

## Effective Public Financial Management (PFM)<sup>1</sup> for Enhanced Public Sector Performance

### Key Messages<sup>2</sup>

The basic framework for PFM reform has been established, the project components of major reforms are well underway and the government is poised to broaden and deepen the reform agenda.

### Key Action

1. Expand existing PFM reforms to improve the quality and level of service delivery, budget efficiency and disbursement.
2. Draft and implement a transparent and comprehensive procurement law underpinned by a professional development program for procurement staff based on modern business processes and IT systems.
3. Remove rigidities in the management of the civil service, to promote efficiency and performance-based human resource policies.
4. Expand the current focus on compliance to strengthened internal controls, and reorient audit and oversight functions to ensure the efficiency and effectiveness of government operations.
5. Coordinate and sequence the PFM reform agenda to promote understanding and ownership among all stakeholders including line ministries and the Parliament (DPR).
6. Develop an effective monitoring and evaluation system that ensures resources are expended to achieve the best possible outcomes

## Where Indonesia Stands Now

**The success of the Indonesian economy over the past several years reflects a restoration of sound macroeconomic management, political stability, and up until recent times a favorable global context.** Growth surpassed 6 percent for two consecutive years and exports more than doubled between 2003 and 2008 thanks in great part to the commodity price boom (see Fig 1). Formal sector employment is expanding again, investment has risen – particularly in the construction sector – and there have been some pleasant surprises in manufacturing exports like automobile parts. But there is room for

improvement as overall manufacturing growth has been weak, the transition out of agriculture slow, and the mining and energy sectors have performed poorly.

PFM in Indonesia now compares favorably with its regional peers and those with comparable per capita GDP<sup>3</sup>, but significant challenges remain. Since 2002, Indonesia has put critical pieces of its PFM foundation in place, passing laws on State Finance, Treasury and Accounting, reorganizing the Ministry of Finance (MoF), issuing an updated Presidential Decree on Procurement and forming a National Public Procurement Agency. While subsequent reform efforts have concentrated on implementation, including budget and treasury modernization, the quality of budget expenditures and the absorptive capacity of budget users remain persistent problems.

1 This note draws on the Bank-Fund Red Cover Report on “Strengthening Budget Management”, January 2009; and other sources.

2 This note covers PFM issues in the context of Central Government while PFM issues related to other levels of government are dealt with in the policy note on decentralization.

3 Indonesia, Public Expenditure and Financial Accountability, October 21, 2007

## Planning and Budget Formulation

**Despite progress, the budget preparation process continues to discourage medium-term fiscal planning and suffers from weak links to policy priorities.** The MoF and the Planning Ministry (BAPPENAS) have yet to develop budget capacity sufficient to anchor budget examination and to improve the quality and relevance of the budget. Consequently, policies are not fully reflected in the national budget, and decision-makers receive inadequate information to inform their deliberations.

**While procedures are improving, the extent of off-budget operations remains unknown** with line ministries, foundations, and the military continuing to operate accounts outside the fiduciary scrutiny of the MoF, thus allowing resources to be accrued and spent beyond the control of elected officials and the public.

**The oversight role of the Parliament (Dewan Perwakilan Rakyat - DPR) has been strengthened, however they remain focused on budgetary details, at the expense of substantive policy issues.** This is a result of the high level of detail provided in the budget documents combined with weak capabilities and inadequate technical support to DPR members.

## Budget execution

**The execution of the capital budget remains a particular problem** (Fig. 1). More than half the capital expenditures are incurred in the last three months of the fiscal year. Primarily, as a result of this, overall budget realization is below the initially-budgeted capital expenditures and the skewed pattern challenges timely and effective project implementation.

**Progress has been made on public procurement in recent years but the reform goals remain unfulfilled and procurement remains an obstacle to effective spending.** The newly established Organization for Government Procurement Policy [LKPP] is developing simplified procurement regulations and making standard bidding documents mandatory for all government and partner agencies. However, capacity and institutional constraints continue to hamper effective procurement. Professional procurement service units are needed in line ministries and districts to replace the ad-hoc procurement committees. LKPP has developed a system for electronic Government Procurement (e-GP) now used by several implementing agencies and ministries including the Ministry of Public Works. However the development of other systems leaves the issue of a consistent E-GP platform unresolved.

**Civil service rules and current practices impede the efficient operation of public institutions and the effective implementation of reform measures,** and make it difficult for managers to select, train, promote and motivate their staff.<sup>4</sup> Modifications to existing organizational structures are laborious and time-consuming, since approval must be sought from the Ministry for State Apparatus. This rigid control system constrains the ability of public ministries and agencies to introduce Performance-Based Budgeting (PBB). The sustainability of sectoral reform is threatened by rigid HR management policies (related to recruitment and selection, promotion, rotation and training). These policies inhibit professionalism and improved performance, and undermine capacity building efforts. At the same time, the MoF and a few other public agencies, have successfully piloted measures aimed at modernizing their human resource management and have introduced structural reorganization, to overcome these limitations.

**Public resources are often wasted because multi-year projects are being implemented on an annual cycle in the absence of a medium-term expenditure framework.** Projects are often delayed and/or rushed through at the end of the budget year due to skewed disbursement practices, implementation constraints and procurement problems. The strict adherence to annual budgeting in the absence of a credible medium-term expenditure framework is not conducive to resource management related to the implementation of multi-year projects. The inefficiencies of the procurement process are compounded by the administrative procedures that require annual reauthorization of financial management teams in budget execution units. Budget execution at the beginning of the year is also delayed as the legislature often withholds budget disbursements of certain line items pending administrative clarifications, even after the budget has been appropriated.

## Audit and Control

**Good progress has been made in recent years to strengthen control and audit functions, but the system remains prone to abuse.** Payroll controls remain weak. Internal controls for the execution of non-salary payments are not fully effective, producing incomplete audit trails and accounting evidence. The current paper-intensive business process fosters inefficiencies and governance concerns. Payments and accounting operate under different systems requiring separate inputs that produce deviations between the Treasury accounting records, and those of

<sup>4</sup> Issues related to civil service reform are covered in more detail in a separate policy note.

the line ministries. These in turn raise concerns about the reliability of accounting information in budget execution reports. Most audits are on compliance issues and system reviews are rarely performed.

## Monitoring and Evaluation

**The recent creation of the Directorate of Performance Evaluation (DPE) under BAPPENAS has strengthened the potential for performance assessment and evaluation functions within the system.** Once fully operational, the unit (established in late 2007), will enable the planning agency to carry out its M&E mandate in relation to the government's development planning documents, the RKP (Rencana Kerja Pemerintah) or annual development plan, and the RPJM (Rencana Pembangunan Jangka Menengah Nasional) or medium-term development plan. This will help improve service delivery and resource allocations, based on demonstrated results. However, moving towards implementing this objective will require the review of regulations, capacity building, and the definition of short- and medium-term action plans.

## Reform Management

**Indonesia's PFM reform effort, launched in 2001, has continued to suffer from the lack of a well coordinated and prioritized/sequenced strategy.** The timely and successful completion of some components of the reform agenda has suffered because of the limited understanding and ownership among stakeholders including line ministries and the DPR.

## How Indonesia Can Rise Further

The 2001 White Paper and the modernization of the regulatory framework in 2002/2003 identified the following reform priorities for PFM:

- ◆ Operational unification of the budget process.
- ◆ Reform of the budget program structure.
- ◆ Introduction of performance-based budgeting and a medium-term expenditure framework.
- ◆ Strengthening of the Fiscal Policy Office's macroeconomic forecasting capability.
- ◆ Implementation of the Treasury Single Account.
- ◆ Reorientation and streamlining of the Chart of Accounts.
- ◆ Implementation of a new budget and treasury system (SPAN).
- ◆ Strengthening the external audit function (BPK).

## Budget formulation

**Preparations for reform of the budget formulation process have begun and implementation is envisaged for the 2010 budget and beyond.** The first budget of the next five-year planning period will outline the new administration's policy priorities. BAPPENAS, in coordination with the MoF will review and revise the existing program structure. The new structure will be embedded in the five-year plan covering the period between 2010 and 2014. The intention is to align programs with organizational structures to create a tighter accountability framework.

**A unified budget presentation is a good start, but fully integrating planning and budgeting remains the ultimate objective.** Business process re-engineering initiated as part of the new budget and treasury system will help integrate various planning and budgeting processes. In the long run, the authorities should create an integrated budget function with a single entity responsible for budgeting for discretionary and nondiscretionary expenditure.

**The government also intends to build a medium-term expenditure perspective into the planning system through a performance-based budget framework.** The annual government planning document lays out the priorities that guide resource allocations in the budget process. To strengthen links between medium-term planning and the budget process, the next five-year plan will be based on a projected medium-term resource envelope and indicative multi-year ceilings for key programs. This should allow the government to better reflect medium-term priorities in annual budgeting. Program targets and expenditure ceilings will need to be updated annually to reflect changes in the fiscal and policy environment. The framework to link those ceilings to the annual budget process has been being developed with a Medium Term Expenditure Framework [MTEF] and Performance Based Budgeting [PBB].

**Looking ahead, implementation of PBB and the MTEF /multi-year Budget framework will ensure that expenditures better reflect the government's policy and program priorities.** With the implementation of PBB, managers should be given the flexibility to optimize the use of their resources including human resources. Better quality, timelier budget execution data is essential to ensure that policy orientation remains on track during budget implementation.

**A DPR performance enhancement team, comprising members representing all parties and headed by the**

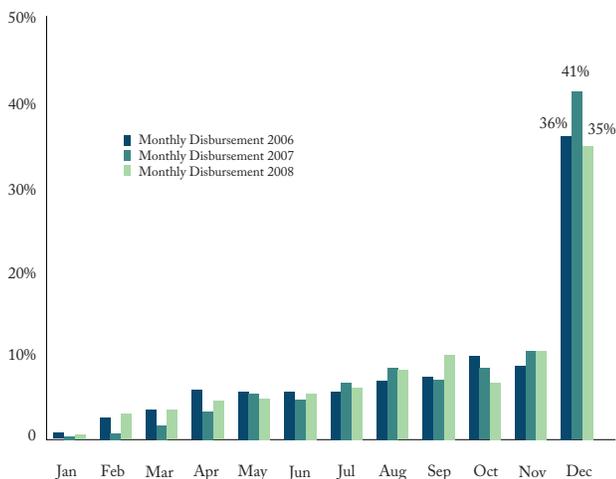
**Speaker was established to propose budget management and performance improvements.** The performance enhancement team has suggested establishing a Public Accounts Committee (PAC) and a Parliamentary Budget Office (PBO) to provide better quality state budget analysis to the Budget Committee. The MoF should initiate a high-level dialogue with the DPR to streamline the involvement of the parliament in the budget process with informal mechanisms agreed upon and launched until more formal structures can be established.

## Budget execution

**The Director General (DG) Treasury has taken several major steps towards improving budget execution.** A structural Treasury Transformation Directorate has been established to help implement better business processes. It is overseeing the implementation of the new budgeting and treasury system (SPAN), revising the Chart of Accounts and has already completed the first wave of modernization of regional treasury offices. The consolidation of the Treasury Single Account system to include revenue accounts is continuing. Steps to remove obstacles to effective budget disbursement include eliminating the annual appointment of heads of budget implementing units, promoting timely procurement processes, providing for budget carryover for certain categories of socially sensitive expenditures, and the development of an action plan to level out the disbursement of capital expenditure over the fiscal year.

**To increase flexibility available to budget holders in managing their resources, MoF should delegate**

Figure 1. Budget execution remains challenging



Note: Monthly disbursement of capital expenditure as a share (%) of total budgeted capital expenditure  
Source: Ministry of Finance and World Bank staff estimates

**increased authority for budgeting to the regional offices and line ministries.** Steps should be taken in tandem to ensure that the reporting system is not compromised. This will relieve the systemic congestion due to an annual budgeting cycle. While annual budget laws permit budget managers and users the flexibility to manage their budget resources, the associated processes are excessively cumbersome. Greater effort should be made to provide advance information of possible bottlenecks in budget disbursement. The appointment of budget users should coincide either with the project or with their term of duty. DG Treasury should find ways to provide incentives to budget users to improve in-year budget disbursement performance.

**Progress has been made on public procurement in recent years but the reform agenda remains vast.** The highest priority is to move from the current ad-hoc approach of procurement committees to a sustainable procurement management function coupled with a national capacity building program. The second priority area is to improve the regulatory framework by anchoring it to a comprehensive national public sector procurement law. The interface between the private sector and system users will improve with national standard bidding documents, an efficient e-GP system, and an independent complaint-handling mechanism. Efforts should also be directed towards strengthening the procurement audit function.

Reform in procurement should prioritize efforts that have a significant impact and produce rapid results including the revision and simplification of Kepress 80, the mandatory use of national standard bidding documents, and the development of a procurement manual. Capacity building activities are needed in partnership with universities and/or training institutions. Development of a monitoring system can be rolled out on a pilot basis and linked to e-GP. Establishing national standards for e-GP systems is a must.

## Audit and control

**The government has issued a regulation on internal control and internal auditing (PP 60/2008),** adopted the Committee of Sponsoring Organizations (COSO) ([www.coso.org](http://www.coso.org)) control framework, and clarified the roles and responsibilities of different players involved in the internal audit process function. The State Audit Agency or BPKP (Badan Pengawasan Keuangan dan Pembangunan) is now responsible for coordinating and developing Indonesia's internal audit function. The Inspector Generals in line ministries and Bawasdas (Badan Pengawas Daerah) or audit units in local governments will have direct

responsibility for the internal audit of their ministry/ local government. The resources available to the Supreme Audit Agency (Badan Pemeriksa Keuangan or BPK) have increased significantly, and BPK is now present in 33 provinces.

**Effective implementation of the COSO framework will strengthen internal controls.** The internal audit function across all levels (BPKP, IGs in line ministries and local government Bawasdas) need to move to a systemic, risk-based approach that is in line with international best practices.

## Monitoring and Evaluation

**The M&E function within government is still evolving and will require capacity building and support for the DPE unit in BAPPENAS.** Assessing whether or not a program is being implemented according to plan and with the desired outcomes is an integral part of sound expenditure management. Developing an effective monitoring system based on a cohesive short- and long-term strategy will ensure that DPE can effectively take on this important mandate. The goal is a combined framework that reviews whether resources were mobilized and utilized, activities were undertaken, and intended outputs and outcomes achieved.

## Reform management

**A comprehensive and integrated PFM reform agenda/ strategy document including realistic timelines is needed.** This strategy will balance implementation capacities, align reform activities with government priorities, ensure reforms are properly sequenced given dependencies, clarify responsibilities and serve as an instrument for outreach and communication. Successful implementation will require a dedicated, high-level steering committee to provide coherence and drive.

**Additional outreach and training to line ministries and the DPR will increase the possibility of sustainable PFM reform.** Traditionally, DG Budget, DG Treasury and BAPPENAS have directed line ministries that have only become involved in the latter stages of the reform implementation process. A better budget reform strategy will include early consultation and communication with, and the training of line ministries and executing agencies.

## How The World Bank Can Help

### Currents Program

**The World Bank supports PFM reform through the Development Policy Loan (DPL) series, via investment loans, public expenditure reviews and a related PFM trust fund.** The DPL-anchored PFM policy dialogues leverage the World Bank's convening power and technical assistance. Investments like the Government Financial Management and Revenue Administration Program (GFMRAP) and the recent Project for Indonesian Tax Administration Reform (PINTAR) provide support for various reforms and related investments. The Public Financial Management Multi Donor Trust fund finances a program of public expenditure reviews, technical assistance packages, long- and short-term advisors on budget formulation and treasury reforms, and other aspects of PFM reform. The Trust Fund has also assisted by financing the 2007/2008 Public Expenditure and Financial Accountability (PEFA) survey.

### Future Support

**With the basic framework for PFM reform established, and major reforms underway, the government is poised to move into a more substantive and difficult phase of the reform agenda.** Through the provision of continued advisory services the World Bank will assist the government's realization of core reforms such as SPAN with additional advisory services to guide budgetary reforms including the implementation of PBB and MTEF. Through its management of the MDTF, the World Bank will ensure that capacity building within the government allows it to absorb reforms and M&E initiatives in a manner that best advances the administration's goals.

**The cornerstone of future PFM reform lies in the budget and treasury system (SPAN) that has now moved through the design and procurement stages into implementation.** The World Bank will continue to support this process with critical stakeholder capacity building and technical assistance. The support will ensure that the technical competence generated through SPAN is adequately leveraged to meet the demands of strategic reforms such as decentralization, PBB, MTEF, accrual accounting and reporting, and efficient management of resources such as cash.

**The World Bank will support the government's efforts to ensure that policies and systems continue to deliver.**

This will include support on public expenditure reviews as Indonesia moves to address service deficiencies in critical areas: current reviews are underway or planned in agriculture, social protection and infrastructure. The World Bank proposes to work with the new M&E Deputy at BAPPENAS to close the cycle on budget, (bring evaluation of programs to bear on program development).

**As the core budget systems and reforms roll out it will be important to extend the PFM engagement to line ministries and subordinate budget units where critical decisions are made.** Most immediately this should include pilot implementation of the COSO framework of internal controls in line ministries. The World Bank is prepared

to assist with the development of a strategy and action plan on development of the internal audit function, and strengthening the Supreme Audit Institution. It will also help on-going initiatives to improve financial management in line ministries and their subordinate institutions.

**Support on procurement reform for the LKPP, line ministries and others will be provided to facilitate the implementation of e-procurement.** It will ensure that government is an informed participant in the market for goods and services, and generating economies of scale in government procurements. Continued reforms in procurement will be interfaced with systems developed in the areas of revenue administration, treasury payments and government accounting and reporting.

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