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Indonesia development policy review

Enhancing government effectiveness in a democratic and decentralized Indonesia

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ASKESKIN	*Asuransi Kesehatan Miskin* (Health Insurance for the Poor)
Bakornas	*Badan Koordinasi Nasional Penanganan Bencana* (National Disaster Management Coordinating Board of Indonesia)
Bapepam LK	*Badan Pengawas Pasar Modal dan Lembaga Keuangan* (Financial Institutions and Capital Markets Supervisory Agency)
Bappenas	*Badan Perencanaan Pembangunan Nasional* (National Development Planning Agency)
BOS	*Bantuan Operasional Sekolah* (School Operational Assistance)
BPK	*Badan Pemeriksa Keuangan* (Supreme Audit Agency)
BPKP	*Badan Pengawasan Keuangan dan Pembangunan* (Financial and Development Supervisory Board)
BPN	*Badan Pertanahan Nasional* (National Land Agency)
BRR	*Badan Rehabilitasi dan Rekonstruksi* (Aceh and Nias Reconstruction and Rehabilitation Agency)
CCT	Conditional Cash Transfer
CDM	Clean Development Mechanism
DAK	*Dana Alokasi Khusus* (Special Allocation Funds)
DAU	*Dana Alokasi Umum* (General Allocation Funds)
DRR	Disaster Risk Reduction
DSM	Demand-Side Management
EAP	East Asia and Pacific?
ECD	Early Childhood Development
FDI	Foreign Direct Investment
GNI	Gross National Income
GoI	Government of Indonesia
IIEE	Indonesian Institute for Energy Economics
JAMKESMAS	*Jaminan Kesehatan Masyarakat* (Public Health Insurance Program)
KDP	*Kecamatan* Development Program
KKPPI	*Komite Kebijakan Percepatan Penyediaan Infrastruktur* (National Committee on Policy for Accelerating Infrastructure Provision)
KON	*Komisi Ombudsman Nasional* (National Ombudsman Commission)
KPK	*Komisi Pemberantasan Korupsi* (Corruption Eradication Commission)
LPKPP	*Lembaga Pengembangan Kebijakan Pengadaan Pemerintah* (National Public Procurement Planning Office)
LPS	*Lembaga Penjamin Simpanan* (Deposit Insurance Corporation)
MDG	Millennium Development Goals
MoA	Ministry of Agriculture
MoF	Ministry of Finance
MoH	Ministry of Health
Musrembang	*Musyawarah Rencana Pembangunan* (Development Plan Consultative Forum)
NBFI	Non-bank Financial Institutions
NCBR	National Committee for Bureaucratic Reform
NSSS	National Social Security System
NPL	Non-performing Loan
P4K	*Pembinaan Peningkatan Pendapatan Petani Kecil* (Small Farmers Income Generation Improvement)
PDAM	*Perusahaan Daerah Air Minum* (Regional Water Utility)
PISA	Program for International Student Assessment
PKH	*Program Keluarga Harapan* (Family Hope Program)
PLN	*Perusahaan Listrik Negara* (National Electricity Company)
PNPM	*Program Nasional Pemberdayaan Masyarakat* (National Program for Community Empowerment)
PPP	Public Private Participation
PPATK	*Pusat Pelaporan dan Analisa Transaksi Keuangan* (Financial Transaction Analysis and Reporting Center)
PSO	Public Service Obligation
RDA	Regional Development Accounts
REDD	Reduced Emissions from Deforestation and Degradation
Reksadana	Managed Funds
Renstra	*Rencana Strategis* (Strategic Plan)
RKP	*Rencana Kerja Pemerintah* (Government Work Plan)

RPJM	*Rencana Pembangunan Jangka Menegah* (Medium-Term Development Plan)
RPO	Rural Producers' Organization
RUEN	*Rencana Umum Energi Nasional* (General Plan for National Energy)
RUKN	*Rencana Umum Ketenagalistrikan Nasional (General Plan for National Electricity)*
RUPPN	*Rencana Umum Perminyakan dan Pergasbumian Nasional* (General Plan for National Oil and Natural Gas)
SLA	Subsidiary Loan Agreement
SME	Small and Medium-size Enterprises
UNCAC	United Nations Convention Against Corruption
UNFCCC COP	United Nations Framework Convention on Climate Change – Conference of the Parties to the Convention
UPP	Urban Poverty Project
UUPK	*Undang-Undang Pokok Kehutanan* (Basic Forestry Law)

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Executive summary

What the report is about and its central thesis

A decade ago, in 1998, Indonesia experienced a severe economic crisis that resulted in the economic dislocation of millions of households, a sharp rise in poverty, a 13 percent decline in GDP, and near bankruptcy of the financial sector. The economic crisis precipitated a dismantling of the previous political order, leading to a period of wrenching political turmoil characterized by several changes in government and the heightening of separatist tensions. Ten years later, Indonesia has emerged economically strong and remarkably stable in political terms. This report takes stock of where things stand today, by reviewing Indonesia's development performance of the last decade, and looks ahead to the development agenda for the next decade.

Indonesia, in 2008, is in many ways a glass half-full

It has the potential, in the decade ahead, to rise to become a dynamic middle-income economy…

…or it could float along, remaining a glass half-empty

Indonesia, in 2009, is in many ways a glass half-full. What it has achieved in terms of macroeconomic and political stability is quite remarkable. If Indonesia is able to build on the robust foundation of macroeconomic and political stability it has established thus far and accelerate growth while ensuring that growth is shared and is sustainable, it has the potential to "fill the glass" in the decade ahead and rise to become a dynamic, competitive, and inclusive middle-income country. At the same time, much remains to be done if that growth is to be sustained in the face of the risks that lie ahead, and if it is to be shared more widely and translate into improvements in the broader dimensions of well-being for Indonesia's population. If these challenges are not addressed, Indonesia risks remaining a glass half-empty, floating along as long as the external economic environment is favorable but still fragile and vulnerable to global downturns and increasingly vulnerable to domestic discontent as aspirations for more widely shared growth and broader improvements in well-being continue to be unfulfilled.

Neither scenario is inevitable but both are possible

Enhancing government effectiveness by adapting and strengthening the institutions of the new democratic and decentralized Indonesia is the central challenge Indonesia faces if it is to "fill the glass" in the decade ahead

Neither scenario is inevitable but both are possible. The central thesis of this report is that which scenario is ultimately realized will depend in large part on how successfully Indonesia is able to navigate its own ongoing and as yet incomplete governance transition from a centralized authoritarian regime to a decentralized democratic state. Thus, the core challenge Indonesia faces in the decade ahead is one of enhancing government effectiveness in the new democratic and decentralized Indonesia by adapting and strengthening the institutions and processes that govern the functioning of the state and shape state-society interactions.

The task will not be easy and it will take time. Democratization and decentralization have fundamentally changed accountability structures and decision-making processes within government. These changes have highlighted systemic weaknesses in the processes and capacity for formulating and implementing policy and have made the process of implementing reforms a more challenging and time-consuming task. Government effectiveness has been limited by insufficient capacity and accountability of civil servants and by coordination problems within government. Because highly competitive elections have led to coalitional politics at the national level and in many regions, and greater voice in the political arena has been afforded to a wide range of non-state actors, the task of reaching consensus on critical policies and reforms has become that much more challenging. Decentralization has changed accountability structures or weakened them, as the division of roles and responsibilities between the various levels of government remains unclear in many spheres of government activity. At the same time, the tasks Indonesia faces, as an emerging middle-income economy, have become more difficult, in part because of its own past successes and in part because the global economic environment is rapidly changing.

Indonesia in 2008 is a glass half-full

Indonesia has done well in terms of macroeconomic performance since the 1998 crisis, and

Indonesia has done extremely well in terms of macroeconomic performance since the 1998 crisis, particularly in the last five years. Per-capita GDP has exceeded pre-crisis levels and growth picked up in the lead-up to the global economic downturn. Indonesian growth accelerated to a ten-year high of 6.3 percent in 2007, and continued at 6.1 percent

particularly in the last five years, and has been less affected than many by the global economic turmoil of 2008 and 2009

in 2008 despite the sharp slowdown in the global economy. Real GDP has been growing at 5 to 6 percent annually since 2002. In 2005, per-capita real GDP for the first time exceeded the high that had been reached in 1997, immediately prior to the crisis, and by early 2009 it was more than one-fifth higher. Prudent macroeconomic management has resulted in lower budget deficits, a much lower debt-to-GDP ratio, and, for the most part, manageable inflation. The financial sector has largely recovered from the 1998 crisis and, overall, financial ratios remained healthy or even improved during the period of greatest distress in global finance. Successive balance of payments surpluses allowed foreign reserves to accumulate, and while these were drawn on when pressure on the IDR peaked in the last quarter of 2008, they have subsequently recovered as that pressure has receded. Indonesia's exports have grown strongly, while the external debt to GDP ratio has fallen. Investment has risen to over 27 percent of GDP, approaching pre-crisis highs.

…and Indonesia has continued its remarkably stable transition from a centralized authoritarian regime to a decentralized democratic polity

In the decade since the crisis, Indonesia's political system has undergone a profound transformation, from a centralized authoritarian regime to a decentralized democratic polity. The transition was initially tumultuous, but there has been a growing sense of political stability, particularly in the last five years, as the democratic process has both deepened and achieved wider acceptance. Constitutional reforms mandating direct elections to all levels of government have created greater electoral accountability. An extensive system of institutional checks and balances has been introduced, apex government oversight and accountability agencies have been established, and the judiciary has been made independent. A "big bang" decentralization in 2001 has devolved substantial funds and authority to local governments and new forms of decentralized participation in policymaking have been created. The political stability and the broader embrace of the democratic process that these changes have engendered have been critical to supporting Indonesia's economic recovery and calming separatist sentiments.

But Indonesia still is a glass half-empty because there has been less progress on other important fronts …

Higher levels of growth have not translated, to the extent hoped for, into greater poverty reduction. A large percentage of the population remains vulnerable to poverty. Despite recent signs of progress, Indonesia lags far behind its more prosperous neighbors in creating higher value-added non-agricultural jobs. Employment growth has failed to match population growth since the crisis and job creation in the formal sector has been especially sluggish. Though the open unemployment rate has fallen since its peak of 11.2 percent in 2005, unemployment remains high, especially among youth. Of greatest concern is that, as of 2008, over 40 percent of Indonesia's labor force still derives its livelihood from low-productivity activities in agriculture and related areas, while only 30 percent of Indonesia's growing labor force appears to have made the transition to what are considered high-value added activities, as employees in the formal manufacturing and services sector or as employers in organized enterprises. Because of geographic and income-related disparities and the poor quality of health, water and sanitation and education service delivery at the local level, Indonesia's performance in terms of human development outcomes has been quite uneven over the last decade despite significant increases in public expenditures. For some indicators, there has been little improvement in the last decade, and in the case of a few, there has even been some regression, and as a result Indonesia lags behind its neighbors in a number of areas. There is considerable evidence as well that Indonesia's environmental quality is deteriorating and its natural resources are being unsustainably depleted. As a result, Indonesia's record on the MDGs is decidedly mixed.

…and while Indonesia has weathered the global economic turmoil better than most economies…

The turmoil in global finance of late 2008 and early 2009 and the subsequent economic downturn did affect Indonesia's financial markets, especially the government bond market and the exchange rate. But the impact on the real economy has been far smaller than for most economies, in particular, Indonesia's neighbors in the region. Some export industries were especially affected by lower prices and retrenched demand, and many firms cut their investment plans, but economic growth remained well positive overall, and the slowdown in Indonesia's growth from early 2008 to the first quarter of 2009 was smaller than all the major economies in East Asia.

…signficant risks remain

Despite the relative robustness of Indonesia's economy, significant risks remain. The openness of its capital accounts, its perceived financial risk rating, and the shallowness of its capital markets leaves financial asset prices susceptible to greater volatility than occur elsewhere. In turn this creates risks for the government's ongoing ability to meet its

financing needs and fund vital infrastructure and social investments, and for the private sector's access to capital. A prolonged period of slower global growth, and a recalibration of growth among Indonesia's neighboring economies from tradables production to domestic demand, also increases the importance of achieving a supportive domestic economic environment if Indonesia is to resume its recent growth rates.

Indonesia in 2008 is a glass half-empty because its post-crisis governance transition is still incomplete…

That Indonesia in 2008 remains a glass half-empty can be traced to its own ongoing and as yet incomplete governance transition from a centralized authoritarian regime to a decentralized democratic state

Indonesia, in 1998, underwent not only a severe economic crisis, but also a dismantling of the previous political order. That Indonesia in 2008 remains a glass half-empty can be traced to the dramatically changed circumstances Indonesia finds itself in as a result of these twin economic and political crises. Though voice and accountability in the political process has increased dramatically in the decade since the crisis this has not translated into similar improvements in other aspects of governance as Indonesia has faced the complex task of reconfiguring the institutions and processes of the state at a time when the global economic environment is rapidly changing. These changes have highlighted systemic weaknesses in the processes and capacity for formulating and implementing policy and have made the process of implementing reforms a more challenging and time-consuming exercise.

Democratization and decentralization has fundamentally changed accountability structures and decision-making processes within government

Democratization and decentralization have fundamentally changed accountability structures and decision-making processes within government and the broader public sphere. Before 1999, power had been concentrated in the executive and largely at the center. In the new Indonesia, power is dispersed and devolved to other actors beyond the executive branch of government at the national level. The national legislature, the judiciary, oversight institutions, and local governments and legislatures all now have a say in the formulation and implementation of government policies and programs. The fact that highly competitive elections have led to coalitional politics at the national level and in many regions, and that greater voice in the political arena has been afforded to a wide range of non-state actors has made the task of policy formulation, of reaching consensus on critical policies and reforms that much more challenging. Decentralization has changed accountability structures or weakened them, as the division of roles and responsibilities between the various levels of government remains unclear in many spheres of government activity.

Government effectiveness has been limited by insufficient capacity and accountability of civil servants…

Government effectiveness has been limited by insufficient capacity and accountability of civil servants, both at the national and the local level. Bureaucratic accountability is limited by rigid civil service rules and the problem is compounded at the local level by a lack of clarity in Indonesia's decentralization framework. Capacity is also low in many arenas of state activity, particularly, but not only, at the local level.

…by coordination problems within government, which has hampered the formulation and implementation of effective policies and programs

Weaknesses in the mechanisms and frameworks that Indonesia has in place for coordinating the formulation and implementation of policies and programs within and across the different branches of government, at both the central and local level, have also hampered the government's effectiveness in promoting Indonesia's development agenda. Both the decision-making processes underlying the formulation of policies and the delineation of roles and responsibilities needed for implementation of policies are often unclear. For instance, uncertainty about economic policies and regulations, which is cited as one of the weakest aspects of Indonesia's investment climate, appears to stem primarily from a lack of coordination across different ministries at the national level and between the national and sub-national governments. Weaknesses in service delivery are also attributable to a confusion of roles and responsibilities between the central line ministries and local governments. That different parts of government may have differing perspectives and competing priorities is to be expected. What Indonesia appears to lack are clear and effective mechanisms for reconciling these differences.

There has been momentum on the control of corruption but it needs to be maintained. And there has been relatively little progress in strengthening the rule of law because of resistance to reform within the judiciary.

…and because the tasks facing Indonesia, as an emerging middle-income economy are more difficult

The tasks facing the Indonesian state have themselves become more challenging in part due to Indonesia's own past successes and emergence as a middle-income economy…

Democratization and decentralization have made the functioning of the Indonesian state more complicated at a time when the tasks facing the state have themselves become more challenging. Partly this is attributable to Indonesia's own past successes and nowhere is this clearer than in the delivery of health and education services. Because government policies in Indonesia, during the three decades of sustained growth prior to the crisis, were quite successful in meeting basic needs and increasing coverage of basic services, Indonesia today faces a second-generation set of challenges—increasing the allocative and technical efficiency of public spending, raising the quality of services, and mitigating the remaining income-related and geographic disparities in access and outcomes. For instance, in the 1970s, the government used part of its windfall oil revenues to finance a large-scale school construction program and hire and deploy teachers. Empirical analysis indicates that the initiative was directly responsible for substantial increases in primary school enrollment. As a result today, the main challenge is less the relatively simple task of construction of school facilities than it is to ensure that children from poor households and remote areas have access to a quality education, that the attrition rates in the transition from primary to secondary school and from secondary to tertiary are brought down, and that the quality and relevance of the education that students receive at all levels is improved. Indonesia's success at resuming growth and its re-entry into the ranks of emerging middle income economies has created its own challenges as well. For instance, like many other emerging middle income economies Indonesia is experiencing simultaneous demographic, epidemiological, and nutritional transitions as population growth slows and the population ages, and growing incomes and changes in lifestyle shift the focus in disease control to non-communicable diseases.

…and in part because of the changed global economic environment

The changed global economic environment implies a very different, though equally important, role for the state than in the past. Agglomeration economies, international production networks, reductions in transport and logistics costs, the growth of information technologies, and the rise of China and India have all changed the nature of competition and the distribution of rewards in the global economy. Home market advantages are now subject to international competitive pressure as continuing progress in transportation and communications has made it increasingly feasible to procure most components from any part of the world. These changes in turn necessitate a shift in the role of the government, not just in Indonesia but all around the world, from one of direct involvement in production to one of regulation and of facilitating private-public partnerships and of enabling private citizens and firms to better prepare themselves to compete in the changed global environment.

Looking ahead to the decade to 2018 and beyond, Indonesia's development agenda is clear

The government's agenda has evolved from restoring and consolidating macroeconomic and political stability to meeting Indonesia's development challenges

The priorities in the first five post-crisis years were to restore macroeconomic and political stability. The government lacked the finances to undertake many needed investments, and the focus was necessarily on fiscal consolidation and on putting in place the basic legislative framework for the new Indonesian polity. The next five have been, first and foremost, about consolidating that hard-earned stability. Fundamental structural reforms were initiated, new laws introduced or existing laws amended, and numerous decrees and regulations issued, in an attempt to reinforce macroeconomic stability, restore confidence in the Indonesian economy and boost investment. And through continued fiscal prudence, the fiscal space has been increased to meet Indonesia's development challenges. At the same time, work was initiated on a broader development agenda, articulated in the medium-term strategy (*Rencana Pembangunan Jangka Menengah*, or RPJM) for 2004-2009. The RPJM specifies three broad and multi-faceted goals: (1) a safe and peaceful Indonesia; (2) a just and democratic Indonesia; and (3) a prosperous Indonesia. The goals articulated in the RPJM have been further elaborated in Annual Work Plans (RKPs) through which the government has identified specific priorities and associated targets.

Economic policy packages introduced in each of the last three years illustrate the

government's recognition of the need to accelerate growth by improving Indonesia's competitiveness. These policy packages have focused on priority areas such as infrastructure, investment climate, financial sector, and SME development that are critical to enhancing Indonesia's competitiveness by promoting private-sector-led investment. Public pronouncements and programmatic initiatives reflect the government's desire to build a more inclusive Indonesia by making growth more broad-based, improving service delivery, and enhancing voice. In particular, in addition to a number of sector-specific initiatives such as the introduction of the ASKESKIN health insurance scheme for the poor and the passage of the Teacher Certification Law to improve teacher quality, the government, in 2007, launched a nation-wide poverty reduction program (PNPM) consolidating and building upon existing models of community-driven development. The government and political leaders are also paying increasing attention to the need for more sustainable growth and development. The 2004-2009 RPJM had three main priorities, and within those a number of targets, one of which was environmental sustainability. This was reflected in the stated commitments by the Indonesian Government, as host of the December 2007 13th Conference of Parties, to putting climate change on the top of Indonesia's development agenda.

Indonesia, in 2008, can be said to have achieved "half" the goals articulated in the 2004-2009 RPJM. Continued political stability has meant a "safe and peaceful Indonesia" and a "democratic" Indonesia that is increasingly confident, while strengthened macroeconomic fundamentals and robust growth has increased the prospects for a "prosperous" Indonesia. But for a truly "prosperous" Indonesia growth needs to be accelerated, and for a "just" Indonesia, that growth has to be more widely shared.

The process of drafting the 2010-2014 RPJM has begun and early indications are that the unfinished agenda of the current plan will frame the broad priorities of the next one. However, the upcoming 2009 presidential and legislative elections necessarily make any statements about the next government's development agenda somewhat speculative.

Accelerating growth

Indonesia has the potential to accelerate growth to the levels it achieved prior to the crisis…

In the three decades prior to the crisis, between 1967 and 1997, Indonesia's economy grew at an annual average rate of 7 percent. Only 11 other countries have enjoyed such an extended period of high sustained growth. Indonesia has the resources and the potential to attain the rates of growth it achieved prior to the crisis.

…if it makes more of its resource endowments and the opportunities afforded by high commodity prices…

Indonesia is a resource-rich economy and increases in commodity prices in recent years have benefited Indonesia. Rising commodity prices lifted Indonesia's terms of trade and increased its current account surplus. Stocks of Indonesian companies with commodity interests led the performance of the Indonesian stock market to one of the world's best performances between January 2005 and mid 2008. But Indonesia did not make enough of the opportunities offered by rising commodity prices. The growth in export values in the last few years has been driven more by export price increases than it has by growth in export. It may well be that the supply response will be forthcoming with a lag because of the multi-year gestation periods for many commodity-related investments. But there are indications that investments themselves have been lagging and the reasons for that have to do with structural impediments specific to Indonesia, in particular the bureaucratic burden faced by firms and the high degree of uncertainty surrounding policies and regulations.

…and at the same time facilitates the market-led development of globally competitive clusters

At the same time, a solely commodity-based growth strategy is unlikely to be sufficient. With its still young population and rapidly growing labor force, Indonesia needs to create jobs on a large scale, something that commodity-sector driven growth is by itself unlikely to yield. With the emergence of China and India as well as a number of low-cost competitors such as Vietnam, Indonesia can no longer rely on its traditional manufacturing export base. Growth of traditional manufactured exports such as textiles, garments and footwear is slowing. So Indonesia may need to further diversify its export basket and to do this it needs to keep pace with its EAP neighbors in facilitating the market-led development of new globally competitive clusters

Alleviating infrastructural bottlenecks is essential for accelerating growth

The poor quality of Indonesia's infrastructure, particularly transport, logistics and energy-related infrastructure, is a significant deterrent to job-creating investment and has hindered Indonesia's competitiveness. Indonesia has among the lowest levels of access to infrastructure in the region and infrastructure performance has actually deteriorated in some sectors in the last decade. Infrastructure investments have declined dramatically since 1996 and though public infrastructure investment has rebounded since 2000, private investment in infrastructure has yet to recover. With insufficient investments in infrastructure, bottlenecks and shortages have begun to emerge.

The government has made infrastructure a major economic priority…

Recognizing its potentially catalytic role in accelerating growth, the government has made infrastructure a major economic priority and has, over the past three years, taken a number of measures. Central among them is an effort to foster Public Private Participations (PPP) in infrastructure. A National Committee on Policy for Accelerating Infrastructure Provision (KKPPI) was established in 2005, which includes a PPP Unit as a center of technical expertise in project preparation. Infrastructure summits have been held in each of the last three years to solicit private investment. And through its annual economy policy packages, the government has aimed to encourage competition, to eliminate discriminatory practices that obstruct the private sector's participation in infrastructure provision, and to redefine the government's role, including separating policy-making, regulatory and operational responsibilities.

…but progress has been slow and concrete results have yet to be obtained because of a variety of institutional challenges

But progress has been slow and concrete results have yet to be obtained because of a variety of institutional challenges. Retail tariff levels remain below costs, and tariff reforms have been hampered by political considerations, discouraging investment in new facilities or expansion of existing service networks, especially for critical sectors such as power and water. Weaknesses in the transparency and efficiency of public infrastructure spending have slowed procurement. Land acquisition processes for infrastructure projects remain cumbersome and often inequitable. Operational and cost inefficiencies plague a number of infrastructure service providers because of weak incentives, and a lack of clarity in roles and responsibilities—policy making, regulatory, and delivery—between central and local service providers and between different institutions, public and private, local and community. The incentives and capacity for local governments to undertake infrastructure investment and ensure the sustainability of such investments through proper maintenance remain weak. Many regional governments have not been able to put the funds made available through intergovernmental transfer to good use in building the necessary infrastructure partly because of limited planning and implementation capacity, and in part because budget execution in key ministries remains slow. In addition, regional borrowing mechanisms remain underdeveloped, further constraining infrastructure finance and public service delivery.

The policy, regulatory and legal uncertainty that characterizes Indonesia's investment climate is the other main deterrent to investment

The uncertainty that characterizes the policy, regulatory and legal aspects of Indonesia's investment climate is the other main deterrent to investment. Though business perceptions of the investment climate have improved since 2003 (except for infrastructure), Indonesia still has a long way to go. In the 2008 Doing Business survey Indonesia was ranked 123rd out of 178 countries in terms of the overall ease of doing business, behind all its EAP neighbors except Cambodia and the Philippines. The government has made efforts to improve the investment climate. Economic policy packages covering the investment climate have been introduced in each of the last three years. An Investment Law and a Tax Administration Law were both passed in 2007. Major reforms of tax and customs administration are underway. Judged in terms of the volume and substance of the reforms announced, the accomplishments have been significant. But effective implementation of the policies has been slowed by poor coordination between the relevant government agencies, and uncertainty about the legal framework and judicial intervention remains high. The local level investment climate is a particular concern because of inconsistent and often arbitrary regulation imposed by local governments.

Making growth inclusive

Because so many of the poor still live in rural areas, revitalizing the

More than half of Indonesia's population, and nearly two-thirds of Indonesia's poor lived in rural areas in 2006. Agricultural growth rates had been falling till recently because public

rural economy is critical to making growth more inclusive

investments in agricultural infrastructure and agricultural support services declined and resource management was neglected following the crisis and subsequent decentralization. Because the share of the labor force engaged in agriculture and related activities remains high, the slowdown in agricultural growth has meant that value-added per worker in agriculture in Indonesia has essentially been stagnant in the last decade and remains low relative to other countries. If growth is to be more inclusive, rural incomes have to grow, and to raise rural incomes, the returns to the main asset of poor and low-income households—their labor—have to be raised. That will mean revitalizing the rural economy by raising agricultural value-added and stimulating rural non-farm employment by improving the rural investment climate.

The technical options for directly raising agricultural yields are currently limited…

…and so raising rural incomes requires promoting the diversification of agriculture into higher-valued added activities and the development of agricultural supply chains

The technical options for directly raising agricultural yields are currently limited, and have been since the early 1990s, especially for rice. And though genetically modified crop technologies hold hope for the future, there are few immediately applicable new technologies available to provide a significant boost to yields. Raising rural incomes will therefore require the diversification of agriculture into higher-valued added activities and the development of agricultural supply chains. To a certain extent this is already happening. Changes in consumption patterns and retailing networks have induced rapid growth in supermarkets, which have begun to influence the agricultural production structure, processing, handling and marketing systems. But more could be done and new approaches will be required given the changed, more decentralized, institutional environment. Decentralized extension systems that involve the private sector and civil society need to be replicated nation-wide and strengthened. Indonesia's agricultural product regulatory framework is quite developed but attention is needed on capacity building and maintaining the integrity of national systems with decentralization. Because less than 25 percent of holders of rural land parcels in Indonesia have a formal land certificate, which reduces incentives to invest and hampers access to credit, clarifying land use rights through land titling and, in the case of communal lands, other approaches, is critical. Better maintenance of district roads and increased access to credit for small and medium enterprises would improve the rural investment climate.

Raising rural incomes will also mean speeding up the transfer of labor out of agriculture to higher value-added activities elsewhere.

Raising rural incomes will also mean speeding up the transfer of labor out of agriculture to higher value-added activities elsewhere. During the first five years after the crisis, increasing numbers of workers were pushed into agriculture, with the result that in 2003 agricultural employment had returned to 1991 levels. In the last five years, that trend has slowly begun to reverse, though more than 40 percent of Indonesia's labor force still remains in agriculture. The slow growth in high value-added (largely urban) jobs is explained in part by the weaknesses in Indonesia's investment climate that have deterred investment but restrictive labor market institutions and policies appear to have also played a role. Indonesia's employment protection legislation is amongst the strictest in East Asia. Legislated severance rates for dismissals have more than doubled since 1996, and on paper, the costs of firing workers are extremely high by both regional and global standards. Minimum wages, which since the decentralization in 2001 have been set at the provincial level, increased sharply in real terms between 1998 and 2003 at a rate well above the growth in labor productivity. At the same time, there is wide recognition that weak enforcement of the legislation means that many workers, in effect, are not protected—particularly those laid-off from smaller and medium-sized firms. Legislation needs to be simplified to increase firms' compliance and the promptness of payments, and lower the potential for litigation, red tape and corruption emerging from the difficulty in interpreting the law.

Indonesia will require a different, more expensive and sophisticated health system in the not-too-distant future…

Like many other emerging middle income economies Indonesia is experiencing simultaneous demographic, epidemiological, and nutritional transitions as population growth slows and the population ages, and growing incomes and changes in lifestyle shift the public health priorities to non-communicable diseases. These transitions are putting additional pressures on the health system and will necessitate a different, more expensive health system in the not-too-distant future, especially since Indonesia is one of a small but growing number of middle income countries that has made the decision to transition to universal health insurance coverage for its population.

…but the immediate task

The immediate task Indonesia faces, however, is to reverse the stagnation in priority

Indonesia faces, however, is to improve priority health outcomes and reduce geographic and income inequities within an imperfect decentralized system

health outcomes such as maternal mortality and child malnutrition rates since 2000, reduce large geographic and income inequities for many health outcomes, and improve its district-based health system. Fragmentation, allocative and technical inefficiencies, low productivity, and, low quality have resulted in low utilization rates of both public and private facilities, and high rates of self-treatment. Experience from around the world suggests that a decentralized model of service delivery can be an important tool for improving accountability of front-line service providers and hence the quality of services. But in Indonesia this potential has yet to be fully realized. Decentralization has indeed put more money and responsibility in the hands of local officials, but there continues to be confusion concerning the division of roles and responsibilities between local governments and the health ministry at the national level. There is little correlation between health spending and health outcomes at the district level, even though decentralization has started reducing fiscal inequities. Service delivery has suffered from these weaknesses in the decentralization framework, which are compounded by, and in some cases reinforce, a lack of capacity and accountability amongst frontline service providers. A lack of professionalism, non-compliance with good practice protocols, high absenteeism (e.g., 40 percent of medical doctors being absent without valid reason during official public working hours), uneven deployment, and low motivation in the health workforce are common problems.

Providing quality education for all

Education is central to the Government of Indonesia's development agenda and Indonesia has made remarkable progress on primary and secondary enrolment rates. However important challenges remain: expanding access by making primary schooling more affordable for the poor, lowering attrition rates in transitions to junior and senior secondary school, raising the quality and relevance of education at all levels and improving governance and increasing accountability throughout the system. The cost of even primary education remains high for many, especially poor, households. The BOS system of direct transfers to schools, and a recently introduced CCT is aiming to improve access for the poor. The spatial distribution and quality of teachers is uneven and Indonesia continues to rank poorly in international standardized tests of student performance and drop out rates are high for junior and secondary education. The government is making efforts to remedy this with the passage of the Teacher Certification Law in 2005 and the provision of incentives to teachers to re-locate to more remote areas. Overall progress has been hindered, however, by the unfinished decentralization agenda, which has left responsibility and accountability for many education areas vague. There is no clear and efficient definition and assignment of functional roles and responsibilities and there is often a misalignment of responsibility and authority. There is a lack of effective management systems and skills (generic and system-based) to implement the reform.

Ensuring growth is sustainable

Managing Indonesia's forestry and coastal resources sustainably while providing adequate livelihoods

Inadequate environmental management is leading to unsustainable degradation of Indonesia's considerable forestry and coastal resources. Many of these resources are common property resources or are perceived to be so. Indonesia's administrative and regulatory framework for environmental management, while improving is still uneven. Forestry policies and legislation are reasonable, but land use rules and allocation decisions are inconsistent, non-transparent, and disputed by many, leading to conflict over land and resources on the ground. Implementation and enforcement of rules and procedures is often poor and slow due to weak commitment by sectoral agencies, low awareness amongst local departments and officials, and capacity challenges—technical and financial—at all levels, but especially at the local level, which has an important share of environmental management responsibilities under the decentralization framework. Weaknesses in the judicial sector and in the rule of law, vested interests, money politics and corruption among the powerful have impeded efforts to match performance with policy. Environmental institutions, roles and responsibilities are fragmented and coordination mechanisms at national and local levels are poorly defined. While the main problems appear to be on the implementation and enforcement front, the policy and planning framework could also be strengthened to provide better incentives for sustainable use of natural resources. At the moment, there is little integration of environmental considerations at the planning and program levels, especially in the public investment

planning process and in regional plans for land and resource use. The challenge of environmental management has also become more complicated in the context of decentralization as many regulatory functions have devolved to provinces and districts, which are reinterpreting existing rules or adopting new regulatory procedures. Some of these innovations strengthen environmental controls, highlighting the potential of decentralized governance, but many relax them or seek to bypass national standards.

Meeting Indonesia's energy needs without sacrificing its environment

Indonesia's energy demand is projected to grow rapidly, with some projections estimating a near-tripling of demand between 2005 and 2020. In 2006, total installed generation capacity of the national power system reached 28,926 MW, making it one of the largest in the region. Given the size of its population, however, Indonesia's per capita electricity consumption and electrification ratio are among the lowest in the region. Because of under-investment in the decade since the crisis, the state-owned power company, PLN—which, as a vertically-integrated power company, generating, transmitting and distributing most of the electricity in the country, effectively has a monopoly—has added relatively little new capacity to its system, and demand is beginning to outstrip supply. PLN's current fuel mix, the legacy of past access to subsidized oil and the slow development of gas production and transmission infrastructure, is skewed towards the use of diesel, with diesel-based power generation currently accounting for over 35 percent of the total electricity generated. With PLN no longer enjoying access to fuel at subsidized prices, and with mandated tariff ceilings (which have not been raised since 2004), the government has had to provide Public Service Obligation (PSO) subsidies to maintain PLN's financial viability Not only has that proved a drain on the central government budget, it distorts PLN's incentives to develop the most cost-effective generation sources. The legal and regulatory framework that governs the electricity sector is presently in a state of uncertainty. This is mainly due to the annulment of 2002 Electricity Law that established the unbundling of PLN and a gradual transition towards greater competition. In addition, the legal ambiguity has impacted electricity pricing policy and hindered private investments. PLN is currently undertaking a substantial expansion program, in particular through a 10,000 MW coal-based "crash" program. Rapid expansion of coal generation raises concerns especially in light of the environmental impacts. In the absence of clean coal technologies, fast growing coal consumption will pose serious threats to the local environment. Indonesia is rich in renewable energy resources and could benefit from increasing the share of renewable energy sources in power generation. Biomass and hydroelectric resources are abundantly available in most of the outer islands, and can be attractive options for switching away from the largely diesel-based generation in many of these locations. Promoting energy savings and efficiency provides further opportunities for ensuring energy security and sustainable development. The Indonesian economy is particularly energy intensive, judging by the value-added (in terms of GDP) that Indonesia obtains per unit of energy, which is lower than most other countries in the region. It is estimated that Demand-Side Management (DSM) measures that are already being considered or implemented to some degree have the potential to reduce power generation capacity needs upwards of 2,500 MW. International experience suggests that DSM measures are most successful when complemented with fiscal incentives and incentives provided through price-based regulation.

Making Indonesia's rapidly growing urban agglomerations livable growth poles

Like much of East Asia, Indonesia has been rapidly urbanizing. Between 1995 and 2005, Indonesia's urban population grew by 39 million or 55 percent, a much greater proportional increase than most other countries in the region. In the decade up to 2015, the urban population is projected to increase by another 39 million, nearly two times the population of Indonesia's largest current urban agglomeration—the greater Jakarta area—which in 2007 had a population of over 22 million. This rapid urbanization is placing significant stresses on Indonesia's urban centers, reducing the quality of life and straining the ability of local governments to deliver services. Investment in water and sanitation services is urgently needed in Indonesia's cities. Only a sixth of a total of 9.6 million low-income urban residents throughout Indonesia and less than half the residents in Jakarta have access to piped water. The environmental consequences of access through large scale private unregulated wells are high. Land subsidence, higher costs of reaching drinkable well water and proximity to septic tanks pose high environmental and health risks. The centralized sewer system covers less than 2 percent of the urban area and most human waste is not treated prior to disposal. The manner in which private sanitation systems (including septic

tanks) are managed and operated frequently risks contamination of ground and surface water. With no significant investment in city-wide sanitation infrastructure in the last 20 years, Indonesia has the lowest percentage of urban households with adequate sanitation in Asia. With limited investment in road infrastructure, most major urban areas are subject to severe traffic congestion, particularly the quickly urbanizing satellite towns. Flooding also continues to be a challenge in urban areas. In 2007, the worst episode of flooding in Jakarta covered 60 percent of the urban area. If urban local governments are to be able to meet these challenges, which they must if Indonesia's urban agglomerations are to be dynamic and livable centers of growth as in other East Asian countries, their ability to mobilize resources and manage expenditures must be enhanced, their institutional capacity for urban planning, including budgeting and development planning has to be strengthened and their management of land and other municipal assets needs to be improved.

Building resilience

Managing disaster risks and preparing for climate change

Indonesia is highly vulnerable to natural disasters, as the record of the last five years attests and the capacity to plan for, insure against, and respond to natural disasters is currently limited. But that may be changing, with the passage in March 2007, of the Disaster Management Law that codifies the national plan for disaster risk reduction [DRR] issued a year earlier, sets out responsibilities for DRR as well as disaster response at the local and national levels and modernizes institutional arrangements for disaster management. Indonesia is also vulnerable to climate change mostly linked to reduced agricultural productivity, higher levels and intensity of flooding and higher incidence of climate change related diseases. Indonesia has developed a strategic, multi-year action plan and policy reform program, outlined in the National Climate Change Action Plan and the Development Planning Response to Climate Change (both from December 2007). This high-level focus should help Indonesia to improve energy and forestry sector management, prepare for the post-2012 climate change regime, and establish a sound framework for coordination and implementation of adaptation activities. But because, institutionally, climate change mitigation and adaptation actions cut across nearly all sectors of the economy and all levels of government, coordinating, planning, and targeting appropriate actions is likely to be a challenge, and the establishment of the National Council on Climate Change in 2008 is an important step in meeting that challenge. Global financing for climate change mitigation efforts offers Indonesia promising opportunities to undertake an integrated approach to climate issues without compromising growth and development. Indonesia has significant potential to control carbon intensity while continuing to develop and grow (including energy efficiency and renewable energy sources), and accessing this kind of innovative financing presents a strategic opportunity for Indonesia, opening the door to carbon market payments and other financing alternatives.

Designing social protection schemes that buffer the population from the adverse impacts of shocks

Indonesia's existing complex suite of social protection schemes has to be expanded and improved. There are four main reasons why. First, Indonesia's social protection system, and in particular its employment protection legislation, is mostly designed to cover urban workers who have a formal labor contract. Since only about a third of the labor force falls into that category, the bulk of Indonesia's workers and their families rely on family ties and community networks, which, as a consequence of sustained economic growth and rural-urban migration, are slowly eroding. Second, Indonesia's population is aging, and is doing so at a much faster pace than OECD countries when they were at similar levels of economic development. Demographic and economic forecasts suggest, for instance, that Indonesia should be growing by an additional two percentage points if it is to reach Japan's income at the same point of aging. The rapidly aging population will become a growing burden on family networks, which currently are the main caretakers of the elderly population, and pressure to extend old age social protection to poor and informal workers who did not contribute much or at all to their pensions during their working years is likely to grow significantly. To avoid placing the burden of increased pension costs on future generations, a fully-funded pension system that is financially sustainable in the long term should be developed soon. Third, Indonesia currently lacks a countrywide safety net that can buffer the population from the adverse impacts of shocks. While the government rolled out unconditional cash transfer schemes at short notice following reductions in fuel subsidies in 2005 and 2008, the absence of an existing reliable targeting mechanism raised concerns about leakage and exclusion in the implementation of the schemes. Had an ongoing safety net program with a tested targeting mechanism already been in place, it might have been possible to rapidly scale it up in the case of large covariate shocks such as the rise in food prices in the first half of 2008. Fourth, an existing safety net that keeps workers who lose their jobs from falling into poverty, might ease resistance to the relaxation of the stringent employment protection legislation that may have inhibited job creation in the past few years. On some of these fronts Indonesia is making progress. It has developed a means-tested health insurance scheme for the poor, and it is piloting a conditional cash transfer program. Through its community-based poverty alleviation scheme it enhances the income-generating capacity of poor rural households.

Enhancing the capacity of and coordination mechanisms among financial sector regulatory and supervision institutions to deal with systemic shocks from either external or internal sources

Indonesia's banking system has gradually become stronger over the past several years and headline indicators of most measures of banking soundness indicate this strength. But, there remain areas of vulnerability, primarily related to the capacity of and coordination mechanisms among financial sector regulatory and supervision institutions to deal with systemic shocks from either external or internal sources. The financial sector safety-net is less than secure. While with the recent increase the deposit guarantee covers 97 percent of depositors, it still covers only 25 percent of deposits, so in case of a bank in distress, large depositors still have the incentive to withdraw their deposits. The deposit insurance agency (LPS) has been given strong powers of bank resolution, but has neither adequate staff nor the on-going knowledge of individual banks, both of which are needed to adequately address resolution. Thus far, the emphasis has been on the organizational structure of the safety net, but there has been less emphasis on thinking about it on a detailed operational basis. These weaknesses are being addressed through the Financial Sector Stability Committee, which has recently become operational, though its mandate is still subject to confirmation by Parliament. The inability of Indonesia to undertake consolidated supervision of financial conglomerates is another area of vulnerability. As in other countries, Indonesia's financial sector supervisory agencies have relatively narrow mandates—for instance, BI's current mandate is to review only "banking operations"—and so unless the separate agencies cooperate in jointly supervising the full set of activities of diversified financial conglomerates, emerging risks may be missed. A similar need for coordinated supervision arises even when firms in different segments of the financial sector are not jointly held but have extensive dealings with one another, for instance, multi-finance companies operating in consumer finance (e.g., motorcycle lending and leasing) depend on commercial banks for funds. In such cases, unless industry regulators work together to jointly assess the overall risk, the supervisory actions of one agency may inadvertently generate contagion-type effects in other segments.

Enhancing government effectiveness is central to realizing the development agenda

The central challenges Indonesia faces today in realizing its development agenda are all, in one form or another, of an institutional nature…

If Indonesia is to realize the development agenda reviewed above and rise to its potential as a competitive, inclusive, sustainable and resilient middle-income country, it has to adapt the institutions and mechanisms that govern the functioning of the state and shape state-society interactions, to the changed circumstances it finds itself in. The central challenges Indonesia faces today in realizing its development agenda are all, in one form or another, of an institutional nature in that they entail furthering Indonesia's as yet incomplete governance transition by improving the effectiveness of public institutions and processes through longer-term institutional and process transformations. Put another way, financing is not the only or even the main challenge Indonesia faces. Spending better, rather than simply spending more…

… even in areas where additional financing is clearly needed

Even in areas where additional financing is clearly needed—for instance, from the private sector in the case of many infrastructure sectors, or from the public sector if the restructuring of Indonesia's health system is to be financially viable—institutional challenges need to first be sorted out for that financing to be forthcoming and for it to be effectively deployed.

Details of the institutional challenges naturally vary from context to context…

…but they all are related to one or more aspects of the governance challenge Indonesia faces

The details of the institutional challenges naturally vary from context to context and from sector to sector. For instance, the particular set of institutional issues that have to be addressed to achieve a breakthrough in the construction of toll roads are the difficulties in land acquisition because of a weak legal framework and weak dispute resolution mechanisms, corruption and weaknesses in public procurement. The ones that hinder the provision of quality education in rural areas are the limited capacity and accountability of frontline service providers and weaknesses in the management and flow of funds. But in both cases, the constraints are clearly of an "institutional variety", and in particular, one that has to do with one or more aspects of governance. illustrates this by mapping the key constraints corresponding to each of the broad priorities identified in the review above of Indonesia's development agenda, to one or more of the components of governance—policy and regulatory quality, government effectiveness conceptualized in terms of coordination, capacity and accountability, control of corruption and rule of law.

There are as well some common core systemic challenges

At the same time, there are a number of core systemic processes and institutions for formulating and implementing policy that are common to all or at least most of the challenges that constitute Indonesia's development agenda. The core processes, human resources and institutions for formulating and implementing policy have to be strengthened. Mechanisms and frameworks must be developed for overcoming coordination problems within and between the national and local levels of government and making the most of the significant decentralization Indonesia has undergone. And the momentum in controlling corruption needs to be sustained and the rule of law strengthened in order to increase confidence in state institutions and build a national consensus around needed reforms.

Reforming public financial management systems

The core public financial management systems public institutions rely on to implement government priorities and effectively spend public funds have to be strengthened. This means greater emphasis on the reform of public sector systems including procurement, financial management and budget execution, project design, contract management, information management, and monitoring and evaluation. Indonesia has made major advances over the last five years in establishing a sound legal and administrative framework to manage its public finances and improve transparency. With the legal architecture in place, reforms have been initiated to reorganize the Ministry of Finance (MoF) and re-engineer business processes across the budget cycle. Budget planning, formulation, reporting and execution have improved but significant weaknesses remain. In particular, the Indonesian budget system is still heavily reliant on *ex-ante* controls and does not yet use *ex-post* control systematically. Indonesia still spends 50 percent of its total capital expenditure in the final quarter of the year and this disrupts project implementation. The process of rapid democratic transition restored parliament's substantial powers in what was previously a closed budgetary system. The institution of appropriate checks and balances, particularly with regard to budgetary decisions, are

important pillars of sound governance systems. However, the evolving practice of very detailed legislative involvement in the current budget preparation process, and the resulting appropriations structure embodied in the budget law and annexes, has profoundly affected the quality of legislative interventions and neither the executive nor the legislature seem to be fully satisfied with executive-legislative interactions in the budgetary realm. The public procurement system has seen incremental improvements but still has significant deficiencies. A national public procurement office (NPPO) has been established as a regulatory body for public procurement but progress in developing a procurement law, as well as standard bidding documents and users manuals has been slow. Due to the absence of a clear professional stream for procurement experts as well as the lack of a national procurement capacity building strategy, there is continuing weakness in procurement capacity in implementing agencies, especially at the provincial and district levels, and that has raised concerns about collusive and corrupt practices in the bidding process and the efficacy of anti-corruption measures and sanctions. The internal audit framework of the government is extensive but its scope and organization do not match needs. Despite (or perhaps because of) the existence of multiple internal audit agencies, the internal audit function continues to be a weak link in governance. The institutional arrangements are complex and the mandates and division of labor between the various internal audit institutions are unclear.

Initiating civil service reforms

A strengthened public financial management system will not by itself resolve the weaknesses in the implementation of programs. Increasing the accountability, incentives and capacity of civil servants is equally critical because the civil service plays such an important role in driving institutional performance. It is generally acknowledged that insufficient administrative and technical capacity and distorted incentive structures within the government bureaucracy limit government effectiveness. The reasons why the capacity and accountability of the Indonesian civil service is low are clear. A large number of agencies with overlapping authority share responsibility for management and oversight of various aspects of the civil service. As a result no single agency is proactively managing the structure and shape of the civil service and no agency has the recognized authority to undertake comprehensive civil service reform. The 2001 decentralization law transferred over three million civil servants from central to local authority, but did not give the local governments adequate powers to determine the size and allocation of civil servants within their jurisdictions. The result is that, since decentralization, there has been a misallocation of civil servants across levels of government. Demand for civil service positions is high, and the recruitment system is characterized by informal payments for entry into the system and for promotions. Performance criteria for promotion are weak, and there are few credible sanctions for low performance and corruption. And the system for determining overall compensation is opaque, discretionary and prone to abuse, with weak links to either individual or group performance. In such a context there is clearly a need to clarify institutional responsibility for civil service reform, improve incentives and governance and revise the legal framework. Action on such a broad systemic front is, however, unlikely to be politically and institutionally feasible. In the meantime, efforts are under way in selected agencies to clarify job descriptions and job grading, enhance performance incentives through greater pay and promotion linkages and improve human resource management functions.

Making decentralization work by clarifying the framework governing center-local relations…

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. Decentralization has transformed Indonesia’s governance and economic landscape. Sub-national governments have become major players in service delivery and their role in public investment and economic development is increasing even as the spatial diversification of economic activity within Indonesia has grown. But the transition is far from complete, overlapping responsibilities abound, and sub-national government accountability and transparency mechanisms are weak. The slow progress on elaborating a clear, consistent decentralization framework has led to confusion over roles and responsibilities between central line ministries and local governments, and horizontal coordination across local governments is extremely limited. The central government continues to spend significant amounts of resources on local government tasks. Unlike most decentralized countries, Indonesia has not transferred significant tax power to local governments, and this has created a possibly unhealthy dependence on transfers from the

center. Local and provincial governments have a key role in public investment particularly in the infrastructure sector. However, borrowing for infrastructure and other projects is underutilized and slow progress on elaborating a clear, consistent intra-governmental fiscal framework has obstructed the flow of development resources. Almost every aspect of local government performance is compromised by the lack of clarity and inadequate coordination, from service delivery to infrastructure provision to the local investment climate to environmental management.

…and increasing the capacity and accountability of local governments…

…by integrating performance incentives into inter-governmental transfers…

…and better monitoring of local government performance and improving sub-national fiscal and financial reporting

In addition to addressing administrative and regulatory issues, improving decentralization outcomes requires increasing the capacity and accountability of local governments. The accountability of local governments to their constituents is crucial for the success of regional autonomy but, by necessity, developing new accountability relationships and systems takes time. One approach would improve performance incentives by providing additional financing for sub-national governments that met established criteria i.e., with respect to financial and other reporting or more ambitiously on service provision (i.e. health and education outcomes or even road maintenance). The Central Government could provide this support through the DAK along with complementary technical assistance in the specified area. An improved system for monitoring of sub-national governments would provide incentives for good performers and technical assistance for those lagging behind. A credible performance system would provide transparency, attract investors to strong regions and provide a basis for an allocation system based on performance and needs. Despite the increased responsibility of sub-national governments, Indonesia does not yet have a sound system of sub-national fiscal and financial reporting to facilitate systematic monitoring and evaluation of performance. In most middle and high-income countries the financial performance of local governments is measured by rating agencies and performance measurement mechanisms create competitive and political pressures. An improved system of reporting that reliably captures the performance of local governments and provinces would represent a positive development.

Building on the momentum gained in anti-corruption efforts…

Indicators of corruption in Indonesia are slowly improving. Most global corruption surveys still place Indonesia low in cross-country rankings but most also indicate that the situation has improved in the last five years. The improvement in perceptions reflects the genuine momentum generated in the fight against corruption in the last three years. With the strong support of the president, who has made the fight against corruption a theme of his administration and ensured that dedicated resources have been made available to at least some of the agencies critical to the anti-corruption initiative, powerful independent oversight and prosecutorial institutions such as the Anti-Corruption Commission (KPK) and the Anti-Corruption Court have begun to deliver tangible results. In addition, institutions like the Supreme Audit Agency (BPK), the Financial Transaction and Analysis Centre (PPATK), and the Attorney General's Office (AGO) have become more active. High profile corruption investigations have been launched, leading to a number of successful prosecutions.

…by strengthening the rule of law

The government now needs to turn to deeper institutional reforms, particularly in the legal and judicial system, where progress in improving governance has been much less evident. The adoption of an impressive blueprint for reform of the court system has not been followed through with effective implementation. Also, despite good success in prosecuting corruption, there has been less progress in developing and implementing a coherent, well-focused anti-corruption strategy and in tackling corruption in those arenas of state activity where concerns about corruption are especially prevalent such as: the judicial sector, supervision of the financial sector, political parties and parliaments, and military procurement and military-owned businesses. Addressing corruption in all four of these areas is critical to the overall fight against corruption.

There have, however, been some important positive recent developments. The legal framework for preventing corruption should be considerably improved with the recent passage of the law on witness protection in 2006, which protects whistleblowers, and the law on freedom of information in 2008, which promotes transparency of essential public information such as budget, expenditure and procurement related information. Of course, the passage of laws is just the beginning and a strong framework to implement the

freedom of information law will be critical to ensure genuine access. Recent KPK investigations involving the judiciary and parliament are beginning to put pressure on these institutions to initiate reforms. That is critical, because without progress in civil service and administrative reform, legal and judicial reform, accountability measures at the local government level, as well as the more sensitive issues of political party and electoral financing and the role of quasi-public foundations (*yayasan*), the early gains from the government's anti-corruption drive may not be translated into sustainable improvements in the quality of governance.

...which will take time, but maintaining a sense of urgency—making haste slowly—is critical

There are no simple or universal recipes or models for complex institutional reforms…

Adapting the institutions and mechanisms that govern the functioning of the state and shape state-society interactions will take time and not be easy. Institutional reforms and process transformations by their very nature are complicated undertakings. Building consensus around more easily implementable but contentious reforms can also be a lengthy process. There are no simple or universal recipes or models for how to do this—the particulars of the model will necessarily vary from context to context.

…and a step-by-step approach may be warranted

And so the approach to reforms may be as important as the substance of the reforms themselves. Whether the task is civil service reform at the national level or improving service delivery at the local level, much trial and error and institutional adaptation is required. The approach often involves piloting reforms—selected from a menu of reform options that hold some promise, but the particulars of which need to be "field-tested"—on a small scale or in a clearly demarcated realm (a region, a ministry, a sector or sub-sector), monitoring and evaluating them carefully and using these assessments to adapt and improve the design of reforms and determine when and how to scale them up.

Indonesia is doing just that in some areas…

Indonesia is doing just that in some areas. Civil service reforms were first initiated only within MoF and that too, only in a limited form. Over time, the scope of the reforms has gradually broadened, while similar reforms have been initiated in selected other institutions such as the Corruption Eradication Commission and the Supreme Audit Agency. Similarly, the approach to budget reforms is going steadily but slowly, initially in selected departments within MoF and Bappenas, but now beginning to move to a few selected line ministries. The nationwide rollout (under the label of PNPM) of the approach to community-based poverty alleviation that was tested and refined over the last decade through the KDP and UPP programs, the piloting of a future conditional cash transfer program (PKH) and to a somewhat lesser degree, the expansion of BOS, are all other examples of this approach, where initiatives, initially limited in scope or scale are being scaled up as evidence accumulates of the effectiveness of the initial efforts.

…but maintaining a sense of urgency—making haste slowly—is critical throughout the process if the hard-earned reform momentum is not to stall because of resistance to reform as well as political dynamics

Though it is important to recognize that institutional reforms take time and it is often advisable to take a step-by-step experimental approach, maintaining a sense of urgency—making haste slowly—is critical throughout the process. That is because without a continued sense of urgency there is a risk that Indonesia's hard-earned reform momentum might stall. The government has shown commitment to reform, but significant obstacles to change remain. There is a risk that the reform effort will languish as even committed reformers are overwhelmed by the extent and complexity of the task of pushing forward institutional reforms and putting in place new ways of doing things in the face of entrenched organizational cultures and behaviors. The task is especially challenging when, as is often the case, the implementation of institutional reforms relies on the very unreformed systems and processes that are themselves the object of change. Those who benefit from the existing system, whether from corruption, capture or nepotism—the very institutional distortions that are often the target of the reform agenda—can use those distortions to politically derail efforts at serious institutional reform. Broader political dynamics can also intervene when the electoral imperatives of coalitional and money politics undermine incentives and efforts to strengthen the accountability of state institutions. A sustained focus on governance and transparency can help by restoring confidence in the legitimacy of public processes and institutions and building a consensus for continued reforms. If Indonesia can make haste slowly and maintain a sense of

urgency in furthering its governance transition, it has the potential to become a dynamic, competitive and inclusive middle-income economy.

Chart A : Why furthering Indonesia's governance transition matters for realizing Indonesia's development agenda

DEVELOPMENT AGENDA	Policy and regulatory quality	Government effectiveness				Control of corruption	Rule of law
		Coordination	Capacity	Accountability		Control of corruption	
		Coordination	Local governments	Civil service	Public financial management		
Accelerating growth							
Alleviating infrastructure bottlenecks					Weaknesses in procurement		
	Difficulties in land acquisition				Difficulties in land acquisition		
	Low tariffs	Delays in budget execution			Delays in budget execution		
	Policy uncertainty		Insufficient local level capacity			Uncertainty about judicial intervention	
Remedying regulatory weaknesses in investment climate	Uncertainty about policy	Inadequate coordination between ministries and between ministries and local governments		Resistance to reform		Uncertainty about judicial intervention	
	Regulatory burden		Limited capacity to formulate and implement reforms			Regulatory burden	
Making growth inclusive							
Raising rural incomes			Insufficient capacity and incentives at the local level				
	Land tenure insecurity					Land tenure insecurity	
	Poor rural investment climate						
Facilitating the transfer of labor	Labor Law	Restrictive minimum wages					
Improving water and sanitation	Low tariffs	Unclear allocation of responsibilities					
		Insufficient horizontal coordination					
		Sub-national financing constraints			Sub-national financing constraints		
Restructuring the health system			Limited capacity and accountability of frontline service providers				
	Fiscal inequities			Uneven staffing			
		Unclear division of responsibilities between local and central government		Weak stewardship	Weaknesses in provider payment and budgeting systems		
Providing quality education for all			Limited capacity and accountability of frontline service providers				
			Weaknesses in management of funds and transfers				

Chart A (continued): Why furthering Indonesia's governance transition matters for realizing Indonesia's development agenda

DEVELOPMENT AGENDA	Policy and regulatory quality	Government effectiveness				Control of corruption	Rule of law
		Coordination	Capacity	Accountability		Control of corruption	
		Coordination	Local governments	Civil service	Public financial management		
Ensuring sustainability							
Managing Indonesia's environmental and common property resources		Unclear division of responsibilities between local and central government		Low awareness and limited capacity		Corruption and weak enforcement of laws	
	Lack of coordination between ministries leading to policy uncertainty				Limited consideration of environmental impacts in public investment planning		
Meeting Indonesia's energy needs without sacrificing its environment	Low tariffs and distorted incentives because of fuel subsidies					Uncertainty about legal framework	
	Complex structure and lack of implementing regulations						
Making Indonesia's urban areas livable			Insufficient budgeting and planning capacity			Improper functioning of land markets	
			Sub-national financing constraints		Sub-national financing constraints		
Building resilience							
Managing disasters and preparing for climate change	Lack of coordination across ministries in policy formulation			Technical capacity is limited		Corruption and weak law enforcement	
Enhancing security and protecting the poor	Untargeted subsidies					Leakages in targeting	
Reducing financial vulnerability	Limited coordination amongst various regulatory and supervisory agencies					Possibilities of corruption and collusion	

A. Indonesia 2009: a glass half-full

Indonesia has emerged from the economic crisis of the late 1990s with mixed results

Indonesia, in 2008, is a glass half-full. Ten years after an extreme economic crisis, which led to a 13 percent decline in GDP, and a concurrent political crisis, Indonesia has emerged economically strong and remarkably stable in political terms. While macroeconomic fundamentals have been strengthened and political stability achieved, there has been considerably less progress on other important fronts. The global financial turmoil is expected to reduce growth for the next year or two but Indonesia should return to higher growth in the medium term. However, there are heighted risks of even slower growth for a longer period due to the global economic slowdown and potential capital reversals.

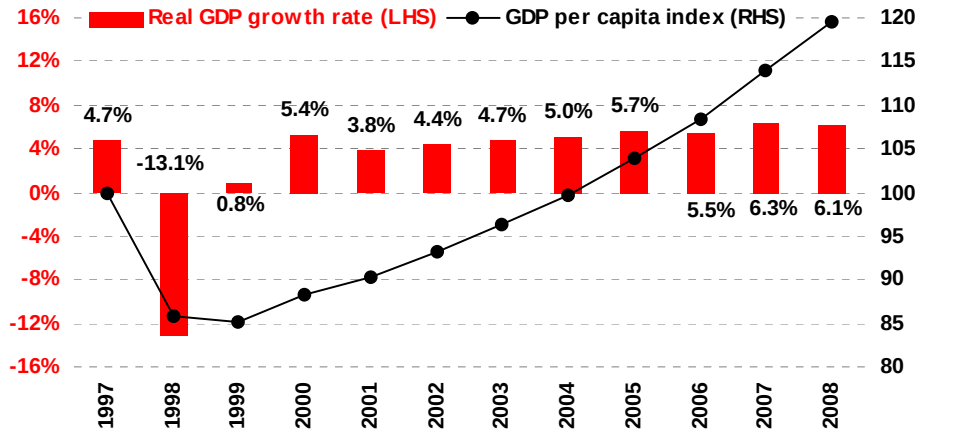
1. Indonesia has done well in terms of macroeconomic performance in the decade since the 1998 Asian crisis

1. a. Per-capita GDP has exceeded pre-crisis levels and growth has picked up

Real and per capita GDP are growing…

Indonesian growth accelerated to a ten-year high of 6.3 percent in 2007 and 6.1 percent in 2008 as the global economy entered a deep recession. Real GDP has been growing at a rate of 5 to 6 percent annually since 2002 and, in 2005, real per-capita GDP for the first time exceeded the high that had been reached immediately prior to the crisis in 1997, and by early 2009 was more than one-fifth higher.

Figure 1.1: Per-capita GDP has exceeded pre-crisis levels and growth has picked up



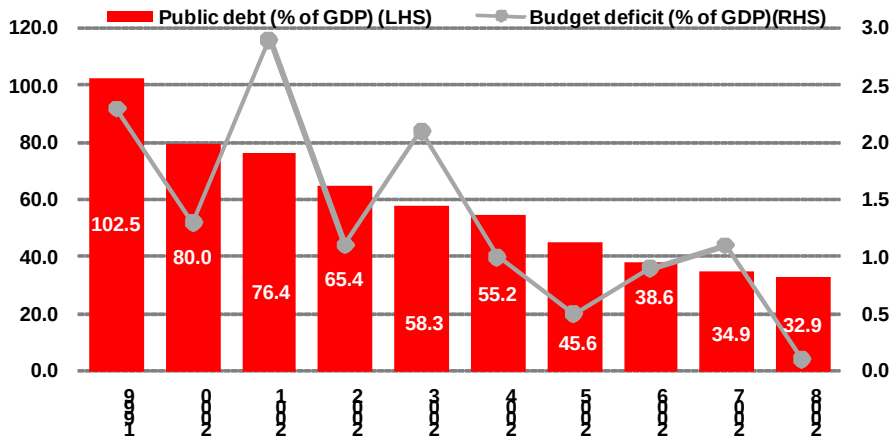
Source: World Bank calculations and BPS.

1. b. Prudent macroeconomic management has resulted in lower budget deficits and a much lower debt-to-GDP ratio

…while debt levels have declined and ratings improved

In the wake of the crisis of 1998, total government debt rose sharply, putting pressure on Indonesia's fiscal and financial position and ultimately its macroeconomic stability. Prudent fiscal management and a strategy of fiscal consolidation have led to a significant reduction in debt levels, from 80 percent of GDP in 2000 to less than 33 percent at the end of 2008. The major ratings agencies have all gradually raised their ratings for Indonesia, with Standard and Poors raising their ratings for Indonesia's sovereign long-term debt from CCC+ in 1998 to B in 2003 to BB in 2008 while Fitch upgraded their rating to BB in early 2008, and as other economies' ratings were being downgraded or placed on negative watch lists, agencies were moving Indonesia to a potential upgrade status during the recent economic turmoil.

Figure 1.2: Prudent macroeconomic management has resulted in lower budget deficits and a much lower debt-to-GDP ratio



Sources and notes: MoF, BI and World Bank staff calculations.

1. c. Inflation has generally been at manageable levels, although periods of rising commodity prices have pushed inflation significantly higher

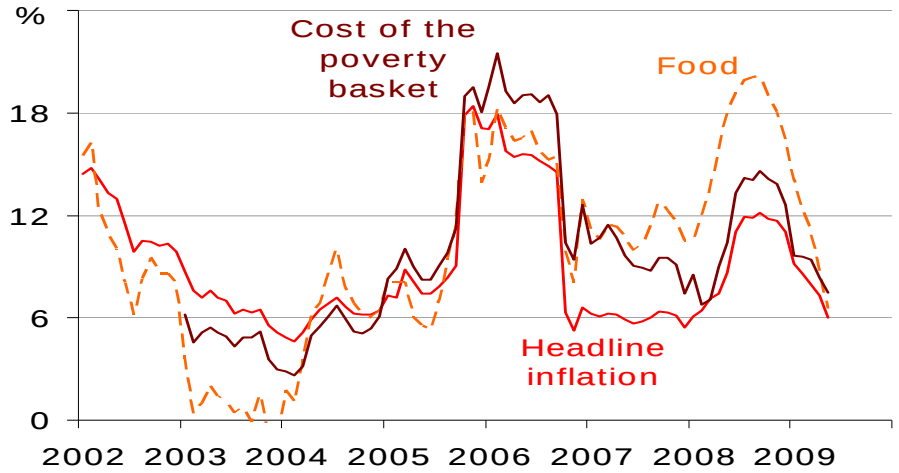
The Bank of Indonesia now has an inflation target…

Indonesia's central bank adopted an inflation targeting framework for the conduct of monetary policy in mid-2005, shifting from the previous dual focus on monetary and inflation targeting. The inflation target is set jointly by Bank Indonesia (BI) and the government, and is framed as a moving band, of inflation limited to one percentage point above or below the target. BI now explains moves in its interest rates policy in terms of inflationary pressures. BI largely lets the exchange rate float, intervening when appreciations lead to concern about export competitiveness, or depreciations risk fuelling domestic inflation, or market volatility is becoming a particularly great .

…and inflation has largely been kept under control, even in the face of surging fuel prices

Inflation has largely been kept under control. While a large increase in fuel prices in late 2005 led to a temporary rise in inflation in 2005 and 2006, inflation quickly moderated, albeit to levels above regional neighbors. The run-up in commodity prices in 2007 and early 2008, especially for food, flowed through from into accelerating consumer prices and into higher core inflation which was exacerbated by the fuel price increase in May 2008. The strengthening economy also raised demand-side price pressures, as capacity constraints are reached, particularly with respect to infrastructure. The central bank tightened monetary policy swiftly, and the drop in commodity prices led to a stabilization in prcies.

Figure 1.3: Inflation has recently been at manageable levels periods of rising commodity prices flowed into higher inflation



Sources and notes: BPS, CEIC, World Bank staff calculations.

1. d. The banking sector has largely recovered from the 1998 crisis and market sentiment, until recently, was positive

The banking sector is now sound while finance and credit are more available

The banking sector is on a much stronger footing than it was a decade ago. NPLs as a share of total loans have fallen from 48.0 percent in 1998 to around 4 percent in early 2009 and other indicators such as capital-asset-ratios have improved. Bank credit to the private sector, especially consumers, has accelerated. Indonesia is now accessing alternative sources of finance for both government (domestic & foreign bonds) and the private sector (bonds & equity). Funds raised in domestic capital markets increased substantially in 2007, while other financial market institutions, such as life insurance, have also expanded rapidly in recent years. Foreign investment and capital flows have been volatile.

1. e. Foreign reserves rose to historic highs on ongoing balance of payments surpluses

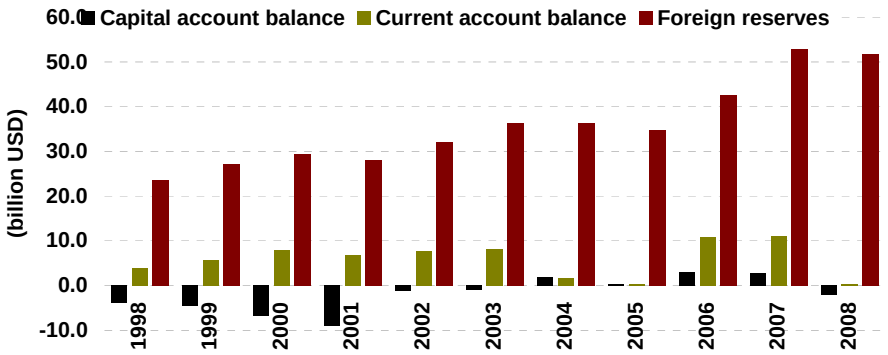
The balance of payments is at a record high while exports are rising and diversifying…

Indonesia's balance of payments has been strong in the years leading up to the global economic turmoil, and exports grew to record levels. In 2007, the current account surplus reached USD12.5 billion, slightly below 2006's USD14.5 billion surplus but much higher than in 2004 (USD1.7 billion) and 2005 (USD0.4 billion). These significantly larger surpluses were partly due to high commodity prices, which pushed exports to almost USD120 billion in 2007. Manufactured exports also continued to grow strongly, at rates above 10 percent in 2006, through 2008. With increasing competition from Vietnam and China, growth has shifted from traditional exports of textiles, clothing and footwear to transport equipment, which grew by over one-quarter in both 2007 and 2008. Indonesia's export destinations have diversified with accelerating exports to other regional emerging economies. Imports had been increasing at a more measured rate, reflecting the relatively slow pace of economic activity in 2005 and 2006, but then accelerated in line with strengthening growth in investment and consumer demand and the run-up in commodity prices. With import values continuing to accelerate in 2008 and commodity prices coming off their highs, the current account surplus was reduced substantially to USD 0.3 billion.

…providing a sizable cushion of international reserves

The strong performance in the current account contributed to the accumulation of official international reserves. These grew rapidly in 2005 through to 2007, and reached USD 60 billion in the first half of 2008 before falling back to a low of USD 50 billion in December, then recovering towards USD 58 bn again through the first half of 2009, level that continue to provide Indonesia some cushion against external shocks. Furthermore, the ratio of total external debt to GDP, a key external risk indicator, fell to below 30 percent at the end of 2009, from a peak of 158 percent in 1998.

Figure 1.4: Indonesia's balance of payments position has been strong up to the global financial turmoil



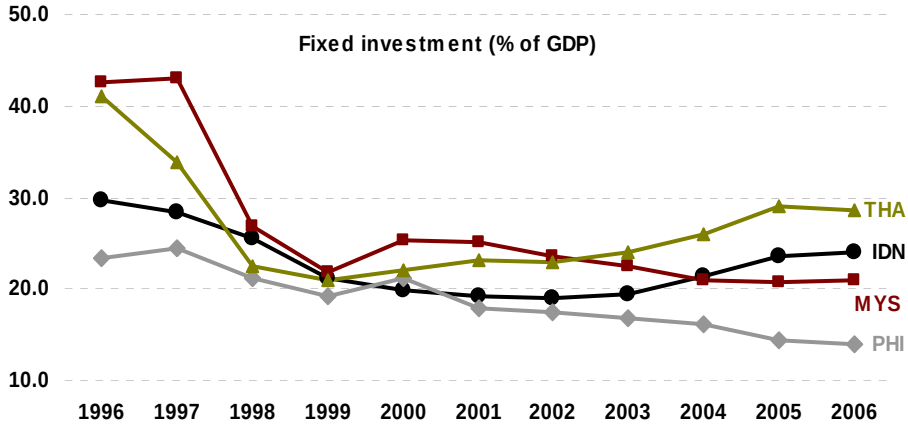
Sources and notes: CEIC and Bank Indonesia.

1. f. Investment, while still low by historical standards, is rising

Public investment has risen steadily and private investment is now following

Following the crisis, investment rates fell to a low of 19 percent of GDP in 2002. Both private and public investment fell, the former because of a combination of both lower domestic saving and lower inward foreign investment, and the latter because of the weak state of public finances. With fiscal consolidation, public investment has steadily increased over the last five years. Private investment has only more recently picked up and still remains below pre-crisis levels, but is rising fast. In 2007, Indonesia's investment rate was 25 percent of GDP.

Figure 1.5: Fixed Investment in Indonesia is rising, but is still low by historical standards



Sources and notes: CEIC and Bank Indonesia.

1. g. The macroeconomic fundamentals strengthened over the last decade have helped Indonesia weather the current global economic crisis

The turmoil on global financial markets and had a large impact on Indonesian markets

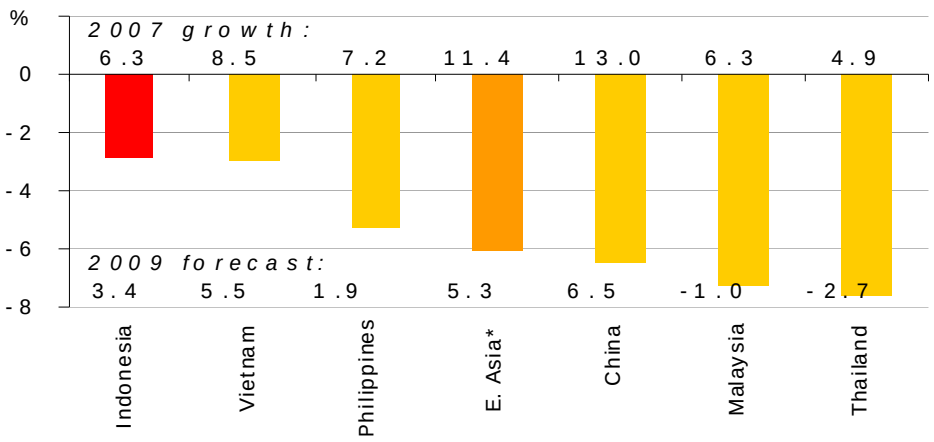
The turmoil on global financial markets, especially in the fall of 2008 and early 2009, had a significant impact on Indonesia's markets. The government bond market was especially affected, as non-residents reduced their holdings on a thin market, creating spikes in yields. Credit default swaps and spreads on Indonesian government USD bonds widened, briefly, to distress levels. The rupiah depreciated sharply, by more than most currencies in the region but much in line with the more freely floating exchange rates associated with commodity prices and carry trade, such as the Australian dollar or South African rand. The Indonesian stock market fell sharply, but the fall was typical of most markets and over a 5-year horizon the market remained a relatively strong performer. Consistent with the greater longer-term volatility in Indonesian financial asset prices, just Indonesian financial

market conditions improved in the second quarter of 2008 just as dramatically as they had deteriorated over the previous months. For example, by mid-year, the currency and equity prices had recorded among the largest increases in the region compared with December, government bond yields were at or below the levels of a year earlier, and spreads on Indonesian government USD debt were below the global average.

…but the downturn in the global economy has affected Indonesia by less than most

In contrast, while most economies entered a deep recession, Indonesia's economy has slowed by less than most and continued to grow at a moderate pace. Some sectors have been deeply affected, especially those exposed to the slump in commodity prices or the contraction in external demand, and firms have generally cut their investment plans. But as global conditions deteriorated, fiscal and monetary policy makers moved swiftly to support domestic demand and protect employment levels, by easing monetary policy, cutting tax rates, and generating new stimulatory spending. These moves coincided with the stabilization in consumer prices to have supported consumer demand – indeed, consumer confidence rose to 4-year highs in early 2009. Election-related spending coinciding with the probable low-point in global economic conditions is also likely to have supported the economy.

Figure 1.6: Indonesia's GDP growth is expected to slow considerably in 2009 but the slowdown relative to 2007 is the mildest in the region



Sources and notes: CEIC and Bank Indonesia.

2. Indonesia has continued its remarkably stable transition from a centralized authoritarian regime to a decentralized democratic polity

Democratization and decentralization have brought greater political stability and accountability…

In the decade since the crisis, Indonesia's political system has undergone a profound transformation, from a centralized authoritarian regime to a decentralized democratic polity. The transition was initially tumultuous but there has been a growing sense of political stability, particularly in the last five years, as the democratic process has both deepened and achieved wider acceptance. Constitutional reforms mandating direct elections to all levels of government have created greater electoral accountability. The political stability and the broader embrace of the democratic process that these changes have engendered have also been critical to supporting Indonesia's economic recovery and calming separatist sentiments.

2. a. The legal and institutional foundations of a decentralized democratic polity have been established

…while responsibility for many government services and funding has also been devolved

With the "big bang" decentralization of 2001, Indonesia went from one of the most centralized countries in the world in administrative, fiscal and political terms, to one of the most decentralized. Within a single year, much of the responsibility for public services was decentralized and new forms of decentralized participation in policymaking have been created. Authority over more than one-third of the budget was shifted from the central

government to over 400 local governments, doubling the share of sub-national governments in public spending. Two-thirds of central civil service staff were reassigned to regions and control of more than 16,000 service facilities was transferred.

Extensive changes have occurred in legislative representation and processes…

The relations between the different branches of government have been fundamentally restructured. An extensive system of checks and balances has been created with new powers for national and local legislatures and the creation of a new upper legislative house to provide stronger regional representation (DPD) at the national level. A system of publicly accessible wealth declarations for public officials has been introduced, along with some conflict of interest guidelines. The direct representation of the military in the political arena has been ended.

…while new institutions have strengthened checks and balances…

To improve the oversight and accountability of state institutions, a number of independent agencies have been established or strengthened. These include the Supreme Audit Agency (answerable to the Parliament), the Judicial Commission, the Police Commission, the Office of the Ombudsman, the Corruption Eradication Commission, the Elections Commission, the Financial Transactions Task Force, the Anti-Corruption Court, and the Commercial Court. The judiciary's independence has been enhanced, with the management of the court system shifting from the Executive Branch to the Supreme Court and legal review vested in a new Constitutional Court.

…and there is space for civil society and an independent media

Indonesia has ratified key international treaties on governance and anti-corruption, including the UN Convention Against Corruption. Finally, and in marked contrast to the pre-crisis period, virtually unfettered space has been provided for a vibrant civil society and independent media to emerge.

2. b. Freely and vigorously contested direct elections to all levels of government have strengthened electoral accountability

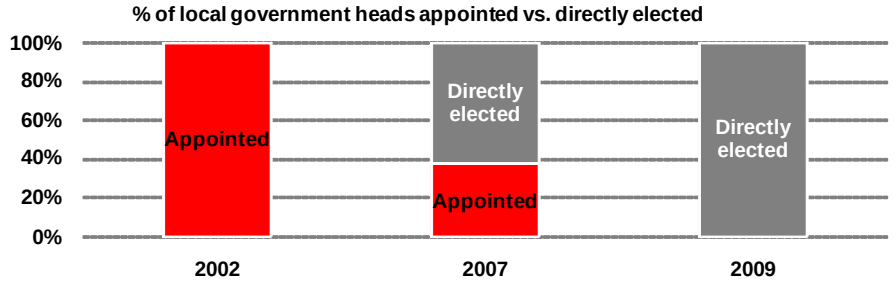
Elections are vigorously contested in a multi-party system…

These reforms, coupled with constitutional reforms mandating direct elections for all levels of government, have greatly increased electoral and political accountability. Indonesia's political system has become highly competitive. Indonesia has had 4 presidents in the decade since the crisis and the fall of the New Order regime, and all have governed within multi-party coalitions. In 2004, Indonesia conducted its first ever direct presidential election, and its third peaceful presidential transition since the crisis. Direct elections to local government are now being held on a rolling basis in all of Indonesia's provinces and districts.

…while politicians are being made more accountable

Political party allegiance and coalition-building, especially at the local level, are highly fluid. There is open political space for the rise (and fall) of new political parties. Issues related to the performance of elected officials, especially regarding governance and corruption, generally rate high among the expressed concerns of voters and in the rhetoric of political campaigns. Though Indonesia's democratic transition may still be quite young, there are clear signs that Indonesia's politicians are increasingly being held accountable for their performance with 40 percent of incumbent governors and district heads voted out of office in 2006.

Figure 2.1: By 2010, all local governments in Indonesia will have directly elected heads



Sources and notes: World Bank.

2. c. Political stability has calmed separatist sentiments and regional conflicts

Greater local political involvement has reduced regional conflict

Another important consequence of growing political stability and greater decentralized governance and regional development is that regional separatism has declined and regional conflicts have diminished. The government received international praise for signing a peace deal in mid-2005 with separatist rebels in Aceh, which has held firm to date. The peace deal ended a 29-year conflict between the Indonesian state and the Free Aceh Movement (GAM) and was made possible by changed attitudes in the wake of the December 2004 tsunami. There have also been reduced tensions in the Poso area of Central Sulawesi, in conflict-prone regions of Maluku and Flores, and in Papua.

3. But Indonesia is still a glass half-empty because there has been less progress on other important fronts …

There has been mixed progress against MDG targets with good news on rising life expectancy and falling child mortality…

Indonesia's progress against a range of Human Development Indicators shows mixed results with Indonesia likely to reach some MDG targets while falling short in others. The good news is that Indonesians are living much longer than they did four decades ago and child mortality has fallen dramatically. Since 1960, Indonesian's life expectancy at birth has increased from 40 years to 68, only slightly lower than China, Thailand or Turkey. In the same period, Indonesia has reduced child mortality by more than one-third and infant mortality by 25 percent.

…and rates of literacy resulting from higher school enrollment and lower attrition rates…

Indonesia has extended compulsory basic schooling to a universal nine-year program and has boosted the literacy rate among 15-24 year olds to 99 percent. Indonesia's progress in boosting primary and secondary enrollment rates has been remarkable. Net primary enrollment is just under 93 percent, and the gross enrollment rate for secondary education has been consistently rising and is now 83 percent at the junior secondary and 54 percent at the senior secondary level. The enrollment gap between males and females and across income groups has also been reduced - especially at the primary education level.

…while progress in gender equity has also been impressive

Indonesia has also made major strides in promoting gender equity and empowering women. The ratio of girls to boys at all levels of the schooling system is at or close to 100 percent. In higher education there has been similar progress with equal numbers of males and females now attending higher education institutions. These advances in women's education have resulted in a literacy rate for youth aged 15-24 that is equivalent for both males and females at 100 percent. Nevertheless, whilst there has been significant progress in life expectancy, lower child mortality rates, literacy and gender equity, there remain significant challenges to advance the overall welfare of Indonesia's people, especially the poor.

3. a. Higher levels of economic growth have not translated, to the extent hoped for, into greater poverty reduction

Nevertheless, higher rates of growth have not been matched by a commensurate fall in the poverty rate…

Though poverty rates fell quickly from peak crisis levels, progress since then has been slow and higher levels of growth have not translated, to the extent hoped for, into greater poverty reduction. With the exception of 2006, when the poverty rate jumped sharply in response to the increase in fuel prices, poverty has been declining in Indonesia since the crisis, and the poverty rate in Indonesia in 2007 had, at 16.6 percent, fallen to below pre-crisis levels. The rate of decline has been disappointing, however, especially in the context of stronger growth. GDP growth averaged 7 percent per year between 1990 and 1996, and headcount poverty fell nearly 4 percentage points, to 11.3 percent. By contrast, since 2003, poverty has fallen by only one percentage point though growth has averaged over 5 percent per year.

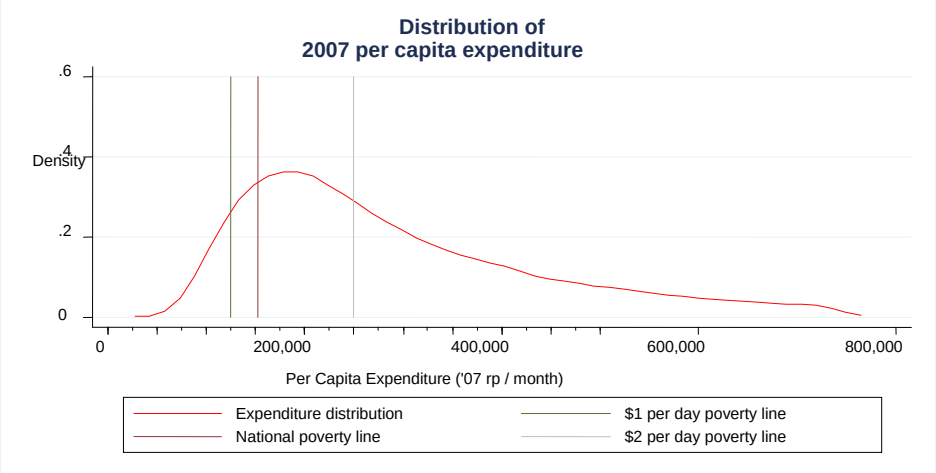
3. b. A large percentage of the population remains vulnerable to poverty

…so many people have been able to move out of poverty while others remain vulnerable

Nearly half of Indonesia's population in 2007 could reasonably be considered amongst the "near poor" or poor because their per-capita consumption levels were less than a third above the national poverty line. These households are vulnerable to a myriad of aggregate and idiosyncratic shocks such as food price increases or health shocks that can drive them into poverty. Although 40.5 percent of the initially poor households escaped poverty between 2003 and 2004, over one-third of the households that had been classified

as non-poor fell into poverty.

Figure 3.1: Nearly half of Indonesia's population in 2007 could be considered near poor or poor



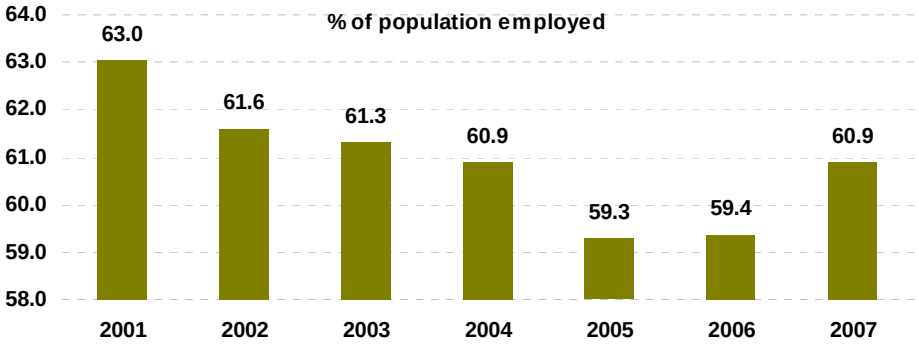
Sources and notes: World Bank calculations from 2007 SUSENAS.

3. c. Despite recent signs of progress, Indonesia lags behind its more prosperous neighbors in producing higher value-added non-agricultural jobs

Employment in the formal sector remains sluggish, unemployment levels remain high, especially among youth and wage levels have stagnated

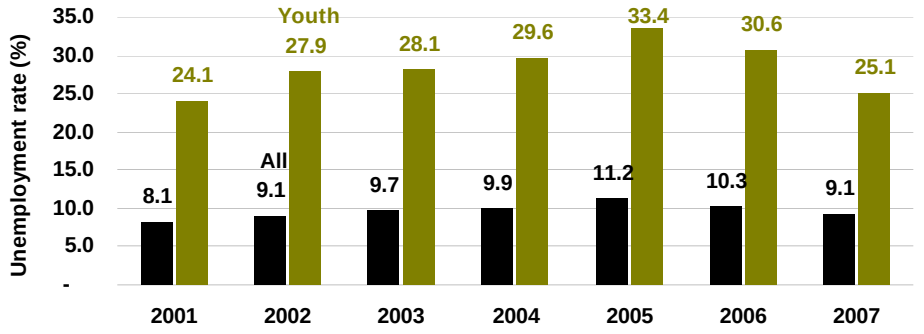
Employment growth has failed to match population growth since the crisis and job creation in the formal sector has been especially sluggish. Between 1999 and 2003, the percentage of the Indonesian workforce employed in the formal sector fell from 43 percent to 35 percent. There are signs of a recovery since then but the employment rate in the formal sector is still below what it was prior to the crisis. The open unemployment rate, which was 8.1 percent in 2001, rose further to 11.2 percent in 2005 before falling to 9.1 percent in 2007. This trend is mostly driven by youth aged 15 to 24, who have consistently made up over half of the unemployed and currently have an unemployment rate of 25 percent. Unemployment is especially high - roughly 33 percent - among young people under the age of 25 with high school and college degrees. In addition, real median wages, after growing rapidly from 1999 to 2003, have since stagnated.

Figure 3.2: Employment growth has failed to match population growth since the crisis



Sources and notes: BPS (SAKERNAS labor force surveys).

Figure 3.3: …and unemployment rates, especially among youth, remain high

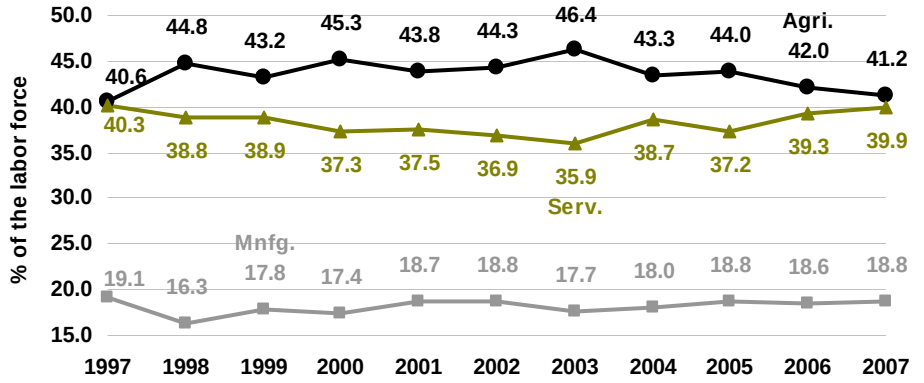


Sources and notes: BPS (SAKERNAS labor force surveys).

A large portion of the Indonesian labor force remains in agriculture, where productivity growth has been low

During the post-crisis recovery period, increasing numbers of workers were pushed into agriculture and by 2003, agricultural employment had returned to 1991 levels. Most of the increase in agricultural employment came at the expense of the service sector, a driver of the pre-crisis expansion. Non-agricultural employment resumed growing rapidly between 2003 and 2006 and agricultural employment fell to its lowest level since 1997. Despite this growth, just 30 percent of the labor force are employed in high-value added activities in manufacturing and services. Indonesia's agricultural productivity has been low with just half the average productivity of the services sector and 1/8 the productivity of industry. There have been no signs of productivity improvement despite the recent falling share of the labor force engaged in agricultural employment.

Figure 3.4: Over 40 percent of Indonesia's labor force is still in agriculture…

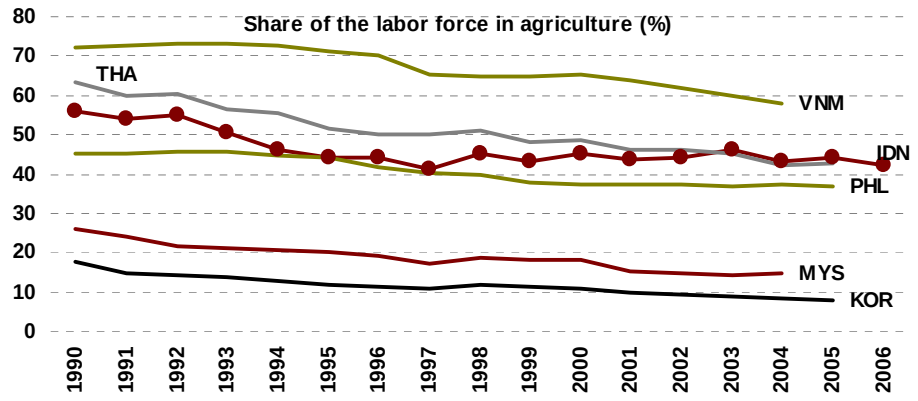


Sources and notes: BPS (SAKERNAS labor force surveys).

Indonesia has reduced agricultural employment more slowly than Thailand and Vietnam, and remains far below Malaysia

In 2008, over 40 percent of Indonesia's labor force still derives its livelihood from low-productivity activities in agriculture and related areas. Indonesia is not keeping up with its neighbors in moving workers out of agriculture and progress has stagnated. Vietnam has a high share of agricultural employment but it is falling quickly as the country's share of industrial employment is increasing and will soon surpass Indonesia. Thailand has already surpassed Indonesia and workers are continuing to move off the farm while Malaysia's share of agriculture workers remains stable and very low.

Figure 3.5: …and unlike its neighbors, Indonesia is not moving its workers out of agriculture



Sources and notes: WDI and BPS (SAKERNAS labor force surveys).

Figure 3.6: Formal sector job creation has been sluggish till recently

Sources and notes: BPS (SAKERNAS labor force surveys).

3. d. Human development outcomes continue to be uneven despite significant increases in public expenditures

Progress in human development indicators has been patchy…

Because of geographic and income-related disparities and differences in the quality of health, water and sanitation and education service delivery at the local level, Indonesia's performance in terms of human development outcomes has been quite uneven over the last decade. Over that period, there has been little improvement in some indicators and, in the case of a few, there has even been some regression. As a result Indonesia lags behind its neighbors in a number of areas.

…and despite impressive gains on some fronts, Indonesia continues to under perform on some critical health outcomes…

Indonesia continues to under-perform in a number of important areas, however, and as a result is unlikely to achieve several of its health-related MDGs. In particular, the country has made very little headway in reducing maternal mortality (which, at 420 per 100,000 births, is high – especially given Indonesia's income level), in improving child nutrition (which have remained at around 25 percent in the last few years), and in addressing geographic and income-related health disparities.

Table 3.1: Indonesia continues to under perform on some critical health outcomes

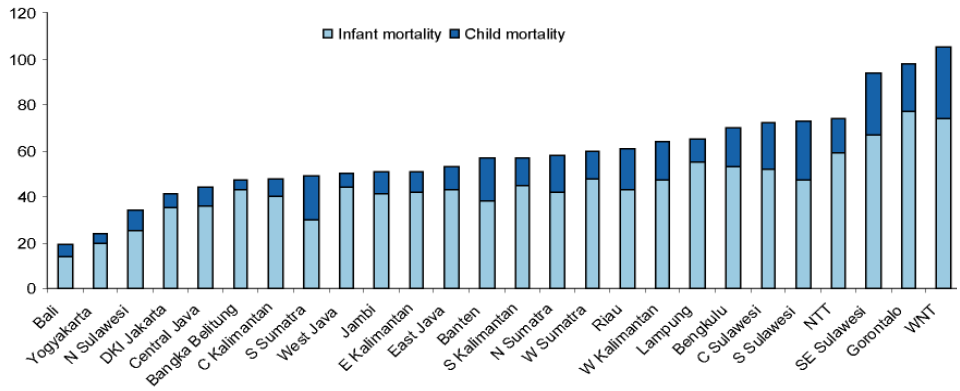
Country or category	Per-capita GNI (2006 USD)	Life expectancy (2006) (years)	Infant mortality rate (2006) (per 1000)	Under-5 mortality rate (2006) (per 1000)	Maternal mortality rate (2005) (per 100,000)	DPT immunization rate (2006) (%)	Skilled birth attendance (2000-2006) (%)
Bangladesh	440	64	52	69	570	88	20
Cambodia	480	57	68	87	540	82	44
Vietnam	690	71	15	17	150	94	90
India	820	64	57	76	450	55	47
Sri Lanka	1,170	75	11	13	58	99	96
Indonesia	**1,420**	**68**	**26**	**34**	**420**	**70**	**72**
Philippines	1,420	71	24	32	230	88	60
China	2,010	72	20	24	45	93	98
Thailand	2,990	70	7	8	110	98	97
Malaysia	5,490	74	10	12	62	96	98
East Asia & Pacific	1672	71	22	27	124	90	92
Lower middle income	1936	71	23	28	130	91	92

Sources and notes: World Bank (2008a) and World Bank (2008b) drawing on WDI and WHO data.

…while regional and income-related disparities are pronounced

National averages for health indicators mask significant geographic and income-related inequalities within the country. In poorer provinces, such as Gorontalo and West Nusa Tenggara, the infant and child mortality rates are four to five times higher than those in richer provinces such as Bali and Yogyakarta. Health indicators for the poor are also far worse than those for the rich: child mortality rates among the poorest quintile in 2003 were 3.5 times the rate among the richest quintiles (World Bank, 2008a).

Figure 3.7: Infant and child mortality rates vary widely across Indonesia's provinces



Sources and notes: Indonesia Demographic and Health Survey, 2002-03.

Advances in school enrolments hide systemic and regional inequities nationwide

Behind the impressive increase in enrollment rates at the national level, wide regional and systemic differences remain. Indonesia tends to lag behind in Early Childhood Education and Higher Education compared with other Lower Middle Income Countries, with gross enrollment rates of 21 percent and 17 percent respectively. In addition, while the enrollment gap between males and females and across income groups has been reduced - especially at the primary education level - striking inequalities remain across income groups at the pre-school, junior secondary and senior secondary levels. The fact that Indonesia scores low and lags behind in student learning in international assessments such as the PISA indicates that the quality of education remains a concern.

Access to piped or improved water in both urban and non-urban areas is inadequate and declining…

Access to water supply services in Indonesia is among the lowest in the region. Provision of piped water services is inadequate. The percentage of the urban population served by piped water had reached 40 percent by 1997 but declined to 31 percent in 2005 while only 17 percent of the total population has access to piped water. Access to "improved" water (a UN definition that excludes bottled water but includes, among other sources, water from

covered wells that may be contaminated) has declined from 90 percent in 1995 to 87 percent. The environmental consequences of access through large-scale use of private unregulated wells are high. Land subsidence, higher costs of reaching drinkable well water and proximity to septic tanks pose high environmental and health risks. The high incidence of water-borne diseases disproportionately affects the poor.

…while the coverage of sanitation services is among the lowest in Asia

Sanitation coverage in Indonesia, at about 55 percent in 2006, is well below the average for South-East Asian countries of 67 percent., while network sewerage coverage, estimated at 1.3 percent, is one of the lowest in Asia. Sanitation coverage has increased nationwide by 9 percentage points since 1990 but, on current trends, Indonesia will fall short of the MDG sanitation target of 73 percent by 10 percentage points, or about 25 million people. Over 96 percent of human waste is not treated prior to disposal while the manner in which private sanitation systems (including septic tanks) are managed and operated frequently risks contamination of ground and surface water.

3. e. Environmental quality is deteriorating and natural resources are being unsustainably depleted

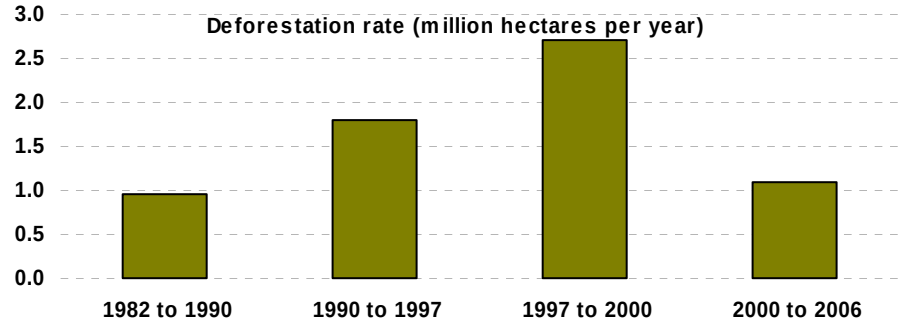
Natural resources are critical to the livelihoods of half the labor force…

Natural resources are critical to Indonesia's economy and to the many poor and rural Indonesians who depend on them for their livelihoods. Two-thirds of Indonesians live in rural areas and are directly or indirectly dependent on common land, coastal and environmental resources that are being rapidly depleted. Farms, plantations, forests and fisheries accounted for one-sixth of GDP in 2007 and half of employment. Agricultural and mineral products are a key input to the manufacturing sector, half of which is food-based. Natural resource based royalties and revenues account for about one-quarter of the central government budget.

…but forest loss and degradation rates are high…

Deforestation rates in Indonesia are amongst the highest in the world and that is the main reason why Indonesia is estimated to be the third largest source of greenhouses gas emissions, behind only the U.S. and China. Forest loss and degradation during the 1990s exceeded 1.5 million hectares per year or an area roughly the size of Java every 10 years, though recent data indicates some improvement.

Figure 3.8: Indonesia's forests are being rapidly degraded



Sources and notes: DG for Rehabilitation and Social Forestry, National Consultation on ADB Regional Review of the Economics of Climate Change in S.E. Asia (23-24 May, 2008, Jakarta)

…causing a host of downstream environmental problems

Forest degradation contributes to decreasing water quality, soil fertility and land productivity as well as increasing water shortages, fires and haze, health impacts, downstream siltation and flooding. Moreover, because more than one-fifth of Indonesians live in government-claimed "forest land" and are vulnerable to shifts in policies and land use claims, environmental problems and conflicts are increasing, putting pressure on state assets and budgets. In addition, twenty-three million hectares, or 12 percent, of Indonesia's lands are classified by the Government of Indonesia (GoI) as "critical" (based on degradation and reduced ecological functions).

Fisheries resources are declining, exacerbating

Fisheries resources that provide the main source of livelihood for fishing communities are declining throughout the country. Fishing communities have nearly twice the poverty rate

high rates of poverty…

as the national average (30 percent compared to 16.5 percent nationally) and are vulnerable to loss of fisheries habitat, climate change and rising fuel prices. Since 1991 fishing efforts have more than doubled while the fish catch has increased only 60 percent. Regional fisheries in the "inner" maritime areas (bordering Java, Bali and Kalimantan), contribute a declining share of Indonesia's total catch, despite significant increases in fishing efforts.

…that creates economic costs for all Indonesians

Indonesia's deteriorating environmental conditions impose significant economic costs (Bappenas, 2007). The health and other economic costs attributable to water pollution and limited access to safe water and sanitation are estimated to have been USD6.3 billion, or roughly 2 percent of GDP, in 2006. The annual costs of air pollution to the Indonesian economy have been calculated at around USD400 million per year. These costs are disproportionately borne by the poor because they are more likely to be exposed to pollution and less likely to be able to afford mitigation measures.

4. Why Indonesia, in 2008, remains a glass half-empty

Economic and political change is still in transition

The limited progress Indonesia has made in many critical areas can be traced to the dramatically changed circumstances resulting from the twin economic and political crises of 1998, and its own ongoing and as yet incomplete transition. These changes have highlighted systemic weaknesses in the processes and capacity for formulating and implementing policy and have made the process of implementing reforms a more challenging and time-consuming task.

4. a. In 1998, Indonesia underwent not only a severe economic crisis, but also a dismantling of the previous political order

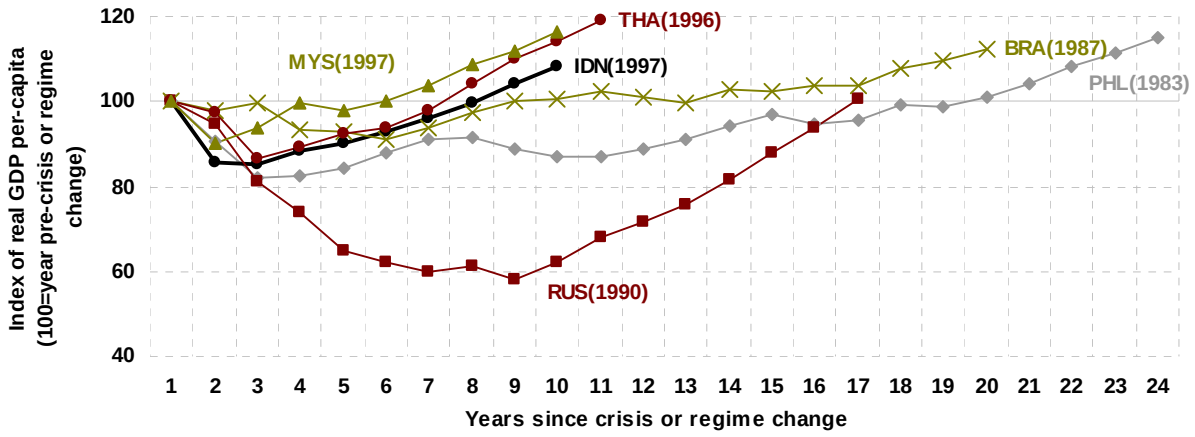
Indonesia experienced a more severe economic crisis than its neighbors…

The Asian financial crisis of 1998 hit Indonesia more severely than it did any of its South-East Asian neighbors and Indonesia took longer to recover than its neighbors. Indonesia's slower recovery is often attributed to the more severe macroeconomic imbalances it faced in the immediate aftermath of the crisis, its less favorable business environment and poorer infrastructure. Unlike its neighbors, however, Indonesia did not just experience an economic crisis but also went through a wrenching political transformation.

…but its recovery compares favorably with other countries that also experienced political upheaval

Indonesia's record over the last decade is thus perhaps more appropriately compared not to its neighbors' performance following the crisis but with Brazil (since the late 1980s) and Russia (since the early 1990s). Like Indonesia, Brazil and Russia are large heterogeneous federal states that also experienced both economic upheaval and a dramatic change in their respective political systems. Closer still, the Philippines since 1986 has also been transformed from a centralized authoritarian regime to a decentralized democratic state in response to popular unrest triggered by economic crisis. Indonesia's recovery following its twin crises compares favorably to the record of these countries following their respective dual crises (see Figure 4.1).

Figure 4.1: Indonesia's growth recovery compared to other countries that experienced economic or political crises



Sources and notes: World Development Indicators.

4. b. The priorities in the first five post-crisis years were to restore macroeconomic and political stability and put in place the basic framework of laws for the new polity

The priority post-crisis was to restore financial and political stability…

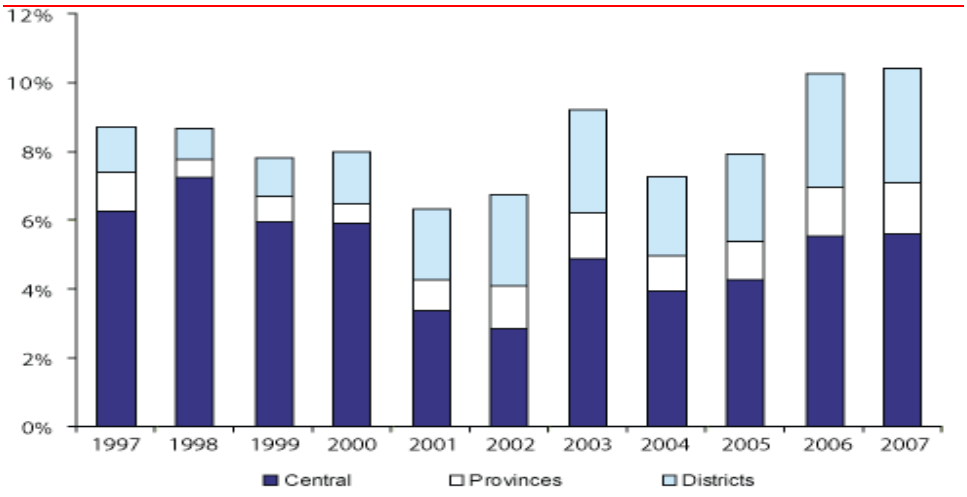
The first five years after the twin crises were, understandably, about restoring stability on both the macroeconomic and political front. The government lacked the finances to undertake many needed investments and the focus was necessarily on fiscal consolidation and putting in place the basic legislative framework for the new Indonesian polity. This was a much more contentious and uncertain process than the simple summary provided earlier might have suggested. Within the space of three years, Indonesia had three presidents, passed a series of laws completely remaking the state and undertook constitutional reforms, all of which were heavily contested and politically charged endeavors. 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. There was little time or money available for efforts directed at Indonesia's longer-term development agenda. By the end of the first five years, however, macroeconomic stability had been restored and, in the political arena too, things were settling down.

4. c. In the last five years the fiscal space has been created and structural reforms initiated in pursuit of the broader development agenda but progress has been slow…

…while recovery has allowed the government to concentrate on initiating fundamental reforms during the last five years…

In the last five years, as the hard-earned stability has been reinforced, fundamental structural reforms have been initiated in several areas. A number of new laws have been introduced or existing laws amended and numerous regulations and decrees have been issued. Following the termination of the 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. The plans were broadly maintained by the government led by President S.B. Yudhoyono who came to power in late 2004. At the same time work has been undertaken on preparing a broader development agenda, articulated in the medium-term development strategy (*Rencana Pembangunan Jangka Menegah* - RPJM) for 2004-2009. Continued fiscal prudence has provided the government with the fiscal space needed to meet Indonesia's development challenges.

Figure 4.2: Prudent fiscal policy has increased the funds available for development spending
(Fiscal space of central and sub-national governments as a % of GDP (1997 to 2007))



Sources and notes: World Bank estimates from Bank Indonesia and Ministry of Finance data. Fiscal space is defined here as discretionary spending—i.e., total expenditures minus salary, interest payments, subsidies and, in the case of the central government, transfers to regions

…although implementation has been problematical

The process of reform has proved challenging - implementation has been slow and often quite weak and ineffective, and there remain some critical areas where further reform at the legislative level has stalled.

4. d. Indonesia's governance transition is still incomplete in that electoral accountability has not yet translated into broader forms of accountability…

Democratization and decentralization have fundamentally changed accountability structures…

Democratization and decentralization have fundamentally changed accountability structures and decision-making processes within government and the broader public sphere. Under the New Order, power was concentrated in the executive and largely at the center. Now power is dispersed and devolved to other actors beyond the executive branch of government at the center. The national legislature, the judiciary, oversight institutions and local governments and legislatures all have a say in the formulation and implementation of government policies and programs, making the task of policy formulation and reaching consensus on critical policies and reforms that much more challenging.

…but the dramatic increase in electoral accountability has not yet translated into broader forms of accountability…

The stability of political transitions in Indonesia over the last decade, the competitiveness of electoral politics, and the emergence of a vibrant civil society and independent media all suggest that voice and accountability in the political process has increased substantially. But this substantial increase in political accountability has not led to concomitant increases in other essential forms of accountability necessary for improved governance outcomes, forms such as legal, bureaucratic and corporate accountability, and the accountability of public service providers to their constituents. The result is that politicians are held accountable for their performance through periodic elections, but appointed officeholders are not routinely held accountable for their performance.

…such as bureaucratic accountability which is limited by rigid civil service rules…

Indonesia's rigid civil service rules limit the ability of even reform-minded agency heads and political leaders to introduce greater accountability over their own staff, though this is changing gradually through a series of pioneering pilot efforts in some agencies. In Indonesia, high level civil service appointments are subject to strict eligibility rules that limit the ability of politicians to promote, transfer, release and recruit new staff. Such rigidities weaken the accountability of civil servants within institutions to their politically appointed leaders. It also weakens the performance incentives for civil servants. In addition, pay and promotion guidelines within Indonesia's civil service provide minimal ability to reward good performance within institutions. Some ministers do have control over a limited range of pay supplements and benefits that could be used more strategically to promote greater accountability for performance, but currently few take advantage of such discretionary compensation sources.

…while weaknesses in service delivery can be traced to the limited accountability of frontline service providers

Indonesia's weaknesses in service delivery can be traced to the limited accountability of frontline service providers such as doctors, nurses, and teachers to their clients or to elected officials and the problem is compounded at the local level by a lack of clarity in Indonesia's decentralization framework. International experience suggests effective service delivery is best ensured by strengthening the "short route" of accountability whereby clients of public services can hold frontline service providers directly accountable for their performance as opposed to depending upon political accountability at the ballot box as a means of providing their feedback. Strengthening this short route of accountability is particularly critical where competitive elections at all levels have not yet translated into other forms of state accountability.

Social accountability mechanisms within public institutions are weak….

Few public institutions in Indonesia make an effort to solicit and monitor client feedback on their performance in a systematic way. External oversight mechanisms with client or citizen participation are limited, though this is changing in some arenas. Public participation and consultation are channeled through highly ritualized, pro-forma processes (such as *Musrembang*) that were inherited from the authoritarian system. While most public institutions do not provide sufficient space for social accountability, it should also be recognized that social mobilization remains at an early stage in Indonesia so that the "demand side" for good governance at the level of public institutions is weak.

…while inadequate public financial management systems weaken financial accountability in government

Inefficiencies in public spending in Indonesia stem from the weaknesses in public financial management systems that diminish financial accountability of government agencies and individual office-holders. Examples of this include weaknesses in procurement processes, non-transparent and non-competitive bidding, which hurt the quality of Indonesia's infrastructure as well as inadequate financial controls within the bureaucracy.

4. e. …and government effectiveness is further constrained by a lack of coordination mechanisms and capacity for formulating and implementing policy

The formulation and implementation of effective policies and programs has been hampered by coordination problems within government…

Weaknesses in the mechanisms and frameworks that Indonesia has in place for coordinating the formulation and implementation of policies and programs within and across the different branches of government, at both the central and local level, have hampered the government's effectiveness in promoting Indonesia's development agenda. Both the decision-making processes underlying the formulation of policies and the delineation of roles and responsibilities needed for implementation of policies are often unclear. Uncertainty about economic policies and regulations, which is cited as one of the weakest aspects of Indonesia's investment climate appears to stem primarily from a lack of coordination across different ministries at the national level and between the national and sub-national governments. Weaknesses in service delivery are also attributable to a confusion of roles and responsibilities between the central line ministries and local governments. That different parts of government may have differing perspectives and competing priorities is to be expected but Indonesia appears to lack clear and effective mechanisms for reconciling these differences.

…as well as confusion of roles and responsibilities between central line ministries and local governments that has impeded service delivery and weakened the investment climate

Following decentralization, sub-national governments have become major players in service delivery and their role in public investment and economic development is increasing. The slow progress on elaborating a clear, consistent decentralization framework has, however, led to confusion over roles and responsibilities between central line ministries and local governments, and horizontal coordination across local governments is extremely limited. Almost every aspect of local government performance is compromised by the lack of clarity and inadequate coordination, from service delivery to infrastructure provision to the local investment climate. Gaps between policy and practice in environmental management have increased under decentralization.

Box 4.1: The lack of mining investment, despite Indonesia's potential provides a particularly stark example of the lack of coordination and uncertainty about policy

Why there hasn't been more investment: uncertainty and inconsistencies in policy

- local governments and the center disagree over who controls mining activity;
- environmental rules are unclear and changing and are interpreted differently by different

ministries;

- an unclear legal environment that causes uncertainty in the administration, interpretation and enforcement of existing regulations;
- arbitrary application of rules for divestment and mine closure undermining the rule of law;
- uncertainty regarding which taxes and royalties are owed, and to whom;
- district licensed mining permits that overlap with concessions provided national permits
- lack of certainty over cost recovery; and
- lack of clarity regarding gas domestic market obligation requirements.

Source: World Bank forum on oil, gas and mining investment climate (2007).

Limited capacity, particularly at the local level, has also hindered government effectiveness

Limited capacity, particularly but not only at the local level, has also hindered government effectiveness. For instance, the lack of a professional stream for procurement experts as well as the lack of a national procurement capacity building strategy results in continuing weakness in procurement capacity in implementing agencies, especially at the provincial and district levels. Financial sector regulators who are unfamiliar with the latest financial instruments, teachers who are unable to pass basic certification exams, and healthcare workers who do not follow professional protocols are some of the other examples.

4. f. The tasks facing the government have themselves become more difficult, in part because of Indonesia's own past successes…

The tasks facing the Indonesian state have themselves become more challenging in part due to Indonesia's own past successes and emergence as a middle-income economy

Democratization and decentralization have made the functioning of the Indonesian state more complicated at a time when the tasks facing the state have themselves become more challenging. This is partly attributable to Indonesia's own past successes and nowhere is this clearer than in the delivery of health and education services. Because government policies in Indonesia during the three decades of sustained growth prior to the crisis were quite successful in meeting basic needs and increasing coverage of basic services, Indonesia today faces a second-generation set of challenges - increasing the allocative and technical efficiency of public spending, raising the quality of services and mitigating income-related and geographic disparities in access and outcomes.

More schools have been built and students enrolled but attrition rates remain high…

For instance, in the 1970s, the government used part of its windfall oil revenues to finance a large-scale school construction program and hire and deploy teachers. Empirical analysis indicates that the initiative was directly responsible for substantial increases in the primary school enrollment rate. As a result, the main challenge today is less the relatively simple task of construction of school facilities than it is to ensure that children from poor households and remote areas have access to a quality education, that school attrition rates are brought down, and that the quality and relevance of the education that students receive at all levels is improved.

…while demographic changes present their own challenges…

Indonesia's success at boosting growth and its re-entry into the ranks of emerging middle income economies has created its own challenges as well. For instance, like many other emerging middle income economies Indonesia is experiencing simultaneous demographic, epidemiological and nutritional transitions as population growth slows and the population ages, and growing incomes and changes in lifestyle shift the public health focus to non-communicable diseases.

4. g. …and in part, because of the changed global economic environment Indonesia faces

…as do globalizing trends which add to the pressure for change

The changed global economic environment implies a very different, though equally important, role for the state than in the past. Agglomeration economies, international production networks, reductions in transport and logistics costs, the growth of information technologies, and the rise of China and India have all changed the nature of competition and the distribution of rewards in the global economy. Home market advantages are now subject to international competitive pressure as continuing progress in transportation and communications has made it increasingly feasible to procure most components from any part of the world. These changes in turn necessitate a shift in the role of the government, not just in Indonesia but all around the world, from one of direct involvement in production to one of regulation, of facilitating private-public partnerships and enabling private citizens

and firms to better prepare themselves to compete in the changed global environment.

5. While Indonesia is in a relatively strong position, the medium-term outlook is uncertain and there are significant downside risks

5. a. Indonesia should weather the global economic slowdown better than many countries but growth will be lower going forward

The severity of the current global economic downturn imply that Indonesia's growth will be lower in the next two years than it has been…

The weaker global growth environment and lower commodity prices have impacted Indonesia's externally-oriented firms' revenues and demand, hence the dividends they pay their owners, the wages they pay their employees and the size of their workforce. Tighter global credit conditions restrict investment and reduces consumer financing, affecting domestic demand. Partially offsetting these negative external developments, Indonesian policy makers have sought to provide some offset, and the stabilization in consumer prices especially appears to have supported overall consumer confidence.

On balance, these developments weaken Indonesia's economic outlook for the coming years. Indonesia's economic growth is expected to slow to around 3.5 percent in 2009 before lifting to 5 percent or a little above in 2010 and then rising towards its current projected potential growth rate of between 6 and 6.5 percent. This slowdown is generally smaller than projected economic growth among other major emerging economies in the region.

Table 5.1: Indonesia's recent and projected macroeconomic performance

	Actual					Projected		
	2004	2005	2006	2007	2008	2009	2010	2011
Real GDP growth (%)	5.0	5.7	5.5	6.3	6.1	3.5	5.0	6.3
Domestic:								
Investment (% change)				9.2	11.7	4.1	8.0	10.2
Consumer price index (% change)	6.2	10.5	13.1	6.5	9.8	5.0	4.0	4.0
Budget deficit (% of GDP)	-1.0	-0.5	-0.9	-1.3	-0.1	-2.5	-1.4	-1.2
External:								
Current account balance (billion USD)	3.3	0.3	9.9	10.4	0.5	1.0	0.0	-1.0
Exports (GNFS) (billion USD)	74.1	89.2	103.0	131.0	155.0	113.0	124.0	140.0
Imports (GNFS) (billion USD)	71.3	91.5	95.3	110.0	145.0	104.0	113.0	125.0

Source and notes: World Bank staff calculations. GNFS refers to "goods and non-factor services".

…but Indonesia is well-positioned because of its size and the structure and destinations of its exports

Indonesia is less exposed to external shocks than other economies in the region. Its trade share (the ratio of imports plus exports to GDP) at about 50 percent of GDP is relatively small even accounting for its size. The structure and destination of Indonesia's exports also protect its external sector from the current downturn. Indonesia's exports are increasingly directed towards emerging economies, especially those in Asia. China's share of Indonesia's exports has doubled this decade, while India's has tripled, although from a low base. Almost two-thirds of Indonesia's exports are primary products, and the prices of these, though projected to decrease from recent highs, are likely to remain high through 2009, according to World Bank forecasts. Further volume growth for these exports is likely given the lagged response of production to price movement.

5. b. There is however considerable uncertainty about the medium-term outlook and Indonesia remains vulnerable on some fronts

Considerable uncertainty surrounds these forecasts – the external environment may be considerably worse, or measures to support domestic demand even more effective than expected

But considerable uncertainty surrounds the baseline outlook. Global economic conditions remain volatile and uncertain. Weaknesses in the global financial sector weakness could prove to have and deeper with more pronounced effect on investment and consumer demand across the developed economies. Sluggish real economies and ongoing weakness in the financial sector could generate a self-perpetuating adverse cycle, leading to further financial instability. And in the medium term are the challenges of higher public debt, weaker consumer demand and unwinding the monetary stimulus in the high-income economies, and on recalibrating emerging economies' growth towards domestic demand.

…and Indonesia remains vulnerable…

Indonesia, however, remains vulnerable. Volatile commodity prices have generally supported Indonesia's terms of trade, the current account and growth, but have adversely

impacted inflation, the fiscal balance and income distribution, while the sharp downward movement in prices in the second half of 2008 was disruptive in the opposite direct. Another round of increases in commodity and oil prices may pose risks if the fiscal and distributional effects are not managed properly. Many financial markets are still embryonic, and susceptible to swift changes in sentiment that may be only marginally related to economic fundamentals, leading to a small but potentially significant risk of sudden capital flight.

…to growing fiscal pressures especially in the budgetary impact of subsidizing dramatically higher global oil prices…

High commodity and crude oil prices also pose risks to Indonesia's public finances. The budgetary costs of energy subsidies and measures to protect consumers from increases in food prices can undermine Indonesia's hard-earned fiscal discipline. Energy subsidies consumed almost one-quarter of Indonesia's 2008 budget, or about 4. 5 percent of GDP, and the unanticipated increase in budgetary outlays on fuel subsidies led to cuts in line ministry budgets. This constitutes a large lost opportunity to invest oil and gas revenues in social programs and infrastructure projects that can lift long-term growth potential. Most of these subsidies are also highly regressive—the richest one-fifth of households directly receive as much as two-thirds of Indonesia's fuel subsidy. Although the government raised subsidized fuel prices by an average of 150 percent in 2005 and a further 28.5 percent in May 2008 this only restrained the rate of growth in the size of subsidies during those periods. The lowering in regulated prices as global energy prices collapsed in December 2008 and January 2009 is likely to create a new round of pressures when fuel prices rise again.

…that also amplifies the impact on government bond yields

Of more immediate concern, however, is the impact on the government's borrowing costs and financial stability. Indonesian government debt markets are sensitive to uncertainty over the size of government energy subsidies and their financing needs and charge a premium on debt when subsidies are expanding. The politically-charged nature of Indonesia's regulated fuel prices amplifies the general uncertainty associated with volatile world oil prices, leading to cases of temporary illiquidity in the government debt markets and sharp increases in the yield on government debt.

5. c. …and the economic slowdown will also slow gains in social outcomes

The global downturn is expected to slow the pace of gains in poverty, while volatility in food prices remain a concern

In the medium term, volatility in food and fuel prices is a source of concern. Food and energy account for three-quarters of household expenditure among low income groups. Rising food prices in the year to mid-2008 could have potentially caused over 8 million more Indonesians to fall into poverty if no policy response had been forthcoming. Both international experience and Indonesia's 2005 and 2008 cash transfer programs have shown that a targeted cash transfer scheme offers the best means of protecting the greatest possible number of poor and low-income households from rising food prices and mitigating the risk of social unrest. The government's move in May 2008 to reduce fuel subsidies financed 9 months of unconditional cash transfer to Indonesia's poor and near-poor, and a renewed, better targeted program may be needed with a new round of volatility.

With this transfer program, the poverty rate is expected to have declined slightly to 15.0 percent in early 2009 from 15.4 percent in early 2008. This reflects firm economic growth, especially for agriculture, and slower growth in food and fuel prices, and it especially reflects the impact of the government's 2008-09 unconditional cash transfer program to poor and near-poor households (BLT). Through 2009 and into 2010, the global economic downturn is expected to put pressure on poverty. Slower growth, and with the BLT having ceased in March 2009, poverty is unlikely to fall much further by early 2010 without a new program of public assistance.

B. Indonesia 2014 and beyond: the development agenda

6. Indonesia's development agenda—what Indonesia aspires to and what the broad challenges are—is clear

A five-year development plan has been prepared that focuses on building a safe, peaceful, just and democratic, prosperous Indonesia…

Since 2005 work has been initiated on a broader development agenda, articulated in the RPJM. The RPJM for the five-year period 2004-2009 specifies three broad and multi-faceted goals: (1) a safe and peaceful Indonesia; (2) a just and democratic Indonesia; and (3) a prosperous Indonesia. Under each of these three broad goals, the RPJM lists more specific objectives in a number of sectoral or thematic policy areas. Recognizing Indonesia's international commitments, the RPJM also incorporates ambitious interim targets toward attaining the eight MDG-related development goals by 2015.

…with annual work plans established to deliver on these goals

For each of the past three years, the goals articulated in the RPJM have been further elaborated in Annual Work Plans (RKPs) through which the government has identified specific priorities and associated targets. The priorities of the annual RKP provide an umbrella guide to aggregate state budget allocations that attempts to align spending, programs, policies and activities with current and evolving development needs while responding to emerging challenges.

Progress has been made on the development agenda in the 2004-2009 RPJM…

Indonesia, in 2008, can be said to have achieved "half" the goals articulated in the 2004-2009 RPJM. Continued political stability has meant a "safe and peaceful" as well as a "democratic" Indonesia that is increasingly confident about its own democratic future, while strengthened macroeconomic fundamentals and robust growth has increased the prospects for a "prosperous" Indonesia. For a truly prosperous Indonesia, however, growth needs to be accelerated, and for a just Indonesia, that growth has to be more widely shared.

…and the next development plan will build on the unfinished agenda…

The process of drafting the 2010-2014 RPJM has begun and early indications are that the unfinished agenda of the current plan will frame the broad priorities of the next one. With 2015 approaching, the Millennium Development Goals are likely to take a prominent place. There are also signs that the government will put a stronger emphasis on program approaches, with key programs targeted to the poor, such as ASKESKIN and PNPM continuing to be implemented in addition to selected sectoral programs. However, the upcoming 2009 presidential elections necessarily make any statements about the next government's development agenda somewhat speculative.

7. Accelerating growth

7. a. Indonesia has the potential to achieve the rates of growth it achieved prior to the crisis

Improving competitiveness will lead to faster growth…

Economic policy packages introduced in each of the last three years indicate that the government recognizes the need to accelerate growth by improving Indonesia's competitiveness. These policy packages have focused on priority areas such as infrastructure, investment climate, the financial sector and SME development that are critical to enhancing Indonesia's competitiveness by promoting private-sector-led investment.

…that could potentially match the growth rates of regional neighbors

In the three decades prior to the crisis - between 1967 and 1997 - Indonesia's economy grew at an annual average rate of 7 percent. Only 11 other countries have enjoyed such an extended period of high sustained growth. Thailand was at Indonesia's current per capita GDP level in 1986, having grown in the previous seven years at almost the same rates as Indonesia has in the last seven. Thailand's growth rate subsequently accelerated and within a decade Thailand was firmly established as a middle-income economy (Figure 7.1). Indonesia has the potential to do the same although there is no guarantee that growth can be accelerated. The case of the Philippines provides a counterexample. In 2000, the Philippines was at the level of GDP per capita that Indonesia was at 2007. Unlike Thailand, however, in the seven subsequent years, growth, while respectable, did not accelerate.

Figure 7.1: From Indonesia's current income levels, some economies achieved economic take-off, while others languished

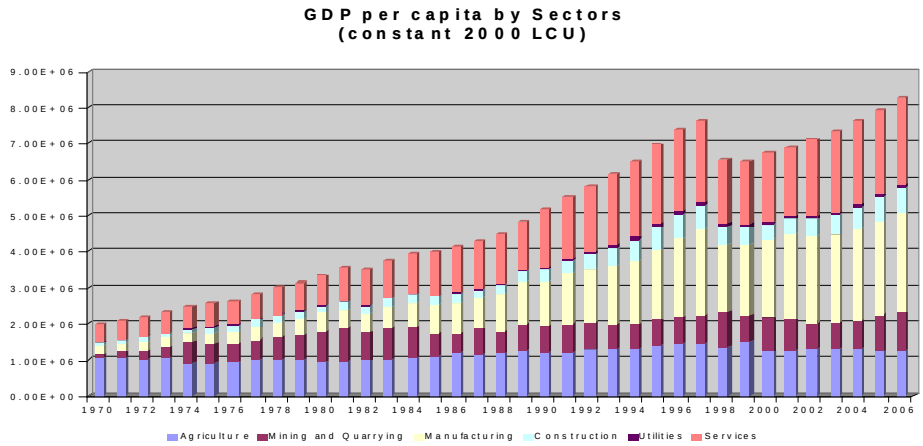
Sources and notes: World Development Indicators.

7. b. Making the most of Indonesia's resource endowments while also developing globally competitive clusters elsewhere

Relatively high commodity prices offer Indonesia, with its natural resource endowments, a unique opportunity to accelerate growth…

Indonesia is a resource-rich economy, however, with the exception of the 1970s, the contribution of the commodities sector to Indonesia's growth has been minimal, primarily because of stagnant or declining prices (Figure 7.2). In the last three years, however, commodity prices rose sharply up to mid-1998. Oil prices more than tripled to new records near USD140 per barrel; metals prices increased five-fold and world grain prices surged 87 percent. World Bank forecasts suggest that while commodity prices have now peaked, they are likely to remain high for the next decade (see Figure 7.3). After 30 years of declining commodity prices, this represents a significant break. Indonesia is not, however, making the most of the opportunities that relatively high mining and energy prices and its resource endowments offer for accelerating growth through a commodities-based strategy.

Figure 7.2: Indonesia's growth in the last-quarter century has come primarily from manufacturing and services



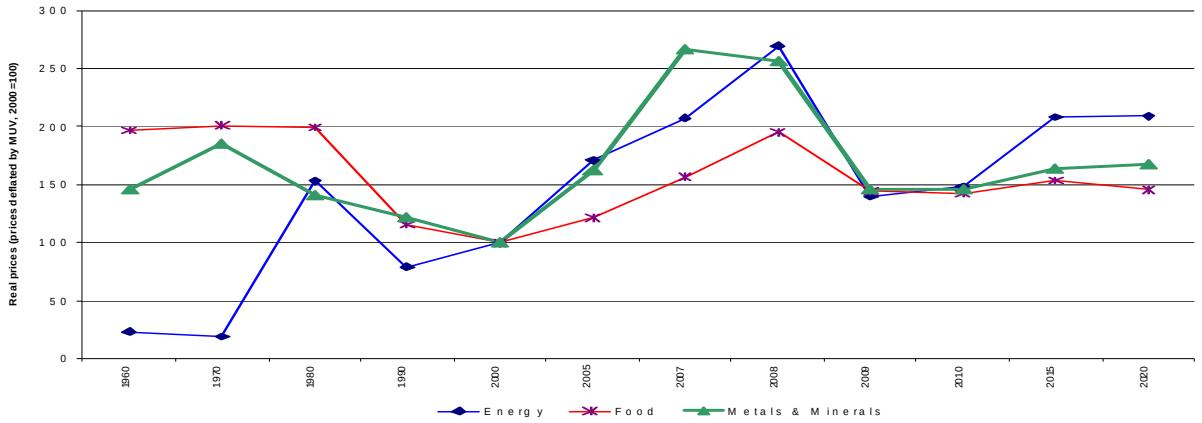
Sources and notes: WDI.

…but its high dependence on commodities leaves it vulnerable to price movements…

Indonesia's economy is especially sensitive to changes in commodities prices because of its relatively high dependence on commodities. Despite having clearly diversified into manufacturing products, commodities still play an important role in Indonesia's international trade, production, financial markets and government revenue. The share of non-fuel commodities in total exports was 39.6 percent, and in total imports, 24.3 percent in 2007 (see Table 7.1). Commodities represent a significant share of GDP: the share of non-fuel commodity exports in GDP was 10.4 percent in 2007 and the share of oil and gas

was 5.2 percent, while the share of manufactured goods is 11.1 percent (World Bank and COMTRADE data). Commodities are also a key source of revenue – plantation, forestry, mining and oil and gas constituted 22% of total government revenue in 2008 – and are important players in the stock market – mining plus agriculture represented 15 percent of total market capitalization in January 2009.

Figure 7.3: Commodity prices are forecast to remain high for the next decade relative to 2000



Sources and notes: World Bank DECPG forecasts.

…although recent price increases lifted Indonesia's terms of trade and trade surplus and contributed to the dramatic rise in Indonesian stock prices

Indonesia benefited from the 2005 to mid-2008 increase in commodity prices. Increases in commodity prices lifted Indonesia's terms of trade and enlarged its current account surplus. From 2005 to 2007, higher commodity prices explained about 78 percent of the $24.5 billion increase in total exports. Export growth largely followed commodity price rises, driven by crude palm oil (which accounts for almost one-quarter of export growth), nickel, chemical materials and copper. Importantly, oil and gas exports have languished, despite the surge in world crude oil prices, with non-oil and gas exports contributing ten times more to total export growth from 2005 to 2007 than oil and gas exports. Stocks of Indonesian companies with commodity interests have led the performance of the Indonesian stock market, which has risen by nearly two and one-half times and been one of the world's best performers since January 2005. Higher commodity prices also prompted an important increase in FDI approvals in the primary sector - albeit limited to certain segments - during 2005-2007 when manufacturing FDI remained stable.

Table 7.1: Commodities account for more than half of Indonesia's merchandise exports

Table 7.1: Commodities account for more than half of Indonesia's merchandise exports				
Merchandise category	**1979-1981**	**1989-1991**	**1999-2001**	**2007**
% of exports				
Agricultural Raw Materials	13.0	6.3	3.6	6.2
Food	7.2	11.4	9.7	14.6
Minerals and Metals	4.1	7.7	9.7	18.7
Oil and Gas	73.1	39.9	22.1	19.7
Manufactures	2.7	36.2	55.6	42.3
% of imports				
Agricultural Raw Materials	3.4	4.9	7.2	3.5
Food	12.7	5.9	11.5	10.5
Minerals and Metals	12.5	11.5	8.5	10.2
Oil and Gas	13.6	8.5	17.6	29.7
Manufactures	66.3	75.2	59.9	52.3
Sources and notes: COMTRADE. Agricultural raw materials comprise SITC section 2 (crude materials except fuels) excluding divisions 22, 27 (crude fertilizers and minerals excluding coal, petroleum, and precious stones), and 28 (metalliferous ores and scrap				

Sources and notes: WDI.

Indonesia is not,

Nevertheless, Indonesia still may not be making enough of the opportunities offered by the

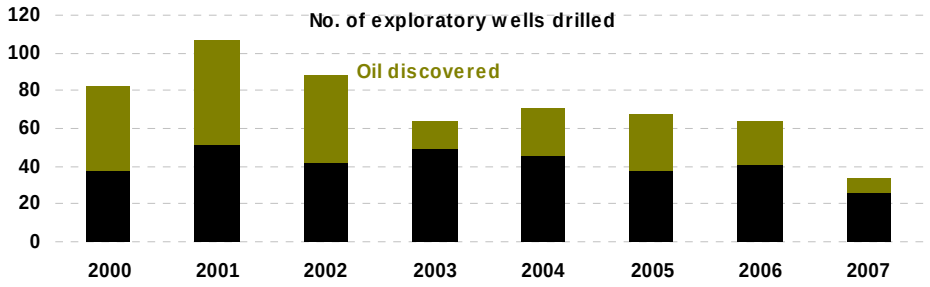
however, making enough of the opportunities offered by higher energy and mineral prices…

present historically high energy and mineral prices. The growth in export values in the last few years has been driven more by export price increases than it has by growth in export volumes. It may well be, however, that an improvement in the supply response is lagging because of the multi-year gestation periods for many commodity-related investments. There are also indications that investments themselves have been lagging and the reasons for that have to do with structural impediments peculiar to Indonesia.

…because investment in the resources sector has been lagging

Despite a sustained commodities boom and excellent geological prospects, Indonesia is facing under-investment in oil, gas and mining. Exploration investment has been almost nonexistent in recent years (Figure 7.4). Greenfield exploration spending dropped to just USD7 million in 2004 from USD54 million pre-crisis, and total investment dropped by two-thirds. Decades of weak investment in oil exploration have led to a 38 percent fall in production since 1994 resulting in Indonesia now being a net importer of oil and oil products.

Figure 7.4: Oil exploration activity in Indonesia has declined steadily since 2000

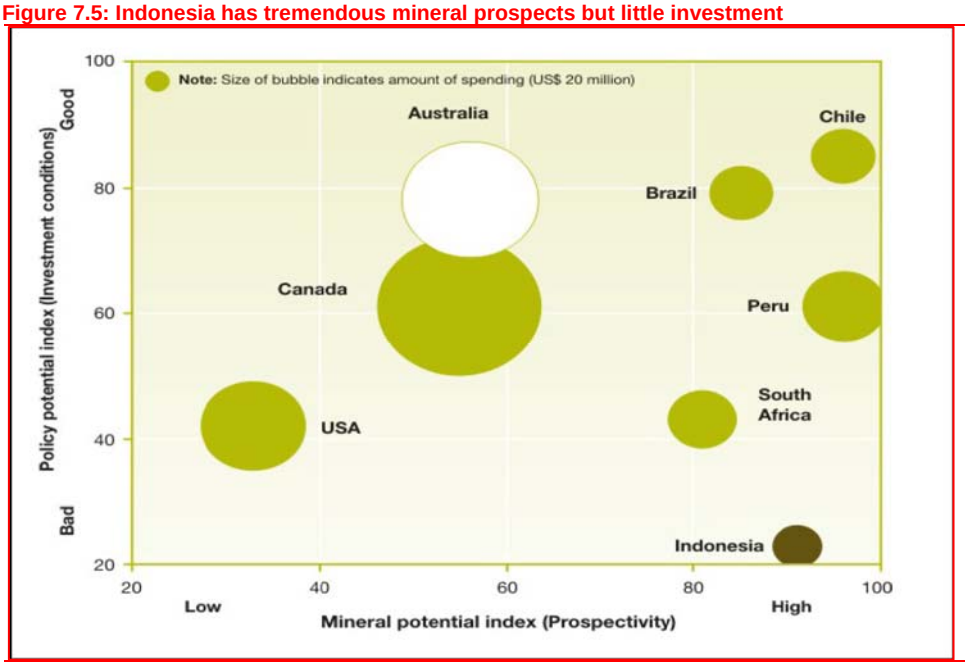


Sources and notes: Ministry of Energy and Mineral Resources.

Minerals production has performed particularly poorly, despite significant potential…

Supply growth has been most strikingly absent in mining. In 2004 Indonesia accounted for less than 1.5 percent of worldwide mining exploration spending. This is despite Indonesia's significant potential - in a 2005 survey of 259 mining and exploration companies worldwide, Indonesia received a score of 97 (out of a maximum of 100) for mining potential and ranked 6th out of 64 regions (Figure 7.5). Although Indonesia is endowed with large reserves of coal, copper, nickel and tin, its production to reserves ratio is low by international standards for some minerals, being, for example, half that of Chile and Australia for copper and of China for coal.

Figure 7.5: Indonesia has tremendous mineral prospects but little investment



Sources and notes: Price Waterhouse Coopers.

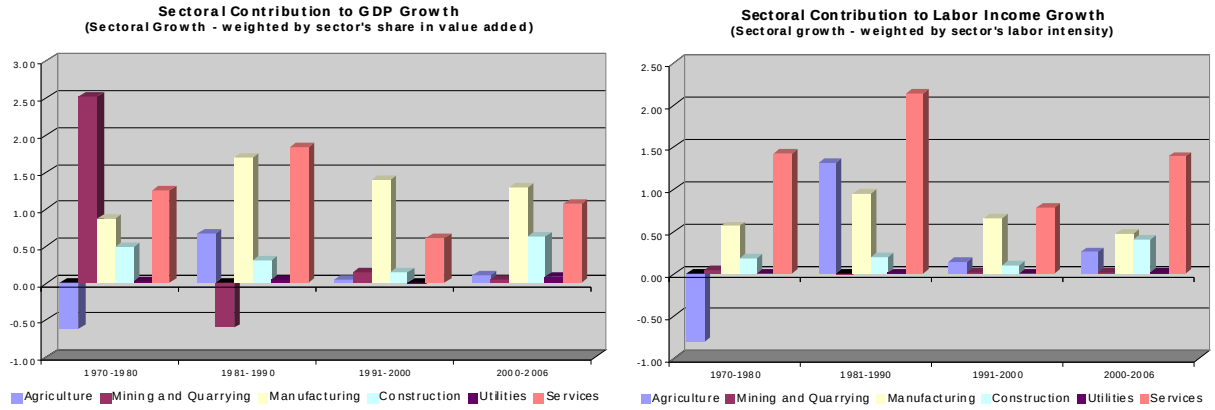
Indonesia's poor investment climate is impeding the resources sector…

The main reason Indonesia is missing out on the global oil, gas and mining resource boom appears to be its investment climate. It remains comparatively unattractive to international resource companies because of its complex bureaucracy and the high degree of uncertainty surrounding policies and regulations. A successful outcome to the ongoing discussions on the implementing regulations for the new mining law may trigger a response by domestic and international mining investors that preliminary estimates suggest could potentially be quite large.

…although growing Indonesia's manufacturing and services sectors is the main priority to absorb an expanding labor force

Indonesia's population is still relatively young and its labor force is growing rapidly. Youth unemployment is already high, as noted earlier, and if Indonesia's future growth is to be broad-based, its growing labor force has to be productively employed. Undoubtedly, growing incomes in the commodity sector will have positive multiplier effects on the rest of the economy, particularly in services and non-tradables. There are already signs that this is happening with the growth of bank deposits in the outer-islands and increasing cement sales and construction activity. Nevertheless, Indonesia's own past growth experience suggests that growth in manufacturing and services will also be necessary to absorb Indonesia's growing labor force. Even in periods when the primary sectors made significant contributions to Indonesia's GDP growth - oil and gas and mining in the 1970s and agriculture in the 1980s - manufactures and services contributed more to labor income growth (Figure 7.6).

Figure 7.6: Even when primary sectors contributed significantly to Indonesia's economic growth, manufacturing and services contributed most to labor income growth



Sources and notes: World Bank estimates using WDI data.

Commodity-led export growth may lead to excessive concentration of exports, which has adversely affected growth elsewhere…

Recent commodity-led export growth has led to an increasing concentration of Indonesia's exports. In 2007, 5 commodities accounted for half of all non-oil and gas export growth, continuing a trend of increasing concentration since 2005 that stands in marked contrast to the period between 1980 and 2004 when Indonesia's export basket was much more diverse. Recent research suggests that excessive concentration of exports can adversely affect growth, in part because it increases vulnerability to exogenous commodity price shocks, but also because it can reflect a lack of innovation and productivity improvement in the private sector.

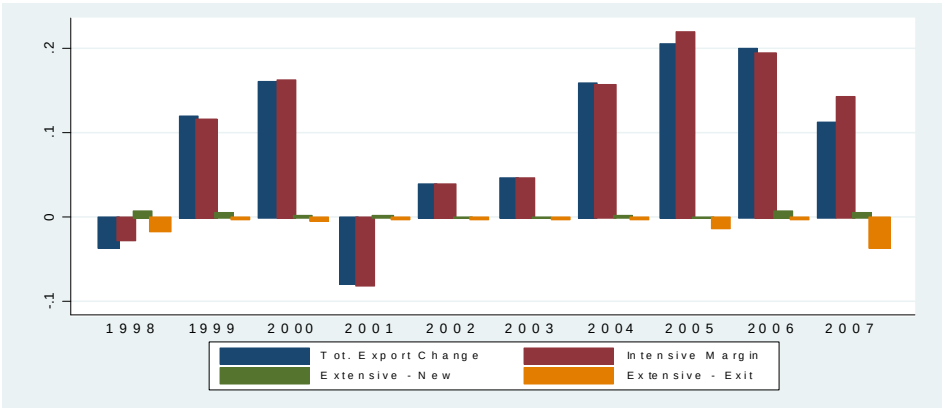
…but natural resources need not be a curse if an economy is able to also diversify its exports…

The implication is that while economies endowed with natural resources should make the most of them, these resources pose a risk only if the economy is not able to also diversify its export base at the same time. Diversification need not involve the promotion of high-tech manufactures but can also originate in efficient resource-based and natural resource processing sectors as these show a substantially lower degree of concentration than primary sectors.

…which hinges on a process of export "discovery" which Indonesia has not been very successful at in the last decade…

Diversification hinges on a process of export discovery as firms "discover" and develop competencies in new and non-traditional products. This could be achieved by increasing the weight of products that are already produced and exported and by producing and exporting new varieties of products. The latter represents a significant challenge. As shown in Figure 7.7, a decomposition of export growth during the period 1998-2007 shows that the expansion of the intensive margin products ("old good stuff") dominates over expansion of "extensive margin" in manufactures (little "new products").

Figure 7.7: Old stuff still dominates export growth: very little creation and very little destruction



Sources and notes: World Bank estimates using data from UN-COMTRADE database.

…with few new products growing in importance

Indonesia's limited progress in diversifying its exports after 1997 is confirmed by Table 7.2 which shows that new products and products that were relatively unimportant in terms of Indonesia's exports in 1997 have remained unimportant after 10 years.

Table 7.2: Export "discovery" has been minimal

	Products that were "undiscovered" in 1997	Products "discovered" between 1997 and 2001	
Year	**Share of all exports**	**Share of all exports**	**Share of mfg. exports**
1997	0.00%		
2001	0.29%	1.17%	1.65%
2007	1.26%	3.12%	6.05%

Sources and notes: Products that Indonesia did not export or those that were in the bottom decile in terms of their share of Indonesia's total exports in 1997 are labeled "undiscovered" products (as of 1997). Products that were "discovered" between 1997 and 2001 are those whose share of Indonesian exports went from zero in 1997 to some positive fraction in 200

Manufactured exports need to diversify into globally competitive clusters

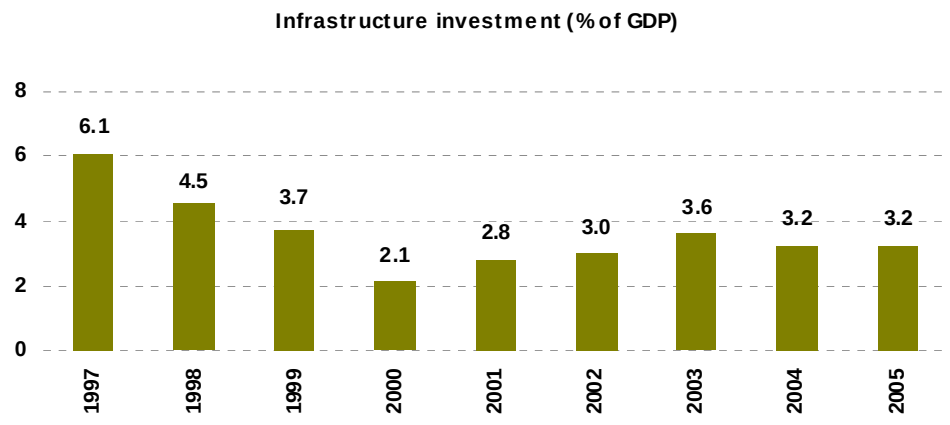
With the emergence of China and India as well as a number of low-cost competitors such as Vietnam, Indonesia can no longer rely on its traditional manufacturing export base. Growth of traditional manufactured exports such as textiles, garments and footwear is slowing. Indonesia instead needs to keep pace with its East Asian neighbors in developing new globally competitive clusters. There are some signs of hope; there has, for example, been rapid growth (37 percent in 2007) in exports of transport-related equipment (e.g. automotive components), however, more clearly needs to be done. The two main priorities are to alleviate infrastructure bottlenecks and reduce the policy, regulatory and legal uncertainty that currently characterizes Indonesia's investment climate.

7. c. Alleviating infrastructure bottlenecks

Indonesia has poor levels of access to infrastructure and investment has declined…

Indonesia has among the lowest levels of access to infrastructure in the region, and infrastructure indicators have actually deteriorated in some sectors in the last decade. Infrastructure investments have declined dramatically since 1996 and, although public infrastructure investment has rebounded since 2000, private investment in infrastructure has yet to recover. Infrastructure investment has risen from a low of 2 percent of GDP in 2000 to just 3 percent of GDP in 2005 which is well below the pre-crisis levels of about 6 percent of GDP.

Figure 7.8: Infrastructure investment, as a percentage of GDP, is about half what it was before the crisis



Sources and notes: World Bank (2007).

…hindering job-creation, competitiveness and economic growth

The poor quality of Indonesia's infrastructure appears to be a significant deterrent to job-creating investment and has hindered Indonesia's competitiveness. Although business perceptions of Indonesia's investment climate have improved, there are no signs of progress, and some of deterioration in the area of infrastructure. Better infrastructure will also be critical if Indonesia is to accelerate growth. Both cross-country analyses and time-

series evidence from Indonesia's own past history suggest that the strength of an economy's infrastructure is closely associated with the economy's growth performance.

The government has initiated a number of regulatory and institutional changes…

Recognizing its potentially catalytic role in accelerating growth, the government has made infrastructure a major economic priority and has taken steps to introduce reforms. A National Committee on Policy for Accelerating Infrastructure Provision (KKPPI) was established in 2005. The KKPPI, which is an inter-ministerial committee chaired by the Coordinating Minister of the Economy, is tasked with increasing both public and private investment in Indonesian infrastructure. In February 2006, the Coordinating Ministry for Economic Affairs announced an Infrastructure Policy Package outlining more than 150 policy reform items that aim to encourage competition, to eliminate discriminatory practices that obstruct the private sector's participation in infrastructure provision, and to redefine the government's role, including separating policy-making, regulatory and operational responsibilities. Infrastructure summits held in 2005 and 2006 to solicit private-sector participation were poorly received as many of the showcased projects were not well prepared while there are still policy blockages in the preparation of bankable projects.

…through an integrated approach that establishes a framework for future progress including an Infrastructure Fund with an equity injection from government…

In July 2007 the government issued an integrated economic policy package (Inpres 6/2007) that builds on the previous year's set of policy packages. The package was intended to identify and spur action on regulatory and institutional reform in four broad areas including infrastructure. Reforms in the infrastructure sector were mainly focused on the establishment of what were seen as key laws, regulations, decrees and institutions and on this it was relatively successful. Laws on maritime and rail transport and power were all completed on schedule in 2007, although the implementing regulations are still being formulated. Master plans for 2008 have also been completed for railways and telecommunications. The division of responsibilities between the central, provincial and *kabupaten* governments was clarified by government regulation. The Indonesian Infrastructure Fund was established in 2007 on schedule and in August 2007 the government committed to investing equity in the fund through government regulation.

…although this reform has yet to translate into large-scale increases in infrastructure spending

The reforms that the government has taken thus far are commendable but they have yet to translate into large-scale increases in infrastructure spending. Budget execution in key ministries remains low and sub-national governments are still arguing over who should be responsible for infrastructure spending. On the PPP front, progress has been disappointing. More than four years after the first infrastructure summit, Indonesia has yet to conduct a single successful tender for a project in compliance with its law governing PPP. With this in mind, the government issued a new policy package (Inpres 5/2008) to update target dates for reforms that have slipped and provide a new set of priorities for the government's reform agenda. The focus on regulatory and institutional reforms from Inpres 6/2007 has been replaced with output-based measures including, inter alia, the number of kilometers of new toll roads to be built by year end.

PPPs are seen as a key component of the solution to pressing infrastructure needs…

PPP reforms have been a central element of the government's infrastructure agenda. Recognizing that meeting Indonesia's infrastructure needs cannot be financed by the public sector alone, the government has sought to enhance the institutional framework for public-private financing of projects. A PPP Unit was established within the KKPPI as a center of technical expertise in project preparation. The unit is responsible for ensuring that projects proposed by the government's line ministries for possible private sector investment meet stringent international best practice guidelines. The Ministry of Finance has supported the infrastructure agenda with the establishment of a risk management unit and the framework for the creation of a guarantee fund to provide public support for private investment in infrastructure is due to be established in December 2008..

…which are causing bottlenecks and shortages, particularly in the road network which is severely underfunded

Nevertheless, with insufficient investments in infrastructure and strong demand growth, bottlenecks and shortages have begun to emerge. The road network, which is the primary means of transportation in Indonesia, grew by 12 percent between 2000 and 2004, while the number of motor vehicles per 1,000 persons increased by 80 percent. The result, not surprisingly, has been increasing congestion which is expected to increase to 55 percent of the network by 2010. The most important infrastructure constraint faced by firms at the *Kabupaten* level is the poor quality of local roads which are a district responsibility. Estimates suggest annual expenditures on *Kabupaten* road maintenance are around Rp1

trillion whereas the full cost of periodic maintenance of the *Kabupaten* road network is estimated at around 17 times that figure. Moreover, national policies inhibit local governments from implementing performance-based contracts which might improve the quality of maintenance and construction.

Enhanced efficiencies and regulations are needed to maximize public and private investment as well as capacity building for local government…

Improvements in the transparency and efficiency of public infrastructure spending and the regulatory environment for private investments are needed and the incentives and capacity for local governments to undertake infrastructure investment have to be improved. Significant funds have been made available to regional governments through the intergovernmental transfer system in order to finance local infrastructure service delivery, but many regional governments have not put those funds to good use in building the necessary infrastructure. In addition, regional borrowing mechanisms remain underdeveloped, further constraining infrastructure finance and public service delivery.

…by, for example, raising retail tariff levels for electricity which are below costing order to allow service providers to invest in infrastructure…

Demand for electricity has been growing at around 6 percent per year since 2000, but there has been no corresponding growth in available system capacity. PLN made 3.5 million new electricity connections in 1997 but now connects only around 1 million new customers per year. Retail tariff levels remain below cost in almost all infrastructure sectors, including electricity, discouraging investment in new facilities or expansion of existing service networks for critical sectors such as power and water. Despite success in raising fuel prices to ensure macroeconomic stability, the government has struggled to increase other tariffs. The government is addressing the large public service obligation (PSO) payment to the state-owned electricity company PLN and Bappenas completed a blueprint for increasing its efficiency through a better designed tariff system.

…while land acquisition mechanisms also need to be reformed

Land acquisition mechanisms have to be reformed to speed up transport and energy investments. Land acquisition remains a key constraint to infrastructure development in Indonesia and while the National Land Body has issued a set of standard operating procedures consistent with the legal framework in place, no benefits have been seen yet by projects stuck in this phase of development.

7. d. Improving the investment climate by remedying weaknesses and inconsistencies in the regulatory and policy environment

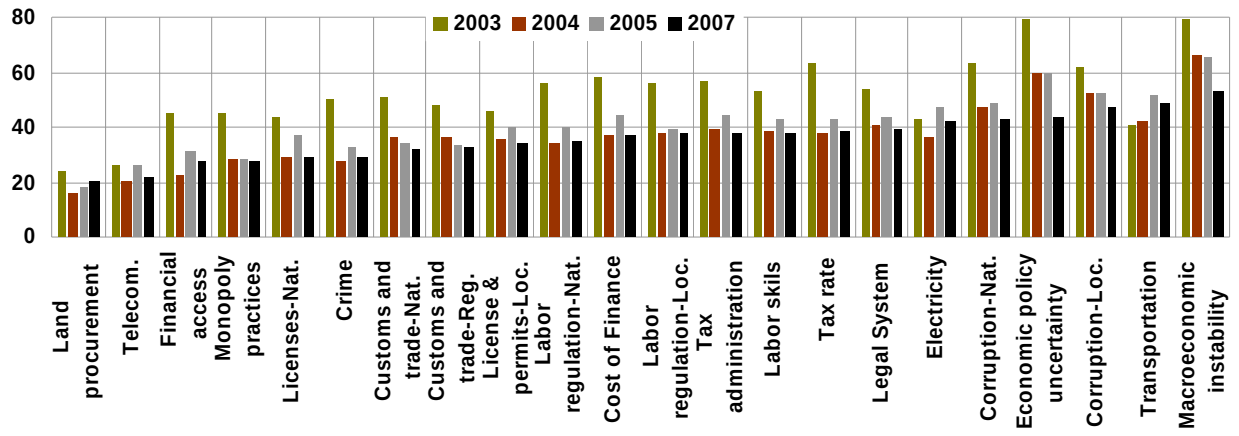
Indonesia's investment climate still ranks poorly in international comparisons…

Indonesia's business environment ranks poorly in international comparisons. In the 2008 *Doing Business* survey, Indonesia was ranked 123rd out of 178 countries in terms of the overall ease of doing business, well behind regional competitors such as Thailand (15), Malaysia (24), China (83) and Vietnam (91) and ahead of only Cambodia and the Philippines. IMD's World Competitiveness Yearbook ranked Indonesia 54th out of 55 countries, well behind the Philippines, India and Thailand. The World Economic Forum's Global Competitiveness Index ranks Indonesia in last place (131st out of 131 countries) in terms of the transparency of government policymaking, and Indonesia is also ranked near the bottom in terms of the quality of infrastructure and labor regulations.

…although business perceptions improved between 2003 and 2007…

Business perceptions of the investment climate have improved since 2003 (except for infrastructure). Concerns about macroeconomic instability, uncertainty regarding economic policy, corruption at both the national and the local level, the burden of taxes, the cost of finance, customs and trade regulations and about almost every aspect of the investment climate have diminished, at least as reflected by the share of firms that report them as major impediments to doing business.

Figure 7.9: Perceptions of Indonesia's investment climate have improved since 2003…
(Percentage of firms who consider the relevant aspect of the investment climate a major or severe obstacle)



Sources and notes: LPEM-UI(2007). See University of Indonesia, Monitoring the Investment Climate: A Report from the Mid-2007 Survey, LPEM-FEUI, December 2007 (in cooperation with the World Bank)

…reflecting the high priority in government policy given to improving the investment climate…

The improvement in perceptions reflects the high priority that the government has placed on improving Indonesia's investment climate. The investment climate is featured prominently in the 2005-2009 Medium Term Plan and has been a central component of the economic reform packages introduced in each of the last three years. Nevertheless, Indonesia still has a long way to go in creating the investment climate needed to accelerate and sustain growth. Macroeconomic instability, infrastructure bottlenecks, corruption, and economic policy uncertainty remain severe obstacles to doing business.

Table 7.3: …but Indonesia still does poorly in international comparisons

Country	Start Business (days)	Firing costs (weeks of salary)	Time to pay taxes (hrs a year)	Enforce a contract (days)
Indonesia	**105**	**108**	**266**	**570**
Thailand	33	54	264	479
Malaysia	24	75	166	600
Vietnam	50	87	1050	295
Philippines	58	91	195	842
China	35	91	872	406
India	33	56	271	1,420

Sources and notes: Doing Business 2008.

...through numerous initiatives such as a new investment law…

A new investment law was submitted to Parliament in March 2006 and enacted in March 2007. The law, which unifies previously separate laws for domestic and foreign investment, mandates equal treatment for foreign and domestic investors and requires that all business activities that are closed or restricted to investors be listed in a single regulation issued by the president. Any activity not listed is fully open to investment. This provision should prevent line ministries from creating their own ad-hoc restrictions on foreign investment. The law also eliminates the limited duration and forced divestiture requirements in the old law (Foreign Investment Law of 1967), allows for binding international arbitration in the event of disputes between the government and foreign investors, provides protection against nationalization and states that expropriation must be based on law and compensated at market prices.

…a landmark tax administration law…

A landmark tax administration law was also passed in 2007 that strengthens the rights of taxpayers and limits arbitrary decision making by tax officials. Taxpayers will no longer be required to pay 100 percent of any tax assessment prior to filing an objection or appeal; only that portion of the assessment which is agreed during the closing conference must be paid before initiating the objection process. The tax office must provide a written explanation concerning the basis for the decision to reject an objection. Taxpayers can request that a tax assessment be cancelled if they were not provided with written findings during the tax audit or if they were not given the opportunity to attend the closing

conference. The new law also reduces the statute of limitations for tax assessments from 10 years to 5 years. The final version of the law was adopted following a lengthy period of consultation between the government and the business community and reflects a new spirit of openness to public-private dialogue on the part of the bureaucracy.

…and a series of economic reform packages…

The government's economic reform program has been articulated through a series of economic policy packages issued in 2006, 2007 and 2008. The first package, entitled *Policy Package to Improve the Investment Climate*, was released in March 2006 and contained 85 specific reform measures across five broad areas: general investment policy, customs and ports, taxes, manpower and SME policy. This was followed by an infrastructure reform package and a finance sector reform package in 2006. A second investment climate policy package was released in June 2007 entitled *Policies to Accelerate Development of the Real Sector and Empower Micro, Small and Medium Enterprises*. This package combined investment climate, infrastructure and financial reforms into a single package covering six areas: institutions, ports and customs, taxation, the financial sector, infrastructure and SMEs. A total of 141 specific actions were stipulated in the package, each with a target date and responsible minister, along with the expected outcome for each action. The government's final reform package, covering the remaining period of the current administration, was signed by the president on May 22, 2008 (Inpres 5/2008). It covers reforms of investment policy, ports and customs, taxes, the financial sector, state-owned enterprises, energy policy, natural resources, the environment and agriculture, SMEs, implementation of the ASEAN Economic Community agreement, infrastructure and labor.

Table 7.4: Indonesia has taken some significant steps in investment climate reforms

- Issuance of comprehensive investment negative list that includes all restrictions in a single more transparent presidential regulation, thereby reducing official discretion and limiting the ability of line ministries to create their own ad-hoc restrictions;
- An acceleration of the VAT refund system for exporters, with "gold list" taxpayers promised refunds in 7 days, low risk exporters in two months and medium risk exporters in four months; and settlement of more than Rp 10 trillion in outstanding VAT claims owed to exporters;
- Establishment of a complaint management system and a code of conduct for tax officials;
- Launching of the Indonesia National Single Window for trade facilitation at the main seaport;
- Simplification of business start-up and licensing procedures; and
- A new law on electronic transactions that provides a legal basis for e-Government.

Sources and notes: World Bank staff.

…that have boosted business confidence…

The impact of these successful reforms is verified in business surveys, which show both improved business perceptions across a wide range of indicators and measurable improvements, such as reduced incidence of paying bribes, faster port and customs clearance and faster tax refunds.

…despite the slow pace of implementation of reforms

Judged from the volume of reform legislation, the accomplishments have been significant, however there is a widespread view that implementation has been less successful. This partly reflects the inherent inertia and resistance to change that is common in any bureaucracy but is also compounded by a lack of coordination within the government as well as uncertainty about legal and judicial intervention. The local level investment climate is a particular concern because of inconsistent and often arbitrary regulation imposed by local governments.. Three examples can illustrate this problem.

Box 7.1: Delays and difficulties in implementing investment climate reforms: three examples

Investment procedures decree

The first investment climate package, issued in March 2006, stipulated that a revised Investment Procedures decree would be issued in conjunction with the new Investment Law. One of the main objectives of this decree, as explained by the president in August 2005, was to replace the existing investment approval system with a simpler registration system. Disagreements within the government, between the economic ministries on the one hand and the Investment Coordinating

Board on the other, prevented this decree from being finalized on time. It was then included as the first item in the next economic policy package (Inpres 6/2007) with an implementation deadline of June 2007. One year later (June 2008) the decree had still not been issued. The government's final economic reform package, signed by the president on May 22 2008, again lists the Investment Procedures decree as the first item with a target deadline of July 2008. Multiple revisions to the decree, and its combination with a decree on one stop shops, have altered the content so that the original objective of eliminating the investment approval system is no longer clear. The drawn-out fate of this decree illustrates the coordination problems that have hindered reform.

Investment Negative List

The 2007 Investment Law stipulates a single comprehensive investment negative list issued as a Presidential decree. The first investment climate policy package (Inpres 3/2006) states that this list will be clear, simple, explicit and transparent. The objective was to create a simple checklist understandable by anyone, eliminating the need for a complex investment screening process dependent on human judgement. Listing all restrictions transparently in a single regulation issued by the president would also prevent line ministries from making up their own ad-hoc restrictions. Unfortunately, in the process of drawing up the new negative list, the line ministries included all of their existing restrictions, many of which were obscure and arbitrarily enforced. Most of these restrictions had not appeared in any previous negative list, making the new list much longer than previous lists. Some ministries also insisted on completely new restrictions. Lacking clear direction from the highest level of government, the bureaucracy issued a new negative list in July 2007 that was considerably more restrictive of foreign investment than previous official lists, (although not necessarily more restrictive than previous practice within ministries). The new negative list also failed to stipulate clearly that existing businesses were fully grandfathered, causing some companies already in operation to be deemed illegal. Ambiguities remained. Once again, the difficulties encountered during implementation reflected a lack of cohesion within the government, with some ministries intent on tightening restrictions on foreign investment and others favoring a more open investment regime.

The 2007 Tax Administration Law

The 2007 Tax Administration Law was viewed as a victory for the business community, which had objected strongly to the draft law submitted to Parliament in 2005. One of the biggest perceived wins was a provision allowing businesses to file a tax objection or appeal without first paying 100 percent of any tax assessment. One year after the new Tax Administration Law was approved by Parliament, however, it became clear that this new provision was not being applied. A little noticed transition article at the end of the law stipulates that the old tax administration law remains in force for "all taxation rights and obligations from tax year 2001 to tax year 2007 which have not been settled." This means that tax assessments for years prior to 2008 continue to follow the provisions of the old law. Given that tax assessments can be issued up to five years after the tax year, taxpayers will still be receiving tax assessments in 2012 that cannot be objected to or appealed without first paying 100 percent of the assessment. While this might not be an implementation failure in a narrow sense, it is a surprise to much of the business community and reflects the tenacity of the bureaucracy at delaying reform.

Source: World Bank.

The challenge now is to improve coordination, reduce uncertainty and complexity…

Uncertainty about government policy, unclear and poorly enforced regulations and excessively complex approval and licensing requirements will continue to be major obstacles to investment in coming years. Weak governance and infrastructure bottlenecks will compound the regulatory problems. The good news is that the main problems are well understood and the government has developed comprehensive reform programs designed to unleash private sector investment for faster growth.

…and overcome bureaucratic inertia and resistance and enhance monitoring and evaluation of government performance

The challenge will be to improve coordination within the government between different ministries and agencies in support of the reform program, and to drive reform against bureaucratic inertia and resistance. Improving the capacity of the government to implement reform will be a necessary element of success, including capacity building for monitoring and evaluation. Building public and regional support for reform will, however, be equally important, as will strengthening the capacity of the private sector to articulate and lobby for a better business environment.

8. Making growth inclusive

Growth needs to be

Public pronouncements and programmatic initiatives reflect the government's desire to

shared and services improved

build a more inclusive Indonesia by making growth more broad-based, improving service delivery and enhancing voice. In particular, in addition to a number of sector-specific initiatives such as the introduction of the ASKESKIN health insurance scheme for the poor and the passage of the Teacher Certification Law to improve teacher quality, the government, in 2007, launched a nation-wide poverty reduction program consolidating and building upon existing models of community-driven development.

8. a. Raising rural incomes by revitalizing the rural economy

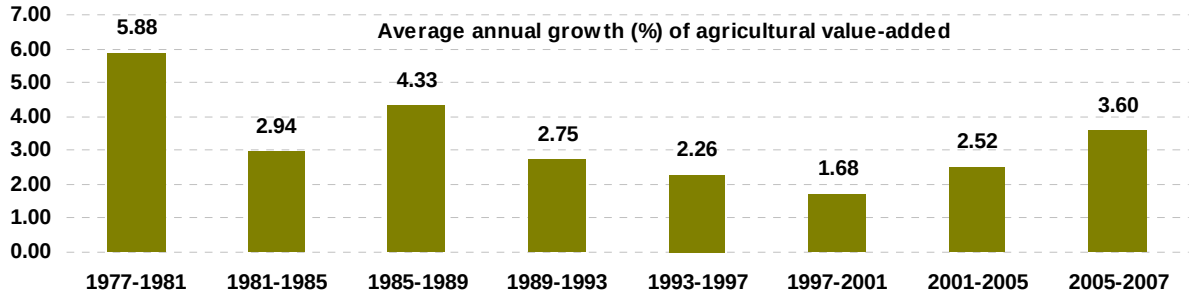
Many of the poor still live in rural areas, so revitalizing the rural economy is critical to making growth more inclusive

More than half of Indonesia's population, and nearly two-thirds of Indonesia's poor lived in rural areas in 2006. On average, rural households derived half of their income from agriculture, with the rest coming from rural non-agricultural activities such as petty trading and seasonal construction work. If growth is to be more inclusive, rural incomes have to grow. That will mean revitalizing the rural economy by raising agricultural productivity and stimulating rural non-farm employment by improving the rural investment climate.

Agricultural growth rates have been falling till recently…

Rural incomes did grow in Indonesia during the 1970s and through much of the 1980s as Indonesia achieved rapid growth in both crop and animal production. "Green revolution" technologies brought large increases in rice yields, and the area under non-food crops grew rapidly outside Java. Agricultural growth rates have fallen, however, since the late 1980s, reaching a low in the first few years after the 1998 crisis before picking up again in the last five years (Figure 8.1.). Continuing the trend from the 1990s, the more rapid recent growth has come primarily from tree and industrial crops, horticulture, fisheries and livestock, which have benefited from rising demand and higher prices. While there has been a shift toward higher value-added agriculture, the shift has remained limited to a few regions and a few commodities within each sub-sector.

Figure 8.1: Agricultural growth rates have been falling till recently



Sources and notes: World Bank estimates using BPS data. Agriculture includes forestry and fisheries activities.

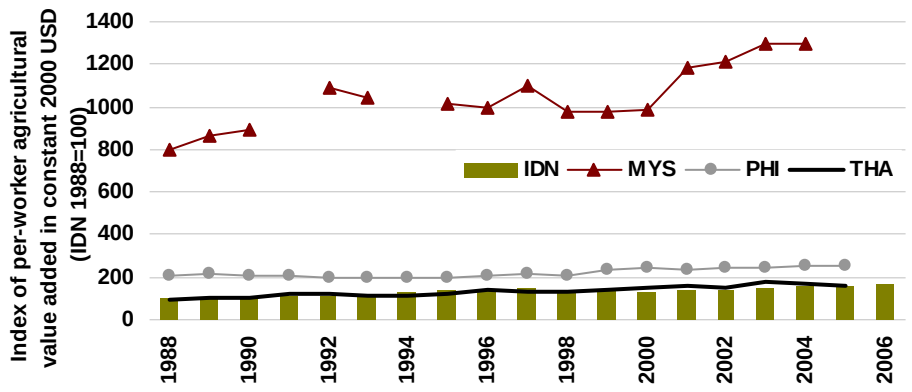
…because both public and private investments in agricultural infrastructure and agricultural support services have declined and resource management has been neglected

A major cause of the agricultural slowdown has been the relative decline in public and private investments in the agricultural sector, particularly since decentralization. Government spending and private investment in agriculture in Indonesia fell in the 1990s as a percentage of agricultural GDP. Investments in irrigation stalled after the crisis leaving much of the current irrigation infrastructure in poor condition. Agricultural research and extension services have suffered serious decline and fewer farmers are actually able to receive such services. Inadequate resource management has resulted in soil degradation in irrigated areas, groundwater depletion, water pollution and degradation of water-related ecosystems, and wasteful use of already developed water supplies. Maintenance has been systematically under-funded, requiring at least one-third of the 3 million hectares of government-designed irrigation schemes to be rehabilitated twice in the last 25 years. Water resources are used unsustainably and growing water scarcity is now projected to further slow irrigated crop yield growth.

Per-worker value-added in agriculture in Indonesia has essentially been stagnant in the last decade

Because the shift to higher-value agriculture has not been more widespread, and because the share of the labor force engaged in agriculture and related activities still remains high, the slowdown in agricultural growth has meant that per-worker value-added in agriculture in Indonesia has essentially been stagnant in the last decade and remains very low relative to other countries (Figure 8.2).

Figure 8.2: Per-worker value-added in Indonesian agriculture has not grown much in the last two decades and is low relative to other countries



Sources and notes: World Bank estimates using WDI data. Agricultural value added per-worker in constant 2000 USD is converted to an index with the value for Indonesia in 1988 being set equal to 100.

Technical options to raise agricultural yields are limited so boosting rural incomes will require diversification into higher-value added activities and the development of agricultural supply chains…

The technical options for directly raising agricultural yields are currently limited, and have been since the early 1990s, especially for rice. Although genetically modified crop technologies hold hope for the future, there are few immediately applicable new technologies available to provide a significant boost to yields. Raising rural incomes will therefore require promoting the diversification of agriculture into higher-valued added activities and the development of agricultural supply chains. To a certain extent this is already happening but more could be done. Changes in consumption patterns and retailing networks have induced rapid growth in supermarkets, which have begun to influence the agricultural production structure, processing, handling and marketing systems. Diversification is especially important in the estimated 24 million hectares of agricultural dry-land where measures which encourage livestock, vegetable intercropping, reforestation of small areas with high-value wood species and diversification into cashew or fruit could all contribute to more stable incomes and poverty reduction.

…through new more participatory approaches to research and extension services involving the private sector and civil society…

New approaches will be required in the context of the changed institutional environment. There is growing evidence of significant benefits to decentralized extension systems that involve the private sector and civil society which need to be replicated nation-wide and strengthened. Governments, specifically local governments, need a paradigm shift from (i) top-down to participatory approaches, (ii) input and technology dissemination to dissemination of market and upstream information and technology, and (iii) from centrally managed extension services to decentralized services, as well as some movement toward privatization of extension services**.** Privatized extension services will assume greater importance in the dry-land cash cropping sub-sector in Eastern Indonesia since exportable commodity production is being increasingly supported by the private sector. The present political climate of Indonesia also provides a more conducive environment for a range of rural producers' organizations (RPOs) than was possible in the past. In all of these initiatives, it is important that measures are put in place that better link agricultural research and extension; the separation of these functions within the Ministry of Agriculture (MoA) has militated against ensuring focus on farmer's problems when setting the research agenda.

…by developing the market-supporting product regulation regime…

Indonesia's agricultural product regulatory framework is quite developed but attention is needed to capacity building, maintaining the integrity of national systems with decentralization and focusing on assisting small holders to meet trade specification requirements. Private markets depend on an effective and streamlined regulatory environment, including grades and standards, food safety, bio-safety and environmental regulation in order to lower transaction costs. Regulations must also be matched by a partnership with traders, processors and producers in a system of effective (and transparent) self-regulation. This will be important not just for domestic consumer

protection and safety, but also to gain and maintain access to international markets. Importing countries are increasingly tightening the quality/safety requirements for food products, including measures that permit "traceability" of the product all the way back to the farm level. Without attention here, a focus on productivity gains for farmers could fail to translate into welfare gains if market outlets are limited.

…and by clarifying land use rights through land titling, where appropriate

Less than 25 percent of holders of rural land parcels have a formal land certificate, compared to almost universal possession of land use certificates by farmers in China and Vietnam. The small number of land owners who possess a formal certificate of ownership is also a constraint to access to credit. Although alternatives exist to the use of land certificates as collateral for loans, Indonesia's underperformance on land administration is a major constraint to expansion of commercial microfinance. Analysis demonstrates that rural recipients of land certificates borrow more, invest more, and earn more from their land-based economic activities (SMERU, 2002). Moreover, around 64 percent of Indonesian land is classified by the Ministry of Forestry as forest land and is therefore administered under the Basic Forestry Law of 1967 (UUPK). UUPK precludes individual land tenure despite the fact there are private dwellings, farms, and even cities on this land. Moreover, some forest land overlaps with land that previously enjoyed traditional land rights (*adat*) adding further complexity. The government has titled over a million parcels of land since 1997, increased capacity at the National Land Agency, and carried out a comprehensive review of the policy and legal reforms needed to modernize the land system under democratic, pro-poor principles. Titling of non-forest land has, however, been slow with only about 25 percent of the nation's estimated 80 million land parcels having been registered in the 40 years since land registration began. If the current pace of registration continues, it would be difficult for land registration to catch up with the growing number of parcels. Moreover, a large share of land off-Java is communal land and private titling of this land may work against the poor and increase conflict. It is, therefore, important that the process of titling is closely supervised in terms of the costs and benefits it accrues to the poor.

Access to credit and poor infrastructure also impedes the growth of small non-farm enterprises and employment in the regions…

The results of the Indonesia Rural Investment Climate Survey show that demand constraints, access to credit, poor roads and unreliable electricity supply top the list of concerns faced by rural micro and small enterprises. This is in marked contrast to macroeconomic instability, policy uncertainty, corruption, the legal system and taxation issues that are the main concerns of large formal firms. Thus a different emphasis is needed both at the national and the regional level to stimulate the growth of micro and small non-farm enterprises in the regions.

…so subsidies should be provided to extend the reach of financial services and enhance their management systems

Access to financial services for micro and small enterprises has been hindered rather than helped by years of subsidized credit programs. Rather than making borrowing cheaper, subsidies should provide incentives for extending the reach of financial services, for example, by extending the successful P4K program which connects rural household enterprises to the formal commercial banking system. Improving the Debtor Information System so that repayment history can become an asset is also a critical need. Bank Indonesia's current Debtor Information System only records outstanding debts. This system needs to be developed to include repayment records both for loans and ultimately other forms of regular payments too. In addition records of repayment to non-bank financial institutions should be included too. In the longer term the government should move towards the creation of private credit bureaus with Bank Indonesia acting as a credit data wholesaler.

8. b. Facilitating the transfer of labor from low-productivity activities in agriculture to higher-value added activities elsewhere

Raising rural incomes will also mean speeding up the transfer of labor from agriculture to higher value-added activities elsewhere.

Raising rural incomes will also mean speeding up the transfer of labor out of agriculture to higher value-added activities elsewhere. Slow growth in high value-added jobs is explained in part by the weaknesses in Indonesia's investment climate but restrictive labor market institutions and policies appear to have also played a role. Indonesia's employment protection legislation is amongst the strictest in East Asia.

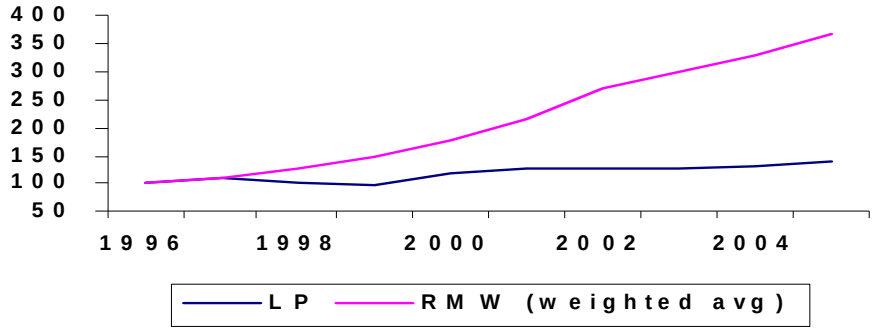
Minimum wage

Minimum wages, which since the decentralization in 2001 have been set at the provincial

legislation needs to be simplified to be effectively enforced…

level, increased sharply (by an average of 19 percent) in real terms between 1998 and 2003 at a rate well above the growth in labor productivity, meaning that the minimum wage is high as a percentage of the median wage.. At the same time, there is wide recognition that weak enforcement of the legislation means that many workers are not protected - particularly those laid-off from smaller and medium-sized firms. Legislation needs to be simplified to increase firms' compliance and the promptness of payments, and lower the potential for litigation, red tape and corruption emerging from the difficulty in interpreting the law. Employers tend to see the prevailing minimum wage not as a floor wage - protecting vulnerable unskilled workers, but more as a relatively high entry level wage in large firms.

Figure 8.3: Minimum wages rose substantially between 1999 and 2003

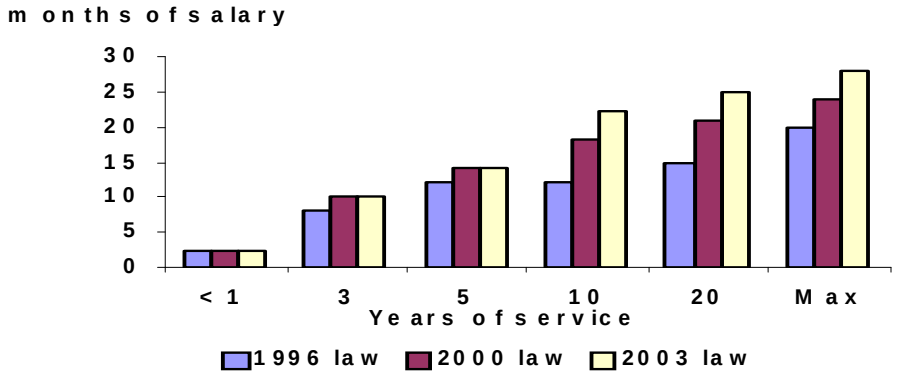


Sources and notes: Selected country labor laws. Severance pay rates are for workers with a tenure of 4 years who were dismissed for economic reasons.

…while high severance payments that make it expensive to fire labor…

Severance pay rates have continuously increased since the mid-1990s and, on paper, the costs of firing workers are extremely high by both regional and global standards. Since 1996 the government has increased severance pay rates and coverage three times. Traditionally, severance pay acts as an unemployment benefit for most wage workers in the formal sector. During most of the Suharto era, severance pay rates and general compliance with the labor legislation were reportedly low. In combination with a repressive political regime, hiring and firing costs were relatively low for employers, resulting in a very flexible labor market, but at the expense of workers' rights and conditions (Manning 1998, Suryahadi, Widyanti and Sumarto 2003).

Figure 8.4: Mandated severance pay in Indonesia increased sharply between 1999 and 2003



Sources and notes: UNPAD (2004)

…and are viewed as barriers to investment…

While the exact empirical impacts of high severance pay rates on employment trends are still being researched, labor regulations are regularly perceived as significant barriers in investment climate surveys. Anecdotal evidence also suggests that many firms fail to pay out mandated severance pay rates, raising worker's income insecurity in the absence of a formal unemployment insurance scheme (LPEM-FEUI Investment Climate Surveys, ADB-

WB Investment Climate Survey 2005). Together with high minimum wage rates, firms in the labor-intensive manufacturing sector were likely facing substantially higher labor costs, which in turn might have reduced the willingness of employers to absorb more labor, especially from the ranks of the young, female and rural labor force.

Figure 8.5: …and the severance pay rates Indonesia mandates are the highest in the region

Sources and notes: Selected country labor laws. Severance pay rates are for workers with a tenure of 4 years who were dismissed for economic reasons.

…so reform is needed in labor costs, especially severance pay and minimum wages which should be set as a safety net	From a policy perspective, reforms in these two areas of labor policy should be prioritized. In the case of severance pay rates, the government is currently drafting a new regulation aiming to reform the severance pay system. In the case of minimum wage policies, reforms should aim to use minimum wages as a safety net wage for lowest paid workers, based on realistic and professional estimates of basic living indexes, which provide the basis for provincial wage councils to recommend the level of the minimum wage.

8. c. Improving the poor quality of, and limited access to, water and sanitation services

Access to water and sanitation services is one of the lowest in the region…

Local governments in Indonesia have historically had significant responsibility over water and sanitation services, in the case of water these services have been provided through utilities that they own and manage. There are over 315 public water utilities (PDAMs) operating in Indonesia - many are too small, with limited customers, low tariffs and weak management, but their main problem is a lack of access to finance for investments. Investments in the water and sanitation sector have sharply declined since the financial crisis, from an average of USD400 million in the 1990s to under USD45 million in 2005. It is estimated that government spending on the sector is about one-tenth of the level needed to achieve 2015 MDG targets. It is not surprising that access to water supply and sanitation in Indonesia is among the lowest in the region.

…due to poor policy, insufficient funding and an absence of clear lines of responsibility

Investment has dried up due to inadequate sector policies, unclear allocation of responsibilities and insufficient financing that has left local utilities in crisis. Inadequate financing has resulted in unpaid debts, arrears accumulation, deferred maintenance and deteriorating services. About 65 percent of PDAM loans with the MoF are in arrears or in default, accounting for USD500 million in debt. PDAMs that are in arrears on past loans from the central government are now prohibited from borrowing again for infrastructure development. Plans for restructuring, rescheduling, and/or writing off PDAM debt, which would allow renewed borrowing have been slow to evolve. Water losses, both physical and administrative, account for up to 60 percent of PDAM production.

Key priorities are tariff reform, debt re-structuring, market-based financing of infrastructure and performance-linked subsidies

Tariffs are set well below cost recovery levels by local governments. The average water tariff for low-income households in Indonesia is less than 50 percent of the lowest tariff in Vietnam, and far below those of other ASEAN countries. Key sector priorities, therefore, include tariff reform and the debt restructuring of water utilities. A more market-based system of financing PDAM infrastructure, perhaps using non-public financial intermediaries and/or various forms of credit enhancements, needs to be developed. Performance based subsidies (Output Based Aid) should be developed to target the poor and to increase efficient service provision.

8. d. Restructuring the health system

Indonesia's health system is at a critical

Indonesia's health system is at a critical juncture and needs to be restructured. It faces the

juncture and needs to be restructured to ensure sustainability

multiple burden of improving key lagging outcomes, better controlling communicable diseases such as TB, dealing with emerging and re-emerging diseases such as HIV/AIDS, avian influenza and polio and addressing changing disease patterns, in particular the rising incidence of non-communicable diseases, all of which present new challenges in terms of disease surveillance, control and immunization. At the same time, with the move towards universal health insurance coverage, Indonesia must address fundamental questions regarding the design, affordability and sustainability of alternative financing and implementation mechanisms of such coverage.

Indonesia is transitioning to universal health coverage to cope with demographic, epidemiological, and nutritional change…

Like many other emerging middle income economies, Indonesia is experiencing simultaneous demographic, epidemiological and nutritional transitions as population growth slows, the population ages and growing incomes and changes in lifestyle shift the public health focus to non-communicable diseases. These transitions are putting additional pressures on the health system and will require a different, more expensive health system in the not-too-distant future, especially since Indonesia is one of a small but growing number of middle income countries that have made the decision to transition to universal health insurance coverage for its population.

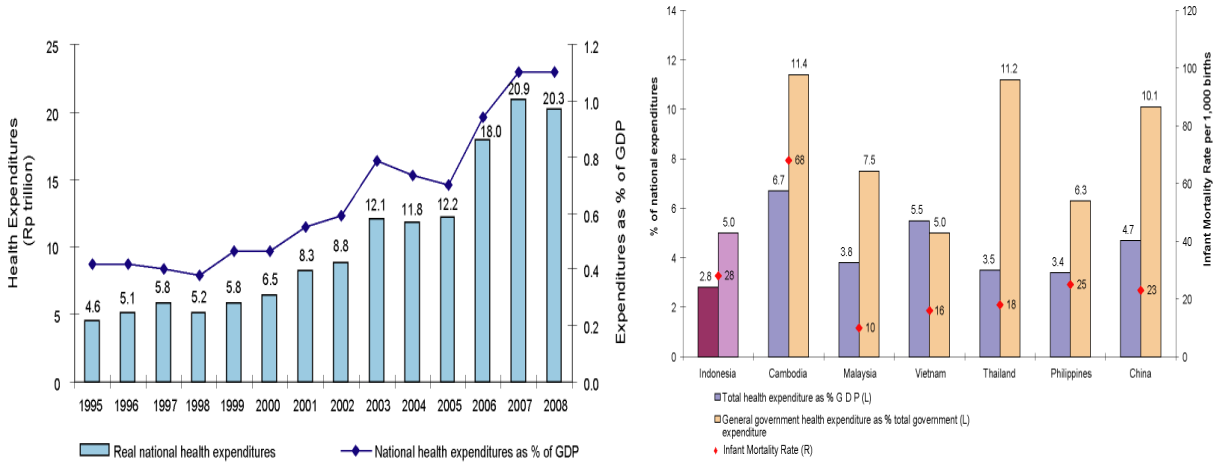
…and the challenge of improving priority health outcomes and reducing geographic and income inequities within an imperfect decentralized system

At the same time Indonesia faces the immediate task of reversing the stagnation which has occurred since 2000 in priority health outcomes such as maternal mortality and child malnutrition rates as well as reducing large geographic and income inequity. Improvements are also needed in the district-based health system, which is still adjusting to the 2001 decentralization that shifted half of all public health financing to the district government level, with provincial and central governments spending 18 percent and 33 percent respectively.

Under-funding may be one reason for the poor performance of Indonesia's health system…

The health system, overall, faces problems of under-funding. Though public expenditures on health rose from 0.4 percent of GDP in 1998 to around 1.1 percent in 2007, the level of spending still remains low in comparison to Indonesia's neighbors in the region. The decentralization of public health services to the district government level has compounded the problem. There is very limited health insurance coverage and financial protection for the poor who also incur half of all health spending directly out-of-pocket, hurting them further.

Figure 8.6: Public health expenditures have risen in the last decade but are still a lower share of the budget than they are for Indonesia's neighbors …



Sources and notes: World Bank estimates from Ministry of Finance data. Expenditures in constant 2000 rupiah prices.

…but it is not the only or even the main problem as fragmentation and inefficiencies resulting in low quality and low utilization rates of public

The low level of public spending is, however, not the only or even the main problem. Capacity to spend and the efficiency of spending, especially at the local level, are arguably even more serious problems. Fragmentation, allocative and technical inefficiencies, low productivity and poor quality have resulted in low utilization rates of both public and private facilities and high rates of self-treatment. Utilization rates of public and

facilities are a major reason for inequities in health access

private facilities, both out-patient and in-patient services have declined since the 1998 crisis, falling to a low of 34 percent in 2006. The latest figures point towards an increase in utilization of public services in particular between 2006 and 2007, most likely due to the government's insurance program for the poor, but utilization rates still remain low with only about 40 percent seeking treatment for an illness. Differences in utilization rates between poor and richer households are a major source of inequity in healthcare access and the main reason why health spending is regressive.

Decentralization has not delivered better services while a confusion of roles and responsibilities between the local and national governments…

Experience from around the world suggests that a decentralized model of service delivery can be a potentially important tool for improving accountability of front-line service providers and hence the quality of services. Since decentralization in 2001, this potential has yet to be fully realized. A lack of professionalism, non-compliance with good practice protocols, high absenteeism (e.g., 40 percent of medical doctors being absent without valid reason during official public working hours), uneven deployment and low motivation in the health workforce are common problems. Decentralization has indeed put more money and responsibility in the hands of local officials, but there continues to be serious confusion concerning the division of roles and responsibilities between local governments and the Ministry of Health (MoH) at the national level. There is very little correlation between health spending and health outcomes at the district level, even though decentralization has started improving fiscal inequities. There are still mismatches in the revenue sharing formulas with respect to accommodating differences in local fiscal capacity and need. After initial progress in decentralization, the MoH appears to be responding to emerging constraints by attempting to re-centralize certain functions while also continuing to apply a uniform service delivery model that does not address a range of different contexts and that risks causing further confusion of roles and responsibilities.

…needs to be clarified to improve service delivery that requires a holistic approach to the health sector to build the capacity for greater local autonomy and enhance the role of the private sector

In order for the GoI to develop an appropriate 5 year plan and to implement its ongoing reform efforts it needs to address all aspects of the health sector including health systems' constraints and other sector impacts on health (e.g. water and sanitation). The MoH stresses maintaining the broad policy settings of the last two decades that call for public funding and provision of healthcare and the uniform implementation of the public health model across diverse settings throughout the country. Making decentralization work will involve building the capacity of institutions at the local level, finding models to ensure the delivery of core public health functions, and transitioning the MoH to its new stewardship/regulatory role whereby hospitals are given greater autonomy. A purchaser-provider split where money follows patients should be implemented. The government has to better recognize the role of the private sector and of decentralized public health institutions, providing guidance and regulation of services such that the benefits of privatization and decentralization are fully captured.

The establishment of JAMKESMAS has made a start in delivering more equitable outcomes although better targeting will be important…

Indonesia also needs to address the implementation and financing challenges brought about by the passing of Law 40/2004 that established the National Social Security System (NSSS) as the starting point for universal health insurance coverage and a holistic reform of the social security system in Indonesia. With the introduction of the ASKESKIN program for the poor in 2005 (now called the JAMKESMAS program), an important step was taken towards achieving this goal. JAMKESMAS is the successor to earlier experiences in providing health cards to the poor, and positive results are starting to show with regard to increased coverage of the poor and increased rates of utilization of public facilities by the poorest quintiles. Fundamental fiscal questions remain regarding the affordability and sustainability of the proposed new health insurance system. With increasing coverage and access to private health care, it will be important to better target government funds to public goods and to subsidized services for the poor.

…to achieve the best outcome from health financing reforms…

The government's health financing reforms face key challenges including: defining the basic benefits package; finding appropriate mechanisms to enrol and the financing of non-formal sector workers. There is also a need to ensure that adequate and equitable financing is available and appropriately balanced among individuals, the national budget, local revenues and through the intergovernmental transfer system. Finally, the GoI needs to develop a transition plan based on local evidence, global best practice and the fiscal and institutional realities facing the country.

…including the key priority of establishing a provider payment system based on outcomes

Provider payment is one of the key areas for reform and an area in which Indonesia's traditional salary, capitation of public health centers, budgeting systems for public hospitals, and fee for service for private providers needs serious upgrading and modernization. Although current spending levels are low, Indonesia, like many countries, faces serious efficiency, access and quality problems. There is urgent need to develop and implement modern payment systems based on 'results' rather than inputs and eliminate supply side subsidies in favour of a 'money follow patients' system in order to encourage technical and allocative efficiency, equity, quality and create 'a level playing field' for the private sector.

8. e. Providing quality education for all

Education is central to the Government of Indonesia's development agenda with a focus on equity, quality and governance...

Education is central to the Government of Indonesia's development agenda. Education spending has significantly increased in recent years and since 2006 national education spending has been higher than for any other sector, exceeding 16 percent of total expenditures, or 3.5 percent of GDP. Indonesia has a constitutional target of allocating 20 percent of the central and local budgets on education. In 2002, the government reaffirmed this spending target and revised the Constitution to emphasize the right of all citizens to education. Furthermore, Law 20/2003 states that there should be no fees for basic education. The Ministry of National Education has chosen a three-pronged development approach with the current five-year (2005-2009) development plan (*Renstra*) focusing on equity and expansion of access, quality, relevance and competitiveness, and governance and accountability. .

…while the most important challenge is getting better outcomes from spending…

The most important challenge is to improve the quality of education spending. Indonesia continues to rank poorly in international standardized tests of student performance, experiences high drop-out rates as well as lower access to junior secondary education. The cost of even primary education remains high for many, especially poor households. School fees and various other school-related expenses create barriers to the poor's access to education and 44 percent of households in the two poorest quintiles report difficulties in financing education for their children. The central government's School Operational Assistance Grant (BOS) program as well as a recently introduced CCT is aiming to improve access for the poor.

Box 8.1: Indonesia's BOS (School Operational Assistance Grant) Program

The BOS system of direct transfers to schools was introduced initially as a scholarship grant program to mitigate the effects of the government's radical fuel subsidy adjustment in 2005 and stabilize the enrollment of children from Indonesia's poorest households. The introduction of BOS served to maintain enrolment levels and to prevent dropouts during a critical period. Quickly thereafter – reflecting the needs of school managers – the program evolved into a general purpose grant for operating costs.

The BOS program amounts to USD1.3 billion, which represents 23 percent of central government education spending and about nine percent of total public spending on education. While BOS represents a small share of total education spending, it is Indonesia's most significant policy reform in education financing in two important aspects: (1) grants are based on a per-pupil formula, and (2) funds are directly channeled to the school. It is the first time in Indonesia that Government funding has been used to support enrollment of pupils rather than the recruitment of additional teachers or other input-focused investment. At the school level the BOS program also provides incentives for headmasters and teachers to focus on maintaining and increasing enrollment levels. The program empowers school managers by allowing them to choose how to allocate the BOS grants and thereby enhances the sense of ownership, encouraging school based management.

After two years of operation, there are indications that BOS has been successful. Not only was there no significant drop in enrollment or increases in drop-out rates in a period of hardship for households, but, in fact, improvements have been recorded since 2005. Three-quarters of households surveyed in a preliminary evaluation reported that they had benefited from BOS funds and over half of the households reported that school fees have been reduced as a result of BOS. Some 90 percent of schools reported receiving the grant in line with their expectations based on enrollment. On average, school fees were reduced by 37 percent in primary schools and 39 percent in junior secondary schools (in real terms).

Source: World Bank.

…through, for example,

The distribution of teachers is inequitable with remote schools often being understaffed

the more equitable distribution of teachers to provide additional resources…

with teachers having lower educational levels. Nevertheless, Indonesia overall has one of the lowest student-teacher ratios in the world, indicating an overall surplus. This is due to inefficiencies and imbalances among urban and rural areas. It is estimated that if a more efficient teacher distribution system is used, the teaching force could be reduced by approximately 20 percent, freeing up resources for other areas of education.

…and improving the quality of teachers through setting standards and certifying and rewarding teachers…

The government is attempting to remedy the unevenness in the spatial distribution in the numbers and quality of teachers with the passage of the Teacher Certification Law (UU14/2005) and the provision of incentives to teachers to locate to more remote areas. The law lays the foundations for a massive teacher certification program which is one of the largest civil service reforms in the world and is expected to take 10 years. The program is a central government initiative to set standards for teachers, upgrade their skills, and ultimately improve the quality of education. The costs of certifying, training and allowance payments imply considerable new investments in education by the government. New incentives will significantly increase teacher salaries including the professional incentive (for certified teachers) and the special area incentive (for teachers working in remote and other hardship areas) that are equal to the teacher's base salary.

…in order to enhance learning outcomes and produce better qualified graduates

Indonesia lags behind in terms of quality of schooling and learning outcomes. Decades of rapid expansion of enrollment have not produced graduates with the consistently high quality of knowledge and skills needed to build a strong society and competitive economy. Indonesia participated in the OECD-sponsored PISA study in 2000, 2003, and 2006. The results show that Indonesian students have improved their performance in reading and math skills, but they still lag behind other lower middle income economies in the sample. As well as unqualified teachers, a key reasons for the low quality of Indonesia's school graduates is an ineffective learning process (focused too heavily on theory and rote learning). Only four of Indonesia's higher education institutions made the Asiaweek 2000 ranking of top Asian universities, with the best ranking only 61 out of 77.

Improving governance and increasing accountability is important in the decentralization era…

The decentralization process, which began in 1999, has left responsibility and accountability for many education areas vague. Recently there has been a strong push for faster and more complete implementation of the decentralization policy. Although the districts have already taken the responsibility for the delivery of primary and secondary education for several years now, public expenditures at the district level are still largely supported by the general allocation fund (DAU) and the special allocation funds (DAK). Assistance provided to districts still often comes in the form of in-kind funding and/or so-called block grants for narrowly defined categories of inputs and activities.

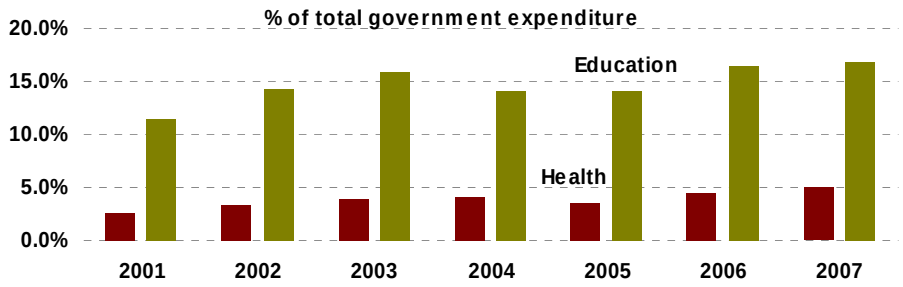
…although there are concerns about the capacity of local government to use funds effectively

There is concern about the capacity of local government to use these funds appropriately. There is no clear and efficient definition and assignment of functional roles and responsibilities and often a misalignment of responsibility and authority. There is a lack of effective management systems and skills (generic and system-based) to implement the reform. Information collection, which was considered to be good before decentralization, has collapsed as many districts no longer turn in data and there is a lack of monitoring and evaluation. The reconstruction of the basic architecture of information collection is essential in order to make more informed policy decisions and properly target programs.

8. f. Improving the allocation and efficiency of expenditures in the context of a decentralized Indonesia, not financing, is the main challenge

The allocation and efficiency of cross-sector spending needs to be improved to improve government efficiency and deliver better services	Spending on health and education has increased during the last 5 years but there are other challenges. These differ across the different sectors and services but a common thread is the need to improve the allocation and efficiency of expenditures. Indonesia now faces the challenge of improving public services and reducing inequalities in accessing them. Despite increased public spending in health and education post decentralization, progress in service delivery is mixed. Rather than focusing solely on increasing public spending, there is merit in a three pronged approach that (i) increases the accountability and incentives of government agencies and providers (ii) strengthens the role of clients in service delivery and (iii) makes inter-governmental relations work.

Figure 8.7: Spending on health and education has increased



Sources and notes: World Bank estimates from MoF data.

8. g. Community-based approaches such as the PNPM offer one means of addressing that challenge by enhancing voice and accountability

Community-based programs such as PNPM and CCT offer the means to improve accountability and effectiveness…

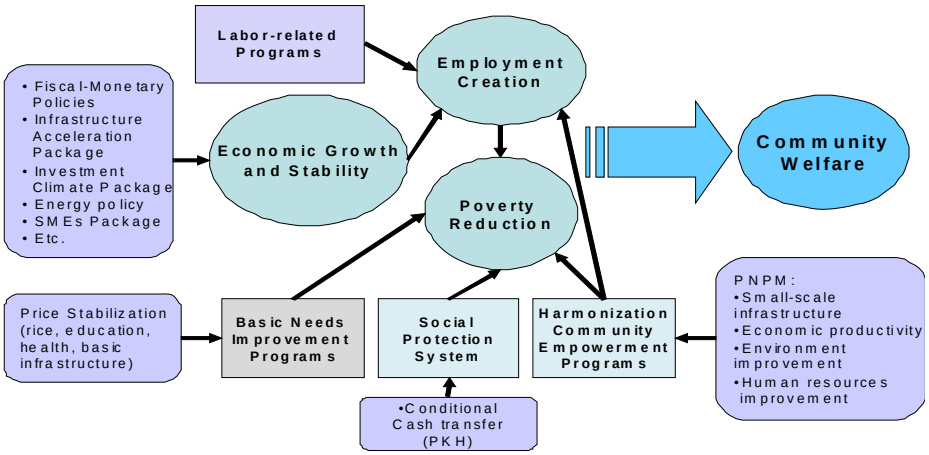
To promote more broad-based post-recovery growth, in August 2006 the Government of Indonesia (GoI) launched the first nationwide poverty reduction program. It comprises two primary pillars: (a) the National Program for Community Empowerment or *Program Nasional Pemberdayaan Masyarakat* (PNPM); and (b) the Conditional Cash Transfer (CCT) Program targeting poor communities and households. A number of sectoral programs are linked to this main umbrella in ways that are expected to increase over time. The Ministries of Education and Health, for example, are expected to target their investments and measure their effects in parallel with the entry of PNPM into poor communities.

…and to deliver benefits to the poor

The government has produced a clear strategic framework for PNPM. The program is part of a much bigger effort to reduce poverty, as shown in Figure 8.8. **Error! Reference source not found.**. The five focal areas for the 2008 poverty reduction action plan are:

- stabilizing prices for basic commodities used by the poor;
- promoting pro-poor growth, with a special focus on small and medium enterprises;
- increasing access of the poor to basic services such as health, education, water and sanitation;
- developing safety nets, primarily through the conditional cash transfer system; and
- consolidating and expanding the community development programs.

Figure 8.8: The strategic framework underpinning Indonesia's poverty reduction efforts



Sources and notes: Bappenas, 2007.

PNPM provides the umbrella for community-driven development…

PNPM will provide an umbrella framework for all community-driven development interventions in Indonesia, which at present number somewhere between 60 and 114 nationally as well internationally-funded community development projects. By consolidating these often overlapping programs under a single framework, PNPM will create a unified design for program delivery, ensure better national targeting of the poorest, the direct transfer of funds to villages, and increased allocations for block grants.

…but finding an effective management framework will not be easy…

Managing the scaled-up national program effectively requires a permanent management framework and finding a sustainable, effective management framework for the scaled-up program will not be easy. Several different options are being discussed. Parliament is suggesting that physical works all be under Public Works but the management of facilitators, local government and training be placed under Home Affairs. Another option is to create a cabinet level *Badan* (Board) similar to the BRR which was created for post-tsunami Aceh and Nias. PNPM's steering committee will review options throughout the project period and propose a preferred management framework to parliament in 2009.

…and future funding is still uncertain

Reaping PNPM's benefits depends on full funding at an average of Rupiah 3.0 billion (approximately USD330,000) per sub-district. Employment and poverty benefits from PNPM are very sensitive to reductions in funding. The Cabinet has already approved in principle full funding, however Indonesia's parliament has only approved funds to 2009. Furthermore, a portion of the approved budgets are consolidated and repackaged existing programs rather than the addition of new resources. The GoI's 2008/2009 budget negotiations will be crucial in assessing the expected benefit stream of the whole PNPM program.

9. Ensuring growth is sustainable

The government is committed to more sustainable growth and development, including environmental sustainability

The government and political leaders are also paying increasing attention to the need for more sustainable growth and development. The 2004-2009 RPJM had three main priorities, and within those a number of targets, one of which was environmental sustainability. This was reflected most recently in the stated commitments by the Indonesian Government, as host of the December 2007 13th Conference of Parties, to put climate change at the top of Indonesia's development agenda.

Although the regulatory framework is improving implementation, enforcement and technical capacity are inadequate

Indonesia's administrative and regulatory framework for environmental management is improving, but remains weak at the level of implementation and enforcement. Implementation and enforcement of rules and procedures has been poor and slow due to weak commitment by sectoral agencies, low awareness in local departments and officials, and capacity challenges at all levels. Environmental institutions, roles and responsibilities are fragmented and coordination mechanisms at national and local levels are poorly defined. One of the key needs is to improve the effectiveness of the environmental management framework by improving technical capacity - human financial and technical resources - especially at the local level which, post-decentralization, has an important share of environmental management responsibilities.

9. a. Managing Indonesia's forestry and marine resources sustainably while providing adequate livelihoods

Poor environment and natural resource management threaten future growth prospects

The GoI recognizes that resource degradation poses a risk for continued growth and development. The Country Natural Resource and Environmental Analysis (Bappenas, 2007) addresses concerns related to energy, water, forestry, mining and climate change. "Negative externalities from inappropriate or inadequate environmental management and over-utilization of natural resources" can undermine future growth prospects by degrading water quality, increasing competition for water quantity, declining quality of air and soils, and contributions to GHG emissions.

Improved forest and watershed management would have widespread benefits across society…

Indonesia's forests and watersheds are a concern because of their social, economic and environmental importance in promoting high quality economic growth and lasting poverty reduction. Indonesia has the world's third largest area of tropical forest and globally significant biodiversity. Improved forest management is essential for improvements in decentralization and democracy, conflict and injustice, poverty and vulnerability. Forest

and watershed management issues touch every segment of civil society. Forests and watersheds are a national asset (67 percent of the country's total land area), a global public good, and central to the livelihoods of many of the 36 million Indonesians living in poverty.

…however a range of threats and poor management come at an economic cost

Indonesia's forest resources and watersheds are not contributing as they should to poverty reduction, economic and social development and environmental sustainability. Instead, forest areas are threatened with degradation, fragmentation and destruction. One-quarter of the "state forest area" lacks tree cover, mainly due to illegal cutting and land conversion fueled by excess industrial processing capacity and a lack of effective management and law enforcement. These underlying drivers also contribute to underperforming plantation lands, losses in GoI tax earnings, and indebted firms. Poor forest management damages the investment climate, rural economic potential as well as Indonesia's competitiveness and international reputation. Forest crime exacerbates problems of budget and fiscal balance, and diverts public revenues that could be better spent on poverty reduction and development goals.

New approaches to sustainable forest management need to be adopted…

As Indonesia moves to stabilization and growth, there are important opportunities to help find new ways of managing forest areas in partnership with local communities, contributing to democracy, justice, equity, rural sector investment, jobs and growth. A more diversified, efficient, competitive and sustainable future is feasible. Studies and roadmaps are available that chart a course toward forest management approaches that entail more plantation-grown timber, less degradation and encroachment, alternative timber sources, retooled mills and higher value-added processing, with more small-scale enterprises and employment.

…although vested interests and corruption will impede the implementation of good management practices

Past efforts have strived to assist the GoI to deliver on its own stated forest management goals and commitments and to promote wider policy dialogue among forest sector stakeholders, however vested interests, money politics and corruption among the powerful impede efforts to match performance with policy. At the same time, poor, rural, traditional and marginalized forest users remain politically disenfranchised and voiceless in most governance and resource allocation decisions. Conflict over land and traditional rights not only undermine economic potential and threaten local livelihoods, but also can turn violent, creating a wider and more negative development impact. Weaknesses in the judicial sector and in the rule of law are nowhere manifested more clearly than in the forestry sector, where competition among governance institutions (police and ministry, central and local) is illustrated in the daily press.

Nevertheless, democratization and decentralization offer some hope for change…

Indonesia's forest sector has been in crisis for some time, yet many observers and analysts believe the likelihood of successful outcomes is higher now than at any time in the past. This is because democratization and decentralization of government are creating positive political pressures and commitment to good governance and fighting corruption at the highest levels. Attitudes and roles among government, big business and civil society are changing. Central policy-making is more consultative and transparent. Local governments are becoming more responsive and accountable. Civil society and business are repositioning themselves for more constructive relationships. In the Department of Forestry, a gradual process of evolution and reform is resulting in new opportunities for improved forest management and governance.

…because implementation of national laws and policies on emissions is compromised by vested interests

Although forestry policies and legislation in managing greenhouse emissions are adequate, law enforcement and implementation are weak and not aimed at reducing emissions. In contrast, land use rules and allocation decisions are inconsistent, non-transparent, and disputed by many, leading to conflict over land and resources on the ground. Forest and peat land conversion to agriculture and plantation crops – or degradation and open access – is an important source of emissions, but the local governments and private interests that make these decisions are not well regulated and do not face incentives to control emissions.

Indonesia's coastal and marine resources are environmental hot-spots

Indonesia is the world's largest archipelagic nation and encompasses some of the world's richest areas in terms of potential economic activity and biodiversity hot spots (including more than one-quarter of coral reefs in the region). The coastline and near-shore waters

that also offer economic potential…

account for about 15 percent of GDP and support the coastal and fisheries activities of 8,400 rural communities and 6 million fishing and aquaculture households spread over 1,100 sub-districts.

…but communities dependent on these diminishing resources are acutely poor with few alternative sources of livelihood

Coastal and fishing communities face a unique poverty-trap because there are few livelihood opportunities available other than continued overexploitation of a declining resource base. Nevertheless, economic opportunities exist because new markets and new technologies are making household aquaculture and value-added processing more feasible and profitable. To improve local livelihoods, the challenge has been to diversify fishers' income streams by supporting new economic opportunities, to create enabling policies for local economic development and to reduce impediments to household aquaculture and small enterprise development. The major constraints and market failures include knowledge of appropriate fisheries production and processing modalities, marketing of these products and access to a formal supply of affordable credit.

There is a need to protect habitat through co-management with local communities

Government-community co-management of protected areas is an important approach to improve governance of fisheries resources. Indonesia has a target to create a marine conservation area of 20 million hectares by 2020. Partnerships between local government and resource users have proven effective in sustainably managing fisheries ecosystems and reaching consensus among communities/users with competing interests. Continuing the decentralization agenda to further empower communities to enter into co-management partnerships can help to rehabilitate depleted fisheries resources and ameliorate the current crisis in the sector.

Awareness has risen but there are still impediments to improving performance…

There has been improved awareness by coastal communities, both national and regional governments, business groups, politicians and academics on the importance of sustainable management of coastal and marine resources. The Ministry of Marine Affairs and Fisheries has, however, identified several fundamental factors that impede performance in the management of marine resources (see Table 9.1).

Table 9.1: Why Indonesia's common property resources are being depleted: proximate and underlying causes

Proximate causes	…and why they occur
• illegal, unreported and unregulated fishing • continuous habitat degradation • conflict over use of coastal and marine resources • poor application of appropriate technology • limited financial resources for fisheries-based economic activities • marine pollution in coastal areas • excessive exploitation • poor law enforcement	• perceived open access by many primary users • competition that weakens bargaining positions in traditional markets • poor information among primary users • small-scale and remote business units • poor knowledge of biological characteristics • ecological linkages among marine-based activities and terrestrial and coastal/marine environments • poverty in coastal communities • poor capacity of regulatory institutions • lack of qualified human resources

Sources and notes: Ministry of Marine Affairs and Fisheries.

Aquaculture production offers a new opportunity...

Due to declining resources, emphasis is now being placed on promoting high value household-based aquaculture production, however many constraints make this a challenging proposition. Fisheries-based rural enterprises lack equity and face credit market failures that inhibit start-up or expansion. Fisheries households need better information about outside job and market opportunities. Lack of appropriate infrastructure (e.g. cold chain to preserve the catch on its way to market) impedes the growth and development of rural, coastal fisheries-based economies.

…while the government has developed a strategy to develop high-value commodities, reduce over-fishing and protect eco-systems

To increase future production and local incomes of poor fishers and fish farmers, it will be necessary to develop high value fisheries commodities, reduce fishing efforts and protect critical fisheries ecosystems. The main engine for economic growth would be the scale-production and processing of fisheries commodities that have high export value, with direct links to poor fisheries households. The GoI has a three-point strategy: (a) enhancing the production and supply chains of export-oriented fisheries commodities; (b)

strengthening and expanding access to finance programs for aqua-farmer groups; and (c) support for collaborative partnerships between resource users, government agencies, and non-government organizations in designing marine reserves and larger marine protected areas.

Raising public awareness is critical to improving management of the environment…

Public awareness is needed to address environmental problems, both through behavior change and through political constituencies for action. There is an active nationwide network of civil society organizations focused on environmental issues, with significant advocacy experience. Recent environmental disasters (floods, mudslides and fires) have stimulated greater public environmental concern. Further analysis of knowledge, attitudes and practices is, however, needed to determine the depth of understanding, public ranking of issues, and useful next steps in moving toward improved outcomes.

…but this needs to be accompanied by government policy that emphasises sustainable use rather than resource depletion…

Nevertheless, Indonesia's macroeconomic policies (tax and non-tax revenue policies and fiscal balancing formulas) appear to favor resource depletion over sustainable use as they reward district governments on resource revenue and not performance or stewardship. The fiscal policy framework also tends to under-tax forestry and fisheries (relative to other natural resources), under-collect taxes that are levied (impeding their ability to influence behavior at the margin) and does not allow charitable contributions by individuals or corporations (undermining one potential source of funding for environmental and conservation improvement). Finally, there is little integration of environmental considerations at the planning and programmatic levels, especially in the public investment planning process and in regional plans for land and resource use.

…although the challenge of environmental management has also become more complicated in the era of decentralization

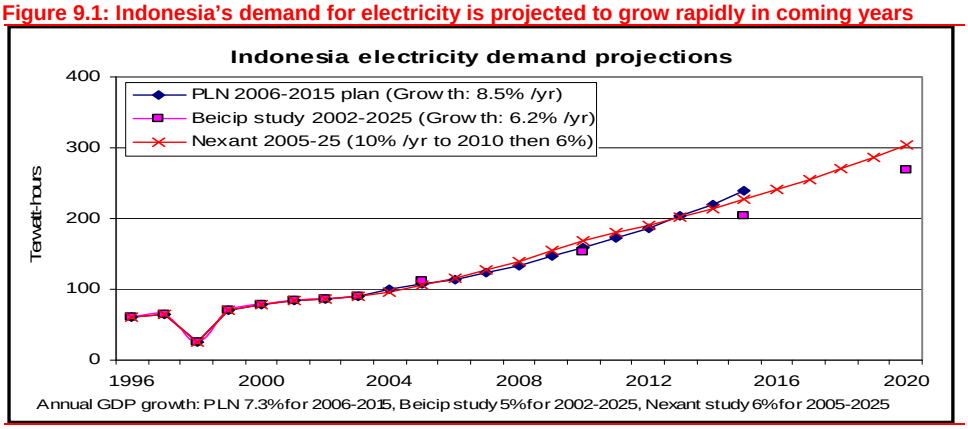
Under decentralization, sub-national governments feel less strongly bound by national guidelines. This creates another hurdle for environmental management, since many of these environmental management responsibilities have been devolved to provincial and district level. Regulatory bodies in many provinces and districts now fall directly under the control of the governor or district head who is often also the proponent of the projects or activities that must be regulated. Despite the substantial investment in environmental policy and staff development, actual implementation of rules and procedures has been poor. Many provinces and districts are reinterpreting existing rules or adopting new regulatory procedures; while some of these innovations strengthen environmental controls, many relax them or seek to bypass national standards. These problems are unlikely to get better under decentralization unless a more effective approach to regulation can be developed.

9. b. Meeting Indonesia's energy needs without sacrificing Indonesia's environment

Under-investment in electricity generating capacity since the crisis is leading to system capacity…

Indonesia's energy demand is projected to grow rapidly, with some projections estimating a near-tripling of demand between 2005 and 2020. In 2006, total installed generating capacity of the national power system reached 28,926 MW, making it one of the largest in the region. Given the size of its population, however, Indonesia's per capita electricity consumption and electrification ratio are still the lowest in the region. Because of under-investment in the decade since the crisis, the state-owned power company, PLN has added relatively little new capacity to its system, and demand is beginning to outstrip supply. Inadequate funding to recover PLN's supply costs under the current electricity tariff regime has created a substantial disincentive to expanding connections and, as a result, many households who live in rural areas and outside of the dominant economic centers of Java and Bali still do not have access to electricity.

Figure 9.1: Indonesia's demand for electricity is projected to grow rapidly in coming years

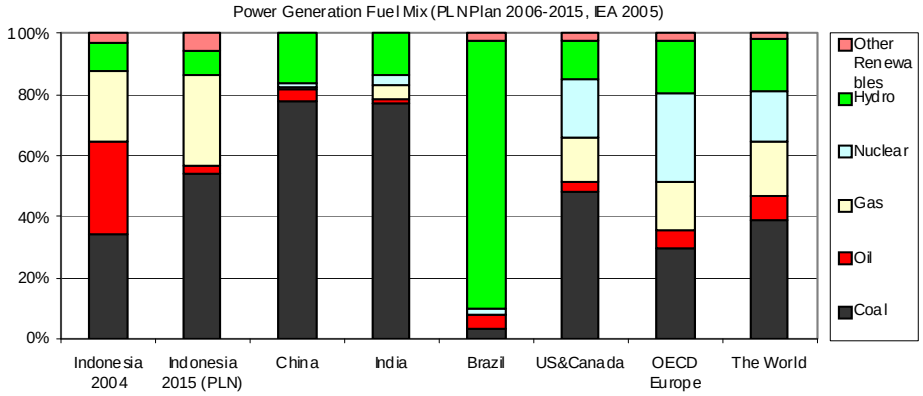


Sources and notes: PLN, Nexant, Beicip Franlab

…while PLN's generating capacity is skewed towards the use of expensive and non-sustainable oil and diesel products

PLN's current fuel mix, the legacy of past access to subsidized oil and the slow development of gas production and transmission infrastructure, is skewed towards the use of diesel, with diesel-based power generation currently accounting for over 35 percent of the total electricity generated. With PLN no longer enjoying access to fuel at subsidized prices, and with mandated tariff ceilings (which have not been raised since 2004), the government has had to provide PSO subsidies to maintain PLN's financial viability in the context of rising oil prices. Not only has that proved a drain on the central government budget - over USD4.2 billion in 2007 - but it distorts PLN's incentive to develop the most cost-effective generation sources.

Figure 9.2: Indonesia relies more on expensive fuel for power generation than other countries



Sources and notes:

The government and PLN have prepared a joint development and expansion strategy…

To combat high supply cost and meet increasing demand, the Government and PLN are focusing on: (i) facilitating private investments and increasing public financing in the sector; (ii) improving generation fuel mix and PLN's management efficiencies; and (iii) promoting rural electrification. Under the strategy, PLN is undertaking a substantial expansion program that entails an estimated USD41.4 billion total investment, most of which (USD28 billion) will be funded by PLN. In addition, the Government and PLN are trying to scale up development of geothermal and other sustainable resources, and strengthen the transmission and distribution systems for efficient use of generation resources and increasing access to the electricity grid. Nevertheless, this is a long-term project (2006-2015) and project preparation efforts will be required to fulfill the investments needs within the planned timetable.

…that includes more efficient use of energy as a key to economic development

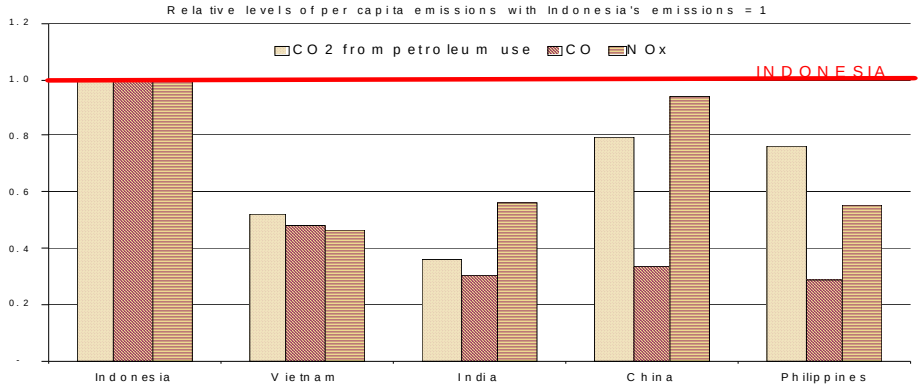
Indonesia understands the strong economic sustainability rationale to address governance and policy concerns in the energy sector. "Relatively low energy consumption per capita and high energy intensity indicate both Indonesia's relatively low welfare levels and

inefficient use of energy." The GoI is also working to improve policy consistency, reduce distortions and improve management to become more efficient and competitive, encourage energy security, improve environmental services and quality of life and to free up budgetary resources for priority needs for investment and job creation.

Nevertheless, excessive use of fossil fuels has significant environmental costs and contributes to climate change…

Excess and inefficient use of energy resources in industry, power production and motor vehicles causes emissions and pollution that damage the environment and impose health and other social costs. Key pollutant levels are high compared with other Asian countries, partly due to excessive use of fossil fuels for electricity generation (see Figure 9.3). Excessive use of fossil fuels also contributes greenhouse gases to the atmosphere – contributing to global climate change. Future threats include increased coal use (due to energy demand), which could exacerbate air pollution problems, forest clearing and contribute to the acid rain problem in the region. IIEE (2007) also notes that power sector expansion plans will also strain water supply and transport systems, especially on Java.

Figure 9.3: Indonesia's emissions per capita are higher than in other countries



Sources and notes: World Resources Institute Climate Change data for CO and NOx; US Department of Energy, Energy Information Administration website for CO2; World Development Indicators 2006 for population. CO2 emissions for 2004; CO and NOx emissions for 2000.

…but Indonesia has significant potential in renewables to contribute to meeting rising demand…

Indonesia is rich in renewable energy resources and could benefit from increasing the share of renewables in power generation (see Figure 9.3). Indonesia is striving to increase its use of renewable energy sources, including geothermal, hydro, solar and biomass. This would not only contribute to meeting increasing demand and enhancing energy security, but also sustainable development. Indonesia has nearly 40 percent of the world's potential geothermal resources which could be a viable addition or alternative for base load power generation. Geothermal generation can be developed at a scale that would be economically feasible, especially if coal prices keep rising. Biomass and hydro resources are abundantly available in most of the outer islands and can be attractive options for switching away from the largely diesel-based generation in many of these locations. To exploit these resources, however, there is a need to develop a strategy and action plan to address technical, policy, and commercial barriers that presently hinder progress. Expanded production of other bio-fuels could also lead to more conversion of forest area into oil palm plantations.

Table 9.2: Indonesia has abundant energy resources other than oil

Major islands	Coal (MTOE)	Natural gas (MTOE)	Oil (MTOE)	Geothermal (MW)	Hydroelectic (MW)	Biomass (MW)
Java	6	165	67	3086	54	13,622
Bali	-	-	-	226	20	347
Sumatra	13,558	425	1,551	5,433	5,489	6,433
Kalimantan	5,885	1,180	200	-	6,047	6,231
Sulawesi	20	24	-	721	4,479	5,337
Nusa Tenggara	-	-	-	645	292	1,174
Maluku	-	-	1	142	217	1,093
Papua	64	24	2	-	24,974	6,814
TOTAL	**19,533**	**1,817**	**1,822**	**10,027***	**41,436**	**41,651**

Sources and notes: Ministry of Energy and Mineral Resources, Indonesia. Total geothermal potential that is presently ready for commercial extraction. There is an estimated additional potential of 17 GW that could be exploited with more development.

…while energy savings and efficiencies can moderate demand

Promoting energy savings and efficiency provides further opportunities for ensuring energy security and sustainable development. It is estimated that Demand-Side Management (DSM) initiatives that are already being considered or implemented to some degree have the potential to reduce power generation capacity needs by upwards of 2,500 MW. If these programs are scaled-up and realize their full potential, this would be tantamount to expanding generation capacity. International experience suggests that DSM measures are most successful when complemented with incentive in price-based regulation of consumption. In order to rapidly assess the benefits and potential of DSM programs, PLN will need to identify priority sectors and incorporate them in the power sector master plan as well as commit adequate financial and human resources.

Delivering on this program is, however, impeded by problems in the legal and regulatory framework

The legal and regulatory framework (see Table 9.3) that governs the electricity sector is presently in a state of uncertainty, complexity and inconsistency. The uncertainty is mainly due to the annulment of the 2002 Electricity Law that established the unbundling of PLN and a gradual transition towards greater competition. The annulment also left PLN in an institutional state of flux since PLN had to suspend its partially completed restructuring measures to unbundle some of its operations as stipulated by the 2002 Law. In addition, the legal ambiguity has impacted on electricity pricing policy and hindered private investments. The complexity and inconsistency results from the patchwork of laws, regulations and plans that were developed independently of each other and that have created adverse conditions, such as over-exploitation of natural resources, insufficient energy for domestic use, under development of renewable energy resources, unfair wealth distribution and environmental degradation (IIEE, 2007).

Table 9.3: Indonesia's legal and policy framework for energy

Energy type	Laws	Policy	Roadmap
Energy	Law 30/2007 on energy	National Energy Policy	Draft blueprint for National Energy Industry (RUEN)
Coal	Draft law on minerals and coal	National Coal Policy	Roadmap for coal and minerals
Oil and natural gas	Law 22/2001 on oil and natural gas	Draft Petroleum Policy (upstream) Draft Fuel policy (downstream)	Draft General Plan for National Oil and Natural Gas (RUPPN)
Renewable energy	Law 30/2007 on energy	Policy on renewable energy and energy conservation (2004)	Roadmap for Green Energy
Geothermal	Law 27/2003 on geothermal energy	Geothermal policy	Blueprint for Development and Utilization of Geothermal energy
Nuclear	Law 10/1997 on nuclear energy	Nuclear policy	Roadmap for nuclear energy
Electricity	Law 15/1985 on electricity	Power sector restructuring policy (1998)	National General Plan on Electricity (RUKN)
	Draft law on electricity		

Sources and notes: Ministry of Energy and Mineral Resources, Indonesia. IIEE (2007).

New laws have been enacted but further change is necessary to improve efficiency, environmental outcomes and access by the poor and SMEs

Law No. 30/2007 on Energy was enacted in August 2007 and provides the umbrella for general energy policy. The new law includes significant improvements over the prior energy management paradigm but the complex structure of laws and regulations remains. Implementing regulations are not yet in place and the proposed national energy board has not yet been formed. Improvements in the regulatory and institutional front will be essential in the energy sector if Indonesia is to meet its key future challenges, namely, (i) improve efficiency on both supply and demand side as well as to reduce supply cost; (ii) move the sector towards an environmental friendly path; and (iii) enhance access to energy for the poor and small and medium sized businesses.

9. c. Making Indonesia's rapidly growing towns and cities livable growth poles

Indonesia's urban centers are facing rapid population growth…

Like much of East Asia, Indonesia has been rapidly urbanizing. Between 1995 and 2005, Indonesia's urban population grew by 55 percent, a much greater proportional increase than most other countries in the region. In absolute numbers, Indonesia's urban population grew by nearly 39 million during the decade. In the decade up to 2015, the urban population is projected to increase by a further 38.4 million, nearly twice the population of Indonesia's largest current urban agglomeration, the greater Jakarta area - often referred to as Jabodetabek - which in 2007 had a population of over 22 million. The changing urban landscape created by Indonesia's urbanization trends does, however, present opportunities for growth through the large agglomeration economies generated.

Table 9.4: Indonesia's urban population is growing rapidly

Country or region	Past and projected increases in urban populations in selected countries (Millions) 1995-2005	2005-2015	2015-2025	(% increase) 1995-2005	2005-2015	2015-2025
China	150.1	152.8	138.7	39.4	28.8	20.3
India	71.8	90.0	122.4	28.3	27.7	29.5
Indonesia	**38.6**	**38.4**	**31.5**	**55.1**	**35.3**	**21.4**
Korea	3.5	2.1	1.0	9.8	5.5	2.4
Malaysia	5.9	5.4	4.4	51.2	31.2	19.5
Philippines	16.0	17.3	16.1	43.1	32.6	22.9
Southeast Asia	75.9	81.0	76.3	44.7	32.9	23.3
Thailand	2.9	3.8	4.9	16.9	18.6	20.4
Vietnam	6.2	8.0	10.0	37.9	35.6	33.0

Sources and notes: UN World Urbanization Prospects 2007.

…although the trend shows regional disparities…

The national average hides regional disparities in urbanization trends. For instance, the population residing in urban areas in the provinces of West Java, DKI Jakarta and Banten is currently about 60 percent of Indonesia's total urban population and is expected to grow to more than 80 percent by 2025. The island of Java represents only 7 percent of the total land area of Indonesia, yet is home to 59 percent of the population.

…and rising rates of rural-urban migration

Although rural-urban migration statistics are limited, available data suggests migration rates continue to rise. Socio-economic linkages between rural and urban areas usually take the form of seasonal migration, remittances for food provision and political/administrative transactions. Net rural-urban migration is, however, estimated to account for approximately 25-30 percent of urban population growth. Migration is having a substantial impact on the structure of urban areas, since many new entrants settle in peri-urban areas, which are poorly linked with infrastructure and other services.

Expanding informal slum settlements present particular challenges in meeting demand for services…

Despite the relative success of slum upgrading projects in many of Indonesia's urban areas, these initiatives are limited and not keeping pace with the growth in informal slum settlements resulting from the growing urban population. As a result, environmental conditions in the country's urban slums have deteriorated and the increasing demand for urban infrastructure services for the urban poor continues to be a challenge. As many slums are still located in central areas of most cities, increasing land values are driving low-income residents, especially new arrivals, into more peripheral areas. Land tenure rights are complex and often entail owners, lessees, sub-lessees, and "sharers"; all made legally binding through the issuance of various certificates.

…that requires urgent investment in infrastructure, especially water and sanitation and roads…

Investment in water sector assets is urgently needed in Indonesia's cities. Throughout Indonesia, an estimated 8 million out of a total of 9.6 million low-income urban residents have no access to piped water. Fewer than 50 percent of Jakarta residents have access to piped water and the centralized sewer system covers less than 2 percent of the urban area. With no significant investment in city-wide sanitation infrastructure in the last 20 years, Indonesia has the lowest percentage of urban households with adequate sanitation in Asia. With limited investment in road infrastructure, most major urban areas are subject to severe traffic congestion, particularly the rapidly urbanizing satellite towns. Flooding also continues to be a challenge in urban areas. In 2007, the worst episode of flooding in Jakarta covered 60 percent of the urban area.

Local governments' capacity to improve services is still inhibited by over-reliance on funding by central government…

Rapid urbanization is placing greater demands on the ability of local governments to deliver services. Decentralization presents an opportunity for local governments to have greater control over the delivery of services, while at the same time presenting difficulties as local governments struggle with their new roles and responsibilities. Local governments are importantly playing a larger role in their own affairs, but a lot still needs to be done to strengthen LGs, improve their functioning, financial and expenditure management and ability to deliver services. Urban municipalities (*kotas*) remain highly dependent on transfers and shared revenues from the central government. For the average municipality, own source revenues constitute less than one-fifth of total revenues, with shared taxes and shared natural resource revenues contributing approximately another one-fifth and the remaining three-fifths being made up by general and special purpose transfers.

…but there must also be attention given to improving central government allocation of funds, removing constraints, institutional strengthening and better land management...

Decentralization presents good opportunities for LGs to take control of their development; however, if urban LGs are to assume their role as the key drivers of economic growth, they need to address some constraints on their ability to support faster growth and greater poverty alleviation efforts. Key challenges fall into four broad categories, namely: (i) improving the central government allocation of funds; (ii) addressing LG financing and borrowing constraints, which is related to enhancing financial resource mobilization and expenditure management; (ii) strengthening LG institutions in order to enhance urban planning, including budgeting and development planning; and (iv) improving the management of land, as well as municipal assets.

…and reining in administrative spending while devolving further taxing power to local government

Administrative spending represents the largest share of sub-national government spending, with other sectors, such as infrastructure, receiving lower shares as a consequence. Deconcentrated spending today mostly goes towards the provision of services that have become the responsibility of the LGs, however unclear and conflicting service assignments persist. Decentralizing property taxes, particularly urban taxes and in the extractive industry sector, would give LGs a significant revenue instrument which could be used to overcome these challenges and better address local needs.

There is no mechanism to support urban investment financing while loan financing from central government is not functioning well...

Despite the need for substantial urban investment financing there is no systematic mechanism in place to support these transactions. Since 1999, sub-national borrowing has remained at consistently low levels. Long-term borrowing is restricted to financing infrastructure that "generates revenue" and local governments cannot finance more than one-sixth of a year's expenditures with borrowed funds. Requiring long-term financing, urban investments are poorly supported by limited municipal revenues. The development of urban local governments can be facilitated with the creation of sound credit markets for local government borrowing to finance capital investment needs. Loan financing is available through GoI Subsidiary Loan Agreements (SLA) and the Regional Development Accounts (RDA) but both financing mechanisms are functioning poorly. As of 2004, 332 out of 431 sub-national borrowers were in arrears on loan repayments to the central government.

…and local governments' ability to borrow on domestic capital markets is inhibited by a complex regulatory framework

Although direct foreign borrowing by local governments is permissible only through special central government approval, LGs are allowed to borrow from domestic capital markets or engage in revenue sharing among provincial and district governments. As of 2007, urban administrative areas in Indonesia had received just 116 loans totalling Rp702 billion. The new regulatory framework for sub-national borrowing introduced new rules related to on-lending, however the new mechanism for submitting and reviewing project proposals and approving loans is complex. The new arrangements also stipulate long-term lending to

sub-national governments may only be used to finance public infrastructure that directly yields revenues for local budgets.

Spatial planning suffers from inadequate vertical integration between agencies…

National Spatial Planning Laws 24/1992 and PP 47/1997 are the basis for urban spatial planning in Indonesia. A National Spatial Development Plan is devised then compartmentalized in Regional, City or District Development Plans. Sector Master Plans are then created based on these development plans, but are not integrated with local development planning or budgets. Central Government bodies engaged in the housing sector include the Ministry of Settlements, the Regional Infrastructure (MSRI), and the National Urban Development Corporation (*Perumnas*).

…while local housing agencies could play a more active role in housing development post-decentralization

Local government housing agencies (*Dinas Perumahan*) draft local housing policy, plan for site identification for housing, monitor and evaluate implementation, and assist in land acquisition. In relation to public housing, the local *dinas* manages government owned housing, allocates public housing, and sets up tenant management groups. To date, most local housing sections have not sought to improve capacities or play a more proactive role in housing development following decentralization.

Bureaucratic deficiencies discourage private investment in housing development and informal means of transaction…

Formal land markets are dominated by developers who must obtain a location permit (*Izin Lokasi*) from the head of the district. The permits comply with local development plans and may require special provisions from the developer. Deficiencies in the formal system, however, have led developers to evade the formal process in order to avoid incurring significant costs related to delays. Delays also discourage private investment in land and housing development. Much of the land around large cities continues to be transacted outside of the formal process.

…while regulatory reform is necessary to clarify responsibilities under the Regional Governance Law…

The Regional Governance Law devolved much of the responsibility for routine land administration to local government. The National Land Agency (BPN) continues to provide some services in monitoring standards and training, however relatively few changes have taken place since the Regional Governance Law was enacted and responsibilities of the BPN relative to the districts have not been defined. Many district Land Offices (LO) have limited capacities and financial resources, further hampering tenure security and other possible benefits of decentralization. Regulatory reforms are needed to reduce costs, lower transaction risks, decrease delays, and improve access to formal financing associated with land titling and registration.

10. Building resilience

10. a. Managing disaster risks and adapting to climate change

Indonesia is highly vulnerable to natural disasters…

Due to its geographic location, Indonesia and its population are highly vulnerable to disasters. In the 2003-2005 period alone, the national disaster coordination agency (*Bakornas*) counted 1,430 disasters, including flooding and windstorms (accounting for 70 percent of all disasters), landslides and geological disasters (earthquakes, tsunamis and volcanic eruptions). In addition, the country is prone to drought, forest fires, epidemics and anthropogenic (technological) disasters. The potential for increased storm and weather variability due to climate change (discussed below) will potentially increase Indonesia's vulnerability further as will increased floods and rising sea-levels.

…that cause large-scale loss of life and significant economic costs

In recent years, the development impacts of disasters on health and livelihoods have been severe. Nearly 170,000 people died in the Aceh tsunami of 2004 with USD5 billion in damages and losses and more than 5,700 people perished in the Yogyakarta earthquake of 2006, with estimated economic costs of USD3.1 billion and thousands of survivors made homeless. The development impact is also enormous, requiring major reconstruction of housing, infrastructure and the economy. Equally important, but less well-known, are the many smaller monthly disasters that result in deaths, injuries and economic hardship. The poor in coastal and natural resource dependent communities are particularly vulnerable to shifting weather patterns, extreme tides or increasing storm severity.

Natural disasters are

Natural disasters are caused by largely uncontrollable forces such as the movement of

uncontrollable but exposure and vulnerability to disaster risk is more manageable

tectonic plates or the eruption of magma through the earth's crust; however, exposure and vulnerability to disaster risk are more controllable. Exposure to risk is increased with poor spatial planning and natural resource management. Vulnerability to risk is greater when there is low public awareness, inadequate infrastructure and poor enforcement of standards such as building codes. Greater exposure and vulnerability to risk factors increases the loss of life and property from disasters.

Indonesia has therefore developed a national action plan for disaster risk reduction…

In 2006, Indonesia issued a national action plan for disaster risk reduction (DRR) that seeks to: a) ensure that DRR is a national and local priority; b) identify, assess and monitor disaster risks and enhance early warning; c) use knowledge, innovation and education to build a culture of safety and resilience; d) reduce underlying risk factors; and e) strengthen disaster preparedness for effective response. In March 2007, the DPR approved the Disaster Management Law that codifies this plan, sets out the responsibilities for DRR as well as disaster response at the local and national levels and modernizes institutional arrangements for disaster management.

…although Indonesia's capacity to plan for, insure against, and respond to natural disasters is currently limited

The GoI's national action plan to improve preparedness and response capacity will require further investments in institutional strengthening, capacity development, enhancing monitoring and data analysis capability, installation of early warning systems and communication networks and outreach and socialization of the priority scheme. Realizing the GoI's plans to reduce underlying risks and build a culture of safety and resilience would entail improvements in spatial planning (with a political commitment to reduce development in threatened areas); public education programs focused on risk, location, and response; and possibly infrastructure investments in key threatened areas. Efforts to improve the capacity to adapt to the effects of climate change (e.g. insurance markets, agriculture changes, information provision systems and spatial planning) could also improve resilience and could also reduce risks associated with some kinds of disasters (e.g. extreme weather).

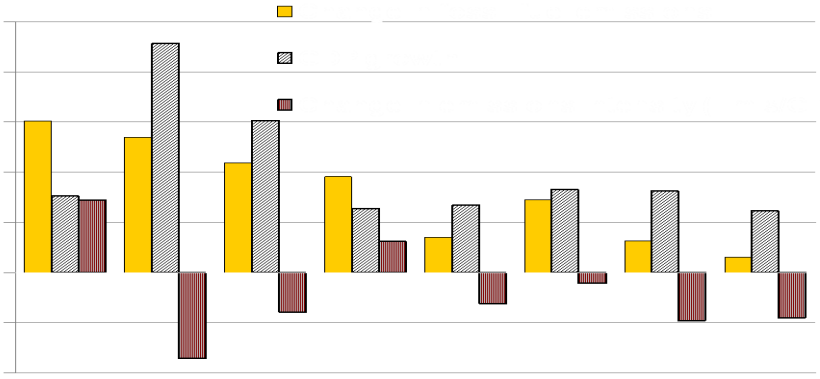
Indonesia is also vulnerable to climate change that will impact on food security, agricultural productivity, livelihoods, health outcomes and natural ecosystems

As a coastal, island, and agricultural nation, Indonesia is particularly vulnerable to the impacts of climate change. The majority of the population lives within 100 km of the coast; a large share of GDP is generated from agricultural (14 percent) and coastal/fishery activities (15 percent), while 43 percent of the labor force is engaged in agriculture and fisheries and 3.3 percent of GDP is generated from tourism. Climate studies suggest that Indonesia is likely to experience modest temperature increases, but climate change will likely result in more intense rainfall and sea-level rise. Potential development impacts include: a) increased threats to food security; b) declining agricultural productivity; c) inundation of productive coastal zones and communities; d) loss of farming and coastal livelihoods; e) consequences for water storage (water reservoirs, electricity generation and drinking water supply); f) intensification of water- and vector-borne diseases; and g) deterioration of coral ecosystems. Given these changes and Indonesia's geographic and socio-economic profile, costs can be expected in coastal cities and communities, agricultural areas, artisanal and commercial fishing, tourism potential and infrastructure development.

High levels of greenhouse emissions in Indonesia are largely driven by poor forestry management practices…

Indonesia's high level of greenhouse gas emissions is being driven by deforestation, forest fires and degradation of land, especially peat swamps. Although forestry policies and legislation are adequate, law enforcement and implementation are weak and not aimed at reducing emissions. Land use rules and allocation decisions are inconsistent, non-transparent and disputed by many, leading to conflict over land and resources on the ground. Forest and peat land conversion to agriculture and plantation crops - or degradation and open access - is an important source of emissions, but the local governments and private interests that make these decisions are not well regulated and do not face incentives to control emissions.

Figure 10.1: Indonesia's fossil-fuel emissions have been growing rapidly



Sources and notes: IEA,2007.

…but are growing rapidly in the energy sector

Emissions from the energy sector are relatively small but growing rapidly as the government pursues a coal-fired power expansion program and because of barriers to the development of renewable energy sources. While energy policies are designed to promote economic development through access to energy, in practice, low energy prices prevent private investment in more extensive renewable energy and energy efficiency programs, while the subsidy program reduces the availability of public resources that could be applied to improve resilience among the poor.

Indonesia's president is strongly committed to climate change actions…

The Government recognizes the challenges and opportunities of climate change and is deeply committed to successful action. The President of Indonesia expressed Indonesia's commitment to climate change action at international venues in 2007. Indonesia has also achieved global visibility as the president of the UNFCCC COP process in 2007, as a leader of the troika countries in the negotiating process up to 2012, as a founder of the Forest-11, and as a leader in the global Finance Ministers' dialogue process.

…and the government is developing a strategic action plan focused on both alleviation and adaptation measures…

The GoI is developing a strategic, multi-year action plan and policy reform program, as outlined in the National Climate Change Action Plan and the Development Planning Response to Climate Change (both from December 2007). This high-level focus will help Indonesia to improve energy and forestry sector management, prepare for the post-2012 climate change regime, and establish a sound framework for coordination and implementation of adaptation activities. Strategic choices about energy sector investments, policy reforms, and inter-ministerial coordination could yield development benefits in terms of new private sector investments, greater energy efficiency, energy security, additional fiscal resources and revenues from GHG emissions reductions.

…and integrating climate change actions and policy reforms in the development planning process while ensuring these do not adversely impact on the poor…

Indonesia is also now integrating climate change actions and policy reforms into the development planning cycle. Bappenas will develop the Medium Term Development Plan in 2009 to guide GoI activities and budgeting during the period 2010-2014. Institutionally, climate change mitigation and adaptation actions cut across nearly all sectors of the economy and all levels of government. This is a challenge for coordination, planning, and targeting appropriate action. The government is working to improve policy consistency, reduce distortions and improve management to become more efficient and competitive, encourage energy security, improve environmental services/quality of life and free up budgetary resources for priority needs for investment and job creation. Both domestically and internationally, Indonesia stresses the pressing need to ensure that efforts to address climate change are not at the expense of the poor.

…through the measures currently being planned

Current adaptation plans focus on water resources management; water supply and sanitation; agriculture, irrigation and farmer education; spatial planning and co-benefits

in agriculture, water use, spatial planning and insurance schemes

and disaster risk management and early warning systems. Longer term interventions could include development and use of pest or drought-resistant crop varieties, adoption of new technologies to reduce crop yield losses, improvements in irrigation efficiency, integrated approaches to river basin and coastal zone management and risk management or insurance schemes to assist farmers and fishers with increasing variability and uncertainty in their planning and operating environments.

Mitigation efforts need not compromise growth and poverty reduction and can also provide strategic opportunities…

The current global climate context is creating an historic opportunity for an integrated approach to climate issues without compromising growth and development. In the aftermath of Bali COP 13, billions of dollars are being mobilized across the globe to help countries with mitigation and adaptation needs (see Box 10.1). An important constraint to the rapid diffusion of new technologies or innovation (for both adaptation and mitigation) is the lack of human, institutional, technical, managerial and financial capacities needed to manage change. Controlling emissions is a potential source of carbon financing that can help offset the cost of better control, new technologies and adaptation needs.

…through new and innovative financing mechanisms that offer incentives for change…

it is clear that the financial and investment flows required both for adaptation and mitigation are beyond the financial capacity of Indonesia and therefore access to global support and instruments will be needed. Innovative financing opportunities such as the Climate Investment Funds under development through Multilateral Development Banks, The Forest Carbon Partnership Facility, global carbon markets, the Adaptation Fund, bilateral donor programs and private sector participation may offer sufficient incentives for change. Accessing this kind of innovative financing presents a strategic opportunity, however, both legally and institutionally, some improvements may be needed to reduce constraints and enhance Indonesia's ability to take advantage of carbon markets and international financial flows.

Box 10.1: Global financing for climate change mitigation offers opportunities for Indonesia

Carbon markets and the Clean Development Mechanism (CDM)
The dramatic growth in recent years in global carbon markets provides opportunities for Indonesia and financial incentives for addressing some mitigation needs while off-setting the potential cost of some actions. With the introduction of emissions trading, the global carbon market has rapidly risen in value to USD64 billion (in 2007), of which USD7 billion was related to transactions under the primary CDM market. Assuming a Carbon Emission Reduction worth USD10 per ton and the estimated potential of the Indonesian carbon credit pipeline by 2012 of 38.7 million carbon credits (excluding the forestry and land-use sector), Indonesia could receive USD387 million in energy-related carbon markets revenues from CDM for a span of several years. More significant still is the potential revenue stream that can be obtained once carbon markets start trading on changes in the deforestation rate.

Reduced Emissions from Deforestation and Degradation (REDD)
New mechanisms under negotiation in the global climate regime offer the potential for payments for Reduced Emissions from Deforestation and Degradation (REDD). Incentive payments of this type could generate revenue that would help to offset the costs and compensate the losses of making real and concrete changes to improve forest management outcomes. It is estimated that if Indonesia could reduce its annual forest loss by half a million hectares the value of CO_2 not released could well be worth USD600 to USD3,000 million annually. Though economic factors are not the only causes of tropical forest decline, it is clear that additional financing of this magnitude, if well managed, could well be a decisive factor in reducing deforestation. Accessing REDD financing will, however, require marked improvements in institutional coordination, law enforcement, forest management and stakeholder engagement – all challenges that have not been met in the recent past. Because of the size of financial flows, however, this mechanism has a greater chance of to contributing to needed governance reforms than traditional aid initiatives to control deforestation. Demonstration activities are now being designed to test approaches. Indonesia, as one of the three most important nations in terms of land use sector emissions, is at the forefront of preparing for REDD.

Source: World Bank (2008).

…however Indonesia also needs to make better use of fiscal and other policy to effect energy conservation

To access these resources, credible policies, programs and institutional arrangements must be put in place. Initial planning and strategy documents have been produced, but are works in progress and institutional responsibilities for implementation are still under discussion and formalization. There is ample scope as well for Indonesia to make better

use of a spectrum of fiscal and other policy instruments at the disposal of national economic authorities to promote energy efficiency, reduce the energy-intensity of industry by encouraging a shift to areas of competitive advantage with low carbon characteristics, and promote investment in and use of local renewable energy resources.

10. b. Enhancing security and protecting the poor

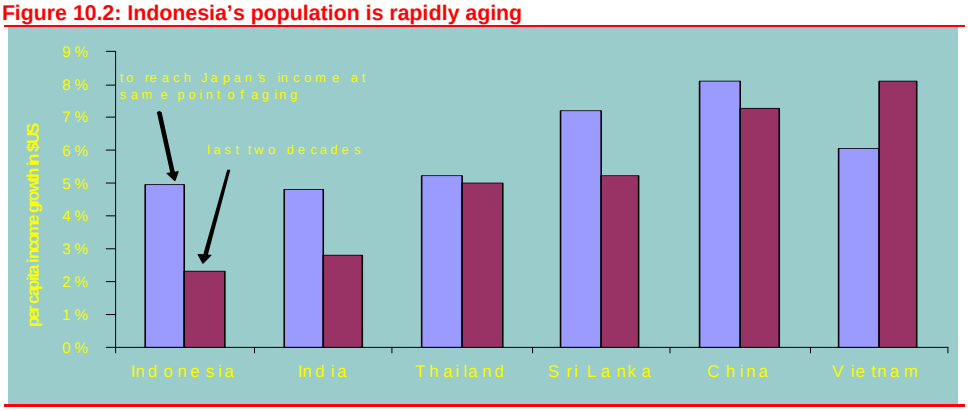
Indonesia's social protection schemes should be expanded because formal employment protection covers only a minority of workers…

Indonesia's existing complex suite of social protection schemes has to be expanded and improved. There are four main reasons why. First, Indonesia's social protection system and, in particular, its employment protection legislation, is mostly designed to cover urban workers who have a formal labor contract. Since only about one-third of the labor force falls into that category, the bulk of Indonesia's workers and their families rely on family ties and community networks, which, as a consequence of sustained economic growth and rural-urban migration, are slowly eroding. The public sector has a limited role. In 2004, social security spending averaged 2.75 percent of government revenues, against 4.86 percent in Thailand; and in 2005, Indonesia spent 0.98 percent of GDP on public health care, against 1.54 percent in Vietnam, 1.82 percent in China, and 2.24 percent in Thailand.

…Indonesia's aging population will place a growing burden on family networks…

Second, Indonesia's population is aging and is doing so at a much faster pace than OECD countries when they were at similar levels of economic development (Figure 10.2). Demographic and economic forecasts suggest, for instance, that Indonesia's economic growth rate should be two percentage points higher if it is to reach Japan's income at the same point of aging. Families, especially poor ones, receive little support to take care of old relatives, and a large share of health spending remains private. The rapidly aging population will exacerbate the burden on family networks, which currently are the main caretakers of the elderly population, and pressure to extend old age social protection to poor and informal workers who have contributed little to nothing to a pension scheme during their working years is likely to grow significantly.

Figure 10.2: Indonesia's population is rapidly aging



Sources and notes: World Bank estimates from WDI and UN World Population Prospects.

…there is no safety net to protect the population from the adverse impacts of unexpected shocks such as rising fuel prices…

Third, Indonesia currently lacks a national safety net that can buffer the population from the adverse impacts of shocks. While the government did manage to roll out an unconditional cash transfer scheme (the BLT) at short notice following reductions in fuel subsidies in 2005 and 2008, the absence of an existing reliable targeting mechanism raised concerns about leakage and exclusion in the implementation of the transfer schemes. Had an ongoing safety net program with a tested targeting mechanism already been in place, it might have been possible to rapidly scale it up in the case of large covariate shocks such as the recent rise in food prices. Targeted cash transfers are a cost-effective way of helping the poor through social assistance that present several advantages. First, by administering cash they can be used to help households cope with several types of shocks. Second, to the extent that the private sector is able to provide cost-effective services, they avoid excessive crowding out of the private sector. Finally, once a means-tested targeting mechanism has been put in place, they can be rapidly scaled up in case of emergencies. Conditional cash transfers present the additional advantage of reducing future poverty and inequality by linking transfers to incentives for

investments in health and human capital. Conditional cash transfers have been proven to increase school enrollment rates and health outcomes. Moreover, to the extent that a good means-testing system has been designed for conditional cash transfers, in times of major crises the same system can be used to administer additional unconditional cash transfers.

…while a safety net for workers losing their jobs might allow the relaxation of employment protection legislation

Fourth, an existing safety net that keeps workers who lose their jobs from falling into poverty, might ease resistance to the relaxation of the stringent employment protection legislation that may have inhibited job creation in the past few years.

Indonesia is making progress on these issues with a health insurance scheme for the poor and a CCT program already established…

On some of these fronts Indonesia is making progress. It has developed a means-tested health insurance scheme for the poor, and it is piloting a conditional cash transfers program. Through its community-based poverty alleviation scheme it enhances the income-generating capacity of poor rural households. In the context of the current conditional cash transfers pilot, a means-testing system could be developed at the national level to be used for rapid scale-up in case of emergencies. Designing an effective means-testing system is the key to avoiding excessive leakage to non-target recipients. As it takes some time to put in place a means-testing system, it could be designed in advance, so that in case of emergency, targeted cash transfers could be rapidly scaled up.

…that should be complemented by a fully-funded pension scheme

To avoid placing the burden of increased pension costs on future generations, a fully-funded pension system that is financially sustainable in the long term should be developed as a priority. The current pay-as-you-go system will soon become financially unsustainable. Pay-as-you-go systems are appealing when the population is rapidly growing (since the costs of paying pensions to retirees are shared across a growing active population), but quickly become financially unsustainable when the population is aging (when a shrinking workforce has to maintain an increasingly high number of retirees). Contributions will soon have to be increased and benefits lowered in order to avoid a deficit in the current (partial) pay-as-you-go system. The extent to which this remains feasible, however, remains unclear.

Caution is, however, needed in the design of a social protection system so as to avoid unintended consequences

Poor social protection design can have long-lasting consequences - both on growth and on poverty reduction. To the extent that it encourages prudent risk-taking, an efficient social protection system enhances and supports growth, while, at the same time, being an effective poverty reduction instrument. Worldwide experience shows that it is much easier to design a good social protection system from a blank page, than to improve the design of an existing one. Each reform entails losers and would-be winners, and it is often the case that losers are a well-organized minority, while would-be winners, though being the majority, tend to be less organized and to have less voice. In this context, short-term, quick-fix solutions that only benefit a well-organized minority could have long-lasting consequences that prevent the development of an efficient social protection system. While it may be premature to embark on radical reforms of the social protection system, it is crucial to develop a medium to long-term vision for reform.

10. c. Reducing vulnerability to financial sector shocks

The banking system is much stronger but there are still areas of vulnerability…

The banking system has gradually become much stronger over the past several years. Headline indicators of most measures of banking soundness confirm this strength, however, there remain areas of vulnerability – especially at an institutional level, as discussed below. Indonesia continues to be a bank-dominated financial sector - the non-bank financial institutions (NBFIs) are much smaller. While there are areas of weakness, vulnerabilities in this sector are likely to affect the overall system to a much smaller extent. Finally, there are growing links between the banks and the NBFIs that raise areas of potential concern and vulnerability.

…including inadequate capital provisions, poor bank lending practices, lack of flexibility in decision making

Firstly, the sound capital position of banks assumes the restructured credits are sound credits whereas in other markets they are considered "impaired assets" until repayment. There is a concern that a number of restructured credits particularly in the state banks have been restructured several times and, accordingly, provisions may be inadequate.

processes and a less than secure financial sector safety net

This would tend to overstate the capital position of the banks. The second concern is with bank lending. The recent BI policy aimed at credit expansion needs to be re-assessed, especially in the current global environment. It is probably an inappropriate time to be supporting a relaxation in prudential standards, although any resultant problems will most likely not manifest themselves through NPLs for 2-3 years. Thirdly, the fact that three former senior Bank Indonesia officials have been arrested for their roles in the provision of liquidity credit during the crisis may hinder rapid decision making if similar support were required in a future situation. Fourthly, the financial sector safety-net is less than secure. The deposit guarantee covers 75 percent of depositors but only 25 percent of deposits, so in the case of a bank in distress, large depositors still have the incentive to withdraw their deposits. The deposit insurance agency (LPS) has been given strong powers of bank resolution, but has neither adequate staff nor the on-going knowledge of individual banks – both of which are needed to adequately address resolution. Thus far, the emphasis has been on the organizational structure of the safety net, but there has been less attention to detailed operational issues. These weaknesses are being addressed through the establishment of the Financial Sector Stability Forum.

Inflation is running ahead of the BI target range, raising concerns about the ability of households to repay loans for consumer items

There is concern in investors' minds - despite BI's inflation targeting framework - about how BI will, over time, get inflation back from the current 12 percent+ to its 5-6 percent target. Price increases usually adversely affect household income, which in turn may cause deteriorating quality of loans to individual consumers i.e. credit card and unsecured multipurpose loans in banks. Commission-based agents have been aggressively selling these products at shopping malls. BI statistics indicate the value of non-performing consumer loans increased by 31 percent year-on-year in 2007 and 27 percent year-on-year in February 2008. A similar story may be seen in motorbike financing by multi-finance companies. Experience with the previous round of fuel price hikes in 2005 indicates that BI has performed creditably in its prudential oversight of such practices. To restrain price expectations in the face of such circumstances, clearer support is, arguably, necessary on the part of BI, in the form of actions on the policy rate and clear statements setting out its agenda.

Government bond yields are rising and will impact on bank balance sheets and cause a possible shift of funds from banks to more attractive investments…

In this environment, the yield on government bonds - that has already increased over the past several months - could potentially increase further. The pressure on government bonds prices will have impacts on several fronts: (i) bank balance sheets. A few banks still keep fixed rate government (recap and non recap) bonds in assets either as short-term investments (to park excess liquidity) or portfolio. Bonds under the latter group are not shown at market prices but nominal values so their capital ratio is somewhat overstated; and (ii) unit link products of life insurance have returns based on equity and debt holdings and may be subject to some volatility. This type of product has been the driver of strong growth in the life insurance market in recent years. Bank liquidity could be a problem if there is a shift of funds from bank deposits to investment products such as government bonds or mutual funds. Bank deposit rates are low and unattractive whereas government bond prices have gone down recently and thus appear to be attractive. This would also expose the banks to an interest rate risk because 90 percent of time deposits in banks are on one month maturity.

…as well as precipitating a run on mutual funds by panicked investors

In addition to the fiscal difficulties posed for the government, rising yields could be a problem for the mutual funds (*reksadana*) as the price of fixed income mutual funds fall and this could again trigger panic and runs on funds. This market has already faced a crisis in 2005 - when nearly three-fourths of the funds were withdrawn from the market by investors. Since then the market has grown again significantly, taking advantage of declining interest rates. Mutual funds have since diversified into equity in addition to the mainstream fixed income funds however many of the debt funds - called "protected funds" - impose liquidity constraints on investors (investors are required to stay in the funds until the maturity of the bonds underlying the fund) and are not marked to market.

BI's prudential regulation and supervision needs to be expanded to non-bank activities and cooperation with the pension

The inability of Indonesia to undertake consolidated supervision of financial conglomerates is an area of vulnerability. BI's current mandate is to review only "banking operations" - and therefore they are vulnerable to poor supervision of NBFIs. For instance if a pension fund was insufficiently funded to the same extent as the capital position of a bank below necessary minimums, BI would become aware of this only if it acted in close

regulator needs to be enhanced

concert with the pension regulator (there is evidence that this may have happened in the case of one large bank a few years ago). Conversely, in the case of insurance firms - especially large ones that have banking arms - the insurance and banking regulators need to be working together. There might be future potential risk if a bank without solid group risk management gears up its securities company operations in areas such as project finance and capital markets underwriting which could potentially cause significant losses. Even among senior bankers there is limited understanding of non-recourse project finance and most see infrastructure finance as a normal corporate finance transaction.

Attention needs to turn to multi finance companies that are heavily reliant on banks for funds and that may be at risk as banks gear up their consumer lending portfolios…

Multi-finance companies - operating in consumer finance (e.g. automobile or motor cycle lending and leasing) depend on commercial banks for funds. Bank lending accounts for over 60 percent of industry funding. There is also a good deal of channeling so the real dependence on banks is likely to be much higher. Some large banks - including state-owned banks - have concentration risks in their portfolios with over 50 percent capital equivalent loaned to the industry. As banks progressively gear up their own consumer lending capacity in-house, the good risks will likely migrate to the banks from the multi-finance companies, thereby increasing the risk profile for the industry considerably. (As an example, in Malaysia most mult-finance companies have closed.) On the other hand, if BI were to instruct banks to quickly reduce their exposures to the industry it could cause further problems for the industry and potentially have a flow-on effect. It is important that the two industry regulators - BI and Bapepam LK – work more closely to jointly assess the true scale of, and subsequently address, this risk.

…while some insurance firms also have solvency problems

Several insurance firms - some large - are known to have solvency issues. Resolution of their problems has effectively been postponed since the crisis - with the focus of resolution efforts being on banks. The size of the problem in some of the institutions has most likely grown substantially. Management weaknesses and poor policy holder records are well-known problems. While the small size of the sector makes it unlikely that the problems here will result in systemic issues, their vulnerability raises significant confidence issues. Depending on the timing at which their problems manifest themselves, they could create contagion effects for the financial sector. There are many small local life insurance companies. They have survived to date because they still have positive cash flow (i.e. still liquid) and are able to pay out claims using the proceeds of new underwriting, however, their solvency ratio might not be high. This risk is partially mitigated with the fact that substantial portions of their business are being ceded to reinsurance companies. Given that many of the insurance products sold in the market are investments with cash value, a loss of confidence in the sector could trigger liquidity and then solvency problems in the sector.

Confidence is critical to maintaining the financial fundamentals and preventing sudden capital outflows

Lastly, Indonesia still remains vulnerable to sudden capital outflows - the hot money issue. Funds can move easily in and out of Indonesia's capital markets and thus maintaining confidence in Indonesia's macroeconomic indicators and financials is important.

C. From 2009 to 2014 and beyond: realizing the development agenda

11. Furthering Indonesia's ongoing, and still incomplete, governance transition is central to realizing the development agenda

The core message of this report is that institutional change is imperative to realizing Indonesia's development agenda

What the preceding review of where things stand, and of Indonesia's development agenda, clearly indicates is that Indonesia's incomplete governance transition is the main reason why Indonesia remains a glass half-empty. The core message of this report is that furthering Indonesia's governance transition by improving the effectiveness of public institutions and processes through longer-term institutional and process transformation is central to realizing Indonesia's development agenda.

11. a. Furthering the governance transition means adapting and strengthening the institutions and mechanisms that govern the functioning of the state and shape state-society interactions

The central challenges Indonesia faces today are all of an institutional nature that will require the transformation of those institutions and processes

If Indonesia is to realize its potential as a competitive, inclusive, sustainable and resilient middle-income country, it has to adapt the institutions and mechanisms that govern the functioning of the state and shape state-society interactions, to the changed circumstances it finds itself in. The central challenges Indonesia faces today in realizing its development agenda are all, in one form or another, of an institutional nature in that they entail furthering Indonesia's as yet incomplete governance transition by improving the effectiveness of public institutions and processes through longer-term institutional and process transformations. Even in areas where additional financing is clearly needed - for instance, from the private sector in the case of many infrastructure sectors, or from the public sector if the restructuring of Indonesia's health system is to be financially viable - institutional challenges need to first be sorted out for that financing to be forthcoming and for it to be effectively deployed.

Although these challenges differ between sectors and contexts…

The details of the institutional challenges naturally vary from context to context and from sector to sector. For instance, the particular set of institutional issues that have to be addressed to achieve a breakthrough in the construction of toll roads are the difficulties in land acquisition because of a weak legal framework and weak dispute resolution mechanisms s well as corruption and weaknesses in public procurement policies and practices. The ones that hinder the provision of quality education in rural areas are the limited capacity and accountability of frontline service providers and weaknesses in the management and flow of funds. In both cases, however, the constraints are clearly of an "institutional variety" and, in particular, one that has to do with one or more aspects of governance. Table 11.1 illustrates this by mapping the key constraints corresponding to each of the broad priorities identified in the review above of Indonesia's development agenda, to one or more of the components of governance - policy and regulatory quality, government effectiveness conceptualized in terms of coordination, capacity and accountability, control of corruption and rule of law.

…there are a number of core systemic processes and policy-making/implementing institutions that are common to all

At the same time, there are a number of core systemic processes and institutions for formulating and implementing policy that are common to all or at least most of the challenges that constitute Indonesia's development agenda (see Table 11.1). These are:

- the public financial management system public institutions rely on to implement government priorities and effectively spend public funds;
- the capacity and accountability of the civil service;
- the decentralization framework determining the flow of funds and the division of responsibilities between levels of government;
- the control of corruption; and
- the judiciary and legal system which ensures the rule of law.

Table 11.1: Why furthering Indonesia's governance transition matters for realizing Indonesia's development agenda

DEVELOPMENT AGENDA	Policy and regulatory quality	Government effectiveness				Control of corruption	Rule of law
		Coordination	Capacity	Accountability		Control of corruption	
		Coordination	Local governments	Civil service	Public financial management		
Accelerating growth							
Alleviating infrastructure bottlenecks					Weaknesses in procurement		
	Difficulties in land acquisition				Difficulties in land acquisition		
	Low tariffs	Delays in budget execution			Delays in budget execution		
	Policy uncertainty		Insufficient local level capacity			Uncertainty about judicial intervention	
Remedying regulatory weaknesses in investment climate	Uncertainty about policy	Inadequate coordination between ministries and between ministries and local governments		Resistance to reform		Uncertainty about judicial intervention	
	Regulatory burden		Limited capacity to formulate and implement reforms			Regulatory burden	
Making growth inclusive							
Raising rural incomes			Insufficient capacity and incentives at the local level				
	Land tenure insecurity					Land tenure insecurity	
	Poor rural investment climate						
Facilitating the transfer of labor	Labor Law	Restrictive minimum wages					
Improving water and sanitation	Low tariffs	Unclear allocation of responsibilities					
		Insufficient horizontal coordination					
		Sub-national financing constraints			Sub-national financing constraints		
Restructuring the health system			Limited capacity and accountability of frontline service providers				
	Fiscal inequities			Uneven staffing			
		Unclear division of responsibilities between local and central government		Weak stewardship	Weaknesses in provider payment and budgeting systems		
Providing quality education for all			Limited capacity and accountability of frontline service providers				
			Weaknesses in management of funds and transfers				

Table 11.1 (continued): Why furthering Indonesia's governance transition matters for realizing Indonesia's development agenda

DEVELOPMENT AGENDA	Policy and regulatory quality	Government effectiveness				Control of corruption	Rule of law
		Coordination	Capacity	Accountability		Control of corruption	
		Coordination	Local governments	Civil service	Public financial management		
Ensuring sustainability							
Managing Indonesia's environmental and common property resources		Unclear division of responsibilities between local and central government		Low awareness and limited capacity		Corruption and weak enforcement of laws	
	Lack of coordination between ministries leading to policy uncertainty				Limited consideration of environmental impacts in public investment planning		
Meeting Indonesia's energy needs without sacrificing its environment	Low tariffs and distorted incentives because of fuel subsidies					Uncertainty about legal framework	
	Complex structure and lack of implementing regulations						
Making Indonesia's urban areas livable			Insufficient budgeting and planning capacity			Improper functioning of land markets	
			Sub-national financing constraints		Sub-national financing constraints		
Building resilience							
Managing disasters and preparing for climate change	Lack of coordination across ministries in policy formulation			Technical capacity is limited		Corruption and weak law enforcement	
Enhancing security and protecting the poor	Untargeted subsidies					Leakages in targeting	
Reducing financial vulnerability	Limited coordination amongst various regulatory and supervisory agencies					Possibilities of corruption and collusion	

12. Restructuring and strengthening the core processes and institutions for formulating and implementing policy

12. a. Reforming public financial management systems

Public financial management systems need to be strengthened…

The core public financial management systems public institutions rely on to implement government priorities and effectively spend public funds have to be strengthened. This means greater emphasis on the reform of public sector systems including procurement, financial management and budget execution, project design, contract management, information management and monitoring and evaluation.

…to complement the legislative reforms and re-engineered budget processes that have already been put in place…

Indonesia has made major advances over the last five years in establishing a sound legal and administrative framework to manage its public finances and improve transparency. New laws on State Finance, State Treasury and State Audit were passed in 2003 and 2004. These laws together have provided Indonesia with the framework for the modernization of public financial management in line with good international practice. With the legal architecture in place, reforms have been initiated to reorganize the Ministry of Finance and re-engineer business processes across the budget cycle by improving budget documentation, making the national budget compatible with the internationally accepted classification systems, streamlining the budget preparation process, consolidating government accounts into a Treasury Single Account (TSA) and establishing forward- budgets.

…although budget preparation still suffers from dual budgeting and inadequate long-term projections

Budget planning, formulation, reporting and execution have improved but significant weaknesses remain. While the budget has been unified for presentation and reporting purposes, the budget preparation process continues to suffer from a *de facto* continuation of dual budgeting, with few links between discretionary and non-discretionary expenditure and less emphasis on expenditure prioritization. The 2008 budget includes for the first time a Medium-Term Budget Framework based on aggregate macro-fiscal forecasts of both revenues and expenditures for two out-years, however budget plans continue to be prepared on a strictly annual basis and medium-term public investment needs are not yet addressed in a systematic framework that reconciles medium-term budgetary costs with aggregate resources.

The reliability of budget reporting would be improved by enhancing accounting capacities and processes and introducing performance-based budgets…

Budget reporting is timely, but not entirely reliable. The aggregate government annual financial statements have been prepared in a timely manner since 2004, which is a remarkable achievement. But external audits suggest the reliability of these financial statements could be improved, which reflects an environment where accounting capacities at the grassroots are weak and accounting processes are not yet integrated or fully automated. Furthermore, the Indonesian budget system is still heavily reliant on *ex-ante* controls and does not yet use *ex-post* control systematically. Indonesia still spends 50 percent of its total capital expenditure in the final quarter of the year and this disrupts project implementation. Integration of planning and budgeting processes, and a move towards performance-based budgeting would improve budget execution, however implementation will take more time and require a clearer strategy.

…within a more democratic system that has enhanced the legislature's oversight role

The process of rapid democratic transition restored parliament's substantial powers in what was previously a closed budgetary system. The institution of appropriate checks and balances, particularly with regard to budgetary decisions, are important pillars of sound governance systems. The evolving practice of very detailed legislative involvement in the current budget preparation process, and the resulting appropriations structure embodied in the budget law and annexes, has profoundly affected the quality of legislative interventions and neither the executive nor the legislature seem to be fully satisfied with executive-legislative interactions in the budgetary realm.

Reforms have been initiated in public procurement with the establishment of a National Public

The public procurement system has seen incremental improvements but still has significant deficiencies. A presidential decree on procurement in 2003 set out the basic principles for public procurement, namely transparency, open and fair competition, economy and efficiency. The decree also established a national public procurement office (NPPO) or *Lembaga Pengembangan Kebijakan Pengadaan Pemerintah* [LPKPP] which

Procurement Office although the legislative framework is still in progress and capacity is lacking…

commenced operations in December 2007 as the regulatory body for public procurement. It is expected to be staffed by July 2008. Although there has been progress in establishing LPKPP, progress in developing a procurement law, as well as standard bidding documents and users manuals has been slow. Due to the absence of a clear professional stream for procurement experts as well as the lack of a national procurement capacity building strategy, there is continuing weakness in procurement capacity in implementing agencies, especially at the provincial and district levels and that has raised concerns about collusive and corrupt practices in the bidding process and the efficacy of anti-corruption measures and sanctions.

…and the internal audit function remains a weak link in governance

The internal audit framework of the government is extensive but its scope and organization do not match needs. Despite (or perhaps because of) the existence of multiple internal audit agencies, the internal audit function continues to be a weak link in governance. The institutional arrangements are complex and the mandates and division of labor between the various internal audit institutions are unclear.

12. b. Initiating civil service reforms

Reforming the civil service to enhance accountability, capacity and incentives is critical…

Increasing the accountability, incentives and capacity of civil servants is equally critical. A strengthened public financial management system will not by itself resolve the weaknesses in the implementation of programs. The civil service plays an equally important role in driving institutional performance. There is an increasing recognition that the lack of administrative capacity and distorted incentive structures within the government bureaucracy has hampered the effectiveness of spending and the quality of service delivery.

…and has the support of the president and his government

A broad consensus on the necessity for civil service reform has grown strongly since the fall of the New Order regime and particularly over the last five years due to the strong reform commitment of President Yudhoyono and his government. In spite of this, there has been very little action from the leaders and institutions that should spearhead reform. Fundamental features of the existing civil service system continue to provide compliance-based human resources management and distorted incentives, resulting in poor performance in large parts of the Indonesian state administration.

Civil service reform is more than reforming HRM practices and must include the way public institutions are structured, operated and financed…

Civil service reform is often presented in Indonesia as simply a matter of reforming human resource management practices or increasing salaries. To have an impact on performance and efficiency, civil service reform must be both broader and deeper while, at the same time, it must be selective and well sequenced. To have the desired impact, civil service reform must also target the way public institutions are structured, operate and are financed, in addition to reforming human resource management practices and salaries. Finally, reform must address features of the civil service that preserve old behavior such as distorted incentives facing individual civil servants. All of this is difficult to effectively address at the institutional level, as fundamental changes in basic HRM policies and processes for the allocation of human resources are required. Reforms at the institutional level therefore become designed in a way that does not challenge current central policies; instead reforming institutions work around existing policies and regulations, for example by adding new allowances instead of reforming the basic pay scheme and introducing merit based selections in a system that largely does not recognize professional, technical skills or the importance of performance.

…but this will take time as the legislative, administrative and cultural changes take place…

The task of civil service reform is therefore a challenging one and will take time, though some initial steps have been taken. Nevertheless, several reform-minded regional governments have initiated strong civil service reforms in such areas as performance budgeting, one-stop public services, productivity improvement measures and transparent recruitment for key positions. The legal framework for the civil service is being reviewed and revised, including the basic Civil Service Law of 1999, the Law on Government Organization and the Law on Pensions. Included in this review are a range of government regulations encompassing decentralization of the civil service, performance appraisal, separations and civil service discipline. The government is therefore beginning to give greater attention to reforms to strengthen human resource capacity, revise standard operating procedures, clarify job descriptions and job grading, enhance performance incentives through greater pay and promotion linkages, improve human resource

management functions and strengthen access to policy research and analysis within government ministries and agencies.

…and reforms initiated in reform-minded agencies are replicated elsewhere

As a consequence of the lack of central engagement, civil service reforms are conceived and implemented at the institutional level, such as in MoF and in a few other central state institutions as well as in several regional governments with strong and reform-minded leadership. Until recently there has not been a common understanding on what civil service reform actually should imply. Today, however, a comprehensive concept for civil service reform has been developed and implemented in MoF. The initiative requires extra budget allocations for its implementation and the DPR, in approving the extra allocation, has required MoF to make sure its reform concept gets replicated in other state institutions. So far, the Supreme Audit Agency (BPK) and the Supreme Court have received extra budget allocations together with specific reform requirements set up by MoF. The replication of the bureaucracy reform is done under the National Committee for Bureaucracy Reform (NCBR), chaired by the Minister for State Apparatus (MenPAN) and including the institutions mentioned and the KPK that is assigned to monitor reform progress in the other institutions.

Box 12.1: The Bureaucracy Reform Initiative of the Ministry of Finance is a promising start

The Bureaucracy Reform Initiative in MoF aims at:

- strengthening MoF's human resource management capacity;
- systematically reviewing business processes;
- modifying job classification/job descriptions in every department;
- creating a revised remuneration scheme based on new job descriptions and pay grades linking pay to responsibilities, complexity, workload and, eventually, performance;
- establishing new guidelines for staff recruitment; and new approaches to career paths including establishment of an assessment center; and
- developing and implementing a new MoF wide HR Information System (HRIS).

New job descriptions and a new grading scheme have been introduced. Take-home pay has been increased by an extra allowance determined by the new job descriptions and by allocating positions to one out of 27 additional grades. In that context, Echelon I officials in MoF have begun to resign from commissioner assignments in state-owned enterprises within their field of authority. Currently, the selection process for recruitment and promotion is being transformed into a process based on announced vacancies, voluntary applications and competitive selection based on merit. Simultaneously, the rotation policy, i.e. the policy under which civil servants in Echelon II – IV are moved between offices, functions and locations on average every third year, is being reviewed to better support career development. Development of a new intranet based HRIS has recently been initiated.

Source: Synnerstrom (2008)

Reforms must be sustained through changes in central policies and regulations

It is important that reforms be sustained through corresponding changes and increased flexibility in central policies and regulatory frameworks. The current divided set-up for civil service management has so far proven incapable of delivering required civil service reforms under a coherent national reform strategy. Indonesia's civil service reform efforts for the coming years will therefore need to focus on several things.

The Minister of Finance has made a start by establishing a task force to examine the remuneration of senior officials linked to job classifications…

The first priority is personnel pay and conditions. The Minister of Finance has set up a task force to examine the entire compensation package for high-ranking state officials with the goal of creating a more transparent, systematic and coherent framework of pay and allowances linked to a comprehensive review of job classifications and categories. This is intended to lead to an independent remuneration commission to determine both the level and structure of the compensation package for Indonesia's highest ranking political officials. Such an approach would be followed by a similar comprehensive review of pay issues for the larger civil service.

…while the reforms initiated in the Finance Ministry need to be extended to other state

A second priority will be to ensure that the reform concept developed by MoF will be widely introduced in other institutions. The additional budgetary allocation necessary gives MoF and eventually the DPR a strong mechanism to safeguard and control reforms to

institutions

ensure they will be implemented and have the desired impact. Today, it is not MenPAN but MoF that is the driving force behind reforms, due to its precedence in reform design and its authority to set up reform requirements linked to budget allocations. Due to the very fast pace in which reforms are implemented in MoF, there will be a need both to evaluate outcomes and assess outputs to maximize impact. For other institutions, improvements can be made in the context of adapting MoF outputs to their operational requirements, for example when introducing new job descriptions and key performance indicators to professionalize jobs and improve performance.

Current HRM policies and the regulatory framework need reform to encourage reform-minded institutions…

Thirdly, current HRM policies and the regulatory framework should be changed so that reforming institutions will not have to work around those policies or violate regulations. Outcomes of reforms should be sustained through amended legal frameworks accommodating what is going on. MenPAN is the competent authority for preparing amendments to the Civil Service Law and is currently planning to submit a new law this year. For the new law to meet current and future reform requirements, however, MenPAN needs to engage in a much broader process involving stakeholders and assessing good international practices. The NCBR could be instrumental in this regard and regional governments need also to become partners in this exercise. Before a law can be put into the inter-governmental and parliamentary processes, a thorough analysis and subsequent definition of new policies need to be undertaken.

…and also feed into the development process for a new Civil Service Law

Lastly, the extension of MoF reforms to other agencies will have to be part of the policy development process leading to a new Civil Service Law. Basic HRM policies that need to be reviewed are, for example, the current lack of professional classification of jobs and the subsequent poor match of skills and requirements in most institutions. In addition, current policies and mechanisms for determination of organizational structures and staffing establishments (*formasi*), need to be reviewed. This is currently done through an administrative process separate from the budget process and leads to poor allocation of human resources, fragmentation of responsibilities and excessive staffing levels.

Most state institutions are working at improving efficiency and service delivery and a new government in 2009 will benefit from the momentum to build a professional civil service

In late 2009, a new government will take office. Unlike 2004, the new government will take over an administration where many serious problems are recognized and openly discussed, where most institutions are actively trying to improve efficiency and service delivery and where clear reform concepts are already established and implemented. The new government will be able to benefit from a strong momentum to actually implement the fundamental reforms required to move the Indonesian state from a compliance-based administration without focus on efficiency and performance into a professionalized administration ruled by efficiency, performance and service delivery standards. Problem recognition and reform commitment on the institutional level has not been missing during the last five years, but central guidance, coordination and follow-up of reforms has.

13. Making the most of decentralization: helping local governments realize their potential

13. a. Improving the framework governing centre-local relations

Responsibility for most public services was devolved in 2001 while central funding for those services was boosted substantially in 2006 and 2007…

Much of the responsibility for public services was decentralized in 2001. The process was based on three basic laws 1) regional autonomy; 2) fiscal relations; and 3) regional government taxes and fees passed between 1999 and 2000. Not surprisingly, the process has been a work in progress and both the regional autonomy and fiscal relations laws were amended in 2004 to provide more clarity while the critical government regulation on functional assignments (central, provincial and district) was only completed in 2007 and the amended version of the Law on regional government taxes is still pending in Parliament. A second phase of decentralization in 2006 increased financial transfers to the regions by 50 percent, followed by a further 15 percent in 2007. Indonesia's roughly 440 local governments now undertake nearly 40 percent of public spending with most services provided by *kabupaten* governments who are responsible for approximately 75 percent of the total with provincial governments 25 percent.

…to equalize financial capacity so resource-

The basic decentralization laws provide that more natural resource revenues are to be retained in the regions where the resources are extracted. As resources (especially oil and

poor regions are not disadvantaged

gas) are concentrated in only a few regions, the process of decentralization has increased regional inequality and, with rising energy prices, the inequity is more pronounced. Fiscal balance funds (especially the General Allocation Grant or DAU) have, however, been designed to compensate for this and the evidence is that the DAU is assisting to equalize financial capacities. By any criteria, however, regions, even the poorest, have received large increases in transfers in recent years (most now have surpluses) and the challenge has moved to spending wisely.

Perceptions about decentralization vary but surveys show that satisfaction with service delivery is improving…

Perceptions about how decentralization is working vary. Claims about poor education and health outcomes, especially malnutrition, abound. Infrastructure deficiencies are observable and businesses list local government procedures as one of the chief impediments to investment. Comprehensive surveys of perceptions indicate, however, that satisfaction with service delivery is improving. When asked about whether things have improved in the last two years, over 70 percent of public service users indicate that they believe that there have been improvements in health and education services, 56 percent in administrative services and 45 percent in police (not decentralized). This matches another survey two years earlier that had a similar outcome.

…but the transition is far from complete with unclear and overlapping responsibilities…

Nevertheless, despite amendments and regulations designed to address legal ambiguities, the framework governing the division of roles, responsibilities and resources between the national and local governments (including between provinces and regencies) remains ineffective and incomplete. The central government continues to spend significant amounts of resources on local government tasks and, de facto, it is not clear who is in charge of key public services. Moreover, a clause in the regulation turns over responsibility for detailing service responsibilities to central departments themselves. There have been recent efforts, including a new regulation on deconcentrated spending, that are designed to address the confusion of roles but experience indicates that the longer the ambiguity about function exists the more entrenched it becomes. An improved functional division among the different levels of government would promote greater clarity, more accountability, higher quality and more efficient service delivery.

…while much central funding is spent on excessive salary and other administrative costs, so reducing the incentive to address civil service costs

Sub-national expenditures at both the province and regency level are dominated by administrative spending (usually for salaries for the administration, local parliament, buildings etc) at close to 30 percent of budgets. By contrast best practice is usually closer to 5 percent. As a result, much of the DAU is earmarked for financing civil service wages. This eliminates the incentive to address civil service costs (and shift spending to capital expenditure and other areas) and reduces the share of the DAU available for fiscal balance. Removal of full coverage would strengthen the equalizing impact between own-source and natural resource revenues and empower sub-national governments to find the optimal combination of inputs (size of workforce, capital, intermediate inputs and outsourcing) for public service delivery.

The equalizing effect of the DAU could be improved while the government's strategy for the DAK is not yet clear…

The equalizing effect of the DAU could, however, be improved. In particular, the elimination of the hold-harmless provision, that each sub-national government has the right to at least as much funding as previously should be enacted. A combined reduction in the pool of DAU funds reserved for salaries and the elimination of the hold-harmless provision would make the pool available for equalization larger and overall transfers more pro-poor. The use of the special autonomy grant (DAK) has been growing rapidly from less than USD500 million in 2005 to USD2.3 billion in 2008. This reflects a conscious decision to reduce deconcentrated spending but, aside from increasing the amounts, it is not yet clear what the government's strategy is for using this important instrument. In particular it would be important to clarify priorities, including its use for poverty reduction and the achievement of minimum standards.

…and there is a need to strengthen sub-national finances by amending the law on regional government taxes and fees and transferring responsibility for generating own-source

Unlike most decentralized countries, Indonesia has not transferred significant tax power to local governments, distorting incentives and creating an unhealthy dependence on transfers from the center. In particular, the central government administers the relatively efficient property tax including setting rates and evaluations although it provides 92 percent of the proceeds to regional governments as part of its transfers. The statutory rate is 0.1 percent to 0.2 percent which is one of the lowest in the world and enforcement is weak. The Amendment to Law 34 on Regional Taxation (due for enactment in 2008)

revenues, including property taxes to the regions…

represents an opportunity to address some of the difficult issues in own source revenues. In particular, the Law moves from a negative list on taxes and fees to a positive list of preferred revenue sources. This should restrict the proliferation of uneconomic local government interventions, which on average have administration costs of 50 percent and some of which have costs above yields. The pending amendment does not provide for control of administration or rates of property taxes to be delegated to sub-national governments, but there has been discussion within Parliament around this issue. Thus the amendment to the Law represents an opportunity to shift this important source of revenue to regional governments and this would address one of the largest imbalances in Indonesia's decentralization, i.e. the lack of regional government revenue sources.

…as well as reforming on-lending and on-granting regulations…

Local and provincial governments, especially in urban areas, have a key role in public investment, particularly in the infrastructure sector where the needs are great. Borrowing for infrastructure and other projects is virtually non-existent with total outstanding sub-national debt at 0.14 percent of GDP. There is a legacy of arrears for both sub-national governments and their local water providers (PDAMs) which inhibits the development of new lending. To increase sub-national government access to credit the government needs to revise on-lending and on-granting regulations to facilitate support for local infrastructure finance and service delivery, to address overly complicated rules and such provisions as those that limit borrowing for non-revenue producing projects. At the same time the arrears problem (including for PDAMs) needs to be addressed comprehensively.

…and transitioning to a market-oriented system of sub-national credit

It will also be important that the central government continue to build credibility on its willingness to use intercept mechanisms for sub-national governments that again fall into arrears. Finally, while regional governments can now borrow in anticipation of increasing sub-national financing needs, especially for urban infrastructure, the government should address the issues that continue to constrain the development of market-based sub-national bonds, including rules about securitization, and procedures to address fiscal distress and bankruptcy. On the sub-national government side, local governments will need to improve transparency including submission of externally audited statements.

Indonesia does not yet have systems in place to improve transparency, accountability and the technical capacity of regional administrations…

Despite the increased responsibility of sub-national governments, and a regulatory framework for regional public financial management, Indonesia does not have systems in place designed to deliver transparency, accountability and efficient development. Most regions need to improve technical capacity and human resources to implement reforms. Sub-national governments are obligated by law to report certain fiscal and financial information to the central government but many are not (in 2006 the central government finally began to impose sanctions with some improvement). Sub-national governments are not required to make this available to the public and most do not.

…and while there are signs of improvement many local governments continue to misuse revenue-raising authority to impede business development and trade…

The devolution of political authority to local governments has also posed challenges for the investment climate. Post-decentralization the initial reaction was often to increase charges on local businesses and trade. Inconsistencies as well as the sheer number of local regulations have made doing business more difficult in many places. Districts have, at times, used their newly acquired powers to issue excessively stringent local labor regulations or target businesses with a plethora of new local taxes, levies and fees. In fact, the costs, delays and inconvenience of business licensing is one of the most commonly mentioned criticisms of the local investment climate. Although illegal, restrictions in the movement of goods across district and provincial borders still exist and impose additional costs and delay to the distribution of goods, interfere in domestic trade and undermine internal market efficiency. Incomplete regulations at decentralization and the tug-of-war between the center and the regions on issues such as investment approval, land and the like affect the "bankability" of investments and have been a factor in the slow recovery of investment post-crisis, especially in mining. Finally, businesses have to face corruption in the regions as they do at the center.

…and compromise the investment climate although there are signs that some reform-minded local governments are

As local level democracy spreads, there are signs that enlightened leadership is increasing and a number of local governments are beginning to address service issues, excessive regulation and policy deficiencies with a focus on improving the investment climate. These "second generation" local governments often have a better understanding of business needs and higher levels of responsiveness to citizen demands and their

now more responsive to the needs of business and their citizens

successes are being noted. Nevertheless, the process of clarifying and shifting responsibilities and building capacity at the local level has been slow. There are a number of reasons: i) views on appropriate models of decentralization are continuing to evolve, in part based on how the situation has played out; ii) the roles and responsibilities of central government institutions are still to be brought into line with the new reality (between and within ministries) raising bureaucratic tensions and resistance as budgets and status shift; iii) incentive problems resulting from the existing framework (e.g. the high share of transfers and a lack of transparency) and; iv) the slow process of creating local government capacity after more than 30 years of centralized decision making. The concern is that a process that stalls during this transition will end up with vested interests building up around an inefficient equilibrium with reduced accountability and efficiency and severe governance problems.

13. b. Increasing the capacity and accountability of local governments

There is ongoing confusion about financial management responsibilities while large surpluses have accrued in resource-endowed regions

Capacity problems at the local level remain. The unclear division of tasks between the Ministry of Finance and the Ministry of Home Affairs has resulted in confusion with respect to financial management, especially as new procedures are introduced. Regional governments have had difficulty spending increased resources and surpluses have built up in most sub-national governments, with especially large surpluses in natural resource-endowed regions. While the situation is improving, sub-national governments have not had experience in dealing with businesses and typically lack understanding of what it takes to create a good business environment.

Improved accountability will require innovative solutions such as performance-based financing…

In addition to addressing administrative and regulatory issues, improving decentralization outcomes requires increasing the capacity and accountability of local governments. The accountability of local governments to their constituents is crucial for the success of regional autonomy but, by necessity, developing new accountability relationships and systems takes time. One approach would involve improving performance by providing additional financing for sub-national governments that met established criteria i.e., with respect to financial and other reporting or, more ambitiously, on service provision (i.e. health and education outcomes or even road maintenance). The central government could provide this support through the DAK along with complementary technical assistance in the specified area.

…better monitoring of local government performance and improving sub-national fiscal and financial reporting

An improved system for monitoring of sub-national governments would provide incentives for good performers and technical assistance for those lagging behind. A credible performance system would provide transparency, attract investors to strong regions and provide a basis for an allocation system based on performance and needs. Despite the increased responsibility of sub-national governments, Indonesia does not yet have a sound system of sub-national fiscal and financial reporting to facilitate systematic monitoring and evaluation. In most middle-income and high-income countries the financial performance of local governments is measured by rating agencies and performance measurement mechanisms create competitive and political pressures. An improved system of reporting that reliably captures the performance of local governments and provinces would represent a positive development.

14. Increasing the legitimacy of the state and building consensus

14. a. Strengthening the rule of law and reforming the judicial system

Years of mismanagement have left the judiciary and law-enforcement agencies in a weakened condition…

The judiciary and associated law-enforcement agencies are perhaps the weakest link in Indonesia's governance and accountability system. In the three decades prior to the crisis, the legal system had been weakened by inadequate funding, ineffective procedures and inconsistent decision making. That led to a systematic demoralization and "deprofessionalization" of judges, police officers, prosecutors and other key players in the legal system, which has, in turn, hampered efforts to reform and improve these institutions. The result is that the rule of law is far from guaranteed in Indonesia today, and the uncertainty about, and the arbitrariness of, judicial interventions continues to be identified as one of the most serious obstacles to investment.

…but open to major

In the initial years following *reformasi*, there had been encouraging signs that the

reforms which have included new oversight agencies and legal institutions…

government and justice sector institutions were open to reform. A number of independent judicial review and oversight mechanisms had been established, including the Judicial Commission, a Prosecutorial Commission to oversee the AGO and a Police Commission. Other bodies that have been established include a Constitutional Court, an Anti-Corruption Court, the KPK and an Ombudsman's Office. The judiciary started a process of reform in 2001 and 2002 that was closely linked to the transfer of court administration from the Ministry of Justice and Human Rights to the Supreme Court (the *satu atap* or "one-roof" system). The Supreme Court, with support from Indonesian civil society and donors, developed a series of nine blueprints that covered most areas of judicial administration and laid out a roadmap for reform. The Supreme Court established a reform team to implement these changes, and many of these initiatives were incorporated into the Government of Indonesia's National Medium Term Development Plan (2004-09). Other agencies, in particular the AGO, launched similar reform initiatives.

…although progress has slowed considerably due to resistance by entrenched interests…

The momentum generated by these initiatives has not translated into substantive progress and reform of the legal system has slowed considerably in recent years. There appear to be two main and inter-related reasons for this. The first is the resistance to reforms from entrenched interests in the legal system. Because of the steps taken to strengthen the independence of the judiciary and insulate it from direct political influence, those interests within the judiciary who are most opposed to any institutional transformation, ironically, now control the reform agenda. In addition, there does not yet appear to be a critical mass of political will to challenge these interests.

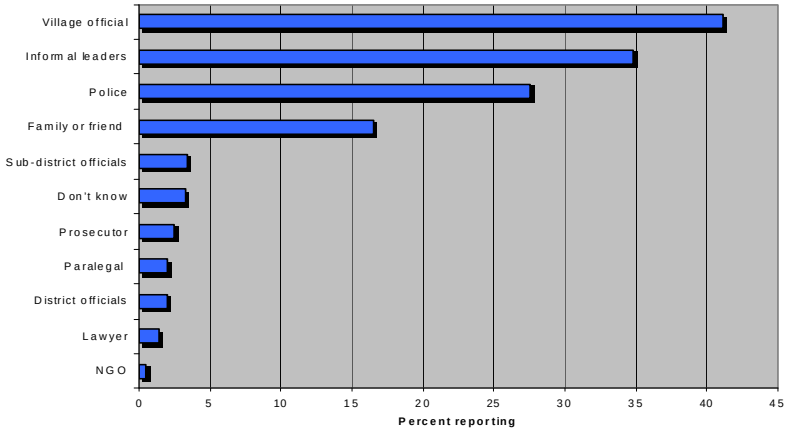
…and contestation between the newly-enlarged body of legal institutions

The second reason is the growth in the number of institutions with judicial and oversight powers, which has led to significant contestation between institutions. Some new institutions, such as the Constitutional Court and the KPK have been successful. The creation of a number of new institutions has, however, resulted in an overlap of jurisdictions and competition between these new institutions and those whose interests lie in maintaining the status quo. In this environment, the process of creating a normative framework at the national level with an appropriate system of checks and balances is likely to be a long-term process, especially when undertaken through trial and error.

A lack of substantive reform at the national level has highlighted the need to strengthen community-based justice systems…

Nevertheless, despite (or perhaps because of) the fact that there is a lack of substantive reform at the national level, efforts are being made to strengthen accountability from the bottom up by nurturing "demand for justice" at the local grassroots level. At the moment, the vast majority of Indonesians continue to have limited or no interaction with the formal legal system. Village heads and community figures (*tokoh masyarakat*) are the main agents of justice for most Indonesians (Figure 14.1). Only the police, of the formal justice sector institutions, play a significant role. To be relevant to the vast majority of the population, the legal system needs to be made more accessible, transparent and accountable, particularly to the poor. Local dispute resolution mechanisms need to be made consistent with state law, and the protection of women and marginalized groups (including ethnic minorities) in non-state systems needs to be strengthened.

Figure 14.1: Most Indonesians resolve disputes and seek justice through traditional channels



Sources and notes: McLaughlin & Perdana (forthcoming) and The Asia Foundation (2001), Survey Report on Citizen's Perceptions of the Indonesian Justice Sector, p.21.

…which are being supported with additional funding to enhance informal, local dispute resolution and mediation services…

With support from donors, the government is making efforts to enhance community legal awareness and to strengthen village level dispute resolution processes and out-of-court mediation services. Communities and civil society are increasingly playing a key role in demanding better performance from justice sector institutions at the local level. Communities who are empowered with knowledge of their rights and provided with access to legal services are placing pressure on district level law enforcement officials to perform their functions in accordance with the law and are supporting local level reformers within the legal sector.

…within a National Strategy on Access to Justice

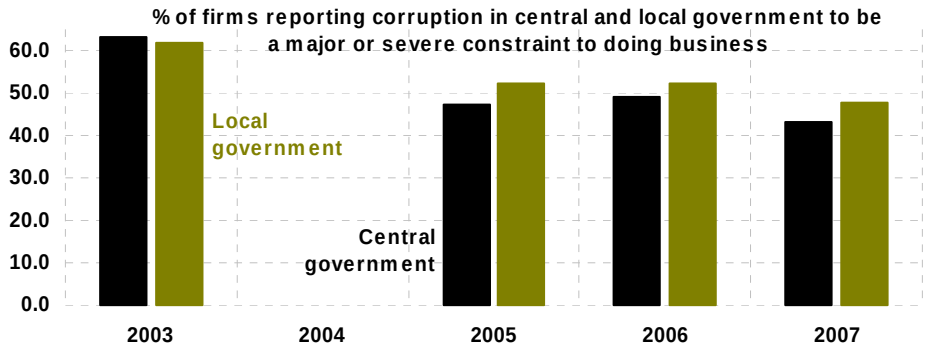
Recognizing the value of these efforts, the Government of Indonesia is drafting a National Strategy on Access to Justice that will attempt to provide a regulatory framework for demand-driven initiatives. The development of the Strategy is being coordinated by Bappenas and the intention is to include it in the next Medium Term Development Plan. The success of this Strategy will depend, to a large degree, on the extent to which it links with, or incorporates, the perspectives of formal justice sector institutions.

14. b. Building on the momentum gained in anti-corruption efforts

Indicators of corruption and the investment climate are improving…

Indicators of corruption in Indonesia are slowly improving. Most global corruption surveys still place Indonesia near the bottom but most also indicate that the situation has improved in the last five years. For instance, the World Governance Indicators standardized Control of Corruption measure for Indonesia rose from -0.97 in 2003 to -0.77 in 2006, raising Indonesia's percentile rank globally from the 14th percentile to the 23rd. Large-sample firm level surveys of Indonesia's investment climate indicate similar improvements. The percentage of firms citing corruption at the local level to be a severe obstacle to doing business fell by nearly 12 percentage points between 2003 and 2007. Perceptions regarding corruption at the national level improved even more markedly, with the percentage citing it as a severe obstacle falling by over 20 percentage points.

Figure 14.2: Perceptions of corruption in government have declined



Sources and notes: LPEM-UI (2007).

…in response to the impetus given by the Yudhoyono Government

The improvement in perceptions reflects the impetus provided to anti-corruption efforts by the Yudhoyono Government that came to power in late 2004. With the strong support of the president, who has made the fight against corruption a theme of his administration dedicated resources have been made available to at least some of the agencies critical to the anti-corruption initiative. The president also continues to enjoy a reputation for personal integrity and there is a perception that nepotism in appointments, political favoritism in commercial relations and regulatory decisions, and political intervention over independent commissions and oversight bodies, which all used to be common practices under previous governments, has diminished.

The legal framework for anti-corruption initiatives was enacted in the early years of *reformasi…*

The legal and regulatory framework needed to support anti-corruption initiatives was put in place in the early years after the crisis with the enactment of a number of anti-corruption laws and their subsequent amendments.[1] These laws define corruption, the roles of different agencies in handling corruption, and the procedures and types of evidence required in corruption investigation, none of which had previously been specified in the criminal code or court process code.

…which established a number of new apex institutions…

In parallel to, and in some cases, as a result of, the enactment of these laws, a number of apex institutions have been established. These include specialized law enforcement institutions and teams such as the KPK, the Indonesia Financial Transaction Reports and Analysis Center (PPATK) and the temporary (from 2005 to 2007) Corruption Eradication Coordination Team (Timtas Tipikor), which have a clear mandate and broad authority to strengthen, streamline and expedite investigation, prosecution and court hearings of corruption cases. They also include the Judicial Commission, Prosecutorial Commission, National Police Commission, and National Ombudsman Commission, whose main functions are to promote reform and to execute external oversight over the general law enforcement agencies such as the police, AGO and the Supreme Court.

…although their achievements to date have shown mixed results with the investigative agencies, KPK and Timtas Tipikor, among the more effective

The record of these institutions has varied. KPK and Timtas Tipikor have exercised their mandate vigorously and quite effectively in investigating and prosecuting high-level corruption cases. Among the list of successfully prosecuted high profile cases are those involving a former governor of Aceh, a former Head of the Investment Coordination Board and former Minister of Fisheries & Maritime Affairs. KPK was also successful in prosecuting heads of local governments and former ambassadors. Table 14.1 shows the number of corruption cases concluded by the KPK, AGO, National Police and the temporary Timtas Tipikor.

[1] Law 28/ 1999 on Clean Government Free from Corruption, Collusion and Nepotism; Law 31/1999 on Eradication of Criminal Act of Corruption; Law 20/ 2001 on Eradication of Criminal Acts of Corruption; and Law 30/ 2002 on Commission of Eradication of Corruption.

Table 14.1: Number of corruption cases concluded by apex agencies between 2004 and 2007

Agency	2004	2005	2006	2007
KPK	12	19	17	29
AGO	241	354	477	460
National Police	116	118	314	97
Timtas Tipikor		10	37	

Sources and notes: Annual Reports of the Anti-Corruption Commission 2005, 2006, 2007, and presentation by the National Police to Stolen Assets Recovery Initiative assessment mission, November 12th 2007.

The oversight agencies have been less effective due to entrenched resistance and inadequate resources…

On the other hand, despite a few successes, the oversight agencies have not been as effective because they have encountered resistance from the very institutions they are meant to oversee and have lacked the adequate investigative authority as well as the financial and human resources to overcome this resistance. Under the law they can only recommend new policies or policy changes to the president and to the leadership of the respective law enforcement agencies. Agencies like the PPATK, the financial intelligence unit, and the National Ombudsman Commission (KON) have also been limited by their lack of investigative authority and resources. Cases have to be referred to the police, often with limited preliminary evidence, and few referrals are investigated.

…while KPK and Timtas Tipikor have been more successful due to an integrated approach, clearly defined mandates and adequate resources

Three features that distinguish KPK and Timtas Tipikor from the others, and which might explain their relative success, are worth noting. The first is that they both were created to resolve the problems stemming from a lack of coordination between existing law enforcement agencies, by bringing together investigators, auditors and prosecutors under the same roof, working jointly on high profile cases. The second is that both had clearly defined mandates and broad investigative authority. Timtas Tipikor had a clearly defined mandate to investigate high profile cases associated with State-Owned Enterprises with a clear timeline (2 years), whereas the KPK has broader investigating authority compared to other law enforcement agencies and has the power to coordinate and supervise other institutions' investigations. The third is that both were provided with adequate financial resources and were able to recruit highly competent professionals. Timtas Tipikor was a group of 45 carefully selected specialists from the AGO, police and the Financial and Development Audit Agency (BPKP). KPK is exempt from the civil service scheme and is therefore able, given its financial resources, to offer attractive remuneration to its staff who, except for prosecutors and investigators seconded from AGO and the police, are mostly recruited from the private sector.

There has been success in prosecuting corruption but less progress in prevention efforts…

While there clearly has been some initial success in prosecuting corruption, there has been less progress in developing and implementing a coherent, well-focused strategy for corruption prevention. The government did, early on, lay out an anti-corruption strategy in two documents - a presidential instruction (Inpres 5/2004) and the National Action Plan for the Eradication of Corruption (RAN-PK) in February 2005. The former instructs all executive branch institutions of the government to expedite efforts to eradicate corruption and the latter collects detailed policy and reform measures from each institution to implement the presidential instruction. Both documents are comprehensive in scope, covering prosecutions, prevention and education however, neither document specifies any deadlines or sanctions. In addition, MenPAN, the ministry tasked with coordinating, monitoring and evaluating implementation, has only limited authority.

…where implementation of an anti-corruption strategy has been weak…

As a result, implementation of these anti-corruption strategy documents has, to date, been weak. Moreover, there are several important corruption-prone arenas of governance that are not covered by these documents. These include the judicial sector, supervision of the financial sector, political parties and parliaments, and military procurement and military-owned businesses. Addressing corruption in all four of these areas is critical to the overall fight against corruption. The general court system, for example, is still largely untouched by the anti-corruption efforts while the successful Anti-Corruption Court has been ruled unconstitutional by the Constitutional Court. The Supreme Court refused to allow the Supreme Audit Agency (BPK) to audit fees generated from registration and trials of cases. Reform in general law enforcement agencies have stalled as the National Police Commission and Prosecutorial Commission have not been given adequate mandates and appropriate resources.

…and wealth disclosure by senior government officials has been lagging

Performance in another important mechanism for corruption prevention - wealth disclosure by public officials has also been lagging. By the end of 2005, only 54 percent of senior government officials had submitted their declarations to the KPK, which is responsible for the management and implementation of the wealth reports of public officials, and only a small share of these submissions have been properly audited. Furthermore, the impact of these declarations is limited by the fact that they are not fully available to the public, as in most countries, and by the fact that the relevant current legislation does not specify a criminal offence for intentional illicit enrichment.

Nevertheless, there is ongoing progress with recently enacted freedom of information and whistleblower legislation …

There have, however, been some important positive recent developments. The legal framework for preventing corruption should be considerably improved with the recent passage of laws on freedom of information and witness protection. The latter protects whistleblowers while the former promotes transparency of essential public information such as budget, expenditure and procurement related information. Of course, the passage of laws is just the beginning and a strong framework to implement the Freedom of Information law will be critical to ensure genuine access. In order to promote international cooperation in recovering proceeds of corruption, Indonesia ratified the United Nations Convention Against Corruption (UNCAC) in 2006 and signed Mutual Legal Assistance treaties with South Korea, China, Australia, Hong Kong, and ASEAN.

…while high-profile investigations by the KPK are putting pressure on institutions to initiate reforms

Recent KPK investigations involving the judiciary and parliament are beginning to put pressures on these institutions to initiate reforms. That is critical, because without progress in civil service and administrative reform, legal and judicial reform, accountability measures at the local government level, as well as the more sensitive issues of political party and electoral financing and the role of quasi-public foundations (*yayasan*), the early gains from the government's anti-corruption drive may not be translated into sustainable improvements in the quality of governance.

15. How to approach strengthening public institutions and processes

15. a. There is no simple recipe for strengthening public institutions and processes and it will take time…

There are no simple or universal recipes or models for complex institutional reforms…

Adapting the institutions and mechanisms that govern the functioning of the state and shape state-society interactions will take time and not be easy. Institutional reforms and process transformations by their very nature are complicated undertakings. Building consensus around more easily implemented but contentious reforms can also be a lengthy process. There are no simple or universal recipes or models for how to do this - the particulars of the model will necessarily vary from context to context.

15. b. …and involve learning from experimentation, monitoring and evaluation and replicating existing pockets of success

…and a step-by-step approach that involves learning from experimentation, monitoring and evaluation, and replicating existing successes may be warranted…

And so the approach to reforms may be as important as the substance of the reforms themselves. Whether the task is civil service reform at the national level or improving service delivery at the local level, much trial and error and institutional adaptation is required. The approach often involves piloting reforms - selected from a menu of reform options that hold some promise, but the particulars of which need to be "field-tested" - on a small scale or in a clearly demarcated realm (a region, a ministry, a sector or sub-sector), monitoring and evaluating them carefully and using these assessments to adapt and improve the design of reforms and determine when and how to scale them up.

…which Indonesia is already doing in some areas…

Indonesia is doing just that in some areas. Civil service reforms were first initiated only within the Ministry of Finance and that too, only in a limited form. Over time, the scope of the reforms has gradually broadened, while similar reforms have been initiated in selected other institutions such as the Corruption Eradication Commission and the Supreme Audit Agency. Similarly, the approach to budget reforms is going steadily but slowly, initially in selected departments within the Ministry of Finance and Bappenas, but now beginning to move to a few selected line ministries. The nationwide rollout (PNPM) of community-based poverty alleviation that was tested and refined over the last decade through the KDP and UPP programs, the piloting of a future conditional cash transfer program (PKH)

and, to a somewhat lesser degree, the expansion of BOS are all other examples of this approach, where initiatives, initially limited in scope or scale are being scaled up as evidence accumulates of the effectiveness of the initial efforts.

15. c. But maintaining a sense of urgency - making haste slowly - is critical

…but maintaining a sense of urgency -making haste slowly - is critical throughout the process if the hard-earned reform momentum is not to stall because of resistance to reform and political dynamics

Though it is important to recognize that institutional reforms take time and it is often advisable to take a step-by-step experimental approach, maintaining a sense of urgency - making haste slowly - is critical throughout the process. That is because without a continued sense of urgency there is a risk that Indonesia's hard-earned reform momentum might stall. The government has shown commitment to reform, but significant obstacles to change remain. There is a risk that the reform effort will languish as even committed reformers are overwhelmed by the extent and complexity of the task of pushing forward institutional reforms and putting in place new ways of doing things in the face of entrenched organizational cultures and behaviors. The task is especially challenging when, as is often the case, the implementation of institutional reforms relies on the very unreformed systems and processes that are themselves the object of change. Those who benefit from the existing system, whether from corruption, capture or nepotism - the very institutional distortions that are often the target of the reform agenda - can use those distortions to politically derail efforts at serious institutional reform. Broader political dynamics can also intervene when the electoral imperatives of coalitional and money politics undermine incentives and efforts to strengthen the accountability of state institutions. A sustained focus on governance and transparency can help by restoring confidence in the legitimacy of public processes and institutions and building a consensus for continued reforms. If Indonesia can make haste slowly and maintain a sense of urgency in furthering its governance transition, it has the potential to become a dynamic, competitive and inclusive middle-income economy.