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INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

PROGRAM DOCUMENT

FOR A PROPOSED

SECOND INSTITUTIONAL STRENGTHENING FOR SOCIAL INCLUSION
(SECOND INSTITUTIONAL, TAX ADMINISTRATION, SOCIAL AND INVESTMENT)
DEVELOPMENT POLICY LOAN

IN THE AMOUNT OF US$ 400 MILLION

TO

THE REPUBLIC OF INDONESIA

OCTOBER 21, 2013

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

REPUBLIC OF INDONESIA
GOVERNMENT FISCAL YEAR
January 1 – December 31

CURRENCY EQUIVALENTS

(Exchange Rate Effective as October 16, 2013)
Currency Unit Rupiah (IDR)
USD 1.00 = IDR 11,316

ABBREVIATIONS AND ACRONYMS

AAA	Analytical and Advisory Activities	KPPN	*Kantor Pelayanan Perbendaharaan Negara* (State Treasury Services Offices)
ADB	Asian Development Bank	LKPP	*Lembaga Kebijakan Pengadaan Barang/Jasa Pemerintah* (National Public Procurement Office)
AFC	Asian Financial Crisis	MDG	Millennium Development Goal
AGO	Attorney General's Office	MDTF	Multi Donor Trust Funds
AMDAL	*Analisa Mengenai Dampak Lingkungan* (Environmental Impact Assessment)	MenPAN	*Kementerian Pemberdayagunaan Aparatur Negara* (State Ministry of State Administrative Reforms)
APBN	*Anggaran Pendapatan dan Belanja Negara* (State Budget)	MHH	Male Headed Households
AusAID	Australian Agency for International Development	MMR	Maternal Mortality Rate
Bappenas	*Badan Perencanaan Pembangunan Nasional* (National Development Planning Agency)	MoF	Ministry of Finance
BI	Bank Indonesia	MoH	Ministry of Health
BLSM	*Bantuan Langsung Sementara Masyarakat* (temporary cash transfer)	MoU	Memorandum of Understanding
BLT	*Bantuan Langsung Tunai* (direct cash transfer)	MP3EI	*Master Plan Percepatan dan Perluasan Penbangunan Ekonomi Indonesia* (Master Plan for Acceleration and Expansion of Indonesia's Economic Development)
BOP	Balance of Payment	MP3KI	*Master Plan Percepatan dan Perluasan Pengurangan Kemiskinan Indonesia* (Master Plan for Acceleration and Expansion for Indonesia's Poverty Reduction)
BPJS	*Badan Pelaksana Jaminan Sosial* (Implementing Agency for Social Safety)	MTEF	Medium-Term Expenditure Framework
BPK	*Badan Pemeriksa Keuangan* (State Audit Agency)	Musrenbang	*Musyawarah Rencana Pembangunan* (Multi stakeholders consultation forum)
BPKP	*Badan Pengawasan Keuangan dan Pembangunan* (Financial and Development Audit Agency)	NTS	National Targeting System
BPS	*Badan Pusat Statistik* (Central Bureau of Statistics)	OECD	Organization for Economic Co-operation and Development
BR	Bureaucracy Reform	OJK	*Otoritas Jasa Keuangan* (Financial Services Authority)
BSM	*Beasiswa Siswa Miskin* (scholarship for poor students)	PBB	Performance Based Budgeting
CMEA	Coordinating Ministry for Economic Affairs	PEFA	Public Expenditure and Financial Accountability
COSO	Committee of Sponsoring Organization	PER	Public Expenditure Review
CPI	Consumer Price Index	PERISAI DPL-DDO	Program for Economic Resilience, Investment and Social Assistance in Indonesia Development Policy Loan- Deferred Drawdown Option
CPS	Country Partnership Strategy	PESF DPL-DDO	Public Expenditure Support FacilityDevelopment Policy Loan- Deferred Drawdown Option
CSA	Control Self-Assessment	PKH	*Program Keluarga Harapan* (Conditional Cash Transfer)
DG	Director General	PP	*Peraturan Pemerintah* (Government Regulation)
DGB	Director General Budget	PPP	Purchasing Power Parity

DGT	Director General Taxes	PREM	Poverty Reduction and Economic Management
DIPA	*Daftar Isian Pelaksanaan Anggaran* (Approved Budget Allocation)	PMK	*Peraturan Menteri Keuangan* (Minister of Finance Regulation)
DNI	*Daftar Negatif Investasi* (Investment Negative List)	PMT	Proxy Means Testing
DPL	Development Policy Loan	PNPM	*Program Nasional Pemberdayaan Masyarakat* (National Program for Community Empowerment)
FASBI	*Fasilitas Simpanan Bank Indonesia* (BI's overnight deposit facility)	PPLS	*Pendataan Program Pelayanan Sosial* (Social service data collection program)
FDI	Foreign Direct Investment	P4S	*Percepatan dan Perluasan Perlindungan Sosial* (Protection Acceleration and Expansion Program)
FHH	Female Headed Households	Pusintek	*Pusat Sistem Informasi dan Teknologi Keuangan* (Center of Information System and Technology)
FIRM DPL	Financial Sector and Investment Climate Reform and Modernization Development Policy Loan	RASKIN	*Beras Miskin* (Rice for the Poor Program)
FX	Foreign Exchange	RPJMN	*Rencana Pembangunan Jangka Menengah Nasional* (National Medium Term Development Plan)
FY	Fiscal Year	SJSN	*Sistem Jaminan Sosial Nasional* or the National Social Security Law (SJSN Law)
GDP	Gross Domestic Product	SAKTI	*Sistem Aplikasi Keuangan Terpadu Instansi* (Agency Integrated Financial Application System)
GFMRAP	Government Financial Management and Revenue Administration Project	Satker	*Satuan Kerja* (Working Unit)
GOI	Government of Indonesia	SBI	*Sertifikat Bank Indonesia* (Bank Indonesia bills)
IBRD	International Bank for Reconstruction and Development	SD	Sustainable Development
ICR	Implementation Completion and Results	SIKD	*Sistem Informasi Keuangan Daerah* (Regional Financial Information System)
ICT	Information and Communication Technology	SPAN	*Sistem Perbendaharaan dan Anggaran Negara* (Integrated Financial Management System)
IDPL	Infrastructure Development Policy Loan	TA	Technical Assistance
IMF	International Monetary Fund	TII	Transparency International Indonesia
INSTANSI DPL	Institutional Strengthening for Social Inclusion Development Policy Loan	TNP2K	*Tim Nasional Percepatan Penanggulanan Kemiskinan* (National Team on Accelerating Poverty Alleviation)
Jamkesmas	*Jaminan Kesehatan Masyarakat* (health service fee waivers for poor and near-poor households)	TSA	Treasury Single Account
JICA	Japan International Cooperation Agency	UHC	Universal Health Care
K/L	*Kementerian Lembaga* (Line Ministries)	UKP4	*Unit Kerja Presiden Bidang Pengawasan dan Pengendalian Pembangunan* (**Presidential** Working **Unit** for Supervision and Management of Development)
KMK	*Keputusan Menteri Keuangan* (Decree of the Minister of Finance)	ULP	*Unit Layanan Pengadaan* (Procurement Service Unit)
KPI	Key Performance Indicators	VAT	Value Added Tax
KPK	*Komisi Pemberantasan Korupsi* (Corruption Eradication Commission)	VSL	Variable Spread Loan

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REPUBLIC OF INDONESIA

SECOND INSTITUTIONAL STRENGTHENING FOR SOCIAL INCLUSION

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The Second Indonesia INSTANSI Development Policy Loan has been prepared by a World Bank team supervised by James A. Brumby (Sector Manager, EASP2), Ndiame Diop (Lead Economist, EASPI), and led by Bernard Myers (EASPI) and Theo Thomas (EASPI). Members of the team are: Dara Lengkong, Ashley Taylor, Alex Sienaert, Yue Man Lee, Mark Ahern, Hari Purnomo, Enda Ginting, Rubino Sugana, Bintoro Suryo Hutomo, Romawaty Sinaga, Retno Sri Handini, Vivi Alatas, Edgar Janz, Ririn Purnamasari, Erwin Ariadharma, Yulia Immajati, Lieke Riyanti (all EASPI), Rajat Narula (EAPFM), Darren Dorkin, Pandu Harimurti, Eko Pambudi (all EASHH), Mitchell Wiener (EASHS).

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LOAN PROGRAM SUMMARY

REPUBLIC OF INDONESIA

SECOND INSTANSI DEVELOPMENT POLICY LOAN

Borrower	Republic of Indonesia
Implementing Agency	Coordinating Ministry for Economic Affairs and the Ministry of Finance
Financing Data	IBRD Variable Spread Loan, USD400 million
Operation Type	The second single tranche operation of a two-year programmatic DPL series. However, the Government has indicated the likelihood for an extension of the series to three years.
Main Policy Areas	Poverty reduction, health, social assistance and of public Finance.
Program Development Objective(s) and Contribution to CPS	This is the second in a series of INSTANSI DPLs that supports the broader goal of the 2013-15 CPS, which is to enhance Indonesia's capacity and institutions for reducing poverty and boosting shared-prosperity. In particular, the INSTANSI DPL series is expected to contribute to the Government of Indonesia's (GoI's) objectives in the following CPS engagement areas: (i) **pro-growth**: promoting prosperity by strengthening the public sector's ability to promote a stable medium-term macro and fiscal environment; (ii) **pro-poor**: promoting communities, protecting the vulnerable and improving health outcomes, by expanding the coverage and improving the targeting of social assistance programs, expanding the national social security health programs, and empowering communities to take charge of their development needs; and (iii) **pro-jobs**: enhancing skills and technology, and improving social protection, by strengthening the public sector's poverty alleviation and public financial management capacities, and also through an expansion of affordable and sustainable social insurance. Policy reforms supported by this operation focus on the following two pillars: (i) **Enhancing poverty alleviation and shared prosperity efforts** through improvements in the design and targeting of social assistance programs aimed at poor and vulnerable households, as demonstrated by the comprehensive compensation package for the subsidized fuel price increase, and implementation of a new national social security system (Sistem Jaminan Sosial Nasional, SJSN); and (ii) **Strengthening public financial management (PFM) for improved service delivery** through improvements in the medium-term results orientation of the budget process, the introduction of a more efficient and effective automated budget and treasury system, and improved accounting, audit, tax administration and sub-national fiscal management.
Key Results Indicators	The second INSTANSI DPL is expected to contribute to the achievement of the following results by mid-2014: **1.** An expansion of targeted social assistance measures for the poor following an increase in the price of subsidized fuel prices, from 8.5 million households to 15.5 million poor and vulnerable beneficiary households (about 70 million individuals) identified through the national registry (PPLS11); **2.** Implementation of a participatory mechanism through which communities can update beneficiary lists for the integrated social protection cards (KPS); **3.** Establishment of a main regulatory framework for implementing the national health insurance program; **4.** Improved budget transparency and planning by strengthening the use of the MTEF, with publication of the details in the 2014 budget; **5.** More efficient and effective public financial management following the introduction of a Presidential regulation governing new procedures and the introduction of a new integrated budget and treasury system in 2014; **6.** Modernization of the core tax system through the establishment of individual e-filing for a

	'Simple Tax Return' and 'Very Simple Tax Return' Forms in 2013.
Risks and Mitigation	• *Macroeconomic risks:* Recently, Indonesia has seen increasing pressures on its external accounts, with the current account deficit widening after a negative terms-of-trade shock and international financing conditions becoming more uncertain. Recent shifts in market sentiment have resulted in sudden, large and potentially disruptive reversals of capital inflows. The external accounts and growth outlook remain sensitive to softening global commodity prices and demand, particularly from China. With portfolio investors focusing on near-term policy responses, there is a risk that this diverts attention from longer-term reforms. However, the GoI has adopted key policy measures aimed towards protecting the poor and improving quality of expenditure, as supported by the ongoing DPL series, which are expected to help shield the risk of a crisis, and mitigate the impact of any economic downturns on households. The Government has developed a track record in precautionary and proactive measures to try to counter such shocks. This includes, for example, policy measures supported under the PERISAI DPL-DDO, approved in May 2012, which, along with parallel facilities from other development partners, also explicitly aims to mitigate GoI financing concerns in the face of a crisis. The Government has also been quick to introduce a package aimed primarily at longer-term structural measures to support exports and employment, moderate import growth, while limiting food price pressures. This has been accompanied by a tightening in monetary policy. There remain questions over the implementation of the policy package and it is likely that further policy adjustments will be required. However, there is the potential that the current macro-economic pressures that Indonesia is facing could allow policymakers the opportunity to make progress on medium-term structural reforms, although this must be offset against the political pressures in the run-up to the 2014 elections. • *Fiscal and subsidy reform risks:* Weakening revenue growth as activity moderates, and high and volatile energy subsidy costs, could significantly reduce fiscal space for other priority programs and undermine medium-term plans. Fuel subsidy spending was projected to rise significantly in 2013, reflecting increased consumption, imposing a substantial budget opportunity cost in terms of spending on key development priorities, as well as contributing to the current account deficit. Despite the political pressures from elections in 2014, a revised Budget incorporated a long-awaited increase in subsidized fuel prices (although the subsidy remains significant), along with a comprehensive compensation package to reduce the impact of higher fuel prices on the poor, was approved on June 17, 2013. The macroeconomic impact of the fuel subsidy reform package is expected to be manageable and largely short-term in nature, with a spike in inflation (although the recent exchange rate depreciation may prolong the upward pressures on inflation). The DPL will seek to build on these measures by promoting more medium-term budgeting, which should better highlight some of the policy trade-offs of fuel subsidies, as well as strengthening the ability of compensatory programs to protect the poor and vulnerable groups, while the broader social insurance programs start to come into effect in 2014. • *Implementation risks:* The focus of PFM reforms on enhancing expenditure controls and oversight will continue to make budget spending difficult in the short term, potentially undermining support for the reforms. Indonesia has made significant strides in PFM with increasing transparency, expenditure controls, and independent oversight. However, this has exacerbated existing problems of budget execution, particularly for capital spending, and increased the risk aversion of government officials, delaying much needed spending. To mitigate this risk, the DPL seeks to balance further strengthening of expenditure controls, with efforts to streamline procedures and improve the quality of spending as policymakers look for more rapid results. • *Coordination risks:* The multiplicity of implementing agencies and their varying institutional capacities create a challenge in coordinating and implementing reform efforts. Under the poverty pillar, the National Team for the Acceleration of Poverty Reduction (TNP2K) has taken the lead in the overall policy planning and coordination of social assistance programs; whereas the Ministry of Health is the main counterpart responsible for the preparation and implementation of the new national social security system (SJSN). Actions under the PFM pillar are undertaken by various Directorate Generals under the MoF. Nevertheless, the reforms supported by the INSTANSI DPL are driven by priorities developed and articulated formally through a platform of dialogue and consensus building within the Government, which the DPL helps to provide. Hence, their implementation helps to further

	enhance coordination between various ministries and agencies. The overall commitment to and ownership of reforms also remain strong, and the Coordinating Ministry for Economic Affairs ensures consistent and effective cross-ministerial coordination. While the challenge will increase as the election period approaches and uncertainty over institutional roles in the next administration increases, past experience has demonstrated continued GoI commitment to reforms, regardless of election outcomes. The DPL program will also continue to support the capacity of the various institutions involved, for example with direct support for the development of the next administration's medium-term plan (RPJMN) and social insurance reforms (SJSN), which are complemented by other Bank instruments, including investment projects, technical assistance and AAA.
Operation ID	P144775

I. INTRODUCTION

1. **This proposed Second INSTANSI DPL (INSTANSI DPL-2) to Indonesia for USD400 million continues the series of the first single-tranche INSTANSI DPL that began in 2012.** The goal of the INSTANSI DPL series is to assist the Government of Indonesia (GoI) to achieve its medium-term growth, poverty reduction and shared prosperity objectives, by supporting measures to enhance Indonesia's capacity and institutions for targeting poverty reduction measures, introducing a major social insurance program, and enhancing the management of public finances for better service delivery. The proposed operation was previously envisioned to be the second of a two-year, programmatic DPL series. However, the Government has recently indicated the possibilityd of continuing the engagement by extending the INSTANSI DPL series from two to three years. Therefore, a set of tentative triggers for a third INSTANSI DPL operation has been developed, which will need to be adjusted and refined, as progress is made and discussions with the GoI counterparts evolve.

2. **Significant progress has indeed been achieved since the beginning of the current Indonesia DPL series in 2004, which led to a deepening in the focus of the World Bank program lending to Indonesia.**[1] Initially focused on supporting the Government macroeconomic stabilization efforts, the DPL series has evolved into separate sectoral DPLs, with the aim of maximizing synergies across the Bank's program in Indonesia, increasing ownership of the reforms by the relevant institutions, and improving the targeting of complementary technical assistance programs. Three sectoral DPLs emerged in 2012: (i) *the Institutional Strengthening for Social Inclusion*[2] *Development Policy Loan* (INSTANSI DPL-2), which is largely a continuation of the previous DPL series that focused on poverty reduction and social delivery, and public financial management (PFM); (ii) *the Connectivity DPL*, which supports reforms to reduce domestic logistics costs and strengthen inclusive development; and (iii) *the Financial Sector and Investment Climate Reform and Modernization Development Policy Loan (FIRM DPL)*, which aimed to promote the development of a sound, efficient and inclusive financial sector and support improvements in the investment climate in Indonesia. To date, the GoI has made formal request only to continue with two of these three DPL series, namely the Second INSTANSI DPL and the Second Connectivity DPLs.

3. **Overall progress achieved under the DPL program continues to be satisfactory.** The DPL program has established a good track record in advancing key policy and institutional reforms to support Indonesia's economic growth and poverty reduction. Supporting Indonesia's relatively ambitious policy reforms is at the core of the World Bank's program in Indonesia.[3] Over the past few years, in addition to the DPL series, the World Bank has also been supporting policy reforms in the infrastructure sector (through the Infrastructure DPL, closed in FY11), the Public Expenditure Support Facility (PESF DPL-DDO) and the PERISAI DPL-DDO, which provide critical support during periods of heightened global financial uncertainty.

4. **The INSTANSI DPL continues to be led by and based on GoI priorities.** The GoI continues to take the lead in outlining the policy actions supported by the proposed INSTANSI DPL-2, based on its reform agenda. To date, all policy actions have been completed.Continuous policy dialogue took place

[1] The previous DPL series consisted of: (i) first DPL series (DPLs 1-4), which was implemented from 2004 to 2007 and anchored to the FY04-08 Country Assistance Strategy (CAS): (ii) second DPL series (DPLs 5-6) that was implemented from 2008-2009; (iii) third DPL series (DPLs 7-8). This series was initially set out as a three-year DPL series (DPLs 7-9) to be implemented from 2010-2012, but was terminated one year earlier, in light of the GoI's request for a renewed three sectoral DPLs (INSTANSI, Connectivity and FIRM DPLs); and (iv) a two-year INSTANSI DPL series (INSTANSI DPLs 1-2).

[2] Note that the original name of the series was the Institutional, Tax Administration, Social and Investment (INSTANSI) DPL. The full name has been changed to better reflect the objectives of the series, with INSTANSI the Bahasa Indonesia word for "Institution".

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

between the different GoI counterparts and the World Bank, through a series of formal dialogues throughout the preparation of the INSTANSI DPL-2, in order to formulate the supported policy actions and to assess their progress. Other development partners also participated actively throughout the policy dialogue. Technical assistance is often provided by different development partners in support of the policy actions identified by the Government. The INSTANSI DPL-2 was negotiated with the GoI in October 2013 and is expected to be presented to the World Bank Board in November 2013.

5. **Following a resilient economic performance since the global financial crisis, Indonesia's economy and policy settings are now adjusting to a number of domestic and external pressures**. These include weak export performance contributing to the notable deterioration in the current account balance, volatile external financing conditions, higher subsidized fuel prices and associated temporary inflation, and a moderation in domestic demand growth. Monetary, exchange rate and fiscal policy adjustments so far have been significant, but more may be required, combined with strong communication and coordination of policies. Ongoing pressures on the external balances, and the prospects of a less supportive international environment with higher global interest rates and less buoyant commodity demand, underscore the need for more policy reforms in a number of areas to support faster and more inclusive growth and poverty reduction, notably the regulatory environment and in manufacturing and trade policy.

6. **Indonesia's fiscal and monetary policy settings will need to continue to adjust to a shifting macroeconomic outlook.** The GoI has taken a number of measures to address the rising domestic and external pressures. Since June 2013, the monetary policy stance has shifted markedly towards tightening and the exchange rate policy has remained flexible. The Government also announced a comprehensive policy package in mid-August. Yet the key risk remains that external funding needs continue to place a strain on the rupiah or reserves, for example due to a further weakening in key export commodity prices or weak net inward investment dynamics, requiring additional monetary policy tightening, denting confidence and further crimping growth. The risks of such a scenario resulting in a loss of macroeconomic stability are mitigated by the fact that the policy framework is proving generally responsive to the risk of macroeconomic imbalances. Policy buffers, although reduced, remain ample, and the structural underpinnings of resilient growth remain in place, suggesting a favorable medium-term outlook for Indonesia. *Hence, the overall macroeconomic policy framework remains adequate for continued support through a development policy operation.*

7. **A set of policy actions have been identified to be supported by the proposed INSTANSI DPL-2, surrounding the following two pillars**:

(i) **Enhancing poverty alleviation and shared prosperity efforts** through improved governance and institutional accountability, better measurement and targeting of the poor and vulnerable in social assistance programs, and implementation of a new national social security system (Sistem Jaminan Sosial Nasional, SJSN); and

(ii) **Strengthening public financial management (PFM)** through improvements in the medium-term results orientation of the budget process, the introduction of a more efficient and effective automated budget and treasury system, streamlining of budget execution procedures, and improved accounting, audit, tax administration and sub-national fiscal management.

8. **The proposed INSTANSI DPL-2 supports the significant increase in social spending under the revised 2013 Budget, in part to help shield poor households from the impact of higher fuel prices.** The design of the social compensation package also demonstrates the important steps that have been taken towards developing a more comprehensive, integrated and well-targeted social support system, supported under previous DPLs. The approved package of compensation measures totals IDR 29 trillion (USD2.7 billion), or about three-quarters of the estimated total fuel subsidy savings in 2013. The compensation package comprises two main components: (a) an unconditional cash transfer (*Bantuan Langsung Sementara*

Masyarakat, BLSM) for 15.5 million of Indonesia's poorest households (around 90 million people) for a period of four months, the provision of additional rice to beneficiaries of the Rice for the Poor (*Raskin*) program, and additional spending on infrastructure programs; and (b) financial assistance for poor students and conditional cash transfers for health (*Program Keluarga Harapan*, PKH) is being expanded.

9. **The proposed operation also supports the strengthening of social protection in Indonesia, through the establishment of a new national social security system (*Sistem Jaminan Sosial Nasional*, SJSN) commencing implementation in 2014**. The SJSN aims to provide all Indonesians with the same health coverage, pension (defined benefit), old-age savings (defined contribution), death benefits and work accident compensation. If well implemented, the SJSN programs can help to reduce vulnerability, protect against economic shocks, facilitate job mobility, reduce elderly poverty, help reduce some forms of inequality, and mobilize scarce savings. However, the success of the new system depends on how well it is designed, implemented and managed. The Government's efforts to implement a well-designed, fiscally sustainable, robust and comprehensive national social protection system will prove challenging and will require a series of major actions from the Government, some of which are supported under this DPL, and relevant administrative bodies in order to succeed.

10. **PFM reforms are an important complement to the DPL because of the impact they can have to improve the quality of service delivery, especially through those programs and services aimed at poverty alleviation and shared prosperity.** In Indonesia PFM reforms would support smoother flow of funds to front-line service delivery units, greater transparency in the use of resources by central and local authorities, better links between resources and outputs/performance, more effective accountability structures, and higher rates of execution for critically needed public infrastructure. As Indonesia embarks on a period of second generation reforms to provide, for example, more sophisticated services in infrastructure, better education, and sustainable social insurance and social delivery systems, it is particularly important to assure macro fiscal stability, as well as improve the quality of spending if growth is to accelerate to 7 percent and higher.

II. COUNTRY CONTEXT

A. The Current State of the Indonesian Economy

11. **Following a resilient economic performance since the global financial crisis, Indonesia's economy and policy settings are now adjusting to a number of domestic and external pressures**: weak export performance contributing to a notable deterioration in the current account balance, volatile external financing conditions, higher subsidized fuel prices and associated temporary inflation, and a moderation in domestic demand growth. Monetary, exchange rate and fiscal policy adjustments so far have been quite significant, but more may be required, combined with strong communication and coordination of policies. Ongoing pressures on the external balances, and the prospects of a less supportive international environment with higher global interest rates and less buoyant commodity demand, underscore the need for more policy reforms in a number of areas to support faster and more inclusive growth and poverty reduction, notably the regulatory environment and in manufacturing and trade policy.

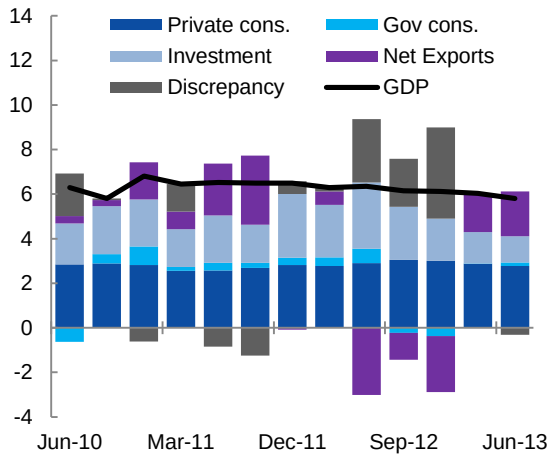
12. **The Indonesian economy has performed strongly over the past decade.** Real annual GDP growth averaged 5.7 percent from 2003 to 2012, lifting real GDP per capita by 54 percent to USD 3,563 (in 2012 US dollars). This solid performance was underpinned by sustained domestic private demand growth, fueled by favorable demographics (a growing labor force and falling dependency ratio), accompanied by rapid urbanization and a growing domestic market. Consumer and investor confidence levels, and the availability of investment funding, were supported by prudent macroeconomic management which, along

with strong economic growth, resulted in greatly improved private and public sector balance sheets. International demand for Indonesia's abundant natural resources, particularly from emerging economies such as China, also played its part, with around two-thirds of exports commodity-related.

13. **The economy proved resilient to the 2008/9 global financial crisis and the subsequent slow and uneven recovery in high-income economies**. Growth slowed from 6.0 percent in 2008 to 4.6 percent in 2009, but subsequently rebounded and has remained in the 5.8-6.5 percent range in every quarter since the beginning of 2010. This resilience can be attributed to strong initial conditions going into the crisis, the related availability and deployment of sizable fiscal and monetary buffers to cushion the shock, and Indonesia's lower dependence on external demand relative to many of its regional peers. Consumer inflation also moderated, from an average of 8.7 percent per year in 2003-08 to 4.9 percent in 2009-12, helped by the absence of any major food or administered price shocks through mid-2013. This solid performance, which contributed to Fitch and Moody's returning Indonesia to investment grade status in late 2011 and early 2012, attracted strong investor interest, fueled by abundant global liquidity. However, portfolio investment inflows, although generally strong, were prone to bouts of significant volatility, providing a reminder that Indonesia remains susceptible to external shocks through the financial channel, given high foreign ownership shares of both stocks and bonds. Inbound foreign direct investment also trended higher, contributing to rapid investment growth rates through 2012 (with fixed investment expenditure reaching one third of nominal GDP).

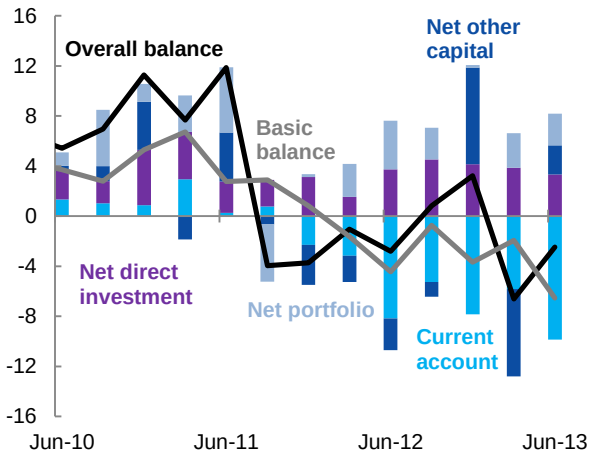
14. **Indonesia's economy, having been hit by a negative trade shock as global commodity prices and demand have fallen since 2011, is now showing signs of a slowdown.** Over 2012, the major drag on growth was net exports, with export volumes rising just 2.0 percent but import volumes increasing by a more robust 6.7 percent, reflecting the strength of domestic demand; net exports consequently reduced growth in 2012 by 1.5 percentage points. Investment growth also fell over the second half of 2012, and by the start of 2013 had become the main driver of the overall GDP growth moderation, decelerating from 12.5 percent yoy in Q2 2012 to 4.7 percent yoy in Q2 2013. The main cause of weaker investment growth has been a sharp slowdown in machinery and equipment spending, reflected in falls in capital goods imports. Fixed investment has shown a strong historical link with commodity sector conditions, and the softening in international commodity prices since early 2011 has likely now filtered into investment. On the production side, weakness is concentrated in commodities sectors, such as mining and quarrying (contracting 1.2 percent yoy in Q2 2013), compared with more robust performance in manufacturing (up 5.8 percent), construction (up 6.9 percent), and especially the services sector (up 7.5 percent).

Figure 1: Net exports were the major drag on GDP growth in 2012, followed in recent quarters by slowing investment
(contributions to real GDP growth, percentage points)



Source: Bank Indonesia (BI); World Bank staff calculations

Figure 2: The movement of the current account into deficit has weighed on overall balance of payment inflows
(nominal USD billion)



Source: BI; World Bank staff calculations

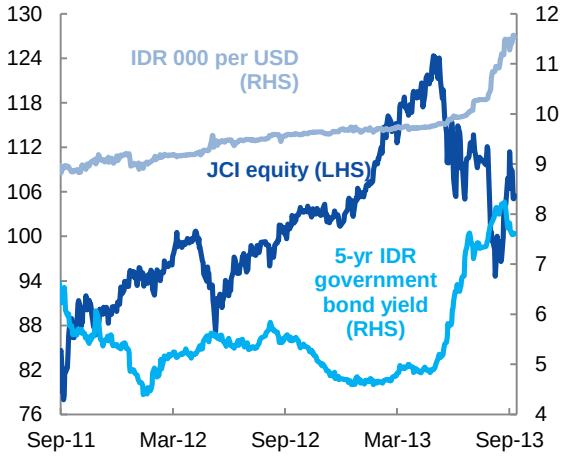
15. **The negative commodity-related shock to exports has resulted in a sharp weakening in the trade balance.** The annual goods trade balance declined from USD 34.8 billion in 2011 to USD 8.6 billion in 2012, reflecting weaker merchandise export values (down 6.0 percent in 2012) coupled with ongoing growth in merchandise imports (which rose by 8.0 percent in 2012). Pressure on the trade balance has persisted so far in 2013, with export revenues down 6.1 percent yoy in H1 2013, and import values down a more modest 2.2 percent yoy, resulting in a cumulative trade deficit of USD 3.3 billion (compared with a USD 512 million surplus in H1 2012). Initially, most of the swing in the trade balance could be attributed to the erosion of the non-oil and gas trade surplus, but since mid-2012 the oil and gas trade deficit has also widened substantially, having previously tended to be close to neutral.

16. **This has contributed to a marked deterioration in Indonesia's current account balance since 2011.** In 2012 Indonesia recorded its first annual current account deficit since 1997, of USD 24.2 billion or 2.8 percent of GDP, compared with a small surplus of 0.2 percent of GDP in 2011. Pressure on the current account has persisted in 2013, with quarterly deficits of USD 5.8 billion (2.6 percent of GDP) and USD 9.8 billion (4.4 percent of GDP) recorded in Q1 and Q2. While the bulk of this swing has been due to the erosion of Indonesia's historically strong goods trade surpluses, sizable structural deficits on the services trade and, especially, income sub-accounts, which have been broadly flat over recent quarters, also continue to weigh on the overall current account balance.

17. **The re-emergence of current account deficits has placed an increased focus on the availability and quality of external financing**, with Indonesia having tended to run a basic balance of payments deficit on a quarterly basis since late 2011, despite robust FDI inflows (of USD 20 billion in 2012 and USD 8.3 billion in H1 2013). Portfolio investment remains volatile and reported private external debt has also risen significantly, almost doubling since 2008 to be USD 131 billion in May 2013, and while external debt solvency metrics remain sound (with total external debt to GDP standing at 28.7 percent of GDP at the end of 2012 according to official estimates), gross external funding needs have consequently increased significantly. External debt disbursements and principal repayments totaled USD 184.4 billion and USD 164.3 billion, respectively, in 2012.

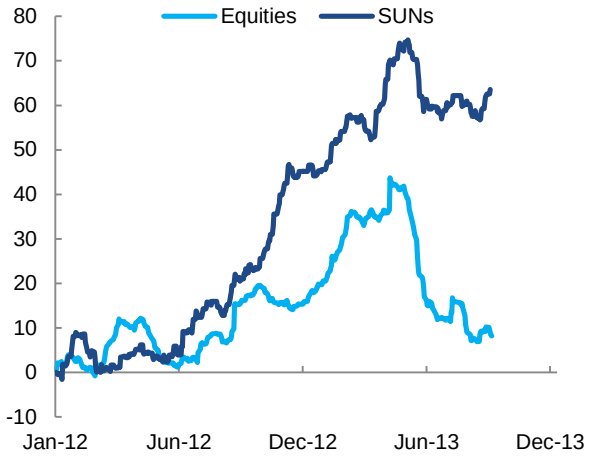
18. **Indonesian asset markets have been significantly affected by the recent pullback in emerging asset markets globally, following the pricing-in of QE "tapering" in the US since early May**. Particularly sharp falls in Indonesian asset prices were seen from mid-August (with an 8.6 percent decline in the equity market over 19-20 August). The rupiah has been under pressure, depreciating by 12.2 percent over August and September, to IDR 11,532 per US dollar (down 19.2 percent since the start of the year). Rupiah-denominated government bond yields have been volatile and, though off their recent peaks at the end of August, remain up 220 to 300 basis points since the start of 2013). The context for these market moves has been one involving the release of weak domestic data, particularly on the second quarter balance of payments, and ongoing domestic and international policy adjustments.

Figure 3: Indonesian asset prices worsened abruptly in Q2 2013 and remained volatile in Q3…
(Equity index, 4 Jan 2011=100, Rupiah and 5-year bond yield)



Source: Bank Indonesia (BI); World Bank staff calculations

Figure 4: …amidst a sharp reversal in portfolio capital inflows, particularly for equities
(cumulative foreign investor net equity purchases and change in holdings of IDR-denominated government bonds, SUNs, since Jan-2012, IDR trillion)



Source: BI; World Bank staff calculations

19. **The macro policy adjustments to these recent pressures are ongoing, but have been seen in both fiscal and monetary policies**. On fiscal policy, the revised Budget for 2013 increased the targeted deficit by 0.7 percentage points to 2.4 percent of GDP, on the back of weaker revenue growth (in line with moderating nominal GDP growth and weak export revenues). Most notably, the Government increased subsidized fuel prices in June for the first time since 2005, increasing the subsidized petrol price by 44 percent to IDR 6,500 per liter and the subsidized diesel price by 22 percent to IDR 5,500 per liter (still well below the market price at the time of over IDR 9,000 per liter). This price rise, which followed the missed opportunity to follow through on proposed reform in 2012, marked a major step forward in increasing the quality of public spending and safeguarding fiscal sustainability. The impact on the poor was cushioned by a significant temporary compensation package for 2013, amounting to just under IDR 30 trillion.

20. **The increase in subsidized fuel prices, while welcome, has contributed to a rise in inflation.** Headline inflation rose sharply to 8.6 percent yoy in July and then 8.8 percent in August, up from 5.9 percent yoy in June and well above the ceiling of Bank Indonesia's 3.5-5.5 percent target band. These moves also reflected the seasonal impact of Ramadan. Prices fell and yoy inflation came down to 8.4 percent in September. The one-off impact of the subsidized fuel price increase is expected to abate fairly rapidly in the coming months (in month-on-month terms, before dropping out of the base by Q3 2014) although pressures may remain from second-round effects or from the exchange rate pass through. Core inflation, although moderate, has picked up somewhat, moving to 4.7 percent yoy in September, from 4 percent in June.

21. **In response to the deterioration in financial markets, and significant pressure on the rupiah, the Government announced a policy package in mid-August.** The package has four pillars: (1) Improving the current account balance. This involves measures to encourage exports, such as fiscal incentives for export-oriented firms in labor-intensive sectors and relaxing the quota on mineral exports, and measures to reduce import growth, such as increasing the required use of bio-diesel in the domestic energy consumption mix. (2) Maintaining economic growth and employment, including fiscal incentives to support labor-intensive sectors, aiming to limit lay-offs. Notably, revisions are also proposed to the setting of the minimum wage in support of a more rational process and fairer outcome. (3) Lowering inflation, including replacing quotas with tariffs for imports of beef and horticulture products. (4) Enhancing investment to

support both growth and capital inflows, including measures to simplify licensing, to expedite the approval of the Revised Negative Investment List, and to move forward with "debottlenecking" key strategic investment projects. While focused on many of the important structural issues faced by the economy, the implementation, both in terms of timing and substance, will clearly be key in determining the impact of the package.

22. **Ahead of the recent period of adjustment, monetary policy was highly accommodative**. Key policy rates remained unchanged from February 2012, when Bank Indonesia cut the lower bound of its interest rate corridor to a record low of 4 percent, and June 2013. In mid-2012, however, BI announced new loan-to-value limits for vehicle and real estate lending, and this appears to have contributed to a decline in credit growth from a peak of 26 percent in May, to a still robust 22 percent in August 2013. These macroprudential adjustments also reflected the pronounced price pressures in some pockets of the property market (e.g. residential apartments, commercial office, and industrial space, in Jakarta up 45 percent, 43 percent and 22 percent, respectively, yoy in December 2012). The macroeconomic stability risks posed by such sharp property price increases are mitigated by the fact that overall property-related exposures in the banking system remain comparatively small at 14 percent of total bank assets, and by BI's prudential measures.

23. **Since June 2013 the monetary policy stance has shifted markedly towards tightening**, in line with the focus on facilitating the adjustment in external balances and limiting inflationary pressures. Pre-empting the increase in subsidized fuel prices, and with pressure on the rupiah intensifying since May, BI surprised markets on June 11 by increasing its overnight deposit facility (FASBI) rate by 25 basis points, followed by a 25 basis point increase in its reference rate at its subsequent June policy meeting. This was followed by a 50 basis point increase in these key policy rates in July. However, policy rates were left unchanged in August and this raised some concerns in the markets, even though new macroprudential measures were also announced. Following the release of weak second quarter balance of payments statistics and intensifying downward pressure on the rupiah, the FASBI and reference rates were lifted by a further 50 basis points at an extraordinary policy meeting held on August 29 (in addition, the upper bound of the interest rate corridor, the BI lending facility rate, was also increased by 25 basis points). This was followed by a further 25 basis point increase in the FASBI, reference and lending facility rates at the scheduled meeting on September 12. Thus, since June 2013, BI has raised its overnight deposit facility (FASBI), and reference, rates by 150 basis points (to 5.5 and 7.25 percent, respectively), and its key lending rate by 50 basis points (to 7.25 percent). A number of macroprudential measures with a tightening bias, and steps to facilitate liquidity management, have also been taken: loan-to-deposit limits have been lowered from 100 to 90 percent, both government bonds and BI certificates of deposit have been allowed to be counted against banks' secondary reserve requirements, and shorter tenor BI deposit securities have been introduced.

24. **Exchange rate policy has remained flexible in as much as the rupiah has been allowed to depreciate through mid-2013,** but improving currency market liquidity and transparency remains a challenge. Foreign currency reserve growth stalled in 2012 (compared with growth of USD 14 billion in 2011), and the rupiah has weakened materially, with the nominal effective exchange rate trending lower since late 2010, to lose 11.8 percent between its late 2010 peak and July 2013. August has seen further, pronounced currency weakness, as also seen in many other major emerging markets (such as Brazil, India and Turkey), taking the rupiah's depreciation over 2013 through the end of August to 15 percent, and 19.2 through the end of September. While the depreciation has mostly been gradual and orderly, there have been some periods (in mid-2011, early 2012, early 2013 and July and August 2013) of very tight foreign currency liquidity, leading to a wide spread between official and market-quoted rupiah spot rates. Foreign currency demand in the commercial currency markets was cut early in 2012 by BI's decision to meet the US dollar needs of the state-owned oil company (Pertamina) directly, a move which coincided with a stabilization of the USD/IDR exchange rate, but was also followed by a substantial drawdown in currency reserves, which fell from USD 112.8 billion in December 2012 to just below USD 105 billion in March 2013. Following the

bout of global emerging market volatility and outflows beginning in May and continuing into the third quarter, reserves have subsequently fallen further, to USD 93 billion in August 2013.

25. **Recent measures by BI may help somewhat to improve currency market conditions. These** include: initiating US Dollar swap auctions to deepen hedging opportunities and, potentially, dampen spot US Dollar demand at times of market uncertainty, reversing the 2011 regulation that imposed a minimum 6-month holding period for foreign investors purchasing BI bills (SBIs) by cutting the required holding period to 1 month, and increasing official foreign exchange buffers, by extending a USD 12 billion-equivalent swap facility with the Bank of Japan (in late August) and USD 16 billion-equivalent swap facility with the People's Bank of China (in October), and announcing a new USD 16 billion-equivalent swap facility with the Bank of Korea (also in October).

26. **Despite the recent pressures in the financial markets, slowdown of growth and depreciation of the rupiah, Indonesian banks have shown resilience to the impact of recent developments.** Bank credit growth is slowing with the rise in new loan approvals weakening. Overall aggregate level banking health indicators remain sound, with low non-performing loans of 2 percent, and high capital adequacy of 18 percent have proven to serve as buffers. Another factor limiting the impact has been banks' relatively low foreign-currency exposures. However, despite this sound financial performance to date, the banking sector could still face pressure from further decelerating growth or additional market turmoil in upcoming months. Such pressures may well impact on smaller banks more markedly, with reports of some tightening in their liquidity in recent months, leading them to raise deposit rates. Substantial efforts have been made to improve crisis communication and protocols among the various institutions (BI, MoF, the new unified financial supervisory authority, OJK, and the deposit insurance agency). However, the transition to the new unified financial supervisory agency, OJK, and the absence of a financial sector safety net law do raise potential risks on the policy response should any systemic bank enter liquidity difficulties. Financing conditions for non-bank corporates have also tightened. Again, while leverage levels remain low, the concern is more of the potential for increased borrowing and repayment costs, particularly for those corporates with external debt without a natural currency hedge, or who have been impacted by declines in global commodity prices.

Table 1: Selected macroeconomic indicators, 2008-12
(in percent of GDP unless indicated otherwise)

	2008	2009	2010	2011	2012
GDP					
Real GDP growth rate (percent)	6.0	4.6	6.2	6.5	6.2
GDP (in billions of US dollars)	510	540	709	846	878
Contributions to growth (percent)					
Consumption	3.7	3.9	2.6	2.8	2.9
o/w Private	2.9	2.7	2.6	2.5	2.8
Gross fixed capital formation	2.5	0.7	1.9	2.0	2.3
Net exports	0.7	1.1	0.8	1.5	-1.5
Exports	4.3	-4.6	6.1	6.0	0.9
Imports	3.6	-5.7	5.3	4.5	2.4
Change in inventories	-1.2	-1.3	0.6	-0.1	2.2
Composition of nominal GDP:					
Consumption	69.0	68.3	65.6	63.6	63.4
Investment	27.7	31.1	32.0	32.0	33.2
Money and credit					
Credit growth (percent)	33.0	16.1	17.5	24.4	24.2
M2 growth (percent)	14.8	12.0	11.3	19.2	14.4
Prices					
Consumer price inflation (eop, percent)	11.1	2.8	7.0	3.8	4.3
Fiscal sector					
Central government revenues	19.8	15.1	15.5	16.3	16.2
Central government expenditures	19.9	16.7	16.2	17.4	18.0
Central government balance	-0.1	-1.6	-0.7	-1.1	-1.8
Primary balance	1.7	0.1	0.6	0.1	-0.6
Gross government debt	33.0	28.4	26.0	24.3	24.0
External sector					
Current account balance (in billions of US dollars)	0.1	10.6	5.1	1.7	-24.4
in percent of GDP	0.0	1.9	0.7	0.2	-2.8
Goods and services balance (in billions of US dollars)	9.9	21.2	21.3	24.2	-1.7
Export growth (fob, percent)	18.3	-14.3	32.1	27.0	-6.1
Import growth (fob, percent)	36.9	-24.0	43.7	30.3	8.4
Net direct investment (in billions of US dollars)	3.4	2.6	11.1	11.5	14.0
Net portfolio investment (in billions of US dollars)	2.5	10.3	13.2	3.8	9.2
Net other investment (in billions of US dollars)	-7.3	-8.2	-2.3	-1.8	1.9
Gross external debt	34.3	29.0	28.2	27.5	29.6
Central Bank reserves (in billions of US dollars)	52	66	96	110	113
Reserves (months of imports & official debt repayments)	4.0	6.6	7.2	6.4	6.1

Source: Central Bureau of Statistics (BPS); Central Bank of Indonesia (BI)

B. Macroeconomic Outlook

27. **Growth prospects have dimmed appreciably and risks to the outlook have risen.** In the base case, GDP growth is expected to shift down fairly moderately, responding to weaker terms of trade, higher interest rates and the negative impact of higher inflation on consumption. This expected, moderate deceleration would be broadly positive for safeguarding macroeconomic stability, and particularly for reducing the current account deficit to more sustainable levels in the context of subdued export performance and tighter international liquidity conditions. However, a more severe growth deceleration cannot be ruled out, with specific risks including a more disorderly currency adjustment and financial market volatility having a more pronounced impact on real economic activity.

28. **GDP growth in 2013 is projected to be 5.6 percent, down from 6.2 percent in 2012, and moving down to 5.3 percent in 2014.** Private consumption is expected to remain the main driver of growth, potentially boosted by early pre-election spending towards the end of 2013 and into 2014. Investment is expected to expand at a much more moderate pace than in 2012. Unlike 2012, net exports are not expected to be a significant drag on growth over 2013, as import volume growth decelerates in line with slower investment growth, and export volume growth remains positive, albeit sluggish. The 2013 growth projection of 5.6 percent is higher than the IMF assessment letter projection of 5.4 percent, reflecting a difference in the profiling of the feed-through of recent policy tightening, moderation in credit growth and financial market developments to growth (with the IMF figure expecting a sharper slowdown in the second half of 2013). Based on recent higher frequency data, the World Bank expects such impacts to flow through with a slightly longer lag. Looking forward to 2015, growth is expected to rise to 5.8 percent, although there is a substantial range of uncertainty around this baseline and risk of moving to a lower growth trajectory. Such risk could materialize in the absence of progress in addressing well-known impediments to medium-term growth in Indonesia and sufficiently supportive external conditions (in terms of trade and FDI inflows in particular).

29. **The current account deficit is expected to widen in 2013, to USD 29 billion, or 3.4 percent of GDP, before narrowing in 2014 to 2.6 percent of GDP.** The overall balance of payments is expected to record a sizable deficit in 2013, reflecting a shortfall in net investment inflows relative to the current account funding need, and resulting in a drawdown of about USD 20 billion in foreign currency reserves. The overall balance of payments deficit is expected to shrink significantly in 2014, reflecting a smaller current account deficit and sustained overall net investment inflows.

30. **Inflation pressures are expected to abate after the mid-2013 price surge triggered by the June subsidized fuel price increase and the seasonal impact of Ramadan.** Headline inflation in Q4 2013 is projected at 9.8 percent compared with 4.4 percent in Q4 2012, and inflation to average 7.3 percent in 2013 and 6.7 percent in 2014. This base case assumes that second-round inflation will remain contained, allowing the price impact of the June fuel price increase to drop out of the base by mid-2014. However, while core inflation has so far remained little-changed, there is a clear risk of some second-round effects from the recent spike in headline inflation, particularly given other cost-push inflation pressures. Exceptionally high minimum wage increases for 2013 were granted (including 44 percent for Greater Jakarta), and while the direct impact of this on the CPI basket is very small, such increases may feed into higher wages across the economy and hence spill over into consumer prices, particularly if reinforced by sizable additional minimum wage increases for 2014. More pass-through from the significant nominal depreciation of the rupiah can also not be ruled out. A further uncertainty for inflation is the possibility of additional reforms to administered prices, notably fuel subsidies. While welcome on equity, efficiency and fiscal grounds, the possibility of additional measures adds upside, albeit largely temporary, inflation risk. Bank Indonesia will need to gauge the risk of these supply-side factors feeding through into higher generalized inflation, which may necessitate further tightening monetary policy.

31. **Risks to the growth outlook are to the downside, given uncertainties over consumer and investor confidence, and downside risks to domestic demand growth.** While domestic demand has remained resilient so far, the headwinds have mounted since June: higher fuel prices and higher generalized consumer price inflation in recent months (eroding purchasing power and consumer confidence), higher interest rates (dampening hitherto rapid credit growth), and potential negative wealth and corporate investment activity impacts from the stock price declines seen since May. These increased challenges are occurring against the backdrop of a continued weakening in international commodity prices, with the US dollar price basket of Indonesia's top six commodity export products declining by 8 percent in 2013 through August (down 35 percent from the post global financial peak reached in February 2011). Commodity prices are a key driver of domestic demand conditions, due to their importance for export revenues, company profits, and for household incomes in parts of the country where the resources sector is important for labor

income, such as oil palm growing regions. Looking further ahead into 2014, investment is likely to face some headwinds from the ongoing failure to address regulatory issues, some policy missteps, and general uncertainties surrounding the electoral process and outcome as the 2014 elections draw nearer. Indonesia also continues to face competition from its peers in the region for export-oriented investment, at a time when labor costs, at least for minimum wage workers, have risen sharply.

32. **Indonesia's fiscal and monetary policy settings will need to continue to adjust to a shifting macroeconomic outlook.** Monetary policy faces the challenge of recalibrating interest and exchanges rates so as to improve the external balances, and guarding against a build-up of inflationary pressures due to supply-side price increases (from higher subsidized fuel prices and the weaker currency), without unduly crimping economic growth and weakening public and private sector balance sheets. The interest rate and exchange rate increases seen so far over 2013 argue that the monetary policy stance has indeed been shifting in the right direction, although more will likely be needed. On the fiscal side, policy planning will need to account for the persistence of slower revenue growth and higher nominal debt-financing costs, placing further focus on the need to lift the quality of spending, in terms of its technical and allocative efficiency, and so as to meet the Government's development objectives. The 2014 Budget, scheduled to be approved by late October 2013, will provide an important gauge of how fiscal policy is adjusting, with the adoption of realistic macroeconomic assumptions, continuation of the hitherto prudent overall fiscal stance, and continued emphasis on redirecting spending away from energy subsidies and towards capital expenditures, being desirable (including a move towards further subsidy reform, although this may prove difficult to achieve given the 2014 elections).

33. **Management of the external balance will be a particularly key challenge and the projection of stable macroeconomic performance is predicated on the avoidance of significant policy missteps in this area, as well as more clarity and implementation progress on the Government's response package (outlined above).** With many of the policies likely to realize an impact only in the medium term, many investors and commentators felt they did not go far enough to bring about a near-term adjustment in the external balances through dampening domestic demand. These fears appear to have been allayed, at least in the short term, by the subsequent rate increase by BI. However, more information on the substantive content of the proposals is still needed, and the degree to which they are seen as being mutually consistent across government, and the manner in which they are implemented, will matter. Investor risk perceptions will likely hinge, in particular, on the extent to which policymakers are seen to be tolerant of somewhat lower domestic demand growth in order to ease balance of payments pressures, making policy coordination and communication paramount, particularly against the backdrop of an intensifying political cycle. Should they be implemented, a number of specific measures mooted in the policy package to encourage investment, such as a less restrictive negative investment list (DNI, governing the restrictions on foreign investment by sector), have the potential to send a positive signal to the market by helping create positive expectations in terms of future FDI flows, and thus bring more stability to the currency market.

34. **In the event of further negative external shocks, Indonesia will feel the effects through the trade, financial and domestic confidence channels, but is in a relatively strong position to respond.** Monitoring and coordination mechanisms are in place to facilitate a flexible response to major market dislocations, with the Forum for the Coordination of Financial Sector Stability having met to discuss developments since financial market conditions began to deteriorate in May 2013, and the BOP monitoring task force of the Ministry of Finance and Bank Indonesia having been reactivated to monitor bank liquidity, FX liquidity and short-term debt exposures.

35. **On both the fiscal and external sectors, the focus is more on ensuring adequate near-term financing than concerns over medium-term debt sustainability.** Private external debt has trended upwards, but was under 30 percent of GDP at the end of 2012, supporting external debt solvency metrics., However, as mentioned, Indonesia's gross external financing needs are substantial, and those arising from the servicing and repayment of external debt are considerably larger than those generated by the current

account deficit. Gross external debt repayments in Q2 2013 totaled USD 43.1 billion versus a quarterly current account deficit of USD 9.8 billion. Tighter external financing conditions and Rupiah depreciation make for a more costly and challenging environment for refinancing existing external debt, over half of which (or 15 percent of GDP) now consists of private external debt. This is particularly the case for corporates without access to natural currency hedges (through US Dollar revenues) and those heavily exposed to the recent weakening in global commodity prices. Official gross reserves of USD 95.7 billion at end-September, while well down from their recent high of USD 124.6 billion in August 2011, remain more than sufficient to cover Indonesia's short-term external financing needs, despite the ratio of short-term external debt to official reserves having risen from 40 percent to around 50 percent at end-2011. However, more importantly, external liquidity risks have risen, with the debt service ratio rising to 80 percent in June 2013, from around 30 percent in mid-2011. Bank Indonesia projects that repayments of external debt excluding trade finance, revolving loans and currency and deposits will total USD 32.6 billion over August to December 2013, of which USD 28.8 billion is private debt, with a further USD 33.4 billion in gross repayments expected in January-July 2014. As mentioned above, in support of contingency arrangements, Bank Indonesia has recently extended bilateral currency swap arrangements with China, Korea and Japan.

36. **Gross fiscal financing needs do remain substantial but the overall fiscal balance sheet remains strong.** Central government debt was just under 24 percent of GDP at the end of 2012, with its downward trajectory in recent years supported by strong nominal GDP growth, exchange rate appreciation and relatively low deficits. Debt sustainability analysis points to the debt-to-GDP ratio picking up somewhat (by 2-3 percentage points) over the next couple of years due to declining nominal GDP growth, the weaker exchange rate and projected higher fiscal deficit (albeit still less than 3 percent of GDP). The baseline projection is for debt-to-GDP to remain in the range of 25-30 percent of GDP over the medium-term, absent significant shocks. Turning to fiscal financing risks, in the event of major disruption to local or international bond markets, crisis management protocols and continent financing facilities with development partners have been set up to support financing of critical public expenditures. The World Bank PERISAI DPL-DDO operation, in addition to supporting short-term policy measures aimed at enhancing crisis preparedness, provides contingent budget support through end June 2014, which the Government intends to draw down only in the event of a significant worsening of the financing conditions. The Government has also secured additional contingent financing of around USD 3 billion from the Government of Japan (JPY 120 billion), Australian Treasury (AUD 1 billion) and the Asian Development Bank (USD 500 million). The Government continues to view the contingent budget support as last resort financing to be used only if the required financing cannot be raised due to a fiscal financing crisis. For 2013, as of 8 October, the Government had reached 82 percent of its revised annual securities issuance target of IDR 331 trillion. Efforts are also being made to support the financing position through, for example, additional funding via program loan operations such as the World Bank DPLs.

37. **Overall, Indonesia's macroeconomic framework is adequate for the proposed operation.** Economic growth is moderating, and in the base case this is projected to stabilize at a pace which is still solid but more commensurate with a sustainable current account deficit. The key risk is that external funding needs continue to place a strain on the rupiah or reserves, for example due to a further weakening in key export commodity prices or weak net inward investment dynamics, requiring additional monetary policy tightening, denting confidence and further crimping growth. The risks of such a scenario resulting in a loss of macroeconomic stability are mitigated by the fact that the policy framework is proving generally responsive to the risk of macroeconomic imbalances. Policy buffers, although reduced, remain ample, and the structural underpinnings of resilient growth remain in place, suggesting a favorable medium-term outlook for Indonesia, predicated, as discussed above, on the implementation of supporting reforms, for example on the investment climate, on enhancing skills and improving infrastructure provision.

Table 2: Selected macroeconomic indicators, actual and projection

	Actual				Projection		
	2009	2010	2011	2012	2013 (p)	2014 (p)	2015 (p)
National accounts							
Real GDP (% change)	4.6	6.1	6.5	6.2	5.6	5.3	5.8
Real investment (% change)	3.3	8.5	8.8	9.8	5.3	4.9	6.1
Real private consumption (% change)	4.9	4.7	4.7	5.3	4.8	5.1	4.6
Real exports (% change)	-9.7	15.3	13.6	2.0	5.6	5.7	7.4
Real imports (% change)	-15.0	17.3	13.3	6.6	2.4	4.8	7.0
Agriculture (% change)	4.0	3.0	3.4	4.0	3.4	2.4	2.7
Industry (% change)	3.6	4.9	5.3	5.2	4.3	4.1	4.7
o/w manufacturing (% change)	2.2	4.7	6.1	5.7	2.9	2.8	3.7
Balance of Payments							
Current account balance (% of GDP)	1.9	0.7	0.2	-2.8	-3.4	-2.6	-1.9
Fiscal variables							
Central government balance (% of GDP)	-1.6	-0.7	-1.1	-1.9	-2.5	-2.3	-2.1
Revenue (% of GDP)	15.1	15.5	16.3	16.2	16.0	16.0	16.0
o/w Tax (% of GDP)	11.0	11.3	11.8	11.9	12.1	12.4	11.8
Expenditure (% of GDP)	16.7	16.2	17.4	18.1	18.6	18.3	18.1
o/w subsidy (% of GDP)	2.5	3.0	4.0	4.2	4.3	4.1	3.5
Central government debt (% of GDP)	28.4	26.0	24.3	24.0	23.5	24.1	24.0
Prices							
GDP deflator (% change)	8.3	8.3	8.1	4.5	2.6	4.2	5.5
CPI inflation (%)	4.8	5.1	5.4	4.3	7.3	6.8	4.5
Exchange rate (IDR/USD)	10,390	9,090	8,770	9,415	..	..	..

C. Poverty, Vulnerability and Shared Prosperity

38. **Sustained growth has allowed poverty reduction to continue, with the national poverty rate falling to 11.4 percent in 2013, but the rate of reduction in recent years has slowed.** Since recovering from the Asian Financial Crisis (AFC), Indonesia's national poverty rate has halved from 24 percent in 1999 to 12 percent in 2012.[4] Despite sustained strong economic growth, however, the rate of poverty reduction is slowing. The 0.5 percentage point fall in poverty between 2011 and 2012 was the smallest decline in the past six years. One of the reasons for a slowing rate of poverty reduction in recent years is that the poverty basket inflation has been considerably higher than both headline and core inflation. In 2013, the fall in poverty picked up slightly as the rate dropped to 11.4 percent, 0.6 of a percentage point from 2012 levels. Even so, about 28 million Indonesians—out of the current population of 246 million—still live below the poverty line (for 2013, the poverty line was set at IDR 271,600 per person per month). Approximately half of these households can be considered as being chronically poor, or consistently measured as poor in three consecutive years.

[4] Indonesia's national poverty line is the weighted average of the provincial urban/rural poverty lines.

39. **Extreme poverty has also been falling, but at a slower pace.** Indonesia identifies those households living below 0.8 times the official poverty line as being extremely poor. Since the AFC, the national extreme poverty rate has fallen from 9.39 percent in 1999 to 3.79 percent in 2012. This reduction has occurred at a slower pace than the drop in the official poverty rate. Based on international comparisons, however, the rate of extreme poverty is higher. In 2010, 18 percent of households in Indonesia fell below the international benchmark for extreme poverty set at PPP$1.25 per day.[5] Despite methodological problems with calculating an international comparable rate of extreme poverty, this indicates that Indonesia continues to face challenges in eradicating extreme poverty.[6]

40. **The falling poverty rate masks a high degree of vulnerability among many non-poor households in Indonesia.** Despite a relatively low official poverty rate, much of the population is clustered near the poverty line. In 1999, 39 percent of households lived below the official near-poor line of 1.2 times the poverty line. This fell to 23 percent by 2012. Despite this drop, about 55 million people lived below the official near-poor line as of March 2012, at which point the line was set at IDR 298,400 per person per month. More alarmingly, 94 million Indonesians lived below 1.5 times the poverty line (IDR 373,000 per person per month). This bottom 40 percent of the population is highly vulnerable to small shocks, such as food price increases, that can send these households into poverty. Consequently, Indonesia experiences a high rate of churning in and out of poverty. Half of the poor in 2010 were not poor in 2009, with over 80 percent of them coming from the poorest 40 percent the year before. As such, many households have experienced poverty: during the past three years a quarter of all Indonesians have been in poverty at least once.[7]

41. **Female-headed households, in particular, experience much more volatile poverty rates than the male-headed households.** Currently, the labor participation rate of women is substantially lower than that of men (Female: 51.2%; Male: 76.3%, based on WB data), and there is a large gender wage gap with women earning only about 70 percent of what men earn. While poverty rates for female-headed households (FHH) and male-headed ones (MHH) experienced a similar reduction over the 2000s, the FHH poverty rate was much more volatile than the MHH rate over the first half of the decade. This suggests that FHH interact with labor markets differently to MHH, face different risks to income and consumption, or have differential access to coping mechanisms and are less able to smooth consumption when shocks occur. The Maternal Mortality Rate (MMR) is still high, and there is a risk that this key MDG target may not be reached (MMR 2015 target of 102 per 100,000 live births, vs. 220 in 2010, according to WB data). Data also suggests that FHH tend to adopt the negative coping strategies through child labor. Despite tangible progress (e.g., gender parity in enrollment rates at all levels of education), persistent gender disparities remain.

42. **Inequality of household consumption has been increasing since 2000.** The Gini coefficient fell from 0.33 in 1997 to 0.30 in 2000 with the AFC having a more deleterious effect on the non-poor.[8] The Gini, however, has steadily increased since 2000, reaching 0.41 by 2012.[9] This level is high by OECD standards, and while around the lower middle income average, is high for the East Asian region and amongst the fastest rising. This recent increase in equality is being driven by stronger consumption growth at the top end of the distribution. After the equalizing effects of the AFC and recovery, the 90th percentile of household

[5] World Bank, as calculated by PovcalNet.

[6] The calculation of extreme poverty in Indonesia for 2010, based on the PPP$1.25 measure is likely an overestimation due to methodological challenges related to the survey data used to calculate the CPI. The data was predominantly based on Jakarta prices, and some of the survey data was collected during a period of high inflation following an increase in the price of subsidized fuel in the fourth quarter of 2009.

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

[8] The Gini coefficient is a number between 0 and 100, with 0 representing perfect equality, and 100 representing a single person holding all consumption/income/wealth.

[9] Official consumption Gini (nominal) from Statistics Indonesia (BPS).

per capital consumption had fallen from 3.7 times the 10th percentile in 1996 to 3.1 in 2003, and 2.1 times the 50th percentile to 1.9. However, since then, the trends have reversed, with the 90th-10th ratio increasing to 4.7 by 2012, and the 90th-50th to 2.5. The relatively stable ratios for the 50th-25th and 50th-10th indicate that it is the increasing consumption at the top end of the distribution relative to the rest, which is driving most of the increase in the Gini coefficient, rather than the middle also pulling away from the bottom.

43. **The relatively low consumption growth of Indonesia's poorest 40 percent, and resulting inequality, may begin to adversely affect social and political cohesion.** Despite strong economic growth, and official poverty approaching 10 percent, there is still a strong public perception that many more Indonesians are not well-off, and that growth has not been shared by all (a perception supported by the data). Moreover, around half of poor and vulnerable households do not receive major social assistance programs, while half of benefits go to the non-poor. There is some evidence that these inequities in access to social assistance have increased crime and decreased social capital.[10]

D. The Political and Social Context

44. **Over the course of 15 years of political and institutional reforms, Indonesia has made remarkable progress towards the goal of becoming a vibrant multi-party and decentralized democracy.** However, at this particular juncture the country is moving towards an election year in 2014. Next year will see the election of a new president by direct vote for only the third time in Indonesia's reform era, and this forthcoming changeover of power is creating tensions within the political system. For most of the life of this second Yudhoyono administration, tensions within and between the three branches of government—the legislative, judicial and executive branches—have been building. Nevertheless, there is commitment by reformers within the Government to push forward on important reform agendas.

45. **The political outlook is clouded by uncertainties over who might become the next president.** Adding to the uncertain political outlook is the limited choice of potential candidates for the post of president in 2014 and uncertainties over the prospects for the continuation of market-oriented policymaking. The current Jakarta governor has increasingly gained popularity, as a clean governance reformer with a focus on improving public service delivery, especially to the poor. However, despite the relatively strong political support for presidency, his formal candidacy has yet to be declared. Meanwhile, as election year approaches, the political pressure for the government to take more populist policies is mounting. Resistance for reduction in fuel subsidies, regulatory uncertainties in the extractive sectors (i.e., mining, oil, and gas), and pressure to increase regional minimum wage rates are among the politically sensitive issues that the government is currently confronting.

46. **There has been a trend towards more interventionist policy making, many of them have involved restrictive measures.** In the past couple of years, economic policymaking has become more driven by aspiration to increase domestic value addition through facilitating investments in agro-industry and downstream processing of commodities and natural resources. Given Indonesia's large pool of labor and increased exposure to commodity and natural resources activities, such aspiration has a strong development dimension. However, many of the policy instruments used to promote the aspiration may have caused adverse results on trade and investment. The decision to restrict exports of minerals by the mining sector together with the forcing of mining companies to invest in high-investment downstream processing in Indonesia had the effect of stifling the mining sector—one of Indonesia's most important drivers of investment and earners of foreign exchange. Furthermore, interventionist policies in the agricultural sector, especially restrictions on imports of beef and horticultural products, had served to stoke inflation and eroded consumer purchasing power at a time when the economy was largely being driven by consumer spending.

[10] See Cameron and Shah (2012).

47. **As a result of the recent market downturn, the Government responded with a package of measures to reassure market on the medium-term economic reform agenda**. Given the potential costs and consequences of not following a reformist path in policymaking, a silver-lining could be that the reformer agenda has been strengthened in the short term by the recent macro volatility. In August 23rd, 2013 the government announced economic stabilization package containing measures intended to achieve the following: (i) improve current account; (ii) safeguard purchasing power and facilitate growth; (iii) contain inflationary pressure; and (iv) maintain investment flows. Some the reform measures involved retracting interventionist policies on trade and proposal for improving certainty in business environment. However, it remains to be seen whether the measures go far enough to achieve the required adjustment in the external balances to alleviate financing pressures and provide confidence to financial market investors. Strong political interests in policymaking as the election approaches may undermine confidence in the reform process.

III. THE GOVERNMENT'S REFORM PROGRAM AND BANK SUPPORT

48. **The INSTANSI DPL-2 continues to support the authorities' reforms to enhance Indonesia's institutional capacity for reducing poverty and boosting shared-prosperity, but gives greater prominence to the policy reforms related to social assistance and social security than the previous DPL.** Substantial policy breakthroughs under the poverty reduction pillar have enabled GoI to focus INSTANSI DPL-2 on a robust set of social inclusion measures, and to allow more time for PFM related reforms to show demonstrable progress. The INSTANSI DPL-2 focuses on a set of medium-term policy measures underpinned by a wide-ranging program of longer-term reforms that the Government has been implementing over the past decade. The World Bank has supported these reforms through a range of programs, including the DPL program since its inception in 2004. Key elements of the Government's longer-term institutional and structural reform program are outlined below, while the proposed INSTANSI DPL-2 program is described in Section V.

A. Indonesia's Overall Development Agenda

49. **A series of five-year development plans have provided the framework for reinforcing economic stability and initiating structural reforms.** Within the first five years after the 1998 crisis, both economic and political stability were largely in place. When President Yudhoyono came to power in late 2004, plans for macroeconomic and fiscal consolidation and a series of structural reforms to restore confidence in the Indonesian economy were included into the National Long-Term Development Plan for 2005-2025. In its second term, the GoI adopted Indonesia's Medium-Term Development Plan (RPJMN) 2010-2014, with responsibility for monitoring progress assigned to the newly established Presidential Working Unit (UKP4). With the target of increasing economic growth to 7 percent and reducing the poverty rate to 8-10 percent by 2014, the RPJMN highlights the need for growth with equity and a range of cross-cutting policies to ensure that development is both sustainable and inclusive. The RPJMN places a special emphasis on increasing investment in infrastructure and strengthening the poverty agenda. Further, it commits the Government to a more equitable and inclusive development for, among others, women and children. The Ministry of Women Empowerment and Child Protection embodies this commitment.

50. **A new Master Plan for Economic Development seeks to accelerate growth and increase equity with a goal of becoming one of the 10 largest economies in the world by 2025.** In May 2011, the GoI launched the Master Plan for *"Acceleration and Expansion of Indonesia's Economic Development 2011-2025"* (MP3EI) based on three strategies: (i) fostering centers of growth in each major island group by developing leading resource-based industrial clusters; (ii) building synergies between those centers of growth, including international connectivity for trade and tourism; and (iii), complementing connectivity by improving human resources capabilities and increasing investments in research and development. Under the plan, business enterprises have a central role in economic development, particularly in generating

investments, creating employment opportunities and fostering innovation. The Government is responsible for creating conducive macro-economic and regulatory conditions for the acceleration and expansion of investments.

51. **A draft Master Plan for the Acceleration and Expansion of Poverty Reduction (MP3KI) that aims to eliminate absolute poverty by 2025 is being prepared by Bappenas.** The plan identifies three main strategies: (i) development of a comprehensive social protection system; (ii) improvement of basic services for poor and vulnerable citizens; and (iii) development of sustainable livelihoods for poor and vulnerable citizens. The social protection strategy consists of social security reform, continued expansion and integration of social assistance, and the development of a short-term shock response system. The plan also includes a target to reduce inequality – measured through the Gini – from 0.41 in 2012 down to 0.32 in 2025. While the strategies have a clear link to ongoing poverty reduction efforts, it is not clear how the strategies and activities will contribute to the reduction of inequality.

52. **The Government's approach to economic policy is based on its four strategic objectives of pro-growth, pro-jobs, pro-poor and pro-green development.** Equity remains a basic principle for balancing economic growth and development amongst large cities and smaller cities and more isolated parts of the country to deliver more even economic development in collaboration with the private sector and job creation across the country. It also includes a focus on reaching Indonesia's poorest. The Government concentrates on 13 programs, which include education, health, poverty reduction, employment creation, infrastructure development, food security, energy, good governance, electoral reform, anti-corruption enforcement, inclusive and equitable development, climate change and environmental protection, and cultural development. Collaboration with the private sector to complement Government's efforts through investments, job creation and innovation is prioritized. Reducing reliance on external finance and maintaining a low debt-to-GDP ratio is also a key GoI priority. In some, but not all of these areas, the Government has sought assistance from the World Bank Group.

B. Key Reform Directions Supported by the DPL

53. **The proposed INSTANSI DPL-2 continues to support the Government's development agenda**, **particularly in enhancing poverty alleviation and shared prosperity, and strengthening PFM for improved service delivery, as outlined in the RPJMN 2010-2014**. The INSTANSI DPL-2 is expected to be complemented by reform efforts pursued under the Second Connectivity DPL, which focuses more on supporting reforms to reduce domestic logistics costs and strengthen inclusive development, as outlined in the MP3EI. This section describes the key government reform achievements and directions under the two pillars supported by the INSTANSI DPL-2.

B.1. Poverty Reduction: Social Assistance and Social Security Reform

54. **The GoI remains committed to accelerating the pace of poverty reduction.** After assuming office in 2010, President Susilo Bambang Yudhoyono adopted a pro-poor approach for his administration, alongside pro-growth, pro-jobs and pro-growth strategies. As such, poverty reduction was identified as one of the highest development priorities in the medium-term development plan (*Rencana Pembangunan Jangka Menengah*, RPJM, 2010-2014). In the plan, the Government set a target to reach a poverty rate of 8-10 percent by 2014 through maintaining strong growth and job creation, and continuing implementation of the national poverty reduction framework. This approach is based on four clusters of programs: (i) Cluster I focuses on social assistance that targets individuals and households; (ii) Cluster II emphasizes interventions at the community level, largely consisting of the national community-driven development program *Program Nasional Pemberdayaan Masyarakat Mandiri Perdesaan* (PNPM-Mandiri); (iii) Cluster III seeks to support enterprises and micro-entrepreneurs; and (iv) Cluster IV provides housing and electricity for the poor, and improved livelihoods.

55. **The strategy to reduce extreme poverty, poverty and vulnerability has largely relied on Indonesia's national social assistance programs.** In 2007, the GoI launched *Program Keluarga Harapan*, (PKH), a conditional cast transfer program designed to address inequalities in health and education services and to provide a direct cash transfer for extremely poor households (i.e., households with per-capita expenditure levels of approximately 0.8 times the BPS-defined poverty line) that meet demographic eligibility requirements. Yet at the same time, these social assistance programs have not reached their potential in contributing to efforts to accelerate poverty reduction. Despite Indonesia's sustained and strong economic growth, the rate of poverty reduction has been slowing. One of the likely contributing factors is low spending on social assistance programs. Indonesia spends 0.5 percent of GDP (2010) on social assistance, which is low in comparison with regional peers and middle-income developing countries. The average for East Asian countries was 1 percent, while Latin American countries—where safety nets are more comprehensive—spend, on average, 1.3 percent of GDP. Low coverage, inadequate benefit levels, poor targeting outcomes, and a high degree of fragmentation across programs are all factors that undermine the effective of social assistance in reducing poverty.

56. **Social assistance programs, a key component of the national framework, have not reached their potential in contributing to efforts to accelerate poverty reduction.** Despite Indonesia's sustained and strong economic growth, the rate of poverty reduction has been slowing. The 0.5 of a percentage point fall in poverty between 2011 and 2012 was the smallest decline in the past six years. About 29 million Indonesians continued to live below the poverty line, as of 2012, which is set at IDR 248,000 per person per month. About half of all poor households are chronically poor, or consistently measured as poor over three consecutive years. One of the likely contributing factors is low spending on social assistance programs. Indonesia spends 0.5 percent of GDP (2010) on social assistance, which is low in comparison with regional peers and middle-income developing countries. The average for East Asian countries was 1 percent, while Latin American countries—where safety nets are more comprehensive—spend, on average, 1.3 percent of GDP. Low coverage, inadequate benefit levels, poor targeting outcomes, and a high degree of fragmentation across programs are all factors that undermine the effective of social assistance in reducing poverty.

57. **In order to boost the potential for social assistance programs, the oversight of national poverty reduction programs was elevated to a cabinet-level national team led by the Vice-President.** The Government recognized that there was a need to reform programs across all clusters in order to improve their performance in contributing to poverty reduction. Therefore, in 2010, the President decided to elevate the overall policy planning and coordination of the national poverty programs to a newly created National Team for the Acceleration of Poverty Reduction (*Tim Nasional Percepatan Penanggulangan Kemiskinan*, or TNP2K). The Vice-President chairs TNP2K, which includes all government agencies responsible for the planning, financing and implementation of poverty reduction programs, including the Ministry of National Development Planning, the Ministry of National Education and Culture, and the Ministry of Social Affairs. TNP2K is supported by a Secretariat, housed in the Office of the Vice-President, and responsible for preparing reform policies and monitoring their implementation

58. **The TNP2K Secretariat was tasked with the mission to improve and integrate poverty reduction programs to enhance their performance in reducing poverty.** This mandate was stated in the decree that established the National Team and its Secretariat, as well as the RPJM and a series of Instructions issued by the President during the beginning of his second term. The main reform aims of the Secretariat were to: (i) reform existing social assistance programs that were identified as government priorities, namely the conditional cash transfer program (*Program Keluarga Harapan*, PKH), financial assistance for poor students (*Bantuan untuk Siswa Miskin*, BSM), the subsidized rice distribution program (*Beras Miskin*, Raskin), and health service fee waivers for poor and near-poor households (*Jaminan Kesehatan Masyarakat*, Jamkesmas); (ii) help ensure the transition of individual programs towards an integrated social assistance system, through the establishment of a national targeting system that helps improve and unify targeting methods; and (iii) continue efforts to improve and consolidate community-driven development programs. A series of working groups was created under the TNP2K to commission

research, formulate reform policies, and support government agencies responsible for implementation of the reforms. Among these working groups included one for Cluster I programs, another focusing on Jamekesmas, another on targeting, and a Cluster II working group.

59. **The DPL series has supported key reforms that aimed towards developing a more effective and integrated system of poverty reduction programs.** Analytical findings on the performance of social assistance programs, generated both by the TNP2K Cluster I Working Group and the World Bank, helped to develop a series of policy actions focusing on the improving the design and delivery of the priority social assistance programs. At the same time, another series of actions supported the development of a national registry of poor and vulnerable households to improve program targeting, the foundation of a national targeting system. To prepare for the reform, the Central Bureau of Statistics (BPS) conducted a large-scale assessment of 25 million households (PPLS11), or just over 40 percent of all Indonesian households during July-August 2011. Households to be assessed were identified using a mix of census-based pre-listed households, community referrals, and updating of existing lists. Proxy-means test (PMT) models were developed to estimate household consumption and applied to the PPLS11 data as a basis for the registry of about 25 million poor and vulnerable households. Other DPL actions focused on improvements of the PNPM-Mandiri program based on the PNPM Roadmap.

60. **One of the Government's strategies to address widespread vulnerability is to expand social assistance programs to also cover the near-poor.** Social assistance programs such as Jamkesmas are extended to both the poor and near-poor populations. Other programs, due to budget and capacity constraints, only reached a share of poor households and few vulnerable households. The development of the unified database, however, allows government programs to reach the bottom 40 percent of the population, which are at most risk of falling into poverty. Social assistance reform strategies, therefore, became a mechanism not only to address poverty eradication, but also to share prosperity with the vulnerable households that fall just above the poverty line.

61. **The second strategy to reduce vulnerability includes implementation of the universal social security programs.** In 2004, the Indonesian Parliament passed landmark legislation—the *Sistem Jaminan Sosial Nasional* or the National Social Security Law (SJSN Law)—for the development of a national social security system. The law stipulates the principles and goals of the national social security system, and establishes a series of social insurance funds financed by employer, worker and government contributions, including five programs – health, pension, old age savings, death benefit and worker accident – that cover all Indonesian workers in both the formal and informal sectors. Moreover, the law stipulates that the Government will subsidize program costs in the health program for the poor. In 2011, the Indonesian Parliament approved the Social Security Administrator Law (BPJS Law) that establishes two nationwide social insurance administrators. BPJS Health is responsible for administering the SJSN Health program and is often referred to as the Indonesian universal health care program, while BPJS Employment is responsible for administering the other four SJSN programs. The BPJS are responsible, among other duties, for registering employers and workers, collecting and enforcing contribution payments, processing claims and paying benefits, and investing social insurance fund assets.

62. **As per the BPJS Law, by January 1 2014, the Government of Indonesia plans to merge all existing social health insurance mechanisms into a single-payer system** with common basic benefits package. This will include the contributory schemes currently administered by PT Askes (Indonesia's social insurance program for the public sector) and PT Jamsostek (the private sector insurance program for the formal sector), as well as the non-contributory schemes by 2014, including the non-contributory Jamkesmas scheme which targets the poor and near-poor. All those currently not covered are expected to have social health insurance coverage by 2019, to achieve universal health coverage (UHC). However, this goal may prove challenging to meet. Although health insurance coverage has increased significantly in Indonesia over the past decade and the Government has made progress in its plans to implement the BPJS Law, almost 60 percent of the population still remains without any coverage, and out-of pocket spending remains high even

among those with coverage. At present, household data estimates indicate that 22 percent of households have coverage from the non-contributory Jamkesmas scheme; 8 percent of households are covered by Askes; 7 percent are covered under Jamsostek; and 4 percent are covered by other forms of insurance coverage; 59 percent of all Indonesian households did not have any form of coverage in 2010.

63. **Improving the performance of Jamkesmas will be key to attaining universal health coverage in Indonesia by the stated goal of 2019, yet several key challenges remain.** On the positive side, about 40 percent of poor and near-poor households are covered under the program, outpatient and inpatient utilization rates have increased among program cardholders, levels of catastrophic payments have declined, and there is generally a positive perception with regard to the program among those who are enrolled. On the negative side, there is evidence of high levels of mis-targeting and leakages to the non-poor, low levels of socialization and awareness of benefits, low utilization and relatively low quality of care, regional inconsistencies in the availability of the basic benefits package, relatively shallow levels of financial protection, and poor accountability and feedback mechanisms. Overall, the biggest challenges relating to the implementation of UHC in Indonesia are those related to ensuring supply-side readiness and the financial sustainability of the program. Further expansion of insurance coverage is expected to be especially challenging since many of those currently not covered are in the informal sector. In addition, ensuring access to quality health services remains an issue, especially in remote, rural areas of the country.

64. **The Bank uses a number of instruments to support the Government's efforts to reform the design and delivery of social assistance and social security programs.** Starting in 2010, a multi-donor trust fund supported by AusAID was established to support the Government in making informed and evidence-based decisions about poverty reduction policies and program design. The trust fund has also been used to build the analytical capacity of local universities and think tanks for research and assessing poverty-related issues. This Partnership for Knowledge-based Poverty Reduction (PKPR) uses a three-pronged strategy in its engagement with the Government that focuses on: (i) providing poverty/vulnerability analytics and building analytical capacity to inform poverty and social protection policies, programs and strategies; (ii) supporting the Government in the design, implementation and evaluation of key poverty and social protection programs; (iii) improving the quality and accessibility of data needed for poverty analysis and policymaking; and (iv) supporting the Government with the implementation of the SJSN employment programs (pension, old age savings, death benefit and work accident), including development of an implementation roadmap, the design and financing strategy for each program, building government computer modeling and risk management capability, assisting the Government with the development of a strategy for contribution collection, and assisting the Government with consensus building and program socialization. Since 2005, the Bank has also been using the DPL series to support government reforms aimed at improving poverty reduction outcomes.

65. **The Bank is also working with other development partners to support the Government's goal of universal health coverage (UHC)**. With support and direct inputs from the MoH, Indonesia's Jamkesmas program has been assessed in a cross-country standardized manner with regard to financing and provision of health care coverage for the poor. The MoH's National Institute of Health Research and Development requested Bank support to analyze the first ever national health facility census (Risfaskes 2011), to optimize their utility for helping inform ongoing policy reforms in the country. Together the Bank and the MoH are using the World Health Organization's Supply Availability and Readiness Assessment (SARA) toolkit to systematically and comprehensively assess district-level variations in the availability of Jamkesmas benefit package across Indonesia. The proposed analysis will assess the scope of benefits available for several tracer conditions that are currently or projected to be high burden in Indonesia. In addition to assessing variations in the scope of key health services across the country, the analysis will also assess the extent to which such variations might influence actuarial estimates of the costs of providing these services based on data derived from Jamkesmas claims, as well as district-level utilization rates and key population health indicators. The Bank is also working with the MoH to analyze human resources for health availability, distribution and performance to meet UHC requirements. Building on its prior work on fiscal

space for health in Indonesia, the Bank will work with the Government to assess the fiscal implications of UHC, by evaluating the different sources of financing that might potentially be available for increasing government health spending to expand and improve coverage.

66. **Meanwhile, the Bank continues to support the Government's community-level poverty reduction program, through the PNPM-Mandiri**. The Bank retains the mandate from the GoI and development partners to serve as trustee for the PNPM Support Facility (PSF), which consolidates and coordinates grant support from the development partners to PNPM-Mandiri. Over the past four years, PNPM-Mandiri continues to benefit the poor, and it receives consistent political support at all government levels. The GoI and national parliament have initiated discussions on a plan for full national budget financing for PNPM, a trend that has already been reflected in the decreasing portion of Bank loan support during the past 3 years. The resolutions from the first PNPM National Congress in 2011 have been formalized by TNP2K through the PNPM Roadmap, which presents two main directions of PNPM, i.e. consolidation and integration of the overall program. The Roadmap comprises five pillars with 12 priority agendas for ensuring the sustainability of PNPM-Mandiri. Lessons and key features from PNPM-Rural are to be adopted into the new village law, which is currently being finalized by the parliament, following close dialogue with the PNPM Oversight. Bappenas is now also finalizing the new Mater Plan for Poverty Alleviation (MP3KI), which foresees the expanded use of the PNPM community-based platform to improve livelihoods.

B.2. Public Finance Management

67. **Since issuing a White Paper in 2002, the Government continues to demonstrate strong, persistent commitment towards building a modern PFM system**. A new regulatory framework has been established,[11] and there have been improvements in the business processes and systems throughout the entire budget cycle, including audit, legislative oversight and supportive civil service reforms, which have addressed a multitude of risks related to capacity constraints, poor infrastructure, and weak governance. In the medium to long term, it is expected that improvements in PFM systems will lead to better targeted and more responsive allocations of public funds to priority development needs and more efficient, transparent and accountable spending. This is fundamental to improving public service delivery and desired development outcomes.

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

69. **Progress in PFM has been substantial over the DPL series and reforms are moving in the right direction, but the impact is less pronounced this year and considerable challenges remain.** The Government's commitment to PFM reform remains high, but the inter-institutional coordination challenges and the technical complexity of some of the reforms (e.g., information systems and performance management) have not enabled GoI to keep pace with the reforms in social security and social assistance. Among others, the Central Government budget modernization reforms (MTEF and PBB) need to be completed to improve the link between policies and budget allocations. The revised regulations and

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

procedures for budget execution need to be fully implemented to address the delays that are particularly affecting infrastructure projects. Relevant and reliable financial reporting needs to be strengthened, including at the subnational level. The COSO control framework needs to be fully implemented and the internal audit function strengthened.

70. **Improving the performance of the tax system also remains a key medium-term reform objective**. The GoI plans to increase tax revenue from its current low level of around 12 percent of GDP, to around 15 percent (closer to the non-OECD regional average).[12] This is well within the estimate of an additional 2-5 percentage point of GDP that could be collected through better coverage and improved compliance.[13] Given that tax policy has already been simplified and rates are broadly in line with regional comparators, this objective needs to be achieved through the next stage of tax administration reforms. The first phase is focused on modernizing tax offices, improving governance, and strengthening the legal framework and was largely completed by 2009. The Directorate General of Taxes (DGT) has restructured, moving from a "tax type" to a functional organization with a field office network targeted to specific taxpayer segments—i.e. large, medium, and small taxpayer offices. The DGT has also introduced new corporate values, a code of conduct and a whistleblower system.

71. **Strengthening the transparency and accountability of the subnational fiscal framework, by ensuring the availability of subnational fiscal information, is another substantive reform objective.** 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; yet the transition is far from complete. Overlapping responsibilities without a coordinated decentralization framework undermine the effectiveness of service delivery, and there are limited accountability and transparency mechanisms at the subnational government level. Ensuring the availability of subnational fiscal information is a step towards ensuring accountability and transparency at the subnational level, which in turn would help create a more coordinated decentralization framework. At the moment, subnational governments constitute about 40 percent of all public expenditures, yet information on subnational fiscal operation is still sparsely available. While the DG Fiscal Balance in the MoF has introduced the regional financial information system (SIKD), progress in establishing a centralized database of fiscal information has been uneven. Recent initiatives, such as stricter enforcement of sanctions for regions that do not submit their budget data in a timely manner and establishment of electronic data transfer mechanisms, have helped expedite progress towards establishment of the centralized database for subnational fiscal information.

72. **Overall, public financial management reforms are technically complex and involve large amounts of data, new procedures and ICT systems.** The size of Indonesia, the scope of its central government PFM systems (covering 29,000 spending units), the number of stakeholders, and the ambitious nature of its reform agenda are particularly challenging and will continue to require significant expertise, coordination and capacity building. Nonetheless, the Government has shown commitment to complete the planned reforms, through annual and medium-term plans and strategies that present the proposed agenda and phasing. The GoI's strategy is also informed, and adjusted, by considerable analytic works that help to prioritize the reforms.

73. **The World Bank uses a number of instruments to support the Government's PFM reform agenda.** The DPL helps to reinforce the Government's ownership of and commitment towards the achievement of reform milestones. Through the Government Financial Management and Revenue Administration Project (GFMRAP), the Bank also provides support to design and implement the aforementioned budget and treasury system (SPAN), which has involved a comprehensive reengineering of business processes, institutional reform and change management. Implementation of SPAN is expected to significantly improve the timeliness, reliability, integrity and transparency of budget spending and reporting

[12] The MoF has a more ambitious medium-term target of 18 percent of GDP for tax revenues.
[13] International Monetary Fund, 2011, Indonesia: Selected Issues, *Revenue Mobilization in Indonesia*, September 2011.

when fully implemented in 2014. As a cross-cutting reform, it should also enhance the capability of managers to more efficiently manage service delivery. The Public Financial Management-Multi Donor Trust Fund (PFM-MDTF) provides additional resources to support critical reform activities and is financed by development partners—the European Commission, the Governments of Canada, the Netherlands and Switzerland, and USAID.

C. Analytical Underpinnings

Poverty alleviation and service delivery

74. **The World Bank provided analytical services to the Government to better understand the challenges facing the poverty reduction and social protection programs in order to inform courses of action for policy and program reforms.** These analytical services included the following:

75. **In 2012, the Bank released *Protecting Poor and Vulnerable Households in Indonesia,* a comprehensive review of the performance and delivery of Indonesia's eight main household social assistance programs and a public expenditure review of the social assistance sector**. The report reviewed the national programs and found that they do not go far enough in protecting the bottom 40 percent of the population that is at greatest risk of falling into poverty. In addition to significant gaps in both risk and population coverage, all of the household-based programs have been limited in their effectiveness due to (a) an insufficient ability to find and prioritize poor or vulnerable households; (b) a total benefit package that is sometimes underfunded, sometimes inadequate for addressing the particular household need or risk, and sometimes delivered with less-than-optimal timing; (c) a passive and implicit reliance on poorly-equipped local implementation partners combined with little explicit financial or technical support; (d) weakly-monitored and insufficiently-detailed implementation procedures; or in many cases a combination of all four of these. The report finds that Indonesia spends 0.5 percent of GDP on social assistance, which is low in comparison with regional neighbors and other middle-income developing countries. Increased fiscal space – a result of starkly declining debt payments – has left room for further increase in social assistance spending. However, regressive energy subsidies, which in some years cost as much as 4.5 percent of GDP, continue to dwarf spending on social assistance programs.

76. **The report outlines the main challenges related to coverage and adequacy that face Indonesia's priority social assistance programs.** While cash transfer programs offer the right type of benefit, the amount is often not enough for households to invest in education services. Neither scholarship programs nor conditional cash transfers provide sufficient benefits for the needs of target households. For example, secondary education expenditures (including placement fees, transportation, and uniforms among others) can be as high as 20 percent of a poor household's annual income, which puts it well beyond the reach of beneficiary households even after transfers. The report found that the current range of household-centered social assistance programs do not go far enough in protecting income and promoting healthy behaviors in chronically poor households, nor do current programs protect all households that are highly vulnerable to shocks. To cover all vulnerable households with some basic protection, the social safety net needs a broader reach. The Bank recommended that social safety nets should target all chronically poor households with greater assistance and be able to provide basic protection to the 40 percent of all households that are most at risk of becoming poor in any given year. Beyond the permanent social assistance programs, the report also recommended the use of quickly-deployable temporary programs to respond during future crises or difficult policy reform. Unconditional cash transfers were identified as an effective temporary safety net that was successful in easing policy reforms and providing beneficiaries with the right benefits to help them cope with shocks. The program provided beneficiary households with cash amounts equal to approximately 15 percent of regular expenditures. These transfers were more than enough to cover increased expenditure on fuels.

77. **In the same year, the Bank also released an analytical report on *Targeting Poor and Vulnerable Households in Indonesia***. The research found that while the poorest households are most likely to receive program benefits, many are excluded while many non-poor households participate. Less than half of the poorest 40 percent of households received unconditional cash transfers (*Bantuan Langsung Tunai*, BLT) and health fee waivers for poor households (*Jaminan Kesehatan Masyarakat*, Jamkesmas), while many non-poor also benefit from programs, with a quarter to a fifth of total benefits going to the richest 40 percent. While over 70 percent of the poorest 40 percent receive Raskin, high population coverage levels are due to sharing the rice among many non-poor households, as well as the poor, resulting in a substantial dilution in benefits to each household. Poor socialization and mistargeting have undermined support for social assistance programs. The percent of communities experiencing protests over the programs ranged from 25 percent for Askeskin (now Jamkesmas), to 56 percent for BLT, with those not receiving assistance being the most likely to complain. Mistargeting, nepotism and a lack of transparency in, and poor socialization of, beneficiary selection were the main sources of complaints. The nature of the community protests suggests that improved targeting of programs would improve satisfaction and buy-in.

78. **The report recommended the development of a National Targeting System (NTS), featuring a beneficiary registry**, which could improve targeting effectiveness and ensure program satisfaction and acceptance. This has already been done in many other countries and has several benefits: (i) the registry can be built using the best targeting methods, providing quality data for all programs, at a lower cost; (ii) social assistance can be coordinated across programs; (iii) duplication, fraud and corruption can be reduced. The unified registry is an important part of an NTS, but is only part of a broader system. It needs to reach the right people by being used by all programs. It needs to stay current because of the fluid nature of poverty in Indonesia, so updating the registry is vital. It also needs to be managed well to ensure effectiveness and legitimacy. The report also documented the findings from field experiments, which demonstrate that incorporating a well-designed and facilitated role for communities in targeting can increase both accuracy and community satisfaction, as can self-targeting. An NTS is only a small part of the cost of social assistance. Constructing the unified registry will cost about IDR 600 billion, which is just over 1 percent of the combined annual program costs of BLT, Raskin and Jamkesmas.

79. **In 2009, the Bank released *Health Financing in Indonesia: A Reform Road Map*, which was part of the inputs prepared at the request of *Bappenas* to inform the development of the National Development Plan 2010–14**. Other inputs included reports on human resources for health, fiscal space for health, health public expenditure review, and assessments of maternal health and pharmaceuticals. *Health Financing* provided a road map for the reform effort, including an analytical assessment of the Indonesian health system and its strengths and weaknesses. It assessed key policy parameters needing resolution and plausible transition options based on the goals of maximizing health outcomes, financial protection, and consumer responsiveness.

80. **In 2011, the Bank released *Actuarial Costing of Universal Health Insurance Coverage in Indonesia: Options and Preliminary Results*, which provided estimates of the likely spending needed for a range of possible transition paths to achieving UHC**. It illustrated the impact of key policy choices on the costs of the program, and provided technical policy staff with both a methodological basis and a tool for undertaking future estimates. The study highlighted the type of data adjustments that need to be made to develop a sound actuarial model, as well as approaches for estimating the impacts of alternative policies.

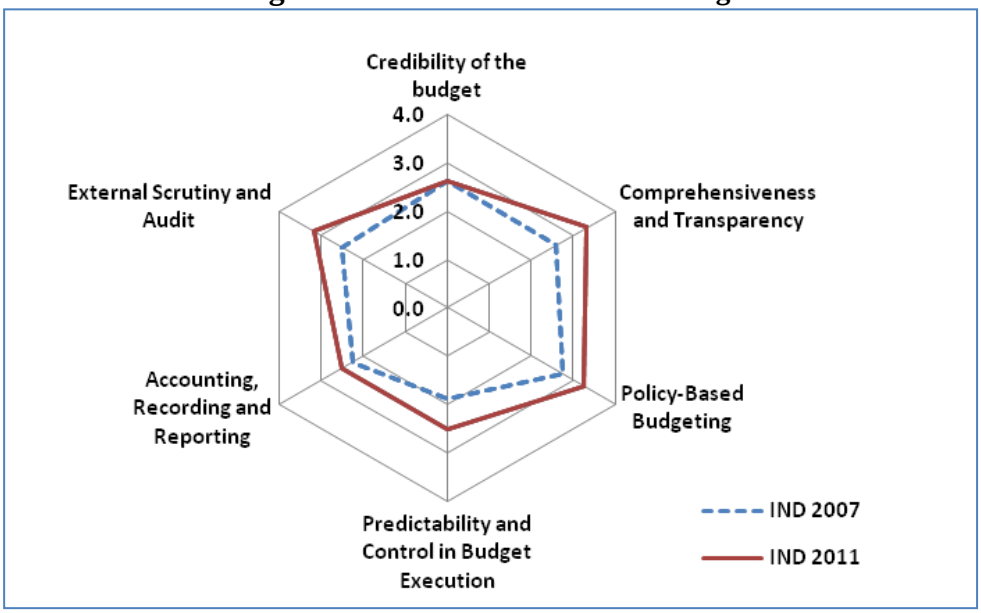
81. **In 2013, the Bank released *The Nuts & Bolts of Jamkesmas: Indonesia's Government-Financed Health Coverage Program*, a case study based a standardized World Bank protocol to analyze the nuts and bolts of health insurance programs that have expanded coverage from the bottom up**. The study described and assessed Jamkesmas and provided a detailed description of the scope, depth, and breadth of coverage provided under Jamkesmas, and highlighted ways in which the program interacts with the rest of Indonesia's health system. The study also summarized and discussed evidence on whether Jamkesmas is attaining its stated objectives of removing financial barriers and improving access to

health care by the poor and near-poor, what could be improved, and what lessons can be learned from the experience of Jamkesmas that could help inform Indonesia's quest for universal coverage.

Public Financial Management

82. **Indonesia's proposed public finance reforms address the findings and recommendations of recent assessments, including those of the World Bank**. A repeat assessment of *the Public Expenditure and Financial Accountability (PEFA)* was conducted in 2011, following a first assessment in 2007. The results showed that Indonesia has made steady progress in strengthening the quality of its PFM systems. The figure below compares the average PEFA ratings for each of the six main characteristics of the budget cycle. Substantive improvements were made in five of the six categories, namely: the comprehensiveness and transparency of the budget, policy based budgeting, predictability and control in budget execution, accounting, recording and reporting, and in external scrutiny and audit.

Figure 5: Indonesia 2011 PEFA ratings



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

83. **The Bank's *2012 DIPA Tracking Study - Identifying the Constraints to Budget Execution in the Infrastructure Sector* also identified challenges surrounding the issue of slow capital budget disbursements**. The survey tracked the implementation process of infrastructure projects and identifies the causes of delay in spending (around 85 percent of the annual allocation was commonly disbursed) and year-end back-loaded payments. The analysis pointed to a multitude of issues, such as lack of synchronization between various regulations, inefficiencies in budget allocation decisions, delays in complying with procurement regulations (e.g. most line ministries have not yet established procurement units), blocked "marking" of budget implementation documents (*Bintang*) and cumbersome budget revisions and new initiatives processes.

84. **The IMF's *Tax Administration Reform and Fiscal Adjustment: The Case of Indonesia (2001-07)* found tangible results from the first phase of tax administration reform efforts**. It was estimated that administrative improvements accounted for over half of the 1.1 percentage points of GDP increase in tax collection over the period 2002–06. Investment climate surveys conducted by the University of

Indonesia also revealed that the compliance costs for filing returns, obtaining VAT refunds, and customs clearance have improved since 2005–07 (although this was not the case in the *Doing Business* surveys). The Tax Office has also shown consistent improvement in the Corruption Perception Index score, measured by Transparency International Indonesia (TII) every two years. In 2012, the TII's Bribery Index, which measures corrupt interaction with the public service, placed the national tax administration as the lowest (best) among government institutions. Nonetheless, the IMF estimated that an additional 2-5 percentage points of GDP could be collected "based on broadening the tax bases and increasing compliance" (IMF, 2011, Indonesia: Selected Issues) and Indonesia still ranks at 131 in the *Doing Business* survey component of Paying Taxes (2013) due to cumbersome compliance requirements.

85. **The Bank's study on *Sub-National Public Expenditure Review 2012* shows that decentralized service delivery and finance has not resulted in major improvements in service outcomes**. The weak service delivery outcomes across all sectors can be explained to a large extent by inefficient subnational government spending. First, sub-nationals spend too much on administration and not enough on service provision. The latest subnational fiscal data show that local governments spend more than 25 percent of their budgets on general administration (the international standard is around five percent). Second, sub-nationals allocate too much to personnel across all sector budgets and not enough specifically to operations, maintenance, and capital (spending on personnel now makes up over 40 percent of total expenditure budgets). One of the policy recommendations suggested by the study is to move toward more performance based inter-government transfer system. This would require a more formal monitoring and evaluation system to assess the performance of local governments. One of the pre-requisites for better monitoring of local government performance is the availability of social, economic and fiscal data from the sub national governments. Timely, updated, and complete sub-national fiscal information is necessary to serve as a base for a comprehensive monitoring and evaluation function.

D. Other Related Reform Priorities and Areas of Development

Civil service/bureaucracy

86. **Outside the main pillars of reform covered by the DPL, the World Bank also supports the GoI's reform efforts in civil service/bureaucracy, which is relevant to the success of this DPL series.** Strengthened poverty alleviation programs and PFM systems will not by themselves resolve the weaknesses in the implementation of public policies, as delivery also depends on improving the institutional capacity and capability of the public sector. Hence, in recognition of this, the Government placed Bureaucracy Reform (BR) as the first priority of the RPJM 2010-14. The MoF has been at the forefront of such reforms for some years. More generally, the President approved a Grand Design for Bureaucracy Reform 2010 - 2025 and Roadmap for Bureaucracy Reform 2010-2014 in late 2010 and the President's Working Unit (UKP4) and a BR Steering Committee, chaired by the Vice-President, are closely monitoring progress. By 2012, some 52 ministries and central agencies (K/Ls) are anticipated to be implementing BR, with the goal of all 78 K/Ls implementing BR by 2014. The Government has also announced the first pilot of BR in selected subnational governments before rolling it out to all 33 provincial and 491 city/district authorities. A new M&E self-assessment system for BR was rolled out in 2012, namely the Bureaucracy Reform Implementation Self-Assessment System (BRISA), an online system to help monitor BR progress and achievements in BR agencies. The system under the Ministry of Administrative and Bureaucracy Reform (MenP AN-RB) also includes a public dashboard measuring the BR progress of all K/Ls. Further, the Government started to recruit civil servants nationally this year after one-year moratorium (January - December 2012), and a draft Civil Service Law (ASN) replacing Law No. 43/1999 on Civil Service Ordinance, which would improve the current institutional arrangements and human resource management for reform, is being discussed with the Parliament, with some expectations that the bill will be passed end of this year. Just recently, the Government has also undertaken a review of organizational structures of selected 16 ministries and agencies, for the purpose of improving efficiency and effectiveness.

Procurement

87. **In recent years the Government has also made significant progress on the regulatory side of government procurement, which is a core element of the overall PFM reform agenda.** Specific steps include the creation in 2007 of LKPP, the national procurement policy and regulatory agency, enactment of Presidential regulations Perpres 54/2010 and Perpres 70/2012, mandating establishment of dedicated Procurement Service Units (ULPs) and use of e-procurement, and issuance in 2013 of updated standard bidding documents for e-procurement. The priority now is to enable effective implementation of the procurement regulations so that the goals of competition, economy, efficiency and transparency envisaged for the new framework are actually achieved. This would entail several actions such as strengthening oversight institutions and mechanisms to ensure that procurement regulations are followed at all levels of government; developing capacity of staff working on procurement so that executing agencies can get the most benefit out of procurement rules through a wide range of implementation options; introducing modern procurement tools such as framework contracts/e-catalogues for enhancing efficiency and getting greater value for money; and establishing a procurement performance monitoring system to enable collection and analysis of actionable and reliable data to inform procurement policy-making as well as to monitor and evaluate results. LKPP has initiated work on some of these areas which are currently at varying levels of progress. Going forward, establishing a fully functional public procurement system will require the Government to continuously assess the performance and outcomes of the system, obtaining feedback from the stakeholders, and making the appropriate adjustments in policies and implementation tools for further improvement.

Governance and Anti-Corruption

88. **The Government has made progress towards combating corruption during the second term (2010-2014) of the President.** Evidence for this has been identified in performance review or evaluation reports of state agencies/institutions, which were undertaken by KPK (Anti-Corruption Commission) and BPK (Supreme Audit). For instance, KPK's Annual Integrity Survey highlighted that improvement in the Integrity Index has substantially improved from 5.42 in 2010 to 6.37 in 2012. At the same time, BPK's summary of annual audits during the 2010-2012 period mentioned that the majority of findings reflected mis-administration. Moreover, as part of efforts to move forward with the National Anti-Corruption agenda, the Heads of KPK, AGO and National Police agreed on a Memorandum of Understanding in March 2012, outlining the strategic actions necessary for strengthening coordination, supervision, support to pre-investigation and investigation, as well as the prosecution proceedings of high-profile corruption cases. To address the human resources challenges within KPK, the President had also issued an instruction in October 2012 to KPK-AGO-National Police, to ensure the availability of investigators in KPK. Specifically, the instruction postpones the withdrawal of AGO and the National Police investigators from KPK, and facilitates KPK to start recruiting its own investigators for greater independence.

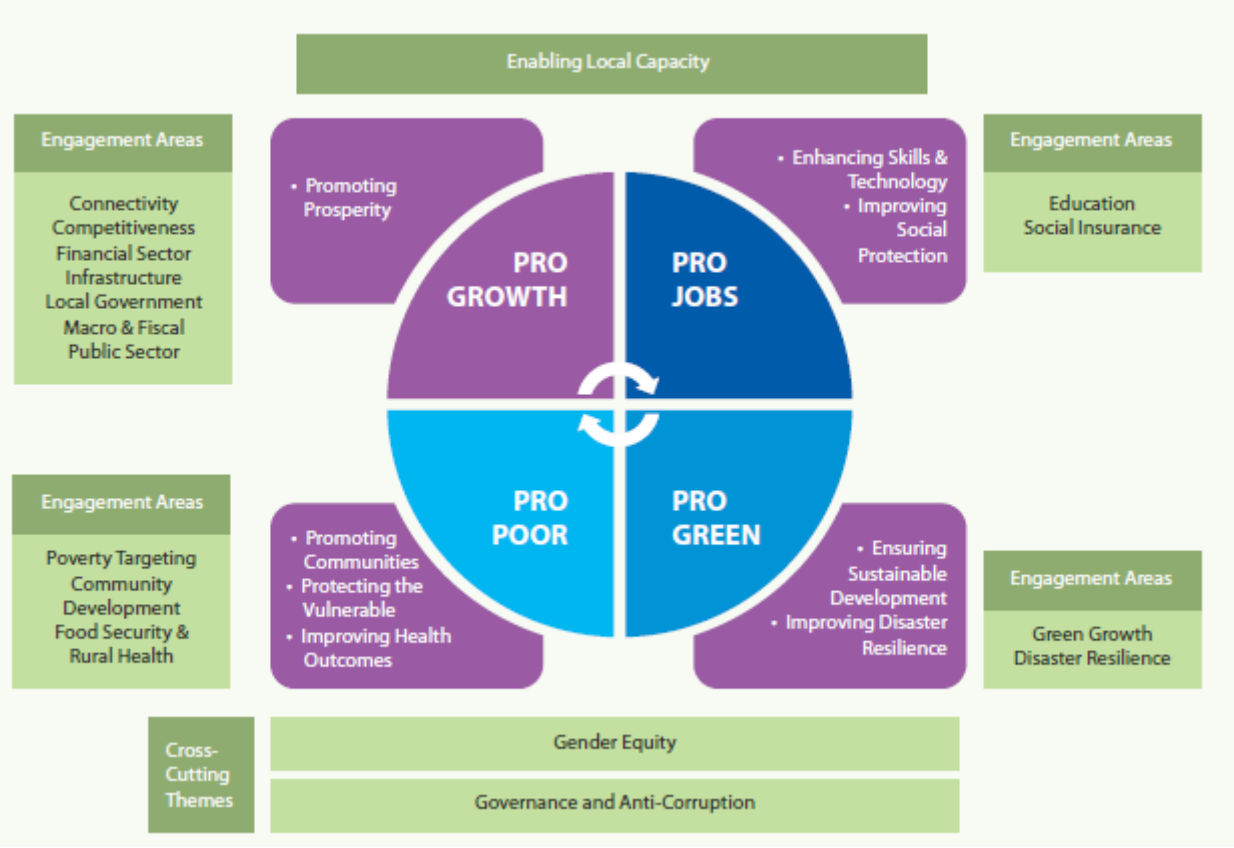
IV. BANK SUPPORT TO THE GOVERNMENT REFORM PROGRAM

A. Links to the 2013-2015 Country Partnership Strategy (CPS)

89. **The proposed INSTANSI DPL-2 supports the broader goal of the 2013-15 CPS, which is to enhance Indonesia's domestic capacity for reducing poverty and boosting equitable and sustainable prosperity.** In particular, the CPS highlights the INSTANSI DPL series as a key World Bank Group instrument for the following engagement areas: (i) pro-growth, by promoting prosperity through macro and fiscal development and strengthening of the public sector; (ii) pro-poor, by protecting the vulnerable and improving health outcomes through poverty targeting and rural health; and (iii) pro-jobs, by improving social protection through more generalized social insurance. Overall, the INSTANSI DPL program is expected to enhance the GoI's ability to meet its financing needs and maintain critical public expenditures,

and use monitoring and evaluation to inform budget allocation. The proposed INSTANSI DPL is also expected to enhance local capacity for detecting and responding to shocks that threaten vulnerable households, increase the number of poverty programs using the national registry of poor and vulnerable households, and increase participation of children from poor families in early childhood education and development programs.

Figure 6: 2013-15 CPS alignement of engagement areas



B. Relationship to Other Bank Operations

90. **The Bank is supporting the GoI's reform agenda using mutually supportive instruments.** While with the DPL series the Bank supports the GoI's ownership and commitment towards the achievement of reform milestones, with other technical assistance and financing instruments it supplements that support through the necessary advisory, human and financial capacity to carry out the reforms. Initiatives such as the GFMRAP, the Tax Administration Reform Project and the Public Financial Management-Multi Donor Trust Fund (PFM-MDTF) directly reinforce changes to the underlying institutional, incentive and organizational frameworks for core functions of the MoF and other related institutions, including fiscal-policy formulation, budgeting, treasury, internal audit, procurement, revenue dispute resolution and legislative oversight.

91. **The DPL series support to the reform of government institutions and systems directly contributes to the effective implementation of the other investment lending operations in the country.** The reform of PFM systems seeks to address some of the core issues faced in the delivery of key investment in social sectors. Examples include the unpredictable release of funds and cumbersome budget adjustments. The proposed INSTANSI DPL-2 will also complement efforts being undertaken through the Second Connectivity DPL, by increasing the transparency and efficiency of the Government's spending and strengthening inter-governmental fiscal relations and reforms that foster accountability.

C. Collaboration with Other Development Partners and the IMF

92. **The proposed INSTANSI DPL-2 reflects a harmonized approach towards meeting the GoI and development partners' agenda.** GoI counterparts have appreciated the development partner harmonization, which led to a notable reduction in the transaction cost of policy dialogue. Moreover, development partner harmonization around the Government's own program has bolstered country ownership of the reform process and has helped change the nature of the relationship with these development partners to one of a reliable partnership. Harmonization around the DPL has allowed development partners to build upon the natural synergies and complementarities that exist across their respective portfolios. The DPL program has also provided a solid foundation to deepen the harmonization agenda in Indonesia with other development partners around this or other initiatives and programs.

Table 3: Development partner contributions to DPL operations

Operation	World Bank	Government of Japan / JICA	Asian Development Bank	Total
DPL 1	300	100	–	400
DPL 2	400	100	200	700
DPL 3	600	100	200	900
DPL 4	600	200	200	1,000
DPL5	750	100	200	1,050
DPL6	750	100	200	1,050
DPL7	600	100	200	900
DPL8	400	200	-	600
INSTANSI	300	-	-	300
INSTANSI DPL-2	400	-	-	400
Total	**5,100**	**1,000**	**1,200**	**7,300**

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

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

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

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

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

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

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

- **Lesson 4: The DPL series can serve as a useful incubator to test out new reform agendas and counterparts.** The DPL has served as a tool to test out reform agendas, like the connectivity, education and finance agendas, to test whether or not a counterpart champion would be able to drive future reforms

through the DPL process. In these cases one or two prior actions (or sometimes just benchmarks) would be selected, the new institutions socialized to the DPL process, and this experience helps guide future program support.

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

Other lessons are:

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

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

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

- **Lesson 9: DPLs are only one instrument among many that are available in a multi-faceted engagement, and the choice of instrument should be contingent on the issue, the political context and the institutional circumstances**. This is related to Principle 3 of the Good Practice Principles on Conditionality but is particularly applicable in the Indonesian case because of the size and scope of the World Bank program here. The Bank program in Indonesia is one of the largest of any country in terms of number of staff and overall resources. Large teams are working closely on a daily basis with government counterparts on a wide range of issues from public financial management and trade and investment, to finance, public expenditures and poverty. In this context the DPL is not the only instrument for supporting reform, but one of several important tools including analytical work, knowledge sharing, and technical assistance.

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

V. THE PROPOSED OPERATION

A. The Second INSTANSI Development Policy Loan

96. **The proposed INSTANSI DPL-2 continues to support the Government's development agenda**, **particularly in enhancing poverty alleviation and shared prosperity, and strengthening PFM for improved service delivery**. While Indonesia's growth has allowed poverty reduction to continue, the rate of reduction has slowed in recent years, and many non-poor households remain vulnerable to small shocks. At the same time, significant improvements are still needed in PFM systems, in order for the allocation of public funds to become better targeted and more responsive to priority development needs, and more efficiently and transparently spent. Addressing these poverty and PFM issues are fundamental to improving public service delivery and desired development outcomes. The INSTANSI DPL-2's focus on its two core areas is underpinned by the rationale that expanding poverty alleviation efforts is essential if Indonesia is to bring about more broad-based improvements in welfare for the poor and near-poor, while the social insurance program will provide a more stable basis for sharing prosperity. Strengthening PFM is also essential for enhancing government effectiveness and governance, particularly in a relatively deconcentrated fiscal and political environment, which is necessary to delivery better levels of public services and infrastructure that are being demanded in an emerging middle-income country. The two pillars are therefore complimentary. Progress achieved under the previous DPL series has been satisfactory overall, which warrants the continued program support for the INSTANSI DPL-2.

97. **The proposed prior actions are well aligned with the Government's strategies and priorities, as outlined in the RPJMN 2010-2014.** The supported prior actions are well aligned with the thrust of the Government's RPJMN 2010-14. Changes were made to some the indicative triggers identified in the first INSTANSI DPL last year, to better reflect the Government's emerging reform agenda. In particular, a set of new prior actions were introduced under the poverty pillar to support the significant increase in social spending under the 2013 Budget, largely to help shield poor households from the impact of higher fuel prices. These new prior actions build upon previous DPL actions that were aimed towards developing a more comprehensive, integrated and well-targeted social support system. Hence, continuity of the DPL program as a whole is largely maintained, as the proposed prior actions continue to advance those reforms that were initiated in the previous DPLs. To date, all of these proposed prior actions have been achieved.

Table 4: Treatment of Indicative Triggers for INSTANSI DPL-2 Identified in INSTANSI DPL-1

Original Indicative Triggers	New Prior Action and Rationale for Adjustment
Pillar 1: Enhancing poverty alleviation and service delivery efforts	
Not previously specified	1. Issued integrated social protection cards (KPS) to fifteen million five hundred thousand (15,500,000) poor and vulnerable beneficiary households identified through the Borrower's national registry (PPLS11), entitling them to subsidized rice allocations (RASKIN), temporary unconditional cash transfers (BLSM), and financial assistance for poor students (BSM). This is a **new prior action** that was not explicitly specified in the previous DPL operation, but was introduced as part of the compensation package for the fuel price increase in June 2013. This new prior action builds previous prior and benchmark actions towards the development of the national registry of poor and vulnerable households (PPLS11), from which the names of the KPS beneficiaries were extracted.
Not previously specified	2. Issued a Ministry of Home Affairs Instruction (No. 541/3150/SJ), for local governments to improve the targeting accuracy of the KPS beneficiary list, through a transparent and participatory community-based mechanism. This is a **new prior action** that was not explicitly specified in the previous DPL operation, but was introduced as part of the compensation package for the fuel price increase in June 2013. This new prior action is a continuation of previous prior and benchmark actions towards the development of the national registry of poor and vulnerable households (PPLS11). Given the dynamic movement of households in and out of poverty, updating mechanisms are required to maintain the accuracy of the targeting system. The Bank's analytical work found that communities are more effective in identifying poorest households, which provided the basis for developing the community targeting updating mechanism promoted through this new prior action.
Not previously specified	3. Issued the FY 2014 Financial Notes and Draft Budget, which includes a report on the 2013 budget allocation for the implementation of temporary safety net programs, which consist of an unconditional cash transfer program and a subsidized rice program for fifteen million five hundred thousand (15,500,000) poor and vulnerable households identified through the PPLS11 to compensate for the fuel price increase of 2013. This is a **new prior action** that was not explicitly specified in the previous DPL operation, but was introduced as part of the compensation package for the fuel price increase in June 2013. This new prior action builds on policy measures aimed towards improving poverty measurements and targeting of the poor which were supported in the previous DPLs.
Not previously specified	4. Issued a Presidential Decree (No. 37/2012) to provide budget allocation to increase the adequacy of benefit levels for the BSM program and expand the coverage of the BSM program using the PPLS11 to identify beneficiaries of the BSM. This is a **new prior action** that was not explicitly specified in the

	previous DPL operation, but was introduced as part of the compensation package for the fuel price increase in June 2013. This new prior action builds on policy measures aimed towards improving poverty measurements and targeting of the poor which were supported in the previous DPLs.
Not previously specified	5. Issued a Presidential Decree (No. 37/2012) to provide budget allocation to increase the adequacy of benefit levels for the conditional cash transfer (PKH) program and expand coverage of the PKH using the PPLS11 to identify beneficiaries of the PKH. This is a **new prior action** that was not explicitly specified in the previous DPL operation, but was introduced as part of the compensation package for the fuel price increase in June 2013. This new prior action builds on policy measures aimed towards improving poverty measurements and targeting of the poor which were supported in the previous DPLs.
Finalize a strategy for the transition of Jamkesmas institutional arrangements from Ministry of Health to the social security system administrator for health (BPJS Health).	6. Issued a Presidential Regulation No. 12/2013 to provide the main regulatory framework for implementation of the national health insurance program. **Trigger expanded** to cover not only strategic measures, but concrete preparatory measures that are critical for starting the implementation of universal health care in 2014.
Program reforms are adopted to improve the targeting of scholarships (i.e., using national registry for new primary school entrants) and supporting poor students through school transition years.	**Trigger expanded** into comprehensive policy measures on improving poverty measurements and targeting of the poor, covering not only scholarships, but all social protection programs (see prior actions 1 to 5 detailed above).
Pillar 2: Strengthening public finance management for improved service delivery	
Use SPAN in the preparation of the 2014 budget, to clearly separate the MTEF elements of the process and facilitate the reconciliation with the prior year forward estimates in the draft budget documents.	**7.** In preparation of the 2014 budget, clearly identified the fiscal changes that impacted the medium-term expenditure framework and facilitated the reconciliation with the 2013 forward estimates in the draft budget law. **Trigger revised.** The implementation of SPAN has been delayed and it was not available for use in the preparation of the 2014 Budget. Hence, the trigger is revised to focus on the substantive elements of the measure without the use of SPAN.
Issue new PP and related MOF regulations on budget execution	**8.** Issued a Government Regulation (No. 45/2013) to support enhanced budget execution. **Trigger maintained.** This is an important policy breakthrough that had been delayed from the previous DPL operation. The newly issued Presidential regulation covers extensive budget execution mechanisms.

(i) Development of procedures and an application for VAT Refunds for Tourists through a website (e-invoice) and (ii) Development of individual e-filing for a 'Simple Tax Return' and 'Very Simple Tax Return Form'	**9.** Issued regulations (Minister of Finance Regulation No. 100/PMK.03/2013 and Director General of Tax Regulation No. PER-28/PJ/2013), to establish procedures and an application for VAT refunds for tourists through a website (e-invoice).. **10.** Issued a regulation (Director General of Tax Regulation No. PER-26/PJ/2013) to establish procedures of individual e-filing for simple tax return and has issued a form for very simple tax return. **Triggers maintained** and split into two separate actions, given their distinction and criticality.
Issue a Government regulation that establishes a new Costing Methodology, in line with the MTEF approach, which also determines the methodology for allocating costs to programs/activities in 2014.	**Trigger maintained as a benchmark.** MOF regulations were issued as part of efforts to better align budgeting with MTEF. However, more extensive reforms in the budgeting process (e.g. level of information presented, and program structure) are needed in order to justify this as a key, prior action.
Implement an integrated baseline and policy review as part of the preparation of the 2014 Budget that includes an assessment of the policy performance in the prior year based on a common definition of performance information.	**Trigger postponed to next operation,** as more time is needed to integrate the work of MOF DG Budget and Bappenas. Instead, as a precedent measure, a new benchmark action is now being introduced, wherein DG Budget and Bappenas establish a framework for developing an integrated baseline and policy review for implementation in the preparation of the 2015 Budget.
Implement a simplified virement procedure that supports the spirit of "let the manager (line ministry) manage"	**Trigger revised and maintained as a benchmark.** Revisions to MOF regulations were made to provide more authority to budget managers and to simplify the virement approval process (from 5 to 1 day). However, these changes have only partially addressed the policy intent, as further reforms are still needed in the budgeting process. Hence, the action was revised from "Implement" to "Take initial steps".
Fully implement the SPAN in all 177 Treasury Local Offices (KPPNs)	**Trigger postponed to next operation.** More time is needed to complete the user acceptance tests and pilot the system, which are prerequisites for full implementation of SPAN.
Establish a professional association of internal auditors and drafts of (a) code of ethics and (b) internal audit standards	**Trigger maintained as a benchmark,** given that the code of ethics and internal audit standards are not yet been formally endorsed and ready to be implemented (expected before end of 2013).

98. **In addition to the prior actions, the INSTANSI DPL-2 also acknowledges a set of benchmark actions**. Although these benchmark actions do not represent requirements with regards to the disbursement of the DPL financing, the GoI has requested that the INSTANSI DPL-2 still acknowledges these benchmark actions during the DPL policy dialogue and program document. Indeed, the benchmark actions represent reform steps that need to be taken before more substantive reforms can take place over the longer run. The classification of prior and benchmark actions allows more prioritization and focus over more critical prior actions, while still acknowledging the GoI's broader reform process. Such classification therefore helps ensure sustained GoI ownership and the mapping out of a comprehensive multi-year DPL program.

A.1. Policy Area I: Enhancing poverty alleviation and shared prosperity efforts

99. **The proposed INSTANSI DPL-2 supports the GoI's reforms that work towards developing an effective and integrated social protection system.** This emerging social protection system consists of two main policy challenges: (i) *reforming and integrating social assistance programs* to both protect those at risk of falling into poverty and promote them so that they are able to share the benefits of Indonesia's

strong growth; and (ii) *preparing for the implementation of universal social security programs*—starting with health insurance programs—that provide adequate protection from risks faced by all households, but are financially and institutionally sustainable.

100. **The GoI has undertaken major reforms of long-term social assistance programs, financed by a reallocation of budget savings from a reduction in fuel subsidies.** The 2013 budget revision included a reduction in fuel subsidies, increasing the price of subsidized fuel from IDR 4,500 to IDR 6,500, which was a major policy reform that was years in the making. From the savings, Parliament allocated IDR 29.05 trillion (about USD 2.8bn), or about 74 percent of the total fuel subsidy savings, to a compensation package that targeted 15.5 million poor and vulnerable households. Of this, 28 percent was re-allocated for the Social Protection Acceleration and Expansion Program (*Program Percepatan dan Perluasan Perlindungan Sosial*, P4S), a major expansion in the coverage and benefit levels of permanent social assistance programs. This expansion, which will remain in effect until the end of the current government administration in December 2014, also provided an opportunity to introduce reforms to integrate and improve the targeting of individual programs, taking a major step towards developing an integrated and comprehensive social assistance system. Hence overall, public expenditures became more beneficial and targeted towards the poor, as the reduced spending on poorly targeted subsidies allowed for increased spending on better targeted social protection programs.

101. **The fuel subsidy compensation program includes short-term safety nets to protect poor and vulnerable households from inflationary shocks.** World Bank projections estimate that, in the absence of compensation, an increase in the fuel price from IDR 4,500 to IDR 6,500 would temporarily halt any further decrease in the poverty rate. These projections suggest that the forecasted poverty rate of 11.4 percent at the end of 2013 would remain fixed at the same level for the first quarter of 2014 (assuming, conservatively, that average inflation increases by 2.5 percentage points in 2013, moving to 8.0 percent year-on-year). This would result in halting the positive trend in Indonesia's poverty rate that has moved continually downward over the past decade (with the exception an increase in the poverty rate in 2006 due to the global food price crisis). To prevent this, Parliament allocated some of the fuel subsidy savings towards a Special Compensation Program (*Program Kompensasi Khusus*) covering the 15.5 million households, or the poorest 25 percent of the population. Forty-seven percent of the total fuel subsidy compensation program was reallocated to finance this temporary program.

102. **Meanwhile, the GoI is also committed to implement a new national social security system over the next four years that will radically change the social protection landscape**. Following the National Social Security (SJSN) Law enacted in 2004, and the Administrators (BPJS) Law enacted in November 2011, the GoI intends to enroll the entire Indonesian population in a public health insurance system. The new social protection program will cover all Indonesians for five benefits, namely health, pensions, old-age savings, death benefits and worker accident.

Reform Aim: Expansion of targeted compensation measures for the poor following subsidized fuel price increase

103. **The GoI has expanded targeted compensation for the poor following the increase in the subsidized fuel price.** Representing a major step towards integrating social assistance programs, the GoI has issued integrated social protection cards (KPS) to fifteen million five hundred thousand (15,500,000) poor and vulnerable beneficiary households identified through the Borrower's national registry (PPLS11), entitling them to subsidized rice allocations (RASKIN), temporary unconditional cash transfers (BLSM), and financial assistance for poor students (BSM). With the launch of *Program Kompensasi Khusus* and P4S, the Government is taking the opportunity to issue a Social Protection Card (*Kartu Perlindungan Sosial*, or KPS) to the poorest 15.5 million households drawn from Unified Database of potential beneficiaries (*Basis Data Terpadu*, or BDT), which was created by the TNP2K Secretariat with the assistance of Central Bureau of Statistics (BPS). The careful design of the database and incorporation of international best practices

means that many of the previously excluded poor households will now become program beneficiaries. The KPS card is the basis for receiving the short-term safety net compensation programs until the end of 2013. The card also entitles households to benefits for an expanded BSM under P4S until the end of 2014, when the cards expire. Indeed, the use of a single card for multiple programs marks an important first step towards an integrated social assistance framework in Indonesia. This will be the first time Indonesia has coordinated social assistance programs and beneficiaries using a single registry, and paves the way in the future for integrated delivery of benefits, as well as complaints and grievances.

104. **The Government is introducing innovations in community targeting to update social protection card beneficiary lists in order to minimize inclusion and exclusion errors.** The Ministry of Home Affairs has issued an instruction for local governments to improve the targeting accuracy of the KPS beneficiary list, through the use of a transparent and participatory community-based mechanism. The Government will be coordinating with local communities to help identify poor households that are currently excluded from the BDT database. Recent field research by the Government, the World Bank and the Abdul Latif Jameel Poverty Action Lab (J-PAL, from the Economics Department of the Massachusetts Institute of Technology) has shown that carefully facilitated community involvement can improve targeting outcomes, particularly amongst the poorest. These findings were based on controlled experiments, using trained facilitators. Successful implementation of community targeting methods, however, will depend on designing and delivering methods that can be scaled up and replicated in communities across the country. If successful, not only will community targeting processes help identify additional poor households to receive compensation, but it will also contribute to the planned 2014 update and expansion of the database, as these households will be incorporated into the recertification process, which is required to keep the BDT updated over time.

105. **The INSTANSI DPL-2 supports the GoI's effort to help cushion the poor and vulnerable from the immediate effects of the fuel price increase, by entitling them to receive temporary safety net programs.** To that end, the GoI has issued the FY 2014 Financial Notes and Draft Budget, which includes a report on the 2013 budget allocation for the implementation of temporary safety net programs, which consist of an unconditional cash transfer program and a subsidized rice program for fifteen million five hundred thousand (15,500,000) poor and vulnerable households identified through the PPLS11 to compensate for the fuel price increase of 2013, represents a key reform achievement. The Special Compensation Program includes two temporary social assistance measures to protect poor and vulnerable households from the inflationary shock of the fuel price increase. First, an unconditional cash transfer (*Bantuan Langsung Sementara Masyarakat*, BLSM) in the amount of IDR 150,000/household/month for a duration of four months will be provided to 15.5 million households in two payments. Second, in addition to the 15kg of rice per poor household per month that is already being distributed through the Raskin program, the Government will provide an additional 45kg of subsidized rice to the same households that will receive BLSM. This will be provided in 15kg bundles once a month for three months.

106. **Although the issuance of unconditional cash transfers is controversial, research shows that they have been effective in providing protection to households that are vulnerable to shocks.** Unconditional cash transfers have been controversial in Indonesia. Therefore, the decision to re-launch such transfers as part of the Special Compensation Program is a critical success in protecting vulnerable households from potential negative impacts associated with the fuel subsidy reduction. Research on Indonesia's past experience with unconditional cash transfers supports this policy decision.[14] Following the increase of fuel prices in 2005, the Government launched the *Bantuan Langsung Tunai* (BLT), which provided cash compensation totaling IDR 1,200,000, delivered in four installments, to a total of 19 million recipient households. The program was again deployed in 2008 when fuel prices temporarily increased further, and 18.4 million households were compensated with a total of IDR 900,000, divided into three payments. Research conducted by the World Bank on the implementation and effectiveness of unconditional

[14] World Bank. 2012. *Bantuan Langsung Tunai (BLT) temporary unconditional cash transfer*.

cash transfers in Indonesia found that BLT was effective in preventing poor households from being negatively affected. The transfers, equal to about 15 percent of monthly spending, were sufficient to keep targeted households from falling further behind. Also, there was no evidence that beneficiary households misspent the transfer; spending on tobacco and alcohol did not increase in BLT households relative to poor households that did not receive the transfer. Similarly, there is no evidence that BLT induced laziness or dependency. In fact, BLT households were more likely (by 10 percentage points) to report that they had found new jobs and moved into employment, perhaps using the BLT money for transportation to more distant but better jobs, or to assist with childcare.

107. **With the provision of temporary unconditional cash transfers, poverty reduction is expected to continue.** The provision of BLSM to poor and vulnerable households will help Indonesia maintain advances in reducing poverty. With the provision of the unconditional cash transfer for a period of four months, the Bank estimates that the poverty rate will fall to 9.5 percent by March 2014, instead of stagnating at 11.4 percent in the cases of price increases but no BLSM compensation, a similar experience to 2008.

108. **Previous research found that the Financial Assistance for Poor Students (BSM) program did not provide benefits to the right households at the right times.** BSM is the third-largest household-based transfer, by central government expenditure, behind Raskin and Jamkesmas, the Government's in-kind food transfer and health fee waiver (respectively). BSM spending has increased in line with the rapid expansion in target beneficiaries. In 2010, IDR 3.6 trillion (around USD 397 million) was spent on the program, equivalent to 4 percent of central government education expenditures. Previously, distribution of assistance was carried out by school-based committees based on local quotas that were not aligned with regional poverty rates. The resulting targeting performance was poor; a student from the richest 60 percent of households was equally likely to receive assistance as a student from the bottom 40 percent of households.

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

110. **Under the current reform, the Government has almost doubled the coverage of the BSM program to now extend to over 16 million beneficiaries.** The GoI issued a Presidential Decree (No. 37/2012) to provide budget allocation to increase the adequacy of benefit levels for the BSM program and expand the coverage of the BSM program using the PPLS11 to identify beneficiaries of the BSM. Through the reforms implemented through the Social Protection Acceleration and Expansion Program (P4S), the coverage of BSM will almost double from 8.7 million to 16.6 million beneficiaries. The delivery mechanism for this program has also been reformed so that beneficiaries can take an active role in receiving their entitled benefits. Under the new system, students from eligible families can directly approach schools, carrying their Social Protection Card and supporting documentation, to claim their entitled assistance. By empowering beneficiaries in this way, it is expected that the expansion of BSM through the P4S program will help to ensure that a greater share of assistance will reach students who are at the greatest risk of dropping out.

111. **The reform will also improve the adequacy of BSM benefit levels so that poor and vulnerable households will be able to afford to keep their children in school.** In the past, assistance was not adequate for poor families to keep their children in school for the mandatory levels of primary and junior/senior secondary education. Typically, the benefit levels were equal to about 30 percent of education out-of-pocket costs faced by families. Also, BSM amounts were not indexed to inflation; therefore beneficiaries saw the value of the transfers erode over time. To correct this, the Government has significantly increased benefit levels through the current reform: primary school (SD) benefits will increase from IDR 360,000 to IDR 450,000 per year per student, while junior secondary (SMP) benefits will increase from IDR 550,000 to IDR 750,000 per year per student. By expanding financial assistance for poor students and increasing benefit levels, the subsidy savings can help to mitigate the problem of rising inequality in Indonesia by improving the mobility of the next generation. Benefit level increases and advances in program targeting address some of the main program challenges identified in the World Bank's review of this social assistance program.[15]

112. **The Government introduced the PKH program in 2007 to address inequalities in health and education services and to provide a direct cash transfer for very poor households.** Conditional cash transfer programs provide cash disbursements to families that fulfill basic obligations related to utilization of health and education services. The cash transfer contributes to immediate poverty alleviation while the continuing commitments to preventative health care practices and education contribute to breaking inter-generational poverty by increasing productive investments in children so that they have better opportunities for the future.[16] The Government launched *Program Keluarga Harapan* (PKH), the conditional cash transfer program, to improve household health and education outcomes. PKH accounts for a large and growing share of Ministry of Social Affairs spending, but remains the second smallest of the Cluster I programs, consuming less than 5 percent of the total budget for social safety nets in 2010.

113. **PKH is a social assistance program that has proven to be effective in tackling chronic and extreme poverty.** An impact evaluation of the program conducted by the World Bank in 2011 found that beneficiaries were significantly more likely to use local health services and adopt healthy behaviors including: pre-natal care, birth deliveries at health facilities, post-natal care, immunizations, and growth monitoring check-ups for babies and infants.[17] Program impact on improving school enrollment and time spent in school, however, was statistically insignificant (with the exception of hours spent in school, which only saw a 5 percent improvement over baseline values). As with BSM, given existing PKH implementation issues identified in the World Bank's review of Indonesia's social assistance programs, the reforms that will be carried out through the P4S program are also likely to increase the effectiveness of the PKH program.

114. **Under the current reform, the Government will increase the coverage of the PKH program and improve integration with other social assistance programs.** The GoI issued a Presidential Decree (No. 37/2012) to provide budget allocation to increase the adequacy of benefit levels for the conditional cash transfer (PKH) program and expand coverage of the PKH using the PPLS11 to identify beneficiaries of the PKH. PKH will be expanded from the current level of 1.5 million households to 2.4 million households in 2013 and 3.2 million households in 2014. Beneficiary lists are extracted from the UDB by the TNP2K Secretariat, and therefore will also include KPS cardholders. By receiving this card, PKH beneficiary families will automatically have access to the BSM program, BLSM and Raskin allocations. This will be the first time that individual programs in Indonesia are deployed as a system to provide comprehensive support

[15] World Bank, 2012. Bantuan Siswa Miskin Cash Transfers for Poor Students.

[16] These two objectives—reducing current poverty and improving the quality of human resources within poor households—are the GoI's stated goals for the PKH program. The GoI has identified four more-specific desired outcomes under these two objectives: (1) improving the socio-economic conditions of the poorest households, (2) improving the educational level of children, (3) improving the health and nutritional status of pregnant women, post-partum mothers, and children under 6 years, and (4) improving the access to and quality of education and health services especially for the poorest households. PKH is expected to also contribute to progress towards achievement of six of the eight MDGs.

[17] World Bank 2012. Programa Keluarga Harapan Conditional Cash Transfer.

to extremely and chronically poor households. Taken together, this assistance will allow them to better afford to invest in health and education services, increasing the chance that their children can better help themselves escape poverty.

115. **Under the P4S program, minimum benefit levels will substantially increase.** Average benefit levels will increase from IDR 1.4 million to IDR 1.8 million per year per household. Minimum benefit levels will increase from IDR 600,000 to IDR 800,000 per year per family, and the maximum benefit level will increase from IDR 2,200,000 to IDR 2,800,000 (the calculation is based on number of number and age of children, and the inclusion of pregnant or lactating women in the family). The increase took effect immediately in June 2013 for existing beneficiary households, while new beneficiary households added through the expansion will receive the revised benefit levels in November 2013. It is likely that this increase will help the program to improve its impact on beneficiary household behaviors. In the past, benefit levels did not match the expenses faced by families in order to afford health and education services. For example, benefit levels were sufficient to cover the total expenditures for one year of junior secondary education, but less than half (43 percent) if transportation costs were included. Similarly, mid-wife delivery charges range between IDR 200,000 – 800,000 (based on a 2008 SMERU study), which at the high end is equivalent to the previous PKH transfer for pregnant mothers. Also, the benefit levels have not been adjusted for inflation, which has eroded the real value of the cash transfers over time; this resulted in a 22 percent decline in the real value of the benefit levels between 2007 and 2010 (adjusted using the poverty basket inflation).

116. **The reforms of the permanent social assistance programs are financed until the end of 2014, but the Government has indicated a vision to sustain the reforms in the future.** These reforms will be in effect for the duration of the current administration (i.e., until December 2014). Moreover, there are indications that the reforms will be sustained in the medium-term future. The government's draft Masterplan for the Acceleration and Expansion of Poverty Reduction (MP3KI) prepared by the National Development Planning Agency (Bappenas) outlines a social protection strategy that extends until 2025. The plan includes an expansion of PKH to cover the poorest 5 percent of households, an expansion of scholarships to cover all students from households included in the national registry, and increases in benefit levels based on estimated needs. This improves the likelihood of sustaining the reforms introduced through the fuel subsidy compensation programs.

Reform Aim: Commence preparations for national social security health programs

117. **The Government is currently implementing a series of health system reforms aimed at attaining Universal Health Coverage (UHC) for its population 2019.** These reforms include a planned merger of all existing contributory and non-contributory social health insurance schemes with streamlined uniform benefits under a single-payer umbrella beginning in 2014, followed by a gradual expansion in breadth of coverage to those currently uncovered. There are likely to be several challenges to effective implementation of UHC in Indonesia, both from institutional health financing, as well as service delivery, perspectives. The ambition to achieve universal health care coverage is indeed an ambitious and long-term reform agenda, extending far beyond the DPL timeframe. From a health financing perspective, high levels of out of pocket spending continue to be a problem for the sector, as this poses significant financial barriers to accessing health care as well as a lack of financial protection for those who do utilize health care. High out of pocket payments are a prominent "risk factor" for impoverishment, especially given that a large proportion of Indonesia's population is vulnerable and lives just above the poverty line. Although household health insurance population coverage rates have increased in the past decade or so—from 15 percent in 1995 to more than 40 percent in 2010—almost 60 percent of the population still remains without any coverage and, at 40 percent of total health spending, out of pocket spending remains high (even among those with coverage; half of all out of pocket spending comes from those already covered). There are also considerable institutional and organizational transformations required to merge all existing social health insurance mechanisms into a single-payer system with common basic benefits package.

118. **Recent health system reforms included a number of key measures to help ensure efficient and effective UHC scale-up starting in 2014**. In 2013, the GoI issued Presidential Regulation to provide the main regulatory framework for implementation of the national health insurance program. This marks a significant regulatory milestone for UHC implementation, covering qualification and participation, registration, contribution, health service organization, service provision and quality, payment administration, complaint management, and dispute settlement. The Ministry of Health also signed a critical Memorandum of Understanding (MoU) on the transformation of Jamkesmas, with PT Askes as the appointed future administrator of BPJS Health. The MoU strengthens coordination and collaboration between the parties, covering the transfer of management and administration of Jamkesmas to BPJS Health, for successful implementation of this health insurance program for the poor and near-poor, by January 1 2014. The MoU covers a multitude of Jamkesmas transformation processes, including updating membership, financing outstanding claims, utilizing the independent verificator team, utilizing claim verification software, and implementing the monitoring and reporting system. Ensuring the availability of medicines and medical supplies in sufficient quality, quantity, type, efficacy, and safety in health care facilities is a particular UHC implementation challenge. Based on PerPres No. 70/2012 on procurement of government goods and services, the Ministry of Health together with the National Public Procurement Agency (*Lembaga Kebijakan Pengadaan Barang/Jasa Pemerintah* – LKPP) developed and began using a new online e-catalog for medicines and medical supplies, to streamline and support central and sub-national procurement. The Ministry of Health has also issued Guidelines for Socialization for UHC implementation, to help policymakers inform citizens about key UHC aspects, including membership enrollment, premium, health providers, benefits package, and organization and feedback. The near term will include additional comprehensive and detailed reforms to implement universal health coverage.

119. **The Government's commitment to UHC will marginally increase government expenditures**. Indonesia has a high level of fiscal space accessible through better use of tax, and reducing poor value expenditures, particularly those related to subsidies. A comprehensive 2011 World Bank actuarial study of Indonesia UHC estimated the likely spending needed for a range of possible scenarios, assuming gradual expansion toward UHC to 2020, factoring in aging and epidemiological changes as well as advances in medical technology and increased demand. In real terms, the 'Low' case scenario for UHC sees an increase in annual expenditures to a total of IDR 65 trillion with 75 percent coverage in 2015 and IDR 127 trillion in 2020 with full UHC, representing 0.59 percent and 1.15 percent of projected 2014 government budget, respectively. Under the 'High' scenario, total expenditures are estimated at IDR 82 trillion in 2015 and IDR 159 trillion in 2020, or 0.74 percent and 1.44 percent of projected 2014 government budget, respectively. Indonesia is actually characterized by relatively low levels of total and government health spending per capita (USD77 and USD38 per capita, respectively). In the broader global context, Indonesia's public spending on health at only around 0.9 percent of GDP in 2011 is one of the lowest levels in the world. By contrast, Cambodia's ratio is 2.1 percent, Malaysia's 2.4 percent, Vietnam's 2.6 percent, China's 2.7 percent, and Thailand's 2.9 percent. At least for now, the issues are not so much of fiscally feasibility and sustainability, but those of under-financing. Regardless, UHC cost containment and efficiency improvements are and should be key parts of the Government strategy to expand UHC.

120. **The SJSN employment programs are designed to have no impact on the APBN**. The contributions are fully paid by employers and workers and the Government is not obligated to pay for the poor as they are in the health program. There are three conditions under which the SJSN employment programs could have an impact on the budget: (i) the programs become underfunded and the budget must contribute to make up for the deficit; (ii) the Government agrees at some point in time in the future to make contributions for the poor and near poor as is done under the health program; and (iii) the Government decides to start a tax-financed social pension as part of its program to avoid elderly poverty.

Reform Aim: Empowering communities to take charge of their development needs

121. **The GoI is moving forward with implementation of the PNPM Roadmap and integrating the approaches into regular planning and budgeting system.** Finalized in 2012, the PNPM Roadmap covers the strategic directions and action plan for the program up to 2014 and beyond. The Roadmap presents two main directions of PNPM, i.e. consolidation and integration of all PNPM programs, and ensuring the sustainability of PNPM-Mandiri through five pillars with 12 priority agendas. As PNPM-Mandiri will "exit" in 2015, the PNPM Roadmap is critical in helping the Government ensure that all of the approaches used at the central to local government levels and at the community levels, are sustainable and can continue up to 2014 and beyond. Among the most critical agendas are full adoption of key success characteristics and results frameworks by all government stakeholders, mainstreaming the block grant model into regular budget system, adoption of community participatory planning as a non-separate part of local regular planning, stronger self-reliant community institutions, and continuation of technical assistance and facilitator support.

A.2. Pillar II: Strengthening Public Finance Management for improved service delivery

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

123. **In the past year the Government has achieved a number of milestones in PFM reforms including**:

- Completing the development and testing of the SPAN system;
- Further strengthening of the use of the MTEF in the budget preparation process;
- Initial steps to improve the systematic monitoring and evaluation of government expenditures as part of the annual budget cycle;
- New regulations to improve budget execution, including steps to streamline the approval of Budget adjustments during the year; and
- New regulations[18] and a training plan to support the implementation of accrual accounting in 2015.

124. **The INSTANSI DPL-2 supports PFM measures designed to enhance the quality of public spending and modernizing the core tax system.** At the forefront of the agenda are measures to improve budget transparency and planning through the use of the MTEF in preparing the budget. Reflecting progress in improving expenditure controls, the Government is also placing increased emphasis on more efficient and effective budget execution procedures to address constraints that are especially affecting infrastructure spending. A particular focus is on modernizing the core tax system to reduce compliance costs faced by taxpayers where a number of initiatives are supported by INSTANSI DPL 2.

Reform Aim: Improve results orientation and medium-term focus in the budget process

125. **The 2003 State Finance Law mandated three pillars of budget reform: (i) a *unified budget*** to remove the previous distinction between development expenditure and routine expenditure, and allow for

[18] PMK 1/2013

prioritization across all kinds of expenditures in the budget; **(ii) a *Medium-Term Expenditure Framework (MTEF)***, which aims at strengthening the capability to plan and prioritize expenditures for the medium term; and **(iii) *performance-based budgeting (PBB),*** which would restructure the budget according to programs and activities and introduce non-financial performance indicators, and allow for a results-based evaluation and budget allocation.

126. **While the unified budget was implemented in the 2005 budget, PBB and the MTEF are still in quite early stages of implementation.** However, notable implementation milestones have already been achieved. In particular, supported by previous DPLs, and following a joint circular from the MoF and Bappenas in 2009, a revised program structure has been introduced by all line ministries and ministry-level agencies. From the 2012 budget the work plans and budget submissions incorporate performance indicators for all programs and activities.

127. **The MTEF also implies a fundamental change in the budget preparation process.** Regulations have been put in place to incorporate medium-term budget forecasts and the treatment of new initiatives during the budget preparation process. The new initiative procedure was first introduced with the preparation of indicative budget ceilings for 2012. As part of INSTANSI DPL 2 a further step has been taken to enhance the credibility of the MTEF. To that end, the GoI, in the preparation of the 2014 budget, clearly identified the fiscal changes that impacted the MTEF and facilitated the reconciliation with the prior year forward estimates in the draft budget law. This is a major implementation milestone for MTEF reforms, as it helps ensure that the MTEF information is publicized and used in all major aspects of the budget preparation cycle. Ultimately, this will help ensure that the MTEF is integrated with the annual budget cycle, rather than operating as a separate planning exercise. A further development will occur with the use of SPAN to prepare the 2015 budget where the intention is to introduce new approaches that will make the budget discussion and documents more strategic, around programs, rather than the current detailed allocations for each spending unit.

128. **In an important move that supports the MTEF and PBB reforms the Government is examining the way in which the costing of transactions and activities is regulated in both the preparation and execution of the budget.** The aim is to replace the existing framework of input focused regulations and establish a control framework that provides increased flexibility for spending units while at the same time encouraging economy in spending. The Government prepared a draft white paper for a new and simplified costing methodology in 2012, and has implemented regulations establishing a new costing methodology, which addresses the roles of the MoF and line ministries and a number of specific costing procedures. It is intended that the costing framework will be further improved as progress is made in a number of associated areas such as simplifying the performance management structure.

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

129. **The annual budget cycle is also being strengthened by gradually introducing new procedures for performance monitoring, evaluation and management**. The importance of reviewing past expenditures as part of the annual budget cycle has been recognized by both Bappenas and MoF and a number of developments have taken place. In 2012, the MoF introduced a new regulation (PMK 249/2011) that requires line ministries to report on budget implementation performance across all programs. Reflecting their joint responsibility for planning and budgeting it has now been agreed that the MoF and Bappenas will build on this initiative by developing a performance review process that feeds into the setting of the baseline. The new process brings together MoF regulation PMK 249 with separate work by Bappenas.

130. **In addition, a number of steps are being taken to develop processes for in-depth reviews of the effectiveness and efficiency of spending**. This spending review approach has two streams. First, the use of detailed expenditure analysis to improve efficiency, which is led by the Directorate General of Treasury and began with a general review of the 2012 budget. Second, targeted assessments of the

efficiency and effectiveness of government expenditure, which is being piloted in the infrastructure sector with a process led by Bappenas but involving the MoF and the executing agencies. The latter approach looks to operationalize some of the findings from recent World Bank reviews of expenditure in the sector. These efforts to strengthen the link between the review of budget expenditures and the planning for the subsequent budget are critical, but challenging, and it is expected that they will take a number of years to be fully developed.

Reform Aim: More Efficient and Effective Financial Management

131. **One of the main objectives of the PFM reform is to unlock the bureaucratic bottlenecks that impede implementation of infrastructure projects that are critical for rapid and sustainable growth.** While the DPL measures support more efficient and effective budget execution in general, the need for streamlining procedures is especially acute for spending units and line ministries in implementing public investment projects. The Government has taken steps to address delays in disbursement caused by certain budget execution procedures, which were identified in a recent World Bank study.[19] The SPAN provides a critical foundation for streamlining procedures while retaining sufficient controls, as it will facilitate the full budget cycle process from preparation, allotment, execution and M&E in one integrated system.

132. **The issuance of a new Presidential Regulation (PP) to support enhanced budget execution, as supported by the INSTANSI DPL 2, has addressed a number of obstacles to budget execution alongside other measures.** These include:

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

133. **Beyond the new budget execution regulation a number of other steps have been taken to improve the regulatory environment.** In-year adjustment (virement) regulations are viewed by spending agencies as overly complex and a major source of spending delays. The MoF introduced in FY 2013 a one-stop service in which the budget management (allocation, allotment, and in-year virement) will be approved by one unit (DG Budget). New regulations build on that change by streamlining the approval process within the MoF. Additional steps are envisaged in coming years to devolve more authority to line ministries and use SPAN to replace existing steps in the approval process.

134. **The MoF has also taken steps to eliminate the use of blocked budget lines ("bintang") by placing greater reliance on ex-post controls.** Considerable delays often occurred during the budget year as

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

spending units cleared blocks prior to executing expenditure. In future, the spending unit will be responsible for ensuring that the necessary requirements for the expenditure are met—subject to audit oversight.

135. **The implementation of SPAN represents a major milestone in the PFM reform agenda.** It will enhance not only the controls over financial transactions but will also provide a basis to improve the performance across the entire budget cycle from planning to reporting. Despite some difficulties encountered during the application development stage, SPAN made good progress in 2011 and 2012. During the last year this involved:

- the completion of an Integration Test which tested all the developed (standard and customized) programs of individual modules; and
- a User Acceptance Test where the system is examined by the end users through use of a number of case scenarios to confirm that it is meeting the specified needs.

136. **The INSTANSI DPL-2 has supported the development of SPAN as reflected in the expected roll-out of the core treasury solution to pilot locations in November 2013.** Over the course of 2013, a link between individual spending units and the SPAN application located in Treasury offices will be developed, and the implementation of the budget preparation module is also expected to occur. These steps will complete the SPAN system.

137. **In addition to the SPAN development, the MoF continues to integrate ICT services across the ministry to enhance coordination and efficiency.** The creation of the ICT shared services unit for the MoF (Pusintek), and the gradual adoption of the ICT blueprint recommendations have been supported under previous DPLs in order to promote greater integrity, security, interoperability and efficiency of the ICT systems. Consistent with this the MoF has advanced ICT integration by establishing a single Data Center (DC) and consolidating five existing DCs into a new facility in Jakarta. This consolidates DCs that were previously run separately by DG Debt Management, DG Customs, DG Budget, DG Treasury and State Revenue Module. Pusintek is also enhancing security awareness, focusing initially on SPAN. During 2013 a major achievement was made with the completion of a disaster recovery center (DRC) in Balikpapan. This provides enhanced support for the MoF ICT users in case of a major incident.

Reform Aim: Improve government accounting and audit functions

138. **A strong internal control system is essential if budgeted resources are to be used as intended.** Through the issuance of Government Regulation (PP60/2008), the Government has adopted the international standard (COSO) as its internal control framework. The regulation and the Presidential Instructions issued subsequently have also clarified the roles and responsibilities of various players in the internal audit arena. The next critical step is to formulate an internal audit strategy and the development of a code of ethics, audit standards and peer review guidelines. As mandated in the regulation, an association of internal auditors has been established to perform these functions, and a draft code of ethics and audit standards have been prepared.

139. **To implement the internal control system,** a Control Self-Assessment (CSA) manual has been prepared and socialized in line ministries and local governments. CSA is one of the key tools for carrying out risk mapping in the line ministries. It is expected that all the line ministries will carry out a risk-mapping exercise, identifying the major risks and how they can be mitigated. To date, the assessments have been carried out in seven ministries.

140. **Indonesia continues to move towards accrual-based accounting.** Financial reports prepared on an accrual basis are more useful both from accountability and decision-making perspectives. The target is to switch to full accrual accounting by 2015. The draft standards have been prepared and the Government has issued new accrual based accounting policies and chart of accounts to support this important change.

Furthermore, the Government has issued a Minister of Finance Regulation on the procedures of depreciating state assets to support the implementation of accrual accounting.

Reform Aim: Improve sub-national fiscal management

141. **Comprehensive fiscal information is important for policymakers trying to decide and monitor the quality of spending, especially with respect to service delivery.** Subnational governments constitute about 40 percent of all public expenditures in Indonesia. However, comprehensive information on their fiscal operations is not yet available. Although the Directorate General of Fiscal Balance, the MoF has been establishing a Regional Financial Information System (SIKD) since 2001, SIKD is still not comprehensive in terms of the number of subnational government covered, the level of detail of fiscal information presented, and the years published. The main reasons are insufficient compliance by subnational governments in submitting timely budget information, and the absence of an electronic data transfer system, which necessitates manual data entry of expenditure information by staff of DG Fiscal Balance.

142. **The MoF DG Fiscal Balance is taking steps to improve the availability of subnational fiscal information.** Starting in 2012, DG Fiscal Balance began to implement sanctions for the regions that did not submit their budget information in a timely manner—particularly by delaying disbursement of the unconditional transfer. DG Fiscal Balance also introduced an electronic data transfer platform called KOMANDAN SIKD which will enable electronic data submission by subnational governments, although this platform is still not fully operational. In conjunction with these reforms DG Fiscal Balance is manually updating the publicly available data for the years leading up to the introduction of KOMANDAN. It is also publishing a consultation document on the routine production and publication of detailed data in order to reach agreement on procedures with data users.

Reform Aim: Improve the organization structure and human resource management in DG Taxes

143. **Since 2000, the Directorate General of Tax (DGT) has taken a number of major steps to transform the tax administration system.** While significant progress has been made in terms of increased numbers of taxpayers and compliance, the Directorate General of Tax (DGT) is still facing challenges in optimizing the tax revenue performance and putting in place the right operating model. The recent economic developments have provided a further reminder of the need for these reforms to support the Government's fiscal requirements.

144. **Ongoing constraints for DGT include ineffective systems and weak human resource management.** Modernizing human resource management, improving professionalism and staff integrity, and strengthening governance are a priority. DGT currently has around 33,000 employees, but lacks staff in key areas, such as tax audit and HR organization. The business rules need to be strengthened in a number of areas to promote greater controls between tax functions and taxpayers. In addition, DGT will need to undergo restructuring and is assessing various alternatives to the current organization structure. DGT will focus on a few priority areas to reform, including developing the organization and procedures for strengthening the data processing centers, procurement services and taxpayer call centers.

145. **Strengthening the performance management system is another of the priorities of DGT's reform agenda**. A new performance management system is being developed to help focus auditors' work to more priority cases and monitor them, taking a more risked-based approach. To achieve the 2013 revenue targets, the business rules need to be strengthened in a number of areas to promote greater controls between tax functions and taxpayers. Each year, DGT will develop an annual audit strategy based on the revenue target for every Regional Office to measure the quality of work and provide a reward mechanism for auditors.

Reform Aim: Modernize the core tax administration system by reducing compliance costs

146. **Alongside the internal reforms, a number of steps have been taken by DGT to modernize the core tax system and reduce compliance costs.** Major outreach programs and simplification efforts have increased the number of registered taxpayers from a total of about 4.8 million in 2006 to more than 22 million by 2013. However, the increase in the number of registered taxpayers, who are mostly individuals and small businesses, has not resulted in a significant increase in revenues, as substantial coverage gaps and systemic administrative weaknesses remain.

147. **With the support of INSTANSI DPL-2 an electronic filing mechanism for individual taxpayers has been established.**[20] The GoI has issued regulations (Minister of Finance Regulation No. 100/PMK.03/2013 and Director General of Tax Regulation No. PER-28/PJ/2013), to establish procedures and an application for VAT refunds for tourists through a website (e-invoice).The main objective of the online system is to provide individual taxpayers with legal certainty, and improved services. Taxpayers can now access the application for registration and currently this mechanism has been used by about 278,000 taxpayers who submitted their returns for tax year 2012. In the near future, this number is expected to increase significantly.

148. **INSTANSI DPL-2 has also supported the establishment of a VAT refund application for tourists.** Since 2010, DGT has run a VAT refund mechanism by establishing VAT refund counters at five airports in Indonesia. With the objective of improving services to taxpayers, DGT has issued a regulation (Director General of Tax Regulation No. PER-26/PJ/2013) to establish procedures of individual e-filing for simple tax return and has issued a form for very simple tax return. The VAT refund application allows registered retail stores to participate in the VAT refund mechanism.[21] Foreign passport holders who have been staying in Indonesia for less than 2 months and have purchased goods with value more than IDR 500,000 from participating retail stores are eligible to collect VAT refunds at the five international airports across Indonesia.

B. Participatory Processes and Consultations

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

150. **Beyond the officially recognized participatory processes, various aspects of the reforms supported by this operation have been subject to extensive specific stakeholders consultations.** In the public financial management and poverty alleviation areas a large number of seminars and workshops have been undertaken during the past year among different government agencies, as well as between the administration and other key relevant stakeholders, not only to discuss technical issues but also reach agreement on policies and reform activities. During the preparation of INSTANSI DPL-2, a series of policy

[20] https://efiling.pajak.go.id
[21] https://vatrefund.pajak.go.id

discussions was held as part of the ongoing engagement with the core economic ministries, culminating in a series of half-day meetings with key counterparts in each of the relevant areas or sub-areas. A roadmap of milestones was then developed, which conforms to the Government's own reform agenda, as laid out in the DPL program matrix in Annex 2. This program matrix will continue to be adjusted and refined as progress continues to be assessed and discussions mature.

C. The Future Program

151. **The Government has recently indicated the possibility of extending the DPL series from two to three years, thereby continuing the DPL operation in 2014.** The Government is presenting its financing needs and desired composition for 2014, consistent with its debt-management strategy that reflects the macro volatility. The Government has indicated that it will possibly continue the INSTANSI DPL engagement by extending the series until 2014, when the elections and change in government administration are expected to take place. To that regard, a set of tentative policy actions for a possible subsequent INSTANSI DPL operation have been tentatively identified and will continue to be developed in consultation with the GoI. As demonstrated in the past, the ownership and commitment to these reforms are expected to continue, despite the imminent change in in administration.

Table 5: Proposed Indicative Triggers for a Possible INSTANSI DPL-3 Operation

Indicative Triggers for 2014
Pillar 1: Enhancing poverty alleviation and service delivery efforts
1. The design and standard operating procedures are completed by the Secretariat of the National Secretariat for the Acceleration of Poverty Reduction (TNP2K) for the updating of the national registry of poor and vulnerable households (PPLS14).
2. Issue a ministerial decree on implementing universal health care, including new capitation standard for primary care and case base group payment schedule for hospital reimbursement.
Pillar 2. Strengthening public financial management for improved service delivery
3. Simplification of the performance-based budgeting architecture to substantially reduce the number of Government outputs
4. Develop an integrated baseline and policy review that includes an assessment of the policy performance in the prior year based on a common definition of performance information for preparation of 2015 budget.
5. Key spending review recommendations are implemented in the planning and budgeting processes for 2015.
6. Fully implement the SPAN as a completed system covering MOF and all spending units.
7. Produce semester Central Government Financial Statement Report (LKPP) from SPAN

VI. OPERATIONAL AND IMPLEMENTATION ISSUES

A. Monitoring and Evaluation

A.1. Monitoring

152. Monitoring the implementation and attainment of the DPL prior actions is done through regular meetings between GoI and development partners, as well as the ongoing engagement with agencies responsible for different prior actions. GoI has established monitoring committees and/or technical groups that are responsible for ensuring the implementation of agreed prior actions, as well as progress follow-up. In addition, the DPL benefits from regular joint development partner-Government meetings to discuss interim progress in achieving agreed milestones in the reform agenda (held in April, June and August 2013) and ongoing policy dialogue between the GoI and World Bank teams. Table 6 below indicates the critical monitoring activities in each policy area.

Table 6 Critical monitoring activities

Policy area	Monitoring activities
Enhancing poverty alleviation	• Ongoing monitoring of the implementation of national poverty alleviation programs by the National Team
	• Ongoing monitoring of poverty related activities in conjunction with development partners as part of regular DPL program and analytic and advisory activities
Strengthening public financial management	• Ongoing monitoring of progress on budget disbursements and identification of key bottlenecks by Bank's Jakarta team and GOI TEPPA
	• Ongoing monitoring of the time profile of budget disbursement, composition of public expenditures, and poverty and employment effects of economic shocks as part of the regular DPL program and analytic and advisory activities

A.2. Evaluation

153. **A results framework has been prepared with a number of indicators to be assessed at the end of the current DPL programmatic series.** The Bank works closely with the Coordinating Ministry for Economic Affairs, the Ministry of Finance and other relevant agencies to monitor and assess reform progress and impacts during the life of the program. In addition to ongoing monitoring of activities, the Bank prepares an Implementation Completion and Results Report (ICR) at the end of each series. The ICR, prepared in consultation with the Government and development partners, is a Bank self-evaluation reporting tool that highlights the key achievements and results, as well as lessons learned.

154. **The ICR for all previous DPL series (DPLs 1-4, 5-6 and 7-8) show the significant progress that the GoI has made in its reform efforts since 2004.** They also highlight the role that the DPL has had in supporting that progress, by ensuring the alignment of support provided by development partners with the GoI's own reform efforts, promoting synergies between program support and other Bank instruments, focusing attention from both the Government and development partners on the most relevant reforms, as well as empowering key reform oriented government officials to advance the implementation of necessary reforms. Monitoring and evaluation will also be supported by budgetary, legislative and economic data provided by the authorities and verified in official disclosures, directives and regulations. Baseline and

updated data will be provided by the respective specialized agencies and tracked according to the Monitoring and Results Framework included in Annex 3.

B. Poverty and Social Impacts and Environmental Aspects

B.1. Poverty

155. **The INSTANSI DPL-2 policy actions have the potential to deliver positive outcomes on poverty over the medium term.** But by themselves, these actions are unlikely to have significant poverty and social consequences or significant environmental effects. *The policy actions aimed at enhancing poverty reduction and strengthening service delivery should have positive effects over the short and medium term.* The National Team for the Acceleration of Poverty Reduction (TNP2K) continues to address the issues of fragmentation and lack of coordination, to improve the effectiveness of national poverty reduction programs. Improvements in systems for better targeting of poverty alleviation programs and measurement of poverty are also expected to support the poor by ensuring that these programs reach the appropriate beneficiaries and by ensuring the availability of more reliable data and information—including those that are sex-disaggregated—which are needed to make sound policy decisions. Household-based poverty reduction programs are being strengthened, which will improve the coverage of health insurance for all families, including the poor, and increase the number of scholarships for poor students at all education levels. Together, these actions are expected to yield positive impacts to the poor and vulnerable social groups throughout Indonesia.

156. **The strengthening of PFM systems more generally are expected to have significant, if indirect, poverty and social benefits.** Improvements in public financial management will improve the capacity of the Government to provide public goods and services, which also benefit the poor. The transparency and quality of public spending and the provision of public services will allow social programs to have a greater impact on targeted populations. Through the subnational fiscal management and tax reform actions, the Government plans to address the various gaps and introduce new systems and procedures that facilitate better compliance, thereby contributing to increased revenue collections and generating additional fiscal resources that can be used in economic development and poverty alleviation efforts. Overall public savings through better fiscal management will allow the GoI to dedicate more resources to pro-poor programs.

B.2. Gender

157. **As equitable development is a major concern for the Government, the DPL also supports institutional and policy reform aimed towards benefiting women in poor households.** The medium-term development plan (RPJMN) outlined the importance of increasing the role of women in development, particularly women's leadership in public sector, business community and social organizations. In consultation with the Ministry of Women's Empowerment, the Ministry of Finance has issued regulations requiring that all K/L budgets are prepared using a 'gender lens'. The regulation requires line ministries to provide a gender budgeting statement in their proposed budget. This has been made compulsory for the line ministries and government institutions at the same level of line ministries.

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

B.3. Environmental

159. **The proposed operation is unlikely to have significant positive or negative effects on the environment, forests and other natural resources.** Policy area 1 actions on enhancing poverty alleviation and shared prosperity by expanding targeted compensation measures for the poor, commencing preparations for national social security programs and empowerment of communities through the PNPM Mandiri program, should have no likely significant negative effects and probably only positive effects. All these actions are designed to have positive social effects in enhancing poverty alleviation and shared prosperity. Policy area 2 actions on strengthening public financial management for improved service delivery should have no significant negative effects. Instead, improved budget transparency, forward planning and monitoring and evaluation should improve effectiveness of spending on development programs to benefit society. Improving tax administration should have no likely significant negative effects. Improving capacity, modernizing, clarifying information and tax collection rules should increase tax compliance, reduce leakage, and aid law enforcement efforts—all contributing to improving the rule of law and the perception of fairness in tax payment.

C. Fiduciary Aspects, Disbursement and Auditing

160. **Public financial management is a central policy area that is supported by the proposed DPL operation.** The Fiduciary Assessment for Indonesia has been carried out and the Fiduciary Risk is rated as **Moderate**.

161. **In summary, significant strides have been made in recent years in the way Indonesia's public finances are managed and in increasing transparency and independent oversight.** In the last three years, progress has been made in the area of budget execution, with the development of a unified budget and a Treasury Single Account (TSA) to strengthen the comprehensiveness and control over spending and cash management. In addition, there have been improvements in the coverage of fiscal accounts, accounting practices, payroll, internal controls and fiscal risk management. Notably, the 2009 audit report was the first to achieve a qualified audit opinion, as opposed to a disclaimer, with around 40 percent of ministries and agencies achieving unqualified audit opinions. Since then, the audit report has continued to be qualified. However, the number of ministries and agencies receiving an unqualified opinion has increased to over 70% for FY 2012. Improvements are required in several areas including refinement in performance-based budgeting, strengthening internal and external audit, improving spending outturns. Weaknesses in financial management and accountability continue to be gradually addressed through the Government's PFM reform program. Also, key elements of the reforms are supported by the DPL series, as well as the GFMRAP project and other initiatives supported by development partners. Furthermore, the Government has also demonstrated increased focus on budget transparency by publishing the annual budget in a timely manner, through the MoF website.

162. **The borrower is the Republic of Indonesia and this operation is a single-tranche IBRD loan of USD 400 million.** The loan will be made available upon loan effectiveness, provided that the Bank is satisfied with the progress achieved by the Borrower in carrying out the Program and with the adequacy of the Borrower's macroeconomic policy framework. The Government has confirmed that Indonesia will borrow this amount as a Variable Spread Loan (VSL) in US dollar currency with an annuity repayment schedule linked to commitments.

163. **The loan disbursement will follow the standard Bank procedures for Development Policy Lending**. The loan amount will be disbursed into a foreign currency account of the borrower at Bank Indonesia that forms part of Indonesia's official foreign exchange reserves. The equivalent rupiah amount will immediately be transferred to the General Operational Treasury (SBUN) account of the borrower that is used to finance budget expenditures, as the loan is intended to be used to support the general Government budget. This arrangement has been followed for the previous DPLs. The borrower, within 30 days, will

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

164. **The foreign exchange control environment is assessed to be generally satisfactory.** The country is no longer subject to the Extended Arrangement from the IMF. Bank Indonesia (BI) was last subject to the transitional procedures under the Fund's safeguards assessment policy in 2002. That assessment recommended remedial action to address a number of vulnerabilities in the audit arrangements of Bank Indonesia. The main recommendations have been implemented, including the establishment of an independent audit committee at Bank Indonesia and the publication of Bank Indonesia's audited financial statements. Audited financial statements for Bank Indonesia for 2012 have been reviewed and the audit report issued by the BPK contained an unqualified opinion.

D. Risks

165. **Continued strong performance by the Government on its reform agenda and the achievement of its medium-term objectives are subject to several risks.** These can be broken down into the following categories: macroeconomic, subsidy reform, implementation and coordination.

166. **Recently, Indonesia has seen increasing pressures on its external accounts, with the current account deficit widening after a negative terms-of-trade shock and international financing conditions becoming more uncertain.** Recent shifts in market sentiment have resulted in sudden, large and potentially disruptive reversals of capital inflows. The external accounts and growth outlook remain sensitive to softening global commodity prices and demand, particularly from China. With portfolio investors focusing on near-term policy responses, there is a risk that this diverts attention from longer-term reforms. However, the GoI has adopted key policy measures aimed towards protecting the poor and improving quality of expenditure, as supported by the ongoing DPL series, which are expected to help shield the risk of a crisis, and mitigate the impact of any economic downturns on households. The Government has developed a track record in precautionary and proactive measures to try to counter such shocks. This includes, for example, policy measures supported under the PERISAI DPL, approved in May 2012, which, along with parallel facilities from other development partners, also explicitly aims to mitigate GoI financing concerns in the face of a crisis. The Government has also been quick to introduce a package aimed primarily at longer-term structural measures to support exports and employment, moderate import growth, while limiting food price pressures. This has been accompanied by a tightening in monetary policy. There remain questions over the implementation of the policy package and it is likely that further policy adjustments will be required. However, there is the potential that the current macro-economic pressures that Indonesia is facing could allow policymakers the opportunity to make progress on medium-term structural reforms, although this must be offset against the political pressures in the run-up to the 2014 elections.

167. **Weakening revenue growth as activity moderates, and high and volatile energy subsidy costs, could significantly reduce fiscal space for other priority programs and undermine medium-term plans**. Fuel subsidy spending was projected to rise significantly in 2013, reflecting increased consumption, imposing a substantial budget opportunity cost in terms of spending on key development priorities as well as contributing to the current account deficit. Despite the political pressures from the elections in 2014, a revised Budget incorporated a long-awaited increase in subsidized fuel prices (although the subsidy remains significant), along with a comprehensive compensation package to reduce the impact of higher fuel prices

on the poor, was approved on June 17. The macroeconomic impact of the fuel subsidy reform package is expected to be manageable and largely short term in nature, with a spike in inflation (although the recent exchange rate depreciation may prolong the upward pressures on inflation). The proposed INSTANSI DPL-2 will seek to build on these measures by promoting more medium-term budgeting, which should better highlight some of the policy trade-offs of fuel subsidies, as well as strengthening the ability of compensatory programs to protect the poor and vulnerable groups, while the broader social insurance programs start to come into effect in 2014.

168. **PFM reforms that focus on enhancing expenditure controls and oversight will continue to make budget spending difficult in the short term, potentially undermining support for the reforms.** Indonesia has made significant strides in PFM with increasing transparency, expenditure controls, and independent oversight. However, this has exacerbated existing problems of budget execution, particularly for capital spending, and increased the risk aversion of government officials, delaying much needed spending. To mitigate this risk, the DPL seeks to balance further strengthening of expenditure controls, with efforts to streamline procedures and improve the quality of spending as policymakers look for more rapid results.

169. **The multiplicity of implementing agencies and their varying institutional capacities create a challenge in coordinating and implementing reform efforts.** Under the poverty pillar, the National Team for the Acceleration of Poverty Reduction (TNP2K) has taken the lead in the overall policy planning and coordination of social assistance programs; whereas the Ministry of Health is the main counterpart responsible for the preparation and implementation of the new national social security system (SJSN). Actions under the PFM pillar are undertaken by various Directorate Generals under the MoF. Nevertheless, the reforms supported by the INSTANSI DPL are driven by priorities developed and articulated formally through a platform of dialogue and consensus building within the Government, which the DPL helps to provide. Hence, their implementation helps to further enhance coordination between various ministries and agencies. The overall commitment to and ownership of reforms also remain strong, and the Coordinating Ministry for Economic Affairs ensures consistent and effective cross-ministerial coordination. Although the challenge will increase as the election period approaches and uncertainty over institutional roles in the next administration increases, past experience has demonstrated continued GoI commitment to reforms, regardless of election outcomes. The DPL program will continue to support the capacity of the various institutions involved, for example with direct support for the development of the next administration's medium-term plan (RPJMN) and social insurance reforms (SJSN), which are complemented by other Bank instruments, including investment projects, technical assistance and AAA.

Annex 1: Letter of Development Policy

Letter of Development Policy

Jakarta, September 30, 2013

No. S-208/M.EKON/ 09 / 2013
No. S-699/ MK.08/ 2013

Mr. Jim Yong Kim
President
The World Bank
Washington D.C, USA

Dear Mr. Kim,

On behalf of the Government of Indonesia, we would like to provide an update on our recent economic reform developments, and to request the World Bank's support through policy-based lending operation of the Second Institutional, Tax, Administration, Social and Investment Development Policy Loan (INSTANSI DPL-2) for USD 400 million.

This operation provides an important package of support that would contribute to Indonesia's medium term economic development, poverty alleviation and shared prosperity objectives. As the current Government is nearly ended its second and final term in office, we remain focused on the core reform agenda to improve economic growth, generate better employment, reduce poverty and regional disparities, while enhancing governance. Sustained solid economic growth in the past few years has generated more employment and reduced poverty. We have strived to put in place a strong macroeconomic foundation for economy to grow further. Despite the current financial markets turbulence, we expect that our economic growth will remain resilient in the future. With a diversified economic base and a growing middle class, consumer spending and investments have good medium-and long-term prospects. While we expect a lower economic growth in 2013, we have continued to adjust our fiscal and monetary policy settings to the recent changes in the external and domestic environment. We have also introduced a policy package to help stabilize the economy and put a more solid foundation for growth in the coming years.

Our key objective is to achieve growth above 6 percent range in the next couple of years, as a more sustainable global economic recovery takes root. In order to reach the country's full potential, we will need to embark upon more progressive reforms to lead the improvements in public institutions and capacities, particularly those aimed towards poverty alleviation, shared prosperity, and developed public financial management. The proposed development policy lending operation is fully aligned with our medium and long term agenda, as detailed in the National Medium-Term Development Plan (RPJMN) 2010-2014. During the last decade, Indonesia has made significant progress toward its economic development and poverty alleviation objectives. We recognize that reform efforts to improve the quality of public spending will need to progress further and we will continue the productive collaboration with our

development partners in this key priority beyond 2013. Therefore, although we had previously envisioned proposed operation to be the last of a two-year, programmatic DPL series, it appears likely at the moment, that the operation would need to be extended from two to three years ahead.

The purpose of this Letter of Development Policy is to provide an update on the Indonesia's recent progress towards implementing its reform program and medium-term agenda in the policy areas supported by the proposed lending operation.

The Economic Situation

Like many other countries in the region, Indonesia has faced a number of external challenges. Since the announcement of the potential quantitative easing (QE) tapering by the US Federal Reserve Bank, the capital flow has swung back somewhat to advanced economies, particularly the US and Japan. It has created a ripple effect across emerging economies that had earlier experienced large capital inflows, including Indonesia. From end-May to late August, the Jakarta Stock Exchange Index fell by close to 25 percent prior to rebounding by 10 percent and the 5-year Indonesia Rupiah (IDR) bond yield rose by 280bps; the rupiah has depreciated by close to 18 percent against the US dollar year to date. The Credit Default Swap (CDS) rate for Indonesia has increased more sharply than other countries in the region. While the primary trigger was external and related to the potential QE tapering, Indonesia has been more severely affected mainly because of its relatively open capital account and the significant foreign presence in its stock and bond markets. At the same time, the domestic bond market is still very shallow compared to other countries in the region.

To cope with the heightened financial market turbulence, the Government has implemented comprehensive measures. On the macro front, Bank Indonesia has increased its policy rate by 150bps from June to September, to reach 7 percent, and allowed more room for the rupiah to depreciate. The Government has also issued structural policy measures targeted to reduce the current account deficit, support investment and exports, and ease inflationary pressure from key commodities. To add a buffer to the country's large reserves, the swap line between Bank Indonesia and Bank of Japan worth USD 12 billion has been extended for another 2 years. In addition, to ensure that Indonesia could continue with its development and reform agenda, even in the event of larger financial market turbulence, the Government had already put together a USD 5 billion contingent financing facility with the support from the Asian Development Bank, Government of Australia, Government of Japan and the World Bank.

Thanks to the extensive structural reforms implemented over the last few years, many of which have been supported by the development partners, Indonesia should continue to be relatively well-positioned to weather the increasing global economic and financial headwinds for emerging markets. The revised 2013 Budget approved in June 2013 also includes measures to increase fuel prices and compensation for the poor, while providing the Government with significant flexibility to respond to evolving global economic conditions. Despite a projected increased budget deficit to 2.4 percent of GDP, needed to support increased infrastructure spending, the downward trajectory of government debt-to-GDP ratio is projected to continue in 2013. With its strong capital base, the financial sector should remain resilient to the financial market turbulence. We believe all these factors, together with continued structural reforms, would support continued solid investment and economic growth in the country over the medium-term.

The Government is committed to continuously improving Indonesia's economic resilience such as improving poverty reduction, strengthening bureaucracy reforms, and programs as outlined

in the proposed 2014 Budget that is currently under discussion with Parliament and is expected to be approved by end October. The proposed Budget also foresees the implementation of new policies such as the health dimension of the new National Social Security Law, as discussed below, and a proposal to adjust electricity tariffs for selected customers to further improve the quality of spending. As in the 2012 and 2013 Budgets, the proposed 2014 Budget includes provisions relating to crisis preparedness to allow the Government the flexibility to respond to potentially rapidly changing macroeconomic developments.

Enhancing the quality of public spending for poverty alleviation and shared prosperity

The Government remains committed to enhance poverty alleviation and shared prosperity efforts. Since taking up office in 2009, the Government continues to intensify policy reforms that support poverty reduction, by adopting a pro-poor approach towards economic development. The RPJMN 2010-2014 emphasized poverty reduction as its highest development priority by maintaining strong growth and job creation, and continuing implementation of the national poverty reduction framework; and the revised 2014 budget maintains this thrust, with a targeted poverty rate of 9 to 10 percent. We recognize the need to boost social assistance programs, in order for them to reach their full potential in contributing to efforts to accelerate poverty reduction. The oversight of national poverty reduction programs was therefore elevated to a cabinet-level national team led by the Vice-President, which continues to play a key role in preparing reform policies and monitoring their implementation. At the same time, in order to move towards a more effective and integrated system of poverty reduction programs, a national registry of poor and vulnerable households was developed to improve program targeting.

Social spending has increased significantly under the revised 2013 Budget, with the introduction of the compensation package for the subsidized fuel price increase in June 2013, which aims to partly help shield poor households from the impact of higher fuel prices. The package demonstrates the important steps that had been taken towards developing a more comprehensive, integrated and well-targeted social support system. These include the policy measures aimed towards improving poverty measurements and targeting of the poor, such as the development of the national registry of poor and vulnerable households. The approved package of compensation measures totals IDR 29 trillion (USD 2.7 billion), or about three-quarters of the estimated total fuel subsidy savings in 2013. The compensation package comprises two main components: (i) an unconditional cash transfer (BLSM) for 15.5 million of Indonesia's poorest households (around 90 million people) for a period of four months, the provision of additional rice to beneficiaries of the Rice for the Poor (*Raskin*) program, and additional spending on infrastructure programs; and (ii) expansion of the financial assistance for poor students and conditional cash transfers for health (PKH).

Indonesia is also moving ahead towards strengthening social protection, through the establishment of a new national social security system. The 2004 landmark legislation on the National Social Security Law (SJSN Law) provides the principles and goals of the national social security system, and establishes a series of social insurance funds financed by employer, worker and government contributions that cover all Indonesian workers in both the formal and informal sectors. More recently, the 2011 Social Security Administrator Law (BPJS Law) establishes two nationwide social insurance administrators: the BPJS Health and the BPJS Employment. In accordance with the BPJS Law, the Government is to merge by January 2014 all existing social health insurance mechanisms into a single-payer system. Improving the performance of National Health Insurance for the Poor and Near Poor (Jamkesmas) will also be

key to attaining universal health coverage in Indonesia by the stated goal of 2019, which necessitates the readiness of the supply-side and the financial sustainability of the program.

Conclusion

Despite the global economic challenges, the Government of Indonesia has continued to implement proactive measures to ensure that the country sustains its solid economic growth and poverty reduction. We are committed to maintaining macroeconomic stability while enhancing our preparedness for meeting any global economic shocks or financial market turbulence. At the same time, we are pushing ahead with our medium- and long-term economic reforms to meet our development priorities. In closing, let us reiterate the Government's strong ownership and commitment to improve the quality of public spending and strengthen social protection program where we are soliciting the support of the World Bank. We look forward to continued engagement and support for Indonesia's economic development agenda in the coming years.

Minister of Finance
Republic of Indonesia

M. Chatib Basri

Coordinating Minister for Economic Affairs
Republic of Indonesia

M. Hatta Rajasa

Annex 2: Instansi Dpl Program Results Framework

Reform Aim	INSTANSI DPL Prior Actions (2012)	INSTANSI DPL-2 Prior Actions (2013)	Indicators	Baseline Data	Post Program Target (post 2014)
Policy area 1: Enhancing poverty alleviation and shared prosperity efforts					
Expansion of targeted compensation measures for the poor following subsidized fuel price increase		Issued integrated social protection cards (KPS) to fifteen million five hundred thousand (15,500,000) poor and vulnerable beneficiary households identified through the Borrower's national registry (PPLS11), entitling them to subsidized rice allocations (RASKIN), temporary unconditional cash transfers (BLSM), and financial assistance for poor students (BSM).	Card distribution coverage, disaggregated by male- and female-headed households	N/A	15.5 million households, of which 14% are female-headed households and 86% male-headed households (consistent with the proportion of FHH in the PPLS11 and census)
		Issued a Ministry of Home Affairs Instruction (No. 541/3150/SJ), for local governments to improve the targeting accuracy of the KPS beneficiary list, through a transparent and participatory community-based mechanism.	Status of mechanism	N/A	Mechanism launched and implemented
		Issued the FY 2014 Financial Notes and Draft Budget, which includes a report on the 2013 budget allocation for the implementation of temporary safety net programs, which consist of an unconditional cash transfer program and a subsidized rice program for fifteen million five hundred thousand (15,500,000) poor and vulnerable households identified through the PPLS11 to compensate for the fuel price increase of 2013.	Unconditional cash transfer program exclusion error of the bottom consumption decile (%)	Overall: 39.4%; Male: 40.6%; and Female 39.2% (2006)	Improved targeting, as demonstrated by reduced exclusion errors
			Raskin exclusion error of the bottom consumption decile (%)	Overall: 24.3%; Male:25.3 %; and Female 25.2% (2010)	

		Issued a Presidential Decree (No. 37/2012) to provide budget allocation to increase the adequacy of benefit levels for the BSM program and expand the coverage of the BSM program using the PPLS11 to identify beneficiaries of the BSM.	Program coverage	8.7 million beneficiaries	16.6 million beneficiaries
			Benefit levels	IDR 360,000 (primary school); IDR 550,000 (junior secondary)	IDR 450,000 (primary school); IDR 750,000 (junior secondary)
		Issued a Presidential Decree (No. 37/2012) to provide budget allocation to increase the adequacy of benefit levels for the conditional cash transfer (PKH) program and expand coverage of the PKH using the PPLS11 to identify beneficiaries of the PKH.	Program coverage	1.5 million households	2.4 million households
			Benefit levels	Average IDR 1.4 million/ year/ household	Average IDR 1.8 million/ year/ household
Commence preparations for national social security health programs	The TNP2K Secretariat has completed a review of new institutional arrangements for the delivery of *Jamkesmas*, taking into account actuarial cost estimates and various scenarios for achieving universal health insurance coverage.	Issued a Presidential Regulation No. 12/2013 to provide the main regulatory framework for implementation of the national health insurance program.	Coverage of Jamkesmas (health insurance program for poor and near poor) members under new BPJS Health system	86.4 million members	Continuation of health insurance for the 86.4 million members during the major health system reform.

Policy area 2: Strengthening public finance management for improved service delivery					
Improve budget information transparency and use of MTEF		In preparation of the 2014 budget, clearly identified the fiscal changes that impacted the medium-term expenditure framework and facilitated the reconciliation with the 2013 forward estimates in the draft budget law.	Publication of reconciliation with prior year forward estimates in draft budget.	No publication.	Improved budget transparency and planning by strengthening the use of the MTEF, with publication of the details in the 2014 budget
			PEFA PI 12: multi-year perspective in fiscal planning, expenditure policy and budgeting	PEFA rating as of most recent PEFA report (2011): C+	PEFA rating improves to at least B.
Strengthen the use of monitoring and evaluation in the planning and budgeting cycle			Budget cycle has process where prior year performance information is assessed in preparing allocations.	Reports on performance received by MoF but not used in preparing budget.	Performance reports provided by pilot K/Ls to MoF and Bappenas and considered in deciding indicative ceilings.
			Inter-agency spending review report used in deciding 2015 budget allocations.	No inter-agency spending review.	Findings of Infrastructure spending review are used in deciding 2015 Budget allocations.

More efficient and effective financial management	The Borrower, through the Ministry of Finance, has issued a Ministerial Regulation (No.112/2012) simplifying and clarifying the practice of withholding funds for budget allocation ("*Bintang*").	Issued a Government Regulation (No. 45/2013) to support enhanced budget execution	Capital expenditure absorption in full year.	In 2012 capital expenditure absorption was 82%.	Capital expenditure absorption is 90% in 2014.
	The Borrower has introduced a new General Ledger under SPAN using daily transaction conversions from the old General Ledger.		SPAN as an IFMIS solution	In 2012 separate budget and treasury systems are being used by spending units.	SPAN is implemented providing an integrated system for financial management.
			Semester report prepared from SPAN	Legacy system is used in 2013 and is not capable of supporting full accrual accounting.	SPAN used in 2014 providing increased assurance of accuracy of account statements and supporting the implementatio n of accrual accounting.
Modernize core tax system	The Borrower has issued a Government Regulation (No.31/2012) for the implementation of Article 35A of Law 28/2007 and a Minister of Finance Decree (No.	Issued regulations (Minister of Finance Regulation No. 100/PMK.03/2013 and Director General of Tax Regulation No. PER-28/PJ/2013), to establish procedures and an application for VAT refunds for tourists through a website (e-invoice)..	Number of VAT refunds for tourist processed online	Zero in 2012	10,000

	194/KMK.03/2012) on the sharing of data between DG Taxes and DG Customs, all of this to facilitate the sharing of third party information for improved tax compliance.	Issued a regulation (Director General of Tax Regulation No. PER-26/PJ/2013) to establish procedures of individual e-filing for simple tax return and has issued a form for very simple tax return.	Number of individuals filing tax returns online (e-filing)	32,475 individual tax returns submitted via e-filing for tax year 2012	1,000,000

Annex 3: The Government of Indonesia's Broader Reform Program

(The INSTANSI DPL-supported reform actions are indicated in bold)

Reform aim	Prior actions and benchmarks and proposed indicative triggers and milestones		
	As of September 2012	**As of September 2013**	**As of September 2014**
Policy area 1: Enhancing poverty alleviation and shared prosperity efforts			
Expansion of targeted compensation measures for the poor following subsidized fuel price increase		**Issued integrated social protection cards (KPS) to fifteen million five hundred thousand (15,500,000) poor and vulnerable beneficiary households identified through the national registry (PPLS11), entitling them to subsidized rice allocations (RASKIN), temporary unconditional cash transfers (BLSM), and financial assistance for poor students (BSM)**	
	Program beneficiary lists for priority Cluster 1 programs (RASKIN, PKH and Jamkesmas) are extracted from the unified database by the TNP2K Secretariat, using eligibility criteria from the implementing agencies	**Issued a Ministry of Home Affairs Instruction (No. 541/3150/SJ), for local governments to improve the targeting accuracy of the KPS beneficiary list, through a transparent and participatory community-based mechanism.**	**The design and standard operating procedures are completed by the Secretariat of the National Secretariat for the Acceleration of Poverty Reduction (TNP2K) for the updating of the national registry of poor and vulnerable households (PPLS14).** Allocation of state budget (APBN) to finance the updating of the national registry of poor and vulnerable households (PPLS14).
		Issued the FY 2014 Financial Notes and Draft Budget, which includes a report on the 2013 budget allocation for the implementation of temporary safety net programs, which consist of an unconditional cash transfer program and a subsidized rice program for fifteen million five hundred thousand (15,500,000) poor and vulnerable households identified through the PPLS11 to compensate for the fuel price increase of 2013.	

Reform aim	Prior actions and benchmarks and proposed indicative triggers and milestones		
	As of September 2012	As of September 2013	As of September 2014
	Prepared a strategy document on reforming the targeting, fragmentation, benefit levels, and outreach strategies for Scholarship for the Poor programs.	**Issued a Presidential Decree (No. 37/2012) to provide budget allocation to increase the adequacy of benefit levels for the BSM program and expand the coverage of the BSM program using the PPLS11 to identify beneficiaries of the BSM**	
		Issued a Presidential Decree (No. 37/2012) to provide budget allocation to increase the adequacy of benefit levels for the conditional cash transfer (PKH) program and expand coverage of the PKH using the PPLS11 to identify beneficiaries of the PKH.	PKH program coverage reaches 3.2 million households by 2014.
			The Ministry of Social Welfare completes the recertification process for PKH beneficiary households.
Commence preparations for national social security health programs	**The TNP2K Secretariat has completed a review of new institutional arrangements for the delivery of *Jamkesmas*, taking into account actuarial cost estimates and various scenarios for achieving universal health insurance coverage.**	**Issued Presidential Regulation No. 12/2013 to provide the main regulatory framework for implementation of the national health insurance program.**	**A strategy for the transition of Jamkesmas institutional arrangements from Ministry of Health to the social security system administrator for health (BPJS Health).**
		Memorandum of Understanding on the transformation of Jamkesmas, between the Ministry of Health and PT Askes as appointed future administrator of BPJS Health.	
		Issued Guidelines for Socialization as part of UHC implementation.	**Ministerial Decree on implementing UHC, including new capitation standard for primary care and case base group payment schedule for hospital reimbursement**.
		Developed online e-catalogs for medicines and medical supplies as part of UHC implementation.	
Empowering communitie		TNP2K finalized and sent to Pokja Pengendali of PNPM of final KPIs for PNPM Mandiri, for implementation..	Recognition of “Desa” as self-governing community or lowest level of government

Reform aim	Prior actions and benchmarks and proposed indicative triggers and milestones		
	As of September 2012	As of September 2013	As of September 2014
s to take charge of their developmen t needs		TNP2K finished and sent to Pokja Pengendali of PNPM, the policy on Facilitator Remuneration, for implementation.	
		TNP2K finishes and sends to Pokja Pengendali PNPM the new criteria of block grant allocations using the composite index reflecting regional characteristics.	2015 block grant allocations to be determined based on IKW-composite index
			Adoption of financial mechanisms for direct transfer of block grants to communities
Policy area 2. Strengthening public financial management for improved service delivery			
Improve results orientation and medium-term focus in the budget process		**In preparation of the 2014 budget, clearly identified the elements impacting the medium-term expenditure framework and facilitated the reconciliation with the 2013 forward estimates in the draft budget law.**	**Simplification of the performance architecture to substantially reduce the number of Government outputs**
			Utilization of Hyperion in the budget preparation to strengthen the institutionalization of the MTEF
	Prepared draft white paper for a new and simplified costing methodology.	Issued Government regulation that establishes a new Costing Methodology, in line with the MTEF approach, which also determines the methodology for allocating costs to activities in 2014.	
Strengthen the use of monitoring and evaluation in the planning and budgeting cycle	Produced draft guidelines to all K/Ls to formulate performance indicators, as part of a National M&E Roadmap to improve the M&E system, to be used for the next RPJMN (2015-19).		
	Circulated draft guidelines for line ministries for the review of baselines in order to find savings to finance new initiatives and improve quality of spending	DGB and Bappenas agreed on a framework for developing an integrated performance-based review for preparation of 2015 budget that includes an assessment of the policy performance in the prior year based on a common definition of performance information.	**Develop an integrated baseline and policy review that includes an assessment of the policy performance in the prior year based on a common definition of performance information for preparation of 2015 budget.**

Reform aim	Prior actions and benchmarks and proposed indicative triggers and milestones		
	As of September 2012	As of September 2013	As of September 2014
		Developed a cross-agency spending review process to be led by Bappenas and an expenditure allocation and execution review completed by DG Treasury MOF, involving in-depth examination of the efficiency of spending and recommendations for revised budget allocations in the following budget.	**Key spending review recommendations are implemented in the planning and budgeting processes for 2015.**
			Roll-out and implement the MONEV application system.
More efficient and effective financial management	Issued white paper analysis on the simplification of virement procedures, consistent with the PP on budget execution for the FY2013 onwards.	Took initial steps to implement a simplified virement procedure that increases the delegated authority of program managers in the line ministries to shift budget resources between major spending categories, to enhance budget performance.	Further extend the authority of line ministries to make virement including through refinement of the definition of outputs.
	The Borrower, through the Ministry of Finance, has issued a Ministerial Regulation (No.112/2012) simplifying and clarifying the practice of withholding funds for budget allocation ("*Bintang*").	Based on a review of the effectiveness of the steps in 2012 to minimize the application of "bintang", introduced further measures that eliminate the "bintang" practice by the Government and put increased reliance on ex-post controls	
	Submitted the final draft Government Regulation (PP) on "Procedures of State Budget Execution" to the Ministry of Justice	**Issued a Government Regulation (No. 45/2013) to support enhanced budget execution.**	
	The Borrower, through its Ministry of Finance, has completed the design and build phase for the new budget preparation system.	Completed the development and user acceptance testing of the core treasury solution (EBS) under SPAN.	
	Commenced development of SAKTI application that will be used by 29,000 Spending Units in linkage (web-based) with the SPAN systems (Hyperion and Oracle EBS)		
	Commenced the testing of SPAN	Rolled out the SPAN treasury solution at pilot	**Fully implement the SPAN as a completed**

Reform aim	Prior actions and benchmarks and proposed indicative triggers and milestones		
	As of September 2012	**As of September 2013**	**As of September 2014**
	application	locations.	**system covering MOF and all spending units.**
	The Borrower has introduced a new General Ledger under SPAN using daily transaction conversions from the old General Ledger.		**Produce semester Central Government Financial Statement Report (LKPP) from SPAN**
	Integrated MOF ICT by having a single Data Center (DC) operational and a consolidation of the existing DCs run at DJPU, DJBC, DJA, DJPB and MPN into this new DC facility located at Pusintek	Continued integration of MOF ICT by setting up a new Data Recovery Center (DRC) facility at Balikpapan and make it operational.	
Improve government accounting and audit functions	Established a task force to facilitate the creation of a professional association of internal auditors	Established a professional association of internal auditors and drafts of (a) code of ethics and (b) internal audit standards	
	BPKP completed and socialized a Control Self Assessment (CSA) manual for the launch of CSAs by line ministries	Seven line ministries completed risk assessment, as mandated by PP 60	
	The Borrower, through its Ministry of Finance, has issued and disseminated a Ministerial Regulation (No. 238/2011) on new accrual based accounting policies and chart of accounts.		
	Issued several decrees that empower the MoF with the authority to control the use of state asset issued	Issued Minister of Finance Regulation on the procedures of depreciating the state assets to support the implementation of accrual accounting	
Improve subnational fiscal management		Made publicly available subnational fiscal realization data from FY2008 until FY2010. The data shall at least cover realization of expenditures by functional classification from 75% of local governments. Realized expenditures data for FY 11 from 80% of local governments shall have been available in soft copy format and ready to be uploaded to DG Fiscal Balance website.	Provide public access to electronic copy of FY 2011 and 2012 local government expenditures realization document from 80% of local governments.
			Publish in DGFB website, data on realized expenditures by functional classification for FY 2012 from at least 80% of local government.

Reform aim	Prior actions and benchmarks and proposed indicative triggers and milestones		
	As of September 2012	As of September 2013	As of September 2014
		Published a standard operating procedures document for the routine production and publication of annual subnational fiscal budget and realization data by the Ministry of Finance.	Revision DG Fiscal Balance Regulation on SOP for production and publication of sub national data taking into account publication of data from the KOMANDAN system and input from the implementation of the existing system
Improve organization and human resources management in DG Taxes	Developed and submitted to MoF academic paper s on: (i) Establishment of Data Processing Centre and Information; (ii) Establishment of Procurement Service Unit (ULP); and (iii) Establishment of Contact Centre	Issued Minister of Finance Regulations on (*i*) Establishment of Data and Information Processing Center; (*ii*) Establishment of Procurement Service Unit (ULP); and (*iii*) Establishment of Contact Center.	
	Issued Director General Regulation regarding performance management system of tax auditor with scalable and consistent manner.	Issued Circular Letter of Director General of Taxes regarding Audit Strategy and Plan for 2013.	Auditor to provide plan for conducting audit.
Modernize the core tax system	Improved the efficiency and effectiveness of the existing core tax systems and the integrity of taxpayer database by integrating the stand alone system (SIPMOD) into the centralized SIDJP in tax offices throughout Indonesia.	Issued the revision of the existing DGT Strategic Plan 2012-2014 (KEP-334/PJ/2012).	On-going implementation of the DGT Strategic Plan, with emphasis on 'quick-wins'.
	The Borrower has issued a Government Regulation (No.31/2012) for the implementation of Article 35A of Law 28/2007 and a Minister of Finance Decree (No. 194/KMK.03/2012) on the sharing of data between DG Taxes and DG Customs, all of this to facilitate the sharing of third party information for improved tax compliance.	**Issued regulations (Minister of Finance Regulation No. 100/PMK.03/2013 and Director General of Tax Regulation No. PER-28/PJ/2013), to establish procedures and an application for VAT refunds for tourists through a website (e-invoice)..**	
		Issued a regulation (Director General of Tax Regulation No. PER-26/PJ/2013) to establish procedures of individual e-filing for simple tax return and has issued a form for very simple tax return.	

Reform aim	Prior actions and benchmarks and proposed indicative triggers and milestones		
	As of September 2012	As of September 2013	As of September 2014
	Issued Minister of Finance Regulations regarding: (i) taxes and duties on exports and imports to and from areas which have been designated as a Free Trade Zone or Free Port; (ii) payment of oil and gas income tax in-kind; and (iii) Taxpayer Identification Number and Taxable Entrepreneur.		

Annex 4: Environmental And Social Review

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

OP 8.60 Assessment of Proposed Program Policy Matrix

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

In Policy area 1: Enhancing poverty alleviation and health service delivery efforts by improving poverty measurements and targeting and improving household-targeted poverty reduction programs should have no likely significant negative effects and probable only positive effects through improved targeting of pro poor programs toward intended beneficiaries. The measures would improve spending and poverty alleviation and better health services. Improving monitoring and grievance handling will improve accountability and responsiveness to intended beneficiaries of government pro poor programs.

In Policy area 2: Strengthening budget formulation and M&E systems should have no significant negative effects. Improved budget transparency, forward planning and monitoring and evaluation should improve effectiveness of spending on development programs to benefit society. Strengthening budget execution systems should have no likely significant negative effects. Improved budgeting systems, guidelines, auditing, software and training should improve effectiveness and accountability of spending on development programs to benefit society and should enable better targeting of resources to the poor. Improving tax administration should have no likely significant negative effects. Improving capacity, modernizing, clarifying information and tax collection rules should increase tax compliance, reduce leakage, and aid law enforcement efforts – all contributing to improving the rule of law and the perception of fairness in tax payment.

Reform aim	Prior actions and benchmarks and proposed indicative triggers and milestones		
	INSTANSI DPL-1 By September 2012	**INSTANSI DPL-2 By September 2013**	**Potential positive or negative effects**
Policy area 1: Enhancing poverty alleviation and shared prosperity efforts			
Expansion of targeted compensation measures for the poor following subsidized fuel price increase		**Issued integrated social protection cards (KPS) to fifteen million five hundred thousand (15,500,000) poor and vulnerable beneficiary households identified through the national registry (PPLS11), entitling them to subsidized rice allocations (RASKIN), temporary unconditional cash transfers (BLSM), and financial assistance for poor students (BSM).**	No likely significant negative effects. Increased efficiency and transparency will benefit the poor. Registration will lead to a better attendance and targeting of poverty reduction activities and will benefit them with unconditional cash transfers.
	Program beneficiary lists for priority Cluster 1 programs (RASKIN, PKH and Jamkesmas) are extracted from the unified database by the TNP2K Secretariat, using eligibility criteria from the implementing agencies	**Issued a Ministry of Home Affairs Instruction (No. 541/3150/SJ), for local governments to improve the targeting accuracy of the KPS beneficiary list, through a transparent and participatory community-based mechanism.**	No likely significant negative effects.
		Issued the FY 2014 Financial Notes and Draft Budget, which includes a report on the 2013 budget allocation for the implementation of temporary safety net programs, which consist of an unconditional cash transfer program and a subsidized rice program for fifteen million five hundred thousand (15,500,000) poor and vulnerable households identified through the PPLS11 to compensate for the fuel price increase of 2013.	No likely significant negative effects.

Reform aim	Prior actions and benchmarks and proposed indicative triggers and milestones		
	INSTANSI DPL-1 By September 2012	**INSTANSI DPL-2 By September 2013**	**Potential positive or negative effects**
	Prepared a strategy document on reforming the targeting, fragmentation, benefit levels, and outreach strategies for Scholarship for the Poor programs.	**Issued a Presidential Decree (No. 37/2012) to provide budget allocation to increase the adequacy of benefit levels for the BSM program and expand the coverage of the BSM program using the PPLS11 to identify beneficiaries of the BSM.**	No likely significant negative effects.
		Issued a Presidential Decree (No. 37/2012) to provide budget allocation to increase the adequacy of benefit levels for the conditional cash transfer (PKH) program and expand coverage of the PKH using the PPLS11 to identify beneficiaries of the PKH.	No likely significant negative effects.
Commence preparations for national social security health programs	**The TNP2K Secretariat has completed a review of new institutional arrangements for the delivery of *Jamkesmas*, taking into account actuarial cost estimates and various scenarios for achieving universal health insurance coverage.**	**Issued Presidential Regulation No. 12/2013 to provide the main regulatory framework for implementation of the national health insurance program.**	No likely significant negative effects.

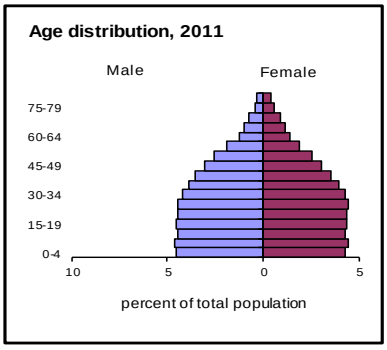
Reform aim	Prior actions and benchmarks and proposed indicative triggers and milestones		
	INSTANSI DPL-1 By September 2012	**INSTANSI DPL-2 By September 2013**	**Potential positive or negative effects**
Policy 2. Strengthening public financial management for improved service delivery			
Improve budget transparency and planning through the use of MTEF in preparing the budget		**In preparation of the 2014 budget, clearly identified the elements impacting the medium-term expenditure framework and facilitated the reconciliation with the 2013 forward estimates in the draft budget law.**	No likely significant negative effects. Improved budget transparency, forward planning and monitoring and evaluation should improve effectiveness of spending on development programs to benefit society.
	The Borrower, through the Ministry of Finance, has issued a Ministerial Regulation (No.112/2012) simplifying and clarifying the practice of withholding funds for budget allocation ("*Bintang*").	**Issued a Government Regulation (No. 45/2013) to support enhanced budget execution**	No likely significant negative effects. Improved budgeting systems, guidelines, auditing software and training should improve effectiveness and accountability of spending on development programs to benefit society.
Develop IFMIS (Integrated Financial Management Information System)	**The Borrower, through its Ministry of Finance, has completed the design and build phase for the new budget preparation system.**		
	The Borrower has introduced a new General Ledger under SPAN using daily transaction conversions from the old General Ledger.		

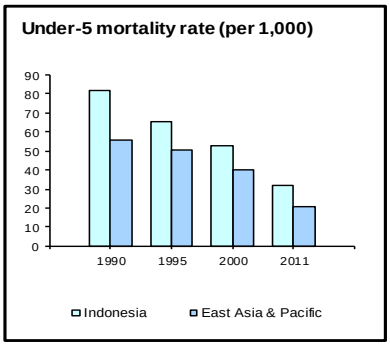
Reform aim	Prior actions and benchmarks and proposed indicative triggers and milestones		
	INSTANSI DPL-1 **By September 2012**	**INSTANSI DPL-2** **By September 2013**	**Potential positive or negative effects**
	The Borrower has issued a Government Regulation (No.31/2012) for the implementation of Article 35A of Law 28/2007 and a Minister of Finance Decree (No. 194/KMK.03/2012) on the sharing of data between DG Taxes and DG Customs, all of this to facilitate the sharing of third party information for improved tax compliance.	**Issued regulations (Minister of Finance Regulation No. 100/PMK.03/2013 and Director General of Tax Regulation No. PER-28/PJ/2013), to establish procedures and an application for VAT refunds for tourists through a website (e-invoice)..**	No likely significant negative effects. Improving tax administration should have no likely significant negative effects. Improving capacity, modernizing, clarifying information and tax collection rules should increase tax compliance, reduce leakage, and aid law enforcement efforts – all contributing to improving the rule of law and the perception of fairness in tax payment.
		Issued a regulation (Director General of Tax Regulation No. PER-26/PJ/2013) to establish procedures of individual e-filing for simple tax return and has issued a form for very simple tax return.	

Annex 5: Indonesia at a Glance

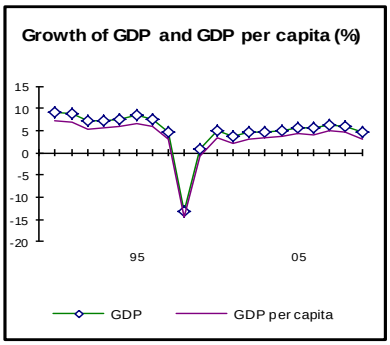
Indonesia at a glance

Key Development Indicators	Indonesia	East Asia & Pacific	Lower middle income
(2012)			
Population, mid-year (millions)	237.5	*1,974*	*2,533*
Surface area (thousand sq. km)	1,905	*16,302*	*20,842*
Population growth (%)	*1.3*	*0.7*	*1.6*
Urban population (% of total population)	*51*	*49*	*39*
GNI (Atlas method, US$ billions)	*764.5*	*8,387*	*4,488*
GNI per capita (Atlas method, US$)	*3,450*	*4,248*	*1,772*
GNI per capita (PPP, international $)	*4,500*	*7,266*	*3,837*
GDP growth (%)	*6.2*	*8.3*	*5.5*
GDP per capita growth (%)	*4.9*	*7.6*	*3.9*
(most recent estimate, 2005–2012)			
Poverty headcount ratio at $1.25 a day (PPP, %)	18	14	30.2
Poverty headcount ratio at $2.00 a day (PPP, %)	46	33	59.5
Life expectancy at birth (years)	69	72	66
Infant mortality (per 1,000 live births)	25	17	46
Child malnutrition (% of children under 5)	19	5	24
Adult literacy, male (% of ages 15 and older)	96	96	80
Adult literacy, female (% of ages 15 and older)	90	91	62
Gross primary enrollment, male (% of age group)	117	110	106
Gross primary enrollment, female (% of age group)	119	112	102
Access to an improved water source (% of population)	84	90	87
Access to improved sanitation facilities (% of population)	59	66	47





Net Aid Flows	1980	1990	2000	2012 [a]
(US$ millions)				
Net ODA and official aid	941	1,716	1,653	*415*
Top 3 donors (in 2010):				
Australia	48	77	72	*356*
France	44	122	22	*262*
United States	117	31	174	*180*
Aid (% of GNI)	1.3	1.6	1.1	*0.1*
Aid per capita (US$)	6	10	8	*2*
Long-Term Economic Trends				
Consumer prices (annual % change)	*9.5*	7.7	3.7	*4.3*
GDP implicit deflator (annual % change)	31.0	7.7	20.4	*4.5*
Exchange rate (annual average, local per US$)	627.0	1,842.8	8,421.8	*9,481.9*
Terms of trade index (2000 = 100)	..	107	100	*133*



					1980–90	1990–2000	2000–12
					(average annual growth %)		
Population, mid-year (millions)	145.5	178.6	208.9	237.5	2.1	1.6	1.4
GDP (US$ millions)	78,013	114,426	165,021	*869,218*	6.1	4.2	5.3
		(% of GDP)					
Agriculture	24.0	19.4	15.6	*14.4*	3.6	2.0	3.4
Industry	41.7	39.1	45.9	*46.9*	7.3	5.2	4.1
Manufacturing	13.0	20.7	27.7	*23.9*	12.8	6.7	4.7
Services	34.3	41.5	38.5	*38.6*	6.5	4.0	7.2
Household final consumption expenditure	51.4	58.9	60.7	*57.3*	5.2	6.6	4.7
General gov't final consumption expenditure	10.5	8.8	6.5	*8.9*	4.6	0.1	8.2
Gross capital formation	24.1	30.7	22.2	*35.3*	7.7	-0.6	5.9
Exports of goods and services	34.2	25.3	41.0	*24.3*	2.7	5.9	7.8
Imports of goods and services	20.2	23.7	30.5	*25.8*	1.2	5.7	8.6
Gross savings	..	..	26.1	*30.9*			

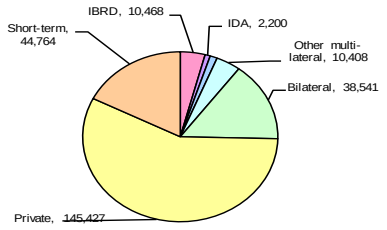
Note: Figures in italics are for years other than those specified. 2011 data are preliminary. .. indicates data are not available.

Balance of Payments and Trade	**2000**	**2012**
(US$ millions)		
Total merchandise exports (fob)	65,408	*188,496*
Total merchandise imports (cif)	44,404	*197,866*
Net trade in goods and services	15,243	*-1,712*
Current account balance	7,998	*-24,431*
as a % of GDP	4.8	*-2.8*
Workers' remittances and compensation of employees (receipts)	1,190	*6,924*
Reserves, including gold	29,268	*112,781*

Central Government Finance		
(% of GDP)		
Current revenue (including grants)	19.7	*16.2*
Tax revenue	11.1	*11.9*
Current expenditure	15.6	*18.1*
Overall surplus/deficit	-1.8	*-1.9*
Highest marginal tax rate (%)		
Individual	..	30
Corporate	30	28

External Debt and Resource Flows		
(US$ millions)		
Total debt outstanding and disbursed	143,344	*254,852*
Total debt service	16,624	*36,641*
Debt relief (HIPC, MDRI)	–	–
Total debt (% of GDP)	86.9	*29.7*
Total debt service (% of exports)	26.2	*80.1*
Foreign direct investment (net inflows)	-4,550	*19,404*
Portfolio equity (net inflows)	-1,021	*1,716*

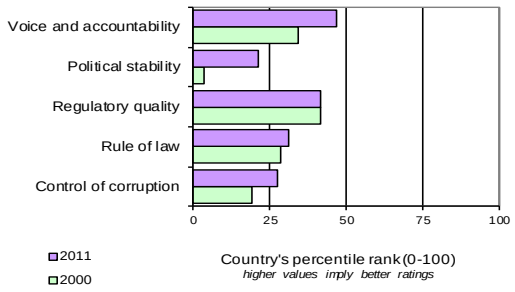
Composition of total external debt, 2012



US$ millions

Private Sector Development	**2000**	**2012**
Time required to start a business (days)	–	*47*
Cost to start a business (% of GNI per capita)	–	*23.5*
Time required to register property (days)	–	22
Ranked as a major constraint to business (% of managers surveyed who agreed)	**2000**	**2011**
Economic & regulatory policty uncertainty	..	*48.2*
Corruption	..	*41.5*
Stock market capitalization (% of GDP)	16.3	*53.1*
Bank capital to asset ratio (%)	6.0	*11.0*

Governance indicators, 2000 and 2011



Source: Kaufmann-Kraay-Mastruzzi, World Bank

Technology and Infrastructure	**2000**	**2011**
Paved roads (% of total)	57.1	*56.9*
Fixed line and mobile phone subscribers (per 100 people)	5	*119*
High technology exports (% of manufactured exports)	16.4	*8.3*

Environment		
Agricultural land (% of land area)	25	*30*
Forest area (% of land area)	54.9	*51.7*
Terrestrial protected areas (% of land area)	13.6	14.1
Freshwater resources per capita (cu. meters)	*9,218*	*8,332*
Freshwater withdrawal (billion cubic meters)	..	..
CO2 emissions per capita (mt)	1.2	*1.9*
GDP per unit of energy use (2005 PPP $ per kg of oil equivalent)	3.6	*4.5*
Energy use per capita (kg of oil equivalent)	727	*867*

World Bank Group portfolio	**2000**	**2011**
(US$ millions)		
IBRD		
Total debt outstanding and disbursed	11,715	*10,468*
Disbursements	1,051	*1,199*
Principal repayments	761	*449*
Interest payments	950	*268*
IDA		
Total debt outstanding and disbursed	714	*2,200*
Disbursements	59	*25*
Total debt service	31	*121*
IFC *(fiscal year)*		
Total disbursed and outstanding portfolio	880	*749*
of which IFC own account	480	*517*
Disbursements for IFC own account	20	*202*
Portfolio sales, prepayments and repayments for IFC own account	43	*196*
MIGA		
Gross exposure	56	*657*
New guarantees	0	*450*

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

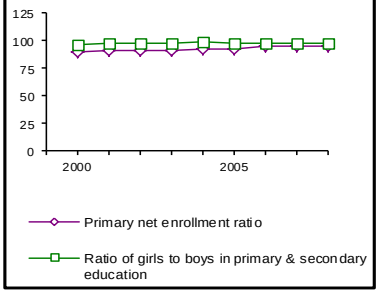
Millennium Development Goals

Indonesia

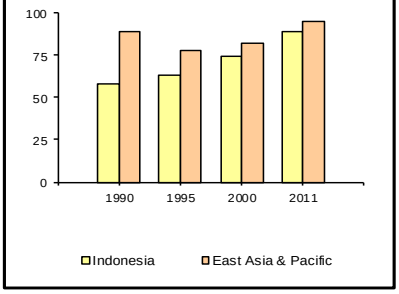
With selected targets to achieve between 1990 and 2015
(estimate closest to date shown, +/- 2 years)

	Indonesia			
Goal 1: halve the rates for extreme poverty and malnutrition	**1990**	**1995**	**2000**	**2011**
Poverty headcount ratio at $1.25 a day (PPP, % of population)	54.3	*43.4*	*47.7*	*18.1*
Poverty headcount ratio at national poverty line (% of population)	..	*17.6*	*23.4*	*12.0*
Share of income or consumption to the poorest qunitile (%)	9.4	*9.0*	*9.6*	*7.3*
Prevalence of malnutrition (% of children under 5)	*31.0*	27.4	24.8	*18.6*
Goal 2: ensure that children are able to complete primary schooling				
Primary school enrollment (net, %)	95	92	90	*96*
Primary completion rate (% of relevant age group)	92	93	*93*	*109*
Secondary school enrollment (gross, %)	46	47	53	*77*
Youth literacy rate (% of people ages 15-24)	96	..	..	*99*
Goal 3: eliminate gender disparity in education and empower women				
Ratio of girls to boys in primary and secondary education (%)	92	93	96	*101*
Women employed in the nonagricultural sector (% of nonagricultural employment)	29	29	32	32
Proportion of seats held by women in national parliament (%)	12	*11*	8	*19*
Goal 4: reduce under-5 mortality by two-thirds				
Under-5 mortality rate (per 1,000)	82	65	53	*32*
Infant mortality rate (per 1,000 live births)	54	45	38	*25*
Measles immunization (proportion of one-year olds immunized, %)	58	63	74	*89*
Goal 5: reduce maternal mortality by three-fourths				
Maternal mortality ratio (modeled estimate, per 100,000 live births)	600	420	340	*220*
Births attended by skilled health staff (% of total)	41	50	67	*82*
Contraceptive prevalence (% of women ages 15-49)	*50*	54	55	*61*
Goal 6: halt and begin to reverse the spread of HIV/AIDS and other major diseases				
Prevalence of HIV (% of population ages 15-49)	0.1	0.1	0.1	*0.3*
Incidence of tuberculosis (per 100,000 people)	206	205	204	*187*
Tuberculosis case detection rate (%, all forms)	..	..	..	..
Goal 7: halve the proportion of people without sustainable access to basic needs				
Access to an improved water source (% of population)	70	74	78	*84*
Access to improved sanitation facilities (% of population)	35	41	47	*59*
Forest area (% of land area)	65.4	..	54.9	*51.7*
Terrestrial protected areas (% of land area)	10.0	10.9	13.6	14.1
CO2 emissions (metric tons per capita)	0.8	1.1	1.2	*1.9*
GDP per unit of energy use (constant 2005 PPP $ per kg of oil equivalent)	3.8	4.1	3.6	*4.5*
Goal 8: develop a global partnership for development				
Telephone mainlines (per 100 people)	0.6	1.7	3.1	*15.9*
Mobile phone subscribers (per 100 people)	0.0	0.1	1.7	*103.1*
Internet users (per 100 people)	0.0	0.0	0.9	*18.0*
Households with a computer (%)	..	..	..	*12.0*

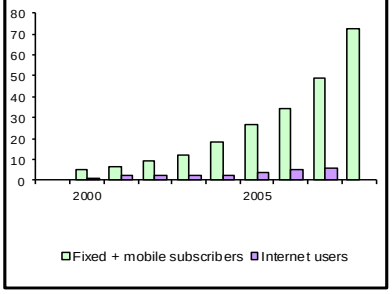
Education indicators (%)



Measles immunization (% of 1-year olds)



ICT indicators (per 100 people)



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