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**Title:** Reform Strategy

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## **Reform Strategy**

### **INTRODUCTION**

The aim of this paper is to strategically improve the public finance management of the Government of Indonesia (GOI) in selected areas of composition of expenditure out-turn (PI-2), effectiveness of internal audit (PI-21) and availability of information on resources received by service delivery units (PI-23). The aim of the reform strategy is to improve these key areas of weaknesses in the PFM of the Government of Indonesia in accordance to the objectives of the Public Expenditure and Financial Accountability (PEFA) and PFM Reform Frameworks. The reform strategy will be divided into four sections: Introduction, Rationale, Reform Strategy Options and Recommendation.

The proposed areas of improvement will create a stronger link for performance accountability and public financial management in the public sector of GOI, which facilitate sound formulation for fiscal sustainability and setting of budget based on expansion of revenue mobilization and clear priority of expenditures (IMF 2016). The analysis of the seven pillars of PFM performance, especially in the category of Budget Reliability and Accounting & Reporting, are to be integrated in this reform strategy in order to provide an insight to the Government of Indonesia (PEFA 2016).

### **RATIONALE FOR PFM REFORM STRATEGY**

The projected governmental revenue and expenditures for the Government of Indonesia have been historically high relative to actual budget execution, which pushes the budget deficit near the statutory limit (IMF 2016). In addition to downward trend in governmental revenue, the setting of the governmental budget needs to reconsider revenue mobilisation and fiscal sustainability. Transparent revenue and expenditure framework are needed to be in place, in order to prioritise the level of expenditure in accordance to a rationalised budget (IMF 2016).

The fiscal sustainability strategy has been rational and applicable with the objective of the Government of Indonesia. Consequently, the fiscal strategy still has room for improvement, specifically in conjunction to the revenue mobilisation in the medium-term basis and prioritised governmental expenditure. The revenue mobilisation can extend to the fiscal

instruments such as tax on non-oil-and-gas and subsidy reversal (IMF 2013). The fiscal policy taken in 2013 by GOI has led to an increase of 44 percent in petrol price and 22 percent in diesel price as well as increase in resettlement fund for susceptible industries through deduction and extended repayment period (IMF 2013). The extension of the policy measure has accounted for rebalancing fiscal deficit and clear macroeconomic policy choices.

### **Areas of Weakness**

Three key weaknesses of Government of Indonesia' PFM includes; (PI-2) Formulation of expenditure execution relative to initial formulated budget (D); (PI-21) The integrity of internal audit (D+); and (PI-23) Paucity of Information on resources conducted by the grass root public service delivery offices (D). The rating produced by the World Bank's PEFA report (2012).

For PI-2, the ramification of expenditure executions relative with initial approved budget exhibits financial gap in term of excessive expenditures exceeding primary expenditures by more than 10 percent in estimated years under review. The rating of the expenditure's ramification was D in 2012 because the performance has been declining relative to 2007 indicator. The financial gap in subsidies and under-expenditures has negatively impacted major governmental projects including infrastructure and energy-intensive programs thus incurring gap in actual expenditure relative to proposed budget (World Bank 2012).

For PI-21, the performance of internal audit has been less than effective in term of institutional allocation of workloads and performance measurement to relative line ministries and public agencies. The functional description and responsibility for internal audit has been allocated to central audit agency, audit general agency, provincial audit agency and district audit agency (The World Bank 2012). The rating has been placed as "D" in 2012, as the performance measurement of internal auditing task has been trivial due to simple auditing tasks that emphasizes on document compliance and validity. The auditing tasks are performed on ad-hoc basis, thus overlooking the core internal control aspect. The validity of internal auditing task is not complying with the benchmark of international practices, hence infrequent and dismissive in nature. Furthermore, the interpretation of the internal auditing report has been challenging given lack of formal auditing task in all corresponsive public

agencies. The frequency of the internal auditing has been challenging in the context of insufficient monitoring and collecting activities (World Bank 2012).

For PI-23, The flow of information on resources received by the grass-root level is rated “D” in 2012 as well as 2007. The emphasized challenge in this indicator is the lack of quality information comprised of actual level of expenditures spent on primary schools and rural health centres. The specification of the indicator is, “the collection and processing of information to demonstrate the resources that were received (in cash or kind) by the most common front-line service delivery unit (focus on primary school and primary health clinic) in relation to the overall resources made available to the sectors (The World Bank 2012: pp.47).” The challenge in this indicator exhibits the difficulty of interpretation of report given different formats taken in grass-root level relative to the central level. Consequently, the flow of information has been ambiguous and misreported by the front-line and local level to the central level. The flow of information has limited thus giving a rise to the problem of paucity (The World Bank 2012).

The rationale for reforms are based on sound PFM frameworks that are composed of coherence, selectivity and learning (Peterson, Course Note 2016). The coherency of the PFM reform frameworks is based on the drivers that include context, ownership, purpose and strategy. The selectivity of PFM reform framework is based on the platforms of transaction, policy and legislation. The learning of the PFM reform framework is based on the phases that are translation, development, pilot, rollout and operation.

### **Three Objectives of PFM**

Aggregate Fiscal Discipline (AFD) is the scale of fiscal synchronization, where budget must include the explicit outcome, enforceable decision. Moreover, the budget formulation and setting should further account for the priority and level of expenditure. The budget setting and formulation should be considered prior to expenditure decisions and capital investments in medium-long term (Schick 1998). The parameter of the budget must be an enforceable given the period of implementation, hence allows for timely policy execution and governmental function in regard to effectiveness and efficiency (Schick 1998).

Allocative Efficiency (AE) is the rudimentary setting of budget, policy and governmental programs that based on priorities and level of demand. The budget setting and formulation should ramify and redistribute resources to highly prioritised public programs based efficiency, in order skim ineffective policies and public capital programs (Schick 1998). The groundwork of expenditure execution is essential in establishing coherent and effective budget. Accordingly, the sound and coherent budget has been able to reduce the excessive demand for expenditures and level of revenues (Schick 1998: pp. 15). The differences in public demands for increasingly higher budget from public agencies will exceed the maximum setting of national budget, therefore a clear and enforceable parameter must be in-placed in order for budget to function properly. Moreover, the public agencies' demands have to be confined in enforced parameters, in order to increase the effectiveness of wealth redistribution of resources (Schick 1998).

Operational Efficiency (OE) are the groundwork for cost-structure for all levels of public agency in creating effective and efficient public service delivery of public goods and services. The outcomes and outputs of the public service delivery should be established in accordance to the level of priority and public demands, while aligning with aspect of the market mechanism (Schick 1998). The proposed process of OE is to individualise input and prioritise the input into outcome groups with consensus from the central level. The control of individualised input group has under-performed given increased ambiguity from individualised input group (Schick 1998).

## **OPTIONS FOR REFORM STRATEGY**

Three key weaknesses of Government of Indonesia' Public Financial Management includes; PI-2, Composition of expenditure out-turn compared to original approved budget (D); PI-21, Effectiveness of internal audit (D+); and PI-23, Availability of Information on resources received by service delivery units (D). The analysis and rating are based on the World Bank's PEFA report dated in 2012.

Option 1: Increase transparency, accountability and performance of budget formulation in term of fiscal sustainability and expenditures execution. A benchmark international practice has to be adapted in term of creating a transparent and coherent budget formulation. The level

of expenditure and revenue has been unrealistically high in the context of the Government of Indonesia. Therefore, a benchmark practice in term of pinpointing an accurate and transparent budget is crucial for the process of budget formulation and budget cycle. (Aggregate Fiscal Discipline and Allocative Efficiency)

Option 2: The internal audit is essential in coercing standardised practices and performance in the public sector. Prior ad-hoc internal audit has been ineffective in performance reporting as well as managing the flow of key information to managerial cohort. Therefore, an enforceable and effective internal audit has been implemented to ensure the fiscal sustainability and performance management. (Operational Efficiency)

Option 3: The flow of information and transparency of internal practice from all levels of governmental agencies in term of accountability and timely reporting. The flow of information is needed to be symmetric from bottom-up, in order for the managerial cohort of the public sector to be able to establish and formulate applicable policies. (Operation Efficiency)

## **RECOMMENDATIONS**

The three main objectives of Public Financial Management (PFM) and the three frameworks of PFM Reform will be taken as the benchmark recommendation for GOI in reforming the PFM system. There are three selected areas of PFM weaknesses in the Government of Indonesia, where PEFA's indicators have a rating of "D". The rating of selected indicators exhibits minimal improvement or declining performance. The first selected indicator (PI-2) is "the composition of expenditure out-turn compared to original approved budget", whereas the indicator exhibits financial and variation gap in budget setting. The first option focuses on the gap of the actual expenditure execution and level of revenue differ from the propose budget by more than ten percent. The gap increasingly varies due to the effects of global financial crisis, which leads to high uncertainty and low trust in the capital expenditure. The expenditures execution in term of subsidies in infrastructure and energy intensive industries has negatively impacted by the uncertain global financial environment and setting of governmental subsidies. The effectiveness and efficiency allocation and redistribution of subsidies in oil and fuel prices has been impacted by the uncertain global financial

environment and energy market. The expenditure decisions have altered during the financial turbulences, hence the gap of expenditures execution relative to proposed budget have varied.

The scope of driver, platform and phases can be implemented in creating a more transparent and accountable practice in term of setting a coherent and transparent budget, where these scopes would lead the public trust in the positive trend. The enforceable parameter of Aggregate Fiscal Discipline (AFD) must be enforced and fiscally synchronised, which can lead to normalise the budget setting and formulation thus abating internal competition from governmental agencies and excessive expenditure demands and level of revenues. The budget formulation of enforceable and established parameter must be considered, given the GOI's many governmental agencies specifically during turbulence period. AE is essential as a mechanism of reallocation and redistribution of resources to prioritised policy and governmental capital programs, therefore the prioritised ramification of expenditure and revenue are key in reforming the PFM of GOI.

The second option focuses on the performance of internal audit as a key controller in resource allocation and redistribution, which can be achieved through economical and cost-saving operation as well as strategy for effective public service delivery. The allocated workloads and tasks of internal audit has to be improved through enforceable and clear guidelines in task allocation and rotations, the assigned head of each respective department must be able to monitor and collect internal auditing in standardised format and timely manner. The resource redistribution should be aimed towards prioritised and effective public body or program with high credibility from internal audit. The current GOI's challenge associated with internal audit is the inability to determine the level of priority of public programs, stakeholders and public agencies, therefore the challenge needs to be resolved in order for the scope of platform and phases to function effectively. The objectives of PFM and PFM reforms are to allocate the resources to prioritised and effective public bodies and programs, hence the involvement of monitoring agency should account for in the reform strategy in these agencies in order to revamp the internal audit practices across all public agencies. Further trainings and singular format for internal auditors are highly recommended, in order for the benchmark practice to be translated in establishing a unified form of reporting and auditing tasks.

The third option focuses on ‘the availability of information on resources by service delivery units’ are essential in formulating coherent budget for public agencies. The difficulty of information asymmetry occurs then immediate reform or restructuring are required. Information are essential in all three objectives of the PFM as well as the scope of PFM Reform Strategy, where the formulation of coherent budget parameter require immense information from the front-line units. AE requires information for determining the most effective allocation and redistribution of resources to relevant sector and programs. OE requires information in order to establish an economical and cost-saving mechanism for agencies to operate effectively and efficiently. The establishment of a unified unit must be considered for information to be transferred effectively and timely.

Drawn from Peterson (2015, 2016), the implementation of PFM reform is based on a chronological rationality, which leads from the commencement that required to accumulate the in-depth knowledge to the outcome which are based on the government’s accountability in ownership and enforceable parameter. The link of three established frameworks for guiding public financial reform are based on the drivers, platforms and phases. The application of drivers of reform framework focuses on the understanding of local context and ownership. After the identification of both aspects then the government can establish a clear purpose and strategy to tackle the area for reform. The platform of the reform framework focuses on involved stakeholders and key instruments that will be utilised to guide and facilitate the strategy to fulfil the purpose from prior strategy.

The phase reform framework focuses on the translation phase, which transforms policy into action and strategy. The development phase applies the strategy with set budget that is adequate but enforceable. The pilot phase collects information in a concentrated environment and disperses feedbacks to all relevant stakeholders, thus increase the awareness of the effects of the strategy. The rollout phase implements the strategy across all intended stakeholders, thus finalising the effects amongst stakeholders. The operation phase sustainably continues the strategy and adapted to changes to make the strategy relevant and coherent through the policy life-process (Peterson 2015;2016).



## **CONCLUSION**

The Government of Indonesia has adopted numerous administrative reforms and decentralisation in the recent years. There are many challenges that the GOI is currently facing, but positive progresses have been made. The setting of priority in public program and agencies have been a welcoming change through many public service delivery agencies. All three option proposed by the reform strategy should be taken in the scopes and objectives of PFM Reform, in order for GOI to experience positive improvements in highly prioritised public programs. The adoption of decentralisation has been positive and it is recommended for the Government of Indonesia to undertake the three proposed reforms in order to follow the benchmark practices around the world. Therefore, the transparent and prioritised setting for budget must be formulated in an enforceable parameters and sustainable in the medium to long term. The ramification of internal audit should be enforced with specific tasks and clear guidelines for conduct and work frequency. The flow of information from grass-root level of public agencies should be reported frequently and in a clear format.

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