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BearingPoint

USAID - MACROECONOMICS AND FISCAL PROJECT

FINAL REPORT

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Introduction

This is the final close-down Report of the USAID Project to provide technical assistance in macro-fiscal policy reform to the government of Indonesia. This Project was undertaken by BearingPoint Inc as Contractors to USAID.

The Project under USAID Tier II: SEGIR Macroeconomic Reform, Contract PCE-I-805-00-00014-00 started 1st August 2002 and scheduled to run to 31 July 2003, as a follow on to the earlier Tax and Fiscal Reform Project conducted under Phases I and II.

The major core objective has been to undertake capacity building activities and provide technical support to the Ministry of Finance (MOF) in the macro-fiscal policy area. The previous Project Final Report[3] provides the essential background and motivation for the work programme.

The dominating feature that has overridden the whole structure of the Project and Task Order, has been the October 2002 Bali bombing incident which resulted in a US State Department ordered departure of USAID contractors from Indonesia. This evacuation lasted 180 days – virtually one half of the life of the project. With the approval of the CTO, management during this period was effected from the BearingPoint office in Singapore.

An further important point that bears repeating is that MOF currently, is the subject of a major re-organisation. In particular, one that will bring it broadly into line with good international practice. ***The support that has been provided under the Project has been influenced heavily by the ongoing changes leading to the planned final organisational structure.*** [See below and Addendum]

The Project in Jakarta has been managed by one resident fiscal adviser located in the Agency for Fiscal Analysis (Badan Analisa Fiskal – BAF) of the Ministry of Finance. One local economist, plus local support staff completed the team.

Through the Project, monitoring Reports were submitted to the CTO at USAID and as required by the Task Order, provide a commentary on progress, achievements, issues arising and problems [*But see Section IV below*]. In addition, briefing on Project progress has been provided to the CTO, other USAID officials and USAID programme visitors/consultants as required.

Good liaison and collaboration has been maintained with other major donors, both multilateral (IMF and World Bank) and country specific. As was the case under the

[3] USAID/KPMG Consulting " Indonesia – Technical Assistance for Taxation, Public Macroeconomics and Commodities Futures Trading", July 2002

earlier Project, within the Indonesian economic policy arena, the Macro/Fiscal Project economist staff, have been regular invitees/attendees at conferences, seminars and other meetings in Indonesia arranged by a wide variety of government, donor, university, policy research and other agencies. In this respect it is worth mentioning the role of the Tax Committee of the American Chamber of Commerce in Jakarta, the Chairman of which Mr Philip Shah, has proved to be a helpful source of both information and support.

USAID provided support through the ongoing involvement of the CTO(s), the recently departed Chief of the Economic Growth Office, Mr. Paul Deuster, and the then Mission Director, Mr. Terry Myers.

On return to Jakarta in mid-April 2003, the Project was invited by USAID to apply for a two month no-cost extension. This was granted with the new close down date of 30 September 2003.

II Task Order and Deliverables

The core of the Task Order, as in the previous phases was centered on the provision of technical assistance in the fiscal policy area to the Agency of Fiscal Analysis (Badan Analisa Fiskal), or BAF, in the Ministry of Finance (MOF), Jakarta.

In addition to this, however, was planned support to the Supreme Audit Board, which lies outside of MOF.

The Deliverables envisaged in the original Task Order were as follows:

1. One short term advisor for an extended stay, providing both additional sophisticated models and support for the financial programming activities. This activity will occur regarding such matters as relevant data analysis and revenue estimating and tax analysis issues.
2. Continuing informal training by the resident fiscal policy advisor, including regular advice and technical assistance as appropriate on data analysis and revenue estimating issues. Regular advice and technical assistance as appropriate to BAF staff on budget and budget presentation issues.
3. One briefing report that provides appropriate technical support to the revenue estimating activities of the Ministry of Finance, partly on the tax side and partly on non-taxes.
4. One report on key technical and timing issues underlying budget forecasting, preparation, presentation, and administration. One seminar on relevant budgetary activities, including an internationally viable model for improved budget presentation in Indonesia.
5. A modest computer procurement for BAF, such as 4 desk-top computers with supporting printers, scanners, etc.
6. Two training courses, principally for the staff of the Supreme Audit Board on performance auditing and/or forensic accounting

7. By 3-31-2003, the contractor is to transfer all activity equipment, reports and other assets to the Ministry of Finance. All local staff duties are also to be transferred to MOF staff. MOF will house the long term advisers and provide them support as their counterpart contribution until the end of the Task Order on 6-30-2003. As such, this Task Order need only cover nine (9) months of funding for local staff and office facilities.

III Organisation and Local Staff

The Project was managed from two locations:

(a) The Fiscal Adviser's office in the Agency for Fiscal Analysis (BAF). This office included a limited amount of office furniture etc provided by this Agency in the Ministry of Finance.

(b) A general Project Office in Jakarta, which together with furniture and equipment had been procured under the previous Tax and Fiscal Reform Project. Because of the very limited accommodation in MOF, the intention as reflected in the Task order was to use this space and facilities to house visiting short – term technical advisers.

Local Indonesian Staff on the Project consisted of:

Abinanto –	Local Economist – operating from both offices.
Poppy Martoyo –	Project Office Financial and General Manager
Irma Dewi Sukanti –	Secretarial Assistant in MOF
Riswandi –	OfficeAssistant/Courier in Main Project Office

All of the above had been members of the Barents/KPMG Tax and Fiscal Reform Projects under the previous phases.

IV Special Factors

(i) Ordered Departure

From the outset, because of the general security situation in Indonesia, there were difficulties. The US authorities introduced tighter conditions relating to the granting of short term technical assistance visits. For all but one or two very special exceptions, through August/September, this gradually developed into something close to a complete embargo which affected all contractors.

However, the Project in effect, had barely started when as a result of the October 2002 Bali bombing incident a US State Department ordered departure, most existing Embassy and USAID contractors had to leave Jakarta. With the approval of the CTO, the evacuation resulted in a re-location of the resident Fiscal Adviser to the BearingPoint Singapore office. Local Project staff remained in Jakarta and because of almost identical time-zones were able to keep in daily contact with the Singapore office.

In all, the Project was forced to operate under these conditions for almost the maximum 180 day period permitted under the USAID rules. In fact, a mid-term visit was permitted and the Fiscal Adviser was able to return to Jakarta three weeks before the evacuation order was lifted. The effect overall, however, was that the Project was being managed for almost one half of its planned life, outside of Indonesia.

(ii) Changes in CTO

During the life of the Project because of the above disruption, there was a series of changes in CTO and at times, with gaps between new responsibilities being announced. This was influenced heavily by the evacuation under which, the relevant USAID personnel were posted back to Washington DC. In fact, this tuned out to be not so bad given that a qualified local Jakarta based economist in USAID was able to keep good contact with the Project.

V Modifications to Project

Changes to the Task Order as originally structured, have been of two kinds: (a) pre-ordered departure and (b) post-ordered departure.

(i) Pre-Ordered Departure

(a) Supreme Audit Board

The initial request for support in July, had come direct to USAID from the Head of the Supreme Audit Board himself. The major concern was that the draft legislation relating to the auditing of government accounts was not tight enough to prevent a range of possibly inappropriate or even illegal financial activities from taking place..

But despite theses initial approaches to USAID and apparent enthusiasm by Indonesian partners for technical assistance to the Supreme Audit Board, it proved in practice to be impossible to make progress.

Over the period 1 August, through September, the Director General Pak Billy Joedono, either failed, or found himself unable to respond to a variety of approaches by the Project team, the CTO and the Head of the USAID Growth Project. Efforts to arrange meetings, develop points of contact and working arrangements came to nothing.

The reasons for this change in attitude are unclear and explanation from Indonesians has not been forthcoming. Certainly there were and still are, some political difficulties in Parliament with respect to the passing of a new State Audit Law. This Law in draft has been seen by some as presenting a potential threat to strong vested interests.

In the event, because of the lack of progress in communication and liason with the Supreme Audit Board, the CTO decided to put this component of the programme to one side. This decision was communicated by e-mail to the Project Fiscal Adviser, 7 September 2002.

(b) Financial Management

Following on from the earlier Phase of the previous Project, through September, the Fiscal Adviser continued to receive requests for technical assistance from the Deputy Chairman (Pak Mulia Nasution) of the MOF Financial Management Review Committee.

It is the initiatives taken by Pak Mulia that have been primarily responsible for the planned re-organisation of MOF[4]. More specifically, the request was for a short term technical adviser to sit with officials and work through three important draft finance laws to ensure consistency with a White Paper on Financial Management Reform. With the approval of the then CTO, (e-mail 20 September 2002), a TOR was drawn up with the objective of identifying a qualified expert.

The ordered departure, including as it did a complete ban on all consultancy visits, prevented these plans from being put in hand.[5]

(c) Inspector General's Office (MOF)

USAID was approached by the Inspector General (IG), Pak Agus Mohamad in MOF, on the isssue of technical assistance in support of the setting up of a Taxpayers Code of Conduct Committee and preparing a draft Code of Conduct. The Project's involvement here was that of facilitator involving the Financial Services Volunteer Corps (FSVC), the ELIPS legal team under a separate USAAID Project, as well as the IMF.

The Project local economist Abinanto was heavily involved over the period August – October is developing good contacts, facilitating discussions and arranging meetings between both external advisers/donors as well as inter-Agency groups in the Ministry.

(ii) Post Ordered Departure

(a) BAF Staffing Re-Organisation

During the evacuation, BAF in the Ministry was subject to a complete change in all senior staff, with consequentials lower down in the structure. In particular, the Director General Pak Achmad Rochjadi was replaced by Pak Anggito Abimanyu, a former special economic adviser to the Minister of Finance. The Director for expenditure policy, Pak Boediarso was replaced by Pal Parluhutan. The key and most influential Director Pak Marwanto was moved to another Agency in MOF, with his position being taken by Pak Boediarso.

(b) New Work Requirements

Primarily as a result of the above staffing changes, the basis for a new set of work priorities began to emerge in the Agency but only slowly. These became more explicit when communicated to the Fiscal Adviser during the three week permitted return from Singapore in February/March. These in turn were passed ontto the CTO - Memo of 14 March 2003 *"Macroeconomics and Fiscal Project"* to Mr James Walker(USAID), cc Mr Paul Deuster (USAID), Mr Harry Aziz(USAID), Mr H. Nester (BearingPoint)

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[4] The re-organisation is to come into effect, January 2004.

[5] It is unfortunate that in the absence of BearingPoint , McKinsey were hired to provide technical support.

VI Tax Reform Policy

(i) Background

As is now well understood, the background against which budget decisions in Indonesia are taken, is influenced heavily by revenue performance. In the fiscal domain, this constitutes one of the biggest problems today. The major tax reforms of 1984 which resulted in soundly constructed tax laws, had both simplified and rationalised the revenue system. They provided a basic in line with good international practice.

As the earlier Report stated:

" However, over a number of years, a series of regulations and other provisions, nearly all of which, have been introduced either as knee-jerk reactions to particular short term circumstances, or as response to powerful interest groups, have served to compromise the policy intentions that motivated the 1984 reforms.

Prominent examples are provided in the field of consumption taxes, where a fundamentaly sound and well articulated VAT law successively, has been distorted by a series of luxury sales and other taxes which have served to undermine the basic principle of a VAT. The resulting mixture of cascading effects is such that today, it is virtually impossible to provide an unambiguous assessment of the impact of the tax structure on the economy, or on the behaviour of the various agents.

The end result is that the record on revenue collections has been and continues to be very poor. Such weak performance in tax collections has constrained fiscal policy, has reduced the flexibility in the consideration of fiscal policy options, which in turn has led to serious financing problems in relation to the budget balance. Currently, this feature of Indonesian public activity is one of the most important areas that requires improvement. It has been the largest point of focus for this Project as a whole and has received continuous attention from the two major international donors. "

Earlier technical assistance efforts in BAF had been concentrated mainly on capacity building to improve revenue forecasts. Also, because of the tax collections problem and as a short term policy expedient, on introducing an explicit revenue target one year ahead.

General support was provided in the area of tax policy. The problems were familiar enough: namely, very powerful revenue departments that can easily dominate discussions with the fledgling policy BAF Agency in MOF. Previous attempts to expose the weaknesses and anomalies that had been allowed to develop had in the end, come to nothing. [See Section IX on Tax Administration below]

More recently, Minister of Finance Boediono demanded yet another effort to make tax policy more effective and relevant to the needs of Indonesia today. In the April of 2003 therefore, he attempted to set up some procedures for pushing forward on tax reform.[6]
In an attempt to dilute the power of the revenue departments, the Director General was asked to involve outside interests such as academics and private bodies e.g. trade and commercial associations, chambers of commerce and so on. *The Project team was invited*

[6] One should note that the word " reform " is much overloaded here, in so far as most of the problems rest in both *the design of existing tax structures and in the way these designs are administered.* In the existing laws, tax bases for example, are uncontroversial and there are no serious issues of fundamental tax reform as such e.g. cash flow versus profits taxation etc....etc.

to become fully involved as integral members of both internal and external committees that have been established

The objective is to have a full review completed for late 2004, with implementation planned for say 2005. Since for the first time, there will be 'democratic' open Presidential and Parliamentary elections in 2004, it is not feasible to go faster than this. *The Project, therefore, has been able to contribute to this initiative up until its close down end-September.*

(iii) Key Issues

The key objective as stated by Pak Boediono, is to create more of a level playing field and simplify the existing system so as to improve competitive performance. In fact, the practical issues are precisely the same as those that have existed for some time and are summarized in the above quotation. Up to the point of close-down, the efforts of the Project team has focused upon the following.

(a) Personal Income Tax

In 2000, the marginal rate structure was changed from a three band to a five band structure.

Pre-2000		Post 2000	
Rupiah(mill)	Marginal Tax Rate%	Rupiah(mill)	Marginal Tax Rate%
0 - 25	10	0 - 25	5
25 -50	15	25 - 50	10
50 plus	30	50 - 100	15
		100 - 200	30
		200 plus	35

The revised structure bears comparison with that in a number of neighbouring countries, although an IMF Fiscal Mission recommended a return to a three rate system. In fact, the choice is neither that important or controversial.

The most important feature and one which has been ignored systematically by the Indonesian tax authorities is that the untaxed personal allowance has remained unchanged in nominal terms for some five years. Today it is worth only one third of its starting value and has pulled many small income earners into tax liability. Further, the lower tax bands have remained the same width in nominal terms also. Hence, overall, there has been a significant degree of 'bracket creep' or 'fiscal drag' in the system.

The policy problem of course, is that in re-valuing the allowance, it is the higher marginal rate taxpayers who benefit most. Thus any assessment of progressivity or regressivity becomes a matter of comparing benefite in net income terms, to those removed from tax entirely, against the tax saving benefits to those who are already in the system. Currently, *the data available is not good enough to undertake such analyses and much more needs to* be done to improve this situation.

The Project produced briefing memos to illustrate the effects on post-tax incomes of changing the personal allowance and these have now been fed into the policy 'reform' process.

(b) Expenditure Taxes

The issues here are very well known. Much good advice with recommendations was provided under the previous Project. The real issue is one of DG Pajak having the will to do what is necessary. Very briefly:

- There is a good VAT law
- This law is compromised in a number of ways e.g. certain imports do not bear the tax and there is a range of so-called luxury sales taxes.
- The excises tax base is very narrow; 99 per cent of excises revenue comes from tobacco but there is a complex structure of tax rates that is intended to reflect industrial structure objectives e.g. protecting the small scale cigarette manufacturer.

Project participation and advice given in the debates has focused on the desirability of returning to the basic sprit of a VAT and the 1984 law.

Much concern has been expressed by Indonesians on the need to introduce some degree of progressivity in the VAT structure. What the Project has tried to do is focus on the trade-offs between having:

- A simple two rate system (zero rate plus say 10 per cent), where the zero rated goods are perhaps unprocessed foods, childrens clothing and educational products

- A three rate structure (say zero, 10 per cent and perhaps 30 per cent), where the higher rate takes in those products that currently bear the luxury sales taxes.

- Maintaining the two rate system but converting the existing luxury sales taxes (particularly on expensive automobiles) into excises.(Currently, revenue yield from excises as a percentage of GDP is very low and much below the figure for neighbouring S.E Asian countries

Expressed in terms of the average tax rate, all of the above of course are "progressive" but a task has been to demonstrate that in general it is not a good idea and in any case, one cannot expect to obtain much real progressivity via a VAT structure. The better objective is to keep the wide base and maintain lower tax rates – *and which is perfectly possible under the original 1984 law.*

BAF has been encouraged to make use of available household expenditure data to help identify income elasticity and make some in inferences about the impact of VAT on spending.

(c) Land & Buildings Taxes

This is a tax instrument with enormous revenue potential, yet for several reasons, mostly political, remains relatively undeveloped. There are two main issues:

- Re-valuing the existing and comprehensive property register. Current valuations are far below typical market prices but there is huge pressure from the elites to delay
- The center is starved of cash resources but this particular tax is well suited as a major source of local revenues within the de-centralisation initiative.

Project advice favours a re-valuation as soon as this is possible but the revenues should be left largely with the regions. There is ample scope in principle, for the center to have sufficient resources from the existing income taxes and VAT, if these are designed and administered as per the existing laws.

In summary, on all of the above, with the encouragement of MOF, there has been active day to day involvement on the part of the Project team. *In facilitating discussions, acting as a liason between the variety of different Agencies involved and in maintaining the information flow, the efforts of our local economist Abinanto have been invaluable.*

At the time of close down, it is too early to say whether Project advice and efforts will be completely successful; probably not. *But what is clear, is that the initiatives are remaining on the agenda. Further, that the ownership of the policies within MOF is now beginning to broaden outside of the revenue Agencies themselves. One could argue with some justification that Project participation has helped to facilitate this crossing of boundaries between the key actors.*

VII Fiscal Policy Training

During the evacuation, it was of course, not possible to engage in what has now become generic training and technical support activities and a 'catch-up' initiative was judged to be necessary.

During the three week visit of the Fiscal Adviser, arrangements were put in hand to set up an integrated set of training modules in Fiscal Policy Analysis for BAF younger staff. Earlier training activities provided in-house, had tended to be more technical but as the earlier Project Close down Report indicated, there still remains only weak capacity in MOF to undertake standard policy analysis work.

Arrangements were made for the policy research arm of the University of Indonesia (LPEM), to deliver a set of training sessions in Fiscal Policy analysis through the month of May. With the agreement of the Directors, it was decided to assume that the relevant

BAF staff had some technical economics background. Thus, an integrated programme was set up that included a range of topics with the emphasis structured around practical examples and applications that currently, are relevant to the Indonesian economic situation. A contact was drawn up with finance to LPEM being provided under the 'revised' Project.

The training course was delivered in Bahasa Indonesia over the four week period, to twenty three of the younger BAF staff, with compulsory attendance throughout.

The following Modules - some running over of several sessions, were presented by LPEM instructors:

R. Achmadi	*Aspects of Public Sector Economic Analysis*
U. Wiharya	*Applications of Input – Output Analysis*
Ryanto	*Applications of Regression and Time Series Analy*sis
R. Simanjuntak	*Taxation Policy in Transition*
M. Ikhsan	*The Fiscal Adjustment Problem*
E. Ginting	*Public Sector Sectoral Issues*

At the end of the course, a three hour written examination was taken by all course members. Certificates of accomplishment presented.

The formal contract with LPEM, all relevant documentation plus the above training module handouts as presented, are available as Project files.

VIII IT Capacity

Again as in the previous phase, The Task Order provided for a further modest PC procurement that would contribute to the improvement of IT capacity in BAF. It was agreed with BAF officials that the revenues and expenditures Directorates where most of the day to day budget policy and analysis work is concentrated, would benefit most from an enhancement of IT capacity.

With the approval of the CTO and in compliance with the USAID regulations and procedures, six new IBM Pentium IV PC's were procured and delivered to BAF for immediate use. These have now been handed over to BAF; are all fully operational in the divisions as designated and signed off as final Product.[7]

[7] The Task Order suggests four PC's plus a laser printer, but MOF preferred not to take the latter, hence two PC's were substituted for this.

A complete record of this activity from inception to final hand over is available on file for inspection.

IX Tax Administration

This heading is not a formal part of the Task Order. Under the earlier phase, a large scale "Blueprint for the Reform of Tax Administration" was produced and delivered to DG Tax. The background and details are set out in the previous Close Down Report.

Given the importance of this work and its direct relation to tax policy, the Macro/Fiscal Project team has monitored closely both the reception of the Blueprints Report and subsequent developments with respect the four new Large Taxpayer Units (LTU's)[8]. Such monitoring has necessitated the maintenance of good working relationships with DG Tax.

It should be noted that all of the work and advice on Tax Policy (above) involves senior and middle ranking staff from DG Tax. These officials attend all meetings of the Policy Reform Committees and unsurprisingly, are the most active participants in such meetings.

The IMF sponsored LTU initiative has been a successful enterprise. Favourable references have come from the Indonesian and particularly, the ex-patriot business community[9].

In addition, from the standpoint of BearingPoint technical assistance, it can be reported that the Blueprint Report continues to be on the reform agenda.

Currently, the intention of DG Tax is to push for improvements to the administrative regime on two fronts:

(i) To spread the good practice experience of managing the LTU's further down the size distribution of companies.
(ii) To begin to incorporate ideas from the Blueprint Report in the Regional Tax offices.

Of much potential importance is the forthcoming re-organisation of MOF. Although the broad structure is announced, some of the details have yet to be clarified. In particular, whether the policy directorates in DG Tax and Customs, will be transferred in to the newly re-constituted BAF. [See Addendum below]

International experience and evidence suggests that even if this transfer does occur, it is unlikely that the revenue departments will be willing to give up their interest in policy entirely. Indeed, the probable result is that a surrogate policy function will be developed

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[8] These are being set up under an IMF programme initiative tied to the LOI.
[9] E.g. the Amcham Tax Committee has welcomed these developments

in the place of that lost. Further, that it is the natural tension between the revenue and policy Agencies that will prevent DG Tax from holding what has to date been monopoly power over tax policy.

Advice from the Project team has been that one way of easing these difficulties is to *ensure that staff are seconded frequently so as to have practical experience of both sides of the issues involved. Over time, this gradually builds up a store of expertise common to both tax administration and tax policy.*

X Other Activities

As one might expect, these have been wide ranging. The following examples, although by no means complete, serve to illustrate Project involvement in economic policy work in BAF. Some of the items below were provided from Singapore, others after return to Jakarta.

Budget

Advice/analysis/briefing are generic activities of the Project. As one central example, the Fiscal Adviser prepared the official presentational release of Budget 2003 for the media and which was used widely across government Ministries/Agencies etc.

Fiscal Sustainability

Clarifying operationally, what is meant by the term. In fact and as is widely known, the technical literature demonstrates that there is considerable debate with no unique definition. The problem for Indonesia is that in flow terms, the public sector deficit is low and at first sight certainly appears to be manageable.

In stock terms however, one sees observes a debt/GDP ratio of around 70 per cent and which shows in the debt interest component of the current budget. However, primary budget surpluses over the past four years have ensured a rapid decline in the debt/GDP ratio. Any reasonable interpretation would be that the fiscal position of Indonesia is on a path that is sustainable. The problem is that financial markets do not want to see a sharp rise in the absolute debt stock even if this ratio is declining.

An interesting point of note is that currently, the fiscal structure is now closing in to where it was in the old Soeharto days. Namely, current expenditure is covered by current revenues, with capital spending being financed by borrowing – *the "golden rule" - a policy that the Project Fiscal Adviser has been promoting in BAF since he arrived !!!*

Macro Programming and Simulations

Financial programming work supported by short-term technical assistance effectively was removed from the agenda. On return to Jakarta, this work was continued on an ad hoc basis within the relevant Macro Analysis Division. The result is that the existing model system constructed with Dutch consultants, now incorporates a financial programming type of core. That is to say, the key identities between the fiscal, monetary and external sectors is now made explicit and these constraints serve to ensure consistency. The fiscal balance is also linked to the debt module provided earlier.

Although modeling capacity remains weak, it has improved a good deal over the past year and there is a small number of good officials who are pushing this work forward. Advice and assistance has been given in designing policy simulations. Quite apart from the technical limitations of existing model systems, there remains a weakness in understanding why and how one characterizes the basic policy stance. Thus for a developing open economy like Indonesia, the assumed response of monetary policy to say an attempted fiscal stimulus is crucial. Simple 'ready reckoner' exercises will not do.

Typically, one might expect the joint effect of the exchange rate and interest rates to largely, or even more than offset the intended effects. *Technical advice and input including substantial drafting was provided in support of a paper presented by the Director General to the Indonesian Economists Association.*

Real Returns and the ICOR

Associated with the above kind of work, notes were provided on simple ways to characterize the medium term path for real GDP and how this might be related to both investment and the real return. The primary objective was to ensure consistency between the real and financial sides of the exercise.

Tax Holidays and Investment Incentives

Significant input to the case against tax holidays and direct investment incentives, was provided under the earlier phase of the Project. Indeed, it was thought that this advice has closed the subject. Unfortunately, through the back door, the recent new Investment Law now includes a provision for investment incentives and the subject is alive again. The justification for this reversal is always " *if others do it then why shouldn't we?* "

The arguments against have been brought out again with a memo written on the available evidence. The most that can be said is that Project efforts constitute a holding action against what is now in the law.

Pension Trusts

The state pension agency Jamsostek has long been the subject of criticism. It is known that returns on the fund are so low as to make a feasible replacement income pension impossible to realize. The institution lacks transparency, accountability is opaque and there appears to be a general management and control problem.

A proposal emerged through Bappenas to place turn Jamsostek into a trust fund and the Fiscal Adviser was asked for advice etc. It was pointed out in memos that trusteeship of itself, guarantees nothing since it does not address the underlying problems. Indeed, in discussions with Indonesian officials, it emerged that most of the Trustee Board Members would be the same people who run the organization anyway !.

International Co-operation
This new activity in MOF developed on return to Jakarta. The Bureau of International Co-operation is being strengthened currently and has a new much higher profile Direector Pak Marwanto.

Indonesia, almost traditionally, has not engaged very much with other embassies abroad on matters of economic policy. The Project was asked if it could provide examples of good practice 'how to do it' and exactly what other countries do. This was done via arranging meetings with various Embassy officials.

Public Policy Presentation
Associated with the above is the observed fact that the presentation of economic performance per se in Indonesia is rather poor. It is striking that outside of the purely political, the attention that Indonesia receives with respect to economic performance is close to zero. In current circumstances, particularly the net capital outflow position, this is important. More specifically:

- Although GDP growth is low at around 3.5 per cent, it is poor everywhere
- The exchange rate has strengthened significantly and has stabilized
- Foreign reserves are substantial at a value of close to one year of imports
- The current account is strong
- Inflation has fallen from high double to mid-single digits
- Interest rates have fallen sharply
- Sustainability has broadly been achieved in the public sector and the economy is generating healthy primary budget surpluses
- The debt/GDP ratio over three years, has fallen by more than 30 percentage points
- Substantial progress has been made with respect to asset disposals

Despite these successes, very little or any of this is being revealed in longer term capital inflows, lower risk premia, higher credit ratings, or in better media publicity generally. It is worth noting that several other S.E Asian countries, Malaysia, Thailand, Korea, are active and successful in this area. Further and strangely, this is an are that appears to be wholly undeveloped in the economy.

Advice, with meetings has been given on how Indonesia might start using overseas representations, commercial attachees, chambers of commerce etc to raise the profile, has been given.

Briefing
For international and other events such as ASEAN, CGI, ADB etc, general economic briefing, both written and oral plus speeches for Ministers/Senior Officials have been provided. Drafts of these are on file.

XI Assessment

The scale of the disruption as described above, together with the other modifications that proved necessary, were such as to necessitate an almost complete revision, indeed re-writing of the original Programme. Most significantly:

- Management of the Project had to be arranged from the Singapore office with the local economist plus support staff remaining in Jakarta.
- All short term ex-patriot technical assistance was cancelled
- Assistance to the Supreme Audit Board was scrapped
- Study visits were no longer permitted
- An absence of effectively six months, coupled with a complete change of senior staff in BAF, overuled all of the Reports/seminars planned in the original Task Order.
- Even some of the planned and agreed replacement work e.g. short – term technical assistance support to the MOF Financial Management Reform Committee had to be abandoned.

Although daily contact was maintained, with being only a small Project, there was risk that it could as it were 'disappear'. A great deal of responsibility in Jakarta, fell to the local economist Abinanto to continue the good relationships with Indonesian partners and to keep our presence and profile intact. The fact that the Project did not disappear and that it was welcomed by BAF officials on return, serves to underline the efforts of Abinanto.

This overall assessment in spirit, is little different from that in the previous Project Close Down Report. Working relationships within MOF and elsewhere have been first class and reasonably, could not be bettered. In short, there has been full consolidation and acceptance of the Team and the ready availability of assistance is taken as given.

That said, there is the natural danger of technical support developing into *substitution* for what Indonesians should be doing themselves. In practice it is difficult to avoid some element of such 'deadweight'. Some of the briefing and speech writing requested, falls into this category.

A constraint that provides an incentive for substitution activities is that MOF staff are highly uneven in quality. The small number of good people are overburdened and some of this work falls to ex-patriot and other advisers. Even so, it serves to develop acceptance in the Ministries. But one cannot over emphasise the fact that generic activities of the kind outlined, do not come easily. One does need to remind that foreign advisers often come from institutions that have been engaged in such work for centuries. Young officials in central policy Departments in the UK for example, learn these skills from day one. In a country that is just opening to world of globalised capital markets, it is easy to take for granted what may be commonplace elsewhere.

Turning to *added value*, again one reminds as in the last Report that

" the process of delivering technical assistance designed to improve technical skills and capacity is a slow one, the outcomes are uncertain and the role of osmosis should not be ignored."

Slow immersion is always a possibility; one is never absolutely sure of one's contribution and deliverables are rarely hard and precise. Through the life of the Project, the following in summary, can be scored as either achievements, or 'near to expected ' achievements.

(i) Tax policy analysis has a long way to go but there are clear improvements in MOF's ability to do this work. Indeed, only two ago, in BAF, none was done at all. The cumulative effect of training, both formal and informal has had a seriously beneficial impact.

(ii) Capacity to do macro policy simulations is limited but formal models do now exist and exercises are now being delivered. Again, only a short time ago, only the crudest of numerical accounting calculations with no explanation were provided.

(iii) The forthcoming re-organisation of MOF (with active involvement, and support from BearingPoint advisers), will make a major contribution to the functional efficiency of MOF itself and of the policy process more generally.

(iv) The passing of one of the most significant recent pieces of legislation, namely the State Finance Law and on which the above re-organisation and the budget process rests, has been facilitated by technical assistance and support provided under this and the earlier Project.

Addendum

Following the general recommendations of the Financial Management Reform Committee, as set out in the White *Paper " Reform of the Public Financial Management System in Indonesia: Principles and Strategy* " July 10 2002, a large scale and long awaited structural reform of MOF organization has now been announced.

With support primarily from the World Bank, this initiative from the Indonesian side, has been masterminded almost single handed by Pak Mulia Nasution, the Director General of the Accountancy Agency in MOF. It is from this relative backwater of the disparate MOF, that one of the most important public sector reforms has emerged.

In parallel with the White Paper, Pak Mulia has been associated with three new laws:

the State Finance Law, the State Treasury Law and the State Audit Law, that have either been passed or are in the process of being passed by the Indonesian Parliament. These laws depend for their effectiveness on the re- organization of MOF as announced. The overriding objective is to create a public sector that is more manageable, transparent and accountable than has been the case to date.

From 2004, MOF will have a separate Budget Office, a separate Treasury Department and a separate Macro/Fiscal Policy Office. Each of these will take in functions undertaken currently by a variety of Agencies/DG's under the existing and convoluted structure. As examples, it is envisaged that the central policy parts of both DG Tax and DG Budgets will be moved to the new Macro/Fiscal Policy Office.

Further down the line, there is the likelihood that there will be established a National Debt Office (currently a Debt Management Unit in MOF) and a Financial Services Authority (currently DG Financial Institutions-again in MOF). In due course, these two organizations could well become independent and arms length with Directors accountable to a Minister/Parliament as is the case in a number of countries.

Whilst a number of consequentials remain to be decided, these changes clearly, will bring Indonesia more into line with good international practice. They will also be recognition that in a world of globalised capital markets, floating exchange rates and monetary policy conducted through independent central banks, ministries of finance need to strong. In nearly all countries, Bappenas-style planning institutions are in decline everywhere, or no longer even exist.

Although there remain rearguard defensive actions from powerful vested interests, it is undeniable that Indonesia is now being obliged to follow the world trend. The forthcoming re-organisation of MOF serves as testimony to this fact.