prior actions (or sometimes just benchmarks) would be selected, the new institutions socialized to the DPL process, and this experience helps guide future program support.

- **Lesson 5: A gradual approach should be taken when working with newly created institutions.** In the case of DPL-7, there was a great sense that the creation of the new task force TNP2K would help energize the policy reforms areas of Pillar 3 and an ambitious reform agenda was envisioned. However, there were complications in the relationship between TNP2K and Bappenas that contributed to a complex environment for achievement of the prior actions. Moreover, it also served to distract from other poverty reform areas that the Bank and Bappenas/TNP2K were working on, as more time was spent resolving DPL issues. Therefore, although Pillar 3 was an established reform area, and both government counterparts had committed champions, it would have been better to have gradually introduced the reform agenda to test out the political dynamics of the two units.

Other lessons are:

- **Lesson 6: Strong Government ownership and committed counterparts are vital, but just as important is ownership over the pace of the reform process**. As a growing middle-income country, Indonesia can access domestic and international capital markets, thus offering it a range of financing choices. While the Bank's financing is attractive, the driving reason for the Government's engagement with the Bank through the DPL program is the utility of the instrument in bolstering, locking in and accelerating critical reforms. To succeed, DPLs not only need the commitment of Government at the highest level but also that of mid-level officials responsible for implementing the reforms and following progress on a daily basis.

- **Lesson 7: Reflecting on the previous IDPL series, on going Bank collaboration with counterparts and support from high-level on policy dialogue are crucial for the success of DPL operation**. Such level of Government support also helps increase commitment from the mid level officials responsible for delivering the policy reforms. Finally, constant dialogue between the Government and the Bank is fundamental and is best facilitated by a strong field presence across sectors which views policy discussions as a natural part of ongoing support.

- **Lesson 8: As in IDPL and other DPL operations, progress on institutional reforms need not be linear and there should be sufficient flexibility for modifications and increased complexity as the reform program evolves**. Institutional reforms that involve changing the way the Government works, especially in the face of entrenched interests and organizational cultures, are complicated, often unpredictable undertakings for which there are no simple recipes. What is needed in this context is commitment to reform, a continued sense of urgency, and preparedness so that when the right opportunity presents itself, reforms that had otherwise been apparently slowed, may be advanced rapidly. This approach can allow for progress through incremental reform.

- **Lesson 9: DPLs are only one instrument among many that are available in a multi-faceted engagement, and the choice of instrument should be contingent on the issue, the political context and the institutional circumstances**. This is related to Principle 3 of the Good Practice

Principles on Conditionality but is particularly applicable in the Indonesian case because of the size and scope of the World Bank program here. The Bank program in Indonesia is one of the largest of any country in terms of number of staff and overall resources. Large teams are working closely on a daily basis with Government counterparts on a wide range of issues from public financial management and trade and investment, to finance, public expenditures and poverty. In this context the DPL is not the only instrument for supporting reform, but one of several important tools including analytical work, knowledge sharing, and technical assistance.

- **Lesson 10: Policy based operations provide an important instrument to convene policy makers, policy implementers, donors and others stakeholders for ongoing dialogue on sector issues.** As highlighted in the previous IDPL operation, across the board, and particularly in the areas of PPP, the water sector, and land acquisition, the convening power of the program was important to integrate related programs and foster peer learning among unrelated activities. The land working group successfully brought a complex land acquisition law to Parliament through an "action plan" developed by the inter-ministerial working group (as part of IDPL). Cross-fertilization across sectors took place in the case of Output Based Aid (OBA). The water sector's success demonstrated to the road sector how OBA could be applied to road maintenance.

V. THE PROPOSED OPERATION

A. The INSTANSI Development Policy Loan

80. The proposed USD300 million INSTANSI DPL marks the beginning of a new series of annual single tranche DPLs. The previous DPL series had focused on improving the investment climate, strengthening PFM and enhancing poverty alleviation and service delivery efforts. As noted earlier, the INSTANSI DPL is being restructured in light of the two other DPLs that are also under preparation, Connectivity and FIRM DPLs, and focuses on the PFM and poverty alleviation and service delivery pillars. The focus on these two core areas is underpinned by the rationale that strengthening PFM is essential for enhancing government effectiveness and governance, particularly in a more deconcentrated fiscal and political environment, and enhancing service delivery and poverty alleviation efforts is essential if Indonesia is to bring about more broad-based improvements in welfare for its people. The two pillars are therefore complimentary. Progress achieved under the previous DPL series has been satisfactory overall, which warrants the continued program support through this INSTANSI DPL, through the following prior actions:

Table 6: Prior Actions for the Indonesia INSTANSI DPL

Reform Aim	No.	Prior Action Implemented by GoI Prior by September 2012
Pillar 1: Strengthening public financial management		
Policy sub-area 1.2. Strengthening budget execution systems		
Streamline budget execution and flexibility of budget management	1.	The Borrower, through the Ministry of Finance, has issued a Ministerial Regulation (No.112/2012) simplifying and clarifying the practice of withholding funds for budget allocation ("*Bintang*").
Develop new Financial Management Information System (IFMIS)	2.	The Borrower has introduced a new General Ledger under SPAN using daily transaction conversions from the old General Ledger.
	3.	The Borrower, through its Ministry of Finance, has completed the design and build phase for the new budget preparation system.
Improve government accounting and audit functions	4.	The Borrower, through its Ministry of Finance, has issued and disseminated a Ministerial Regulation (No. 238/2011) on new accrual based accounting policies and chart of accounts.
Policy sub-area 1.3. Improving tax administration		
Modernize core tax system	5.	The Borrower has issued a Government Regulation (No.31/2012) for the implementation of Article 35A of Law 28/2007 and a Minister of Finance Decree (No. 194/KMK.03/2012) on the sharing of data between DG Tax and DG Customs, all of this to facilitate the sharing of third party information for improved tax compliance.
Pillar 2: Enhancing poverty alleviation and service delivery efforts		
Improve poverty measurements and targeting of the poor	6.	The Borrower, through TNP2K, has signed four memoranda of understanding with the Coordinating Ministry of Peoples Welfare, the Ministry of Health, and the Ministry of Education and Culture, and the Ministry of Social Affairs, respectively, whereby the referred ministries agreed to use the unified database held by the TNP2K Secretariat to select the beneficiaries of the *Raskin, Jamkesmas, BSM* and *PKH* programs, respectively.
Improve household-targeted poverty reduction programs (Cluster 1)	7.	The TNP2K Secretariat has completed a review of new institutional arrangements for the delivery of *Jamkesmas*, taking into account actuarial cost estimates and various scenarios for achieving universal health insurance coverage.
Improve community-based poverty reduction programs (Cluster 2)	8.	The Borrower, through TNP2K, has issued a roadmap for PNPM (including strategic directions and action plan) to guide the long-term implementation of PNPM and to strengthen the integration of PNPM with local governments.

81. The eight INSTANSI DPL prior actions identified above were developed based on the continuing DPL program dialogue with the GoI. Four of these prior actions had previously been indicated in the DPL-8 program document. In addition, the following four prior actions are being proposed, which were developed based on the GoI's continuing reform agenda: (i) Issue a Minister of Finance Regulation simplifying and clarifying the practice of withholding funds for budget allocations ("*Bintang*"); (ii) Introduce new General Ledger under SPAN (daily transaction conversion stage); (iii) Complete the design and build phase for the new budget planning system; and (iv) Finalize the PNPM Roadmap, which covers strategic directions and action plan.

82. A number of prior actions that were indicated in DPL-8 are no longer supported through the INSTANSI DPL. These include the following: (a) Start implementation of Single Sign-On for two key agencies of INSW (i.e. BPOM and Customs), which is now being supported separately through the Connectivity DPL; (b) Issue draft guidelines for an M&E framework, based on specific performance indicators, that provide the basis for the next RPJMN and annual budgeting, which has been downgraded into a benchmark action as it will be a 'living document' refined over the course of the next year or so; (c) Issue new law (PP) and related MoF regulations governing budget execution, which is being delayed to the 2013 INSTANSI prior actions; and (d) Draft procurement law submitted to Parliament, where the timing is uncertain and support is being provided outside of the DPL through technical assistance.

83. In addition to the prior actions, the INSTANSI DPL also supports a set of benchmark actions. These benchmark actions represent reform steps that need to be taken before more substantive reforms can take place over the longer run. The classification of prior and benchmark actions allows more prioritization and focus over more critical prior actions, while still acknowledging the GoI's broader reform process. Such classification therefore helps ensure sustained GoI ownership and the mapping out of a comprehensive multi-year DPL program. Details on the prior and benchmark actions are provided in Annexes 2-3.

A.1. Pillar I: Strengthening Public Finance Management

84. The Government continues to modernize its PFM in order to improve the integrity, accountability, transparency and performance of the budget. The 2002 *White Paper* provided the overall framework for the subsequent implementation of PFM reforms in Indonesia, commencing with a major revision of the enabling legal framework. These efforts are part of a broader public sector reform agenda to improve governance, enhance public service delivery and ultimately achieve sustained economic growth and poverty alleviation. The initial reforms focused on consolidating the budget, improving expenditure controls and strengthening oversight, particularly the financial audits. The Government has simultaneously been developing a new Financial Management Information System (IFMIS), called SPAN, aimed at increasing the integrity, reliability and efficiency of budget and treasury operations, while enabling more timely and robust budget reporting and oversight.

85. In the past year the Government has achieved notable milestones in PFM reforms including:

- The finalization of new PFM business processes that have been used to configure the SPAN system—including the new Chart of Accounts (CoA), General Ledger design, spending, commitment and payment procedures, cash management etc. — the MoF approved a new project charter and a comprehensive transition plan for rolling out SPAN in 2013;
- Further progress in implementing the MTEF, with a number of important reforms in the budget preparation process;
- New regulations to improve budget execution, i.e. to promote multi-year contracts; reform Budget virement to give more authority to program managers; to streamline budget documentation; and
- The Government issued a new regulation to support the implementation of accrual accounting (PP 71/2011), supported by a MoF regulation detailing the accounting policies under the new CoA.

86. The INSTANSI-DPL is increasingly supporting measures designed to enhance the quality of public spending. At the forefront of the agenda is the move toward **performance-based budgeting (PBB)** and a fully operational **Medium-Term Expenditure Framework (MTEF)**, as required by the 2003 State Finance Law. This includes further steps to improve the link between the monitoring and evaluation of past performance and future budget decisions. Reflecting progress in improving expenditure controls, the Government is placing increased emphasis on streamlining the budget execution process to address constraints that are particularly affecting infrastructure spending. Further reforms are aimed at improving the management of state assets and liabilities, enhancing public sector (e-)procurement, and strengthening audit and accounting functions.

Policy Sub-Area I.1. Strengthening Budget Formulation and M&E Systems

Reform Aim: Improve results orientation and MTEF in the budget process

87. The 2003 State Finance Law mandated three pillars of budget reform: (**i) a *unified budget*** to remove the previous distinction between development expenditure and routine expenditure and allow for prioritization across all kinds of expenditures in the budget; **(ii) a *Medium-Term Expenditure Framework (MTEF)***, which aims at strengthening the capability to plan and prioritize expenditures for the medium term; and **(iii) *performance-based budgeting (PBB),*** which would restructure the budget according to programs and activities and introduce non-financial performance indicators, and allow for a results-based evaluation and budget allocation.

88. While the unified budget was implemented in the 2005 budget, PBB and the MTEF are still in the early stages of implementation. However, notable implementation milestones have already been achieved. Supported by previous DPLs, and following a joint circular from the MoF and Bappenas in 2009, a revised program structure has been introduced by all line ministries and ministry-level agencies with the RPJMN 2010-2014 and FY2011 budget. The work plans and budget submissions for 2012 incorporate performance indicators for all programs and activities. As a first crucial step in implementing the MTEF, work plans and budget documents — from the plans (RKP and Renja-KL) to the budget document (RKA-KL) — have also been transformed into rolling multi-year documents and line ministries and agencies have prepared detailed forward estimates for two out-years beyond the fiscal year as required by the MoF regulation in 2010.

89. The MTEF also implies a fundamental change in the budget preparation process. Regulations have been put in place to incorporate medium-term budget forecasts and the treatment of new initiatives during the budget preparation process. The new initiative procedure was first introduced with the preparation of indicative budget ceilings for 2012. To enhance the credibility of the MTEF, the Government has prepared documentation that explains differences between proposed budget ceilings and previous medium-term forward estimates. The documentation was previously intended to be presented to Parliament (DPR) along with the draft 2013 budget law, but is now planned for next year. This is a major implementation milestone for MTEF reforms, as it helps ensure that the MTEF information is publicized and used in all major aspects of the budget preparation cycle. Ultimately, this will help ensure that the MTEF is integrated with the annual budget cycle, rather than operating as a separate planning exercise. This change will need strong commitment from all the relevant stakeholders, intensified capacity building, and changes to business processes and systems. A further development will occur with the use of SPAN to prepare the 2014 budget in 2013. The increased functionality provided through the budget preparation module will allow the Government to clearly separate the MTEF elements in preparing the 2014 budget and facilitate a more detailed reconciliation with the prior year forward estimates in budget documents. In the coming year consideration will also be given to budget reforms that enhance the strategic nature of the DPR's examination of the budget. The intention is to introduce new approaches in the budget discussion and documents that emphasize budget appropriation at the program level rather than the detailed allocation for each spending unit.

90. In an important move that supports the MTEF and PBB reforms the Government is examining the way in which the costing of transactions and activities is regulated in both the preparation and execution of the budget. The aim is to replace the existing framework of input focused regulations and establish a control framework that provides increased flexibility for spending units while at the same time encouraging economy in spending. The Government has prepared a draft white paper for a new and simplified costing methodology, and in 2013 it expects to have in place regulations establishing a new costing methodology, in line with the baseline and new initiatives processes of the MTEF, which also determine the basis for allocating costs to programs/activities.

Reform Aim: Strengthen the use of monitoring and evaluation in the planning and budgeting cycle

91. The annual budget cycle is also being strengthened by gradually introducing new procedures for performance monitoring, evaluation and management. During the preparation of the 2013 budget the government circulated draft guidelines (PMK No. 112/2012) for line ministries for the review of baselines in order to find savings to finance new initiatives and improve the quality of spending. Through this process around Rp 20 trillion in baseline reductions were identified that were used to finance new policy measures. This initiative is expected to be further developed during 2013 by introducing an integrated baseline review process that includes an assessment of the policy performance in the prior year when determining the baseline. In addition a targeted spending review process is being developed that makes an in-depth examination of the effectiveness and efficiency of spending feeding into the subsequent budget process. The effort to strengthen the link between the M&E of budget expenditures and the planning for the subsequent budget is critical, but challenging. It aims to achieve continuous improvements to the quality of spending by building lessons from the past budgets into the next cycle. Alongside these process improvements the introduction of the SPAN system is also expected to provide crucial support to the emerging M&E agenda by facilitating the reporting of financial and non-financial information by spending units and line ministries.

Reform Aim: Streamline budget execution and flexibility of budget management

92. One of the main objectives of the PFM reform is to streamline and simplify the budget execution process and provide more flexibility to the spending units in implementing and managing their budgets. This is particularly important given the challenges faced by spending units and line ministries in implementing infrastructure projects. The SPAN provides a critical foundation for streamlining procedures while retaining control, as it will facilitate the full budget cycle process from preparation, allotment, and execution until M&E in one integrated database. However, as part of the INSTANSI-DPL several additional steps are envisaged to address delays caused by the process of virement, the prevalence of the use of "bintang" and a number of elements of the current budget execution regulation. These were identified as key factors behind delays in disbursement in a recent World Bank study.[10]

93. Despite recent revisions, virement regulations are still viewed by spending agencies as overly complex and a major source of spending delays. The level of delegated authority and approval processed could be further simplified and streamlined. There are currently five different authorities that may be involved in budget revisions: the Parliament (DPR), the Finance Minister, DG Budget, DG Treasury and the spending unit itself. This is due to a combination of the limited flexibility given by the DPR and the lengthy processes at the MoF in approving in-year budget virement. For the latter, the MoF has decided that starting in FY 2013 it will apply a one-stop service in which the budget management (allocation, allotment, and in-year virement) will be approved by one unit (DG Budget). The INSTANSI-DPL is supporting the

[10] DIPA Tracking Study – "Identifying the Contraints to Budget Execution in the Infrastructure Sector", May 2012.

development of a MoF White Paper that examines the simplification of virement procedures, consistent with the proposed new government regulation (PP) on budget execution.

94. The practice of withholding funds for 'approved' budget lines ("*Bintang*") is an important factor constraining budget execution. The "*Bintang*" is imposed either by the MOF or the DPR when there are reservations about a particular budget allocation, often because the documents supporting the expenditure are considered incomplete. However, this practice often creates more confusion and delays than simply rejecting incomplete budget submissions, particulary if it relates to only a portion of a program. It would often be preferable for the detailed assessment of the supporting documents to be reviewed either during budget execution or ex post. As a first step to address this problem the MoF issued a new regulation (PMK No. 112/2012) simplifying and clarifying the practice of withholding funds for budget allocations ("*Bintang*"). In 2013, the MoF intends to review the effectiveness of the new regulation and to consider additional measures aimed at eliminating the use of the "*Bintang*" practice and putting increased reliance on ex-post controls.

95. Finalization of the draft Government Regulation (PP) on budget execution is a priority action for the MoF, which will address some current obstacles to budget execution alongside other measures. These include:

- Removing the requirement to appoint Satker officials annually: Although the multi-year appointment of officials was introduced by Presidential Regulation No. 53/2010, most Satker officials still assume that their appointment is only effective for one fiscal year and they are reluctant to execute the budget for the new FY until they receive a new appointment letter. This PP clarifies that the appointments of Satker personnel (proxy budget user/head of Satker; commitment makers; payment verifier; treasurer) are not limited to one fiscal year.
- Confirming the rule of advance (early) procurement before the fiscal year started: Although Presidential Regulation No. 53/2010 on Procurement permitted line ministries to start the procurement process prior to the beginning of a new fiscal year, many Satker are reluctant to apply this flexibility since it is not yet regulated by the MoF. This PP will give assurance to the Satker staff that they are allowed to conduct advance procurement and, to cover any related costs in processing, a contract that will be signed the next fiscal year.
- Integrating the State Financial Information System: This PP requires the MoF to organize an integrated State Financial Information System that will cover both the line ministries' information system for state finance, and the local government information system for local government finance.

In April 2012, the Finance Minister requested the Justice and Human Rights Minister to finalize the draft PP through a harmonization process involving meetings with the other line ministries. All stakeholders have agreed the measures and the MoF has submitted the final draft of the PP on "Procedures of State Budget Execution" to the Ministry of Justice and Human Rights to be sent to the President for approval. The MoF is optimistic that the PP can be issued before the end of FY 2012.

Reform Aim: Development of SPAN and enhanced ICT integration and services

96. The implementation of SPAN represents a major milestone in the PFM reform agenda. It will enhance not only the controls over financial transactions but will also provide a basis to improve the performance across the entire budget cycle from planning to reporting. Given the importance of this reform, it features prominently in the INSTANSI-DPL.

97. Despite some difficulties encountered during the application development stage, SPAN made good progress in 2011 and 2012 and is expected to be rolled out in stages to all 177 Treasury Offices (KPPN) early in FY 2013. In the past year there have been some important achievements which include:

(i) A revised Project Charter, which contains details of activity implementation such as objectives, scope, governance, risks and work plan schedule, was approved by all stakeholders, including the Minister of Finance; (ii) Changes in the business processes used in the SPAN configuration were approved by the Directors General; (iii) The Functional Requirements were frozen; (iv) The new Chart of Accounts (COA) structure was signed-off; (v) Data from the legacy systems were validated and cleaned, ready for migration to SPAN; and (vi) the testing phase commenced.

98. **The next critical stage in the implementation of SPAN is the completion of the application build phase, which precedes user acceptance testing.** The INSTANSI-DPL is supporting the completion of the design and build phase for the new budget preparation system. The completion of the build phase will reflect that all 414 Application Functional Designs (AFD) and technical designs are completed; issues on conversion items are closed; SPAN interfaces with other external applications are finished; all programs for customization are developed; and end-user manuals are created. Once the build phase is completed, the SPAN application will be ready for the User Acceptance Test before it is rolled out to all treasury offices in stages starting in early 2013.

99. **Alongside the preparation of the SPAN application the project involves the development of a link between individual Satker and the system located in Treasury offices.** An integrated web-based application called SAKTI (Sistem Aplikasi Keuangan Terpadu Instansi) is proposed for this purpose. The MoF has signed a contract for developing the web-based SAKTI application that will be used by all the 29,000 Spending Units to link with the SPAN (Hyperion and Oracle EBS). The finalized SAKTI application will be used by all spending units in 2013 once SPAN is in operation. The inclusion of a solution for budget submissions through SAKTI will be important to ensure full budget system integration and harmonization.

100. **The SPAN project includes the development of a new budget preparation module that provides more advanced functionality to support both budget planning and performance management.** In September 2012, the DGB has completed the design and build phase for the new budget preparation system_(Hyperion), which is ready to be tested by both DG Budget and line ministries as the users. The completion of Hyperion has been delayed from the original scheduled roll-out in 2012 because the developer was required to develop the Custom Web application to enable Hyperion to fulfill the needs of DG Budget to continue to perform budget approval, virement (budget revision) and fund blocking ("bintang") at the Spending Unit (Satker) level. Custom Web is a connecting bridge between the SAKTI applications, which will be used by about 29,000 work units, and Hyperion, which will be used by 250 budget portfolio program managers at the Echelon 1 level of the line ministries. The MoF is expected to use all the new applications (SAKTI, Hyperion, Custom Web and SPAN) to support the 2014 budget preparation in 2013, replacing the RKA-KL application.

101. **From an accounting and reporting perspective, an important milestone has been with the introduction of a new General Ledger under SPAN.** This was accomplished in March 2012 and marked the completion of the first step in the roll out process of SPAN. This phase reflects the daily conversion of fiscal data from the old to the new chart of accounts (COA) in the general ledger of SPAN, known as the "GL Open stage". It means that fiscal information can be reported on the basis of the improved COA from the data that is now stored in the SPAN database. It is expected that the semester and annual central government financial statement report will be prepared from SPAN in 2013, as the system is also being fully deployed (once completed there will be no need for conversion tables as all transactions will be processed in SPAN).

102. **One of the most significant challenges of SPAN is to ensure that users are properly trained and receptive to the new system.** This preparation is considered one of the key success factors in such large ICT enabled institutional reform programs. Therefore a 'Change management and communications' program has been underway since late 2010. The program has helped the MoF complete the training modules for SPAN and make available the necessary training related resources (e.g. detailed

training plan, physical training facilities, trainer staff and sufficient budget). The timing of the change management and communication program is critical to support the successful roll out of SPAN. Over the coming year it is envisaged that the training programs for all SPAN users (Training for Trainers, End Users and User Acceptance Test training) will be completed.

103. Beyond the SPAN development, the INSTANSI-DPL continues to support the MoF's strategy to integrate ICT services across the ministry to enhance coordination and efficiency. The creation of the ICT shared services unit for the MoF (PUSINTEK), and the gradual adoption of the ICT blueprint recommendations have been supported under previous DPLs in order to promote greater integrity, security, interoperability and efficiency of the ICT systems. Consistent with the direction set by the Finance Minister the MoF has advanced ICT integration by establishing a single Data Center (DC) and consolidating five existing DCs into a new facility (Pusintek) in Jakarta. This consolidates DCs that were previously run separately by DG Debt Management, DG Customs, DG Budget, DG Treasury and State Revenue Module. A further step envisaged in the coming year is to bring the IT security awareness of all MoF units to the desired level.

Reform Aim: Improve government accounting and audit functions

104. Weaknesses in internal controls and fragmentation of the internal audit function pose a significant risk to reforms introduced in other areas of public financial management. The 2007 PEFA assessment classified internal controls as weak and the internal audit function in the country as fragmented and characterized by weak capacity. Subsequently, the GoI issued Government Regulation No. 60/2008 and Presidential Instructions (Inpres No. 4/2011) on Government Internal Audit Systems as required by Article 58 of Government Regulation No. 60/2008. These regulations have been a cornerstone for government internal control and audit systems, as the Government has thereby adopted the Committee of Sponsoring Organization (COSO) as its control framework and also clarified the roles and responsibilities of various players in the internal audit arena. The next critical step is formulation of an internal audit strategy and the development of a code of ethics, audit standards and peer review guidelines. However, PP No. 60/2008 mandates the creation of an association of internal auditors to perform these functions. Hence, INSTANSI DPL supports the establishment of a task force to facilitate the creation of a professional association of internal auditors. Once the professional association is in place, its mandate would be to develop a code of ethics, audit standards and peer review guidelines for internal auditors.

105. Regarding the implementation of the Government internal control system based on the COSO model, after developing a strategy for roll-out to various ministries and line departments, a Control Self Assessment (CSA) manual has already been prepared and is now being socialized in five line ministries and three local governments. CSA is one of the key tools for carrying out risk mapping in the line ministries. It is expected that all the line ministries will carry out a risk-mapping exercise, identifying the major risks and how they can be mitigated. This is at the heart of PP No. 60/2008 and the adoption of a COSO control framework in Indonesia.

106. Indonesia continues to move towards accrual-based accounting. Financial reports prepared on an accrual basis are more useful both from accountability and decision-making perspectives. The target is to switch to full accrual accounting by 2015. The draft standards have already been prepared and the Government has issued Government Regulation No. 71/2010 on accrual-based accounting. This marked the achievement of policy consensus among various government stakeholders on an accounting framework that would enable the Government to better manage its finances and risks. Subsequently, the Government issued and disseminated a Minister of Finance Regulation (PMK No. 238/2011) on new accrual based accounting policies and chart of accounts. The MoF regulation formally adopts the new chart of accounts and accrual-based accounting policies.

Policy Sub-Area I.3. Improving tax administration

107. Improving the efficiency and effectiveness of tax administration is expected to increase revenue while lowering taxpayers' compliance costs. The DGT remains constrained by ineffective systems and weak human resource management, which force it to implement an inefficient "cookie cutter" model for the tax office organization structure and hinders the creation of professional service staff, for example in tax audit. The focus of the current phase of tax administration reform is on strengthening the self-assessment system, streamlining business processes, realigning the organization structure, improving the quality and integrity of ICT, introducing risk-based compliance enforcement and resource allocation, modernizing human resource management, improving professionalism and staff integrity and strengthening governance to support the entire tax operations. DGT's medium-term reform strategy is therefore concentrated into two inter-related programmatic streams reflected in the DPL:

- Modernizing the core tax administration system, by ensuring more equitable enforcement and lowering taxpayer compliance costs through improving the efficiency and effectiveness of the core tax administration system; and
- Modernizing DGT human resources, improving professionalism and staff integrity, and strengthening governance to reduce corruption.

108. The Bank-supported Project for Indonesian Tax Administration Reform (PINTAR) is a major component of DGT's efforts to improve its efficiency and effectiveness, but procurement delays have pushed back implementation. The USD110 million PINTAR was designed to follow a systematic and integrated approach to strengthen and streamline business processes, modernize human resource management, and enhance information technology infrastructure. PINTAR is also designed to adopt a project and change management approach based on international standards and practices to implement reforms in key aspects of the core tax administration system, including: (i) taxpayer registration, (ii) returns and payments processing; (iii) taxpayer and revenue accounts database; (iv) centralized document management; and (v) risk-based audit and collection. However, as with many ICT related programs, the procurement is complex and faces significant delays and uncertainty. Furthermore, DGT is reviewing its strategic plan and the requirements for the reform and procurement are likely to need revising.

Reform Aim: Modernize DGT human resource management

109. Modernizing human resource management, improving professionalism and staff integrity, and strengthening governance is a priority for DGT's reform agenda. DGT currently has around 33,000 employees, but lacks staff in key areas, such as tax audit and HR organization. The business rules need to be strengthened in a number of areas to promote greater controls between tax functions and taxpayers. Although an *HR Strategic Blueprint* was completed in 2011, DGT currently still has limited flexibility to reform and modernize the HR management and organization to support the overall tax administration reforms due to the rigidity of government-wide standards. DGT will likely require exemptions from the centralized rules currently controlled by the State Ministry of State Administration Reform (MenPan).

110. DGT initiated the national Bureaucracy Reform (BR) program in 2012. This was reflected in the Director General of Taxes Decree No. 146/2012 concerning the Establishment of a BR and Institutional Transformation Team. Since institutional transformation is also becoming a critical agenda throughout the MoF, all the initiatives and activities in support of BR in DGT are in line with the MoF's broader institutional transformation objectives, which are reflected in the MoF's Destination Statement 2014. Furthermore, DGT's BR programs follow MenPan-RB Regulation No. 20/2010, which includes nine pillars in support of the national micro program of BR: (i) Change Management; (ii) Laws and Regulations Alignment; (iii) Organizational Strengthening and Alignment; (iv) Business Process Improvement; (v) HR

Management Improvement; (vi) Supervisory Strengthening; (vii) Performance Accountability; (viii) Public Service Quality Improvement; and (ix) Monitoring and Evaluation.

111. In carrying out BR and designing the future organization structure, DGT will need to undergo restructuring. DGT is assessing the impact of the current strategic plan and future concepts for the operations relative to DGT's current organization. The initiative to review the strengths and weaknesses of its current organization structure provides an opportunity to realign the future business processes with the future organization structure, although in the absence of PINTAR this is likely to be a more limited process and the original milestone of approving a new organizational impact assessment for the reforms has been dropped. Instead, the DGT will focus on a few priority areas to reform, including developing the organization and procedures for strengthening the data processing centers, procurement services and taxpayer call centers. A new performance management system is also being developed to help focus and monitor tax auditors' work to more priority cases, taking a more risked-based approach.

Reform Aim: Modernize the core tax administration system

112. Major outreach programs and simplification efforts have increased the number of registered taxpayers from a total of about 4.8 million in 2006 to more than 20 million by 2012. However, the increase in the number of registered taxpayers, who are mostly individuals and small businesses, has not resulted in a significant increase in revenues, as substantial coverage gaps and systemic weaknesses remain.

113. The delay in PINTAR has pushed back the deployment of a new integrated core tax information system to at least 2015. To maintain the reform momentum DGT is continuing to identify and realize "quick wins." These include improving the performance of the current ICT system (SIDJP), removing duplicates from the taxpayer master file, systematically compiling third-party data, further developing tools to facilitate compliance activities, reallocating human resources based on risks and revenue potential, and implementing online systems for processing VAT refunds for tourists. One of the most important reforms to increase revenue in the short term is to be able to check tax assessments and audits against third-party sources. To this end, the Government has issued a Government Regulation for the implementation of Article 35A of Law 28/2007, and a Minister of Finance decree on the sharing of data between DG Tax and DG Customs, all of this to facilitate the sharing of third party information for improved tax compliance. Another milestone in the reform, is DGT is also stabilizing and upgrading its existing core tax system, SIDJP, and gradually replacing the outdated, off-line tax system, SIPMOD, which is currently still operating in more than 150 tax offices, and integrating them into SIDJP. After the integration is completed, all tax offices will have access to an integrated, centralized registration system and taxpayer accounts. In addition, tax offices will be able to assess taxpayer compliance using specialized benchmarking tools.

114. DGT is continuing to enhance the regulatory environment to support the modernization and efficiency of the tax system. The issuance of three priority regulations is included in the INSTANSI DPL as benchmark actions. A new MoF regulation is designed to allow oil and gas production sharing contractors to pay income tax in kind to reduce oil imports and transaction costs in the sector (supporting Government Regulation No. 79/2010 regarding the income tax to increase the share of oil and gas production for domestic use). Strengthening the regulations regarding taxes and duties on the export and import of goods to and from the many Free Trade Zones and Free Ports is designed to control the use to legitimate transactions while the regulation on the Taxpayer Identification Number and Taxable Entrepreneurs is designed to improve the reliability of the system, where there are currently often multiple and duplicate identifiers.

115. Moving forward, DGT needs to realign all strategic reform initiatives and update its medium-term strategic plan to obtain commitment from DGT top management. Besides implementing PINTAR, DGT is also carrying out a major bureaucracy reform, which is part of the ministry-wide initiative.

In addition, DGT is currently reviewing and considering for restructuring its organization structure. These major initiatives as well as other donor-supported activities and “quick wins” require realignment with the existing and to-be-updated DGT Strategic Plan to obtain top management commitment and ensure availability of resources.

A.2. Policy Area II: Poverty Reduction

116. To further accelerate the pace of poverty reduction, the Government is pursuing key reforms of its national poverty reduction programs. These reforms include institutionalizing governance structures to improve the overall coordination and implementation of poverty reduction programs; developing systems for M&E program delivery and effectiveness, and assessment of the programs; developing a national targeting system to ensure that program benefits reach the intended poor and vulnerable beneficiaries; and empowering local governments, communities and service providers to deliver quality services as an effective approach to leverage local knowledge to identify obstacles to development while building capacity for coordinated action. INSTANSI DPL will support the Government’s reform objective by improving governance and institutional accountability through the strengthening of M&E systems, enhancing the targeting of the poor, improving household targeted poverty reduction programs that have been prioritized by the Government, and improving community based poverty reduction programs.

Reform Aim: Improve governance and institutional accountability

117. The Government has re-organized the institutional arrangements for the governance and oversight of the national poverty alleviation programs to support an ambitious reform agenda. In 2010, the President elevated oversight of the poverty strategy to the National Team for the Acceleration of Poverty Reduction (TNP2K), which is chaired by the Vice-President. The key objectives of TNP2K are to: (i) design and oversee a large-scale program of social assistance and poverty reduction; (ii) consolidate, simplify, and improve the efficiency of existing programs; and (iii) identify important but troubled social assistance programs and resolve their implementation problems. TNP2K is supported by a Secretariat that is responsible for drafting policies (with a priority on social assistance reform), establishing a national targeting system, and integrating monitoring and evaluation activities. The Secretariat includes six working groups that function as internal ‘think tanks’ focusing on: (i) Cluster I; (ii) health fee waivers for the poor (Jamkesmas); (iii) Cluster II; (iv) Cluster III; (v) targeting, and; (vi) M&E. The mandate of TNP2K and its Secretariat extends for the full duration of the current administration, until the end of 2014.

118. The M&E working group under TNP2K is spearheading efforts to develop an integrated M&E framework for major poverty reduction programs. Program M&E functions have typically been carried out individually by the respective implementing agencies. However, neither the extent of M&E activities, nor the quality has been consistent. As a result, the Government is highly reliant on monitoring and evaluation activities carried out by research institutions and development agencies. The M&E working group serves as the focal point within the Government that provides high-quality and up-to-date information about the performance of the key national poverty reduction programs. Its development of an M&E framework will support decisions by TNP2K concerning program mix, scale and budget allocations while, at the same time, improving public accountability over the use of public resources.

Reform Aim: Improve poverty measurements and targeting of the poor

119. One of the key reforms to improve the integration and effectiveness of social assistance programs is the establishment of a national targeting system for household poverty reduction programs. Previously, household poverty reduction programs used different targeting approaches and relied on separate recipient databases. This leads to duplication of efforts, inconsistency in application, and dampened program impact. There is also the need for a sensitive poverty measurement and targeting of the poor that consider the different gender features and impact of poverty at intra-household level, which could provide information on women's and men's different access and control over resources, including benefits from anti poverty and social protection program. To address these issues, a targeting working group was established in the Secretariat of TNP2K. The working group has been tasked with creating and maintaining a national targeting system that will be housed in the TNP2K Secretariat.

120. TNP2K has successfully created a national registry of poor and vulnerable households that can be used to improve the targeting of social assistance programs. This action was one of the priority reforms identified in the Government's medium-term development plan and subsequent Presidential Instructions. To prepare for the reform, the Central Bureau of Indonesia (BPS) conducted a large-scale assessment of 25 million households (PPLS11), or just over 40 percent of all Indonesian households during July-August 2011. Households to be assessed were identified using a mix of census-based pre-listed households, community referrals, and updating of existing lists. Proxy-means test (PMT) models were developed to estimate household consumption and applied to the PPLS11 data as a basis for the registry of about 25 million poor and vulnerable households. In January 2012, the TNP2K Secretariat delivered the registry to the Vice-President who, in turn, issued instructions stipulating that program beneficiary lists for Cluster 1 programs (Rice for the Poor - RASKIN, Conditional Cash Transfer - PKH, Scholarship for the Poor - BSM and Health Fee Waiver for the Poor - Jamkesmas) must be extracted from the unified database by the TNP2K Secretariat, using eligibility criteria identified by the implementing agencies. Subsequently, the TNP2K has signed MoUs with the Coordinating Ministry of Peoples Welfare, the Ministry of Health, the Ministry of Education and Culture and the Ministry of Social Affairs, whereby the referred ministries agreed to use the unified database held by the TNP2K Secretariat to select the beneficiaries of the *Raskin*, *Jamkesmas*, *BSM* and *PKH* programs, respectively.

121. There is good reason to believe that the creation of a national registry represents a significant advance in targeting poor households for social assistance in Indonesia. The initial 2005 list of the poor (PSE05) was constructed hastily by the BPS using a simple scoring system to classify households within poverty categories. The quality of the scoring was limited by the need to quickly apply it before a planned fuel price increase. More problematically, the households to be assessed were largely selected by sub-village heads on the basis of unknown and subjective criteria, meaning that many poor households were excluded from the list and many non-poor households included. It has been estimated that over 50 percent of the target population for the list were excluded. The 2008 update of this list (PPLS08) used international-standard PMT models to assess households, but mainly revisited the 2005 list, meaning that many excluded poor remained off the list. In 2011, however, over 70 percent of the households assessed came from a new listing of potentially poor households, drawn from information in the 2010 Population Census, meaning all households in Indonesia had a chance of being included. Also, the new registry was created using new and advanced PMT models that were developed and tested by the TNP2K Secretariat and the Bank.

122. Implementing agencies have begun to use the national registry to improve the targeting performance of national social assistance programs. Beneficiary lists for RASKIN program, a reissuance of Jamkesmas (health fee waiver) cards and the PKH expansion were extracted from the registry. Discussions between the National Development Planning Agency (Bappenas) and TNP2K have resulted in an agreement to use the new data to target any household-targeted emergency and/or crisis response programs. Broader demand for targeting assistance is rapidly growing: to date, the TNP2K Secretariat has received over 25 requests from local governments and agencies to use the unified database. The Targeting Working Group in the TNP2K Secretariat has been actively recruiting a larger team, which is an important institutional development for the management and implementation of the emerging national targeting system.

123. The TNP2K Secretariat is also preparing an integrated complaints and grievances process that will help in updating the national registry. A clear process for addressing complaints and grievances that quickly resolves disputes is a critical component of National Targeting System. The most common complaints are usually related to poor households being excluded from a program, which would only become known after program beneficiary lists are extracted and applies. Therefore, the targeting unit in the National Team's Secretariat plans to develop a coordinated process for each program and ensuring that eligible households that receive one social assistance program can also receive other social assistance programs. Towards establishing a coordinated grievance and complaint resolution system, the TNP2K Secretariat is currently preparing a pilot of complaint and grievances mechanism for the PKH program.

124. **Proposed revisions for the poverty measurement methodology will be submitted for the consideration of the next administration.** The Government has taken a series of preparatory steps towards the revision of the methodology, which were included as previous prior actions for the DPL-7. BPS has completed national poverty line simulations using the alternative measurement methodologies. The TNP2K Secretariat has also conducted a series of consultations in BPS and key government stakeholders to identify a poverty measurement methodology for consideration, which included universities, NGOs and key line ministries. Given the sensitivity of the debate on poverty levels and how these are calculated, the Government has made a decision not to move forward with adopting a revised methodology, but recommends that the change be undertaken by the next administration upon entry into office in order to de-politicize the debate concerning poverty measurement. Nevertheless, the decision by the Government not to revise the poverty measurement methodology will not affect progress towards meeting its poverty reduction targets, as the baseline and target are based on the current methodology, and will be the metric used to measure success. Also, even though the GoI has opted not to implement measurement reforms during the current administration, the test models indicate that the improvements would not have resulted in major changes in identification of the poor.

Reform Aim: Improve household-targeted poverty reduction programs

125. **The Government is committed to reforming and integrating its array of household-based social assistance programs.** To address the current fragmentation of household programs, the Government announced its intent to move towards developing an integrated family-based social assistance system (RPJM 2010-14). Reforms are not only needed across programs, but also within individual programs to improve their effectiveness. Several priority programs are the focus of current reform efforts including: the household-based conditional cash transfer program (PKH), health fee waivers for the poor (Jamkesmas), and scholarships for the poor. At the same time, much remains to be learned about the other social assistance programs in order to support future reforms agendas.

126. **A program providing health fee waivers to poor households is part of the Government's overall commitment to enroll the entire population in a public health insurance scheme.** The Government will implement a new national social security system over the course of the next four years that will radically change the social protection paradigm. The legal basis for these changes are the national social security law (SJSN law), enacted in 2004, and the recently enacted law on administrators (BPJS Law), enacted in November 2011. The new social protection program will cover all Indonesians for five benefits, namely health, pensions, old-age savings, death benefits and worker accident.

127. **The Government is reviewing the design and financial sustainability of the national health insurance program targeting poor households.** The review is part of an overall review of the social security and safety net programs coordinated by the Coordinating Ministry for People's Welfare and for which a new Social Assistance Commission has been established. Once the review is completed, the Government will assess how to scale up the programs to eventually achieve universal coverage, while maintaining financial sustainability. The programs would need to be designed to support the substantial proportion of poor and near-poor households that need assistance, many of whom live in rural and remote areas, and are self-employed people or working in the informal sector. There is little information about the benefits package and its likely impact on the health and financial security of the uninsured. There is also limited understanding regarding the infrastructure and human resources needed to assure effective access to the promised benefits and the measures to ensure quality and efficiency. The ambition to achieve universal

health care coverage is indeed an ambitious and long-term reform agenda, extending far beyond the DPL timeframe. The Government has set its objective to achieve universal health insurance coverage (UHC) incrementally by 2019. This decision subsequently has raised questions regarding institutional arrangement for Jamkesmas program and the sustainability of the UHC program. In that regard, the TNP2K Secretariat completed a review of new institutional arrangements for the delivery of Jamkesmas, taking into account actuarial cost estimates and various scenarios for achieving universal health insurance coverage. The new institutional arrangements for the national social health insurance consequently involve two existing social health insurance programs beside the Jamkesmas program. Although the Government has initiated the development of the new arrangement, the complexity of merging these health plans which have different operation systems, benefit packages and target population groups, requires additional time. Therefore the schedule for the finalization of the new institutional arrangement for the Jamkesmas program has changed to a new schedule in 2013.

128. The Government is also focusing on reforming programs that provide scholarship to students from poor households. These scholarship programs exist at all public schools across all levels of education and provide currently enrolled students from poor households with an annual cash transfer in one lump sum installment. The funds are intended for use on education fees and other non-fee costs of attending school, such as transportation to school and uniforms, and thereby aim to remove barriers to access to education. BSM is actually not a unified program, but rather consists of 10 largely independent scholarship programs, with implementation responsibilities delineated by type and level of education, and lack of a central coordinating unit. While the program shows potential, the design and implementation of the program undermines its effectiveness. Attention is needed to pursue reforms to coordinate the programs and improve their impact.

129. A review of the scholarship programs indicates reforms are needed to improve the delivery and effectiveness. The program review, conducted by the World Bank as part of the social assistance public expenditure and program review, found that although the scholarships programs are national in reach, they reach few students and perform suboptimally in identifying poor students. Also, the programs tend not to target those who are unfamiliar with the school system and its administrators. One major difficulty is that participation in the programs does not help address difficult and costly transition years — between elementary and junior secondary, and again between junior and senior secondary — when the overwhelming majority of dropouts occur. Finally, support operations like M&E are weak because these functions have been partly delegated to schools, which are also the main agency in charge of delivering scholarship funds to beneficiaries.

130. The TNP2K Secretariat is working together with the Ministry of Education and Culture to reform its scholarship programs. Reviews of the design and performance of the scholarship programs have been used by the TNP2K Secretariat's Cluster 1 Working Group to identify actions for a program reform strategy. This strategy has been used as the basis for engaging with the Ministry and specific units responsible for the implementation of individual scholarship programs. Several advances have been made in initiating reform actions, including a pilot to use the national registry to target new entrants to junior secondary school (SMP) who have been excluded from the BSM program in the past. Due to budget limitations, however, the pilot is currently restricted to targeting the poorest 5-10 percent of households

131. At the same time the Government will examine more closely the performance of Raskin, the subsidized rice distribution program. Raskin is the longest-serving of the permanent social assistance programs, and aims to help households fulfill their food needs and reduce their financial burden through the provision of subsidized rice. The program typically accounts for over half of total expenditures on social assistance, estimated at 54 percent in 2010. There is much room for improvement in the performance of the program. Although Bulog documents state that almost enough rice was procured in 2010 (but not in previous years), all the Raskin rice eventually available on the ground implies that slightly less than half of the promised 14 kilograms was available to eligible households. Further sharing or redistribution (at the village level) to non-eligible households meant that targeted households only received between 3 and 4 kilograms. Given the size of the program and ongoing food security concerns, there is growing interest in reforming the program in order to improve its ability to protect poor and vulnerable households.

132. The National Team Secretariat, therefore, is also working together with the Coordinating Ministry of Social Welfare (Menko Kesra) to improve Raskin's performance. Reforms began with three actions: i) applying new quotas that are closer in-line with current poverty rates, ii) extracting beneficiary names and addresses from the national registry, and iii) publicly posting the name of program beneficiaries. The TNP2K Secretariat has also initiated a pilot project with Menko Kesra that will distribute cards directly to beneficiaries containing clear information on the amounts to which they are entitled. The aim of the pilot is to improve program transparency and accountability in order to increase benefit levels actually received by beneficiary households.

Reform Aim: Improve community-based poverty reduction programs

133. As a national program and pillar of the Government's Cluster 2 poverty reduction strategy, the National Program for Community Empowerment (PNPM) is at a critical juncture. While PNPM continues to deliver tremendous results in communities, ongoing analysis shows the fragility of some of PNPM's institutions, both nationally and locally. The 2011 National PNPM Congress provided a platform for representatives from communities, local government and various stakeholders to share and discuss with the senior leadership in the Coordinating Ministry for People's Welfare, TNP2K, Bappenas, Ministry of Home Affairs, and Ministry of Public Works what their views and aspirations for the program up to 2014 and beyond. The results of this rigorous analytical work and over 12 years experience with PNPM and its processor community-driven development programs, are being used to inform the Government's PNPM Roadmap, which articulates the strategic direction for PNPM. The Government has_finalized the PNPM Roadmap, which covers strategic directions and action plan for the PNPM. After public consultation and formal endorsement of the PNPM Roadmap, its implementation by line ministries is expected to start in early 2013. The Roadmap is expected to help guide the long-term implementation of the PNPM program and strengthen integration with local governments. Key areas of focus of the PNPM Roadmap include: (a) integration of multiple PNPM programs at the local level; (b) clarification of roles of facilitators; (c) strengthening of capacity of local level institutions and clarification of legal framework; (d) adoption of core PNPM principles in functioning of Local Government; and (e) good governance and downward accountability." The PNPM Roadmap is also expected to help address gender equality issues, particularly through the action plans on integration of community empowerment program, the role of Local Government and good governance. The PNPM-Rural in particular plays a substantial role in addressing gender issues, as it reaches about 40 million beneficiaries, with about half of which are estimated to be women. The PNPM-Rural supports a savings and loan group or Revolving Loan Fund (RLF) that is exclusively targeted on women and has benefitted about 4 million beneficiaries, who are organized in 463,796 groups. Women are informed about the availability and conditions of the initiative through facilitators at community level.

134. The Government continues to take steps to strengthen PNPM program's fiduciary and management systems. During the preparation of PNPM-Rural IV in 2011, the Government and development partners agreed to strengthen the program's: (a) institutional and management capacity; (b) management information systems (MIS); (c) complaints handling system; (d) formal and informal fiduciary controls; and (e) quality of facilitation. Progress has been made during the implementation of PNPM-Rural IV in the strengthening of fiduciary and management arrangements. An MIS Improvement Project, which includes the development of a more effective and robust complaints handling system to enable effective data collection, and analysis as well as meaningful reporting to management, is underway. The Government is introducing service standards for improving management and responsiveness to beneficiaries, particularly in areas that have experienced major complaints. These service standards have been finalized and disseminated and now need to be monitored and followed up. The Government's existing complaints handling system is being improved and expanded with an SMS (text message)-gateway, which is now operational, and a web based system, which is now being finalized. The web based system will undergo final user acceptance testing and is expected to be implemented in late 2012.

B. Participatory Processes and Consultations

135. Democratic consolidation and decentralization of authority in Indonesia have translated into a political preference for wide buy-in and participatory, consensus-building approaches to decision-making, not only in terms of regulatory reforms but also planning and budgeting processes. While this is believed to have slowed or blunted some reform measures, it is believed to mitigate against radicalism, steadily improve public participation, and contribute to more democratic, accountable, professional and responsive governance. This commitment has been formalized and endorsed through several regulations (e.g. Law No. 25/2004 on National Development Planning and Joint Ministerial Decree 2006 and 2007 on Musrenbang), including those institutionalizing the creation of multi-stakeholder consultation forums — Musrenbang (Musyawarah Rencana Pembangunan) — at all levels, concerning several time frames. Musrenbang is the principal process for negotiating, reconciling and harmonizing differences between the Government and non-government stakeholders, and reaching collective consensus on development priorities, including regulatory reforms and budgets. While challenges still remain, the instrument is being increasingly adopted at all government levels.

136. Beyond the officially recognized participatory processes, various aspects of the reforms supported by this operation have been subject to extensive specific stakeholders consultations. In the public financial management and poverty alleviation areas a large number of seminars and workshops have been undertaken during the past year among different government agencies, as well as between the administration and other key relevant stakeholders, not only to discuss technical issues but also reach agreements on policies and reform activities. During the preparation of INSTANSI DPL, a series of policy discussions was held as part of the ongoing engagement with the core economic ministries, culminating in a series of half-day meetings with key counterparts in each of the relevant areas or sub-areas. A roadmap of milestones was then developed, which conforms to the Government's own reform agenda, as laid out in the DPL program matrix in Annex 3. This program matrix will continue to be adjusted and refined as progress continues to be assessed and discussions mature.

C. The Future Program

137. An indicative policy program for next year's DPL operation has been discussed with the Government in order to help map out the reforms supported under the entire DPL series. This mapping out of the overall two-year DPL series allows a more strategic consideration of critical subsequent reforms and provides the basis for judgment on the continuation of the next DPL operation. A total of 8 triggers have been tentatively identified for the next INSTANSI DPL operation. However, these are ideas that have recently emerged, which will need to be adjusted and refined as progress is made and discussions evolve. In essence, the Government envisages that future reforms that might be supported by the DPL series would move beyond the strengthening of the control and compliance framework and systems, although further improvements are planned in these areas, to enhance the performance orientation of the budget and PFM and to help strengthen the budget as a tool for meeting many of the other RPJMN targets as the focus shifts toward enhancing the *Quality of Spending.* This would help to bring the two pillars of the INSTANSI DPL closer together, focusing support for PFM and poverty reforms on the quality of public spending and the delivery of services.

Table 7: Indicative Triggers for Subsequent INSTANSI DPL Operation

Reform Aim	No.	Indicative Triggers for 2013
Pillar 1: Strengthening public financial management		
Policy sub-area 1.1. Strengthening budget formulation and M&E systems		
Improve budget transparency and use of MTEF in preparing the budget.	1.	Use SPAN in the preparation of the 2014 budget,to clearly separate the MTEF elements of the process and facilitate the reconciliation with the prior year forward estimates in the draft budget documents.
	2.	Issue a Government regulation that establishes a new Costing Methodology, in line with the MTEF approach, which also determines the methodology for allocating costs to programs/activities in 2014.
Strengthen the use of monitoring and evaluation in the planning and budgeting cycle	3.	Implement an integrated baseline and policy review as part of the preparation of the 2014 Budget that includes an assessment of the policy performance in the prior year based on a common definition of performance information.
Policy sub-area 1.2. Strengthening budget execution systems		
Streamline budget execution and flexibility of budget management	4.	Implement a simplified virement procedure that supports the spirit of "let the manager (line ministry) manage"
	5.	Issue new PP and related MOF regulations on budget execution
Develop new Financial Management Information System (IFMIS)	6.	Fully implement the SPAN in all 177 Treasury Local Offices (KPPNs)
Improve government accounting and audit functions	7.	Establish a professional association of internal auditors and drafts of (a) code of ethics and (b) internal audit standards
Policy sub-area 1.3. Improving tax administration		
Modernize the core tax system	8.	(i) Development of procedures and an application for VAT Refunds for Tourists through a website (e-invoice) and (ii) Development of individual e-filing for a 'Simple Tax Return' and 'Very Simple Tax Return Form'
Pillar 2: Enhancing poverty alleviation and service delivery efforts		
Improve household-targeted poverty reduction programs (Cluster 1)	9.	Finalize a strategy for the transition of Jamkesmas institutional arrangements from Ministry of Health to the social security system administrator for health (BPJS Health).
	10.	Program reforms are adopted to improve the targeting of scholarships (i.e., using national registry for new primary school entrants) and supporting poor students through school transition years.

VI. OPERATIONAL AND IMPLEMENTATION ISSUES

A. Monitoring and Evaluation

A.1. Monitoring

138. Monitoring the implementation and attainment of the DPL prior actions is done through regular meetings between GoI and development partners as well as the ongoing engagement with agencies responsible for different prior actions. GoI has established monitoring committees and/or technical groups that are responsible for ensuring the implementation of agreed prior actions as well as progress follow-up. In addition, the DPL benefits from regular joint donor-Government meetings to discuss interim progress in achieving agreed milestones in the reform agenda (held in April and June 2012 for the preparation of INSTANSI DPL) and ongoing policy dialogue between the GoI and World Bank teams. Table 6 below indicates the critical monitoring activities in each policy area.

Table 8: Critical Monitoring Activities

Policy area	Monitoring activities
Strengthening public financial management	• Ongoing monitoring of progress on budget disbursements and identification of key bottlenecks by the PFM MDTF Policy Advisory Committee
	• Ongoing monitoring of the time profile of budget disbursement, composition of public expenditures, and poverty and employment effects of economic shocks as part of the regular DPL program and analytic and advisory activities
Enhancing poverty alleviation and service –delivery	• Ongoing monitoring of the implementation of national poverty alleviation programs by the National Team
	• Ongoing monitoring of poverty related activities in conjunction with development partners as part of regular DPL program and analytic and advisory activities

A.2. Evaluation

139. A results framework has been prepared with a number of indicators to be assessed at the end of the current DPL programmatic series. The Bank will work closely with the Coordinating Ministry for Economic Affairs, the Ministry of Finance and other relevant agencies to monitor and assess reform progress and impacts during the life of the program. In addition to ongoing monitoring of activities, the Bank prepares an Implementation Completion and Results Report (ICR) at the end of each series. The ICR, prepared in consultation with the Government and development partners, is a Bank self-evaluation reporting tool that highlights the key achievements and results, as well as lessons learned. The ICR for all previous DPL series (DPLs 1-4, 5-6 and 7-8) show the significant progress that the GOI has made in its reform efforts since 2004, as well as highlight the role that the DPL has had in supporting that progress, by ensuring the alignment of support provided by development partners with GoI own reform efforts, promoting synergies between program support and other Bank instruments, focusing attention from both the Government and development partners on the most relevant reforms as well as empowering key reform oriented government officials to advance the implementation of necessary reforms. Monitoring and evaluation will also be supported by budgetary, legislative and economic data provided by the authorities and verified in official disclosures, directives and regulations. Baseline and updated data will be provided by the respective specialized agencies and tracked according to the Monitoring and Results Framework included in Annex 3.

B. Poverty and Social Impacts and Environmental Aspects

B.1. Poverty

140. The INSTANSI DPL policy actions are unlikely to have significant poverty and social consequences or significant environmental effects, while several actions have the potential to deliver positive outcomes on poverty over the medium term. The strengthening of public financial management systems are expected to have significant, if indirect, poverty and social benefits. Improvements in public financial management will improve the capacity of the Government to provide public goods and services, which also benefit the poor. The transparency and quality of public spending and the provision of public services will allow social programs to have a greater impact on targeted populations. With the tax reform actions the Government plans to reduce tax gaps and introduce new systems and procedures that facilitate better compliance, thereby contributing to increased revenue collections and generating additional fiscal resources that can be used in economic development and poverty alleviation efforts. Overall public savings through better fiscal management will allow the GoI to dedicate more resources to pro-poor programs.

141. The policy actions aimed at enhancing poverty reduction and strengthening service delivery should have positive effects over the short and medium term. The National Team for the Acceleration of Poverty Reduction continues to address the issues of fragmentation and lack of coordination, to improve the effectiveness of national poverty reduction programs. Improvements in systems for better targeting of poverty alleviation programs and measurement of poverty are also expected to support the poor by ensuring that these programs reach the appropriate beneficiaries and by ensuring the availability of more reliable data and information — including those that are gender-disaggregated — which are needed to make sound policy decisions. Household-based poverty reduction programs are being strengthened, which will improve the coverage of health insurance for all families, including the poor, and increase the number of scholarships for poor students at all education levels. Further, finalizing the PNPM-Mandiri road map for strategic directions and action plan will help to ensure the program's ongoing effectiveness and sustainability. Other actions aim to improve the PNPM programs ability and effectiveness in responding to and addressing concerns raised by program beneficiaries. Together, these actions are expected to yield positive impacts to the poor and vulnerable social groups throughout Indonesia.

B.2. Gender

142. As equitable development is a major concern for the Government, the DPL also supports institutional and policy reform aimed towards benefiting women in poor households. The medium term development plan (RPJMN) outlined the importance of increasing the role of women in development, particularly women's leadership in public sector, business community and social organizations. This DPL program in particular supports the strengthening of a PNPM-Mandiri program, which diligently involves women during its implementation. The PNPM program places strong emphasis on the promotion of women's participation in rural areas in particular, with a number of initiatives to improve gender equity and increase women's participation. PNPM-Rural adopted the successful strategy to promote gender equity and women's empowerment of KDP, including: (i) economic empowerment by revolving funds and microfinance programs involving women as members; (ii) political empowerment by ensuring women's voices are heard during program development and planning through establishing women's specific forum; and (iii) social empowerment by requiring that one of the two village development proposals come from women's planning group.

143. Reform in the area of targeted social assistance will also benefit the poor and vulnerable females. The National Targeting System (NTS) will be used to target poor households, especially vulnerable households with certain practical and strategic gender needs such as households with pregnant women or headed by women. The proposed NTS design and social service data collection survey (PPLS11) will ensure that such programs can be properly targeted. Furthermore, the analytical research and field experiments will consider the practical and strategic gender needs on targeting outcomes, such as the legal status of female-headed households, and the gender impact of holding community meetings in the day or evening. Hence, improving the effectiveness of targeting will directly benefit this constituency.

B.3. Environmental

144. **The proposed operation is unlikely to have significant positive or negative effects on the environment, forests and other natural resources.** Policy area 1.1 actions to strengthen public financial management through the budget formulation and M&E systems and to improve the results orientation and medium-term view in the budget process will not have negative environmental effects. Policy area 1.2 actions to strengthen budget execution and cash management systems and improve accounting and audit policies, functions and practices will not have negative environmental effects. Both areas of action are more likely to have positive social effects in terms of improving governance, transparency and accountability. Pillar 2 actions to enhance poverty alleviation and service delivery efforts through measurement, targeting of the poor, improved eligibility criteria and improved institutional arrangements for delivering and expanding health insurance coverage will not have negative environmental effects. These actions are designed to have positive social effects in reducing poverty and increasing insurance coverage.

C. Fiduciary Aspects, Disbursement and Auditing

145. **Public financial management is a central policy area that is supported by the proposed DPL operation.** Annexes 5 and 7 provide a detailed discussion on the state of public financial management in the country. The Fiduciary Assessment for Indonesia has been carried out and the Fiduciary Risk is rated as Moderate. This discussion and the conclusions therein are appropriate for the proposed INSTANSI DPL.

146. **In summary, significant strides have been made in recent years in the way Indonesia's public finances are managed and in increasing transparency and independent oversight.** In the last three years, progress has been made in the area of budget execution, with the development of a unified budget and a Treasury Single Account (TSA) to strengthen the comprehensiveness and control over spending and cash management. In addition, there have been improvements in the coverage of fiscal accounts, accounting practices, payroll, internal controls and fiscal risk management. Notably, the 2009 audit report was the first to achieve a qualified audit opinion, as opposed to a disclaimer, with around 40 percent of ministries and agencies achieving unqualified audit opinions. However, improvements are required in several areas including refinement in performance-based budgeting, strengthening internal and external audit, improving spending outturns. Weaknesses in financial management and accountability continue to be gradually addressed through the Government's PFM reform program. Also, key elements of the reforms are supported by the DPL series, as well as the GFMRAP project and other initiatives supported by development partners. Furthermore, the Government has also demonstrated increased focus on budget transparency by publishing the annual budget in a timely manner, through the MoF website.

147. **The borrower is the Republic of Indonesia and this operation is a single-tranche IBRD loan of USD 300 million.** The loan will be made available upon loan effectiveness, as the Bank is satisfied with the progress achieved by the Borrower in carrying out the Program and with the adequacy of the Borrower's macroeconomic policy framework. The Government has confirmed that Indonesia will borrow this amount as a Variable Spread Loan (VSL) in US dollar currency with an annuity repayment schedule linked to commitments.

148. **The loan disbursement will follow the standard Bank procedures for Development Policy Lending**. The loan amount will be disbursed into a foreign currency account of the borrower at Bank Indonesia that forms part of Indonesia's official foreign exchange reserves. The equivalent rupiah amount will immediately be transferred to the General Operational Treasury (SBUN) account of the borrower that is

used to finance budget expenditures, as the loan is intended to be used to support the general Government budget. This arrangement has been followed for the previous DPLs. The borrower, within 30 days, will provide to the Bank a written confirmation that this transfer has been completed, and provide to the Bank any other relevant information relating to these matters, including the exchange rate of the conversion from US dollars to rupiah, that the Bank may reasonably request. Disbursements of the loan will not be linked to any specific purchases and no procurement requirements have to be satisfied, except that the borrower is required to comply with the standard negative list of excluded items that may not be financed with Bank loan proceeds, as defined in Schedule 1 to the loan agreement. If any portion of the loan is used to finance ineligible expenditures as so defined in the loan agreement, the Bank has the right to require the Government to promptly, upon notice from IBRD, refund the amount equal to such payment to the Bank. Amounts refunded to the Bank will be cancelled from the loan.

149. **The foreign exchange control environment is assessed to be generally satisfactory.** The country is no longer subject to the Extended Arrangement from the IMF. Bank Indonesia (BI) was last subject to the transitional procedures under the Fund's safeguards assessment policy in 2002. That assessment recommended remedial action to address a number of vulnerabilities in the audit arrangements of Bank Indonesia. The main recommendations have been implemented, including the establishment of an independent audit committee at Bank Indonesia and the publication of Bank Indonesia's audited financial statements. Audited financial statements for Bank Indonesia for 2011 have been reviewed and the audit report issued by the BPK contained an unqualified opinion. Given that the foreign exchange environment does not present a significant risk, a separate annual audit will not be needed for this operation.

D. Risks

150. **Continued strong performance by the Government on its reform agenda and the achievement of its medium-term objectives are subject to several risks.** These can be broken down into the following categories: political risks; external vulnerabilities; increasing food prices; the risks posed by subsidies; fiduciary and reputational risks; and institutional capacity risks.

151. **Some recent policymaking outcomes from the administration have tended to be protectionist, generating concerns that there may be increasing risk of political pressure by vested interests.** The risk of political pressure by vested interests may result in lobbying efforts that could potentially undermine progress in some reform areas. For example, the issuance of a decree that will eventually eliminate foreign majority ownership of mines, appears to signify the move away from efficiency and towards serving special interests. Other controversial policy moves include: the scrapping of direct gubernatorial elections, in what is the first move to diminish democracy in Indonesia since it embarked on its democratization process in 1998; the banning of rattan exports to protect domestic furniture makers; restrictions on imports of horticultural products; and the tighter rules on establishing retail and restaurant franchises, in a bid to promote domestic businesses at the expense of foreign competitors. Overall, this protectionist trend and the regulatory uncertainty that it creates could potentially expand to other sectors, especially if economic growth slows as a result of the accelerating global slowdown and also as political tensions build in the run-up to 2014. The DPL program is expected to help put in place a mechanism for stronger GoI coordination and consultation on key reform areas, thereby providing more regulatory certainty.

152. **The multiplicity of implementing agencies and their varying institutional capacities could create a challenge in coordinating the DPL reform efforts.** The reforms supported by the INSTANSI DPL are driven by priorities that were developed and articulated formally through dialogue and consensus within the Government, hence their implementation help further enhance coordination between the relevant various ministries and agencies. The overall commitment and ownership to reforms also remains strong, and the Coordinating Ministry for Economic Affairs has performed very well in ensuring consistent and effective cross-ministerial coordination. The DPL program has also helped strengthen the capacity of

various institutions involved in the DPL program, which is also complemented by other Bank instruments, including investment projects, technical assistance and AAA.

153. Significant and rapid shifts in market sentiment could result in sudden, large and potentially disruptive capital outflows while the external accounts, and growth outlook, remain sensitive to global commodity prices and demand, particularly from China. Changes in market sentiment may be due to external factors, such as movements in global risk aversion, which expose Indonesia's continued economic vulnerabilities. However, there have been significant improvements in the Indonesian macroeconomic framework in recent years, which have translated into improved resilience to external shocks. The Government has also developed a track record in precautionary and proactive measures during the recent global financial turmoil, which would help limit the impact of turbulence in international markets on Indonesia. Furthermore, the recent PERISAI DPL, approved in May 2012, plus the parallel facilities from other development partners, explicitly aims to mitigate GoI financing concerns in the face of a crisis. But, in addition to financial shocks, recent export declines have highlighted Indonesia's exposure to adverse movements in global commodity prices and demand. One source of such shocks would be a sharper-than-expected slowdown in China, which would also have regional spillovers to markets such as Japan, with the effects feeding through into Indonesia's domestic demand and growth. With the current account moving into deficit, and portfolio flows remaining volatile, there is therefore a need for continued emphasis on supporting the performance of FDI.

154. Highly volatile international oil prices create uncertainty about the Government's energy subsidies costs, hampering overall budget spending. The revised 2012 Budget approved by Parliament provided for the possibility of increasing subsidized fuel prices, if international oil prices were 15 percent above the level assumed in the budget over a six-month period, combined with cash transfers to the poor. However, with international oil prices falling, this condition is unlikely to be met in 2012. Fuel subsidy spending in 2013 remains very high, reflecting continued increases in consumption, and imposing a substantial opportunity cost in terms of spending on other key development priorities. In the run-up to the next presidential election in 2014, it is uncertain whether and when the Government will implement a fuel price hike given that it represents a relatively unpopular policy.

155. Challenges remain to improve Indonesia's public financial management. However, in recent years Indonesia has made significant strides in the way its public finances are managed and in increasing transparency and independent oversight. In almost all areas of public financial management, changes in the legal and regulatory architecture are now largely complete and the momentum has shifted towards implementation of new practices. The Fiduciary Assessment for Indonesia has been carried out and the Fiduciary Risk is rated as Moderate.

156. Rises in domestic and international food prices may offset some of the benefits of growth and divert Government attention from longer term reforms. The GoI is well aware of the risks and challenges that lie ahead and has taken a number of precautionary and proactive measures in response. These include the use of trade measures, as in 2008, to mitigate the impact of rising food prices; the use of budgetary sources to expand social protection program and to intervene in stabilizing food prices; and issuance of Presidential Decree No. 5/2011 to implement mitigation actions aimed at safeguarding domestic rice production against extreme weather. For non-food, non-oil commodity prices the opposite dynamics are present. For example, sharp falls in prices could spill over to domestic consumption and investment.

Annex 1: Letter of Development Policy (to be added)

Letter of Development Policy

Jakarta, October 5 2012

NO. S-295/M.EKON/10/2012
No. S-733/MK.08/2012

Mr. James Yong Kim
President
The World Bank
1818 H Street, NW
Washington, DC 20433

Dear Mr. Kim,

On behalf of the Government of Indonesia, we would like to express our gratitude for the long term support that the World Bank has provided as a development partner within the multilateral economic and financial framework. We are hereby writing, on behalf of the Government of Indonesia to request the World Bank support through three lending operations:

- *The Institutional, Tax Administration, Social and Investment Development Policy Loan (INSTANSI DPL)* for USD 300 million.
- *The Financial Sector and Investment Climate Reform and Modernization Development Policy Loan (FIRM DPL)* for USD 100 million.
- *The Connectivity Development Policy Loan* for USD 100 million.

These three operations together form an important package of support to the Government that will help it achieve its medium term economic development and poverty reduction goals for Indonesia. Each of the development policy loans addresses strategic areas of reform including public financial management, poverty alleviation, financial sector development, investment climate, and connectivity. The three operations are fully aligned with the priority elements of our development agenda, as we have outlined in Indonesia's National Medium-Term Development Plan (RPJMN) 2010-2014, the Master Plan for Acceleration and Expansion of Indonesia's Economic Development 2011-2025 (MP3EI), as well as the Annual Government Action Plans (RKP), ministry/agency work programs, and reform packages. As you are aware, Indonesia has made important progress over the past decade in many areas of social and economic development and poverty reduction. However, continued implementation of its earnest reform agenda is essential if it is to meet the goals in terms of sustainable and inclusive growth. This Letter of Development Policy outlines the Government's recent progress implementing its reform program and its medium term agenda in the areas supported by the loans.

Indonesia has established a good track record in advancing key policy and institutional reforms. The Government intends to continue the reforms, and anticipates that the proposed program lending overall will continue to support these efforts. The financial support provided for these three DPLs will complement and build upon the DPLs 1-8 supported from 2003-2011 and the USD 2.0 billion in financing provided by the World Bank through the Program for Economic Resilience, Investment and Social Assistance (PERISAI) Development Policy Loan with Deferred Drawdown Option in May 2012. Since May, other development partners including the Government of Japan, Australia, and the Asian Development Bank have also committed additional financing to PERISAI, which aims to enhance the Government's preparedness to address the potential adverse impact of ongoing volatility in financial markets on Government's ability to meet its gross fiscal financing needs from markets. This facility is expected to help ensure that Indonesia can continue with its earnest development and reform agenda even in the event of a crisis.

Output growth in Indonesia has been consistent throughout the last decade, broad based and strong, as well as relatively crisis resistant, bouncing back to pre-crisis levels since 2008-9. This mainly reflects increasing private sector investment and strong domestic consumption. Through its fiscal policy stance and policy reform agenda, the Government also made efforts to support growth in the face of a weaker, and uncertain, international environment, in conjunction with Bank Indonesia's supportive monetary policy.

Indonesia also enjoys low fiscal deficits, supported by the Government efforts to increase revenue and contain our expenditures, and we have concurrently been able to reduce our external imbalances and improve investor sentiment. In the future, we are committed to furthering our efforts to enhance our crisis preparedness and reduce any potential financial market volatility in the face of ongoing global economic turmoil, and in parallel, boost medium term growth.

Enhancing the quality of public spending for poverty reduction and service delivery

The Government remains committed to accelerating the pace of poverty reduction. Since the 2009 elections, there has been renewed commitment by the Government to intensify policy reforms that support poverty reduction and improve the effectiveness of national poverty reduction programs. The RPJMN 2010-2014 highlights the Government's aim to lower the poverty rate to 8-10 percent by 2014 under the President's triple-track development strategy (pro-growth, pro-jobs and pro-poor) that will reduce poverty by strengthening economic growth, stimulating job creation, and deepening investments in our poverty reduction strategy. The latter include further improvements in the targeting and monitoring of poverty alleviation programs and measurement of poverty, to ensure that these programs reach the intended beneficiaries and to better inform policy choices going forward.

We also recognize that better targeted allocations of public funds toward development priorities and more efficient, transparent and accountable spending are essential to further improving public service delivery and the overall quality of spending. Over the past decade, we have made significant progress in the way public finances are managed and in increasing transparency and independent oversight. Changes in the legal and regulatory framework are now largely complete, expenditure controls have been strengthened within a unified budget, government accounting standards have been formally established and are largely being adhered to in the production of comprehensive annual financial statements, while the capacity of the internal and external audit functions continues to grow. A new public Financial Management Information System (SPAN), which should streamline budget execution and provide more timely and robust information for budget management at all levels of government, is expected to be rolled out in 2013. The reform momentum has also gradually shifted toward the implementation of more performance orientated practices with the introduction of the Medium-Term Expenditure framework (MTEF), Performance-Based Budgeting (PBB), and results-based monitoring.

Developing a sound, efficient and inclusive financial sector

In recent years, the Government has made important progress in terms of achieving stability in the financial sector. This has been demonstrated by improved soundness indicators of the banking sector in particular, and the relatively modest impact to date of both the global financial market instability since 2008 and ongoing crisis in the Eurozone. The Government has responded proactively to such global developments, identifying and implementing key measures to maintain the stability of the financial sector and to reduce volatility in our financial markets. For instance, the Government has established a bond stabilization framework that aims to stabilize the government bond market in the case of a sudden reversal in capital flows or shock. This mechanism includes a number of potential actions to stabilize government bond market in the case of crisis.

In addition to our efforts noted above, we plan to continue our longer term reforms to promote financial sector stability, by pursuing reform of the underlying legal and regulatory framework. Reinforcing the Government's commitment to promote the financial stability, in October 2011, the Indonesian Parliament passed the new Financial Services Authority Law (the "OJK Law"), which provides the legal basis for the establishment of a new consolidated financial sector supervisory authority. Importantly, in the medium and longer term this law provides us with an opportunity to further strengthen the quality of financial sector supervision in Indonesia. In this way, the new law establishes a legal basis for improved coordination in monitoring financial sector stability through the Financial Sector Stability Coordination Forum. To this end, we are supporting efforts to improve crisis prevention and management arrangements. This has included development of the National Crisis Management Protocol, and agreement on information sharing and coordination arrangements between the Ministry of Finance, Bank Indonesia, and Indonesia Deposit Insurance Corporation (LPS).

The current global economic environment reinforces the importance for Indonesia financial sector authorities to continue to implement its reform agenda related to financial sector diversification and inclusion. This includes the pursuit of deeper reforms of the financial sector to enhance efficiency and expand access to services for the poor and underserved. In the medium term, this will imply measures to promote the development of non-bank financial institutions, including capital markets and insurance sector. Specific reform challenges and priority measures are outlined in the Bapepam-LK Capital Market and NBFI Master Plan 2010-2014, which is currently under implementation. The Government's reform program will also include taking important steps to implement the National Strategy for Financial Inclusion in order to enhance the prospects of the poor engaging in Indonesia's financial system and accessing a wide range of saving, credit, and insurance products. The development of a sound, deep, and efficient financial sector in Indonesia is required to promote medium term job creation, enterprise development, and poverty reduction.

Supporting improvements in the investment climate

The Government has recently embarked on a wide range of prudent regulatory reforms in order to improve competitiveness and encourage investment in Indonesia. As a result of these measures, a number of perception-based and objective indicators of the investment climate improved, and this has been reflected in increasing investment flows. In 2010, Indonesia emerged from the recent financial crisis of 2008-2009 with FDI inflows at over USD 13 billion, and further enjoyed substantially increased FDI levels of 19.2 billion in 2011.

Building on these efforts, we plan to deepen our focus on providing a positive investment climate that enables business to grow and will work with us towards achieving our goal to boost Indonesia's economic growth to 7-9 percent during the coming decades, as outlined in our Master Plan for the Acceleration and Expansion of Indonesia's Economic Development 2011-2025. Under this framework, we recognize that a healthy business climate increases investment and leads to stronger job-generating growth. Therefore we plan to continue reform in areas such as business licensing and regulatory reform, for example by establishing a regulatory review committee specifically supporting MP3EI. As part of the efforts to improve the business environment, we are also focusing on commercial dispute resolution, and developing the legal framework to streamline current procedures and decrease delays in small claims resolution. Looking forward, we plan to work together with all parties, including both central and local government, on debottlenecking, regulations, incentives and the acceleration of infrastructure development needed by all stakeholders in Indonesia's growth.

Improving national connectivity

The government realizes that addressing challenges in connectivity is an important for Indonesia to optimize its growth potentials and strengthen inclusive growth. Bottlenecks in connectivity have been identified as a major development constraint that Indonesia needs to address, if it wishes to see rapid economic transformation. Poor domestic connectivity has increased domestic logistics cost, hinder integration in domestic economy, undermine manufacturing competitiveness and impose barriers for inclusive growth in lagging regions in Indonesia. Problems in international connectivity also impede Indonesia's potential to benefit fully from integration with the global market.

Addressing connectivity challenges is a cross-cutting issue and integral part in Indonesia's Five-Year National Strategic Plan RPJMN 2010-2014 and the Master Plan for Acceleration and Expansion of Indonesia's Economic Development 2011-2025 (MP3EI) that the Government is committed to implement. MP3EI outlines the importance the Government places on strengthening national connectivity, with the Master Plan calling for efforts to reinforce, connect and complement the six regional corridors of growth in particular.

In recent years, the Government has also made significant policy and institutional reform efforts to address connectivity challenges. The Government introduced reforms aimed at improving policy coordination surrounding connectivity, improving domestic logistics efficiency, facilitating investment in public infrastructure projects, improving trade facilitation and strengthening inclusive development. We introduced a National Logistics Blueprint that will guide reforms in logistics and established the mechanism for linking these reforms with implementation of the MP3EI. Recently, we issued an implementing regulation for the new Land Acquisition Law that would help facilitate investment projects that enhance national connectivity. The Government has also introduced reforms to strengthen Information and Communications Technology (ICT) connection, particularly for Eastern Indonesia. On international connectivity, we continue to undertake reforms surrounding the Indonesian National Single Window (INSW) as a mechanism to better facilitate international trade.

We therefore plan to focus our efforts going forward on a reform program that is aimed at reducing domestic logistics costs and strengthen inclusive development, including efforts to strengthen national coordination and regulation, and connectivity on an intra-island, inter-island and international level.

Conclusion

In conclusion, Indonesia continues to make solid progress in the areas to be supported by the DPL program lending, specifically towards enhancing the quality of public spending for poverty reduction and service delivery, developing a sound, efficient and inclusive financial sector, supporting improvements in the investment climate, and improving national connectivity. We therefore appreciate your positive response to our request for support and look forward to working with you in the context of the INSTANSI, FIRM, and Connectivity DPLs.

Minister of Finance
Republic of Indonesia

Agus D.W Martowardojo

Coordinating Minister for Economic Affairs
Republic of Indonesia

M. Hatta Rajasa

ANNEX 2: INSTANSI DPL PROGRAM POLICY MATRIX

(Prior actions (2012) and indicative triggers (2013) are indicated in bold and are linked to program disbursement, while benchmark actions/milestones are not)

Reform aim	**Prior actions and benchmarks and proposed indicative triggers and milestones**	
	By September 2012	**By September 2013**
Policy area 1: Strengthening public financial management		
Policy sub-area 1.1. Strengthening budget formulation and M&E systems		
Improve budget information transparency and use of MTEF		**Use SPAN in the preparation of the 2014 budget to clearly separate the MTEF elements of the process and facilitate the reconciliation with the prior year forward estimates in the draft budget documents**
	Prepared draft white paper for a new and simplified costing methodology.	**Issue Government regulation that establishes a new Costing Methodology, in line with the MTEF approach, which also determines the methodology for allocating costs to programs/activities in 2014.**
Strengthen the use of monitoring and evaluation in the planning and budgeting cycle	Produced draft guidelines to all K/Ls to formulate performance indicators, as part of a National M&E Roadmap to improve the M&E system, to be used for the next RPJMN (2015-19).	
	Circulated draft guidelines for line ministries for the review of baselines in order to find savings to finance new initiatives and improve quality of spending	**Implement an integrated baseline and policy review as part of the preparation of the 2014 Budget that includes an assessment of the policy performance in the prior year based on a common definition of performance information.**
		Develop a targeted spending review process that involves an in-depth examination of the effectiveness and efficiency of spending and makes recommendations for revised budget allocations in the following budget.
		Use SPAN to collate and report on both financial and non-financial information to support the monitoring of K/L performance
Policy sub-area 1.2. Strengthening budget execution systems		
Streamline budget execution and flexibility of budget management	Issued white paper analysis on the simplification of virement procedures, consistent with the PP on budget execution for the FY2013 onwards.	**Implement a simplified virement procedure that supports the spirit of "let the manager (line ministry) manage"**
	The Borrower, through the Ministry of Finance, has issued a Ministerial Regulation (No.112/2012) simplifying and clarifying the practice of withholding funds for budget allocation ("*Bintang*").	Based on a review the effectiveness of the steps in 2012 to minimize the application of "bintang" introduce further measures that eliminate the "bintang" practice and put increased reliance on ex-post controls

Reform aim	Prior actions and benchmarks and proposed indicative triggers and milestones	
	By September 2012	**By September 2013**
	Submitted the final draft Government Regulation (PP) on "Procedures of State Budget Execution" to the Ministry of Justice	**Issue new PP and related MOF regulations on budget execution**
Develop IFMIS (Integrated Financial Management Information System)	**The Borrower, through its Ministry of Finance, has completed the design and build phase for the new budget preparation system.**	Complete Hyperion interfaces with SAKTI and full implementation of SPAN budget planning solution (Hyperion and Custom Web) to substitute the legacy RKA-KL application
	Commenced development of SAKTI application that will be used by 29,000 Spending Units in linkage (web-based) with the SPAN systems (Hyperion and Oracle EBS)	Finalize SAKTI application, with distribution to and usage by all 29,000 Spending Units throughout Indonesia
	Commenced the testing of SPAN application	**Fully implement the SPAN in all 177 Treasury Local Offices (KPPNs)**
	The Borrower has introduced a new General Ledger under SPAN using daily transaction conversions from the old General Ledger.	Produce semester and annual Central Government financial statement reports from SPAN
Improve provision of ICT Integration and Services	Integrated MOF ICT by having a single Data Center (DC) operational and a consolidation of the existing DCs run at DJPU, DJBC, DJA, DJPB and MPN into this new DC facility located at Pusintek	Achieve the desired level of IT Security Awareness for all MOF units
Strengthen management of state assets	Issued several decrees that empower the MoF with the authority to control the use of state asset issued	Issue Minister of Finance Regulation on the procedures of depreciating the state assets to support the implementation of the accrual accounting
Improve government accounting and audit functions	Established a task force to facilitate the creation of a professional association of internal auditors	**Establish a professional association of internal auditors and drafts of (a) code of ethics and (b) internal audit standards**
	BPKP completed and socialized a Control Self Assessment (CSA) manual for the launch of CSAs by line ministries	30 line ministries complete risk assessment, as mandated by PP 60
	The Borrower, through its Ministry of Finance, has issued and disseminated a Ministerial Regulation (No. 238/2011) on new accrual based accounting policies and chart of accounts.	

Reform aim	Prior actions and benchmarks and proposed indicative triggers and milestones	
	By September 2012	**By September 2013**
Policy sub-area 1.3. Improving tax administration		
Improve human resources management in DG Tax	Developed and submitted to MoF academic paper s on: (i) Establishment of Data Processing Centre and Information; (ii) Establishment of Procurement Service Unit (ULP); and (iii) Establishment of Contact Centre	Endorsement by Ministry of Finance of the academic papers on: (i) Establishment of Data Processing Centre and Information; (ii) Establishment of Procurement Service Unit (ULP); and (iii) Establishment of Contact Centre
	Issued Director General Regulation regarding performance management system of tax auditor with scalable and consistent manner.	
Modernize the core tax system	Improved the efficiency and effectiveness of the existing core tax systems and the integrity of taxpayer database by integrating the stand alone system (SIPMOD) into the centralized SIDJP in tax offices throughout Indonesia.	Issue Medium Term DGT Strategic Plan
	The Borrower has issued a Government Regulation (No.31/2012) for the implementation of Article 35A of Law 28/2007 and a Minister of Finance Decree (No. 194/KMK.03/2012) on the sharing of data between DG Tax and DG Customs, all of this to facilitate the sharing of third party information for improved tax compliance.	**Development of procedure and an application for VAT Refunds for Tourists through a website (e-invoice)** [11] **Development of individual e-filing for 'Simple Tax Return' and 'Very Simple Tax Return Form'**[15]
	Issued Minister of Finance Regulations regarding: (i) taxes and duties on exports and imports to and from areas which have been designated as a Free Trade Zone or Free Port; (ii) payment of oil and gas income tax in-kind; and (iii) Taxpayer Identification Number and Taxable Entrepreneur.	
Policy area 2: Enhancing poverty alleviation and service delivery efforts		
Improve governance and institutional accountability	Finalized the M&E integration strategy and workplan.	
	Agreements are in place between TNP2K Secretariat and key Government agencies to integrate M&E systems starting with PKH and PNPM (urban and rural).	Pilot for a grievance resolution system is designed and initiated in select social assistance program (proposed: PKH).

[11] The Government will confirm which action will become a trigger at the loan negotiation.

Reform aim	**Prior actions and benchmarks and proposed indicative triggers and milestones**	
	By September 2012	**By September 2013**
	TNP2K Secretariat presented design options for a proposed unified grievance and complaint resolution system to Government agencies responsible for RASKIN and PKH program implementation and coordination	
Improve poverty measurements and targeting of the poor	**The Borrower, through TNP2K, has signed four memoranda of understanding with the Coordinating Ministry of Peoples Welfare, the Ministry of Health, and the Ministry of Education and Culture, and the Ministry of Social Affairs, respectively, whereby the referred ministries agreed to use the unified database held by the TNP2K Secretariat to select the beneficiaries of the *Raskin, Jamkesmas, BSM* and *PKH* programs, respectively.**	
Improve household-targeted poverty reduction programs (Cluster 1)	**The TNP2K Secretariat has completed a review of new institutional arrangements for the delivery of *Jamkesmas*, taking into account actuarial cost estimates and various scenarios for achieving universal health insurance coverage.**	**A strategy for the transition of Jamkesmas institutional arrangements from Ministry of Health to the social security system administrator for health (BPJS Health).**
	Prepared a strategy document on reforming the targeting, fragmentation, benefit levels, and outreach strategies for Scholarship for the Poor programs.	**Program reforms are adopted to improve the targeting of scholarships (i.e., using national registry for new primary school entrants) and supporting poor students through school transition years.**
	Commenced piloting of new methods for targeting of beneficiaries of the Rice for the Poor program (RASKIN).	Evaluation of the usage of the national registry by social assistance programs is conducted (from Raskin pilot).
Improve community-based poverty reduction programs (Cluster 2)	**The Borrower, through TNP2K, has issued a roadmap for PNPM (including strategic directions and action plan) to guide the long-term implementation of PNPM and to strengthen the integration of PNPM with Local Governments.**	
	Introduced service standards for improving management and responsiveness to beneficiaries, particularly in areas that have experienced major complaints.	

ANNEX 3: INSTANSI DPL Program Monitoring and Results Framework

Reform Aim	INSTANSI DPL Prior Actions (2012)	INSTANSI DPL Prior Actions (2013)	Indicators	Baseline Data	Post Program Target (post 2013)
Policy area 1: Strengthening public finance management					
Overarching Outcome: Greater integrity and more effective use and management of public funds			% of K/Ls with Unqualified audit opinion % of total capital expenditure disbursed on by end of Q2 /2	63% in LKKP for FY2010 18.1% (Q2-2012, end Q2 disb to Revised budget APBN-P)	84% for FY2013 22%
Improve budget information transparency and use of MTEF		Use SPAN in the preparation of the 2014 budget to clearly separate the MTEF elements of the process and facilitate the reconciliation with the prior year forward estimates in the draft budget documents Issue a Government regulation that establishes a new Costing Methodology, in line with the MTEF approach, which also determines the methodology for allocating costs to programs/activities in 2014.	PEFA PI 12: multi-year perspective in fiscal planning, expenditure policy and budgeting /3	PEFA rating as of most recent PEFA report (2011): C+	PEFA rating improves to at least B.
Improve the monitoring and evaluation system		Implement an integrated baseline and policy review as part of the preparation of the 2014 Budget that includes an assessment of the policy performance in the prior year based on a common definition of performance information. .			

Reform Aim	INSTANSI DPL Prior Actions (2012)	INSTANSI DPL Prior Actions (2013)	Indicators	Baseline Data	Post Program Target (post 2013)
Streamline budget execution and flexibility of budget management	The Borrower, through the Ministry of Finance, has issued a Ministerial Regulation (No.112/2012) simplifying and clarifying the practice of withholding funds for budget allocation ("*Bintang*").	Implement a simplified virement procedure that supports the spirit of "let the manager (line ministry) manage"	PEFA PI 17: Recording and management of cash balances, debt and guarantees /3	PEFA rating as of most recent PEFA report (2011): B+	PEFA rating improves to an A.
		Issue new PP and related MOF regulations on budget execution			
Develop new Financial Management Information System (IFMIS)	The Borrower has introduced a new General Ledger under SPAN using daily transaction conversions from the old General Ledger.	Fully implement the SPAN in all 177 Treasury Local Offices (KPPNs)			
	The Borrower, through its Ministry of Finance, has completed the design and build phase for the new budget preparation system.				
Improve Government accounting and audit functions	The Borrower, through its Ministry of Finance, has issued and disseminated a Ministerial Regulation (No. 238/2011) on new accrual based accounting policies and chart of accounts.	Establish a professional association of internal auditors and drafts of (a) code of ethics and (b) internal audit standards	Central and local government introduce accrual based accounting methods in 2015 /2	Central Govt. has a cash-toward accrual accounting system with local Govt. using cash basis.	Accounting standards and systems in place for move to accrual based accounting by 2014 in central and local Govt.

Reform Aim	INSTANSI DPL Prior Actions (2012)	INSTANSI DPL Prior Actions (2013)	Indicators	Baseline Data	Post Program Target (post 2013)
Modernize core tax system	The Borrower has issued a Government Regulation (No.31/2012) for the implementation of Article 35A of Law 28/2007 and a Minister of Finance Decree (No. 194/KMK.03/2012) on the sharing of data between DG Tax and DG Customs, all of this to facilitate the sharing of third party information for improved tax compliance.	(i) Development of procedure and application of VAT Refund (e-invoice) for Tourist through website and (ii) Development of individual e-filing for Simple Tax Return and Very Simple Tax Return Form.[12]	Domestic non-oil and gas tax revenues to GDP (%) /2	4.7% (Avg 2009-2011)	4.9%
Expected outcome: GoI efforts to reduce poverty and vulnerability are strengthened through better informed and evidence-based policy and program decisions			% of social assistance program to central Government expenditure /4	3.3% (2011)	4.5%
			Proportion of targeted female headed households receiving social assistance /5	82% (2011)	Figure to increase.
Improve poverty measurements and targeting of the poor	The Borrower, through TNP2K, has signed four memoranda of understanding with the Coordinating Ministry of Peoples Welfare, the Ministry of Health, and the Ministry of Education and Culture, and the Ministry of Social Affairs, respectively, whereby the referred ministries agreed to use the unified database held by the TNP2K Secretariat to select the beneficiaries of the *Raskin, Jamkesmas, BSM* and *PKH* programs, respectively.		Number of line ministries using the unified database to identify program beneficiaries /6	4 (PKH, Jamkesmas, BSM and Raskin)	6

[12] The Government will confirm which action will become a trigger at the loan negotiation.

Reform Aim	INSTANSI DPL Prior Actions (2012)	INSTANSI DPL Prior Actions (2013)	Indicators	Baseline Data	Post Program Target (post 2013)
Improving household-targeted poverty reduction programs (Cluster 1)	The TNP2K Secretariat has completed a review of new institutional arrangements for the delivery of *Jamkesmas*, taking into account actuarial cost estimates and various scenarios for achieving universal health insurance coverage.	Finalize a strategy for the transition of Jamkesmas institutional arrangements from Ministry of Health to the social security system administrator for health (BPJS Health).	% of the poor having health insurance /7	43%	48%
		Program reforms are adopted to improve the targeting of scholarships (i.e., using national registry for new primary school entrants) and supporting poor students through school transition years.			
Improving community-based poverty reduction programs (Cluster II)	The Borrower, through TNP2K, has issued a roadmap for PNPM (including strategic directions and action plan) to guide the long-term implementation of PNPM and to strengthen the integration of PNPM with Local Governments.		Number of villages, kecamatan and cities receiving social empowerment assistance /8	57,000 rural villages in 5,100 sub-districts (*kecamatans*)	Figures to increase.

Indicator data source:
/1 BPS
/2 MoF
/3 PEFA Report
/4 WB staff estimates based on four main Social Assistance programs, i.e. Jamkesmas, PKH, BSM and Raskin.
/5 Susenas
/6 TNP2K
/7 MoH
/8 PNPM

Annex 4: Looking back: Results Achieved in Previous DPLs

The Indonesian DPLs benefit from a large field team presence that is actively engaged with the Government through various other instruments in addition to the DPL. The socialization on both sides is quite deep and the processing has become quite standard. As a result, although the task team leaders for the DPLs change, the lessons learnt from previous DPLs are seamlessly incorporated into future operations, and the series has become quite mature and efficient.

The lessons of previous DPL series are still instrumental to the success of the DPL 7-8 series, highlighted in the lessons learned in section D, and worth noting:

ICR DPL 1-4:

- **A DPL program "driven" by the Government.** For a long-term sustained ownership of the DPL program by the Government, there needs to be more than just Government "buy-in" of a set of policy actions that are suggested by the Bank's or other development partners' analytic assessment of what the main priorities are. Rather, the DPL program needs to be "driven" by the government's own reform agenda and perhaps more importantly, that the pace and scope of reforms be driven by the judgment and tactical sense of key reformers regarding what may or may not be bureaucratically or politically feasible at a particular point in time. Such an approach is not without its tradeoffs. The pace of reforms may, at times, and on certain issues seem more incremental rather than"substantive". However, this also helps to break down the reforms into deliverable segments that maintain the reform momentum and consolidate implementation until the timing was right for larger breakthroughs (e.g. as happened with the TSA and NSW) Over the long-term, such an approach has the potential to yield, as occurred in Indonesia, genuine government ownership of the DPL program, and a robust foundation from which the DPL process can be continuously improved and refined.

- **Success lies in following up on the implementation details of the reform process, which is critical to the sustainable effectiveness of the reforms.** Too often the implementation stage of a DPL sponsored reform is overlooked to focus on the next higher level reform—however, the Indonesia DPL specifically focused on numerous detailed implementation triggers to ground the reform, make it operational and transparent, and therefore successfully effective. As a result, having multiple prior actions has been an effective way for the Indonesia DPL to broaden its reform agenda, but more importantly, to make concrete steps forward in the reforms initiated and thereby make the reforms sustainable in the medium term.

- **Constant collaboration and dialogue between the GoI and the Bank was fundamental to its success.** In this respect, the Bank's heavy field presence enabled it to interact frequently with the government, not just on the DPL but in other related engagements that supported the DPL policy areas. This in turn afforded the Government the ability to appoint high level counterparts to ensure that the triggers would be met, as their mandate was not just narrowly focused on the DPL reform triggers but also in the broader engagement. As a result, the appointment and socialization of high-ranking motivated counterparts, greatly enabled pushing through the triggers and ensuring the loan could be delivered.

- **Mapping out a reform program would provide meaningful direction, substantive results, and less criticism over trigger selection.** In the past DPLs, some reforms, such as the Treasury Single Account, had key reforms implemented annually that resulted in a substantial improvement in Government operation from DPL1 to DPL4. These "storybook" reforms are also more sustainable, as the reforms progressed and were deepened, and the parties involved remained engaged in the DPL reform process.

ICR DPL 5-6:

- **Mapping out a reform program provides meaningful direction and substantive results down the road, but a degree of flexibility is still needed, especially to ensure sustained government ownership.** Compared with the first, the second DPL series was more systematic in adopting a multi-year strategic frame for the program, and laying out a basic mapping of the reform program that more specifically describes the end goals. While the initial mapping out of a detailed strategy and a multi-year agenda under each of the various DPL reform aims allowed a more strategic consideration of what the most critical next reform steps might be, ensuring sustained Government commitment to furthering the various reform objectives was even more critical. Indeed, institutional and policy reforms are usually complicated and involve unpredictable undertakings. Such reforms often need to go through a trial and error process, where there may be the occasional dead-ends that require backtracking and finding an alternate route. Hence a degree of flexibility should be maintained, so that when the right opportunity presents itself, reforms that had otherwise been apparently slow can be supported and advanced more rapidly.

- **Continuous DPL dialogue strengthened the Government's knowledge base, which in turn allowed more proactive and swift measures to be taken at a time of crisis.** The continued policy dialogue under the DPL has strengthened the knowledge base and allowed the Government to move proactively and take precautionary measures at the time of crisis. Establishment of the FSSF, for instance, has formed the basis for the financial sector safety net and allowed the Government to swiftly address systemic risks in the financial system. The Government was also able to proceed quickly in requesting for the DDO-DPL, which eventually helped in restoring public confidence and advancing other policy reforms. Had the DPL been non-existent, the swift resolution of the financial systemic risks and quick delivery of the DDO-DPL at the time of crisis would not have been possible.

- **The reclassification of policy actions — into prior and benchmark actions — allowed a more prioritized and programmatic approach.** While DPL 5 is very much a continuation of the first DPL series' medium-term institutional efforts, the indicative DPL 5 triggers identified at the preparation of DPL 4 were reassessed, then reclassified into prior and benchmark actions that signify progress towards longer-term reforms. Indeed, some benchmark actions that may appear incremental at face value are actually steps that need to be taken before more substantive reforms can take place. Hence, the reclassification of actions allowed more priority and focus over the more critical, key prior actions, while still acknowledging the Government's pace and scope of reform process. This not only helped in ensuring a sustained Government ownership, but also in mapping out a more comprehensive, multi-year strategic frame for the program.

- **DPLs are only one instrument among many that are available in a multi-faceted engagement, and the choice of instrument should be contingent on the issue, the political context and the institutional circumstances.** The Bank program in Indonesia is one of the largest of any country in terms of number of staff and overall resources. Large teams are working closely on a daily basis with Government counterparts at often very senior levels on a wide range of issues from public financial management and trade and investment, finance, public expenditures and poverty. In this context, the DPL is not the only instrument for supporting reform, but rather complementary to other instruments such as investment projects, TA and AAA.

Annex 5: TECHNICAL ANNEX ON PUBLIC FINANCIAL MANAGEMENT

I. Background and Analytical Underpinnings

The INSTANSI DPL operation sets out to provide general budget support to the Indonesian Government and will be executed through the Government's public financial management (PFM) systems. In order to assess the attendant fiduciary risks with respect to the proceeds of this operation, this annex summarizes the current state of these systems as well as ongoing reform efforts to further enhance them.

Performance of Indonesia's public financial management systems was comprehensively measured in 2007, when a PEFA assessment was conducted for the first time. Results of this assessment reflected a mixed picture of strengths and weaknesses. Key strengths pertained to transparent and comprehensive budget documentation, a well defined budget process with both executive and legislative adhering to the schedule, a budget classification which complied with international standards and a strengthened external audit function. The first PEFA also highlighted the sound regulatory framework that had been put in place for almost all PFM areas, major reorganization had taken place at the Ministry of Finance, and advances had been made in budget preparation, such as instituting a unified budget. Weaknesses, on the other hand, were identified across dimensions of budget execution such as financial reporting, the high variation between budgets and outturns, and internal controls.

The 2011 PEFA repeat assessment showed a marked improvement in budget controls and reporting (see the summary in Annex 6). Notably, the 2009 external audit report was the first to achieve a 'qualified' audit opinion, as opposed to a disclaimer, with around 40 percent of ministries and agencies (K/Ls) achieving an 'unqualified opinion'. Furthermore, the Government has publicly set an ambitious target for achieving an unqualified audit opinion for all K/Ls by 2014, with 77 percent achieving this for FY2011. The new assessment also confirmed that substantive progress has been made, particularly in the area of budget execution, with the development of a Treasury Single Account to strengthen the comprehensiveness and control over spending and cash management (with support under previous DPLs). In addition, there have been improvements in the coverage of fiscal accounts, accounting practices, payroll and internal controls and fiscal risk management.

However, it is still early to measure improvements in some important areas, for example: the medium-term expenditure framework and performance orientated budgeting have only recently been introduced and will require considerable refinement over the next few years; there is an ongoing capacity building effort to strengthen internal and external audit; the computerized GFMIS (SPAN) that will strengthen financial management capabilities will be rolled out in 2013; despite the new procurement law and introduction of eprocurement and new disclosure policies weaknesses remain that often cause lengthy delays; and accrual accounting is due to be introduced in 2015. In addition, the assessment highlighted the ongoing problems of the large variation in spending outturns, particularly for capital expenditure, which perhaps reflects the focus on tightening expenditure controls and compliance at the expense of improving delivery and performance in the short-term.

Many reforms therefore remain a 'work in progress'. Nonetheless, both assessments acknowledge the reform efforts of key stakeholders of the budget process, which have been ongoing since the political transition in 1998 and especially following the MOF White Paper in 2001. The Government continues to demonstrate its commitment to the reforms set out in this White Paper, although the timing and sequencing is evolving around the main pillars of the budget system to reflect the variable capacity constraints and changing political/policy and economic priorities. However the main objectives have remained the same, these include: (i) improving the results-orientation in state budget planning and development; (ii) modernizing budget and treasury management; (iii) strengthening monitoring and evaluation of public expenditures and programs; (iv) improving the public procurement systems; (v) improving Government accounting and audit functions; and, last but not least, (vi) civil service reforms to improve the quality and performance of the workforce. This annex also includes reforms in the following areas: (vii) debt management; (viii) regional public financial management; as well as (xi) governance and anti-corruption.

The commentaries below draw on recent economic and sector work undertaken by the World Bank and other development partners. Besides the aforementioned PEFA, it takes into consideration the findings of a joint Bank-Fund mission on Strengthening Budget Management undertaken in June 2008, the September 2008 update of the Fiscal Transparency ROSC (IMF Country Report No. 08/298, Selected Issues; Indonesia). More recently, insights on latest reform progress were derived from the EC funded evaluation the PFM Multi-Donor Trust Fund (PFM MDTF) in late 2010, the development of a Medium-Term Strategy Note for the PFM MDTF and a Bank report on identifying the constraints to budget execution in the infrastructure sector in 2012.

II. Reform Priorities: Achievements, Challenges & the Way Ahead

1. Improving Results-Orientation in State Budget Planning and Development

As indicated in the PEFA reports, substantial advances have already been made in Indonesia's budget preparation process since the passing of the Law on State Finances No. 17/ 2003. For example, the introduction of a unified budget in 2005, which combined the previously separate recurrent and development budgets, has had a significant impact on overall budget planning and transparency.

Generally, more work needs to be done to implement Performance Based Budgeting (PBB) and the Medium-Term Expenditure Framework (MTEF) in order to ensure that policy orientation and fiscal sustainability become an integral part of the Indonesian State Budget, as prescribed by Law 17/ 2003. Following the issuance of a joint MoF and Bappenas manual on PBB and MTEF in June 2009 and pilot projects with six line ministries, a major breakthrough for PBB/MTEF implementation was the revision of the program structure in the Government's planning and budget documents that were conducted throughout the second half of 2009. The new program structure aligns Government programs with organizational structures and establishes much clearer lines of accountability for program performance. Along with the new program structure, line ministries have also formulated targets and indicators, which provide a better basis for evaluating the performance of programs and activities in the coming years, thus fulfilling a fundamental prerequisite of PBB. The new programs, targets, and indicators were incorporated in the RPJMN for 2010-14, and implemented in the FY2011 budget.

The 2011 budget was also the first year of implementing a detailed MTEF process. Ministries prepared budget estimates for two years following the fiscal year (2012 and 2013) and incorporated them into the budget documentation presented to Parliament in August (though Parliament will not be appropriating funds beyond the fiscal year). MoF regulation No. 104/2010 concerning the completion of budget submission or RKA-KL templates for 2011, contains detailed guidelines for preparing these forward estimates at the level of components. The Government is aware that this is an exercise that will have to be refined going forward, and, as described in the previous DPL indicators, new elements, such as the definition of the baseline and new initiatives were incorporated in the 2012 budget process, ensuring better linkages between planning (RKP) and budget documents (RKA-KL) and improving the use of the rolling financial estimates.

The Government also recognizes that PBB/MTEF implementation needs to be strengthened further. For the near term (1 year) there is an ongoing need to improve the quality of program structures and performance indicators and to fine-tune the existing MTEF and costing system. For the medium term (2-4 years) the focus of budget reforms should gradually shift towards (i) developing a PBB-driven Monitoring and Evaluation (M&E) system and related concepts, such as a concept of how performance information could impact on budget allocations in the future, (ii) enhancing capacity to conduct a range of modern budget analytical techniques in accordance with PBB and introducing the appropriate change management and organizational arrangements, and (iii) strengthening the link between budget and bureaucracy reforms, in particular the link to performance management—the MoF has introduced strategic performance management based on the Balanced Scorecard (BSC) and key Performance Indicators (KPIs) for all Directorates in the Ministry. Some BSC indicators correspond with PBB indicators, and, while still at an early stage, the link between PBB and performance management has the potential to provide stronger managerial incentives for successful program implementation. A joint roadmap to address the above points and to help plan and sequence budget and planning reforms going forward is currently being developed by the MoF and Bappenas, with assistance from World Bank advisors.

In terms of legislative oversight, the Parliament's (DPR) new role in shaping the state budget and in overseeing budget processes was institutionalized in Law No. 27/2009. According to this law, two new arrangements were implemented by DPR with regards to budget preparation and oversight procedures in 2009. Firstly, the former Budget Committee became the Budget Board (Badan Anggaran) and a permanent entity of DPR responsible for the endorsement of the state budget. Secondly, the State or Public Finance Accountability Board (Badan Akuntabilitas Keuangan Negara) was established as a permanent entity of DPR to review audit results of state financial reports prepared by the State Audit Agency (BPK). Although not mandated in the law, preliminary planning has started also for the establishment of a Parliamentary Budget Office (PBO), which is intended to provide support for the implementation of the budget function of Parliament through providing data, information, analysis and research needed by the members of Parliament in their discussions of the annual state budget.

On top of these new institutional arrangements, the DPR needs to continue building: (i) independent support and research capacity to support legislative budget review; (ii) general capacity development in budget analysis and oversight including familiarity with PBB and MTEF; and (iii) follow-up of external audit findings to ensure that the executive is held accountable for transparent and efficient budget execution. Capacity building of the DPR is thus to remain an important pillar in the reform framework.

2. Improving Budget and Treasury Management

Though significant advances have been made on the budget preparation side, expenditure outturns continue to deviate significantly from the budget (as highlighted in the PEFA update), and with severe bunching toward the end of the year. This spending pattern is of concern because project implementation is disrupted by an adverse cycle, and persistent under-spending on capital expenditure constrains much needed infrastructure investments. Indonesia remains committed to smoothing budget implementation and execution through modernization of the treasury system.

The Government Regulation (PP) on budget execution is the only remaining PP to be issued to underpin the State Treasury Law of 2004 and the State Finance Law of 2003. Finalization and issuance of this new regulation is currently expected in 2013 and is important because it would provide a firmer legal basis for recent some lower level regulations that have been issued to help try to overcome spending problems (e.g. Perpres #53/2010 which regulates on the appointment of Satker [spending unit] officials, Perpres #54/2010 that allows advanced procurement, or simplifying virement—i.e. with the White paper supported by this DPL) as well as clarifying functions, roles and responsibilities of key officials. It would also provide a firmer legal basis for using the new automated treasury and budget preparation system (Sistem Perbendaharaan dan Anggaran Negara, or SPAN) and the new business process improvements envisaged under SPAN as well as providing authority to the Ministry of Finance to consolidate and report on fiscal data for the general Government.

SPAN is expected to be rolled out in 2013, having been conceived around 2004. It will replace the multitude of financial data processing applications currently used by Government institutions. It is a cross-cutting reform that should increase the timeliness, reliability and transparency of budget disbursement and reporting as well as improve the capability of managers in the efficient management of public resources. Business process improvements in the area of budget formulation, budget execution and accounting have recently been agreed with the business users. The change management and communication aspects related to the implementation of SPAN are now in place to support implementation. The SPAN turnkey implementation vendor is continuing to develop the COTS application software while the new Data Center and Data Recovery Center have been completed.

Nonetheless, challenges for the SPAN implementation remain. These include development of business processes for managing non-financial performance data, and the strengthening of PUSINTEK's capability to serve as a central ICT services provider for SPAN, as well as the rest of the MOF. The capacity building needs for implementation activities under SPAN are also considerable, and continued advisory services to help facilitate the implementation of PFM reforms in general, and SPAN in particular, will be necessary. Also, there is a recognized priority for building the capacity on accounting standards, including migration to accrual accounting (currently planned for 2015) and related requirements for training of staff, and audit.

Cash management has improved significantly with the continued implementation of the Treasury Single Account (TSA), and since 2007 the TSA for expenditure management has been made operational in all MoF Treasury offices. The TSA system was subsequently extended to cover revenue collection bank accounts, which are now swept daily to the TSA. The MoF and Bank Indonesia have signed an agreement providing for payment of interest on Government cash balances held in the TSA with Bank Indonesia. Interest is also collected on cash balances held in petty cash bank accounts of spending units through a system of "pooled" balances computed daily. However, the periodic census of Government bank accounts continues to report a number of accounts still outside the coverage of the TSA and the Treasury is continuing to review and incorporate most of these bank accounts into the TSA in a phased manner.

Cash flow forecasting has been rudimentary and the poor quality of cash forecasts is one of the factors resulting in year-end bunching of expenditures. The accelerated draw down of Government cash balances in December perpetuates wasteful procurement practices and also impacts monetary policy. To improve cash planning in the spending units and improve cash forecasting data, the Treasury issued detailed regulations on cash forecasting in November 2009 and rolled out a new IT application to assist spending units in implementing the new regulations in 2010-2011. Training and socialization for all Satker in the implementation of the new regulations and software is on-going.

A joint WB-IMF assessment of the GoI's Asset and Liabilities Management (ALM) carried out in mid-2009 indicated that the uncoordinated management of the gross asset-liability portfolio of the Government and Bank Indonesia could lead to substantial risk to the overall balance sheet. A follow up mission in late 2010 largely reiterated these conclusions and emphasized that the risks need to be mitigated through optimization of borrowing and better reserve management. The MOF has recently reinvigorated its ALM reform program with the support of the Australian Government and World Bank.

3. Strengthening Monitoring and Evaluation of Public Expenditures and Programs

To ensure more effective development planning and policy making, an improved capacity to analyze the efficiency of public spending is essential. Several analytical pieces have been produced in the last few years, and efforts by Bappenas and the MoF, especially through the trust fund supported IPEA initiative, to improve the quality of public spending and the delivery of public services. One important aspect going forward will be the development of a central monitoring and evaluation (M&E) system that would bring together Government financial and nonfinancial performance information, and so provide a basic framework and reference tool for more performance-oriented budget analysis and policy-making, in line with the principles of PBB and MTEF reform.[13]

[13] Such a system would not only be crucial for PBB and MTEF reform but would also assist the Ministry of State Apparatus Reform in evaluating the performance and accountability of government institutions, the Special Working Unit for Delivery of the President (UKP4) by providing a substantive context by which to evaluate achievement of short-term (bimonthly) physical program outputs, and, the individual line ministries in efforts to improve their programs, activities, and self-assessment of internal monitoring and evaluation systems.

Efforts to develop such an M&E system are already underway, and the objective is to have a fully functioning M&E system in place for the next RPJMN (2015-19). This will require the establishment of procedures to retrieve performance data and the design of reporting as well as ensuring that performance data is measurable and of high-quality. Performance information was, as mentioned above, for the first time developed by all ministries for their respective programs and activities in the form of outcome and output indicators in 2009 and implemented with both the RPJMN 2010-14 and FY2011 budget. The quality of this information is being further reviewed, and a yearly evaluation of the performance information provided by line ministries should enhance their quality, incrementally over time. A final M&E manual for the line ministries on how to formulate and report performance information is then, as aligned with the next RPJMN schedule, envisaged for 2013.

4. Improving the Public Procurement System

The past few years have witnessed improvements in the public procurement environment. Keppres No. 80/2003 provided a national public procurement regulation that meets most of what is generally regarded as accepted international practice, including basic principles: transparency, open competition, economy and efficiency. Keppres No. 80/2003 also established the basis for sanctions, complaint-handling and requirements for certification of users. It also abolished several weak practices such as mandatory prequalification for all types of procurement and requirements that segregated the national market and provided preferential treatment to local suppliers/contractors in each province/district. This decree also paved the way for establishing a regulatory body for public procurement. Perpres No. 106/2007 was signed in December 2007 establishing an independent agency, the Lembaga Kebijakan Pengadaan Barang/Jasa Pemerintah (LKPP) or National Public Procurement Agency, that is responsible for sustainable, integrated, focused and coordinated planning and development of strategies/policies/regulations associated with the procurement of goods/works/services using public funds. This institution reports directly to the President. In addition to the chairman, who heads LKPP, and an executive secretary, there are four departments, each headed by a deputy with responsibilities for: (i) strategy and policy development; (ii) monitoring, evaluation and information systems; (iii) human resources development; and (iv) legal affairs and settlement of objections.

While Keppres No. 80/2003 was a welcome development for the country, the public procurement system still has significant deficiencies in its regulatory and, more importantly, implementation aspects. There has been slow progress in the development of procurement regulations anchored by a law; slow progress in the development and use of standard tools in terms of bidding documents and users manuals; collusion and corruption practices in the bidding process; and concerns over the efficiency of the compliant mechanisms and sanction measures are still significant. However, the most significant deficiency is the absence of professional procurement management and weakness in procurement capacity in implementing agencies, especially at the provincial and district levels.

This is supported by the findings of some analytical tools and reports such as the self-diagnostic assessment conducted by the Government in 2007 using the base-line indicators (BLIs) tool developed under the World Bank and OECD Development Assistance Committee Procurement Round Table initiative. The assessment of the BLIs presents a “snapshot” comparison of the actual system against the international standards or the “model system” that the BLIs represent. Baseline bench marking of Indonesia’s procurement system in June 2007 showed it scoring 62.5 percent for the Legislative and Regulatory Framework (PILLAR I), 55 percent for Institutional Framework and Management Capacity (PILLAR II), 59.3 percent for Procurement Operations and Market Practices (PILLAR III) and 69 percent for Integrity and Transparency of the Public Procurement System (PILLAR IV) in comparison with recognized international standards. While the establishment of LKPP should increase the overall score for Pillar II, the assessment indicates that there are significant areas that need improvement. The LKPP is currently moving on two parallel tracks to reform the public procurement system: (i) *Legislative and Regulatory Framework*; and (ii) *Public Procurement Function and Capacity Building*.

Legislative and Regulatory Framework: Indonesia's legal framework for public sector procurement can best be strengthened by anchoring it with an overarching consolidated and comprehensive national public sector procurement law at the highest level that: (i) establishes the fundamental principles and procedures applicable to all public sector procurement; (ii) establishes clear responsibilities for a permanent procurement management function within implementing agencies; and (iii) amends other laws that refer to public sector procurement and ensures that such a law has the necessary authority in a decentralized environment. To achieve that, LKPP has been working on the preparation of a new procurement law and a new presidential decree. A draft procurement law has been the subject of a public consultation process, which included Government agencies and international development partners. The draft law proposes a broader scope for coverage which includes concessions and PPP transactions. It states some main principles and proposes to further detail these through separate implementation decrees. The Bank has also provided comments and recommendations on the draft, mainly concerning the need to ensure that all the main principles that will govern public procurement in the country are clearly stated in the law. Given the need for further consultations with various stakeholders in order to formulate the important issues more carefully, the submission of the draft law is being delayed into 2012. Nevertheless, the current Presidential decree on public procurement No. 54/2010 has been effective since January 2011, introducing many improvements, the two major of which are the mandatory establishment of Procurement Service Units (ULPs) by 2014 and the use of e-tendering by 2012. This will be applicable to all implementing agencies. PP 54/2010 was also updated in 2012, in an effort to help smooth budget implementation.

To maximize the opportunity for reform when preparing a procurement law, it is important to take into consideration that a number of laws have been enacted since 2000 that impact, or make reference to, public procurement. These include construction law, state finance, treasury, audit and small-scale business. The pace of Indonesia's decentralization reforms has impacted public sector procurement at all levels of Government, with ministers, governors, and even mayors able to issue decrees, regulations and instructions. The plethora of regulations is often inconsistent and many regulations do not meet accepted international practice. Consequently the need for national procurement policies and standards are critical.
Historically, there are no national standard bidding documents that are used regularly by all Government agencies in the country. Some implementing agencies (such as the Ministry of Public Works) have developed standard bidding documents for their own use. NPPO (the predecessor of LKPP) has drafted and piloted seven National Model (Standard) Bidding Documents to cover main types of procurement. LKPP is now updating these documents and producing other samples. The use of these documents is still not mandatory and they are being used on a pilot basis. With the support of a trust fund from the MDTF-PFM, LKPP is planning to review these documents to make them consistent with the new Perpres as well as to increase harmonization with the standard bidding documents of International Development Partners such as the World Bank, ADB and JICA.

Public Procurement Function and Capacity Building: There has been growing concerns, both by the Government and the Development Partners over the pace of projects implementation. Significant delays and slow disbursement seem to occur throughout the entire PFM cycle. Projects reported delays and difficulties in budget preparation and approval, budget execution, and implementation/procurement. Specifically, there are concerns with the organization of the procurement management function as well as the capacity of procurement committee members. While Keppres No. 80/2003 required certification of all procurement committee members, the certification process by itself did not support the development of procurement capacity; while the current ad-hoc nature of managing procurement does not allow for building sustainable knowledge within implementing agencies.

The LKPP has completed a human resources development (HRD) strategy to professionalize and support the public procurement sector by developing and facilitating a competency based capacity building process and creation of professional and dedicated cadre. The strategy identified the following challenges which resonate with concerns raised by stakeholders: (i) Overall low capacity among officials in handling public procurement responsibilities, in compliance with Perpres 54 and other relevant procurement legislation adopted and used by other public agencies; (ii) The large number of public entities that currently undertake procurement operations, and the difficulties encountered in reaching, serving and supporting all of them; (iii) Lack of consistency and uniformity in structures and approaches to public procurement activities; (iv) The ad hoc and part-time nature of procurement assignments in the public service, which prevents any career progression and retards the overall development of the field of public in procurement; (v) Lack of geographic representation in the availability of trainers; (vi) Current procurement training is limited to Perpres 54, and does not include training on the broad principles and practice of procurement, or on the other procurement laws or guidelines that adopted in other Ministries and agencies; (vii) There is a wide range of entities involved in procurement training, but they are not yet governed by a set of standards to preserve quality and consistency in delivery; (viii) Lack of a rational, well considered and selective approach to the identification of officials that are ready to undertake procurement training and take the certification exams, resulting in a high failure rate; (ix) High cost of providing procurement training to officials over longer periods, resulting in inadequate training period; (x) Lack of training and specialization in procurement in higher education.

In response, the goals of LKPP HR strategy are the following:
Strategic Goal 1: *Coordinated and integrated planning for Human Resource Development*
Strategic Goal 2: *Building professionalism in procurement*
Strategic Goal 3: *Developing adequate facilities for public procurement training*
Strategic Goal 4: *Developing effective training materials in public procurement*
Strategic Goal 5: *Build an effective national network of public procurement trainers*
Strategic Goal 6: *Ensure that public officials in procurement are properly certified*
Strategic Goal 7: *Undertake initiatives to be fully responsive in the services and support given to clients*
Strategic Goal 8: *Enhance the quality of training for officials in public procurement*

These strategic objectives will generate lots of tasks that will require significant resources. LKPP has already issued a decree to create procurement service units at all implementing agencies by 2014. It has also started work on developing competency based training material. In summary, even though the full strategy has not been officially and publicly adopted by LKPP, the completion of this strategy and acting on some of its components is a move, albeit slow, in the right direction

In the meantime, there are several ongoing activities to improve procurement management in implementing agencies. The Directorate General of Highways (DGH) in MoPW has established a procurement team to support overall procurement in the DGH. MoF has already established a procurement function with an Echelon II level manager which is a significant precedent in the country. At the Local Governments' level, there are some ongoing activities as around nine provincial governments and 130 Local Government/municipalities has already established ULPs with varying role and function. Some of these activities have been supported by the World Bank-funded Local Governments' projects (ILGRIP and USDRP) as well as other development partners.

So far, there are several initiatives on this area but progress is still slow. The absence of professional procurement management in implementing agencies, fragmentation of procurement responsibility and weak procurement capacity are the most important impediments to improving public procurement in the country. LKPP should focus its resources on implementation of the human resources strategy that could tackle the challenges in this area and support the development of training institutions in universities and private sector. LKPP should also provide support and guidance to the ongoing pilot activities in establishing procurement teams/units in MoF, DGH and Local Governments to ensure support and success of these pilots. Another important subject this human resources strategy should address is the approach to strengthen the capacity of the Government auditing agencies to carry procurement audit.

Corruption, sanctions and independent appeals mechanism: Despite improvements in the public procurement system, concerns remain over corrupt and collusive practices. While addressing this requires an overall governance strategy (as addressed further below), there are several important elements in the procurement system that can support such a strategy, for example an independent complaints mechanism, an effective sanctions mechanism, and improving transparency in the procurement process through the use of e-procurement.

Perpres 54/2010 requires the establishment of a complaints handling mechanism. However, this is not set up independently but within each implementing agency. While it is imperative to develop procedures for an independent complaints handling mechanism, LKPP should avoid becoming the agency to which these complaints are addressed but rather develop a system and monitor its efficiency and reliability. The sanctions mechanism is operated by each implementing agency, in accordance with Perpres 54/2010 requirements. There is no clarity on the effectiveness of this system, which warrants an assessment to be conducted by LKPP on the effectiveness of the current sanctions mechanisms and possible improvements in the implementation process.

E-procurement: The Ministry of Public Works, Ministry of Communications and Information and the City of Surabaya have all been at the forefront in the development of e-Government Procurement (e-GP) technology. The LKPP is currently taking the lead on the implementation of e-GP in Indonesia at a national and sub-national level. With the requirement for all procurement to be done electronically by 2012, there has been rapid increase in the number of provinces and Local Governments using e-procurement. Most recent data indicate that around 31 Provincial Governments and 380 Local Governments have introduced e-procurement. However the volume of procurement carried through the system and up to which phase the system is used (i.e bids announcement, bids distribution, bids submission etc…) also varies by location. As for MoPW, their system seems to be a more comprehensive and centralized one. In 2011, it has handled most of all planned procurement activities for 2011, with a total of 12,000 contracts and 30,000 registered bidders. The increased use of e-procurement can be a good measure to increase transparency and efficiency in the procurement process. However, it will also be critical for Government agencies to agree on a roadmap for the development of e-GP in the country, setting the roles of the different stakeholders, and the responsibility for ensuring minimum inter-operability and core data standards for the various e-GP providers to comply with.

5. Improving Government Accounting and Audit Functions

Accounting and Reporting on Budget Execution

BPK has given a ‘qualified’ opinion on Government financial statements for 2011. This is the third successive year that government annual financial statements have received a ‘qualified’ opinion after a ‘disclaimer’ status in the previous five years. The major qualifications in the audit report relate to mismatch between budget classifications and the realizations, problems in assets management and under-recording of pension funds. BPK also identified some key internal control weaknesses in the Government’s functioning.

There has also been an improvement in the number of line ministries (K/L) receiving favorable opinions from the external auditors. The number of K/Ls with an unqualified opinion has increased from 7 out of 81 for FY2006, to 67 out of 87 in FY2011, with the number of K/Ls with disclaimers coming down.

Capacity constraints in the line ministries are the biggest challenge. The number of trained accountants in line ministries and sub national governments is low, and the quality of their work needs improvement. DG Treasury has a proposal to carry out a needs assessment of accountants in line ministries and also assess the pipeline of accountants that are coming out of universities to draw a blue print of how the accounting capacity in the line ministries will be strengthened in the long term. Human resource issues remain the most critical aspect of the accounting function in the country and MOF needs to pay close attention to training and capacity building of accounting staff throughout the country.

The annual financial statements are prepared on an accrual basis and there is a plan to move to full accrual accounting for line ministries and sub-national governments by 2015. Under the State Finance Law of 2003, full accrual accounting had initially expected to be rolled out in 2009. However, given the implementation challenges the Government and DPR subsequently agreed to a more gradual transition process, which has been reflected in the annual budget law since 2008 and includes the revised 2015 target date in the Government Regulation #71/2010. The accounting standards for accrual accounting have already been prepared and a Government regulation on these has been issued. Draft accounting policies and chart of accounts have been prepared and under review. The pilot implementation is expected to start in 2013.

Internal Controls and Internal Audit

Key reform priorities in the area of internal control and internal audit therefore are: (a) roll out of SPAN; (b) implementation of the COSO control framework and (c) rationalization and strengthening of internal audit function of the Government.

As mentioned already above, the SPAN turnkey provider has commenced work on configuring the COTS application software and roll out is targeted for 2012. The new business processes being configured in SPAN are expected to strengthen internal controls by introducing a formal commitment control system in the line ministries, ensuring adherence to the budget ceilings, reducing the time lags in processing payments and budget revisions, and maintaining electronic trails of all modifications to source data. However, the limited capacity in the MoF and other line ministries, and ownership of the program by the business owner are key challenges. To address this, the PFM team in the Bank is closely engaged in the process. In addition, a communications and change management consultant is helping the MoF deal with human resources challenges through the transition.

Through Government Regulation (PP) No. 60/2008, the Government has adopted COSO as its internal control framework. The regulation embraces the core principles of the COSO framework in a comprehensive manner but the key challenge lies in the implementation of the framework. The Government regulation entrusts BPKP with the role of designing the internal control implementation, by providing guidance and training to the line ministries on COSO implementation. BPKP has prepared an ambitious road map for COSO implementation. In FY 2009 and 2010, PP 60/2008 has been socialized to 28 Ministries/ Government Institution, 87 vertical institutions and 345 Local Governments. Training has already been conducted in 16 ministries and 105 Local Governments. Diagnostic assessment is also currently underway in 13 ministries and 50 Local Governments.

On internal audit, the quality of audit by Inspector Generals (IGs) in line ministries and in Local Government inspectorates remains sub-optimal with little focus on risk-based audit. A recent mapping process on the capacity of the government internal audit function in Indonesia based on the Internal Audit Capability Model (IA-CM) developed by the IIA revealed that 93 percent (25 IGs and 237 Local Government inspectorates) of the respondents (i) conducted transactional audits for accuracy and compliance purposes only; (ii) audit plans were not prepared based on stakeholder priorities; and (iii) audit output was based on the capacity of certain individuals

Lack of trained and skilled auditors and the scale of the country with Local Government inspectorate auditors needed in over 500 locations makes the task of reforming the internal audit function in the country challenging. It is important that a central agency assumes the role of coordination of internal audit function in the country. Presidential instructions (INPRES 4) regulating Government internal audit systems as required by Article 58 of Government Regulation No. 60/ 2008 have been issued. The next step is preparation of a strategy for internal audit expected in 2012. Meanwhile, some of the IGs in line ministries, including the MoF and the MPW, have embarked on a significant modernization of their functions. The IGs of both the MoF and the MPW have adopted a risk-based approach to internal audit and are engaged in a review of technical skills of their staff and technical guidance available to them.

External Audit

After a peer review for BPK conducted by the Dutch Court of Auditors in 2009 pointed out that BPK had made major strides in its mandate, capacity and practices in the last five years, BPK has continued to maintain that momentum. There has been a significant growth in the budget, the number of staff and the number of regional offices.[14] The report also identified some areas for improvement, mainly the need to improve the readability of audit reports and the quality of analysis in the audit. However, the peer review concluded that BPK was on the right track and had made major improvements in its functioning in the last five years.

BPK has prepared a new strategic plan for the 2011-15. The new strategic plan reflects both lessons from the peer review and the vision of the new BPK Board. BPK has also prepared a detailed implementation plan to support the execution of the strategic plan.

BPK performs financial, performance, and special purpose audits. The audits are undertaken in accordance with State Finance Auditing Standards (SPKN) which are stipulated in BPK regulation No.1/2007. SPKN contains professional requirements for auditors, audit quality audit reports, and is binding on BPK and institutions that conduct state finance audits for or on behalf of BPK. These standards are generally in line with international standards and have been applied.

BPK has bilateral arrangements with many other SAIs that have helped BPK in procuring specialized skills in many areas. Its arrangement with NAO Australia, for instance, has helped BPK in acquiring technical skills in the area of performance audit. The Dutch and Norwegian SAIs are also actively supporting BPK.

BPK has been able to submit the audited financial statements within 5 months of the end of the fiscal year for the past five years. BPK also submits interim audit reports to the Parliament every six months.

6. Civil Service Reform

In late 2006, the Ministry of Finance initiated the Bureaucracy Reform Initiative (BRI). Through this initiative it has focused on reforming organizational structures and standard operating procedures (SOP), and on reforming HRM policies and practices to adhere to the established reform objectives: (i) to create a clean, professional and accountable state apparatus; and (ii) to create an efficient and effective bureaucracy so as to provide high quality public services. Ministerial Decree No. 30/KMK.01/2007 outlines the reforms in detail. A key element of the BRI has been to increase staff pay through an additional allowance, a budget allocation for which is approved annually by Parliament.[15]

The BRI has led to many important outcomes in the MoF: professional quality of new staff has improved and accountability is better enforced including strengthened work discipline; corruption has decreased in

[14] The number of BPK staff has risen from 2,854 in 2004 to 5,556 in 2009. The annual budget for FY10 is Rp 2.02 trillion compared with Rp 234 billion in 2004.

[15] Note: The BRI was deemed so crucial that when approving the extra allocation for the first time in 2006, the Parliament decided to expand the BRI to the State Audit Institution (BPK) and the Supreme Court on a pilot basis. In 2007, the National committee for Bureaucracy Reform was set up to coordinate reforms among institutions and provisions were included in Law No. 17/2007 on Long and Mid-Term Planning mandating all 73 central government institutions to implement BRI before the end of 2011 in support of which MenPAN has issued regulations and voluminous guidelines related to the reform process.

spite of backlashes within DG Customs and within DG Tax; performance of staff has improved and key performance indicators have been introduced at the level of Echelon 1 units including signed performance contracts for the responsible managers; and service delivery has been simplified and speeded up within DG's with client relations. Below are some of the most important achievements:

- Some 8,000 SOPs have been revised to improve efficiency and to minimize direct non-transparent interaction between MoF officials and members of the public.
- Almost 20,000 job descriptions have been revised to better reflect professional requirements, job responsibilities and complexities.
- A new grading scheme has been introduced on top of the general grading scheme (17 grades) linked to the reformed job descriptions and allocating positions to one of 27 additional grades.
- A new allowance, linked to the new additional grades, has increased take-home pay for MoF officials considerably.
- Performance based management has been introduced and KPIs have been defined to the level of echelon 1 while the cascading down to lower levels is still ongoing.
- Recruitment criteria and processes have been significantly improved and today the MoF only recruits PNS candidates that have gone through STAN.
- An Assessment Centre has been created and a large network of assessors established.
- A selection process for promotion based on internally announced vacancies, voluntary applications and competitive selection based on merit has been piloted.
- Competency based training is more and more replacing structural training.
- Improved Human Resources Information System (HRIS) is under development.
- Permanent Project Management Units have been established in DG Tax and in DG Treasury.

In April 2009, the Minister of Finance announced the second chapter of BR, with the human capital development and information system for human resources as key priorities. In connection with previous reforms, other issues also materialized and more areas were identified as targets for reforms for the second chapter, such as an inherent redundancy created by overstaffing and low quality of some staff.

More broadly, the Government has commenced the process of implementing an agency by agency reform, guided by an overarching policy framework set out in a *Grand Design for Bureaucracy Reform* (BR)for 2010–2025 along with a *Road Map for 2010–2014* that were eventually approved in December 2010. The management structure and processes governing the reform consist of a multi-layered inter-ministerial management structure under the Vice President's office. It includes a Steering Committee, the National BR Team (NBRT), the National BR Management Unit (NBRMU), a quality control entity (*QA Team*) and an advisory entity (*Independent Team*).

Reform proposals of ministries and agencies (K/Ls) are vetted in this system through a complex process. The format and substance of proposals should reflect the orientation set out in the 9 guidance 'books', approved in January 2011, that provide implementation guidelines for bureaucracy reform and summarize critical aspects of the reform. As of mid-2012 some 52 (K/Ls), including the MoF have been approved and have obtained Performance Allowances. This removes the 'exceptional' nature of these reforms in the MoF, which required annual re-approval by the DPR. The goal is still to have all 76 Central Government institutions implementing BR by 2014. In addition, the Government has decided to extend the BR roll-out to 9 provinces and 99 Local Governments as a pilot project to precede a final roll-out to all government entities at all three levels of Government (in total there are 33 provinces and 491 cities/districts).

However, while this process has formalized the substantive requirements of K/Ls for participating in the reform program, it has two overall weaknesses. First, it does not provide a sufficient basis for a 'reward and punishment' model that would ensure the transformation of agencies. Second, it does not address the systemic regulatory constraints that handicap reform-minded agencies from achieving their objectives**.**

Nonetheless, the Government is working on these constraints, and a new civil service law has been proposed by the DPR.

It is important to continue the reform process within the MoF. In line with existing policies and plans, and building on the progress achieved so far, the MoF is pursuing the second chapter of reforms, which includes inter alia:

- Strengthening the corporate values to support enhanced professionalism, integrity and accountability;
- Continuing the professionalization of jobs and the competence based training policy;
- Professionalizing HR functions and providing opportunities for professional certification for HR staff (for example staff in DG Taxes HR department achieved high-levels of HR certification in 2010);
- Strengthening professional career paths and reform rotation practices to support professionalization, capacity building and career management;
- Working towards an open recruitment policy which would strengthen professionalization and allow a greater professional mobility;
- Pursuing the development of talent management system to identify and prepare future leaders;
- Decentralizing HRM activities to levels where they would be most efficiently executed including necessary supporting restructuring;
- Improving the new grading system and reform the allowance distribution;
- Finalize the HRIS in combination with separate HRIS in the big DGs (DG Tax is due to start its development in 2011); and
- Prepare policies and proposals for right-sizing allowing more radical restructuring policies.

7. Debt Management

In recent years, two major initiatives in debt management have been implemented: A clear debt management strategy, which was publicly announced and a newly created DG for Debt Management, with a risk management oversight function for both domestic and external debts. A new debt strategy for 2010-14 was published in 2010[16]. By end-2011, the Government debt-to-GDP ratio had declined to below 25 percent from the peak of over 90 percent in 1999, with only a minimal increase through the exchange rate volatility and stimulus spending associated with the global financial crisis.

Great advances have been made since 2009 in the quality of the Government's domestic and external debt reporting, with the MoF and Bank Indonesia now issuing a joint publication, inconsistencies between official Indonesian and external sources being reconciled, and the World Bank reviewing with a view to upgrading its rating of the quality of Indonesian official Government and external debt statistics. The *Fiscal Risk Statement* is comprehensive and incorporated in the annual budget documents. The statement considers financial liabilities, contingent liabilities and potential risks from a range of external and internal factors.

8. Reforming Regional Public Financial Management

Decentralization has provided Sub-national Governments with significant resources and responsibilities. More than one-third of overall public spending is now executed by Sub-national Governments. This level of expenditure requires an adequate regulatory framework, together with sufficient PFM capacity at the sub-national level if it is to be fully effective. In order to address this, in 2005 the Central Government passed comprehensive legislation on PFM reforms at the sub-national level, with the aim of mirroring reforms already being implemented at the center. However, the results have been limited due to lack of technical and human resources that most regions have to implement the reforms. For example, Sub-national Governments are obliged by law to report certain fiscal and financial information to the Central Government within a clear

[16] See: www.dmo.or.id

timeframe. In reality, many Sub-national Governments struggle to meet their deadlines for submission even though the number of such submissions has been decreasing.

Current budget allocation and disbursement practices contribute to fiscal discipline at the central level but they constrain successful financial management at the local level. Allocations to individual sub-national government units are formally issued after the passage of the Central Government budget in October prior to the fiscal year in question and commence through derivative regulations (e.g., ministerial decrees). While this may appear to allow sufficient time for sub-national governments to finalize their budgets, in reality budget allocations of shared non-tax revenue (oil and gas) are frequently issued close to the beginning, or first few months, of the fiscal year. The notional allocations are frequently underestimated by the Central Government and disbursements from the center to the regions are back-loaded towards the end of the fiscal year. This is because the transfers in the final quarter are based on actual revenues, which are usually higher than projected revenues.

Sub-national Governments are struggling to spend their increasing budgets and have built up reserves in recent years for three main reasons. First, Sub-national Governments often underestimate their revenues due to lack of revenue-management capacity, compounded by the under-budgeting of transfers by the central Government. Second, the issuance of budget allocations (especially allocation for shared non-tax revenue), combined with Sub-national Government's lack of revenue-management capacity, in particular in estimating potential own source revenue (PAD), often resulted in low quality planning where budget projections are based on previous year allocation. Hence, in many cases, there are significant revisions in the regional budget adjustment (APBD Perubahan). Third, delays in the budget approval process and lack of implementation capacity result in under-spending of budgeted programs by Sub-national Governments. Fourth, Sub-national Governments may not have the capacity to spend the resources at their disposal when these resources increase significantly and abruptly. This was the case with the 64 percent increase in DAU from 2005 to 2006, which led to a significant increase in sub-national government reserves.

Some challenges in addressing the constraints in PFM at the sub-national level include: (i) providing timely estimates from the sectoral ministries of revenue-sharing transfers; (ii) building the capacity of Sub-national Governments to better estimate their fiscal resources and manage accumulated reserves; and (iii) improving and streamlining the budget approval process. The need to streamline the budget approval process in particular affects Law No. 33/2004, which stipulates that provincial and district budgets must be approved by the Ministry of Home Affairs and the Provincial Government, respectively. This process may be one factor contributing towards lengthening the budget approval process.

In order to address the financial management issues and challenges at the sub-national level, the Central Government has implemented several reforms:

Burden-sharing policy

Introduced in 2009, this policy incorporates major subsidies, including fuel subsidies, into the DAU pool allocation. The policy will increase the accuracy of transfer projections during the full fiscal year, given that there is a disincentive for the Central Government to under-estimate the oil price assumption, especially in relation to regional transfers. A more rational oil price assumption will lead to better estimates of revenue-sharing which, in turn, will help Sub-national Governments to better plan their budgets.

Two actions are needed to optimize this policy. First, the Central Government should establish a system to regularly monitor quarterly revenue-sharing transfers, as stipulated in Law No. 33/2004. Second, the Central Government, through the relevant agencies, needs to improve production estimates for revenue-sharing, especially if back-loaded transfers at the end of the fiscal year persist.

Late budget approval sanctions

Starting from 2008, the Government has applied sanctions to improve the budget approval process. Based on Government Regulation (PP) No. 56/2005 and MoF Decree No. 46/2006 regarding the Regional Financial Information System, provincial and district governments have to submit their annual budgets to the MoF before 31 January of the corresponding fiscal year. Sub-national Governments that miss the deadline by at least one month will receive a warning letter to submit their budget before 31 March. If a sub-national government has not submitted its budget by that date, the MoF, in coordination with the MoHA, can sanction the Sub-national Government by postponing the transfer of its DAU (25 percent of monthly transfers) until the budget is submitted.

This sanction initiative has resulted in timelier budget submissions. Between 2006 and 2007, 54 percent of Sub-national Governments approved their budgets after March. In 2008, the year the sanction was introduced, 87 percent of Sub-national Governments submitted their budgets to the MoF before March. If the Government wishes to ensure the effectiveness of this reform, the MoF should continue to monitor Sub-national Government budget submissions.

The MoF can also assist Sub-national Governments in managing reserves and surpluses by strengthening the regulatory framework for sub-national financial management. In doing so, the MoF should develop guidelines for regions on the accumulation and use of reserves. These guidelines should help Sub-national Governments use their reserves more effectively, for example, by: (i) settling outstanding arrears, given that about 85 percent of Sub-national Governments in arrears could clear these arrears by drawing on reserves; and (ii) where Sub-national Governments have constant or increasingly high levels of reserves, using them to increase investment in public infrastructure.

9. Governance and Anti-Corruption

The public has expressed a strong demand for more accountable government, as indicated in the re-election of the incumbent Government for its strong anti-corruption platform. Shortly following the reelection, the President responded by creating a special unit called UKP4 (Presidential Working Unit for Supervision and Management of Development), chaired by the highly respected Kuntoro Mangkusubroto, to reduce bottlenecks — including governance related issues — in management and development and to expedite delivery of government programs. Among its priorities is the acceleration of civil service and tax reforms, and processes are already underway to deliver on this mandate. The Law on Access to Public Information is passed and declared effective, and the public is hopeful that the provisions of the law will bring about more transparent and accountable services.

Under the new Corruption Court law, the Special Anti Corruption Court is now created in seven provinces under the auspices of the Supreme Court, with the plan to replicate it in all provinces and then districts. This is taking place despite a 2006 Constitutional Court ruling, according to which the Special Court — previously trying cases investigated and prosecuted by the Anti-Corruption Commission (KPK) — was considered unconstitutional since it was seen as creating a dual criminal justice process for corruption cases. The Special Court has thereby maintained its original composition — with ad hoc judges in the judicial panels - and will try all corruption cases prosecuted by public prosecutors or from the KPK. This however, raises a different concern: The Supreme Court has to recruit and train highly qualified ad hoc judges designated in the 7 locations, and there is a fear that the lack of quality in resources may affect the credibility of the Special Court. The main challenge at the regional level will be to staff these special courts with qualified staff. A dubious and until now very rare acquittal in a trial conducted by the KPK in the Bandung regional Special Anti-Corruption Court highlights the weakness of such regional courts. Previously, the KPK always prosecuted its cases through the Corrupt Crimes Court in Jakarta, which established a reputation for integrity since it was first established in 2004. However, the 2009 Corrupt Crimes Court Law provided for the expansion of the specialized court to several provinces and these courts became operational in 2010. These regional courts have issued numerous acquittals so far.

In terms of corruption investigation, the pace had been slow. Previous high profile cases of corruption highlighted the challenges in reforming the judicial and law-enforcement systems in Indonesia. These included allegations of corruption affecting political parties, investigators conspiring with a corrupt tax auditor, senior police and Attorney General Office (AGO) personnel fabricating evidence against two Anti-Corruption Commission (KPK) deputy-chairs, and police officials conducting suspicious financial transactions. Although progress towards the resolution of these cases remains slow, substantial efforts are being made through targeted engagements at the national level (e.g. through the Attorney General's Office, the Judicial Commission, the Anti-Corruption Courts and the Anti-Corruption Commission) and at the local grassroots level.

The selection process for four KPK Commissioners has been completed, with some promising figures known for personal integrity and anti corruption activism advancing to the final stage of selection by the parliament. The KPK has declared its commitment to continue prosecuting high level cases and support reform in key ministries and agencies.

The Constitutional Court, on the other hand, has demonstrated its strong role in resolving political disputes — which is critical particularly in the disputes laden with money politics at the time of local elections. There is a strong public expectation that the rulings may reduce the practice of election rigging in local elections.

Last but not least, institutional reform increases its outreach and intensity. Taxation office reform is in place, following the prosecution and investigation of a number of tax officers, and some ministries (such as Ministry of National Education and Ministry of Public Works) are developing ways of improving institutional accountability. Local Governments have made their own initiatives and set examples for good governance practices.

As the Government has demonstrated its commitment to fight against corruption and to promote reform, the success of its strategy depends on a combination of both strong enforcement and rigorous institutional reform. With the creation of a high profile Presidential unit and task force, serious efforts have to be made to ensure that reforms are sustainable beyond the terms of the ad hoc unit and task force and that recommendations made by the two are effectively applied.

III. Key Areas for Future Attention

In sum, for the period ahead, the following will be key areas for attention and monitoring for Indonesian PFM:

- Maintaining the coherence and momentum in PFM reforms;
- Deepening the reforms of the Central Government budgetary systems to strengthen policy orientation and medium term planning in budget preparation with a particular focus on improving the quality of performance data, fine-tuning the existing MTEF and costing system and developing a PBB/MTEF based M&E system;
- Ensuring greater integrity and more effective management of public funds through further extension and fine-tuning of the TSA, increasing the quality of cash management, and strengthening PUSINTEK as the shared IT services provider;
- Enhancing the Government's budget analysis capacity, primarily by developing a consolidated M&E system that integrates financial and non-financial data in accordance with PBB principles and streamlines and consolidates information of the complex M&E environment;
- Improving the public procurement system by developing a consistent legal framework through anchoring it in an overarching and consolidated national procurement law that regulates all principles and responsibilities in public procurement, by building the procurement management function as well as the capacity of procurement committee members based on a comprehensive human resources

development strategy, and by improving transparency in the procurement process, for example, through the development of a national e-procurement system;

- Ensuring relevant and reliable financial reporting by strengthening human resources in Government accounting and reporting, especially at the line ministry level and especially with regards to accrual accounting;
- Strengthening the internal audit function in the country by rolling out the treasury payment system as planned, implementing the COSO framework, conducting capacity building for Government inspectorate auditors, especially with a view to risk-based audit, and identifying an agency to assume coordination of the internal audit function;
- Detailing and implementing BPK's strategic plan 2011-1015 for improving the quality of external audit reports;
- Continuing civil service reform in the MoF in the context of the second chapter of the national bureaucracy reform initiative;
- Implementing the new debt management strategy and maintaining the quality of debt reporting
- Addressing constraints in PFM at the sub-national level by (i) providing timely estimates from the sectoral ministries of revenue-sharing transfers; (ii) building the capacity of sub-national governments to better estimate their fiscal resources and manage accumulated reserves; and (iii) improving and streamlining the budget approval process;
- Developing a coherent and well-focused strategy for corruption prevention within the state administration and ensuring its sustainability beyond the terms of the ad hoc task force.

All these reforms are being actively considered by the Government, and, as indicated further above, implementation plans are either being developed by the Government or implementation is already underway. The capacity to centrally monitor these and other reforms has already been established at the Secretary-General's office of the MoF (PUSHAKA). However, Indonesia would benefit from a coherent reform plan or strategy to ensure proper phasing and coordination of PFM reforms. This would also allow for enhanced monitoring and accountability within the Government and thus provide additional momentum and direction to reform efforts. As an interim step, the PFM MDTF Medium Term Strategy Note (MTSN), was presented by the Minister of Finance to senior management and all donors working in this area (not just contributing donors) at the 2012 Policy Advisory Committee.

Management of Foreign Exchange

The foreign exchange control environment is assessed to be generally satisfactory. The country is no longer subject to the Extended Arrangement from the IMF. Bank Indonesia (BI) was last subject to the transitional procedures under the Fund's safeguards assessment policy in 2002. That assessment recommended remedial action to address a number of vulnerabilities in the audit arrangements of BI. The main recommendations have been implemented, including the establishment of an independent audit committee at Bank Indonesia and the publication of Bank Indonesia's audited financial statements. Audited financial statements for Bank Indonesia for 2009 by BPK contain an unqualified opinion.

IV. Summary

In recent years, Indonesia has made significant strides in the way its public finances are managed and in increasing transparency and independent oversight. In almost all areas of PFM, changes in the legal and regulatory architecture are now largely complete and the momentum has shifted towards implementation of new PFM practices. Advances have been made in budget preparation with the introduction of MTEF and PBB, government accounting standards have been formally established and are being adhered to in several respects to produce comprehensive annual financial statements, and the external audit function has made significant progress in the last few years. However, internal controls in the execution of budget by spending agencies need improvement. A Government Financial Management Information System (GFMIS) to provide information for budget management at all levels of government is expected to be rolled out in 2013, while weak controls in budget execution processes have the potential of jeopardizing gains from reforms introduced in other areas of PFM.

However, weaknesses in financial management and accountability continue to be gradually addressed through the PFM reform program discussed above, and development partners are actively engaged in this process. Much remains to be done, and it will take time to realize the full impact of these reforms. But the trajectory of reform is in the right direction, and, most importantly, the Government continues to demonstrate high commitment in completing the planned reforms. The reforms when implemented will further reduce the level of fiduciary risks. Taking this into consideration, the Bank assessment team does not propose putting in place any additional fiduciary arrangements for this operation.

Annex 6: ENVIRONMENTAL AND SOCIAL REVIEW

A broader overview of Indonesia's environmental and social issues is updated annually for the Country Policy and Institutional Assessment (CPIA), which can be found at http://connectprem.worldbank.org/units/EASPR/cpia/web/CPIA%20Countries%20-%20EAP%20-%20Indonesia.aspx

OP 8.60 Assessment of Proposed Program Policy Matrix

2. OP 8.60 (Development Policy Lending) mandates the Bank to determine whether policies supported by the operation are likely to have significant negative environmental and social effects. For policies with likely significant effects, the Bank summarizes analytic knowledge of these effects and of the borrower's systems for reducing adverse effects and enhancing positive effects, also describing how any significant gaps would be addressed before or during program implementation. In conducting this review, the team consulted Bank guidance on analysis of "likelihood of significant effects," relying on the (i) *Good Practice Note: Using Poverty and Social Impact Analysis to Support Development Policy Operations; (ii) Assessing the Environmental, Forest, and Other Natural Resource Aspects of Development Policy Lending – A World Bank Toolkit (2008)*, (iii) *Good Practice Note on Environmental and Natural Resource Aspects of Development Policy Lending.*

In Policy area 1: Strengthening budget formulation and M&E systems should have no likely significant negative effects. Improved budget transparency, forward planning and monitoring and evaluation should improve effectiveness of spending on development programs to benefit society. Strengthening budget execution systems should have no likely significant negative effects. Improved budgeting systems, guidelines, auditing, software and training should improve effectiveness and accountability of spending on development programs to benefit society. Improving tax administration should have no likely significant negative effects. Improving capacity, modernizing, clarifying information and tax collection rules should increase tax compliance, reduce leakage, and aid law enforcement efforts – all contributing to improving the rule of law and the perception of fairness in tax payment.

In Policy area 2, enhancing poverty alleviation and service delivery efforts by improving poverty measurements and targeting and improving household- targeted poverty reduction programs should have no likely significant negative effects and probable positive effects through improved targeting of pro poor programs toward intended beneficiaries. Improving monitoring and grievance handling will improve accountability and responsiveness to intended beneficiaries of government pro poor programs. No likely significant negative effects are expected from finalizing the plan for the future of the national community empowerment program. Introducing standards for improving management and responsiveness to beneficiaries, particularly in areas that have experienced major complaints, would send a positive message about governance and create an incentive for improved performance.

Reform Aim	No.	Proposed Policy Actions 1st INSTANSI DPL (by September 2012)	Environmental Review (OP 8.60 review of "likely" and "significant" "effects")
Policy area 1: Strengthening public financial management			
Policy sub-area 1.1. Strengthening budget formulation and M&E systems			
Improve budget information transparency and use of MTEF	1	Prepared draft white paper for a new and simplified costing methodology.	No likely significant negative effects. Improved budget transparency, forward planning and monitoring and evaluation should improve effectiveness of spending on development programs to benefit society.
Improve the monitoring and evaluation system, with information feeding into the planning and budgeting cycle	2	Produced draft guidelines to all K/Ls to formulate performance indicators, as part of a National M&E Roadmap to improve the M&E system, to be used for the next RPJMN (2015-19).	
	3	Circulated draft guidelines for line ministries for the review of baselines in order to find savings to finance new initiatives and improve quality of spending	
Policy sub-area 1.2. Strengthening budget execution systems			
Streamline budget execution and flexibility of budget management	4	Issued white paper analysis on the simplification of virement procedures, consistent with the PP on budget execution for the FY2013 onwards.	No likely significant negative effects. Improved budgeting systems, guidelines, auditing, software and training should improve effectiveness and accountability of spending on development programs to benefit society.
	5	**The Borrower, through the Ministry of Finance, has issued a Ministerial Regulation (No.112/2012) simplifying and clarifying the practice of withholding funds for budget allocation ("*Bintang*").**	
	6	Submitted the final draft Government Regulation (PP) on "Procedures of State Budget Execution" to the Ministry of Justice	
Develop IFMIS (Integrated Financial Management Information System)	7	**The Borrower, through its Ministry of Finance, has completed the design and build phase for the new budget preparation system.**	
	8	Commenced development of SAKTI application that will be used by 29,000 Spending Units in linkage (web-based) with the SPAN systems (Hyperion and Oracle EBS)	
	9	Commenced the testing of SPAN application	
	10	**The Borrower has introduced a new General Ledger under SPAN using daily transaction conversions from the old General Ledger.**	

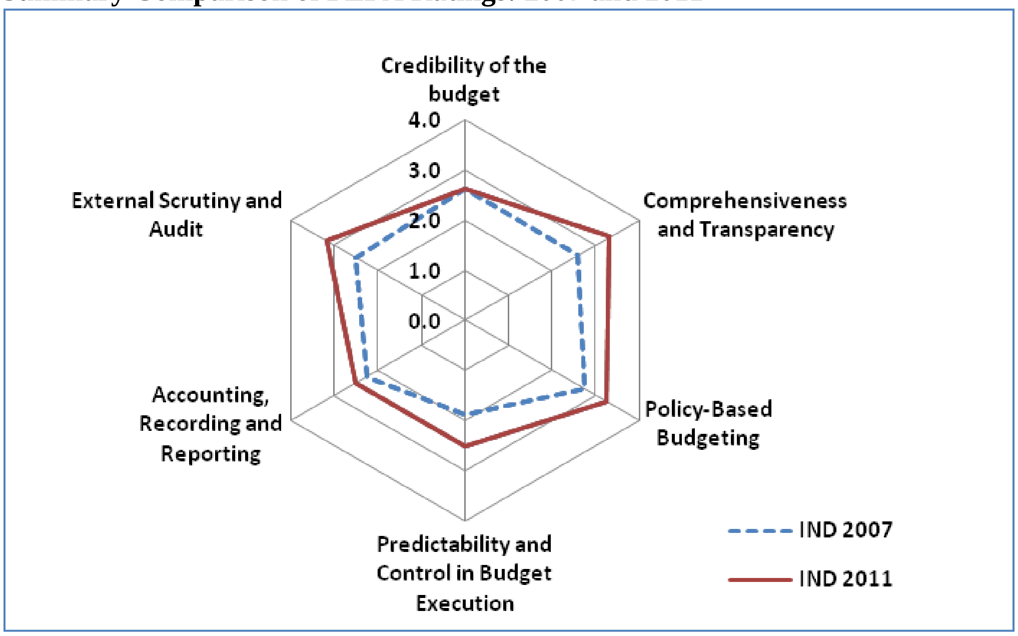
Improve provision of ICT Integration and Services	11	Integrated MOF ICT by having a single Data Center (DC) operational and a consolidation of the existing DCs run at DJPU, DJBC, DJA, DJPB and MPN into this new DC facility located at Pusintek	
Strengthen management of state assets	12	Issued several decrees that empower the MoF with the authority to control the use of state asset issued	
Improve government accounting and audit functions	13	Established a task force to facilitate the creation of a professional association of internal auditors	
	14	BPKP completed and socialized a Control Self Assessment (CSA) manual for the launch of CSAs by line ministries	
	15	**The Borrower, through its Ministry of Finance, has issued and disseminated a Ministerial Regulation (No. 238/2011) on new accrual based accounting policies and chart of accounts.**	
Policy sub-area 1.3. Improving tax administration			
Improve human resources management in DG Tax	16	Developed and submitted to MoF academic paper s on: (i) Establishment of Data Processing Centre and Information; (ii) Establishment of Procurement Service Unit (ULP); and (iii) Establishment of Contact Centre	No likely significant negative effects. Improving capacity, modernizing, clarifying information and tax collection rules should increase tax compliance, reduce leakage, and aid law enforcement efforts – all contributing to improving the rule of law and the perception of fairness in tax payment.
	17	Issued Director General Regulation regarding performance management system of tax auditor with scalable and consistent manner.	
Modernize the core tax system	18	Improved the efficiency and effectiveness of the existing core tax systems and the integrity of taxpayer database by integrating the stand alone system (SIPMOD) into the centralized SIDJP in tax offices throughout Indonesia.	
	19	**The Borrower has issued a Government Regulation (No.31/2012) for the implementation of Article 35A of Law 28/2007 and a Minister of Finance Decree (No. 194/KMK.03/2012) on the sharing of data between DG Tax and DG Customs, all of this to facilitate the sharing of third party information for improved tax compliance.**	
	20	Issued Minister of Finance Regulations regarding: (i) taxes and duties on exports and imports to and from areas which have been designated as a Free Trade Zone or Free Port; (ii) payment of oil and gas income tax in-kind; and (iii) Taxpayer Identification Number and Taxable Entrepreneur.	

<table>
<tr><th colspan="4">Policy area 2: Enhancing poverty alleviation and service delivery efforts</th></tr>
<tr><td rowspan="3">Improve governance and institutional accountability</td><td>21</td><td>Finalized the M&E integration strategy and workplan.</td><td rowspan="3">No likely significant negative effects. Improving monitoring and grievance handling will improve accountability and responsiveness to intended beneficiaries of government pro poor programs.</td></tr>
<tr><td>22</td><td>Agreements are in place between TNP2K Secretariat and key government agencies to integrate M&E systems starting with PKH and PNPM (urban and rural).</td></tr>
<tr><td>23</td><td>TNP2K Secretariat presented design options for a proposed unified grievance and complaint resolution system to government agencies responsible for RASKIN and PKH program implementation and coordination</td></tr>
<tr><td>Improve poverty measurements and targeting of the poor</td><td>24</td><td>The Borrower, through TNP2K, has signed four memoranda of understanding with the Coordinating Ministry of Peoples Welfare, the Ministry of Health, and the Ministry of Education and Culture, and the Ministry of Social Affairs, respectively, whereby the referred ministries agreed to use the unified database held by the TNP2K Secretariat to select the beneficiaries of the Raskin, Jamkesmas, BSM and PKH programs, respectively.</td><td rowspan="4">No likely significant negative effects and probable positive effects through improved targeting of pro poor programs toward intended beneficiaries.</td></tr>
<tr><td rowspan="3">Improve household- targeted poverty reduction programs (Cluster 1)</td><td>25</td><td>The TNP2K Secretariat has completed a review of new institutional arrangements for the delivery of Jamkesmas, taking into account actuarial cost estimates and various scenarios for achieving universal health insurance coverage.</td></tr>
<tr><td>26</td><td>Prepared a strategy document on reforming the targeting, fragmentation, benefit levels, and outreach strategies for Scholarship for the Poor programs.</td></tr>
<tr><td>27</td><td>Commenced piloting of new methods for targeting of beneficiaries of the Rice for the Poor program (RASKIN).</td></tr>
<tr><td rowspan="2">Improve community-based poverty reduction programs (Cluster 2)</td><td>28</td><td>The Borrower, through TNP2K, has issued a roadmap for PNPM (including strategic directions and action plan) to guide the long-term implementation of PNPM and to strengthen the integration of PNPM with local governments.</td><td rowspan="2">No likely significant negative effects from finalizing the plan for the future of the national community empowerment program. Introducing standards for improving management and responsiveness to beneficiaries, particularly in areas that have experienced major complaints, would send a positive message about governance and create an incentive for improved performance.</td></tr>
<tr><td>29</td><td>Introduced service standards for improving management and responsiveness to beneficiaries, particularly in areas that have experienced major complaints.</td></tr>
</table>

Annex 7: Summary of 2011 PEFA Update

A repeat assessment of the Public Expenditure and Financial Accountability (PEFA) was conducted in 2011, following a first assessment in 2007. The results showed that Indonesia has made steady progress in strengthening the quality of its Public Financial Management (PFM) systems and processes. The chart below compares the average PEFA ratings for each of the six main categories of the budget cycle. Improvements made in four of the six categories, namely: the comprehensiveness and transparency of the budget, policy based budgeting, predictability and control in budget execution, and in accounting, recording and reporting.

Summary Comparison of PEFA Ratings: 2007 and 2011



Note: The Chart shows the simple average of the PEFA ratings in each category, with a maximum rating of 4 for an 'A' and 1 for a 'D' and half a point is given for a '+'.

Credibility of the Budget

The assessment in 2011 considers the budget outturns, relative to the budget, for 2007-09, which includes the global financial crisis. The crisis increased uncertainty over international commodity prices and many governments, including Indonesia, undertook emergency fiscal stimulus measures in 2008. These features made fiscal planning even more difficult than normal. However, while the credibility of aggregate budget outturns seems to have increased, the composition of spending, relative to the budget, has deteriorated as many ministries and agencies (K/Ls) have consistently under spent their budgets (even during the stimulus period) while subsidy payments have been volatile as domestic prices have been slow to adjust to changes in international prices.

Comprehensiveness and Transparency of the Budget

The comprehensiveness and transparency of the budget system has generally improved since 2007. Changes in management of the Government Treasury, such as establishing a Treasury Single Account, the disclosure (and closure) of many off-budget ministry bank accounts and the incorporation of the regional development and investment accounts into financial reports and budget documents have contributed to increased transparency and a reduction in unreported government operations. The public access to budget information has also improved while there has been a steady improvement in the coverage and scope of the annual fiscal risk statement, which was first included in the 2008 budget.

(a) Policy Based Budgeting

Indonesia is only just starting to introduce a medium-term expenditure framework (MTEF) and a move towards performance based budgeting (PBB). In 2009, a revision was made to the program structure. The new program structure aligns programs with organizational structures and establishes much clearer lines of accountability for performance. The new structure have been incorporated in the five year national plan (RPJM) for 2010-14, and first implemented in the 2011 budget. The 2011 budget was also the first year of implementing a detailed MTEF process, which ministries prepared budget estimates for two years following the fiscal year (2012 and 2013).

(b) Predictability and Control in Budget Execution

There has been little improvement in the indicators for revenue administration, despite ongoing reform efforts, and significant challenges remain. A rapid increase in the number of registered taxpayers has taken place over the last few years, although weaknesses in the assessment and enforcement processes undermine compliance rates, which significantly reduce revenues, and tax arrears remain relatively high.

There have been some significant improvements in budget execution control processes. Improvements have been made in the recoding of cash balances and debt, particularly as the Treasury Single Account and cash forecasting have continued to be strengthened. New IT systems and procedures have strengthened the management of personnel and payroll information at the MDA and regional treasury (KPPN) level, although weaknesses remain in reconciling the information at the center and with procedures at the SNG level. However, in practice budget execution continues to be plagued by delays due to cumbersome and rigid procedures and lengthy procurement processes. Expenditure on goods and services and capital expenditures tends to be heavily skewed towards the end of the fiscal year with capital expenditure allocations frequently under-spent.

The Government has adopted COSO as its control framework. This has clarified the roles and responsibilities on internal audit. However, the quality of audit by Inspector Generals (IGs) in line ministries and in local government remains sub-optimal, with little focus on risk-based audit, even though some of the IGs in line ministries, including the MoF and the MPW, have embarked on a significant modernization of their functions.

The external auditor, BPK, has given a ‘qualified’ opinion on government financial statements since 2009, after a ‘disclaimer’ status in the previous five years. The major qualifications in the audit report relate to mismatches between budget classifications and the realizations, problems in assets management and under-recording of pension funds. BPK also identified some key internal control weaknesses. The number of line ministries with a clean opinion has also increased, from 16 in 2007 to 34 in 2008 to 53 in 2010. The number of ministries with disclaimers has come down from 33 in 2007 to 18 in 2008 to 2 in 2010.

(c) Accounting, Recording and Reporting

The annual financial statements are prepared on an accrual basis and there is a plan to move to full accrual accounting for line ministries and sub-national governments by 2015. The accounting standards for accrual accounting have already been prepared and a Government regulation on these has recently been issued. Draft accounting policies and chart of accounts have been prepared and under review. The pilot implementation is expected to start in 2013.

(d) External Scrutiny and Audit

Parliament (DPR) is developing new roles to help shape and oversee the state budget, though these remain largely work in progress. Two new arrangements were implemented by the DPR in 2009. Firstly, the former Budget Committee became the Budget Board (Badan Anggaran) and a permanent entity responsible for the endorsement of the state budget. Secondly, the State or Public Finance Accountability Board (Badan Akuntabilitas Keuangan Negara) was established as a permanent entity to review audit reports prepared by the State Audit Agency (BPK).

A peer review for BPK conducted by the Dutch Court of Auditors in 2009 pointed out that BPK had made major strides in its mandate, capacity and practices in the last five years. There has been a significant growth in the budget, the number of staff and the number of regional offices. The report also identified some areas for improvement, mainly the need to improve the readability of audit reports and the quality of analysis in the audit.

(e) Strategic Allocation of Resources

Though significant advances have been made on the budget preparation side, in-year expenditures continue to deviate from plan. The development of a fully operational MTEF and PBB, with well articulated medium term fiscal targets and detailed indicative revenue and expenditure figures at the MDA and program level, should help to bolster aggregate fiscal discipline, expenditure prioritization and the efficiency of spending—the lack of medium-term certainty seems to be one of the factors that reduces the ability of MDAs to enter into multi-year commitments and contracts and hinders much needed capital spending.

(f) Efficient Service Delivery

The limited flexibility to manage and adjust resources during the year may compromise efficient service delivery by limiting the ability to respond to changing needs or to adapt to improve program performance. While this may be have been an appropriate response in the aftermath of the 1998 crisis where weak governance systems contributed to the loss of control, the result is at times excessive risk aversion and under-spending. However it should also be noted that much service delivery, for example in education and health, is now primarily the responsibility of SNGs, rather than central government, and introducing improved controls and accountability while also promoting greater performance orientation at this level is likely to be a long-term challenge.

Nontheless, the move to enhance the performance of the public sector, through PBB and performance management, is becoming a priority within Government. As robust expenditure controls and compliance mechanisms are being established and then strengthened, the Government's focus is increasingly turning toward improving the delivery of public services and infrastructure to support development. This includes both the setting and monitoring of high level objectives as well as mechanisms of downward accountability, such as performance reports for MDAs along with greater flexibility in managing their programs.

Prospects for Reform Planning and Implementation

In recent years, Indonesia has made significant strides in the way its public finances are managed and in increasing transparency and independent oversight. In almost all areas of the PFM cycle, changes in the legal and regulatory architecture are now largely complete and the momentum has shifted towards implementation of new PFM practices that strengthen controls while also moving toward a more performance and quality orientated system for service delivery.

INTERNATIONAL MONETARY FUND
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September 25, 2012

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes 2012 Article IV Consultation with Indonesia

On September 7, 2012, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Indonesia.[1]

Background

Indonesia's economic performance remains strong. At 6.5 percent, growth in 2011 was the highest in over a decade. Growth is now easing modestly on account of the weakened external environment, offset partly by continuing strong domestic demand. Exports have declined in volume terms so far in 2012, while import growth has accelerated sharply on account of strong investment, which grew at 20 percent (Q2, year-on-year). Robust private consumption and a wider fiscal deficit have also provided some support to growth this year. With external demand expected to remain weak and inventories, which have built up significantly in recent months, expected to level out, economic growth is projected at 6 percent for 2012 before it picks up again in 2013.

Headline CPI inflation bottomed out at 3.7 percent (year-on-year) in January, but with sequential momentum strong for both core and noncore items, it rose to 4.6 percent in July. Inflation is expected to end the year at 5 percent, within the authorities' target range of 4.5±1 percent. The fiscal stance is expected to continue to provide a moderate stimulus, with the 2012 deficit projected to rise to 1.8 percent of GDP, up from 1.1 percent in 2011. An increase in subsidized

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

energy prices, proposed by the government for this year in April, was put off by parliament, unless oil prices exceed a revised higher threshold. The postponement of the price adjustment will boost energy subsidies to 3.5 percent of GDP, compared with the 2.6 percent of GDP in total allocated to all of development spending.

Both the rupiah and equity markets came under pressure during the spring of 2012 when outflows picked up sharply, compounding pressures on the exchange rate from the weakening current account. Bank Indonesia (BI) initially resisted market pressures, which contributed to illiquidity in the foreign exchange market, with onshore/offshore spreads widening sharply in early May. Market conditions improved subsequently after BI increased its sales of foreign exchange, while also allowing the rupiah to depreciate at a faster rate. The current account is expected to record a deficit of 1.9 percent of GDP this year, funded mostly by strong foreign direct investment inflows.

Despite some tightening of liquidity conditions and the imposition of prudential limits on consumer and property lending in recent months, financial conditions remain accommodative. As global conditions deteriorated and domestic inflation slowed during August 2011–February 2012, BI eased monetary policy. Since May, unsterilized sales of foreign exchange have helped absorb some excess liquidity, money market rates have risen 30–50 basis points (bps), and BI has increased the lower bound of its interest rate policy corridor by 25 bps. However, liquidity remains high in historical comparison and credit growth (26 percent year-on-year) continues at a robust pace.

Banking system asset quality remains satisfactory and banks are profitable and well capitalized. The authorities have taken several important steps recently to strengthen financial stability. These include: (i) the establishment of a Financial Services Authority that will be fully operational by end-2014; (ii) establishment of a high level forum for coordinating financial stability; and (iii) finalization of a Memorandum of Understanding among all entities currently responsible for financial stability. However, the passage of an effective financial system safety net legislation remains outstanding.

Executive Board Assessment

Executive Directors commended the authorities for their sound economic management, which has helped Indonesia maintain a strong economic performance despite a challenging global environment. Directors noted that, although downside risks remain elevated, the economy's sound fundamentals and ample buffers would allow counter cyclical policy responses, if needed.

Directors noted that, while inflation is within the target band, excess bank liquidity and rapid credit growth warrant continued vigilance and a tightening bias for monetary policy. More broadly, they welcomed the ongoing review of the monetary policy framework, and encouraged the authorities to strengthen their communications strategy to send clearer signals to financial markets and better inform market expectations.

Directors commended the soundness and resilience of the financial system, noting that banks are well capitalized and profitable. They welcomed various initiatives underway to bolster financial regulation and oversight, and recommended careful implementation to minimize transitional risks. They also encouraged the authorities to move quickly to address the remaining gaps in the regime against money laundering and terrorism financing.

Executive Directors welcomed the authorities' commitment to exchange rate flexibility. They underscored that official intervention in the foreign exchange market should take place in the context of a well defined strategy to limit short run volatility. Further development of domestic capital markets would also aid the intermediation of capital flows, reducing volatility. Directors took note of the staff's assessment that the exchange rate is moderately under valued.

Directors commended the authorities' prudent fiscal policies grounded on a strong fiscal framework that has led to a build up of fiscal buffers and a decline in the public debt. They generally considered the modest fiscal stimulus in 2012 to be appropriate in the face of headwinds to growth from the external environment. Directors encouraged the authorities to further advance with fiscal reforms, highlighting the need to improve budget execution, re orient government spending toward the social sectors and infrastructure, replace energy subsidies with targeted cash transfers to the vulnerable, and boost revenue collections.

Directors agreed that deeper structural reforms hold the key to sustained, broad based economic growth. In particular, an open foreign trade and investment regime will be crucial, and should be balanced carefully against domestic industrial policy considerations. In this context, Directors encouraged the authorities to push ahead with reforms to increase Indonesia's productivity and competitiveness. These would include more investment in human capital, a reduction in the cost of doing business, deepening of financial markets, and labor market reforms. Infrastructure and supply bottlenecks also need to be addressed.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case. The staff report (use the free Adobe Acrobat Reader to view this pdf file) for the 2012 Article IV Consultation with Indonesia is also available.

Indonesia: Selected Economic Indicators

	2008	2009	2010	2011	2012 Proj.	2013 Proj.
Real GDP (percent change)	6.0	4.6	6.2	6.5	6.0	6.3
Domestic demand	7.6	5.2	5.9	6.2	7.7	6.7
Of which:						
Private consumption	5.3	4.9	4.7	4.7	4.9	4.9
Gross fixed investment	11.9	3.3	8.5	8.8	11.0	10.0
Change in stocks 1/	0.1	-0.2	0.6	0.5	0.8	0.1
Net exports 1/	0.7	1.2	0.9	1.5	-1.8	-0.4
Saving and investment (in percent of GDP)						
Gross investment 2/	27.8	31.0	32.6	32.8	34.2	35.2
Gross national saving	27.8	33.0	33.3	33.0	32.3	33.3
Foreign saving (external current account balance)	0.0	-2.0	-0.7	-0.2	1.9	2.0
Prices (12-month percent change)						
Consumer prices (end period)	11.1	2.8	7.0	3.8	5.0	5.1
Consumer prices (period average)	9.8	4.8	5.1	5.4	4.4	5.0
Public finances (in percent of GDP)						
Central government revenue	19.8	15.1	15.8	16.1	16.3	16.0
Central government expenditure	19.9	16.7	16.4	17.3	18.1	17.7
Central government balance	-0.1	-1.6	-0.6	-1.1	-1.8	-1.8
Primary balance	1.7	0.1	0.8	0.1	-0.5	-0.5
Central government debt	33.2	28.6	26.9	24.5	23.5	21.5
Money and credit (12-month percent change; end of period)						
Rupiah M2	12.7	13.8	16.5	17.4	...	...
Base money	-9.2	16.7	28.9	18.3	...	...
Private sector credit	30.7	8.1	22.1	25.8	...	...
One-month interbank rate (period average)	9.1	7.4	6.4	6.2	...	...
Balance of payments (in billions of U.S. dollars)						
Oil and gas (net)	-23.9	-15.2	-25.4	-38.7	-41.2	-40.7
Non-oil exports (f.o.b)	107.9	99.0	129.4	162.7	159.6	167.2
Non-oil imports (f.o.b)	-92.8	-73.5	-102.0	-127.9	-143.5	-154.6
Current account balance	0.1	10.6	5.1	1.7	-17.3	-20.2
Foreign direct investment	9.3	4.9	13.8	18.9	21.4	21.5
Overall balance	-1.9	14.2	30.3	13.8	-2.2	2.5
Gross reserves						
In billions of U.S. dollars (end period)	51.6	66.1	96.2	110.1	107.8	110.3
In months of imports	5.7	5.2	5.9	6.7	5.9	5.7
As a percent of short-term debt 3/	178.5	211.0	226.5	238.4	225.7	217.2
Total external debt						
In billions of U.S. dollars	155.1	172.9	202.4	225.4	233.2	247.9
In percent of GDP	30.4	32.1	28.6	26.6	25.7	23.9
Exchange rate (period average)						
Rupiah per U.S. dollar	9,697	10,406	9,086	8,774	...	...
Nominal effective exchange rate (2005=100)	90.8	86.6	95.2	93.5	...	...
Memorandum items:						
Oil production (thousands of barrels per day)	976	949	945	907	895	890
Indonesian oil price (US$/bbl)	97.0	61.6	79.4	111.5	107.2	101.5
Nominal GDP (in trillions of rupiah)	4,949	5,606	6,436	7,427	8,469	9,745
Nominal GDP (in billions of U.S. dollars)	510	539	708	846	906	1,036

Sources: Data provided by the Indonesian authorities; and IMF staff estimates.

1/ Contribution to GDP growth (percentage points).

2/ Includes changes in stocks.

3/ Short-term debt on a remaining maturity basis.

Annex 9: Debt Sustainability Analysis

Indonesia's government debt as a share of GDP has fallen steadily over the past decade, including through the recent global financial crisis. Indeed, Indonesia was the only G20 economy to record a falling debt to GDP ratio between 2008 and the end of 2009, due to its modest deficits (with an expansion of the deficit to only 1.6 percent of GDP in 2009) and ongoing growth (especially in nominal terms). This represents a continuation of the trends of the past decade during which the combination of fiscal conservatism and GDP growth well above, often negative, ex post real interest rates has contributed to a decline in public debt from around 90 percent in 2000 to below 25 percent. These trends are expected to continue over the medium-term. In 2012, even with the projected expansion of the deficit, mainly due to higher fiscal spending on fuel subsidies, the debt to GDP is projected to continue to fall given strong nominal growth projections.

Baseline projections suggest Indonesia's debt to GDP ratios should continue falling over the coming half-decade. The projected fall in the debt to GDP ratio can vary with those projected by other multilateral agencies, depending in particular on the projected growth in Indonesia's GDP deflator which is used. The baseline projection in the table below is based on the assumption that the GDP deflator will continue to grow faster than CPI inflation, although the difference between the two growth rates will converge gradually. The assumed continued stability of the nominal rupiah/USD exchange rate over the medium-term is also supportive of debt dynamics going forward. The budget deficit is assumed to widen in 2012 before declining, in line with the near-term projections set out in the Government's 2013 proposed Budget. It is then assumed that the primary deficit widens towards 2016 as the government embarks on greater infrastructure and social investment in line with its medium-term development plans.

Indonesia's downward debt dynamics appear to be robust to a plausible range of macroeconomic shocks. In shocks to underlying assumptions based on recent trends, past shocks and past volatility, the debt projections remain on a downward path. The historical period used to calculate these shocks includes the last ten years of data, during which there have been a number of adverse shocks to Indonesia's exchange rate, for example during the recent global crisis, although growth has been positive with relatively little variation. Even with a shock of a 10 percent of GDP increases in debt liabilities in 2013, the debt ratio almost comes back down to its 2011 value by 2017. However, when considering these results, it is worth noting that this debt sustainability analysis focuses on solvency issues rather than liquidity and roll-over risks, which may occur even if solvency is solid. As mentioned in the macro round-up while Indonesia's near-term financing position is supported by cash reserves from previous over-financing and the still conservative fiscal deficits it remains sensitive to shifts in financing conditions. This sensitivity is one of the rationales for putting in place the contingent financing of the PERISAI DPL-DDO and parallel facilities from other development partners.

Table 7: Sensitivity Analysis for Key Indicators of Indonesia's Government Debt

	Actual							Projections					
	2007	2008	2009	2010	2011			2012	2013	2014	2015	2016	2017
								I. Baseline Projections					
1 **Public sector debt 1/**	35.2	33.0	28.4	26.1	24.4			**23.7**	**22.2**	**20.5**	**19.0**	**17.7**	**16.8**
o/w foreign-currency denominated	16.5	17.2	13.5	12.0	11.1			10.3	9.3	8.4	7.6	6.9	6.3
2 Change in public sector debt	-4.6	-2.2	-4.6	-2.3	-1.6			-0.7	-1.5	-1.6	-1.6	-1.2	-0.9
3 Identified debt-creating flows (4+7+12)	-5.0	-4.8	-4.5	-3.5	-2.1			-0.5	-1.5	-1.7	-1.6	-1.3	-0.9
4 Primary deficit	-0.8	-1.7	-0.1	-0.6	-0.1			0.7	0.2	0.1	0.1	0.3	0.5
5 Revenue and grants	17.9	19.8	15.1	15.5	16.3			15.6	15.6	15.8	15.9	16.1	16.2
6 Primary (noninterest) expenditure	17.2	18.1	15.0	14.8	16.2			16.3	15.8	15.9	16.0	16.4	16.7
7 Automatic debt dynamics 2/	-4.2	-3.1	-4.4	-2.8	-2.0			-1.2	-1.7	-1.8	-1.7	-1.6	-1.5
8 Contribution from interest rate/growth differential 3/	-4.1	-5.3	-2.2	-2.3	-2.2			-1.4	-1.7	-1.8	-1.7	-1.5	-1.4
9 Of which contribution from real interest rate	-2.0	-3.6	-0.9	-0.8	-0.8			-0.1	-0.3	-0.5	-0.5	-0.4	-0.4
10 Of which contribution from real GDP growth	-2.1	-1.7	-1.3	-1.5	-1.5			-1.3	-1.3	-1.3	-1.2	-1.1	-1.1
11 Contribution from exchange rate depreciation 4/	0.0	2.2	-2.2	-0.5	0.2			0.3	0.0	0.0	0.0	0.0	0.0
12 Other identified debt-creating flows	-0.1	0.0	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0
13 Privatization receipts (negative)	-0.1	0.0	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0
14 Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0
15 Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0
16 Residual, including asset changes (2-3)	0.4	2.6	-0.1	1.2	0.5			-0.3	0.0	0.0	0.0	0.0	0.0
Public sector debt-to-revenue ratio 1/	196.3	166.3	187.4	168.5	149.8			151.8	142.2	130.5	119.2	110.5	104.0
Key Macroeconomic and Fiscal Assumptions						10-Year Historical Average	10-Year Standard Deviation						
Real GDP growth (in percent)	6.3	6.0	4.6	6.2	6.5	5.5	0.7	6.0	6.4	6.6	6.7	6.8	6.8
Average nominal interest rate on public debt (in percent) 6/	6.0	6.4	5.7	5.6	5.6	5.6	0.6	7.0	7.0	6.7	6.3	6.0	5.6
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	-5.2	-11.7	-2.6	-2.5	-2.8	-4.7	4.0	-0.2	-1.1	-2.1	-2.2	-2.0	-1.9
Nominal appreciation (increase in US dollar value of local currency eop, in percent)	0.2	-14.0	16.5	4.5	-2.0	1.7	9.9	…	…	…	…	…	…
Inflation rate (GDP deflator, in percent)	11.3	18.1	8.3	8.1	8.4	10.3	4.1	7.2	8.1	8.7	8.5	8.0	7.5
Growth of real primary spending (deflated by GDP deflator, in percent)	3.8	12.1	-13.2	4.6	16.2	6.7	12.8	6.8	2.9	7.4	7.4	9.4	9.2
Primary deficit	-0.8	-1.7	-0.1	-0.6	-0.1	-1.3	1.1	0.7	0.2	0.1	0.1	0.3	0.5
								II. Stress Tests for Public Debt Ratio					
A. Alternative Scenarios													
A1. Key variables are at their historical averages in 2012-2017 7/								**23.8**	**20.2**	**17.0**	**14.1**	**11.4**	**9.0**
A2. No policy change (constant primary balance) in 2012-2017								**23.7**	**21.8**	**21.6**	**20.1**	**20.3**	**19.0**
B. Bound Tests													
B1. Real interest rate is at baseline plus one standard deviations								**23.7**	**22.6**	**21.3**	**20.0**	**19.1**	**18.4**
B2. Real GDP growth is at baseline minus one-half standard deviation								**23.7**	**22.3**	**20.9**	**19.5**	**18.5**	**17.9**
B3. Primary balance is at baseline minus one-half standard deviation								**23.7**	**22.7**	**21.6**	**20.4**	**19.6**	**19.1**
B4. Combination of B1-B3 using one-quarter standard deviation shocks								**23.7**	**22.7**	**21.5**	**20.3**	**19.4**	**18.9**
B5. One time 30 percent real depreciation in 2013 8/								**23.7**	**27.9**	**25.8**	**23.8**	**22.2**	**20.9**
B6. 10 percent of GDP increase in other debt-creating flows in 2013								**23.7**	**32.2**	**29.7**	**27.4**	**25.4**	**23.9**

1/ Indicate coverage of public sector, e.g., general government or nonfinancial public sector. Also whether net or gross debt is used.

2/ Derived as $[(r - \pi(1+g) - g + \alpha\varepsilon(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; α = share of foreign-currency denominated debt; and ε = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

3/ The real interest rate contribution is derived from the denominator in footnote 2/ as $r - \pi\ (1+g)$ and the real growth contribution as -g.

4/ The exchange rate contribution is derived from the numerator in footnote 2/ as $\alpha\varepsilon(1+r)$.

5/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.

6/ Derived as nominal interest expenditure divided by previous period debt stock.

7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.

8/ Real depreciation is defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

(In percent of GDP, unless otherwise indicated)

	Actual							Projections					
	2006	2007	2008	2009	2010			2011	2012	2013	2014	2015	2016
								I. Baseline Projections					
1 **Public sector debt 1/**	39.8	35.2	33.0	28.4	26.0			**24.3**	**22.3**	**20.4**	**18.9**	**17.8**	**17.1**
o/w foreign-currency denominated	17.5	14.8	14.8	10.9	9.5			8.6	7.8	7.0	6.4	5.9	5.5
2 Change in public sector debt	-7.9	-4.6	-2.2	-4.6	-2.3			-1.7	-2.0	-1.9	-1.5	-1.1	-0.7
3 Identified debt-creating flows (4+7+12)	-8.1	-5.0	-5.0	-4.2	-3.4			-2.1	-2.0	-1.9	-1.5	-1.1	-0.7
4 Primary deficit	-1.5	-0.8	-1.7	-0.1	-0.6			0.3	0.0	-0.1	0.1	0.3	0.5
5 Revenue and grants	19.1	17.9	19.8	15.1	15.5			16.1	15.6	15.8	15.9	16.1	16.2
6 Primary (noninterest) expenditure	17.6	17.2	18.1	15.1	14.8			16.4	15.6	15.7	16.0	16.4	16.7
7 Automatic debt dynamics 2/	-6.5	-4.2	-3.3	-4.1	-2.7			-2.3	-2.0	-1.9	-1.6	-1.4	-1.2
8 Contribution from interest rate/growth differential 3/	-5.7	-4.1	-5.3	-2.2	-2.2			-2.0	-2.0	-1.9	-1.6	-1.4	-1.2
9 Of which contribution from real interest rate	-3.5	-2.0	-3.6	-0.9	-0.7			-0.5	-0.7	-0.6	-0.4	-0.3	-0.1
10 Of which contribution from real GDP growth	-2.2	-2.1	-1.7	-1.3	-1.5			-1.4	-1.4	-1.3	-1.2	-1.2	-1.1
11 Contribution from exchange rate depreciation 4/	-0.8	0.0	2.0	-1.9	-0.4			-0.3	0.0	0.0	0.0	0.0	0.0
12 Other identified debt-creating flows	-0.1	-0.1	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0
13 Privatization receipts (negative)	-0.1	-0.1	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0
14 Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0
15 Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0	0.0
16 Residual, including asset changes (2-3)	0.2	0.4	2.8	-0.4	1.0			0.3	0.0	0.0	0.0	0.0	0.0
Public sector debt-to-revenue ratio 1/	208.2	196.3	166.3	187.4	168.1			151.0	143.1	129.5	118.7	110.8	105.5
Key Macroeconomic and Fiscal Assumptions						10-Year Historical Average	10-Year Standard Deviation						
Real GDP growth (in percent)	5.5	6.3	6.0	4.6	6.1	5.2	0.9	6.4	6.5	6.7	6.8	7.0	7.0
Average nominal interest rate on public debt (in percent) 6/	6.0	6.0	6.4	5.7	5.6	5.7	0.7	6.4	7.0	6.7	6.3	6.0	5.6
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	-8.1	-5.2	-11.7	-2.6	-2.5	-5.2	4.1	-1.9	-2.6	-2.4	-1.7	-1.1	-0.4
Nominal appreciation (increase in US dollar value of local currency, in percent)	4.2	0.2	-14.0	16.5	4.7	1.1	10.3						
Inflation rate (GDP deflator, in percent)	14.1	11.3	18.1	8.3	8.0	10.8	4.2	8.3	9.6	9.0	8.0	7.0	6.0
Growth of real primary spending (deflated by GDP deflator, in percent)	15.3	3.8	12.1	-13.2	4.7	4.1	13.3	17.2	1.9	6.9	8.9	9.6	9.3
Primary deficit	-1.5	-0.8	-1.7	-0.1	-0.6	-1.6	1.1	0.3	0.0	-0.1	0.1	0.3	0.5
								II. Stress Tests for Public Debt Ratio					
A. Alternative Scenarios													
A1. Key variables are at their historical averages in 2011-2016 7/								24.3	20.4	16.8	13.6	10.7	8.1
A2. No policy change (constant primary balance) in 2011-2016								24.3	22.7	21.1	19.7	18.5	17.4
B. Bound Tests													
B1. Real interest rate is at baseline plus one standard deviations								24.3	22.7	21.2	20.0	19.2	18.7
B2. Real GDP growth is at baseline minus one-half standard deviation								24.3	22.5	20.7	19.5	18.7	18.3
B3. Primary balance is at baseline minus one-half standard deviation								24.3	22.8	21.4	20.3	19.7	19.4
B4. Combination of B1-B3 using one-quarter standard deviation shocks								24.3	22.8	21.4	20.3	19.6	19.2
B5. One time 30 percent real depreciation in 2012 8/								24.3	27.4	25.0	23.2	21.8	20.8
B6. 10 percent of GDP increase in other debt-creating flows in 2012								24.3	32.3	29.6	27.3	25.6	24.4

1/ Government gross debt.

2/ Derived as [(r - π(1+g) - g + αε(1+r)]/(1+g+π+gπ)) times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; α = share of foreign-currency denominated debt; and ε = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

3/ The real interest rate contribution is derived from the denominator in footnote 2/ as r - π (1+g) and the real growth contribution as -g.

4/ The exchange rate contribution is derived from the numerator in footnote 2/ as αε(1+r).

5/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.

6/ Derived as nominal interest expenditure divided by previous period debt stock.

7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.

8/ Real depreciation is defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

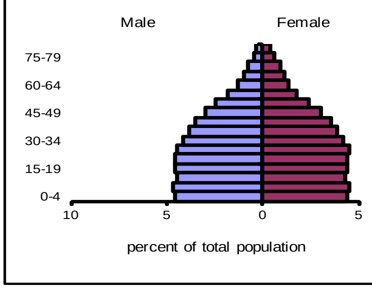
Annex 10: Indonesia at a Glance

Indonesia at a glance

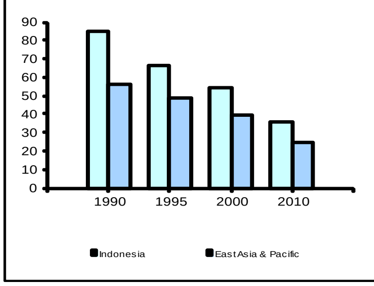
10/12/12

Key Development Indicators	Indonesia	East Asia & Pacific	Lower middle income
(2011)			
Population, mid-year (millions)	242.3	1,962	2,519
Surface area (thousand sq. km)	1,905	16,302	23,579
Population growth (%)	1.0	0.7	1.5
Urban population (% of total population)	54	46	39
GNI (Atlas method, US$ billions)	649.6	7,249	4,078
GNI per capita (Atlas method, US$)	2,680	3,696	1,619
GNI per capita (PPP, international $)	4,200	6,657	3,632
GDP growth (%)	6.5	9.7	6.9
GDP per capita growth (%)	5.4	8.9	5.3
(most recent estimate, 2005–2011)			
Poverty headcount ratio at $1.25 a day (PPP, %)	18	14	..
Poverty headcount ratio at $2.00 a day (PPP, %)	46	33	..
Life expectancy at birth (years)	68	72	65
Infant mortality (per 1,000 live births)	27	20	50
Child malnutrition (% of children under 5)	18	6	25
Adult literacy, male (% of ages 15 and older)	95	96	80
Adult literacy, female (% of ages 15 and older)	89	91	62
Gross primary enrollment, male (% of age group)	119	111	110
Gross primary enrollment, female (% of age group)	115	112	104
Access to an improved water source (% of population)	80	90	87
Access to improved sanitation facilities (% of population)	52	66	47

Age distribution, 2010

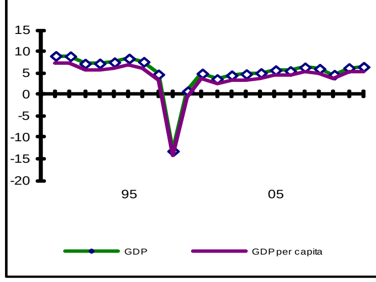


Under-5 mortality rate (per 1,000)



Net Aid Flows	**1980**	**1990**	**2000**	**2011**
(US$ millions)				
Net ODA and official aid	941	1,716	1,653	1,393
Top 3 donors (in 2010):				
Australia	48	77	72	356
France	44	122	22	262
United States	117	31	174	180
Aid (% of GNI)	1.3	1.6	1.1	0.2
Aid per capita (US$)	6	9	8	6

Growth of GDP and GDP per capita (%)



Long-Term Economic Trends	1980	1990	2000	2011	**1980–90**	**1990–2000**	**2000–11**
Consumer prices (annual % change)	9.5	7.7	3.7	5.4			
GDP implicit deflator (annual % change)	10.4	7.7	20.4	8.4			
Exchange rate (annual average, local per US$)	627	1,843	8,422	10,121			
Terms of trade index (2000 = 100)	..	107	100	137			
					(average annual growth %)		
Population, mid-year (millions)	151	184	213	242	2.0	1.5	1.2
GDP (US$ billions)	78	114	165	734	6.1	4.2	5.4
		(% of GDP)					
Agriculture	24.0	19.4	15.6	14.7	3.6	2.0	3.5
Industry	41.7	39.1	45.9	47.2	7.3	5.2	4.2
Manufacturing	13.0	20.7	27.7	24.3	12.8	6.7	4.6
Services	34.3	41.5	38.5	38.1	6.5	4.0	7.4
Household final consumption expenditure	51.4	58.9	60.7	56.8	5.2	6.6	4.6
General gov't final consumption expenditure	10.5	8.8	6.5	9.0	4.6	0.1	7.8
Gross capital formation	24.1	30.7	22.2	32.8	7.7	-0.6	6.4
Exports of goods and services	34.2	25.3	41.0	26.3	2.7	5.9	7.7
Imports of goods and services	20.2	23.7	30.5	24.9	1.2	5.7	8.2
Gross savings	28.7	28.1	26.1	31.3			

Note: Figures in italics are for years other than those specified. 2011 data are preliminary. .. indicates data are not available.
a. Aid data are for 2010.

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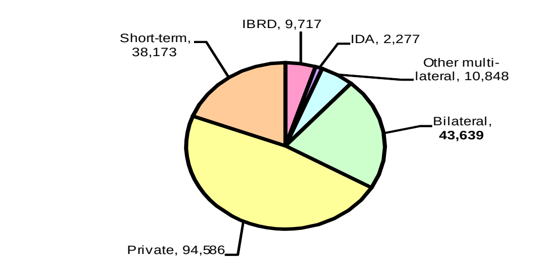
Balance of Payments and Trade	**2000**	**2011**
(US$ millions)		
Total merchandise exports (fob)	65,408	200,788
Total merchandise imports (cif)	44,404	182,604
Net trade in goods and services	15,243	24,154
Current account balance	7,998	1,712
as a % of GDP	4.8	0.2
Workers' remittances and compensation of employees (receipts)	1,190	6,916
Reserves, including gold	29,268	106,530

Central Government Finance		
(% of GDP)		
Current revenue (including grants)	19.7	16.3
Tax revenue	11.1	11.8
Current expenditure	15.6	10.3
Overall surplus/deficit	-1.8	-1.1
Highest marginal tax rate (%)		
Individual	35	30
Corporate	30	28

External Debt and Resource Flows		
(US$ millions)		
Total debt outstanding and disbursed	143,344	199,240
Total debt service	16,624	30,681
Debt relief (HIPC, MDRI)	–	–
Total debt (% of GDP)	86.9	27.2
Total debt service (% of exports)	26.2	13.0
Foreign direct investment (net inflows)	-4,550	19,242
Portfolio equity (net inflows)	-1,021	-326

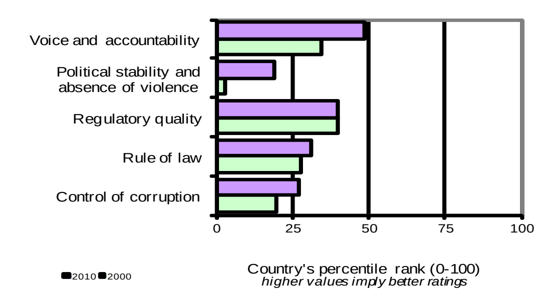
Composition of total external debt, 2011



US$ millions

Private Sector Development	**2000**	**2011**
Time required to start a business (days)	–	45
Cost to start a business (% of GNI per capita)	–	21.5
Time required to register property (days)	–	22
Ranked as a major constraint to business	**2000**	**2010**
(% of managers surveyed who agreed)		
Economic and regulatory policy uncertainty	48.2	
Corruption	41.5	
Stock market capitalization (% of GDP)	16.3	58.4
Bank capital to asset ratio (%)	6.0	11.4

Governance indicators, 2000 and 2010



Source: Worldwide Governance Indicators (www.govindicators.org)

Technology and Infrastructure	**2000**	**2010**
Paved roads (% of total)	57.1	56.9
Fixed line and mobile phone subscribers (per 100 people)	5	108
High technology exports (% of manufactured exports)	16.4	11.4

Environment		
Agricultural land (% of land area)	25	30
Forest area (% of land area)	54.9	52.1
Terrestrial protected areas (% of land area)	13.6	14.1
Freshwater resources per capita (cu. meters)	9,218	8,504
Freshwater withdrawal (billion cubic meters)	..	..
CO2 emissions per capita (mt)	1.2	1.7
GDP per unit of energy use (2005 PPP $ per kg of oil equivalent)	3.6	4.3
Energy use per capita (kg of oil equivalent)	730	851

World Bank Group portfolio	**2000**	**2010**
(US$ millions)		
IBRD		
Total debt outstanding and disbursed	11,715	9,054
Disbursements	1,051	2,078
Principal repayments	761	900
Interest payments	950	291
IDA		
Total debt outstanding and disbursed	714	2,313
Disbursements	59	142
Total debt service	31	49
IFC (fiscal year)		
Total disbursed and outstanding portfolio	880	648
of which IFC own account	480	507
Disbursements for IFC own account	20	46
Portfolio sales, prepayments and repayments for IFC own account	43	165
MIGA		
Gross exposure	56	207
New guarantees	0	207

Note: Figures in italics are for years other than those specified. 2011 data are preliminary. 10/12/12
.. indicates data are not available. – indicates observation is not applicable.

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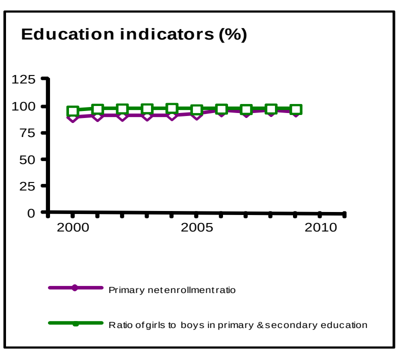
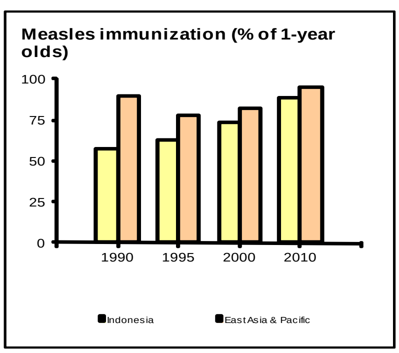
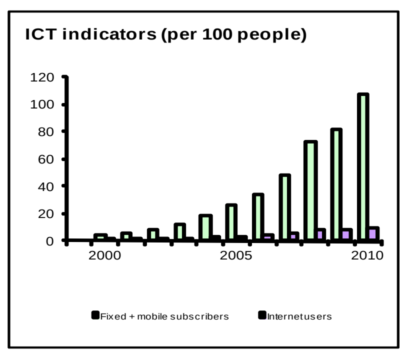
With selected targets to achieve betw een 1990 and 2015
(estimate closest to date shown, +/- 2 years)

	Indonesia			
Goal 1: halve the rates for extreme poverty and malnutrition	**1990**	**1995**	**2000**	**2010**
Poverty headcount ratio at $1.25 a day (PPP, % of population)	54.3	43.4	47.7	18.1
Poverty headcount ratio at national poverty line (% of population)	..	17.6	23.4	13.3
Share of income or consumption to the poorest qunitile (%)	9.4	9.0	9.6	8.3
Prevalence of malnutrition (% of children under 5)	31.0	27.4	24.8	17.5
Goal 2: ensure that children are able to complete primary schooling				
Primary school enrollment (net, %)	98	95	90	95
Primary completion rate (% of relevant age group)	96	99	93	105
Secondary school enrollment (gross, %)	48	49	53	77
Youth literacy rate (% of people ages 15-24)	96	..	..	99
Goal 3: eliminate gender disparity in education and empower women				
Ratio of girls to boys in primary and secondary education (%)	93	93	96	98
Women employed in the nonagricultural sector (% of nonagricultural employment)	29	29	32	32
Proportion of seats held by women in national parliament (%)	12	13	8	18
Goal 4: reduce under-5 mortality by two-thirds				
Under-5 mortality rate (per 1,000)	85	67	54	35
Infant mortality rate (per 1,000 live births)	56	46	38	27
Measles immunization (proportion of one-year olds immunized, %)	58	63	74	89
Goal 5: reduce maternal mortality by three-fourths				
Maternal mortality ratio (modeled estimate, per 100,000 live births)	620	440	350	240
Births attended by skilled health staff (% of total)	32	37	64	75
Contraceptive prevalence (% of women ages 15-49)	50	54	55	57
Goal 6: halt and begin to reverse the spread of HIV/AIDS and other major diseases				
Prevalence of HIV (% of population ages 15-49)	0.1	0.1	0.1	0.2
Incidence of tuberculosis (per 100,000 people)	189	189	189	189
Tuberculosis case detection rate (%, all forms)	21	9	21	66
Goal 7: halve the proportion of people without sustainable access to basic needs				
Access to an improved water source (% of population)	71	74	77	80
Access to improved sanitation facilities (% of population)	33	38	44	52
Forest area (% of land area)	65.4	..	54.9	52.1
Terrestrial protected areas (% of land area)	10.0	10.9	13.6	14.1
CO_2 emissions (metric tons per capita)	0.8	1.1	1.2	1.7
GDP per unit of energy use (constant 2005 PPP $ per kg of oil equivalent)	3.7	4.0	3.6	4.3
Goal 8: develop a global partnership for development				
Telephone mainlines (per 100 people)	0.6	1.7	3.1	15.8
Mobile phone subscribers (per 100 people)	0.0	0.1	1.7	91.7
Internet users (per 100 people)	0.0	0.0	0.9	9.9
Computer users (per 100 people)	..	..	..	1.5







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