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CLASSIFICATION: Att 1 to App 3B, Ch 3, HB 4 (TM 4:11)

AID 1120-1	AGENCY FOR INTERNATIONAL DEVELOPMENT PROGRAM ASSISTANCE APPROVAL DOCUMENT	1. PAAD NO. 497-T-601A 497-T-601B, 497-T-601C AMENDMENT #1	
PAAD		2. COUNTRY Indonesia	
		3. CATEGORY Budget Support and Related Technical Assistance	
		4. DATE	
5. TO:	The Director, USAID/Indonesia	6. OYS CHANGE NO.	
7. FROM:	Peter Gajewski Chief, Economic Policy Support Office	8. OYS INCREASE	
		TO BE TAKEN FROM: None	
9. APPROVAL REQUESTED FOR COMMITMENT OF:	\$ 20,000,000	10. APPROPRIATION - Appr. 72-1191021 BPC: Q DNA-89-37497-KG-39 C DNA-89-37497-JG-39	
11. TYPE FUNDING	12. LOCAL CURRENCY ARRANGEMENT	13. ESTIMATED DELIVERY PERIOD	14. TRANSACTION ELIGIBILITY DATE
<input type="checkbox"/> LOAN <input checked="" type="checkbox"/> GRANT <input type="checkbox"/> INFORMAL <input type="checkbox"/> FORMAL <input checked="" type="checkbox"/> NONE		N/A	N/A
15. COMMODITIES FINANCED			
N/A			

16. PERMITTED SOURCE	17. ESTIMATED SOURCE
U.S. and Indonesia: \$1,500,000	U.S.: \$1,000,000 (TA)
Limited F.W.:	Industrialized Countries:
Free World:	Local: \$18,500,000 (Budget Support)
Cash:	Other: \$ 500,000 (local TA)
Budget Support \$18,500,000	

18. SUMMARY DESCRIPTION

The Agriculture and Rural Sector Support Program is designed to support policy changes targeted at increasing rural employment and incomes during a critical period in Indonesia's development process. Under the original ARSSP the Government has shown a commitment to policy reform beyond the expectations held at the time the ARSSP was signed, but there remains much to be done. Effective implementation of these reforms and adoption of further measures will be necessary to continue to spur agricultural and rural development.

This amendment proposes to add \$20.0 million of additional DA resources from FY 89 funds to be used in conjunction with approximately \$20 million of PL 480 Title 1 resources to support an agreed new policy agenda until the end of Indonesia Fiscal Year 1991 (March 31, 1992) This amendment proposes to allocate \$18.5 million of the DA funds to budget support of key elements of the Indonesian government whose activities support the design and/or implementation of the policy agenda. The remaining \$1.5 million will be used for technical and related assistance required by the program. This document describes the economic context within which the program will operate, the policy objectives of the program, and the implementation plan for management and oversight of the program.

19. CLEARANCE	DATE	20. ACTION
ARD: MWi <i>MW</i>	8/28/89	<input checked="" type="checkbox"/> APPROVED <input type="checkbox"/> DISAPPROVED
PSD: JWatson JCarroll <i>JW</i>	8/30/89	<i>Daniel N. Merwin</i> 9/1/89 AUTHORIZED SIGNATURE DATE Director TITLE
PPS: GLewis <i>GL</i>	8/30/89	
LA: PScott <i>PS</i>	9/1/89	
FIN: CChristensen <i>CC</i>	8/31/89	

ACTION MEMORANDUM FOR THE DIRECTOR, USAID, INDONESIA

FROM : Peter Gajewski, EPSO



SUBJECT: Agriculture and Rural Sector Support Program (497-0357)
- PAAD amendment No. 1

Action: Your approval is requested to authorize amendment to the Agriculture and Rural Sector Support Program (ARSSP) to provide an additional grant in the amount of \$20.0 million. Authority to amend the program agreement and to increase funding by up to \$20.0 million was redelegated to you by the Assistant Administrator, Bureau for Asia and the Near East in STATE 12356 dated July 1, 1989.

Discussion: The current program completion date for ARSSP is March 31, 1990. This program USAID is providing \$41.5 million in budget support and \$1.5 million in technical assistance to the Government of Indonesia. Budget support has assisted the Government in its efforts to support important policy reform efforts in agricultural diversification and domestic resource mobilization. This support was provided during a time that the Government was operating under a very austere budget regime due to worldwide depression in oil prices.

An interim evaluation of the ARSSP, completed in April 1989, states that: (1) the program had contributed significantly to the GOI's ability to address critical policy issues and (2) the GOI had more than achieved the policy reform targets of the program. The evaluation recommends that the program (1) add additional funds, (2) extend the PACD date, and (3) budget support be more focused on policy objectives and their implementation.

Based on findings and recommendations of the evaluation team (plus guidance from USAID/Washington), specific changes in the program have been negotiated with the GOI. In particular, GOI and USAID agreed to a new policy agenda which represents additional progress towards agricultural diversification and resource mobilization, as well as new items of agricultural trade, regional development, and environmental protection. Program budget applications have been broadly agreed with senior officials of the Ministries of Agriculture, Finance, and Bappenas, following the evaluation guidelines.

A letter of request for this amendment, addressed to you, together with the policy agenda has been received from the Chairman of Bappenas, Dr. Saleh Affif.

Recommendation: That you authorize and approve the Agriculture and Rural Sector Support Program amendment for U.S. fiscal years 1989/90 and 1990/91, which cover Indonesian fiscal years 1990/91 and 1991/92, by signing the attached PAAD facesheet. You are

also requested at the same time to approve the environmental review determination (categorical exclusion) for the amendment, which has been concurred in by the ANE Bureau Environmental Officer, by signing where indicated in Annex 5.

Drafted: M Hammig, EPSO 

Cleared: LARoss, EPSO (draft)
JHradsky, PPS (draft)
PScott, LA (draft)
MWinter, ARD (draft)
JWatson, PSD (draft)
CChristensen, FIN 

GLOSSARY OF TERMS

ARD	-	USAID Agriculture and Rural Development office
ARSSP	-	Agricultural and Rural Sector Support Program
BAPPENAS	-	Indonesian National Development Planning Agency
CDSS	-	Country Development Strategy Statement
CM	-	USAID Contract Management Services
CP	-	Condition Precedent
CY	-	calendar year
DA	-	development assistance
DUP/DIP	-	Indonesian planning budgets for development expenditures
EPSO	-	USAID Economic Policy Support Office
FIN	-	USAID Office of Finance
FY	-	U.S. fiscal year
GDP	-	gross domestic product
GNP	-	gross national product
GOI	-	Government of Indonesia
IFY	-	Indonesian Fiscal Year
IPM	-	Integrated Pest Management
IU+	-	general importer; a license required for importation of certain goods into Indonesia
JCC	-	Joint Career Corps, a means of hiring U.S. university professionals for long-term assignments overseas
LA	-	USAID Legal Advisor
PAAD	-	Program Assistance Approval Document
PACD	-	Program Assistance Completion Date
PC	-	USAID Program Committee
PIL	-	Program Implementation Letter
PIR	-	Program Implementation Review
PSD	-	USAID Private Sector Development office
PPS	-	USAID Program and Project Support Office
Repelita V	-	Government of Indonesia five-year plan number five
TA	-	technical assistance
USAID or AID	-	United States Agency for International Development
USG	-	United States Government

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I. SUMMARY AND RECOMMENDATIONS

A. Program Title:

Agriculture and Rural Sector Support Program (ARSSP)

B. Assistance Proposed:

FY89 DA Section 103 Authorization : \$20.0 million
Total : \$20.0 million

GOI Contribution to Program
FY89 PL 480 Title I : \$ 5.0 million
FY90 PL 480 Title I : (\$10.0 - \$20.0 million)
Grand Total : \$35.0 - \$45.0 million
=====

C. Period of Implementation:

The \$18.5 million budget support component of the program will be implemented during Indonesian Fiscal Years 1990/91 and 1991/92, from April 1, 1990 through March 31, 1992. The \$1.5 million technical assistance component will be implemented from April 1, 1990 through December 31, 1992.

D. Summary Program Description:

This amendment will extend the ARSSP for two years. Experience so far has shown that substantive policy progress in Indonesia has been achieved and that USAID's budget support contribution under the ARSSP has contributed positively to the Indonesian Government's ability to carry on development activities considered crucial during a time of considerable fiscal hardship. This amendment will, therefore, extend the ARSSP for an additional two years. Specific elements of the ARSSP are being modified in the amendment in accordance with our experience so far and the recommendations of the interim evaluation completed in March 1989.

Fundamental changes in the ARSSP include a new policy agenda which differs from the original agenda in that agenda items which have been achieved or considered to be of lesser importance have been deleted while new items are added that represent important avenues of future policy action. Some objectives of the original agenda which have not been fully achieved, or where implementation is incomplete but considered critical, are kept in the new agenda. The new agenda recognizes the significant steps that have been taken by the GOI since the inception of the ARSSP, and proposes to continue the momentum of policy reform that currently exists in Indonesia.

The second major change in the ARSSP involves greater targeting of budget support. The evaluation revealed that budget support under the ARSSP had its greatest impact when funds were allocated to GOI agencies involved in activities that were directly related to the design, implementation, and/or analysis of policy change. Therefore, budget support will be focused, to the

extent possible, on agencies of the Ministries of Agriculture and Finance, BAPPENAS, and the Central Bureau of Statistics having direct responsibility for the design, implementation, and/or analyses of policies cited on the amendment agenda.

The third major change in the ARSSP relates to program management. Because of GOI budgeting procedures that preclude the comingling of ARSSP and GOI Development Budget funds, and require detailed accounting to end use for both GOI and donor funds, expenditures of funds provided under ARSSP are identified by GOI with specific uses while funds provided under ARSSP are intended by AID as general budget support and are not required or intended by AID to be tied to specific end uses (except for the TA component of the program). There is a risk therefore that ARSSP funds could be identified by GOI with activities or procurements that AID does not wish to have itself associated with for important policy reasons. Therefore, procedures have been instituted to ensure that ARSSP funds are not identified by GOI with activities which AID would be prohibited from financing for important legal and policy reasons if this were a project assistance activity. Special monitoring systems are established to verify that such expenditures are not made.

Further management issues involve the monitoring of policy progress and the impact of budget support. Procedures are established and responsibilities delineated for day-to-day program management within USAID and for periodic higher-level reviews by relevant officials of USAID and the GOI.

E. Statutory Checklist

The statutory checklist is contained in Annex 2.

F. Recommendations

It is recommended that this amendment to the ARSSP Program authorizing an additional \$20.0 million of FY89 Development Assistance funds for this program be approved.

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II. MACROECONOMIC OVERVIEW

Indonesia's economy has experienced major external shocks since 1981 caused by the deep decline in the price of oil and unfavorable international currency fluctuations. To contain the internal effects of these shocks, the government implemented a strong stabilization program. The government also introduced many far-reaching structural reforms to reduce the economy's dependence on oil and to position it well for sustained growth into the future.

The principal stabilization policies included several significant devaluations of the rupiah and the maintenance of a free foreign exchange regime a revised interest rate policy which compensates for devaluation and maintains (or exceeds) interest earning parity with earnings obtainable for hard currency deposits; and a tight fiscal policy which reduces government expenditures while increasing revenues. The results of these actions have been a containment of aggregate demand commensurate with the decline in foreign exchange availabilities. Inflation has been reduced from 15.3 percent during 1973-1981 to 8.4 percent from 1981-1988 despite the effects of devaluation and high rates of interest on domestic prices.

Equally impressive measures were taken to adjust the structure of the economy away from its heavy dependence on oil exports. In addition to the adjustment effects inherent in the stabilization policies, the government has substantially improved its investment and trade regime and deepened capital markets. Non-tariff barriers have been reduced, investment procedures have been simplified and an array of new financial instruments has been introduced.

The economy's response to these measures has been impressive. Since 1981/1982, non-oil exports have grown at an average annual rate of 47.9 percent, jumping from 18.3 percent of total exports to 52.5 percent in 1987/1988. They are projected to grow an additional 27 percent this year to reach 61 percent of exports. At this level, non-oil exports will finance 90.3 percent of non-oil imports -- a dramatic change from 1981/1982 when non-oil exports financed only 28.8 percent of non-oil imports. On the GOI annual budget, dependence on oil exports for revenues has declined from 70.7 percent in 1982/1982 to an estimated 41.3 percent in 1988/1989.

Structural change is also reflected in increased private sector activity and improved efficiency in the economy. The private sector more than compensated for the decline in public investment so that total fixed investment grew slightly from 1981/1982 to 1988/1989. Private fixed investment as a percentage of total fixed investment has increased from 52.1 percent in 1981/1982 to 56.9 percent in 1988/1989. The average rate of return on investment has increased from 13.1 percent in 1982-1985 to 21.9 percent in 1986-1988.¹ During the same period the incremental capital output ratio

1. The average rate of return on investment is calculated by the IBRD as the rate of growth of non-oil GDP as a percentage of the average investment during the period.

declined from 7.8 to 5.2 and total factor productivity rose from -2.5 to 1.0.².

The profound change is best summarized by the overall growth performance of the economy during this period of oil price decline and unfavorable international currency fluctuations. Since 1981, GNP has averaged a positive real growth of 3.3 percent per year, reaching an estimated 4.7 percent in 1988. Per capita GNP growth has also been positive reaching 2.7 percent in 1988. Throughout the period, government policy has promoted this level of performance while maintaining current on its large external debt service payments.

Despite these impressive results, at least three interrelated aspects of the economy warrant attention and appropriate policy action.— Those areas are: 1) the agricultural sector, 2) income distribution, and 3) the savings rate. Agriculture's contribution to GNP in 1987 was 23.4 percent (in constant 1983 prices). However, this sector provided the principal employment to about 54.5 percent of the work force. While the percentage of the work force in agriculture has remained essentially stable since 1980, the sector's growth, averaging 2.9 percent per year, has been less than the economy's growth of 3.3 percent. Consequently, average earnings in agriculture, which were well below average earnings for non-agricultural employment in 1980, actually declined relative to non-agricultural earnings by 1987. In constant 1983 rupiahs, the average income of workers whose principal employment was agriculture declined from 26.9 percent of non-agricultural income in 1980 to 25.6 percent in 1987. In part, this is due to sluggish performance in some non-agricultural activities which, in other economies, help raise agricultural incomes by drawing away surplus agricultural labor. However, the slow growth of the agriculture sector itself is also a contributing factor.

The problem of the slow growth in agriculture reflects the government's slow progress in extending deregulation reforms to agricultural production and trade. Rice production is still the principal focus of government attention in terms of inputs, credit and extension to ensure the goal of rice self-sufficiency. Rice production is subsidized via these inputs. Most of the principal agricultural imports are still managed by the government or private monopolies. Many of the inputs used in agro-industries are constrained so that prices are considerably above those for similar inputs in competing and neighboring countries. These policies, in addition to constraining the growth potential of the sector, also foster the conditions which promote the disparities in income between agriculture and non-agriculture employment.

As noted above, income disparities also arise from conditions in other sectors of the economy. While per capita income has increased since 1981,

2. Incremental capital-output ratio is net investment divided by the increase in output during the period. Total factor productivity is calculated by the IBRD as the difference between the growth of value added and the growth of labor and capital (weighted by their income shares).

average real income per worker has declined as the labor force has grown faster than the population and GNP. Labor force data, when compared with GNP by sector of origin, suggest that in addition to agriculture, a deterioration of income per worker is occurring in sectors such as construction and wholesale/retail trade. These sectors showed the highest growth of employment. Because of the relatively low skill level required for entry, income per worker reflects a crowding effect in these sectors attributable to an influx of workers unable to find employment in higher skill sectors.

Income distribution problems arising from slow growth in the agriculture sector and the abundance of workers in low skill sectors make it particularly difficult to raise the economy's savings rate despite the attractiveness of interest rates on savings. The consumption requirements of the relatively large number of low paid workers with stagnating incomes requires an extraordinarily high savings rate among high income earners and the government in order to achieve the desired level of national savings. Given the difficulty experienced in the economy since 1981, as well as the fact that the economy is still experiencing difficulties, the private sector may be acting too cautiously in terms of accumulating savings in Indonesia. Similarly, the government, in trying to minimize the impact of the reform, may have been too cautious in the past about revenue raising measures to increase public savings. Since 1984, private sector savings have risen from 11.8 percent of GNP to 13.8 percent in 1988. Public sector savings have risen from 4.9 percent in 1986 to 6 percent in 1988. However, neither savings rate has reached the levels attained in 1981 (18.6 percent and 9.2 percent for private and public respectively).

The importance of increasing domestic savings arises because domestic investment, necessary for economic growth, exceeds domestic savings (by 2.4 percent in 1988). To avoid an increase in foreign debt, the economy will need to close the domestic investment-savings gap. At the current rate of investment, domestic savings should rise to 22.2 percent of GNP. It needs to be raised above this level in order to finance a larger investment effort and stimulate greater growth. The GOI has recently launched a major effort to increase domestic tax revenues as one means of reaching this objective.

The combination of the slow pace of reform in agriculture and a low rate of domestic savings, particularly in the public sector, is seriously retarding the overall improvement in economic conditions. The pace of reform in these areas relative to the macro-economic and financial sector reforms should be increased to improve the sectoral balance in economic growth and reduce the problem of income disparities.

Equally important, additional measures are needed in agriculture and resource mobilization to help reduce the dependence of the development budget on external donor resources. In 1981, at the height of the oil boom, government revenues were 175 percent of routine expenditures and financed 75 percent of the development budget. In 1989, government revenues were 108 percent of routine expenditures and financed only 14 percent of the development budget. This change is not only due to the loss of oil revenues but also to the dramatic growth of debt service in the routine budget. In 1981, debt service payments were 13.1 percent of the routine budget. However,

by 1989, while the budget had grown 230 percent, debt service payments grew to 51.6 percent of routine expenditures. Indonesia's debt arises from the substantial amount of donor loans financing the development budget and the revaluation in non-dollar denominated foreign currency loans due to the devaluation of the dollar against other hard currencies.

The GOI is concerned about these areas and has expressed its intention to introduce corrective measures during the new five year plan (Repelita V). The ARSSP amendment, which has been carefully negotiated with the government, reflects a set of policy reforms in the areas of agricultural diversification, agricultural trade, resource mobilization, investment and environmental protection which relate specifically to these problems.

III. ARSSP BACKGROUND AND RESULTS TO DATE

The ARSSP was developed as a sector assistance program to support the development and implementation of important policy reforms related to diversification of agriculture and domestic resource mobilization. The ARSSP was approved in the context of a larger donor effort to provide Indonesia with an exceptional level of resources -- primarily for balance of payments and budget support -- necessitated by Indonesia's resource shortfall as a result of the collapse in the price of oil and other adverse external shocks to the economy. For its part, the government of Indonesia has used these exceptional donor resources to support and moderate the effects of its program to adjust the structure of the economy away from its heavy dependency on oil exports.

Initially, the government's reform program has concentrated on financial deregulations and reforms designed to stimulate the banking and industrial sectors. The ARSSP has provided the vehicle for in-depth policy analysis and dialogue between the government and USAID on agricultural diversification and domestic resource mobilization. ARSSP resources have directly supported policy reform by financing consultants and studies. Program resources have also indirectly supported the policy reform agenda by providing essential budgetary support to key government ministries and agencies related to the program's objectives.

The ARSSP program creates a relationship between USAID and parts of the GOI through which AID can lend its support to implementing specific key aspects of the GOI's overall policy reform program. The basic premise of this program approach is that AID can use its resources most effectively to achieve the broad reaching improvements in the overall policy framework by focussing on a finite set of critical measures that require implementation, and associating AID resources on the process. Specifically, it means identifying objectives in critical areas, collaborating -through studies, analysis, dialogue - with relevant GOI entities, and providing associated budget support to help sustain the effort and strengthen the relationship between AID and the relevant parties. Over time the relationship results in increased attention being focussed on the problem, and increases the chances for a significant favorable conclusion more effectively and quickly than would otherwise have been the case.

The ARSSP, which was signed in August 1987, authorized \$43 million in grant funds over a two and one-half year period. Of this \$43 million, up to \$1.5 million of ARSSP resources was allocated to finance technical assistance, with the remainder allocated to budget support. The current PACD of ARSSP is March 31, 1990 (The PACD for the technical assistance component of the program is November 30, 1990). The policy reform and budget support effort under ARSSP was also supplemented with additional budget support of \$22.815 million in local currency generations from Indonesia's P.L. 480 Title I program. This represents a grand total of \$65.815 million of USG resources which were attributed to the original ARSSP.

An interim evaluation of the ARSSP program in February 1989 determined that ARSSP is an important and useful means of assisting the GOI to advance its policy reform agenda and the program can provide quick disbursing

budgetary support during a period of revenue shortfalls and adjustments in the Indonesian economy. The evaluation concluded that overall performance on the ARSSP policy agenda surpassed expectations for this point in the program, with progress toward pesticide and fertilizer subsidy reductions, transport deregulation and banking reform being especially noteworthy. While progress in other areas was mixed, the "menu" approach of the agenda allowed for flexibility in specific achievements, as long as overall performance was judged adequate.

The evaluation team also recommended improvements for this amendment. These included recommendations that the amendment agenda be more focused on key areas of policy concern and based on greater degree of analyses up front. However, individual agenda items (sub-objectives) could be less tightly structured and based on levels of specificity more acceptable to the GOI. That is, the major objectives of policy reforms will be clearly defined, but the measures required to achieve those objectives will be described in general terms amenable to the political realities of the policy reform process.

The evaluation found that budget support was more productive when AID targeted its resources toward areas more directly supporting the policy agenda. It consequently recommended that the amended program more consciously focus on supporting GOI agencies involved with activities that directly pertain to the objectives of the program. The evaluation further noted that the additionality approach under ARSSP was not productive and that overall, the staff requirements to manage ARSSP were more than expected.

In its conclusion, the evaluation team recommended continued AID support in the area of policy reform for agriculture and finance because of: (1) the demonstrated sincerity of the GOI to forge ahead with reform, (2) the continuing severe external economic environment necessitating rapid adjustment, and (3) the continuing need to reform policy in order to eliminate disincentives to efficient growth and development. Finally, the team proposed increasing the funds under ARSSP and extending the PACD.

IV. ROLE OF THE ARSSP AMENDMENT

As noted in Sections II and III, Indonesia's policy performance has been very good over the past several years, but continuing reform is needed in agriculture and domestic resource mobilization to improve the balance in the economic restructuring process. ARSSP has played an important role in supporting this process at the sectoral level to date and can continue to play a substantive role over the short to medium term. This amendment accordingly proposes to add \$20.0 million of additional DA resources in FY 89 to be used in conjunction with approximately \$5 million of PL 480 Title I resources in FY 89 and all PL 480 Title I resources in FY 90 (estimated to be \$10 - \$20 million) to support an agreed policy agenda until the end of Indonesian Fiscal Year 1991 (March 31, 1992).

This amendment provides the opportunity to reinforce the ARSSP conceptual approach to development in its provision of flexible program resources in support of important policy reforms. The benefits of more traditional project interventions in ARSSP's areas of interest would be reduced in the present policy environment. In agriculture, gains to farmers, agricultural laborers, agro-processors and traders depend importantly on the government's willingness to further relax its controls and support of monopolistic practices. The detailed central planning approach in agriculture which has directed research, extension, input availability and credit to rice self-sufficiency must give way to alternative, market-based systems which achieve government policy objectives with less distortion in the prices and programs affecting individual producers. Similarly, in domestic resource mobilization, gains now depend on policy changes which make the revenue system more efficient, which permit the private sector to be more active in the provision of social services and which decentralize substantive elements of the fiscal system. Growth in direct private investment, particularly in agro-processing industries, is restrained more by policy constraints than by a lack of programs or facilities which could be addressed by more traditional projectized assistance.

This amendment to ARSSP additionally permits AID to build on the policy success of the original project by deepening the policy dialogue in agricultural trade and natural resource management. Achieving the objectives of more open and competitive trade in agricultural commodities requires that certain key commodity transactions which now occur in restrictive markets be permitted to occur in a more competitive environment. However, the ARSSP process of technical study and policy dialogue can permit the government to substantively review its policies affecting trade in other agricultural commodities.

Sustaining a more diverse agricultural system also requires urgent attention to environmental policies and natural resource management. Not only is there a need for specific measures to insure more sustainable agricultural systems, but attention must be given to control of industrial pollution and hazardous waste disposal. Including this policy element in ARSSP provides a link between the need to protect the environment and production and productivity gains in agriculture. As a result of these measures, resources

are more wisely managed.

The ARSSP amendment also provides USAID with the opportunity to refine selected features of the original ARSSP design. In particular, Indonesia's budgeting procedures require that all foreign assistance to the development budget be separated and tracked to its final use. This circumstance was not fully known at the start of the ARSSP. Moreover, the recent ARSSP evaluation found that the government was specifically identifying ARSSP funds with certain expenditures which AID might not ordinarily finance. As a result of further discussions with the government, the government agreed that ARSSP funds would not be used to pay the costs of certain items included on an agreed "negative" list. 1.

While the concept of budget support is retained in this amendment, the separate handling of ARSSP funds by the government and the need to monitor the list of ineligible items requires a greater degree of AID monitoring of ARSSP funds than that envisioned in the original PAAD. This amendment establishes the appropriate systems for funds accountability within the context of program budget support. While the new system (described in detail in Section VII Financial Plan) requires more AID staff involvement in fiscal oversight and accountability, our involvement does not approach the level required by a project mode of assistance.

A second refinement of the ARSSP approach incorporated in this amendment is an improvement in the linkage between the policy agenda and the budget support. Under the original program, budget support to a particular element of a ministry was determined primarily on the basis of the needs of an individual ministerial department in reaching its program or institutional objectives. Thus, the linkage between the ministerial departments receiving budget support and the policy agenda was usually indirect. Under this amendment, an effort will be made, where possible, to provide budget support to those units in the government having specific responsibility to formulate or implement the policy agenda of ARSSP.

USAID will seek to ensure that ARSSP funds are thus "targetted" to government agencies whose activities are directly related to the ARSSP policy agenda. Programming of actual expenditures of ARSSP budget support within those agencies will continue to be the responsibility of the GOI.

USAID responsibility for programming of ARSSP expenditures does not devolve below the agency level.

The Mission carefully considered alternative approaches for providing budget support before choosing the more targeted approach and, by necessity,

1. Through PIL no. 9 dated March 1, 1989, USAID provided the GOI with a list of items which should not be identified with funding provided under ARSSP. This list includes procurements or activities which, if financed under AID project assistance procedures, would be ineligible for AID financing for legal or policy reasons. The GOI has agreed not to identify ARSSP funding with such uses.

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the continued application of the negative list to the use of ARSSP funds. These included a search for opportunities to comingle ARSSP funds with government resources so that there was no further involvement in tracking uses below the budget level. Also, consideration was given to the development of a "positive" list which would allow ARSSP funds to be used for specifically identified uses which would present no financing ineligibility issues. These options all involved provision of ARSSP budget support to the routine budget. It was found in each case that a movement away from targeting budget support to those units responsible for the policy agenda decreases, to various degrees, the AID program management burden. However, the alternatives also decreased the likelihood that the ARSSP program goals would be achieved because the Indonesian budgeting process can not assure that the government entities related to the policy agenda will get the necessary GOI resources if ARSSP funds are channelled elsewhere in the budget. The Indonesia budget development process is too complicated to guarantee that fungibility would work in favor of achieving program goals.

AID's participation in programming budget support to selected units responsible for the policy agenda will require greater staff management responsibility. However, as noted in the ARSSP evaluation, this approach increases the likelihood that the policies will be formulated and implemented as planned. Furthermore, this approach is the only effective substitute for policy conditionality -- a concept not acceptable to the GOI.

V. PROGRAM DESCRIPTION AND ANALYSIS

The ARSSP consists of three interrelated components -- the policy agenda, budget support and technical assistance. The heart of the program is the policy agenda. Its formulation, negotiation and implementation yield the economic benefits to Indonesia expected from the program. Success in the policy agenda component is made possible because of the commitment of the government to economic reform in general and to the ARSSP policy concerns in particular. However, success is also made possible because ARSSP provides resources to the budgets of elements of the government responsible for formulating, implementing and supporting the specific policy reforms contained in the ARSSP agenda. Furthermore, the inputs financed under the technical assistance component are organized so as to help direct and manage the ARSSP process to achieve its objectives.

The technical assistance component is distinguished from the budget support component by its projectized approach to assistance. AID and the GOI have agreed to projectize the technical assistance component because its activities relate directly to the provision of essential inputs needed for ARSSP development, management and oversight. This contrasts with the budget support component which augments the resources of government entities whose general functions contribute to ARSSP objectives. Consequently, under the budget support component, AID is not involved in the determination of which inputs these entities should procure to carry out their function. Rather, AID's objective is to be sure that these entities have sufficient resources so that their functions are adequately performed.

A. The Policy Agenda

The policy agenda consists of five broad objectives, with sets of more specific sub-objectives for each as appropriate. These five objectives represent areas of policy concern that are consistent with the general guidelines of the Indonesian 5-year plan (Repelita V). They also represent areas of particular interest to USAID. The policy reforms included in this agenda would contribute substantially toward the development process in Indonesia.

The policy agenda is deliberately ambitious and represents a significant further advancement of agriculture and domestic resource mobilization policy objectives that began under ARSSP in 1987. The agenda also introduces new policy initiatives in agricultural trade and natural resources. The analytical basis for the agricultural and resource mobilization agenda is well established stemming from substantial USAID involvement at the project level as well as the special amendment analysis. The new initiatives are derived from more recent analytical work by consultants and staff in conjunction with AID's burgeoning interest and focus on trade, natural resource and environmental management. Substantial progress in the policy areas of agricultural diversification, resource mobilization, financial markets and natural resources should be possible during this amendment due, in part, to the historical and institutional linkages between AID and the GOI. We expect that a substantial proportion of the policy sub-objectives will be achieved during the 2-year life of the ARSSP amendment. Progress in the proposed new

area of agricultural commodity trade is more problematic. The amendment proposes to add the new area of trade, however, because of its importance to the structural adjustment program, the need to stimulate agro-processing industries and AID's emphasis on expanded private sector involvement in trade. At a minimum ARSSP will provide a mechanism to initiate substantive dialogue regarding trade policy issues as the Mission pursues development of other project/program interventions.

USAID and the government plan to carefully monitor the implementation of the policy agenda through a series of detailed benchmarks. These benchmarks will be finalized prior to the disbursement of funds under this amendment and will constitute the primary basis for USAID's quarterly and final evaluation of the ARSSP's policy achievements.

The following is a general presentation and discussion of the policy objectives and sub-objectives:

Policy Objective no. 1. Diversify agricultural production taking advantage of regional comparative advantage and promoting development of related agro-industries.

The Government of Indonesia will continue to focus its agricultural policy on three principal objectives: 1) to maintain rice self-sufficiency; 2) to further diversify the sector to accommodate self-sufficiency objectives in other agricultural products and to take advantage of new market opportunities, and 3) to promote non-oil exports. The diversification process includes both vertical and horizontal elements. Vertically, stimulation of growth of agro-processing and other agro-industrial activities will provide significant employment and income generating opportunities for rural areas. Horizontally, production of crops other than rice often provide greater returns and require more labor input. Since demand for secondary crops is increasing rapidly, crop diversification will increase employment in rural areas, provide farmers with increased profit opportunities, and offer consumers a broader variety of foodstuffs.

[USAID Mission monitoring responsibility for this objective will be assigned to the Agriculture and Rural Development Office.]

Policy sub-objectives:

1.1 Align agricultural policy instruments so that farmers receive appropriate market signals to capitalize on natural comparative advantage.

To promote the diversification goal of Indonesian agricultural policy, comparative advantage must play an important role. The Government's program to encourage diversification includes the following activities: 1) to review existing pricing policies to ensure that price incentives are consistent with development goals; 2) strengthen extension services and research linkages to provide technical assistance on a wider range of production alternatives; and 3) identify and begin eliminating constraints that hinder or prevent farmer access to credit, technology, extension services, and other factors that prevent farmers from diversifying their production.

1.2 Implement the integrated pest management program for rice and extend it to include other crops.

The government removed all subsidies on agricultural pesticides on January 1, 1989. Farmers and extension personnel require extensive training in integrated pest management (IPM) practices to compensate for increased pesticide cost and to promote more environmentally sound production practices. The important objective of IPM is to reduce health hazards while maintaining high crop yield potential. The Government of Indonesia has embarked on a very ambitious program to train farmers in IPM techniques. This program has been successfully begun, but there remains much to accomplish before the task is complete.

1.3 Produce, distribute, and utilize fertilizers efficiently.

Fertilizer is an essential farm production input. The Government has encouraged the growth of fertilizer production facilities, and it has assisted in the distribution of fertilizer to farmers. Final use of fertilizer is partially based on recommendations from Government extension workers. Fertilizer production facilities vary widely in their ability to produce fertilizer economically. Costs of distributing fertilizers need to be reduced. There is evidence that officially recommended fertilizer use levels are too high for some nutrients in some regions. The Government is committed to seeking ways to increase efficiency at all levels of the fertilizer production, distribution and farm use systems.

1.4 Broaden the national mandate of Agricultural Research Centers to be more responsive to regional needs and introduce a system of direct outreach from research stations to regional extension centers and farmers.

It is important that agricultural inputs be adapted to differences in agro-ecological zones to better meet national food production goals. Crop varieties and production practices must be adjusted to account for differences in soils, climatic conditions and farming systems to maximize output. With limited resources and diverse ecological conditions, a program that focuses on regional needs rather than national requirements will be more effective in increasing outputs and incomes, and thus promote the diversification and self-sufficiency goals simultaneously. It is important that the Government sustain at least the scale of research effort necessary to maintain adequate levels of output. Furthermore, it is imperative that research results be made available more readily and rapidly to farmers and that researchers are working to solve farmer problems. An expanded outreach program including demonstration plots, will result in a closer working relationship among researchers, extension workers, and local farmers, and consequently promote more effective dissemination of information.

1.5 Review the implementation of the shipping deregulation reforms of November 1988.

Reforms that will significantly change the system of inter-island shipping in Indonesia were formally announced in November 1988. While a number have been implemented, several institutional factors have prevented full implementation. Completion of these reforms will significantly reduce

inter-island transport costs through greater efficiency and the entry of more competition. Thus, new opportunities will be opened to agriculture, agro-industrial development, and other commercial activities.

1.6. Take advantage of new market opportunities in fruit crops by encouraging investment opportunities in small plantations.

Indonesia must become more efficient in the production of tree crops to compete with neighboring countries. Medium size units will be much more competitive than the very small fruit farms typical of Indonesia. A number of these larger estates in an area can provide a large enough supply of the desired varieties and quality to facilitate entry into international markets. However, financing of these types of estates will continue to be a problem. More financial institutions need to recognize that the financing plan must include a grace period to allow trees to reach a productive stage; the payback period should be sufficiently long to permit adequate cash flow; and banks should allow a relatively low initial equity holding by investors.

Policy Objective no. 2. Increase the efficiency and competitiveness of Indonesian international agricultural trade.

Indonesia is a large agricultural trader. Agricultural imports in 1987 totaled nearly US\$ 1.2 billion, while exports amounted to nearly US\$ 6.0 billion. Indonesian trade in agricultural products has been controlled through a system of import, export, and distribution licenses. Recent reforms have begun to shift some of these licensing restrictions to a freer system of control through tariffs. By continuing its efforts toward agricultural trade deregulation, the Government of Indonesia can greatly increase the competitiveness and efficiency of this sector, and thereby lower consumer food prices and stimulate growth of trade-oriented agro-businesses.

[USAID Mission monitoring responsibility for this objective will be assigned to the Economic Policy Support Office.]

Policy sub-objectives:

2.1 Lower import tariffs and surcharges on selected imported agricultural products.

Nearly 85 percent of the agricultural items whose import comes under the IU+ license are subject to import duties and surcharges over 25 percent. This has led to a significant amount of smuggling activity and resulting loss of government revenue. Cutting tariffs to lower levels will likely increase trade, lower consumer costs, and raise government revenue.

2.2 Encourage higher quality plantation crops from both government plantations and small holders.

Prices received by Indonesian farmers for plantation crops are generally lower than prices received by competitors in neighboring countries. These low prices are related to lower quality products. Although there is a market for low quality products, significant opportunities exist for value-added gains

from producing for higher quality markets. A system of marketing, education, and credit that will promote higher quality production of plantation of crops is needed. The marketing and pricing system needs to fully reflect premiums for quality. Competition among buyers is one way to help promote quality premiums as well as overall higher prices.

2.3 Establish a more effective relationship between trade associations and relevant government agencies to promote the export of Indonesian agricultural products.

The group best able to promote the export of a commodity is always the group responsible for its manufacture. However, producers often lack the resources or training necessary for effective promotion. Until producer organizations become strong enough to represent themselves off-shore, government commercial representatives can provide outreach to potential markets. By formalizing a relationship between official Government representation in foreign countries and domestic commercial export interests, the job of promoting export products can be made much easier. Very large benefits stand to be gained from more effective promotion in the very competitive world food markets.

Policy Objective no. 3. Mobilize public resources and effectively apply them at regional and local levels.

Domestic revenues are currently inadequate to cover development expenditures. Therefore, Indonesia has been borrowing externally to finance critical development activities. Borrowing of this magnitude is clearly not sustainable over the medium term. To address this issue the Government has begun a concerted effort to increase public revenues. Domestic public sector revenues must continue to be increased and more effectively spent. Privatizing some local and centrally provided public services would also help generate cost savings.

[USAID Mission monitoring responsibility for this objective will be assigned to the Private Sector Development and Economic Policy Support Office.]

Policy sub-objectives:

3.1 Continue to increase tax revenues through more effective and more equitable means. Accelerate the tax "post audits" program.

Personal income tax collections have increased steadily over the past few years. Experts contend that continued aggressive collection efforts will significantly increase these revenues in the future. As this process evolves it is important to ensure that the tax burden is equitably spread across all income groups.

3.2 Periodically review new sources of revenue for local governments and discourage them from current "ad hoc" taxing practices.

Local governments sometimes enhance their revenues by instituting various forms of local taxes. The forms of these taxes vary across the country.

Local governments should be given uniform taxing authority that will provide needed revenue on a consistent basis.

3.3 Accelerate the program of private sector participation in providing public services.

Considerable cost savings and more efficient service provision can be obtained in many instances by privatization of many services currently provided by public institutions. In some cases the services could be turned over entirely to private businesses; in other cases new partnerships between public and private interests could be mutually beneficial.

3.4 Improve the effectiveness of resource transfer programs from the central government to the regions and local governments.

During Repelita V, Rp. 21.4 trillion is allocated for providing regional government services. This is 20 percent of public development funds. However, regional authorities currently have little say over how funds are obtained or for what purposes regional funds are spent. While the central government must maintain adequate safeguards, public funds will be used more efficiently to respond to the needs of regional constituencies by giving regional authorities more responsibility over collection and expenditure of public revenues.

Policy Objective no. 4. Increase total investment in Indonesia, particularly off-Java, through accelerated implementation of financial deregulations to meet Repelita V targets, generate income growth and employment.

To sustain economic growth in Indonesia after the end of Repelita V without special assistance from foreign donors, private investment will have to continue to provide at least half of total investment during the period 1988-1993. This will be difficult to achieve unless financial, trade, and investment deregulation continues at an accelerated pace. Many financial market deregulation measures have already been announced. The urgent task ahead is to implement them in an effective manner.

[USAID Mission monitoring responsibility for this objective will be assigned to the Private Sector Development Office.]

Policy sub-objectives:

4.1 Sustain financial deregulation efforts which impact on rural areas and the informal sector of the economy.

Faster implementation will spur investment and employment. The combination of trade, investment, and financial deregulations lays the groundwork for opening up economic activities throughout Indonesia. Expanded economic activity in a wider variety of sectors of the economy will further reduce reliance on the oil sector, broaden the scope of employment opportunities available to the growing work force, provide alternatives to

agriculture for rural workers, and increase incomes of the rural poor.

4.2 Increase the rate of growth of foreign investment in Indonesia.

To achieve the needed increase in private investment, Indonesia must attract investment from foreign as well as domestic sources. Large amounts of foreign capital are available. Given a favorable investment environment, private foreign capital can contribute effectively to promote Indonesian economic development.

Policy Objective no. 5. Develop appropriate policy approaches to assure that environmental and natural resources are managed wisely to sustain the economic development process.

For the past two decades Indonesia has achieved an impressive rate of economic development, largely through the exploitation of its abundant petroleum, forest, agricultural, fishery and other valuable natural resources. While this strategy has resulted in high growth rates, it has also meant that natural resource systems have been depleted. Although future economic growth will increasingly be dependent on the gradual expansion of industry to serve both domestic and international markets, natural resources will continue to play an important part in the development strategy. At present, over 40 percent of GDP and 50 percent of employment are derived from primary sectors, not including the considerable and growing contributions attributable to the downstream processing of natural resources or the indirect effects on tourism and other closely related sectors. It is very important that the Government adopt wise policies to sustain the productivity of the natural resource base.

[USAID Mission monitoring responsibility for this objective will be assigned to the Agriculture and Rural Development Office.]

Policy sub-objective:

5.1. Strengthen the ability to systematically analyze agricultural policies and projects from the standpoint of their economic and ecological viability and sustainability.

There is an urgent need for government agencies to broaden the scope of policy formulation and analyses to include environmental concerns. The balance between economic growth and environmental quality is very important in Indonesia. To maintain this balance, it is essential that agricultural development policies be particularly sensitive to issues of resource management and sustainability. These emerging policy issues are often not amenable to the single commodity and standardized approaches of the past. They are more closely linked to the broad perspective of Indonesia's diverse resources and environmental conditions. Projects and policy programs must be studied from the perspective of their potential impact on long-run productivity levels. Particular attention should be paid to the impact on the natural resource base of land clearing methods, cultivation practices, chemical input use, use of fragile lands, and processing facilities and their disposal of waste products.

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5.2 Consolidate the authority and responsibility for pollution and hazardous waste control and monitoring within an appropriate system.

There are a growing number of costly environmental problems associated with the improper treatment and handling of wastes and toxic substances. Responsibility for monitoring pollution and hazardous wastes is fragmented among many agencies hindering efforts to assess the magnitude of these problems. Authority for the establishment of standards, regulations, and incentives for compliance is also scattered among several government bodies. As the industrialization process accelerates in Indonesia, it will become increasingly important that an effective government organizational structure is in place to ensure that the risks to human health and natural systems are not excessive.

B. Budget Support

The budget support component of ARSSP is designed to meet several essential needs. The most important purpose is to insure that units and activities within the government of Indonesia responsible for formulating or implementing ARSSP policy objectives receive adequate funding to effectively carry out their work. Examples of such units which conduct activities directly related to the ARSSP policy agenda are the Office of the Secretary General of the Ministry of Agriculture, the Director General for Taxation in the Ministry of Finance and elements of BAPPENAS responsible for agriculture policy. The ARSSP evaluation noted that the effectiveness of ARSSP's support could be improved by strengthening the linkage between budget support and policy and institutional reform measures.

The second purpose of budget support is to augment the resources of units whose works have become more essential for sectoral growth and improved efficiency because of the new policy environment. For example, the elimination of the pesticide subsidy has created the prerequisite policy environment for successful implementation of an Integrated Pest Management program. ARSSP budget support to government agencies implementing IPM helps to insure that that program is adequately developed to meet the need created by the policy reform. Similarly, the objective of diversification in agriculture places a new burden on the resources of those agencies engaged in agriculture research and extension as the policy environment in agriculture shifts toward a market-based orientation.

The third purpose of budget support is to maintain the attention of ARSSP managers in USAID and the GOI on the policy agenda. The process of negotiating the allocation of budget support focuses attention on the relationship between policy priorities and budget priorities. The actual provision of budget support helps realign budget priorities in support of the policy agenda during a time when the government of Indonesia has very limited flexibility in the use of its own resources because of the unavoidable demands of the routine budget.

The GOI schedule for preparing its FY90 budget requires that the development budgets of individual units within the government be formulated in November and December 1989 and finalized by February and March, 1990. ARSSP

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resources which form a part of the government's development budgets are programmed as part of the normal GOI DUP/DIP budget procedures (described in the original PAAD). The final budget detail will be negotiated and agreed to by PIL in early CY 1990. However, USAID intends to provide budget support to help finance programs within the Ministry of Agriculture, the Ministry of Finance, the Central Bureau of Statistics and BAPPENAS.

Under the Ministry of Agriculture, USAID plans to continue budget support for the Office of the Director General because of the specific responsibility this office has for policy formulation. USAID will also consider the budgetary needs and absorptive capacity of activities carried out by the Agency for Agriculture Research and Development. It should be noted that the government-wide austerity measures imposed in 1983 severely limited GOI funding of research and training by the GOI. This limitation helps assure that ARSSP fund can be effectively programmed as additional resources for research and training.

USAID plans to provide budget support to the Ministry of Finance to support ARSSP policy agenda items 3 and 4.

C. Technical Assistance component

The technical assistance component of the ARSSP responds to several distinct needs. The process of policy change requires substantial investments in ex ante studies and analyses to ensure that decisions are based on a sound understanding of the economic issues. Also, as policy reforms are put into place, ex post analyses of their economic impacts provide important feedback as a guide to further actions. The technical assistance component will fulfill this need. Through the use of expert advisors and analysts ARSSP can enhance the GOI's ability to conduct essential program analyses and evaluation. Examples of the technical studies to be carried out under this component are: follow-up analysis of the agriculture trade regime; an analysis of the effects of shipping deregulation; continuation of the development and application of the agricultural sector model; and an analysis of Bank Indonesia's open market operations.

Technical assistance will also be used to facilitate implementation of policy reforms through support of special events such as seminars or workshops to address some of the implementation aspects of reform.

This component will also fund the JCC program manager, the overall program evaluation scheduled for April 1991 and the financial monitoring of the budget support by an independent accounting firm described in Section VII.

Because of the lag time required to complete studies and to accommodate possible ex post evaluations and analyses of the ARSSP impacts, the PACD date for the technical assistance component of the program is December 31, 1992.

D. Update of Assumptions and Analyses:

The fundamental assumptions and analyses upon which the original PAAD was based remain correct.

1) Key Assumption:

Conditionality: The original PAAD pointed out the strong unwillingness of the GOI to enter into an agreement which conditioned assistance on specific policy measures. The GOI argued that such an approach would be politically unacceptable and would limit flexibility in the choice and timing of policy instruments to meet program objectives. Consequently the ARSSP policy agenda was developed as a menu of items reflecting GOI policy intentions. There was no performance conditionality between action on the policy agenda and the disbursement of ARSSP budget support. Rather, the ARSSP agreement committed the program to disburse budget support on the assumption that the GOI would and could carry out a significant portion of the policy menu.

The February 1989 evaluation validated this assumption. The GOI's performance in implementing the policy agenda has been impressive and has shown results. Conditionality in the provision of budget support was unnecessary because of the GOI's commitment to the reforms.

However, the evaluation suggested that ARSSP budget support, while remaining unconditional, could be better linked to the policy reform process by a more careful targeting of these resources to units of the government responsible for formulating, analyzing, implementing and monitoring the specific actions derived from the policy agenda. This amendment embodies these evaluation findings.

2) Analyses of the Policy Framework:

Macroeconomic Policy: The government continues to be strongly committed to the macroeconomic reform program which was described in the original ARSSP PAAD. The primary objectives of the reform are to continue to move the economy to a greater reliance on markets for the allocation of resources and to shift the economy away from its dependence on oil. The key policy initiatives to achieve these objectives are: 1) the establishment and maintenance of an open and market based foreign exchange regime; 2) the promotion of increased growth and export of non-oil sector commodities and services; and 3) strong austerity measures in the government's budget to achieve domestic price stability.

The reform program is comprehensive and integrated. The government's ability to sustain a stable, open exchange regime is based on its actions to carry out complementary policies affecting interest rates, investment opportunities and inflation in order to improve the investment climate and stem capital flight. Interest rate policy and the development of more

sophisticated financial and capital markets have kept the rupiah attractive as a store of value. Furthermore, measures which decontrolled and simplified investment approvals and trade related to manufacturing and service industries have increased investment opportunities, efficiency and profitability for the private sector. Finally, quick action to reduce government expenditures has prevented the crowding out of the private sector by the government and has reduced inflation.

Over the next several years the government plans to reinforce the policy framework with measures to further stimulate the non-oil sector, improve domestic savings and contain the growth of external debt. These measures are intended to broaden Indonesia's industrial base as well as increase the domestic value added component in current manufactured goods. By further opening the economy, the government expects its policies to simultaneously improve performance in exports and import substitution.

Agriculture Diversification: Policy change in agriculture continues to be heavily influenced by the GOI's priority for self-sufficiency in the production of rice. Changes which create a more sound economic environment for the production of alternative crops are cautiously considered and implemented only if they pose no harmful effects to the objective of rice self-sufficiency. Most agricultural support systems (i.e., input supply, research, extension and credit) still reinforce local, regional and national indicative rice production targets.

However, the need to further shift the national economy away from its dependence on oil has raised the importance of agricultural diversification to be a key theme of Repelita V. This is presented in the Five Year Plan as two objectives. The first, and probably more important, is agricultural diversification designed to make Indonesia self-sufficient in certain crops, animal products and fish in addition to rice. The second, promotes agricultural production and agro-processing industries for export. In this regard, attention will be given first to plantation crops and fishery products.

The government's increased interest in improving the agriculture sector's contribution to growth and diversification objectives bodes well for progress on the ARSSP policy agenda. However, because the policy initiative derives more from an import substitution than an export promotion perspective, there is some danger that the potential benefits could be lost if protectionist measures are used to help achieve the targets. The government has employed protectionist measures such as the 1987/1988 ban on rice imports to artificially raise domestic rice prices and stimulate production. The ARSSP will need to be particularly vigilant in its monitoring of the reform process to help ensure that induced price distortions are avoided.

Agriculture Trade: As noted in the original ARSSP PAAD, many of the reforms which opened the trade regime did not extend to trade in agricultural goods. The ARSSP amendment is introducing a policy agenda to support a deregulation of agricultural trade because of the importance of deregulation to improved production and productivity in agriculture. The policy agenda and its associated dialogue recognize the difficulty of the undertaking in light of the present policy environment. Nevertheless, it is timely to engage in

analysis and dialogue on this issue because of the government's interest as expressed in Repelita V and its agreement to the inclusion of trade related measures on the ARSSP policy agenda.

Domestic Resource Mobilization: The ARSSP amendment shifts the emphasis of this agenda item towards public finance issues. Substantial progress has been made in expanding the capital market and improving the financial sector. The government's attention is now turning to improving its capability to assess and collect taxes and generate non-tax revenue. On the expenditure side, there is interest in developing greater private sector participation in the provision of services which are now being provided by the government.

There is a high degree of enthusiasm within the government for increasing public savings. New tax measures are being considered and implemented and the administrative structure of tax collection is being strengthened with assistance from the IRS. However, there has been a tendency to substitute high tax rates on certain transactions as a substitute for previous administrative controls on these transactions. This situation is perhaps most apparent in customs duties. In monitoring this agenda item, it will be important to ensure that the resulting system is broad based, elastic and transparent.

Financial Deregulation: Perhaps the most important policy reforms undertaken by the Indonesian Government in recent years were the series of financial deregulation packages in the Fall 1988. As a result of these actions, a wide range of investment opportunities has opened for both foreign and domestic entrepreneurs. New taxes on time deposits, a new stock exchange in Surabaya, rights to foreign banks to establish themselves in rural areas, new opportunities for foreign joint venture investments, and transport licensing reforms all combine to greatly enhance the investment climate in Indonesia. It is expected that these reforms will contribute to development of a broad-based, diverse economy commensurate with Indonesia's size, location, and natural resource base.

The ARSSP amendment recognizes the importance of these recent reforms and seeks to sustain their momentum. Two issues central to the ARSSP are also key to the financial reforms objective: as industrial growth increases, labor and other resources will be shifted out of agriculture to fulfill the needs of these new areas of economic activity; a major source of growth within the agriculture sector will come from new opportunities for production, processing, and marketing of agricultural products for expanding domestic markets and for new export markets. Clearly, the agriculture sector stands to gain considerably from concomitant growth in the industrial sector. Likewise the industrial sector benefits greatly in that the agricultural sector supports the excess labor supply until the industrial sector is ready and able to absorb it.

Also, it is important to recognize that, though the reforms that have been announced are significant, there remains much to be done to improve the investment climate. The reforms of 1988 mark a major step in the right direction, but Government policy makers must continue to be vigilant to ensure

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that reforms are fully implemented, and that succeeding policy actions will be taken to capitalize on these beginnings.

Environment: Indonesia is at a critical juncture in its efforts to sustain the economic development process. As a guiding principle, the Government desires to promote development of a broad-based economy that will be less dependent on oil as a source of foreign exchange and domestic savings, and less dependent on agriculture as the source of income and employment for the majority of its citizens. It is clear that Indonesia possesses a very rich natural resource base which will be looked to as a source of much of the planned future economic growth. However, policy-makers are faced with the task of preserving the delicate balance between economic exploitation for sustained growth and development, and depletion and degradation of the stock of raw materials. Increasing attention is being given to adjusting the development strategy to take account of growing evidence which shows that natural resources are not as abundant as in the past. There is a need to adjust some of the assumptions underlying the current development strategy and to institute new approaches which better recognize growing natural resource scarcity and the costs of environmental degradation. Action must be taken now if a sustainable development course is to be followed. Much greater attention must be given to the special considerations needed to establish sustainable management patterns for renewable resources and to acknowledge the finiteness of exhaustible resources.

Concern for the environment is reflected in the policy agenda by sub-objectives that stress the importance of taking account of environmental impacts in the planning process and of monitoring and disposing of hazardous waste products. These concerns are not limited to a particular sector, or sectors of the economy. However, they are particularly acute when related to agriculture. Growing populations must be assured of sustained agricultural growth if future generations are to benefit from current development efforts. As industrial growth increases, it is important that harmful byproducts of industrial growth are controlled and not permitted to impede concurrent agricultural growth.

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V. FINANCIAL PLAN

A. Budget Support Disbursement

The ARSSP amendment will provide \$15.5 million in GOI FY90 and \$3.0 million in IFY91 for budget support of selected units within the Ministry of Agriculture, Ministry of Finance, the Central Bureau of Statistics and The National Planning Agency. 1.

The budget support will be used to augment the development budgets of the units described above. However, specific allocations will be determined by mutual agreement between BAPPENAS and USAID prior to the start of the GOI fiscal year (April 1, 1990 and April 1, 1991).

Disbursements will be made quarterly on the basis of a request from the Director General for Budget, Ministry of Finance. The disbursements for each quarter will be released at the beginning of the quarter and will be approximately one-fourth of the total annual ARSSP budget contribution. If a recipient unit does not require all or a part of its planned quarterly disbursement, AID and BAPPENAS may agree to reprogram the funds to other entities in need of resources consistent with the ARSSP objectives. In this regard, ARSSP funds may be carried over in a recipient's budget to the next Indonesian fiscal year.

Disbursements for budget support will be made to a non-interest bearing special account in the Central Bank of Indonesia. They will then be transferred to the budgets of the individual recipient unit.

B. Budget Support Monitoring

The principal responsibility for the management of ARSSP budget support resources rests with the recipient GOI ministries. USAID has initiated procedures for conducting a financial management capability review to establish the adequacy of the GOI's programming and budgetary systems, and the quality of the management, accounting and internal controls at Bank Indonesia, the Ministry of Agriculture, the Ministry of Finance, the National Development Planning Agency and the Central Bureau of Statistics. The financial management assessment will determine if (1) the recipient agencies are complying satisfactorily with all terms and conditions of the ARSSP Agreement and its Implementation Letters; (2) the GOI programming and budget systems provide satisfactory assurances that the mutually agreed upon objective of the program will be achieved; and (3) the accounting and internal control systems and procedures in place are adequate to ensure proper management, control and reporting of the receipt and use of all goods and services acquired with funds provided, and will reasonably prevent the use of funds for purposes identified in Implementation Letter No. 9 dated March 1, 1989 (negative list). If the

1. A total of \$20.0 million will be authorized from FY89 resources for ARSSP. From that total \$3.0 million will be allocated to IFY91/92 budget support activities. Increasing this funding level may be possible from FY90 resources, however a separate authorization will be required.

review reveals that GOI procedures are deficient then steps will be taken to correct the deficiencies.

USAID will monitor the disbursement of funds through quarterly financial reports provided by the Directorate General for Budget, Ministry of Finance. The quarterly financial reports will provide cash flow information on the special account at Bank Indonesia and the ARSSP accounts in each implementing ministry. Included in these reports will be information for each unit's budget on amounts previously disbursed, amounts expended, and amounts to be disbursed in the present quarter. Furthermore, the report will certify that no ARSSP funds were used for purposes disallowed by the terms of PIL No. 9.

In addition to the normal USAID review of the GOI quarterly financial reports, USAID will employ an independent accounting firm to review GOI records on a semi-annual basis. An important focus of this independent review will be to verify compliance with the terms of PIL No. 9 (negative list). Should this independent assessment determine that funds were used for purposes disallowed by the terms of PIL No. 9, the GOI will refund the amounts so used to the ARSSP special account at Bank Indonesia. These funds may then be reprogrammed within the program for other needs consistent with the program's objectives.

C. Technical Assistance

The ARSSP amendment will provide \$1.5 million for technical assistance during the period covered by this amendment. As noted in Section V.C. above, these funds will be used to obtain expert services and studies related to the design of policy reform packages and the assessment of their implementation. A portion of these funds will be reserved for the evaluation of ARSSP. Also, a portion will be reserved to obtain the services of an accounting firm to help monitor the budget support provided by ARSSP. Allocation of the remainder will be determined by the ARSSP program manager with standard review by the appropriate technical and support offices within USAID, and with the concurrence of BAPPENAS. The monitoring of this \$1.5 million technical assistance will be in accordance with normal project financing procedures.

VII. IMPLEMENTATION PLAN AND MANAGEMENT

A. Implementation Plan

1. Timeframe Planning

Key implementation actions, over time, are illustrated in Figure 1. These timeframe decision points represent current best estimates of appropriately sequenced ARSSP Amendment activities and contain, for purposes of overall planning, selected activities which will take place both before and after (for a possible follow-on ARSSP program) the proposed Amendment.

2. Programming and Budgeting

Program/budget management procedures have already been described in Section VI ("Financial Plan"). It is anticipated that the Implementation Workshop, to be held in October, 1989 will be used by ARSSP Program Management from USAID and the GOI to finalize all critical aspects of ARSSP Amendment planning and to establish procedures for management of the program.

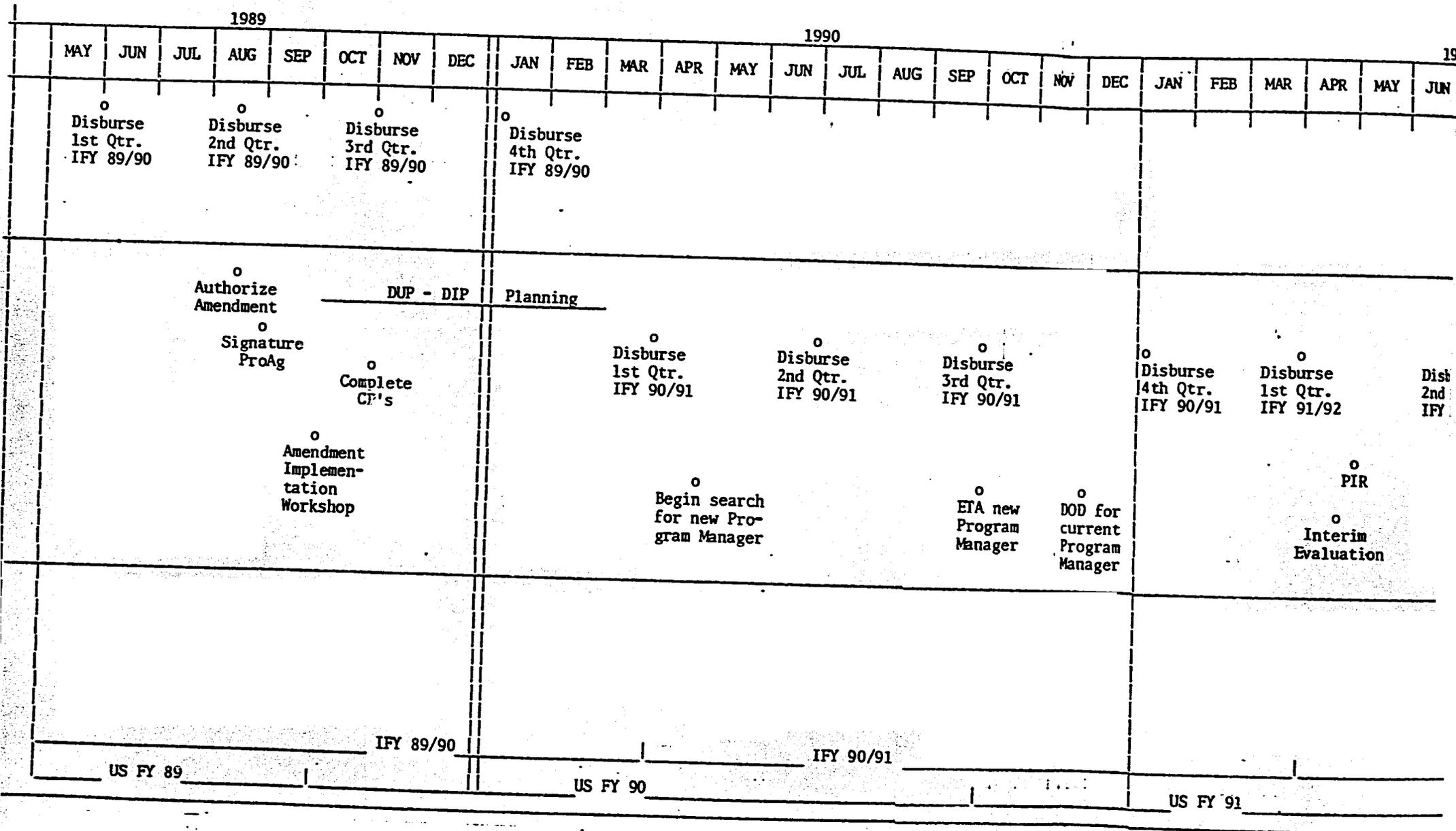
The implementation workshop will be organized and chaired by USAID. The workshop will be attended by representatives of the relevant technical offices within USAID, as well as the support offices. The GOI will be represented by representatives of BAPPENAS, the Ministries receiving ARSSP budget support funds, and the Central Bureau of Statistics. This meeting will be used to formally discuss and agree upon program management issues including: 1) responsibility for policy agenda tracking; 2) establishment of a timetable for meetings to discuss progress and/or problems with the Program; and 3) other issues related to the Program. The purpose of this meeting is to clearly delineate management responsibilities, to ensure that all concerned parties are aware of how the Program will operate.

3. Monitoring

Routine monitoring of the ARSSP Amendment will focus on two different areas: monitoring of the policy agenda and financial monitoring. Results of routine tracking will be organized by the ARSSP manager each quarter and will be used for semi-annual review by USAID and the GOI through their respective monitoring systems.

a) Policy agenda monitoring will be a major substantive aspect of the everyday management of the program. The USAID Program Manager, located in EPSO, will work closely with his counterpart in BAPPENAS and maintain a routine system of tracking of the policy agenda benchmarks. The exact nature of tracking and the allocation of detailed tracking responsibilities will be determined at the Implementation Workshop scheduled for October, 1989. Approaches to tracking will include 1) special studies, 2) routinized monitoring by respective USAID and GOI technical offices, and 3) a comprehensive program evaluation (described below).

FIGURE 1 : ARSSP AMENDMENT TIMEFRAME PLANNING



WV

b) Financial monitoring will be carried out, as noted in Section VI, in the form of quarterly statements produced by the Ministry of Finance Directorate General of Budget and through independent review every six months.

4. Evaluation

It is expected that the reasonably thorough and sustained monitoring process noted above will permit both USAID and the GOI to gain considerable insight into the nature and direction of individual items on the policy reform agenda. All results and issues generated by the oversight process will be periodically evaluated by a broader audience within USAID and the GOI, respectively.

USAID and GOI representatives will meet twice yearly as soon as possible after the Mission Program Implementation Review (PIR), to examine policy progress, and to discuss program management issues such as funds disbursements and others as appropriate.

A formal interim evaluation, similar to that undertaken in February 1989, for the original ARSSP program and with a particular emphasis on impact analysis, will be carried out by a special outside team of experts. This evaluation, planned for April, 1991, will also be structured so as to provide useful analysis for any follow-on ARSSP activity, if so decided.

B. Implementation Management

1. Framework and Operational Principles

The ARSSP Interim Evaluation contains numerous useful recommendations for enhancing the quality of ARSSP management. Those recommendations have been extensively drawn upon to formulate the implementation procedures for this Amendment. In order to streamline management, implementation procedures are made as simple and flexible as possible, while remaining within the currently known ground rules for USAID and GOI activities. Because of the importance of the ARSSP activity for both the USAID portfolio and for GOI decision-makers, care has been taken to focus feedback on substance rather than process, and in a manner which is compatible with both USG and GOI system.

2. Operational Arrangements

— a) Within USAID: Within USAID, day-to-day implementation of the program will be the responsibility of the ARSSP program manager, under the direction of the EPSO Office Chief and in collaboration with the technical office analysts from ARD, PSD and PPS. The Technical office analysts are expected to contribute to the monitoring/evaluation process in their particular area of expertise. Their role will be specifically defined, and percentage of time allocated, at the time of the October, 1989 Implementation Workshop.

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Broader Mission management oversight will be provided by a Program Committee (PC) consisting of the ARSSP management team noted above, relevant technical office chiefs (PSD, ARD, EPSO), the PPS backstop, and selected support staff (LA, CM, FIN), as appropriate. The Program Committee will be chaired by the Program Manager. The PC will meet semi-annually, at the time of the Mission's normally scheduled PIR and will be charged with:

- reviewing policy and financial monitoring to date;
- providing guidance to EPSO and the Director on procedural issues relating to program management;
- reviewing the policy agenda from the broader perspective of the overall policy environment and providing guidance to EPSO and the Director on the policy agenda, current and future.

Evaluation of ARSSP will also be used to feed into the regular annual Mission PIR.

b) Within the GOI: Within the GOI, day-to-day management will be the responsibility of the Chief of the Bureau of Agriculture and Irrigation in BAPPENAS. He and his staff will liaise with other relevant offices in BAPPENAS, the Ministry of Finance, the Ministry of Agriculture and the Central Bureau of Statistics.

Organized GOI oversight of the ARSSP Program will take place as part of the regularly scheduled USAID/GOI semi-annual portfolio implementation review, and will draw upon the results of USAID PIR project implementation reports as well as the data contained within the recently established BAPPENAS Project Monitoring System, operated by the Bureau of Monitoring of Foreign Economic Cooperation Implementation.

Likewise, representatives of BAPPENAS and/or key technical ministries will work closely with USAID on the ARSSP evaluation. It is expected that reporting on the status and impact of the policy agenda, as well as assistance in overcoming potential implementation bottlenecks, can be carried to the Ministry level through the Implementation Acceleration Group, as required, following the joint USAID/GOI semi-annual review.

c) Between USAID and the GOI: Representatives of the offices within USAID assigned monitoring responsibilities for particular policy objectives will meet at least semi-annually with representatives of the GOI involved with action on the policy agenda to ensure that progress is monitored and that both groups are fully aware of the status of the policy change process. For example, representatives of USAID's ARD office will meet with representatives of the GOI active in relation to policy objectives one and five (most likely from the Ministry of Agriculture).

VIII. EVALUATION PLAN

One external evaluation is planned to assess progress under the amendment as a basis to document results and determine the need and justification for any further sector assistance after the PACD. The evaluation will cover much the same ground as the evaluation of the original ARSSP; including progress on the policy agenda, performance of the budget support component, additional assistance needs, and proposed adjustments and improvements to the ARSSP process. Also, the evaluation should probe further into the impact of the reform agenda to date, to provide more feedback on the appropriateness of the agenda and to document to the extent possible the extent to which ARSSP supports the CDSS objective of improving long term sustainable employment and income opportunities.

One possibility the evaluation should consider is whether a continuation of the ARSSP approach and general policy agenda is appropriate for Indonesian FY 92/93. To meet the needs of the Indonesian budget process such assistance must be obligated no later than US FY 1991. It is expected that the evaluation will take place in April, 1991 in order to provide adequate time to develop a follow-on activity in U.S. FY 91 for Indonesian FY 92-93 if it appears warranted. This date also permits greater GOI participation since it follows the busy budget planning period prior to April 1.

Other issues the evaluation should resolve include the continuing relevance of budget support as the GOI's revenues accelerate, the continuing appropriateness of the target policy sectors as structural reforms evolve, and the effectiveness of the program's revised systems and management arrangements to meet the needs of the sector program modality within the context of AID staffing constraints.

Funds for the evaluation will come from the technical assistance component and should provide for 18 person weeks to develop the report. Expertise on the team should include policy development and evaluation expertise, economic skills, sector program design skills; (including familiarity with AID requirements and policy) program management skills, and financial management skills.

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IX. CONDITIONS PRECEDENT AND COVENANTS

All CPs and Covenants of the original ARSSP agreement remain effective. The following additions are made through this amendment:

A. Conditions Precedent To Disbursement

1. Disbursement for Budget Support for IFY 1990/91 and IFY 1991/92 : Prior to the disbursement of funds under the Grant for budget support in IFY 1990/91 and IFY 1991/92, or to issuance by AID of documentation pursuant to which disbursement will be made, the Grantee shall, except as AID may otherwise agree in writing, furnish to AID, in form and substance satisfactory to AID, budget plans for the relevant Ministries of the Government of Indonesia who will receive budget support through this Grant with projected needs per quarter for the IFY covered by the proposed disbursement.

B. Covenants

1. Special Covenants

a) Policy Agenda: The Grantee agrees that it shall diligently pursue the comprehensive policy agenda which have been included in annexes to the Program Grant Agreement.

ANNEX 1

GOI LETTER OF REQUEST



REPUBLIC OF INDONESIA
NATIONAL DEVELOPMENT PLANNING AGENCY
JAKARTA, INDONESIA

No : 2918/K/8/1989

Jakarta, August 31, 1989

Mr. David Merrill

Director

— USAID Mission

c/o American Embassy

Jakarta

Dear Mr. Merrill:

The Government of Indonesia wishes to request that the USAID/Indonesia Agriculture and Rural Sector Support Program (497-0357) be amended to increase development assistance through the program by US\$ 20,000,000 and to extend the life of the program for an additional period of two years, to March 31, 1992. This letter provides a review of our experience with the first two years of the ARSSP, and a description of the current situation and our plans for further efforts under the program amendment.

Since the initiation of the ARSSP in August, 1987, the Government of Indonesia has accelerated the pace of economic reforms. Subsidies on agricultural pesticides have been eliminated while those on fertilizer have been reduced; interisland shipping has been largely deregulated; banking regulations have been changed to make it easier for banks to provide services in rural areas;

and non-tariff trade barriers on several agricultural commodities have been replaced by tariffs. During this period, the ARSSP has helped the Government maintain certain important public service functions by providing financial support to the budgets of the Ministry of Agriculture, Ministry of finance and Bappenas. The budget support enhanced the efforts of implementing the policy changes.

At present the Government is facing the task of maintaining the momentum for economic policy reform. The Government is keenly aware of the need to keep track the implementation of the policy changes and to identify possible areas for future reforms. During Repelita V, the economy is expected to move away from its critical dependence on oil to a more diversified economy. To achieve this, policies must be put in place to encourage entrepreneurial activities in all sectors. The ARSSP has already contributed to policy reform process in the past years and a continuation of the ARSSP will undoubtedly contribute to efforts in the coming years. Within the next two years agriculture and rural sectors are expected to be an important focus of reform. Briefly, I will describe here some areas of mutual concern to the Government and USAID.

Agricultural diversification continues to be an area of critical importance to economic growth in Indonesia. To take advantage of the emerging export opportunities and to satisfy the growing needs of domestic population, the agricultural production

capacities of the nation must expand to provide a wider variety of products while sustaining an adequate level of output of the basic foodstuffs. Steps have recently been taken to eliminate unnecessary non tariff trade restraints on several agricultural products. However, there remain important steps to be undertaken in this area. Reform on agricultural trade restrictions will work in tandem with the agricultural diversification policy objective to stimulate future trade growth.

As the economy diversifies away from oil, public revenues will have to come from a broader tax base. Policies to enhance the efficient mobilization and utilization of public resources, particularly at regional and local levels, will be a crucial element. This is another policy focus in the coming years.

Repelita V states that the major sources of growth will come from the private sector through increased private investment. Major policy reforms to stimulate investment have already been announced. We need to monitor closely and continuously their implementation.

The Government is particularly concerned that economic growth take place without causing undesirable deterioration of the natural environment. The process of economic growth must be tempered by an effective public concern for protecting the ecological balance necessary to ensure that the natural resource base will be available long into the future.

A list of the agriculture and rural sector policies that form the basis for the ARSSP is given in the attachment to this letter.

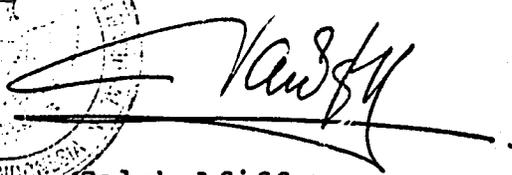
Resources provided through the ARSSP amendment will support the design, implementation, and analysis of the policy reforms mentioned here. ARSSP funds will be allocated each year, by mutual agreement, to agencies of the Ministry of Agriculture, the Ministry of Finance, BAPPENAS, and/or the Central Bureau of Statistics. To the extent possible, agency funding will be directly related to activities that support the policy initiatives specified on the ARSSP agenda.

We look forward to your favorable consideration and thank you for your kind cooperation.

Yours sincerely,

Minister of National Development,
Planning/Chairman of Bappenas




Saleh Afiff

Attachment

Government of Indonesia's Policy Agenda in Support of the Agriculture and Rural Sector Support Program Amendment for Indonesian Fiscal Years 1990/91 and 1991/92

Introduction

This policy agenda consists of five selected objectives, each with a set of sub-objectives. These represent activities that the Government of Indonesia considers to be important for furthering development of the agriculture and finance sectors of the economy. The list of selected changes that the Government is considering is presented below.

1. Program objective and milestones for Agricultural Diversification

Diversify agricultural production taking advantage of regional comparative advantage and promoting development of related agro-industries.

sub-objectives:

1.1 Align agricultural policy instruments so that farmers receive appropriate market signals to capitalize on natural comparative advantage.

1.2 Implement the integrated pest management program in rice and extend it to include other crops.

1.3 Produce, distribute, and utilize fertilizers efficiently.

1.4 Broaden the national mandate of agricultural research centers to be more responsive to regional needs and introduce a system of direct outreach from research stations to regional extension centers and farmers.

1.5 Assess the implementation of the shipping deregulation reforms of November 1988.

1.6 Take advantage of new market opportunities in fruit crops by encouraging investment opportunities in small plantations.

2. Program objective and milestones for Agricultural Trade

Increase the efficiency and competitiveness of Indonesian international agricultural trade.

sub-objectives:

2.1 Lower import tariffs and surcharges on selected imported agricultural products.

2.2 Encourage higher quality plantation crops from both government plantations and small holders.

2.3 Establish a more effective relationship between trade associations and relevant government agencies to promote the export of Indonesian agricultural products.

3. Program objective and milestones for Domestic Resource Mobilization

Mobilize public resources and effectively apply them at regional and local levels.

sub-objectives:

3.1 Continue to increase tax revenues through more effective and more equitable means. Accelerate the tax "post audits" program.

3.2 Periodically review new sources of revenue for local governments and discourage them from their current "ad hoc" taxing practices.

3.3 Accelerate the program of private sector participation in providing public services.

3.4 Improve the effectiveness of resource transfer program from the central government to the regions and local governments.

4. Program objective and milestones for Implementation of Financial Deregulations

Increase total investment in Indonesia, particularly off-Java, through accelerated implementation of financial deregulations to meet Repelita V targets and to generate income growth and employment.

sub-objectives:

4.1 Sustain existing financial deregulation efforts which impact more on rural areas and the "informal" sector of the economy.

4.2 Improve climate of foreign investment in Indonesia.

5. Program objective and milestones for Environmental and Natural Resources

Develop appropriate policy approaches to assure that environmental and natural resources are managed wisely to sustain the economic development process.

sub-objectives:

5.1 Strengthen the ability to systematically analyze agricultural policies and projects from the standpoint of their economic and ecological viability and sustainability.

5.2 Consolidate the authority and responsibility for pollution and hazardous waste control and monitoring within an appropriate system.

ANNEX 2

STATUTORY CHECKLIST

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3 (A) 2 - NONPROJECT ASSISTANCE CHECKLIST

The criteria listed in Part A are applicable generally to FAA funds, and should be used irrespective of the program's funding source. In part B a distinction is made between the criteria applicable to Economic Support Fund assistance and the criteria applicable to Development Assistance. Selection of the criteria will depend on the funding source for the program.

CROSS REFERENCES: IS COUNTRY CHECKLIST UP TO DATE? 1) YES
HAS STANDARD ITEM CHECKLIST BEEN REVIEWED? 2) YES

A. GENERAL CRITERIA FOR NONPROJECT ASSISTANCE

1. FY 1989 Appropriation Act Sec. 523; FAA Sec. 634A. Describe how authorization and appropriations committees of Senate and House have been or will be notified concerning the project. expired on 8/8/1989. A CN for this amendment was submitted to the Senate and House Committees and
2. FSS Sec. 611 (a) (2). If further legislative action is required within recipient country, what is basis for reasonable expectation that such action will be completed in time to permit orderly accomplishment of purpose of the assistance? No further legislative action is required within the host country
3. FAA Sec. 209. Is assistance more efficiently and effectively provided through regional or multilateral organizations? If so, why is assistance not so provided? Information and conclusions on whether assistance will encourage developing countries to cooperate in regional development programs. This Program is specifically focussed on economic development problems in Indonesia and can not be implemented as a regional program.
4. FAA Sec. 601 (a). Information and conclusions on whether assistance will encourage efforts of the country to: (a) increase the flow of international trade; (b) foster private initiative and competition; (c) encourage development and use of cooperatives, credit unions, and savings and loan associations; (d) discourage monopolistic practices; (e) improve technical efficiency of industry, agriculture, and commerce; and (f) strengthen free labor unions. The Program policy agenda is specifically designed to encourage efforts of Indonesia in (a), (b), (d), and (e).

5. FAA Sec. 601 (b). Information and conclusions on how assistance will encourage U.S. private trade and investment abroad and encourage private U.S. participation in foreign assistance programs (including use of private trade channels and the services of U.S. private enterprise). The Program's principal objective is to open up financial and investment markets to increased trade and investment from U.S. and other sources.
6. FAA Secs. 612 (b), 636 (h); FY 1989 Appropriations Act Secs. 507, 509. Describe steps taken to assure that, to the maximum extent possible, foreign currencies owned by the U.S. are utilized in lieu of dollars to meet the cost of contractual and other services. The GOI will be contributing substantial amounts of host country owned local currencies for activities supported under the Program.
7. FAA Sec. 612 (d). Does the U.S. own excess foreign currency of the country and, if so, what arrangements have been made for its release? NO
8. FAA Sec. 601 (e). Will the assistance utilize competitive selection procedures for the awarding of contracts, except where applicable procurement rules allow otherwise? YES
9. FAA Sec. 121 (d). If assistance is being furnished under the Sahel Development Program, has a determination been made that the host government has an adequate system for accounting for and controlling receipt and expenditure of A.I.D. funds? N/A
10. FY 1989 Appropriations Act. Will assistance be designed so that the percentage of women participants will be demonstrably increased? This Program does not involve the direct financing of activities

B. FUNDING CRITERIA FOR NONPROJECT ASSISTANCE

1. Nonproject Criteria for Economic Support Fund

a. FAA Sec. 531 (a). Will this assistance promote economic and political stability? To the maximum extent feasible, is this assistance consistent with the policy directions, purposes, and programs of Part I of the FAA? N/A

b. FAA Sec. 531 (e). Will assistance under this chapter be used for military or paramilitary activities? N/A

c. FAA Sec. 531 (d). Will ESF funds made available for commodity import programs or other program assistance be used to generate local currencies? If so, will at least 50 percent of such local currencies be available to support activities consistent with the objectives of FAA sections 103 through 106?

N/A

e. FY 1989 Appropriations Act. If assistance is in the form of a cash transfer: (a) are all such cash payments to be maintained by the country in a separate account and not to be commingled with any other funds? (b) will all local currencies that may be generated with funds provided as a cash transfer to such a country also be in accordance with FAA Section 609 (which requires such local currencies to be made available to the U.S. Government as the U.S. determines necessary for the requirements of the U.S. Government, and which requires the remainder to be used for programs agreed to by the U.S. Government to carry out the purposes for which new funds authorized by the FAA would themselves be available? (c) Has Congress received prior notification providing the detail how the funds will be used, including the U.S. interests that appropriate, the economic policy reforms transfer assistance?

N/A

2. Nonproject Criteria for Development Assistance

a. FAA Secs. 102 (a), 111, 113, 281 (a). Extent to which activity will (a) effectively involve the poor in development, by expanding access to economy at local level, increasing labor-intensive production and the use of appropriate technology, spreading investment out from cities to small towns and rural areas, and insuring wide participation of the poor in the benefits of development on a sustained basis, using the appropriate U.S. institutions; (b) help develop cooperative, especially by technical assistance, to assist rural and urban poor to help themselves toward better life, and otherwise encourage democratic private and local governmental institutions; (c) support the self-help efforts of developing countries; (d) promote the participation of women in the national economies of developing countries and the improvement of women's status; and (e) utilize and encourage regional cooperation by developing countries?

The Program supports the development by the host country of sound economic and resource management policies which, in turn, should increase employment and incomes at all levels, including in the agricultural and rural sector.

b. FAA Secs. 103, 103A, 104, 105, 106, 120-21.
Is assistance being made available (include only applicable paragraph which corresponds to source of funds used; if more than one fund source is used for assistance, include relevant paragraph for each fund source):

(1) [103] for agriculture, rural development or nutrition; if so (a) extent to which activity is specifically designed to increase productivity and income of rural poor; [103A] if for agricultural research, account shall be taken of the needs of small farmers, and extensive use of field testing to adapt basic research to local conditions shall be made; (b) extent to which assistance is used in coordination with efforts carried out under Sec. 104 to help improve nutrition of the people of developing countries through encouragement of increased production of crops with greater nutritional value; improvement of planning, research, and education with respect to nutrition, particularly with reference to improvement and expanded use of indigenously produced foodstuffs; and the undertaking of pilot or demonstration programs explicitly addressing the problem of malnutrition of poor and vulnerable people; and (c) extent to which activity increases national food security by improving food policies and management and by strengthening national food reserves, with particular concern for the needs of the poor, through measures encouraging domestic production, building national food reserves, expanding available storage facilities, reducing post harvest food losses, and improving food distribution.

(2) [104] for population planning under Sec. 104(b) or health under Sec. 104(c); if so, extent to which activity emphasizes low-cost, integrated delivery systems for health, nutrition and family planning for the poorest people, with particular attention to the needs of mothers and young children, using paramedical and auxiliary medical personnel, clinics and health posts, commercial distribution systems, and other modes of community outreach.

The policy agenda supported by the Program is specifically targeted at increasing income and employment in the agricultural sector through increases in agricultural diversification, agricultural trade, financial deregulation, and improvement of environmental and natural resource management policies.

N/A

(3) [105] for education, public administration, or human resources development; if so, (a) extent to which activity strengthens non-formal education, makes formal education more relevant, especially for rural families and urban poor, and strengthens management capability of institutions enabling the poor to participate in development; and (b) extent to which assistance provides advanced education and training of people of developing countries in such disciplines as are required for planning and implementation of public and private development activities.

N/A

(4) [106] for energy, private voluntary organizations, and selected development problems; if so, extent activity is:

(i) (a) concerned with data collection and analysis, the training of skilled personnel, research on and development of suitable energy sources, and pilot projects to test new methods of energy production; and (b) facilitative of research on and development and use of small-scale, decentralized, renewable energy sources for rural areas, emphasizing development of energy resources which are environmentally acceptable and require minimum capital investment;

N/A

(ii) concerned with technical cooperation and development, especially with U.S. private and voluntary, or regional and international development, organizations;

(iii) research into, and evaluation of, economic development processes and techniques;

(iv) reconstruction after natural or manmade disaster and programs of disaster preparedness;

(v) for special development problems, and to enable proper utilization of infrastructure and related projects funded with earlier U.S. assistance;

(vi) for urban development, especially small, labor-intensive enterprises, marketing system for small producers, and financial or other institutions to help urban poor participate in economic and social development

(5) [120-21] for the Sahelian region; if so, (a) extent to which there is international coordination in planning and implementation; participation and support by African countries and organizations in determining development priorities; and a long-term, multidonor development plan which calls for equitable burden-sharing with other donors; (b) host government has an adequate system for accounting for and controlling receipt and expenditure of projects funds (dollars or local currency generated therefrom)?

N/A

c. FY 1989 Appropriations Act. Have local currencies generated by the sale of imports or foreign exchange by the government of a country in Sub-Saharan Africa from funds appropriated under Sub-Saharan Africa, DA been deposited in a special account established by the government, and are these local currencies available only for use, in accordance with an agreement with the United States, for development activities which are consistent with the policy directions of Section 102 of the FAA and for necessary administrative requirements of the U.S. Government?

N/A

d. FAA Sec. 107. Is special emphasis placed on use of appropriate technology (defined as relatively smaller, cost-saving, labor-using technologies that are generally most appropriate for the small farms, small businesses, and small incomes of the poor)?

N/A

e. FAA Sec. 281 (b). Describe extent to which the activity recognizes the particular needs, desires, and capacities of the people of the country; utilizes the country's intellectual resources to encourage institutional development; and supports civic education and training in skills required for effective participation in governmental and political processes essential to self-government.

The Program directly supports the GOI's efforts to formulate sound development policies through institutional support.

f. FAA Sec. 101 (a). Does the activity give reasonable promise of contributing to the development of economic resources, or to the increase of productive capacities and self-sustaining economic growth?

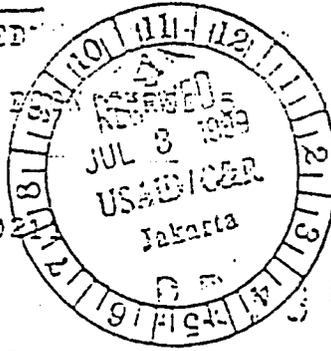
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ANNEX 3

PAIP APPROVAL CABLE

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TAGS:

SUBJECT: AGRICULTURE AND RURAL SECTOR SUPPORT PROGRAM
 (497-2357) - ANE REVIEW OF PROPOSED AMENDMENT

REFERENCES: A. JAKARTA 7939; B. JAKARTA 7000;
 C. STATE 145733

LSU

1. AA/ANE HEREBY REDELEGATES TO THE MISSION DIRECTOR AUTHORITY TO AMEND THE AGRICULTURE AND RURAL SECTOR SUPPORT PROGRAM (ARSSP) TO ADD UP TO 20 MILLION DOLLARS ABOVE THE 42 MILLION ALREADY AUTHORIZED. THE MISSION SHOULD GIVE AID/W AN OPPORTUNITY TO COMMENT ON THE POLICY AGENDA TO BE AGREED WITH THE GOI WHEN NEGOTIATIONS ON THE ARSSP AMENDMENT ARE FURTHER ADVANCED.

2. DISCUSSIONS WITH THE MISSION DIRECTOR AND MISSION STAFF DURING PROGRAM WEEK, INCLUDING AN ARSSP AMENDMENT REVIEW MAY 28, INCLUDED EXCELLENT COVERAGE BY MISSION OF THE ISSUES IN REFTELS B AND C: I) THE POLICY AGENDA, II) THE PROPOSED BUDGET SUPPORT APPROACH, AND III) PROGRAM MANAGEMENT. HOWEVER, WE WILL WANT TO HAVE AN OPPORTUNITY TO COMMENT ON THE POLICY AGENDA WHEN IT HAS BEEN PARED DOWN TO THE ACTION ITEMS THE MISSION

WANTS/EXPECTS TO NEGOTIATE WITH THE GOI BEFORE THE PROGRAM AGREEMENT IS CONCLUDED. THE MISSION CAN CABLE THE AGENDA WHEN IT JUDGES APPROPRIATE. WE EXPECT THE AGENDA TO INCLUDE PERFORMANCE INDICATORS AND THE LIKELY TIMEFRAME FOR ACHIEVING THEM SO THAT PROGRESS CAN BE MEASURED.

3. THE POLICY AGENDA: THE REVIEWS RESOLVED THE QUESTION WHETHER THE AGRICULTURAL DIVERSIFICATION AGENDA ITEMS ARE CONSISTENT WITH THE DRAFT REGIONAL AGRICULTURAL SECTOR STRATEGY. BOTH LOOK TO MARKET DRIVEN CHOICES OF CROPS TO BE ENCOURAGED AND TO REMOVAL OF RIGIDITIES IN PRICING OF INPUTS AND PRODUCTS. THE CROPS TO BE ENCOURAGED SHOULD BE THOSE IN WHICH THERE IS INCREASING

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DEMAND SO THAT INCREASED PRODUCTION DOES NOT REDUCE PRICES AND FOR WHICH INDONESIAN COSTS ARE BELOW BORDER PRICES.

4. THE PROPOSED BUDGET SUPPORT APPROACH: THE MISSION'S APPROACH TO TARGETING BUDGET SUPPORT ON THE GOI AGENCIES WITH REFORM AND DEVELOPMENT ROLES AS DESCRIBED IN THE ARSSP REVIEW WAS FOUND TO BE SOUND. OUR UNDERSTANDINGS ARE: A. ARSSP FUNDS WILL NOT DIRECTLY FINANCE SPECIFIC INPUT PACKAGES, AND B. THE AGENCY OR SIMILAR LEVEL BUDGETS TO BE SUPPORTED WILL BE LARGE ENOUGH AND HAVE AMPLE APPROPRIATE USES TO ABSORB EASILY ARSSP FUNDS AS A REASONABLE PORTION OF TOTAL FUNDING. P.L. NO. 9 OF MARCH 1, 1989, OR A SIMILAR STATEMENT, CAN BE USED TO INDICATE TO THE GOI WHAT ARE APPROPRIATE USES OF A.I.D. FUNDS IF THE SYSTEM REQUIRES THIS.

HOWEVER, YOU MAY ALSO WISE TO CONSIDER OTHER APPROACHES THAT COULD AVOID THIS REQUIREMENT. FOR EXAMPLE, AN AGREED QUARTERLY DOLLAR REIMBURSEMENT REPEAT REIMBURSEMENT FOR MEETING GOI BUDGETARY TARGETS FOR AGENCIES IMPLEMENTING ARSSP POLICY AGENDA. THIS MIGHT ALLEVIATE PROBLEMS FROM GOI DIFFERENTIATING SOURCES OF FUNDS FROM DONORS.

5. ADDITIONALITY: IN A SIDE MEETING WITH PPC, MISSION STAFF AND ANE/PD REVIEWED HOW ANNUAL APRIL REVIEWS START FROM BUDGETS APPROVED FOR USE OF GOI RESOURCES AND ADD ARSSP FUNDS WHERE THEY IMPROVE ABILITY OF AGENCIES TO CARRY OUT REFORM AND DEVELOPMENT ACTIVITIES. THIS USE OF ARSSP FUNDS MEETS THE TEST OF SHOWING THAT THE A.I.D. ASSISTANCE MAKES A DIFFERENCE IN WHAT ACTUALLY HAPPENS AS A RESULT OF OUR ASSISTANCE. (OF COURSE, MISSION WILL HAVE TO ASSURE ITSELF THAT FUTURE BUDGETS DO NOT

PURPOSEFULLY UNDERFUND THE ARSSP-SUPPORTED AGENCIES RELATIVE TO OTHER AGENCIES IN THE EXPECTATION OF ARSSP SUPPORT TO MAKE UP THE DIFFERENCE.)

THE KEY CONSIDERATION IS THE AID SECTOR ASSISTANCE POLICY GUIDANCE (HB 1, PART VII) TEST THAT "THE LEVEL OF GOVERNMENT RESOURCES IS APPROPRIATE TO THE IMPORTANCE OF THE SECTOR (ANALOGOUSLY, IN THE GOI CONTEXT, AGENCY) IN THE COUNTRY'S DEVELOPMENT, THE PROPER ROLE OF GOVERNMENT IN THE SECTOR, AND THE OVERALL LEVEL OF GOVERNMENT RESOURCES AVAILABLE." IF, THROUGH AID'S DIALOGUE AND/OR FINANCIAL SUPPORT THE "APPROPRIATE" LEVEL IS ACHIEVED, THEN THE ADDITIONALITY TEST OF MAKING A DIFFERENCE IS MET.

6. PROGRAM MANAGEMENT: THE SEPARATE WRAP-UP CABLE FOR PROGRAM WEEK DISCUSSED MANAGEMENT MATTERS.

7. REF A REQUEST FOR APPROVAL OF AN ADDITIONAL FIVE

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MILLI ON DOLLARS: APPROVAL OF A 20 MILLION DOLLAR
AMENDMENT AT THIS TIME IS BASED ON THE POSSIBLE

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INCLUSION OF DOLS 3 MILLION OF FY 1989 "GOOD PERFORMANCE" FUNDS WITH THE 17 MILLION ALREADY PROGRAMMED. WE DO NOT WANT TO GO INTO FUTURE YEARS FUNDING WITHOUT A BETTER UNDERSTANDING OF THE BENCHMARKS, TIMING OF FUTURE FUNDING AND ITS RELATION TO THE POLICY AGENDA.

WE ARE ALSO CONCERNED THAT THE INDONESIAN FY 1990/91 AND 1991/92 CASH FLOW NEEDS OF THE GOI AGENCIES ARSSP SUPPORTS ARE NOT YET CLEAR. REF A INDICATES THAT EVEN THE DOLS 20 MILLION TO BE OBLIGATED IN U.S. FY 1989 WILL NOT BE FULLY DISBURSED UNTIL FY 1991/92. THIS SUGGESTS THAT ANOTHER LOOK SHOULD BE TAKEN AT ARSSP FUNDING REQUIREMENTS BEFORE DECIDING HOW MUCH MORE FUNDING IT WILL REQUIRE AND ON WHAT SCHEDULE.

WE CONTINUE TO SUPPORT ARS[P OR SIMILAR MECHANISMS AS A PREFERRED WAY TO SUPPORT INDONESIAN DEVELOPMENT REFORMS. WHEN THE POLICY AGENDA, PROGRESS AGAINST BENCHMARKS AND CASH FLOW NEEDS ARE CLEARER NEXT YEAR, WE WOULD WELCOME A PROPOSAL FOR ADDITIONAL FUNDING.

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ANNEX 4

EVALUATION SUMMARY

SUMMARY OF FINDINGS

1. Though there were intentionally no conditionality provisions in this program, the Government of Indonesia's progress on the ARSSP policy agenda has been far greater than was expected for this point in the program. For some items (e.g., pesticide and fertilizer subsidy reductions, inter-insular transport deregulation, banking reform, etc.) policy reforms have surpassed expectations, while for other items reform progress has been less rapid. However, it is clear that overall progress on policy reform has exceeded AID's expectations at the outset of ARSSP.

2. It is impossible to prove a causal relationship between AID assistance through ARSSP and policy reform; however, the negotiation of the policy agenda and AID commitments to use of ARSSP funds to finance the implementation of such reforms imply that an important link has been established. Though much remains to be done in the area of agricultural and financial sector policy, ARSSP has contributed to the policy reform process by:

a) providing key officials with resources to support policy research, analysis, and review which reportedly generated reform proposals and helped broaden the consensus for policy change;

b) financing study tours to provide exposure to alternative policy regimes;

c) providing support for the start-up of the Integrated Pest Management program as an alternative to high-pesticide use crop management;

d) financing technical research on key areas such as fertilizer response, to support adjustments in agricultural input pricing policy; and

e) filling a niche in donor program assistance by focusing attention on agricultural incentive issues.

3. Formulation of the ARSSP agenda raised the level of policy dialogue between the GOI and AID to focus on sectoral or sub-sectoral issues -- a considerably higher level than the previous focus of discussions. Project experience, existing analytic work in some areas, and credibility with the GOI contributed to formulation of the agenda.

4. The policy agenda items are of varying importance, utility, and precision. Future policy agenda items should be developed carefully and focused on specific areas of interest, while maintaining the broad "menu" approach to setting the agenda that permits activities in more than one sector of the economy.

5. Initially, ARSSP was to provide short-term "bridging" support to the development budget to tide the Government over during a period of budgetary shortfall as they implemented their subsidy reduction and revenue mobilization measures. AID applied budget support to the budgets of agencies AID considered important to its project portfolio. It was not intended that these funds be used for policy support; rather as support to the development budget, which served in turn as part of a general multi-donor effort to support the policy reform process. What AID discovered during implementation was that it was possible to use a portion of the budget support funds to assist implementation of the policy changes decided upon by the Government. The team believes that such "targeted budget support" is the best and highest use of budget support, and that it should constitute the bulk, if not all, of such uses of AID-provided funds in future program assistance. Accordingly, the GOI's programming of ARSSP budget support should increasingly focus on activities that directly pertain to the objectives of the program. Further, active AID participation in the identification and proposal of GOI programming options to advance policy and institutional reforms in the agriculture and financial sectors is recommended to the extent it can be appropriately done.

6. The team finds that the Mission's effort to ensure "additionality" of support to selected agencies vis-a-vis fluctuations in the Government's development budget as a whole, while well intentioned, is impossible to achieve, a waste of time and effort, and should be abandoned.

7. The team concludes that the common view that D.A. sector program assistance requires relatively less staff per dollar than project assistance is greatly exaggerated. To be effective in facilitating policy change, D.A. sector program assistance requires nearly as much staff, if not as much, as project assistance. It was over-optimistic to think that there were relatively lighter policy analysis or budget monitoring requirements. Accordingly, ARSSP was understaffed until recently. What is true, however, is that the mix of skills required changes and that more J.C.C.-type policy analysts in addition to USDH are needed. At the same time USDH and FSNDH are also needed to manage the program and give direction to the policy dialogue. The team recommends that one additional person with an accounting and information systems background be hired.

8. As ARSSP cuts across various Mission offices, the role of each office in policy analysis, support to ARSSP agenda items from projects, program administration, and contribution to an ARSSP information management system needs to be formalized and clarified. ARSSP will not work except as a team effort that includes many offices.

9. The team finds that project assistance remains essential for effective program assistance; that projects alone are an insufficient source of analysis needed for policy based program assistance because program assistance has its own policy analysis requirements; and that targeted program assistance fills a

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niche in the Mission's program instruments because it is able to do some important things differently and more quickly than project assistance.

10. The Mission finds itself in a tricky area between pure program assistance (cash grant or C.I.P.) and project assistance, and the recommendations of this evaluation to move toward "targeted budget support" take it slightly nearer to the project mode. Even though this area has difficulties in terms of the program-project spectrum and in terms of accountability (projects are tighter), it also has the potential to make a contribution to policy implementation that, dollar-for-dollar, could well be greater than other donors' program assistance. AID would be the only donor with this kind of fund for financing policy implementation costs, and the implementation costs in any event are more commensurate with the amount of money AID has available, in contrast to the sizeable contribution to the budget that comes from other donors' program aid.

11. ARSSP has laid a sound basis for continued AID support of the policy reform process. This support should build upon the successes of early ARSSP implementation. Continued support in the area of policy reform for agriculture and finance is warranted because of:

- a) the demonstrated sincerity of Government to forge ahead with reform;
- b) the continuing severe external economic environment necessitating rapid adjustment, and
- c) the continuing need to reform policy in order to eliminate disincentives to efficient growth and development.

Thus, the evaluation team recommends an amendment to ARSSP, responding to the recommendations of the evaluation, increasing funding, and extending the PACD to March 31, 1992.

12. Please note that this summary highlights primarily the findings and recommendations of interest to the audience following ARSSP as one case study in D.A. sector program assistance. Several other important observations and recommendations pertaining to ARSSP are contained in the body of the report.

ANNEX 5

INITIAL ENVIRONMENTAL EXAMINATION

- (A) PROJECT COUNTRY: Indonesia
- (B) ACTIVITY: Agricultural and Rural Sector Support Program
(497-0357), Amendment
- (C) FUNDING: \$ 20 million
- (D) PERIOD OF FUNDING: FY 87 - FY 89
- (E) STATEMENT PREPARED BY: Michael Hamberg, EPSO, USAID/Indonesia
- (F) ENVIRONMENTAL ACTION RECOMMENDED: Categorical Exclusion under AID
Regulation 16, Section 216.2 (c)
(1) (ii)
- (G) ACTION REQUESTED BY: James Hradsky, PPS, USAID/Indonesia
- (H) LEGAL ADVISOR CLEARANCE: Paul Scott, LA, USAID/Indonesia
- (I) ENVIRONMENTAL OFFICER CLEARANCE: Jerry Bisson, ARD/RRM
- (J) DECISION OF USAID/INDONESIA DIRECTOR
APPROVED: *Justin Meier*
DISAPPROVED:
DATE: 9/1/89
- (K) DECISION OF ANE ENVIRONMENTAL OFFICER
APPROVED: *M. Luk, ANE/PO/ENV*
DISAPPROVED:
DATE: 8-24-89

EXAMINATION OF THE NATURE, SCOPE AND MAGNITUDE OF THE ENVIRONMENTAL IMPACT

A. DESCRIPTION OF THE PROGRAM:

The proposed program consists of funds provided to support Government of Indonesia budget expenditures and policy movements directed at improving rural employment and incomes. Some technical assistance will be provided to help accomplish related analyses. AID will not be directly involved in how the budget support funds are spent, other than confirming that broad budget categories receive agreed levels of GOI funding during the GOI Fiscal Year. AID will have neither knowledge nor control of specific activities within those budget categories, except for separately financed AID projects which might be included within the categories.

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Among the policy reforms supported by this program is one item which directly addresses environmental issues. Thus the program itself constitutes a positive move toward environmental protection.

B. RECOMMENDED ENVIRONMENTAL ACTION:

Considering the above program approach, the proposed activities should be categorically excluded from further environmental review. This proposal is in accordance with AID Regulation 16, Section 216.2(c) (2) (i) (technical assistance activities not directly affecting the environment) and 216.2(c) (2) (iii) (analyses and studies), and the criteria set forth in Section 216.2(c) (1), which permits a categorical exclusion when AID does not have knowledge of or control over, and the objective of AID in furnishing assistance does not require, either prior to approval of financing or prior to implementation of specific activities, knowledge of or control over the details of the specific activities financed (budget support component).

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