Main findings of the Public Expenditure Review

Ralph van Doorn, Senior Economist
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01 Indonesia’s development trajectory has been remarkable, but many development challenges remain

02 A Public Expenditure Review is a tool to evaluate efficiency and effectiveness of spending

03 Main constraints to adequate, efficient and effective spending

04 Recommendations to improve Indonesia’s quality of spending
Over the past two decades, Indonesia’s development trajectory has been remarkable with many notable achievements.
Over the past two decades Indonesia’s development trajectory has been remarkable with many notable achievements.

1. Average GDP Growth
   - 5.3% annually between 2000 and 2018...

2. GNI per Capita
   - 6x leading gross national income (GNI) per capita to grow more than six fold...
   - 2000: US$580
   - 2018: US$3,840

3. Poverty Rates
   - Poverty rates to decline fast
   - 2000: 19%
   - March 2019: 9.4%

4. Human capital outcomes improved
   - With increased life expectancy and reduced under-five mortality
   - 2000: 66 years
   - 2017: 69 years
   - Under-five mortality
     - Per 1,000 live births
     - 2000: 52
     - 2017: 25

5. Infrastructure access also improved
   - With an increase in households’ access to improved drinking water and sanitation services
   - Drinking water
     - 2000: 49%
     - 2017: 34%
   - Sanitation service
     - 2000: 73%
     - 2017: 69%
But many development challenges remain: Indonesia still faces large human capital and infrastructure gaps
But many development challenges remain: Indonesia still faces large human capital and infrastructure gaps.

**Human Capital**

53%

A child born in Indonesia today will only be 53 percent as productive when she grows up as she could be if she enjoyed complete education and full health.

**Infra gap**

US$ 1.6 trillion Gap

- **Advanced**
  - 30.634

- **Emerging**
  - 10.247

- **Indonesia**
  - 4.221

Indonesia’s per capita public capital stock is only a third of other emerging economies, implying an estimated gap in infrastructure assets of around US$1.6 trillion, affecting long-term growth.

**Stunting Prevalence**

Source: Ministry of Health.

**Growth GDP**

The ongoing COVID-19 Pandemic in 2020 puts these gains in development outcomes at risk.

1. GDP growth in 2020 is projected to be the lowest since the 1997 financial crisis with adverse impact on income and employment, especially in the informal sector.

2. The government put in place a large fiscal response package to contain the pandemic, support households and livelihoods, and support the economic recovery.

3. However, cuts to public infrastructure spending to accommodate the response will lead to delays in infrastructure development.

4. Lower revenue, higher debt and interest payments will reduce fiscal space for priority spending on health, social assistance and infrastructure.
02 Why a Public Expenditure Review for Indonesia?
<table>
<thead>
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<th><strong>Why a Public Expenditure Review for Indonesia?</strong></th>
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<td><strong>Sustainability &amp; adequacy</strong></td>
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<td>Is the level of Indonesia's public spending sustainable and adequate to address Indonesia's development challenges, both on aggregate and within sectors?</td>
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Looking at tool box & important sectors to close human capital & infra gaps

### PART 1: Overview & Institutional environment

1. Overview: *aggregate spending, sustainability, efficiency and effectiveness*
2. PFM: Improving expenditure management for better quality of spending
3. Reforming the intergovernmental fiscal transfer system for better services
4. Data for better policy making

#### HUMAN CAPITAL

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#### INFRASTRUCTURE

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<td>Water supply &amp; sanitation</td>
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### PART 2: Human Capital

### PART 3: Infrastructure
Main constraints to adequate, efficient and effective spending
Indonesia’s public spending is low relative to its peers due to low revenue collection

General government expenditure, % of GDP

General government revenue, % of GDP

Note: General government consists of central, state (province) and local (district) government; The sample of chosen countries are 38 emerging markets and middle-income economies, based on groupings by IMF Fiscal Monitor (October 2018); Horizontal axis: GDP per capita in constant 2010 US$, then converted into logarithmic (log) form.
Source: IMF Fiscal Monitor (October 2018).
But thanks to subsidy reforms, spending on infrastructure, health and social assistance has increased with a strong focus on reducing stunting.
...and fiscal policy has become more effective in reducing poverty and inequality

Fiscal policy has become more efficient at reducing poverty and inequality over time:

Poverty reduction in 2017 was achieved with relatively fewer resources than in 2012 thanks to better targeted social assistance.

Impact of fiscal policy on poverty and inequality in Indonesia (Percentage points / Gini points)

Impact on poverty rate
Impact on Gini coefficient

Source: World Bank staff estimates from Susenas, March round
However...

Spending on priority areas has increased, but remains inadequate.

Resources are not always spent on the right interventions.

Even when resources are directed to the right interventions, spending is not always efficient.

Public spending reduces inequality, but is not always effective in achieving the desired pro-equity outcomes.
Spending on priority areas has increased, but remains inadequate... compared to other peer countries

Resources are not always spent on the right interventions

Low spending in Early Childhood Education and Development

Not enough spending on maintenance in many infrastructure sectors

Even when resources are directed to the right interventions, spending is not always efficient

Many schools still do not have adequate equipment and books to create a conducive learning environment, despite 20 percent of the budget spending mandate

Public spending reduces inequality, but is not always effective in achieving the desired pro-equity outcomes

Main subsidy schemes are regressive and favor wealthier households over lower-income ones (housing, energy)
Main findings

The review identifies the following constraints to improve the quality of spending to close gaps in human capital and infrastructure:

1. Limited fiscal space for development spending

2. Systemic constraints across sectors impede efforts to improve the quality of spending

3. Sector-specific constraints to the efficiency and effectiveness of spending
Main findings

1 Limited fiscal space for development spending

Low revenue collection, especially from tax

Spending on poorly targeted subsidies and less effective programs

2 Systemic constraints across sectors impede efforts to improve the quality of spending

Lack consistency between planning and budgeting and performance orientation of the budget

Coordination challenges across agencies and between levels of government

Fiscal transfers to SNGs do not incentivize performance

Inadequate data and information systems

Constraints to private sector participation

3 Sector-specific constraints to the efficiency and effectiveness of spending in the human capital sectors and in the infrastructure sectors

Points 2 and 3 will be discussed on June 23, 24 and 25
Recommendations to improve Indonesia’s quality of spending
Fiscal space will be tight post-COVID: Without reforms, revenue is unlikely to return to pre-COVID levels, while debt and interest expenditure will increase.
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**Revenue unlikely to recover post-COVID due to sluggish commodity prices recovery and CIT rate cuts**

- No tax reform scenario
- Pre-Covid Baseline

**Rising interest expenditure due to rising debt will crowd out priority expenditure**

- No tax reform scenario
- Pre-Covid Baseline
What to do?

1. Maintain and widen fiscal space for development spending
2. Address systemic constraints to quality of spending
3. Address sector-specific constraints to efficient and effective spending by improving design and implementation of major sectoral programs
Double down on the tax agenda

Lock in reforms to energy and fertilizer subsidies, while commodity prices are low; and focus spending on the poor
Double down on the tax agenda

Need tax measures now, so that post-COVID, it offsets impact of sluggish commodity price recovery and CIT rate cuts to restore tax to pre-COVID level:

- Widen the tax base
- Introduce taxes to meet environmental and health objectives
- Improve tax compliance
- See next session!
Maintain and widen fiscal space for development spending

Lock in reforms to energy and fertilizer subsidies, while commodity prices are low; and focus spending on the poor

Despite bold reform in 2015, budget subsidies increased in 2017-2019 on and off-budget

Central Government explicit subsidy and estimated implicit subsidy spending (IDR trillion)
Reforming subsidies will reduce poverty, improve productivity, reduce environmental impact

- **Energy subsidies**: a large share enjoyed by middle class and up
- **Fertilizer subsidies**: over 30% of subsidized fertilizer leaks to non-targeted producers, like oil palm plantations; 60% of subsidies benefit largest 40% of farmers
Maintain and widen fiscal space for development spending

Substantial scope to increase fiscal space for priority spending by increasing revenue, removing VAT exemptions and reforming untargeted subsidies

Even after compensating the bottom 40 percent for the removal of VAT exemptions and energy subsidies, the net fiscal gain would be 1.3 percent of GDP per year

<table>
<thead>
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<th>Reform</th>
<th>Gross fiscal gain</th>
<th>Compensation for bottom 40 percent</th>
<th>Net fiscal gain</th>
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</thead>
<tbody>
<tr>
<td>Eliminating energy subsidies</td>
<td>0.7</td>
<td>0.3</td>
<td>0.4</td>
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<tr>
<td>Tobacco excise reform</td>
<td>0.7</td>
<td>-</td>
<td>0.7</td>
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<tr>
<td>Removal of VAT exemptions</td>
<td>0.4</td>
<td>0.2</td>
<td>0.2</td>
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<tr>
<td>Total space for additional spending</td>
<td>1.8</td>
<td>0.5</td>
<td>1.3</td>
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</table>
Get more bang for the buck

1. Build quality houses where people want to live

‘Satu Juta Rumah’ housing construction targets achieved, **but housing are being built in non-urban areas and many are left vacant**

Half of all subsidized housing is located in rural areas while urban housing need is growing

- Non-metro rural: 52%
- Rural periphery: 5%
- Non-metro urban: 5%
- Urban periphery: 27%
- Metro core: 17%
- NA: 2%

...and poor quality is main reason for vacancies

- PSU poor conditions: 45%
- No electricity/clean water: 2%
- Building construction: 2%
- Change in employment: 17%
- Poor construction quality: 2%
- Lack of access: 5%

**Better location closer to jobs and public services and quality**

**can lead to lower vacancy rates and less waste of public resources**
2. Spend more and better on early interventions – it is better (and cheaper) than treatment, especially in the age of COVID

| Health: Strengthen capacity and quality of primary health care: |
| - lower average visit cost |
| - earlier screening will lead to higher treatment compliance and success |

| Education: Increase demand for and supply of early childhood education and development (ECED) |

| Social assistance: Adapt core social assistance programs and ensure that Unified Poverty Database (DTKS) is updated for rapid disaster response, so poor and vulnerable households can recover better from natural disasters |

| Nutrition: Overall spending on nutrition is more than adequate to cover a full package of nutrition interventions But reduce fragmentation and improve efficiency of spending through better information, stronger accountability for results |
Get more bang for the buck

3. Spend more on maintenance and road preservation and attract more private sector financing given tight infrastructure budget

**Water resources management (irrigation):** Convert River-Basin Organizations, responsible for irrigation, into revenue-receiving entities, such as General Service Bodies (BLUs), to earn income for increased O&M needs.

**Water supply and sanitation:** Reform the regulatory environment of local water companies (PDAMs) to enhance their financial sustainability and ability to cover O&M and to invest in improved and expanded services.

**National roads:**
- Increase the funding pool available for national roads and expressways, including by leveraging private sector investment.
- However, when insufficient fiscal resources are available, prioritize asset preservation over new investment.

**Private sector financing:** Strengthen PPP regulatory framework, change SOE incentives, improving pricing mechanisms and deepen capital markets, especially for expressway development, affordable housing in urban centers and local water supply through PDAM.
Get more bang for the buck

4. Give cities enough resources to manage congestion

Urbanizing areas face **pressing service and infrastructure financing needs**, but General Allocation Transfer (DAU) discriminates against fast-growing cities.

1. Move to DAU formula based on a “per clients” basis: e.g., # school-age population, # poor, kms of roads

2. Offer a “package deal” to losing regions, for example through a Special Allocation Grant (DAK) “Afirmasi” (lagging regions) for those with infrastructure gaps.
Summary

To improve the efficiency and effectiveness of spending, the report makes the following recommendations:

1. Maintain and widen fiscal space for development spending and get more bang for the buck
2. Address systemic constraints to quality of spending
3. Address sector-specific constraints to efficient and effective spending by improving design and implementation of major sectoral programs
Summary

To improve the effectiveness and efficiency of spending, the report makes the following recommendations:

1. Maintain and widen fiscal space for development spending and get more bang for the buck
   - Collect more revenue to spend more on health, education, social assistance and infrastructure
   - Target spending only for the poor
   - Spend more on early and preventive health and education programs – it is better and cheaper than doing it later
   - Spend more on infrastructure maintenance today – so there will be less costly rebuilding tomorrow
   - Give fast-growing cities more money - to make more of them more livable and less congested

2. Address systemic constraints to quality of spending
   - Ensure the budget helps achieve national development priorities better and focuses on quality, not only quantity
   - Collect better data on results and delivery of development priorities to improve budget performance
   - Focus fiscal transfers to local governments on outputs and performance
   - Central and local governments work better together to deliver infrastructure and health services
   - Attract more private sector finance to close the infrastructure gap because the budget is not big enough

3. Address sector-specific constraints to efficient and effective spending by improving design and implementation of major sectoral programs

Strengthen institutions to direct money to priorities and results

Points 2 and 3 will be discussed on June 23, 24 and 25
## Navigating the Report

### PART 1  Overview & Institutional environment

1. **Overview:** aggregate spending, sustainability, efficiency and effectiveness
2. **PFM:** Improving expenditure management for better quality of spending
3. **Reforming the intergovernmental fiscal transfer system for better services**
4. **Data for better policy making**

### PART 2  Human Capital

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### PART 3  Infrastructure

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*Note: The specific dates (June 23, June 24, June 25) are placeholders and should be replaced with the actual dates.*
Available for download at worldbank.org/idper

Navigating the Report

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**PART 2  Human Capital**

**PART 3  Infrastructure**
Terima Kasih!