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Budgeting in Indonesia

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This article discusses Indonesia's economic and fiscal performance following the 1997/98 financial crisis and the transition to democracy, as well as the budget formulation process and the role of Parliament. Aspects of budget implementation are discussed throughout the article.

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Preface

In an exchange of letters between the Indonesian Ministry of Finance and the OECD in the summer of 2008, it was agreed that the OECD would prepare a profile of Indonesia's budgeting process. The profile would offer a general overview of Indonesia's system of budgeting. The profile concentrates on the national government only.

The profile is divided into three sections. The introduction discusses Indonesia's economic and fiscal performance following the 1997/98 financial crisis and the transition to democracy. The second section focuses on the budget formulation process. The third discusses the role of Parliament. Aspects of budget implementation are discussed throughout the profile.

An OECD mission visited Jakarta in October 2008 to prepare this profile. During its visit, the mission met with senior officials from the various parts of the Ministry of Finance, the National Development Planning Agency (BAPPENAS) and the Ministry of State Apparatus, as well as from several spending ministries and agencies. The mission also met with senior representatives of the Indonesian Parliament and the Supreme Audit Institution of the Republic of Indonesia (BPK).

The mission would like to express its gratitude and appreciation to Mr. Mulia Nasution, the Secretary-General of the Indonesian Ministry of Finance, for his support and the generous time he and his senior colleagues shared with the mission during its stay in Jakarta. The warm and cordial reception by the Indonesian authorities is gratefully acknowledged.

Finally, the mission would like to extend its gratitude to the World Bank for its support in organising the mission and for its invaluable assistance during the mission's stay in Jakarta and throughout the preparation of this profile.

The views expressed in this profile are those of the OECD Secretariat and should not be attributed to governments of OECD member countries, or to any organisation or individual consulted for this profile.

1. Introduction

Indonesia has historically maintained a responsible and conservative fiscal policy, focused on sustaining aggregate fiscal discipline. In the years prior to the Asian financial crisis, the budget had a moderate surplus (1-3% of GDP) and public debt was relatively low (25% of GDP). The country enjoyed a high rate of economic growth – and thus expanding public resources – and development policies were at the forefront.

The Asian financial crisis affected Indonesia's economy profoundly. The economy shrank by over 13% of GDP in 1998. Government debt rose dramatically in 1997 and 1998 and reached almost 100% of GDP in 1999, reflecting the cost of providing liquidity and eventually the take-over of the banking system.

The financial crisis triggered political upheaval in Indonesia, with the resignation of the long-serving president. The country experienced a series of successive governments as

Box 1. **Indonesia: A short description**

Indonesia is the world's largest archipelago-state, consisting of some 17 000 islands – all straddling the equator. These include five major islands: Sumatra, Java, Kalimantan (Indonesian Borneo), Sulawesi, and the Indonesian part of New Guinea, known as Papua or Irian Jaya. The distance from west Indonesia to east Indonesia is 5 150 kilometers, slightly less than the distance between Paris and New York. The capital of Indonesia, Jakarta, is located on the island of Java.

Indonesia's population of 235 million people makes it the fourth most populous country in the world, following China, India and the United States. Indonesia's population is overwhelmingly Muslim (85%), making it the world's largest Islamic country. Other religions include Christianity (11%) and Hinduism, Buddhism and Confucianism (4%). Indonesia is a secular state. Its national motto, "Unity in Diversity", reflects the many ethnic and cultural backgrounds of its population.

Garuda is Indonesia's official symbol. This mythological bird has 17 feathers on each wing, 8 on the tail and 45 on the neck. These numbers stand for the date Indonesia proclaimed its independence from the Netherlands: 17 August 1945.

Bahasa Indonesia is the national language. It is similar to Malay and written in Roman script based on European orthography.

Indonesia is endowed with vast natural resources, including oil and natural gas, coal, tin, copper, nickel ore, bauxite, copper, coal, silver, and gold as well as timber.

Indonesia was the hardest-hit Asian country during the 1997/98 Asian financial crisis which resulted in political and social disorder. The long-serving president resigned and Indonesia embarked on its transition to democracy. Today, Indonesia is a thriving democracy.

Indonesia has suffered many shocks since its transition to democracy, including repeated natural disasters. The heaviest losses were sustained in the December 2004 *tsunami* which claimed over 200 000 lives and displaced over 300 000 people.

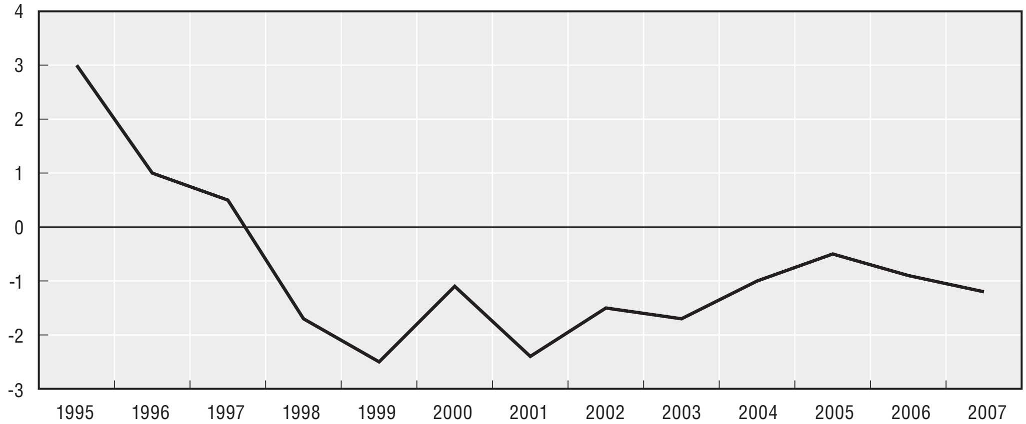
new democratic constitutional arrangements were being finalised. Today, the Parliament is freely elected and has assumed great powers, not least in the area of budgeting. The President, who was previously appointed by Parliament, became directly elected. Great power was also devolved from the centre to regional governments with the "big bang" decentralisation programme.

However, fiscal policy continued on a responsible and conservative track and acted as an anchor for the whole economy. In fact, prudent budget policy is generally seen as having been instrumental in the economic recovery. Even during the height of the fiscal crisis, deficits were modest (reaching a high of 2.5% of GDP). This situation was the result of major expenditure cuts – largely in public investment and other development expenditures – to offset lower levels of revenue and rising interest expenditures to finance the growing level of debt.

In recent years, the government's deficit has ranged between 0.5% and 1.2% of GDP. Debt levels have come down substantially, reaching 35% of GDP in 2008. This situation reflects the steadily improving economic performance as well as the proceeds from the sale of assets taken over during the crisis.

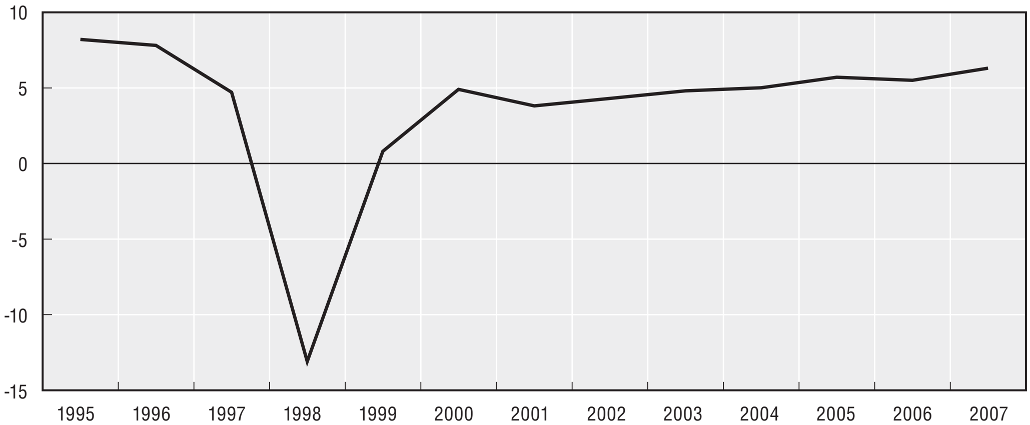
Several significant changes have occurred to the composition of expenditures over time. First, and as noted above, public investment and other development expenditures were cut significantly immediately following the crisis to fund sharply higher interest

Figure 1. **Fiscal balance (per cent of GDP)**



Source: Data provided by the Indonesian authorities.

Figure 2. **Real GDP**

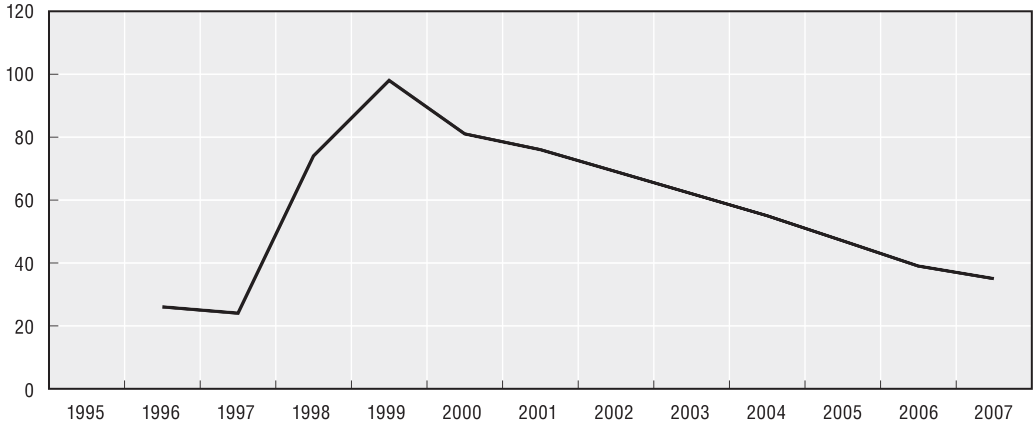


Source: Data provided by the Indonesian authorities.

expenditure. This situation has now been reversed, with lower interest expenditure giving room for increased public investment and other development expenditures as well as increased spending on education and health. Second, a significant amount of operating expenditure (salaries and other running costs) was transformed into transfer payments to regional governments, as they assumed many government services through the decentralisation programme. Third, fuel and electricity subsidies weighed heavily on the budget. Despite significant cuts in the subsidies, fuel subsidies accounted for almost 20% of spending in 2008, up from about 13% in 2007, owing to high international oil prices. Fuel subsidies are discussed further in Sub-section 2.2.4.

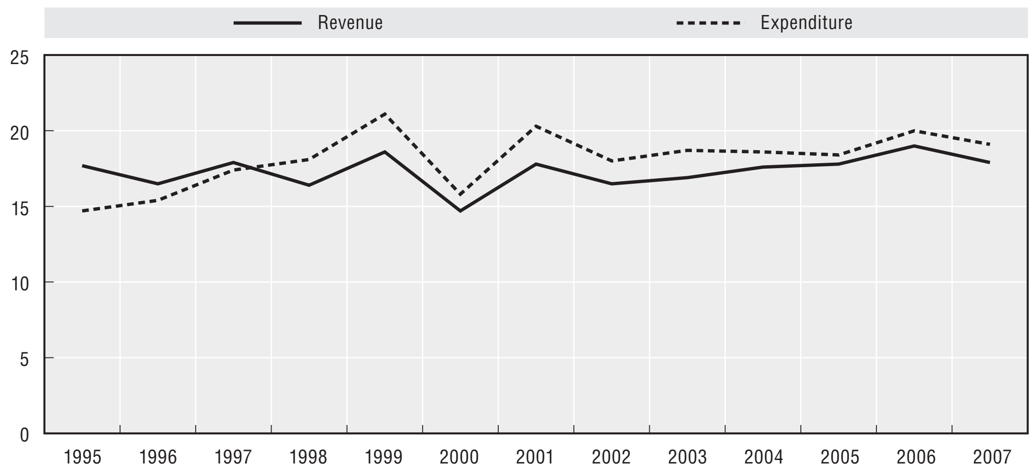
The government has also placed emphasis on strengthening the revenue side of the budget by increasing the share of non-oil and gas receipts. This serves not only to increase revenue, but also to lessen dependence on volatile oil and gas receipts. Improved tax administration has been key in this regard, especially in the field of personal income tax which is heavily dependent on a small number of taxpayers. For example, in 2007, nearly 60% of personal income tax revenues came from only 1% of taxpayers.

Figure 3. **Debt (per cent of GDP)**



Source: Data provided by the Indonesian authorities.

Figure 4. **Revenues and expenditures (per cent of GDP)**



Source: Data provided by the Indonesian authorities.

Box 2. **Indonesia's response to the current financial crisis**

In late January 2009, Indonesia announced a stimulus package worth 1.5% of GDP in increased expenditure. The money will be earmarked for infrastructure and other projects in order to generate employment. This package will see the government's projected budget deficit go from 1% of GDP to 2.5%. These measures were announced following the enactment of the 2009 budget, and the government will seek Parliament's agreement in a supplementary budget later in the year.

2. Budget formulation

This section outlines the budget formulation process in Indonesia. It is divided into four sub-sections. The first outlines the fundamental changes implemented following the 1997/98 economic and political crisis. The second sub-section describes distinctive characteristics of the Indonesian budget process. The third highlights each step in the annual budget formulation process. The fourth sub-section concludes.

2.1. "Reinventing budgeting" following the 1997/98 economic and political crisis

The Indonesian budgeting system was transformed following the 1997/98 economic and political crisis. This transformation involved:

- a new legal framework for budgeting;
- a unified and more comprehensive budget;
- massive fiscal decentralisation and the empowerment of local governments.

A fourth point – the transformation of the role of Parliament in the budget process – is outlined in Section 3 below.

2.1.1. New legal framework for budgeting

Prior to the crisis, there was no effective legal framework for budgeting in Indonesia. In fact, the process was essentially a continuation of the Dutch colonial budgeting system where the preparation of the budget was conducted internally by the Governor-General. The process was characterised by a lack of transparency and accountability. After independence, this executive-driven legal framework was embraced by Indonesia's very strong presidents.

Following the crisis and the transition to democracy, a strong emphasis was placed on reforming the legal framework for budgeting. A series of successive laws were adopted in the early 2000s following extensive consultations involving a multitude of stakeholders. The major laws are:

- The State Finances Law 17/2003.
- The State Treasury Law 1/2004.
- The State Planning Law 25/2004.
- The Regional Governance Law 32/2004 (which replaced an earlier law from 1999).
- The Fiscal Balance Law 33/2004 (which replaced an earlier law from 1999).
- The State Audit Law 15/2004.

The State Finances Law 17/2003 details the constitutional provisions for the budget process, mandates specific milestones and dates for the preparation and adoption of the budget, specifies general principles and authorities for the management and accountability of state finances, and establishes the financial relationship between the central government and other institutions.

The State Treasury Law 1/2004 outlines the responsibilities of the Treasury and articulates the creation of treasurers in government ministries and agencies, together with general principles on the management and accountability of public funds.

The State Planning Law 25/2004 outlines the national development planning process, the preparation and approval of plans, and the role of the National Development Planning Agency (BAPPENAS).

The Regional Governance Law 32/2004 outlines the responsibility of regional governments for a range of public services, including education, health, public infrastructure, agriculture, industry and trade, investment, the environment, land, labour, and transport. It replaced an earlier law from 1999.

The Fiscal Balance Law 33/2004 outlines the responsibility of regional governments for managing their own public finances, their revenue-raising authority and the system of transfers from the national government. It replaced an earlier law from 1999.

The State Audit Law 15/2004 outlines the operational framework of the Supreme Audit Institution of the Republic of Indonesia (BPK), and mandates it as a professional and independent institution required to submit its reports to Parliament.

Several comments can be made about these laws. First, all of the laws were enacted unanimously by the Indonesian Parliament. This is part of the Indonesian tradition of seeking consensus. It is a major achievement for such critical pieces of legislation to be passed in the immediate post-crisis environment. However, it is also a reflection of the fact that, in certain areas, the laws are open to interpretation and their exact meaning has not been fully established. For example, the State Treasury Law mandated the future use of accruals, but whether this was meant to apply only to the financial statements or also to the budget was not clear. Neither was it clear whether it applied to certain transactions only, such as agency-specific or consolidated whole-of-government accounts.

Second, the laws are very specific and detailed in other areas. This relates principally to the requirements for detailed input controls in the laws and to various "fences" – including fiscal rules – designed to promote fiscal responsibility and the prudent use of public money. This detail was largely a function of two factors. The trauma associated with the financial crisis led to the creation of the various "fences". Indonesia's endemic problems with corruption were also behind the emphasis on detailed input controls. The controls were viewed as forming the basis for greater accountability for the use of funds.

Third, the separate budgeting and planning laws were largely enacted in isolation from each other. In fact, the explanatory notes to the State Finances Law 17/2003 were quite dismissive of the national planning function. One year later, the new State Planning Law 25/2004 strongly endorsed the national planning function. Indonesian officials emphasise, however, that through co-ordinated implementation regulations, the respective laws work well together. As is discussed later, the budgeting and planning functions do in fact appear to interact with each other well and avoid duplication of functions.

2.1.2. A unified and more comprehensive budget

The second major transformation was to have a unified and more comprehensive budget. Previously, there were separate routine (operating) and development (capital) budgets and significant off-budget activity. Efforts in this area took several different forms.

The first step was to merge the separate routine and development budgets as of 2005. This division was originally intended to emphasise the significance of development. It was the focus of development assistance to Indonesia and it reflected the division of responsibility between the Ministry of Finance (routine) and BAPPENAS (development). The newly unified budget formed the basis for the enhanced interaction of the planning and budgeting functions. It served to avoid duplication and to make the assessment of the different policy option trade-offs more efficient, as is discussed later in this section.

The more difficult step was to bring various activities that were previously off budget onto the budget – *i.e.* to make the budget more comprehensive. Such off-budget activity can be divided into two groups.

The first group consists of government activity whose classification had to be changed to include it in the budget. The outstanding examples here were various revolving funds and funds financed by specific earmarked taxes. Great progress has been made in this area, and these funds are now mostly incorporated into the budget and the government's financial statements.

The second group of off-budget activity consists of various commercial and other activities which individual government ministries and agencies had set up over time to supplement their official budget allocations. The outstanding example is the military which previously used to be self-financed through such activities to a very large extent. Significant progress has been made in this area although it is very difficult to quantify. The best indicator may be that the growth in on-budget military expenditure has been about 100% in real terms since 2001. This figure is said to reflect, for the most part, on-budget expenditure replacing off-budget expenditure. However, the process of conversion will be long and gradual. It should also be emphasised that this is not just a technical exercise but also reflects a historic change in the balance of power between the civilian government and the military.

Finally, previous governments had granted various special concessions and land development privileges to friends of the government. These concessions and privileges were often associated with corruption and misuse of government funds. The government has recently started recovering such assets and incorporating them into the budget.

2.1.3. Massive fiscal decentralisation and regional government autonomy

The third major transformation was Indonesia's "big bang" decentralisation programme which began in 2001 and which involved unprecedented political autonomy for the regions as well as the transfer of significant functions from the central government. The programme was very much designed to further the democratic reform agenda by bringing government closer to the people, instead of being concentrated in Jakarta. Regional governments were directly elected rather than being appointed by the national government.

The decentralisation programme was also meant to stem the rising resentment of outer provinces that wanted self-determination, most notably the resource-rich provinces. It was for this reason that the decentralisation programme was focused on devolving power to the 400+ regions rather than the 32 provinces. There was more danger of separatism at the provincial level than at the regional level.

The programme involved massive and rapid changes, perhaps best symbolised by the transfer of 2.5 million civil servants – including in education, health care, and infrastructure development – with just one year of preparation. There were relatively few service interruptions and the regional governments performed their functions well. This is no small achievement given the circumstances and the short lead time. The share of total expenditure accounted for by regional governments rose significantly, from less than 10% to one-third of total government expenditure in a very short period of time.

The decentralisation programme was greatly facilitated by Indonesia's previous system of deconcentration. Deconcentration was the practice whereby national government ministries and agencies organised themselves on a regional level. Decentralisation meant that those regional offices no longer reported to the respective ministries and agencies, but to the newly elected regional governments themselves.

Regional governments, however, have very limited own fiscal resources. They depend overwhelmingly (90%) on transfers from the national government. The taxing power remains very much centrally based today.

The fiscal transfer arrangements are composed of three key elements:

- revenue sharing;
- general allocation grants;
- specific allocation grants.

Revenue sharing involves the national government sharing property tax, personal income tax and natural resources revenue (oil, gas, forestry and mining) with the regions. The rates of revenue sharing for natural resources vary, with the producing regions receiving a disproportionately higher rate of revenue sharing. Revenue sharing accounts for over one-fourth of all transfers from the national government.

The general allocation grants require the transfer of 26% of all central government revenue (after revenue sharing). There are two components.[1] First, grants are distributed on a derivative basis to cover the wages of officials previously employed in deconcentrated units and now transferred to the regions. This distribution guarantees their salaries and greatly facilitates decentralisation. Second, the grant includes an amount based on a formula that takes into account the difference between a region's fiscal needs (which depends on indicators such as population, human development index, and land area) and its fiscal capacity (defined as the sum of own revenues and shared revenues). In practice, the grant is overwhelmingly focused on covering salary costs, with only a minor component dedicated to equalisation. General allocation grants amount to two-thirds of all transfers from the national government.

Specific allocation grants are used for special needs of individual regions – including funding for natural disasters and other emergencies – and for financing central priorities at the regional level. Regions apply to the central government for the grant and must provide 10% matching funds from their own resources. Such grants account for less than one-tenth of all transfers from the national government.

Fiscal discipline was maintained during this transition period and continues to be maintained. In fact, regional governments have been unable to spend significant sums of money due to capacity constraints. The energy-rich regions have benefitted greatly from the rise in commodity prices and have amassed significant reserves.

Regional governments must submit their budgets and have them approved by the national government. There are also significant constraints on local government borrowing, including the need for pre-approval from the national government and a complete ban on foreign borrowing.

The decentralisation programme has not been free of problems, however, and full implementation will take time. Some functions are yet to be clearly defined between different levels of governments and, in some instances, ministries continue to exert influence over the activities of the regional governments. There is a need for greater own resources and fiscal equalisation for regional governments, but resources have increased in all cases. There are capacity constraints at lower levels, and further institution building is required. The issue of corruption is especially relevant at the regional level as well.

2.1.4. New role for Parliament

As noted, the fourth major pillar of the post-crisis transformation was the highly assertive role of the new democratic Parliament in the budget process. This role is described in Section 3 below.

2.2. Distinctive characteristics of the Indonesian budget process

This sub-section reviews five distinctive characteristics of the Indonesian budget formulation system:

- a fiscal rule;
- underspending of budget appropriations;
- national planning function;
- special role of fuel in the budget;
- rigidities in the budget.

2.2.1. The fiscal rule[2]

Indonesia has historically maintained a responsible and conservative fiscal policy. In the years prior to the Asian financial crisis, the budget had a moderate surplus (1-3% of GDP), and public debt was relatively low (25% of GDP).

The Asian financial crisis affected Indonesia's economy profoundly. The economy shrank by over 13% of GDP in 1998. Government debt rose dramatically in 1997 and 1998 – reaching almost 100% of GDP in 1999 – reflecting the cost of providing liquidity and eventually the take-over of the banking system.

Fiscal policy, however, continued on a responsible and conservative track and acted as an anchor for the whole economy. Even during the crisis, deficits were modest, reaching a high of 2.5% of GDP. This percentage reflected large expenditure cuts to offset lower levels of revenue and rising interest expenditures to finance the growing level of debt.

In 2003, Indonesia adopted a fiscal rule which caps annual deficits at 3% of GDP and accumulated debt at 60% of GDP. At that time, the government's deficit was 1.7% of GDP and debt was at 57% of GDP, and the economy was well on its path to recovery.

The aim of the fiscal rule – very much inspired by the Maastricht criteria for Economic and Monetary Union in Europe – was to solidify these gains and to promote future fiscal discipline by enacting these fiscal responsibility criteria into law. There was broad political agreement for the fiscal rule, reflecting the general consensus that a stable macroeconomy was an essential framework condition for sustained growth.

It was emphasised that these were maximum levels, and Indonesia's actual fiscal performance has consistently been much better than the criteria of the fiscal rule. The debt levels have continued to decrease, reaching 35% of GDP in 2008. This percentage reflects mainly the proceeds from the sale of the assets taken over during the crisis as well as the steadily improving economic growth. Annual deficits have ranged between 0.5% and 1.2% of GDP since 2003.

A regulation, based on the law, interprets the fiscal rule to apply to both the central government and lower levels of government. (The data in Figures 1-4 above reflect the central government only.) Due to the general fiscal controls exerted on lower levels of government, their inclusion would not materially change the overall deficit and debt figures.

2.2.2. Underspending of budget appropriations

It is most noteworthy that government ministries and agencies typically do not fully use all of their budget allocations. This spending applies principally to capital expenditure and the purchase of goods and services from third party vendors. Spending on such items also tends to be concentrated during the last few months of the fiscal year, suggesting inefficient use of resources as well.

Most recently, only about 88% of such appropriations were spent in total during the year, which is an improvement on earlier years, and about half of all appropriations are disbursed during the last three months of the year. There have in fact been instances where over 50% of such expenditures were disbursed in only the last month of the fiscal year (December).

Several explanations have been put forth for this phenomenon. First, appropriations for such items have increased sharply in recent years. It is common in OECD countries for there to be a noticeable lag between such sharp increases in appropriations and the resulting increases in spending. This lag is generally resolved by the use of carry-forward facilities. While such facilities do exist in Indonesia – including the possibility of multi-year appropriations – experience shows that they are only used to a very limited extent. In reality, projects come to a halt at the end of each budget year and, in some cases, funding for projects has ceased entirely in some years only to continue later.

Second, a cumbersome process is in place for getting all necessary approvals to disburse such funds. Procurement falls within the authority of each government department or agency; there is no centralised procurement agency. Each capital project requires the nomination of individual project managers, treasurers and procurement officers. For projects over EUR 4 000, a special tender committee needs to be constituted to award the contract. The procurement committee is *ad hoc*; its members perform this function in addition to their regular assignments. The selection of the individual officers and members of the tender committee must be based on criteria stated in the procurement regulations. Only when these procurement formalities are fulfilled will a spending warrant be issued. Ministries find it difficult to have the requisite human resources capacity to comply with these procurement regulations, especially in times of sharply increased funding.

Third, the delays appear to reflect caution resulting from the government's anti-corruption efforts. Procurement has been identified as particularly high risk for corruption, and stiff penalties have been instituted for violators. This characteristic has resulted in special vigilance in adhering to the procurement regulations. It has also fostered reluctance among officials to serve in procurement positions. A director of BAPPENAS (the National Development Planning Agency) said that underspending occurs because officials were afraid that actions taken in good faith might contravene the new rules in some way: "If they do nothing, they will not face any risk of prosecution, so it's better not to make any decisions."[3]

This problem may well be a temporary transition issue as people become more and more familiar with the necessary rules, including those pertaining to anti-corruption. There is, however, also a capacity issue with the need for increased training of staff to make procurement decisions. This issue is already being addressed. There may also be a case for establishing a central procurement agency, where individual ministries and agencies could (voluntarily) go in order to carry out their procurement needs. The current

National Public Procurement Office only focuses on setting procurement policy and on training and certification of procurement staff.

2.2.3. National planning function

Indonesia has a strong central planning function which is undertaken by BAPPENAS, the National Development Planning Agency. In relation to the budget process, the roles of the plan and BAPPENAS can be seen in several lights.

First, there is a long history of development planning in Indonesia, and it is viewed in a very positive light. Indonesia's very impressive growth since independence is seen to a great degree as a function of successful development planning. The plan is comprehensive as it takes account of multiple public policy instruments in addition to budgeting to achieve the goals of the plan, *i.e.* regulatory measures. The plan is also more future-oriented with a longer time horizon than the budget.

Second, the plan has been the major organising vehicle for development assistance from donors to Indonesia. In that sense, the plan can be seen in effect as a marketing device for attracting foreign assistance and also for highlighting opportunities for private sector investment in various capital projects (public-private partnerships).

Third, the five-year plan parallels the five-year term of office of the President. As such, it functions to explicitly highlight the political priorities of the government and is in essence the policy agenda for the President's term of office.

It is important to note that the five-year plan is not a rolling plan, but a fixed one issued at the beginning of a President's term of office. It is broad in scope and is operationalised each year through annual work plans, which are very much linked to the budget process.

Fourth, the plan reflects the division of responsibility between BAPPENAS and the Ministry of Finance. In contrast to the Ministry of Finance where most staff have a finance and accounting background, the staff of BAPPENAS have substantive expertise in the various sectors, such as economic development, infrastructure, social development, health care, and education. BAPPENAS maintains close substantive relationships with the various sectoral ministries. For example, BAPPENAS has separate directors paralleling each and every government ministry and agency. By contrast, the Directorate-General for the Budget in the Ministry of Finance has three directors that together parallel the rest of the government. The current very close co-operation between the Ministry of Finance and BAPPENAS is imperative, as the latter is best placed today to advise on sectoral and ministerial priorities.

The Indonesian planning system is therefore different from a typical central planning model. It cannot be characterised as having parallel planning and budgeting structures that duplicate each other in isolation from each other. They do complement each other at present. It can more accurately be said that a core planning function of the typical budget office is located outside the budget office in Indonesia, namely in BAPPENAS. In OECD countries, this planning function would be integrated in a single budget office, rather than separately as is the case in Indonesia. There are further inefficiencies in Indonesia, as the plan and the budget have separate structures – although this separation is being addressed as part of the performance budgeting reforms.

Box 3. Reorganisation of the Ministry of Finance

The Ministry of Finance has evolved greatly in recent years. First, some functions of the Directorate-General for the Budget were moved in 2003 to newly established directorates-general: treasury operations and budget implementation functions were moved to the new Directorate-General for the Treasury and fiscal relations with lower levels of government were moved to the new Directorate-General for Fiscal Balance. Second, the role of the Directorate-General for the Budget is in transition. It is most involved in costing budget proposals and is best placed to manage the new medium-term expenditure framework being developed. Third, a new Fiscal Policy Office was created in 2006. This office is focused on macroeconomics, long-term fiscal sustainability and fiscal risks, discussed in Sub-section 2.3.1.

2.2.4. Special role of fuel in the budget

Fuel plays a special role in the Indonesian budget, both on the revenue side and the expenditure side. Indonesia is an oil-producing country. However, oil production volume has steadily declined over the past ten years – by 40% in total – and, last year, Indonesia symbolically withdrew from the Organisation of Petroleum Exporting Countries (OPEC). Indonesia generally exports crude oil products and imports refined oil products.

Oil revenues account for a very substantial share of total revenue. In 2008, nearly over 15% of total revenue came from oil and other energy sources. Much of this revenue is shared with regional governments, especially the producing regions.

On the expenditure side, fuel subsidies accounted for almost 20% of total spending in 2008. Fuel subsidies correspond to the transfers from the central government to the state-owned oil company (PERTAMINA) to cover the losses the company incurs when the domestic price of fuel is kept below international prices.

The volatility of oil prices plays havoc with the Indonesian budget. At some (lower) international prices, the government's revenue exceeds its expenditure on subsidies. At other (higher) international prices, the expenditure on subsidies exceeds the revenue from fuel. The government has made significant reductions in the level of the subsidies in 2001/02, 2005 and 2008. Until most recently, these reductions were more than offset by rising international fuel prices, and the total expenditure on fuel subsidies increased significantly over this period.

The authorities have reiterated on several occasions their intention to eliminate these subsidies, as they benefit the well-off more than vulnerable individuals (who consume less) and because the subsidies crowd out higher quality expenditure on infrastructure investment, human capital accumulation and social protection programmes. This proposal has however faced strong political opposition, especially as oil prices have been rising.

Finally, there are some dysfunctional incentives for the government to underestimate oil revenue in the budget.

2.2.5. Rigidities in the budget

All budgets are rigid in one sense, and changes occur only at the margins ("incremental budgeting"). Indonesia, however, has some unique rigidities – at several levels – which limit annual flexibility.

First, the revenue-sharing arrangements impose rigidities. Much of the natural resources revenue and 26% of all government revenue (net of revenue sharing) must be transferred to regional governments in the form of general allocation grants.

Second, there are constitutional provisions that mandate the level of allocations to certain sectors. For example, the Constitution mandates that 20% of total revenue must be allocated to education. There is disagreement as to what should be considered "education" for these purposes, and there have been numerous court cases to resolve the issue.

Third, there are numerous other examples of tax revenue being earmarked for certain functions. The largest example is forestry fees that are dedicated to reforestation and related activities. Other and numerous examples are often small in amount but do accumulate.

The effect of earmarking varies greatly according to how specific it is. Earmarking in bulk to large sectors such as education – which is generally and objectively considered to need additional resources – is the equivalent of setting expenditure ceilings, or rather "floors", for those sectors. Budgeting then consists of allocating that aggregate amount among the various programmes within the sector. Earmarking for very specific purposes imposes rigidities of a different order. This type of earmarking undermines effective budgeting, and measures should be taken to avoid such specific earmarking.

Civil servants are also generally tenured for life once appointed. This protection has the effect of largely insulating them from fiscal adjustments and from critical scrutiny during the budget formulation process.

More generally, the traditional split of budgeting into development and routine budgets left the latter largely on "auto pilot" and not subject to critical scrutiny. This problem is now being addressed, but room for manoeuvre is limited, not least because of civil service protections.

2.3. Annual budget formulation cycle

The annual budget formulation cycle can be divided into five stages:

- establishing the level of resources available for the next budget;
- establishing priorities for new programmes;
- pre-budget discussions with the Parliament;
- finalisation of the budget proposal;
- preparing detailed budget implementation guidance.

2.3.1. Establishing the level of resources available for the next budget

The first step in the annual budget formulation process is establishing the level of financial resources available. This activity typically starts in February to guide the budget formulation process, but is continually refined until the budget proposal is finalised. This activity is the responsibility of the Ministry of Finance, namely the Fiscal Policy Office and the Directorate-General for the Budget.

The Fiscal Policy Office prepares the economic assumptions and revenue forecasts for the budget, thus establishing the maximum level of expenditures under the government's deficit target.

The Fiscal Policy Office relies on a committee of technical experts to prepare the economic assumptions and revenue forecasts. Its members represent the Ministry of Finance, BAPPENAS (the National Development Planning Agency), the National Statistical Agency, the Central Bank, the Ministry of Energy and Mineral Resources, and the co-ordinating Ministry for Economy, Finance and Industry. This committee is chaired by the Ministry of Finance which has final responsibility for the economic assumptions and revenue forecasts.

This committee will meet on numerous occasions. Several of the participating bodies have an independent forecasting capacity and will come to the meetings with their internal results. These results will be discussed, and new information from bodies with specialised insights – *e.g.* the Ministry of Energy and Mineral Resources – will be incorporated and deliberated.

Interestingly, this committee proposes a range – albeit a narrow one – rather than fixed points for each variable: economic growth, foreign exchange, interest, inflation, oil price and crude oil production. Fixing the exact variables within the range is subject to negotiations between the government and Parliament.

The budget documentation makes explicit the key economic assumptions and provides sensitivity analysis for some of them – *i.e.* the effects of different oil prices. However, there is no independent scrutiny of the assumptions nor formal comparison with private sector assumptions or other forecasts. The underlying macroeconomic models are not made publicly available.

It should be noted that projecting oil prices and oil production has been especially difficult in recent times. Indonesia is generally viewed as having forecasted these variables very conservatively in the past. There may also be dysfunctional incentives to do so. Under Indonesia's revenue-sharing arrangements with regional governments, the amount is based on the assumed oil prices contained in the budget. If the actual revenue is higher, there is no need to share the additional revenue. If the actual revenue is lower, the government cannot get any money back from the regional governments. In some years, the oil price was underestimated by over 100%. More recently, the oil prices were more realistic but still underestimated by just over 10%.

At the same time, the Fiscal Policy Office has been incorporating larger prudency reserves as a risk management strategy for the accuracy of the economic assumptions. These reserves total about EUR 1.5 billion. The emergence of these reserves several years ago aimed to increase the transparency of the contingency reserves, as they had previously been incorporated implicitly in the excessively conservation economic assumptions. The Fiscal Policy Office also prepares an annual fiscal risk statement which accompanies the budget. It identifies, assesses and quantifies the level of fiscal risks – including in the state-owned enterprises sector – in terms of contingent liabilities and other risks.

Once the macroeconomic framework has been established, the Directorate-General for the Budget divides the resulting available resources into those that are required for funding ongoing activities ("non-discretionary") and those that are available for new programmes ("discretionary"). These two categories largely mirror the previous dual budgeting system of "routine" expenditures and "development" expenditures, respectively.

For the first category, the Directorate-General for the Budget will take the current year's budget and apply set norms and indexes to arrive at a figure for the next year's budget. For example, salaries would rise by a certain percentage. This process also highlights the rigid nature of the budget: once an amount is in the (routine) budget, the system generally assumes that it will stay there in perpetuity. The Directorate-General for the Budget will

Box 4. **Economic assumptions**

Economic assumptions are the government's principal fiscal risk. In OECD experience, nothing derails the government's annual budget more than the use of inaccurate economic assumptions. The greatest risk is for the assumptions to be "too optimistic", thus making it seem that more resources are available than is really the case. In OECD countries, the focus is to ensure the independence of those responsible for the calculations, to insulate them from political pressure.

In some countries, the political tradition grants independence to the economics departments within finance ministries – for example, in the Nordic countries. In other countries, separate and independent government bodies exist to calculate the economic assumptions – for example, in the Netherlands with the Central Planning Bureau. In other countries, expert panels are drawn from the relevant institutions that are responsible for the economic assumptions – for example, in Australia. In the United States, the independent, non-partisan Congressional Budget Office plays a leading role in ensuring the accuracy of the economic assumptions. In other countries, non-government organisations play a leading role in calculating the economic assumptions. Canada, for example, bases its assumptions on an average of leading private sector forecasts. Chile uses an independent non-governmental panel of experts to determine the economic assumptions. All these arrangements ensure safeguards against the use of unrealistic, or "optimistic", economic assumptions.

The Indonesian practice of politically negotiating the economic assumptions – albeit within calculated ranges – between the government and Parliament is not applied in OECD countries.

Box 5. **Medium-term expenditure frameworks (MTEF)**

Indonesia is in the process of adopting a medium-term expenditure framework. Such a framework will greatly assist the Directorate-General for the Budget in carrying out its functions in this area. The MTEF extends the time frame of budgeting and offers baseline projections on the future costs of existing programmes. Importantly, it will also show the full multi-year costs of new programmes, including the future operating expenditure associated with capital projects.

Most OECD countries use an MTEF, but a much smaller number do so successfully. Based on OECD experience, three key dangers with an MTEF must be highlighted:

- First, ensure that the MTEF follows the same format and detail as the budget. This parallel structure will make their linkage natural and will foster the use of the MTEF. There are major implications for Indonesia where the current very detailed budget documentation may need to be simplified significantly in order to successfully implement an MTEF.
- Second, ensure that the MTEF is always up to date. Some OECD countries update the MTEF every week, following cabinet meetings. Any decision made at the cabinet meeting that has a fiscal impact would immediately be incorporated in the MTEF. Otherwise, the risk is that the MTEF becomes obsolete, and there would in effect be a need for a new MTEF each year rather than having an updated rolling one in place.
- Third, locate the responsibility for the MTEF within the same unit that deals with the regular budgeting responsibilities. That unit will have the most ready access to the information and the incentive to keep it up to date because it will see value for itself in doing so. Having a special MTEF unit separate from the budget office almost guarantees the failure of an MTEF.

also adjust certain amounts on an exceptional basis. The most frequent adjustment would be to accommodate an activity that was not operational for the full year in the current budget, *i.e.* a new office opened in the middle of the year would be adjusted exceptionally to take account of operating costs for the full year during the following fiscal year.

It should be noted that the Fiscal Policy Office itself also estimates the amounts of oil subsidies, of transfers to regional governments, and of interest payments. Those amounts are already deducted from the level of available resources which are "handed over" to the Directorate-General for the Budget.

2.3.2. Establishing priorities for new programmes

Once the Ministry of Finance has established the ceiling for resources available for new, "discretionary" programmes, BAPPENAS takes the lead responsibility, in co-operation with the Ministry of Finance, for allocating those funds.

The first point of reference is the five-year plan whose preparation will have been co-ordinated by BAPPENAS at the beginning of the President's five-year term of office. This is a comprehensive, fixed plan which elaborates the President's priorities.

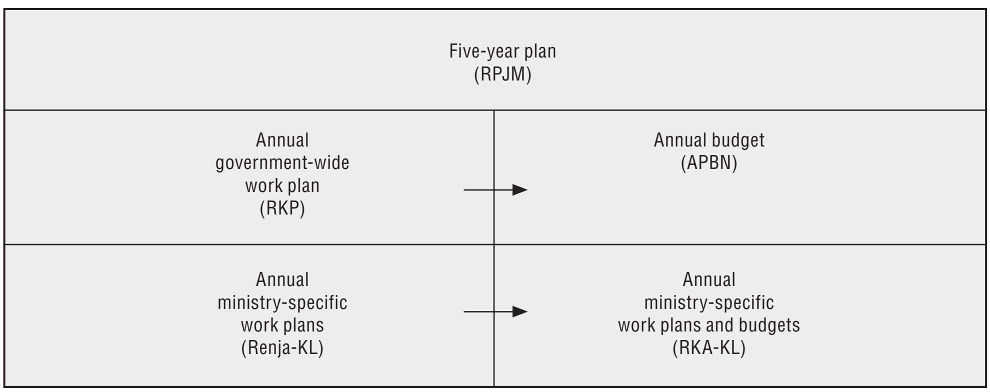
An annual government-wide work plan (RKP) elaborates on the national priorities specified in the five-year plan (RPJM). The annual government-wide work plan provides the general framework for the preparation of ministry-specific work plans (Renja-KL) and ministry-specific work plans and budgets (RKA-KL). A schema is shown in Figure 5.

BAPPENAS will have started the year with a series of internal workshops identifying the specific priorities for the following year and their funding needs. Once BAPPENAS receives the expenditure ceiling from the Ministry of Finance in early March, it will fine-tune its draft government-wide work plan and new programme initiatives.

The President and Vice-President are actively involved in this stage. They will meet several times with the minister for BAPPENAS, the finance minister and the three co-ordinating ministers (see Box 6). In certain cases, individual ministers will attend the meetings as well. These meetings generally take place in an informal "retreat" setting.

The exercise is essentially top-down, although spending ministries do of course give input through preliminary contact with BAPPENAS and through the co-ordinating ministers. This process culminates in a March cabinet meeting to discuss the draft annual government-wide work plan and to approve its broad outlines.

Figure 5. **Hierarchy of planning and budgeting in Indonesia**



Box 6. **“Spending ministries” and “co-ordinating ministries”**

The term “spending ministries” refers to the 73 organisations in the Indonesian government. These organisations include the 36 ministries with a cabinet post and 37 non-departmental government institutions.

Due to the large number of organisations, Indonesia operates a system of three “co-ordinating ministries”: for Economy, Finance and Industry; for People’s Welfare; and for Political, Legal and Security Affairs, respectively. Each of the 73 organisations is associated with one of the three co-ordinating ministries.

The co-ordinating ministries were especially powerful during the pre-democracy period when their role was primarily to communicate to ministers the decisions made by the President. The process has become much more open now. Most recently, the post of the co-ordinating Minister for Economic Affairs was given to the Minister of Finance who performs both duties concurrently.

Following the March meeting, BAPPENAS and the Ministry of Finance issue a joint budget circular to spending ministries. The circular provides guidelines on the preparation of ministry-specific work plans and includes indicative budget ceilings for each ministry, broken down by programmes and expenditure types.

Each spending ministry must then finalise its ministry-specific work plan on the basis of the indicative budget ceilings and submit it to BAPPENAS and the Ministry of Finance. During April, meetings are held between each spending ministry and BAPPENAS and the Ministry of Finance. These discussions take place at the level of senior officials. BAPPENAS focuses on the substantive aspects of the ministry-specific work plan. The Ministry of Finance’s key role is to ensure robust costing of new initiatives. It is exceptional if changes are made to the aggregate budget ceilings, but changes within them can be made.

BAPPENAS also conducts a series of national forums *(Musrenbang)* with regional governments, deconcentrated units of government ministries and various civil society organisations before finalising the government-wide work plan. These forums typically take place in late April or early May. The *Musrenbang* are principally an occasion for BAPPENAS to outline the draft government-wide work plan and to solicit any changes at the margins. The *Musrenbang* are also an important input to the regional governments’ budget formulation processes.

The final government-wide work plan is issued by the President following a cabinet meeting in May. By law, it must be issued no later than mid-May. The President will then meet with ministers and heads of agencies to emphasise the importance of carrying out the government-wide work plan.

The government-wide work plan is based on the structure of the government five-year plan. It contains 160 programmes, varying substantially in scope and size. Programmes are not aligned to organisational structures, and about 30 of them cut across ministry boundaries. These programmes are in turn divided into about 1 300 activities, but this differs from the programme structure of the budget. The performance budgeting reforms aim to unify this structure – a unification that is profoundly important for simplifying the relationship between the plan and the budget and for creating a unified chart of accounts for planning, budget formulation and budget implementation.

Box 7. **Performance budgeting**

Indonesia is committed to the introduction of performance budgeting and is already taking important steps towards that goal. Its experience with the plan provides an important foundation for the introduction of performance budgeting.

OECD countries have reported a number of benefits from using performance information, not least the fact that it generates a sharper focus on results within government. The process also provides more and better understanding of government goals and priorities and on how different programmes contribute to them.

Performance budgeting is a simple concept that is applied in great variety across OECD countries. Some countries focus on the presentational value of performing budgeting – *i.e.* to improve the transparency of the budget by providing information on results. At the other extreme, some countries use performance budgeting to directly link appropriations to results in certain sectors. Most commonly, countries employ performance budgeting to inform budget allocations.

Implementing performance budgeting can be done in a top-down or bottom-up fashion; it can be introduced incrementally or as a "big bang" undertaking; it can focus on outputs or outcomes, or both; it can be used comprehensively throughout the budget, or only partially in certain sectors; and it can employ targets, or not. It is fair to say that no two countries have implemented performance budgeting in exactly the same manner. Nonetheless there are emerging lessons from OECD countries.

First, the structure of performance information should follow the organisational structure, as accountability will always be on an organisational basis – *i.e.* programmes should not cut across ministries and agencies. In some cases, an organisation will have just one programme associated with it, although having 3-5 programmes is more common. Again, the multiple programmes would generally mirror the organisation's internal structure. The experience with attempts to present performance and results information independently of the organisational structure is extremely disappointing. If there is good reason for two organisations to share the same performance and results information, then there is probably good reason to consider merging those organisations.

Second, it is fundamental to link outputs with their full costs. For example, not allocating staff costs to the different outputs undermines the whole performance budgeting exercise. Furthermore, full costs include not only the direct costs of the service, but also costs shared with other programmes (joint costs). Determining full costs can be complex, especially when joint costs must be allocated. The effort made in costing should be commensurate with the scale of the programmes. In some cases, it may be appropriate to use reasonable estimates for allocating joint costs rather than elaborate cost accounting systems.

Third, concerns persist about information quality and information overload. Frequent changes to the measurement basis for performance information tend to erode confidence in its quality. In some countries, the national audit office has a role in ensuring the integrity of performance information. Performance information should also be commensurate with the needs of the user. Very detailed performance information in most cases should be used only for in-agency management purposes. External reporting to Parliament and the public should be more high level. In Sweden, parliamentary committees, ministries and agencies engage in dialogue on what is the appropriate level of performance information to be reported externally.

Box 7. **Performance budgeting** *(cont.)*

Fourth, the introduction of performance budgeting is often linked to broader efforts to improve expenditure control as well as public sector efficiency and performance. Thus, performance budgeting is generally combined with increased flexibility for managers in return for stronger accountability for the results, so as to enable them to decide how to best deliver public services. If not linked to broader reforms, there is a risk that managers will view performance budgeting as simply another layer of central control and will resist it. Provisions for sanctions – including dismissal of staff – in the case of non-performance need to be in place. Robust systems of accountability and control, including internal and external audit, are required before granting increased flexibility.

Finally, the most difficult issue with implementing performance budgeting in OECD countries is to persuade politicians – Ministers and Members of Parliament – to use it in decision making. They overwhelmingly continue to focus on inputs and ignore performance and results information.

In the case of Indonesia, the very detailed budget documentation and parliamentary deliberations pose a fundamental obstacle for the successful introduction of performance budgeting.

2.3.3. Pre-budget discussions with Parliament

Immediately following the issue of the government-wide work plan, the government submits a "fiscal policy and budget priorities" document to Parliament. This document is essentially a pre-budget report that includes a description of the macroeconomic framework, fiscal policies and priorities, deficit target, revenue projections and proposed expenditure ceilings for the upcoming budget year. The government also submits the government-wide work plan and ministry-specific work plans for information. The discussions take place in two parallel venues.

First, the Ministry of Finance and BAPPENAS have discussions with the Budget Committee and with Commission XI. The Budget Committee is a "committee of committees" that is composed of selected members of the 11 sectoral commissions. Commission XI is a sectoral commission dealing with economic and financial affairs. Commissions are described in greater detail in Section 3 on the role of Parliament.

These first discussions focus on the broad macroeconomic and fiscal policy objectives, including energy subsidies and transfers to regional governments. Specifically, the Ministry of Finance and Parliament will arrive at fixed points within the proposed ranges for the key economic assumptions and revenue forecasts. Working groups consisting of representative of the government and Parliament are generally formed for the detailed discussions of the economic assumptions and revenue forecasts.

Second, individual spending ministries will have discussions with their respective sectoral commissions on their ministry-specific work plans and proposed expenditures. These discussions generally focus on small and detailed items of expenditures rather than a general overview. However, the relationship between ministries and their respective commission varies greatly. The aggregate ceilings for ministries would generally not change but their composition could.

These parliamentary pre-budget discussions take approximately one month to conclude. This phase is an important one in the budget process, as the macroeconomic framework for the upcoming budget is agreed at this time.

2.3.4. Finalisation of the budget proposal

After agreement with Parliament on budget policies and priorities in mid-June, the Ministry of Finance issues a revised budget circular including a preliminary budget ceiling for ministries' programmes. Again, the overall budget ceiling rarely changes but its composition does.

Ministries and agencies revise and finalise their ministry-specific work plans in line with the preliminary ceiling issued by the Ministry of Finance. It is noteworthy that spending ministries will often have informal contact with their respective parliamentary commissions during this phase.

Ministries and agencies then prepare their ministry-specific work plans and budgets (RKA-KL), which have a different structure and format than the ministry-specific work plans (Renja-KL). Efforts are being made to harmonise the two as part of Indonesia's performance budgeting reforms. Ministries must submit the RKA-KL and the Renja-KL by 15 July. BAPPENAS reviews them to ensure conformity with the government-wide work plan, and the Directorate-General for the Budget reviews them for compliance with the preliminary budget ceilings, unit costs and classification. Currently, performance information is not systematically integrated into the ministry-specific work plans and budgets.

The Ministry of Finance finalises the budget documentation and prepares the budget proposal and the accompanying financial notes. The budget contains the estimated revenue, estimated expenditure, appropriations, and general provisions applicable to the appropriations. The financial notes contain details on expenditure allocations by economic, functional, organisational (ministry/agency) and programme classification; they also contain information on macroeconomic assumptions, debt management, the "fiscal risk statement" and other supplementary information. The annual government-wide work plan is submitted as an appendix to the budget.

The President delivers a budget speech to Parliament on 16 August, when the budget documentation is presented to Parliament as well. Indonesia's Independence Day is 17 August and, by tradition, the budget is delivered the day before this national holiday.

2.3.5. Preparing detailed budget implementation guidance

It is rather unusual to cite guidance as the last step in the budget formulation process, but Indonesia is unique in this respect. The budget is approved by Parliament a full two months prior to the fiscal year in order to prepare the detailed budget implementation guidance which can in fact be viewed as the last stage of the budget formulation process.[4]

The budget that is approved by 31 October is at a very detailed level. The problem is that Parliament's review sometimes goes beyond this date even if the budget has been formally approved. It should be emphasised that Parliament's review is not a formal part of the budget process. Individual sectoral commissions can place "holds" on disbursements from the approved budget until their concerns have been addressed. These "holds" are generally at a very detailed level. The concerns are addressed in discussions (negotiations) between each ministry and its respective sectoral commission in Parliament. The result has sometimes been that – even with the two-month period to finalise the details – budget

Box 8. Budget documentation

Budget documentation should follow three basic principles: comprehensiveness (*i.e.* include information on all relevant activity), transparency (*i.e.* fully disclose all relevant information) and simplicity (*i.e.* promote understanding by users of the budget documentation). There can be tension between the last two principles, transparency *versus* simplicity.

There has been a trend in OECD countries to simplify the budget documentation presented to Parliament, to allow Members of Parliament and the public a greater overview of the government's activities, focusing more on performance and results and less on very detailed input information. Such information continues to be available but in other types of documents. Detailed input information is typically available *ex post* in the financial reports of individual ministries and agencies and in the consolidated government financial statements. This simplification of budget documentation generally occurs alongside the introduction of other reforms such as medium-term expenditure frameworks and performance budgeting.

It would appear especially appealing for Indonesia to reconsider its budget documentation, which is very detailed and cumbersome, as it embarks on the introduction of other reforms. This would in turn serve to reorient the basis for parliamentary deliberations of the budget.

disbursement has not been authorised until several months into the next fiscal year. In 2007, for example, about 45% of total expenditures were delayed.

Following the final approval of Parliament's sectoral commissions, the Directorate-General for the Budget prepares disbursement warrants that are issued at the level of "budget users" (*Satker*). There are over 20 000 such budget users. Each warrant is very detailed, providing breakdowns by organisation, function, sub-function, activities, and two levels of economic classification of expenditure. Each breakdown must be respected, and reallocations (virements) are very difficult, even within *Satkers*. The use of carry-overs is possible for certain transactions, but in practice is not used to any significant extent. Spending ministries then prepare budget implementation guidance (DIPAs) for each of their budget users.

2.4. Conclusion

The economic and political crisis of 1997/98 triggered truly transformative changes to budgeting in Indonesia. Changes included creating a modern legal framework for budgeting, unifying the budget and making it more comprehensive by trimming off-budget activity, and rapidly introducing a massive decentralisation programme. While some aspects of these reforms are not complete, the scale of this undertaking cannot be overestimated. Fiscal discipline was maintained throughout this period, and it should also be noted that Indonesia experienced major shocks at that time – including the catastrophic *tsunami* – which makes the achievements all the more noteworthy.

Compared to practices in OECD countries, the biggest distinction in Indonesia is the existence of a national planning function alongside budgeting and the corresponding institutional arrangement, with the Ministry of Finance and BAPPENAS both playing a key role. They do, however, appear to work well together and the division of roles appears to be clear. The reform to unify the structure of the plan and the budget will further harmonise the two and remove inefficiencies.

Box 9. **Regional treasury offices**

Indonesia operates a system of regional treasury offices throughout the country, some 172 in total. All budget receipts and outlays pass through one of these offices except for ongoing payments such as salaries which are handled centrally. The regional treasury offices are part of the Directorate-General for the Treasury in the Ministry of Finance.

An ongoing process of streamlining the operations of the regional treasury offices is in place. Payments to vendors are processed in one working day from receipt of the payment order from the *Satkers*. This timing is most impressive given the prevalence of paper documents rather than online transmission of data in this process. A large-scale computerisation project is currently under way.

At the beginning of each year, *Satkers* register their DIPAs with their respective regional treasury office. The documentation presented with the DIPA includes the annual ministry-specific work plan and budget and the projected monthly cash flows.

Regional treasury offices receive the payment order in paper form which is checked for completeness of documentation. It is then verified against the DIPA and for consistency with underlying documents. The payment order is then confirmed by the head of the regional Treasury Office. After ensuring the availability of funds in the bank account of the regional Treasury Office, all certified payment orders are sent at the end of the day by messenger to the bank for overnight payment.

Although *Satkers* do provide their projected monthly cash flows to their regional Treasury Offices, they are in fact entitled to spend up to their total annual budget allocations at any time. There is no monthly apportionment of the annual budget. Good cash management practices are thus impaired, as regional Treasury Offices maintain buffer balances and the government is limited in its ability to invest (seasonal) surplus balances.

Indonesia operates a fiscal rule based on maximum deficits and debt, similar to the Maastricht criteria for Economic and Monetary Union in Europe. The rule has not been tested, as Indonesia's fiscal performance has been significantly better than the limits contained in the fiscal rule. Consideration could be given to introducing a more operational expenditure-based fiscal rule.

Underspending and the concentration of spending in the last months of the fiscal year constitute a significant problem in budget implementation. This situation relates principally to capital expenditure and the purchase of goods and services from third party vendors. Further capacity building in procurement is essential to implement the budget as enacted and to ensure higher quality expenditures.

The experiences of OECD countries with economic assumptions (Box 4), medium-term expenditure frameworks (Box 5), performance budgeting (Box 7) and budget documentation (Box 8) could serve as useful inputs for Indonesia as it embarks on reforms in these areas. A particular challenge is Indonesia's emphasis on a great level of detail on an input basis in its official budget documentation, which in turn forms the basis for Parliament's deliberations at the same level of details and inputs. This amount of detail will hamper some of the reform initiatives under consideration in Indonesia.

The State Treasury Law 1/2004 mandates the future use of accruals, although it is unclear whether this was meant to apply only to the financial statements or to the budget as well. Neither is it clear whether it applies to certain transactions only, to agency-specific financial statements or to consolidated whole-of-government financial statements. The emerging consensus in OECD countries is to apply accruals only to the government's financial statements and to continue to budget on a cash basis, or to apply accruals only to specific transactions in the budget such as civil service pension programmes. It does not appear that the introduction of accruals should be a priority for Indonesia.

3. The role of Parliament

Following the transition to democracy in 1998, the Indonesian Parliament acquired a strong role in the budget process. Prior to that, power was overwhelmingly concentrated in the government, and its budget proposal was never questioned nor amended by Parliament.

Today, Parliament is deeply involved in every stage of the budget process, from the earliest budget formulation stages to budget implementation. Parliament has unlimited powers to amend the budget proposal submitted by the government. Indeed, Parliament does amend the budget, sometimes significantly. Parliament's scrutiny tends to focus more on detailed line items than overall budget policy and strategic priorities. Parliament is hampered by its lack of capacity in this area, reflecting its history of non-involvement in the budget process.

This section outlines the parliamentary budget process. It is divided into four sub-sections. The first describes the Indonesian Parliament as an institution. The second examines the parliamentary budget process for approving the government's budget proposal. The third reviews the resources available to Parliament to assist in its budget approval role and draws on the experiences of other countries. The fourth sub-section concludes.

3.1. The Indonesian Parliament

The Indonesian Parliament is a bicameral institution consisting of the House of Representatives and the Regional Representatives Council, the upper chamber. The Regional Representatives Council has a very limited set of tasks and is principally an advisory body. It has no role in the budget process where the House has sole responsibility.

The House of Representatives consists of 550 members elected for five-year terms. A proportional representation electoral system is in use, with multi-member constituencies (between 3 seats and 12 seats each) as established by the independent Election Commission. The elections are based on party lists – *i.e.* citizens vote for one party rather than individuals in their constituencies.

The Regional Representatives Council consists of 128 members – namely, four representatives from each of Indonesia's 32 provinces – elected for five-year terms. In contrast to the House of Representatives, the Constitution provides that these elections should be based on individuals, not parties, although many members do in fact have strong party affiliations. With an average of 30 candidates contesting the four seats in each province in the last election, many candidates were elected with less than 10% of the vote.

Previously, 38 members of the armed forces and the police were appointed *ex officio* to seats in Parliament. As part of the democratic reforms, those appointed seats were abolished.

There are currently 16 political parties in the House of Representatives. The two largest parties have roughly 20% of the seats each. Another five parties have about 10% of the seats each. The final 10% of seats is split among nine small parties, some of which have only one elected Member of Parliament.

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As a result of this fragmentation, political parties are grouped into factions. There are currently ten such factions. The larger parties individually form a faction whereas the smaller parties have to join one of the larger parties' factions or the smaller parties have to unite to form a faction themselves. Every Member of Parliament must be a member of a faction. The faction is the principal organising vehicle in Parliament whereby the activities of Members of Parliament are co-ordinated in order to increase the effectiveness and efficiency of the House of Representatives. Indonesia is known for strong party (faction) discipline and the powerful role of party (faction) leaders.

Box 10. **The President of Indonesia**

The President of Indonesia was previously appointed by Parliament. From 2004, the President has been directly elected by the people for a term of five years. This was a profound reform, with the President now accountable directly to the people rather than to Parliament.

A two-round majority run-off electoral system is used in order to ensure that the President has strong backing across the country. For a candidate to be elected, he/she must not only poll an absolute majority of votes cast but also meet a distribution requirement of 20% of the vote in at least half of the provinces.

It is interesting that, in appointing ministers, the President generally consults with the leaders of the various parties (factions) in Parliament and appoints ministers based on their recommendations. In that sense, Indonesia has elements of both a presidential and parliamentary system of government. The ministers are, however, directly responsible to the President and not to Parliament. When ministers appear before Parliament, they do so as representatives of the President.

3.2. Parliamentary budget approval process

As was discussed above, Parliament interacts extensively with the government throughout the budget process:

- approving overall fiscal policy orientation and preliminary budget ceilings;
- holding informal discussions between ministries and agencies and their respective sectoral commissions on contents of budget proposals;
- approving the government's formal budget proposal;
- approving detailed budget implementation guidance.

This sub-section will focus on the third element, as the others were discussed earlier.

The government's budget proposal is submitted on 16 August each year, one day prior to Indonesia's Independence Day which is a national holiday. This date also represents the start of Parliament's annual session. On this day, the President delivers a budget speech to a joint session of the Indonesian Parliament. This very high-profile event is the outstanding event on Parliament's annual calendar. Parliament is adjourned following the speech.

When Parliament reconvenes, it holds two plenary sessions dedicated to a general exchange of views on the government's budget proposal. The Minister of Finance (and other ministers, as appropriate) responds on behalf of the President. However, this exchange is more ceremonial than substantive in content.

Table 1. **Parliamentary budget approval timetable**

Mid-May	The government submits the pre-budget report.
Mid-May to mid-June	Discussions are held by the Ministry of Finance with the Budget Committee on fiscal policy and overall ceilings. Discussions are held by spending ministries and agencies with their respective sectoral commissions on detailed allocations.
16 August	The government submits the budget proposal. The President delivers the budget speech.
16 August to late October	The Budget Committee and sectoral commissions review the budget proposal.
By 31 October	The House of Representatives approves the annual budget.
November-December[1]	Finalisation of detailed budget implementation guidance ("informal" process).
1 January	Start of fiscal year.

1. Finalisation of detailed budget implementation guidance may extend into the new fiscal year.

The budget is then referred to the Budget Committee where Parliament's scrutiny of the budget takes place. The deliberations in the Budget Committee constitute the first reading of the budget proposal. The Budget Committee is considered the most powerful committee in Parliament. It consists of 83 members representing the 11 sectoral commissions in Parliament; it is therefore a "committee of committees". The representatives from sectoral Commission XI play an especially active role in the Budget Committee. Commission XI is the counterpart to the Ministry of Finance and BAPPENAS.

The Budget Committee meets frequently over the next two months as it conducts the scrutiny. The finance minister will appear before the committee at the start of its deliberations, and may be accompanied by the minister for BAPPENAS, the Central Bank governor, and other spending ministers. During this stage, each party (faction) will state its views on the budget in more detail and the government will respond. Senior officials from the Ministry of Finance will have extensive discussions with the Budget Committee throughout its scrutiny period.

The Budget Committee focuses on reviewing the macroeconomic assumptions and revenue forecasts on which the budget is based, government expenditure priorities for different sectors, and the financing of the budget deficit.

The Budget Committee is guided by the deficit target agreed with the government during the preceding months (June-August). During its scrutiny, the committee focuses especially on revising the macroeconomic assumptions and revenue forecasts upwards, thus adding resources to fund additional expenditures. The analytical basis for such revisions is not clear, but is likely in response to the government's (past) practice of underestimating revenue, especially oil revenue. Each faction may produce a specific list of issues in this regard. The Budget Committee usually forms several smaller working groups to focus on specific subjects.

Most notably, the meetings of the Budget Committee are not open to the public and no record is made available of its proceedings.

During its scrutiny, the Budget Committee also invites sectoral commissions to submit advisory opinions on budget priorities and financial needs. Any additional resources may go to financing these requests. In general, the Budget Committee accepts all advisory opinions from sectoral commissions, as they would have been agreed informally before being submitted. In this context, it is important to highlight that the sectoral commissions interact only with their respective ministries and agencies. Neither officials from the Ministry of Finance nor BAPPENAS participate in the sectoral meetings.

Box 11. The sectoral commissions

There are 11 sectoral commissions which mirror the work of groups of government ministries and agencies. Each ministry and agency "belongs to" one of the sectoral commissions. The sectoral commissions play a key role in the budget process by focusing on the detailed allocations of individual appropriations within their respective sectors. There is a very close relationship between the commissions and their respective ministries and agencies throughout the year. Ministries and agencies exercise great care to satisfy the wishes of their sectoral commissions.

The work of the commissions can be viewed to a large degree as independent of the review by the Budget Committee. This independence is demonstrated by the fact that the Budget Committee will endorse the budget proposal and the House of Representatives will approve it before the sectoral commissions have finished their work. The result is delays in issuing budget implementation guidance, as discussed in Sub-section 2.3.5. However, it should be noted that practices vary greatly between commissions.

There are on average 50 members in each commission. Their members are elected in proportion to each party's (faction's) share of seats in Parliament.

The second – and final – reading of the budget takes place in plenary session by the end of October. The leadership of the Budget Committee will report on its deliberations, the parties (factions) will deliver their final opinion on the budget, and the government (Minister of Finance) will respond. This final reading is largely a formality, as the House in plenary session always endorses the conclusions reached by its commissions.

It is most noteworthy that the budget – as amended by the Budget Committee – is enacted by consensus, rather than by majority voting. This phenomenon is very much in line with the political culture of Indonesia which emphasises continuous deliberations and negotiations among parties (factions) until a satisfactory agreement is reached by all. As part of this emphasis on consensus, the government itself must be in agreement with the final proposal as well.

The approval of the budget two months prior to the start of the fiscal year is meant to give sufficient time to finalise budget implementation guidance and for sub-national governments to finalise their own budgets prior to the start of the fiscal year. Fiscal transfers are the primary revenue source of sub-national governments.

As was noted previously, even though the budget has been enacted, the sectoral commissions may continue their scrutiny and place restrictions on the implementation of the budget (see also Box 11).

3.3. The capacity of Parliament

The capacity of the Indonesian Parliament in its review of the budget proposal is weak. This weakness manifests itself on several levels. First, there is great turnover of Members of Parliament. Second, the overall resources of Parliament have not increased in line with its new responsibilities. Third, there is not a sufficient specialised analytical capacity in Parliament despite recent reorganisations of the functions of the Parliamentary Secretariat-General.

In the latest elections to the House of Representatives, nearly three-fourths (75%) of the elected Members of Parliament were entering Parliament for the first time. This

Box 12. **Mid-year budget revisions**

The Indonesian government must present to Parliament a half-year report on budget implementation for the first six months and the outlook for the whole fiscal year. These reports have on occasion given rise to supplementary budgets, sometimes significantly revising the budget. For example, the underestimated oil and gas revenue in the original budget would become apparent and those new resources would be allocated as part of the mid-year budget revisions – typically for infrastructure and other development projects. With the more accurate oil and gas revenue projections in the most recent budgets, the level of the mid-year budget revisions has decreased significantly.

Indonesia has also experienced significant natural disasters – including the catastrophic *tsunami* and devastating earthquakes – which have given rise to in-year emergency revisions of the budget as well.

situation does in part reflect the transition to democracy, but it also highlights the lack of legislative experience of most Members of Parliament. This lack is especially acute in such complex matters as deliberating the budget where Members of Parliament – especially new ones – can be overwhelmed by the sheer magnitude of the budget documents, their technical detail, and the years of expertise possessed by government budget officials. As a result, Members of Parliament tend to focus on very small details of the budget rather than overall fiscal policy and strategic budget directions. Members of Parliament have also not had the expertise nor the strength in numbers to overhaul some processes and structures in Parliament. The fragmentation of Parliament into multiple small parties exacerbates this problem.

In terms of overall resourcing of Parliament, it is striking that it is largely similar to the previous era when Parliament had no effective role. In fact, Parliament is subordinate to the government when it comes to resourcing. The government must agree to the Parliament's own budget. The staff of Parliament are government employees, hired according to traditional civil service procedures. All organisational changes and staff actions need to be approved by the government. Staff are generally hired in their youth and hired for life. New hires are essentially trained "on the job" rather than bringing in needed specialised knowledge.

In terms of specific analytical capacity, there are 35 experts in the Secretariat-General of the House of Representatives. Their responsibilities are to support Parliament in its entire realm of activities. Among the 35 experts, there are only seven who are solely responsible for providing support in the budgeting area, in spite of recent reorganisations. They appear also to focus on preparing lengthy research studies rather than on timely policy synthesis and analysis for Members of Parliament.

Most recently, commissions have been allowed to hire part-time advisers to assist them. The advisers are not civil servants but individuals with specialised expertise, and are often associated with a specific political party (faction).

In addition, each Member of Parliament is entitled to hire one expert on a contract basis (*i.e.* not civil servants), and each party (faction) can also recruit a limited number of experts according to its proportion of seats in the House of Representatives. These experts are obviously not dedicated exclusively to budgeting issues.

Box 13. **The Swedish parliamentary budget process***

During 1996 and 1997, fundamental changes were made to the manner in which the Swedish Parliament approves the budget. There are no restrictions on Parliament's ability to amend the budget, but a rigorous institutional process has been put in place to promote budget discipline. It is one of the most modern parliamentary budget processes in OECD member countries.

The key reform focused on introducing a top-down budgetary process where aggregate levels of expenditure are approved before individual appropriations. This process operates on several cascading levels. A "Spring Fiscal Policy Bill" is presented to Parliament in April, five months before the budget is submitted to Parliament. The bill proposes limits on the aggregate level of government expenditures and government revenues. Parliament debates these aggregate limits and enacts them into law in early June. Again, there are no restrictions on Parliament's ability to amend the government's proposal. The bill has created a vehicle whereby debate in Parliament can focus on the appropriate size of the public sector and the economic impact of various combinations of aggregate revenues and aggregate expenditures. The budget – which is presented in September – must be in conformity with the aggregate level of revenues and expenditures as approved in the Spring Fiscal Policy Bill. The budget as presented to Parliament is divided into 27 expenditure areas. Parliament debates and approves by late November the level of aggregate expenditure for each of the 27 expenditure areas. Again, there are no restrictions on changes as long as the total voted in the Spring Fiscal Policy Bill is respected. Finally, Parliament decides in late December on the level of individual appropriations within each of the 27 expenditure areas. Parliament can make any changes to individual appropriations within the aggregate level of expenditure for each of the 27 expenditure areas.

A strong division of labour among the committees of Parliament accompanied these reforms. The Finance Committee is concerned mainly with the aggregate level of expenditures and revenue as contained in the Spring Fiscal Policy Bill and in the level of total expenditure for each of the 27 expenditure areas. The Finance Committee has essentially been given the role of "policeman" of the parliamentary budget process. Individual appropriations within an expenditure area are the concern of the relevant sectoral committee of Parliament. For example, the Health Committee would recommend the allocation within the relevant expenditure area for health. (The 27 expenditure areas reflect the committee structure of Parliament.) Involving the sectoral committees in this way also supports the use of performance information by Parliament.

Indonesia has similar organisational features and may wish to consider aspects of the Swedish system to strengthen the institutional framework for parliamentary treatment of the budget.

* For a description of such a system in operation, see Jon R. Blöndal (2001), "Budgeting in Sweden", *OECD Journal on Budgeting*, 1:1.

Regardless of this latest development, the commissions rely on cost calculations submitted by the Ministry of Finance or the respective line ministries when discussing the budgetary impact of various amendments under consideration. Although there appears to be confidence in the cost calculations prepared by the ministries, there have been calls to set up an independent budget office so that Parliament will not be dependent on the government for such matters.

Box 14. **Korea National Assembly Budget Office (NABO)**

As the Korean National Assembly took a more active role in the budget process following the transition to democracy, it established an independent National Assembly Budget Office in 2003 to assist it. The official mission of the NABO is to:

- conduct research and analysis on the budget, settlement of accounts and performance of fiscal operations;
- estimate costs for bills;
- analyse and evaluate national programmes and medium/long-term fiscal requirements; and
- conduct research and analysis on request by committees or members of the National Assembly.

The NABO is organised into three substantive divisions: the Budget Analysis Division, the Economic Analysis Division, and the Programme Evaluation Division. It has over 100 full-time professional staff members. The Chief of the NABO is appointed by the Speaker of the National Assembly and approved by the House Steering Committee. The Chief appoints all NABO staff; for higher-level staff, the Speaker must confirm the appointment based solely on professional competence, not political affiliation. Over 90% of staff members hold advanced degrees in economics, public policy, accounting or related fields.

3.4. Conclusion

Following the transition to democracy in Indonesia, Parliament has taken on its role in the budget process with great zeal. This move is to be commended, as the budget is the single most important policy document of governments and its scrutiny and amendment where necessary by parliaments is imperative for a well-functioning democracy.

Indonesia's Parliament stands out when compared to most OECD member country parliaments on several counts.

First, the Indonesian Parliament is involved in more details and at more occasions throughout the budget process than the parliament of any OECD country. While the pre-budget phase is exemplary, it would be more beneficial if Parliament were to focus on budget policy in more aggregate and strategic terms. The government could assist in this regard by providing appropriate high-level budget documentation at that point rather than the very detailed work plans, for example. As a result, Parliament could focus more on inter-sectoral allocations of funding and thus take on a greater role in setting overall budget policy. Parliament's emphasis on detail also inhibits the successful implementation of medium-term expenditure frameworks and performance budgeting.

Second, the practice of undertaking political negotiations on the economic assumptions and revenue forecasts that underlie the budget is at odds with OECD practice. In OECD countries, the usual procedure is to obtain such assumptions and forecasts on a purely technical and independent basis. The aim is to make them so professional that they are not subject to political debate.

Third, the role of the Budget Committee *versus* the sectoral commissions could be made more explicit. Again, the involvement of the sectoral commissions in the Indonesian budget process is exemplary by OECD standards. If the Budget Committee were to focus more on aggregates and strategic priorities, it could be in a position to issue budget ceilings to the sectoral commissions. This change could be part of the introduction of a formal multi-step budget approval process in Parliament to foster fiscal discipline. As noted in Box 13 on Sweden, the role of the Budget Committee could evolve into a fiscal "policeman" akin to the role of the Ministry of Finance *versus* spending ministries. The fact that the Indonesian Budget Committee is a "committee of committees" representing the sectoral commissions may complicate this proposed new role.

Fourth, much of the power of the sectoral commissions stems from informal arrangements, such as their frequent contacts with their respective ministries and agencies. For example, the role of the sectoral commissions in the budget implementation guidance is completely informal.

Fifth, the final decisions of Parliament are by consensus achieved through informal negotiations and discussions among the various parties (factions) rather than majority voting. This situation reflects Indonesian political tradition. It does however hamper transparency, as the means of reaching consensus takes place outside of public view.

Finally, the capacity of Parliament is quite limited in exercising its important budget-related functions. Due to the high turnover of Members of Parliament, an emphasis on providing training and analytical support for them is critical. The option of creating an independent, non-partisan, professional parliamentary budget office to provide high quality support is especially attractive.

4. Concluding remarks

The economic and political crisis of 1997/98 triggered truly transformative changes to budgeting in Indonesia. With the creation of a modern legal framework for budgeting, the budget has been unified and made more comprehensive, and a massive decentralisation programme has been launched. It is commendable that fiscal discipline was maintained throughout this period. Indonesia could now consider introducing a more operational expenditure-based fiscal rule. In addition, it would be advisable to avoid the concentration of spending in the last months of the fiscal year. Another particular challenge is Indonesia's emphasis on a great level of detail on an input basis in its official budget documentation, which in turn forms the basis for Parliament's deliberations. This amount of detail will hamper some of the reform initiatives under consideration in Indonesia, although Parliament has taken on its role in the budget process with great zeal, and the existence of a national planning function alongside budgeting augurs well for Indonesia's fiscal health.

Notes

1. In the original 1999 legislation, each region received a lump-sum payment of equal amount regardless of size. This provision was eliminated with the 2004 legislation as it had created incentives for regions to split, thus yielding higher grants.
2. For a discussion of the appropriate design of fiscal rules and the benefits of expenditure-based rather than deficit-based fiscal rules, see Anderson and Minarik (2006).
3. Mr. Bambang Prijambodo, as quoted by Reuters.
4. This early approval is also meant to give regional governments time to finalise their budgets, as they are highly dependent on transfers from the national government.

References

Anderson, B. and J.J. Minarik (2006), "Design Choices for Fiscal Policy Rules", *OECD Journal on Budgeting*, 5:4.

Blöndal, J.R. (2001), "Budgeting in Sweden", *OECD Journal on Budgeting*, 1:1.