

**GOOD GOVERNANCE AND ANTICORRUPTION:
*THE ROAD FORWARD FOR INDONESIA***

Paper Presented by the Asian Development Bank
at the Eighth Meeting of the Consultative Group on Indonesia

27–28 July 1999
Paris, France

I. Introduction

A. Governance and Anticorruption

1. Combating corruption is increasingly recognized as a crucial step by both donor and recipient countries to stimulate economic growth and reduce poverty. Until recently, corruption was relegated to the status of a second order issue in the quest for socioeconomic development. In the late 1960s to the mid-1980s, macroeconomic policy of most developing countries, and major donors, emphasized stabilization—and for good reasons. Unless the macroeconomic environment was stable, not much else could be done to stimulate an economy. From the mid-1980s to the early 1990s, trade and market liberalization took centerfield. With most developing countries gaining reasonably good control of their macro economy, structural constraints to reducing state intervention and curbing monopolies emerged as the major policy concerns. By the mid-1990s however these issues came to be superseded by concerns with corruption. This is not surprising since the underlying rationale that underpinned the trade/market liberalization drive was the recognition that rent-seeking thrives in highly protected environments, creating many informal arbitrage opportunities for government officials and the private sector.

2. This heightened concern with corruption is supported by recent research into the impact of corruption on investment and growth. Mauro's (1995) research indicates that "a one standard deviation improvement in bureaucratic inefficiency is significantly associated with an increase in the average investment rate by 4.3 percent of GDP" and "with a 1.3 percentage point increase in the annual growth rate of GDP per capita."¹ Similarly, Keefer and Knack indicate that improving the quality of public institutions in developing countries to levels that are more similar to those in developed countries reduces the gap in income per capita between the two.² And, Wei has also shown that an increase in (bureaucratic) corruption from a level akin to Singapore's to one more akin to Mexico's is "equivalent to a thirty two percentage point increase in the tax rate" on multinational firms" and "a one percent increase in a host country's tax rate on multinationals is associated with a five percent reduction in that country's inward foreign direct investment."³

3. Though donors and recipient countries have together become significantly preoccupied with combating corruption, the thrust of their strategies has revolved around improving governance: reducing arbitrary state intervention, reforming the management of the public sector, legal and judicial reform, and using citizen "voice" mechanisms. As the 1997 World Development Report argues that policy distortions, an unpredictable judiciary, low civil service wages (relative to the private sector), and the lack of merit based recruitment into the public service are among the major causal factors that breed and nurture corruption. To combat corruption, one must turn attention to governance factors: corruption is principally a symptom of bad governance.

4. From the late 1960s to the mid-1980s, Indonesia focussed on macroeconomic management and successfully established effective mechanisms for controlling inflation. By the early 1980's, inefficiencies in the economy started to impinge significantly on further growth prospects. This led to a gradual, and perhaps selective, process of trade and market

¹ Mauro, Paolo. 1995. "Corruption and Growth," *Quarterly Journal of Economics*, August, pp. 681-712.

² Knack, Stephen and Philip Keefer. 1995. "Institutions and Economic Performance: Cross Country tests Using Alternative Institutional Measures," *Economics and Politics* 7(3), pp. 202-227.

³ Wei, Shang-Jin. 1997. "How Taxing is Corruption on International Investors," Working Paper 6030, National Bureau of Economic Research.

liberalization. And with this, GDP continued to grow at an impressive rate. But, this era of uninterrupted growth spanning three decades, that catapulted the country from a poverty stricken nation to a middle income economy, came to a sudden halt in 1997 as the financial crisis in Thailand engulfed the whole East Asia region and Indonesia in particular, in a severe economic crisis. As the crisis unfolded unprecedented demands (from the citizens) for institutional change emerged. At the core of these demands has been the desire to curb corruption at all levels of government. Indeed the acronym KKN (corruption, collusion, and nepotism) has come to symbolize the calls for fundamental change; change that the public hopes will lead to renewed and sustainable economic growth fostered by greater participation of the citizenry in public decision making.

5. In recognition of the increasing awareness and aspirations of civil society in governance-related matters, the Government indicated at the last CGI Meeting (1998) that it would accord high priority to good governance. Alongside, the ADB adopted an Anticorruption Policy in July 1998 to guide its anti-corruption efforts. The purpose of this brief paper is to summarize the progress made so far in combating corruption in Indonesia and outline a course for future action.

B. A Broad Conceptual Framework for Addressing Corruption⁴

1. Encouraging and Sustaining Market Competition

6. If efforts to improve governance and thus curb corruption are to yield sustainable results, a high priority should be given to correcting market distortions that impair fair competition and foster excessive monopoly rents. Corruption thrives in an environment governed by weak checks and balances. Empirical evidence shows that there are indeed very weak forms of checks and balances in markets dominated by a few sellers, and particularly so in monopolies. In such markets, rent-seeking thrives. In this environment, a regulatory mechanism that is not transparent can easily result in corruption. The sellers can easily collude to bribe government officials to institute regulations that favor them over consumers. Consumers, on the other hand, often confront serious collective action problems and thus cannot mount counter pressures. This results usually in poor quality products, high prices, and substantial corruption.

7. The lack of or uneven access to information is one major problem that inhibits the proper functioning of competitive markets.⁵ Firms or buyers who have better information than others can and often use this to their advantage and to the detriment of others. The establishment of standards for accounting, auditing, and production helps alleviate this problem. For example, ISO standards help consumers as well as public agencies distinguish between better and poorer quality products and thus prevent firms from passing on bad products at high prices. International standards for accounting help investors better evaluate the comparative performance (past, present, and future) of large multinational firms. Several developed countries have in fact moved their public sectors towards internationally accepted standards for accrual accounting in order to make it easier for accountants in the private sector (especially in the banking sector) to evaluate the performance of government agencies and thus increase public sector accountability.

8. In many countries (including many member countries of the OECD), the state has been directly involved in productive activities: state intervention has taken the form of ownership and

⁴ The framework is adapted from that used in the ADB's Anticorruption Policy.

⁵ There is a considerable literature in economics on problems of information and their adverse effects on markets.

management of firms—state-owned enterprises (SOEs). This has created even weaker checks and balances since the state controls both the regulatory regime and production. Not surprisingly, corruption has been perceived to be more pervasive in countries with a large state enterprise sector.⁶ The response of many countries to this perversion has been to privatize SOEs in order to introduce market pressure in the production sector.

2. Promoting an Efficient, Transparent, and Accountable Public Administration

9. Rules governing public administration have a profound effect on the performance of government agencies. Bad rules encourage inconsistent and disruptive behavior among civil servants and thus bad outcomes. Public services are delivered poorly with corruption often greasing the wheels to have them delivered at all. As the World Development Report 1997 indicates, bureaucratic corruption is a symptom of a dysfunctional public sector management.

10. Reforming the civil service and overhauling the budgeting system are key to improving public sector management. Poor pay, complex and antiquated pay and allowance structures, over employment, nonmerit based recruitment and promotion, and conflicting mandates often characterize the civil service in many developing countries (including Indonesia). Each of these factors creates perverse incentives that encourage civil servants to engage in corruption.⁷ An opaque, incoherent, and undisciplined budgeting system by itself creates many opportunities for corruption; but, in combination with a malfunctioning civil service, it magnifies the problem manifold.

11. Strengthening the capabilities of oversight agencies is an important element of any strategy to encourage better public sector management. Oversight agencies form a critical part of the checks and balances within government that create pressure on civil servants (as well as politicians) to perform their duties and responsibilities as specified in their agencies' mandates. Their role is particularly important in the area of procurement where opportunities for corruption are most likely to reside.

12. In countries with large populations and/or land area, decentralization (fiscal and administrative) is key to improving public administration and in particular the delivery of basic public services. By allocating responsibilities and authority to smaller political units, decentralization brings government closer to the people it is supposed to serve. It thus creates an environment more conducive to promoting greater transparency and accountability in the provision of public services. These increased responsibilities and authority however need to be matched by corresponding financial arrangements. Fiscal decentralization is thus needed as well. It should be noted however that this requires striking an appropriate balance between central government controls and local government flexibility. For example, without appropriate central constraints on borrowing, local government units could easily inflate the deficit to unsustainable levels, as has happened in a number of Latin American countries. On the other

⁶ As always there are exceptions to this, e.g. Singapore, but research has shown that, for developing and transition economies, heavier state involvement in actual production is associated with higher levels of rent-seeking and, by implication, corruption. See Waterbury, John, 1993, *Exposed to Innumerable Illusions: Public Enterprise and State Power in Egypt, India, Mexico, and Turkey*; The World Bank, 1996, *Bureaucrats in Business*, Policy Research Report.

⁷ Evans, Peter and Jim Rausch. 1996; *Bureaucratic Structure and Economic Growth: Some Preliminary Analysis of Data on 35 Developing Countries*, Working paper, University of California, Berkeley; Campos J. Edgardo and Sanjay Pradhan. 1997. *Building Blocks Toward a More Effective Public Sector*, Working Paper, World Bank Institute.

hand too many constraints will hamstring local governments and limit their ability to deliver services that match the demands of citizens within their jurisdiction.

3. Citizen Participation

13. Discussions of governance and anticorruption invariably get intertwined with the issue of democratization. Democratization tends to get entangled in philosophical and technical debates. But these concerns generally detract from its fundamental feature—citizen participation in decision making. Citizen participation through elections, voice mechanisms, and the media creates pressure on public officials to provide public services efficiently and to formulate (and implement through the bureaucracy) policies that promote the general welfare of the country. It introduces the necessary element of public accountability of politicians and civil servants without which corruption cannot be adequately curbed.

14. Citizen participation, whether through NGOs, cooperatives, or the like is most effective at the micro or local level because the link between public officials responsible for the project or program and the citizenry is more direct and well defined and thus transparency and accountability are much easier introduced and enforced. At this level, participation takes the form of “voice mechanisms” which can range from so-called regular client surveys of specific government services or program to direct participation in the management (and thus decision making) such as is found in irrigation projects in some developing countries. The basic function of these mechanisms is to create more transparency in the implementation of projects/programs and greater accountability of public officials in charge of implementation. The link with decentralization is evident.

4. Legal and Judicial Reform

15. The rule of law is fundamental to creating an environment suitable for and nurturing of economic growth and thus is equally crucial for alleviating poverty.⁸ As some empirical research suggests, there is a strong negative correlation between the rule of law and corruption.

16. Among legal institutions, the judiciary is first among equals. For without effective enforcement, good laws, whatever their nature or orientation, are of little consequence. Weak enforcement generally implies that judges can be bought and thus court decisions can be unpredictable. This has negative implications for investment, growth, and by implication poverty reduction. For example, an extensive in depth analysis of the impact of judicial performance on investment and growth in Brazil reveals that with improved judicial performance investment could be expected to increase by approximately 10 percent and rate of GDP growth in GDP by about 25 percent.⁹ The implication is that judicial reform is a necessary prerequisite and of foremost importance for sustained economic development.

5. The Role of Official Watchdogs

17. Curbing and rationalizing government intervention, reforming public administration, and encouraging citizen participation are all targeted towards altering the incentive structures that govern the behavior of public officials in ways that induce them to perform their duties adequately, if not efficiently, and thus indirectly reduce corruption. Such reforms however need

⁸ See North, Douglas. 1980. Institutions, Institutional Change, and Economic Performance, Cambridge, England: Cambridge University Press.

⁹ Pinheiro, Armando C. 1998. “Economic Costs of Judicial Inefficiency in Brazil,” unpublished report, IDESP.

to be supplemented by efforts designed to catch and penalize corrupt acts. Legal and judicial reforms create the venue and means to prosecute and impose penalties on corrupt officials. To round out an anticorruption strategy, mechanisms to identify and catch these officials have to be established. This generally comes in the form of a watchdog agency such as the Independent Commission Against Corruption in Hong Kong and the Corrupt Practices Investigation Bureau. If effective, a watchdog agency raises the opportunity cost of engaging in corrupt activities and thus reduces the incentive to do so.¹⁰

II. Recent Developments in Promoting Better Governance

A. Promoting Market-based Development

18. Under the Economic Recovery Program agreed with international financial institutions, the Government has begun to address the requisites for reducing state intervention and promoting greater market competition. It has introduced a number of measures to remove price controls and subsidies and to break up state monopolies in the marketing and distribution of key commodities including wheat, sugar, cloves, paper and plywood, cement, and fertilizer. It has also further rationalized and reduced import tariffs and has committed to eliminating nontariff barriers other than those required for environmental or health considerations. And, it has created a Masterplan for carrying out the reform of the state owned enterprise sector which includes among others strengthening the corporate governance of SOEs, systematic corporate and financial restructuring of the SOEs, liquidation of nonviable enterprises, and scheduling of enterprises for divestment and privatization.

19. Parliament has passed an Anti-Monopoly Law. The law bans price fixing cartels or any such agreements between firms that constrain competition through the division of product ranges or marketing territories. It also provides a mandate for the establishment of an Independent Supervisory Commission to investigate and impose administrative penalties for violations of the law (although it fails to specify clearly what authority the commission will have to enforce its decisions).

20. Parliament has also enacted a Consumer Protection Law, Law 8/1999 (see annex B) to complement the anti-monopoly law. This law protects the consumers' rights when using products and services, and in choosing and obtaining goods and services at fair prices. It also provides a mandate for the creation of a National Consumer Protection Agency and delegates to it the authority to implement the law. It is hoped that with improved consumer rights, the consumer can finally be "king" and induce greater competition among firms.

21. Significant progress has been achieved in strengthening the legal and regulatory regime for the banking sector. Parliament recently passed a new Central Bank Law which grants the Bank of Indonesia (BI) considerable independence and authority over the formulation and implementation of prudential regulations. BI has issued new prudential regulations concerning loan classification, loan loss provisioning, treatment of debt restructuring operations, liquidity management, foreign currency exposure, connected lending, capital adequacy ratio, and publication of financial statements.

¹⁰ See Quah, Jon. 1995. Controlling Corruption in City States: A Comparative Study of Hong Kong and Singapore, Crime, Law, and Social Change, 22: 319-414 for lessons for making a watchdog agency effective.

B. Reforming Public Administration

22. The main thrust of efforts in reforming public administration has been in the area of decentralization. In May this year, the President signed two laws that will significantly change the relations between central and local governments. Law No. 22/1999 on Local Government Administration (UU PD) and Law No. 25/1999 on Central-Local Fiscal Balance (UU PKPD) were signed by the President on 7 May and 20 May, respectively. Both laws were approved by the Parliament, with considerable debate on the latter.

23. Law 22/1999 (UU PD) replaces Law 5/1974 on Local Government Administration and Law No. 5/1979 on Village Administration. The latter was the first major government commitment to the principle of decentralization with the express intent of devolving many functions of government to the local level. This new law, which essentially deals with administrative decentralization, introduces landmark changes in central-local government relations. Among them are the following.

- (i) Kota/Kabupaten (roughly districts) are now fully autonomous and no longer report hierarchically to provinces.
- (ii) A district head functions solely as the head of the autonomous local government and is now directly and solely responsible to the local parliament (DPRD).
- (iii) The candidates for district head no longer require the recommendation of the provincial governor or a preapproval by the Ministry of Home Affairs. This, combined with the likelihood that the DPRD will consist of a diversity of parties in coalitions, means district heads will become truly elected officials and will be oriented much more closely toward priorities of local voters and empowerment of the public.
- (iv) All functions not specifically assigned to central and provincial level governments "reside" in the districts.
- (v) The vast majority of central ministries are no longer allowed to maintain independent deconcentrated offices in the Provinces or in the districts for purposes of executing projects/programs.

If implemented in the specified two-year time schedule and if supported with appropriate financial resources, UU PD will change radically the nature of local politics and public administration. With the inevitable and significant changes implied by this law, there will undoubtedly be both positive and negative results, which could lead to administrative chaos if not carefully managed.

24. Law 25/1999 (UU PKPD) replaces Law No. 32/ 1956 (which was never implemented) and alters the structure of local government financing that has been in place essentially since independence. The objectives of UU PKPD are to provide sources of financial resources that are consistent with the devolution of responsibilities in the UU PD and retain a (difficult to define) balance between the often conflicting objectives of national equity and local autonomy.

25. Following the enactment of the two laws, both the Ministry of Home Affairs (MOHA) and the Ministry of Finance (MOF) set about the task of preparing follow up regulations, MOHA for UU PD and MOF for UU PKPD. These efforts have been undertaken largely in parallel, despite the fact that the issues involved are deeply intertwined. A Presidential Decree giving *Menkowsabngpan* the overall coordination role in preparing the follow up instruments was issued recently and task forces are now being envisioned to handle follow up products in the various fields required, bringing together the various agencies involved: MOHA and other relevant agencies—BAKN, BPKP, LAN, MOF, and BAPPENAS. This clarification of the

mandates may work to pull relevant Ministries/agencies closer together in the task, but, because such coordination has been rare in the past, there is some concern that it may not come about as hoped.

26. The current overpreoccupation with decentralization is understandable given three decades of iron fisted centralized rule. Ideally, the decentralization process should be undertaken in conjunction with other governance-related reforms, in particular, civil service, budget, and judicial reforms. Reform efforts on the latter are relatively muted compared to the decentralization push. This could cause potentially serious problems.

27. Difficulties could be faced in addressing corruption and bringing about a more transparent and accountable budget if decentralization is attempted independently of other reforms. Attempts to improve the budgeting system reorienting it towards a performance focus could be made doubly difficult if the current problems are simply “transferred” to the regions via decentralization. Likewise, overly precipitous decentralization that does not take into account fiscal realities and operational challenges could result in functions (and even staff) being transferred ahead of funds (which may be quite sticky given the current claims on the central budget). The result may be a civil service at the regional/local level that has reduced access to development funds that have been traditionally used to supplement wages, with unintended effects on local good governance as the civil servants find ways to survive—corruption could very well be decentralized and more widespread and thus much more difficult to control.

28. The lack of effort in promoting genuine change in the judiciary could also hamper the decentralization thrust. Uncertainty and lack of experience are likely to produce some problematic implementing regulations for the decentralization laws. Without a adequately functioning judiciary, this would foster abuse and corruption at the local level that will be more difficult to hold in check.

29. The Government is aware of these potential difficulties and has undertaken a study on separating the judiciary from the executive branch. At present, judges and prosecutors are under the authority of the Ministry of Justice and thus lack the independence needed for them to perform their tasks appropriately. If the recommendations of the study are implemented, this would be an important first step towards reforming the judiciary and help give it the needed teeth to enforce anti-corruption and related laws.

C. Specific Anticorruption Efforts

30. Direct anticorruption efforts have also been launched. Most recently, both the Government and Parliament have agreed to establish an independent commission to serve as a repository for the records of assets of government officials, to audit these assets, and, in general, to investigate allegations of corruption among government officials. The new anti-corruption Law, Law 28/1999 (see annex A), which provides the legal basis for the commission, requires public officials in “corruption” sensitive positions to declare their assets prior to assuming their posts and to agree to have their assets open to an official audit during/and or after their term. In a related matter, the Government has begun to address weaknesses in the area of public procurement and project implementation. It has formed several working groups to draft a new presidential decree on improved procurement procedures which it is hoped will facilitate and improve the implementation of public projects.

31. The Financial and Development Supervisory Agency (BPKP) has developed an anticorruption manual—the so-called Blue Manual—that presents its National Anticorruption

Strategy (see para. 35). BPKP has devoted considerable effort to take the lead in the fight against corruption. Because it has been perceived to be part of the administrative structure itself, its efforts have not taken root. Some observers indicate that another agency outside the administrative structure may have to take on the lead effort in combating corruption for things to succeed.

III. International Assistance for Promoting Better Governance

32. The ADB has been and will continue to be a strong supporter of governance reform in Indonesia. As a major multilateral development institution and one of the leading sources of development funding in Asia and the Pacific Region, the ADB believes in the importance of emphasizing anti-corruption initiatives as part of its broader work on governance issues.

33. In Indonesia, the Bank's support for promotion of good governance including anticorruption initiatives that predate the Bank's adoption of its Anticorruption Policy. As a major initiative for improving public financial management and corporate governance, the Bank approved a \$1.5 billion loan that supports (i) policy reforms that improve regulations of and corporate governance within the financial sector and support greater competition, (ii) a revision of the anticorruption law, (iii) institutional strengthening of BPKP, the national audit agency, and (iv) research on public administration reforms. International consultants were engaged to help Bank of Indonesia conduct independent financial audits of private banks. Assistance was provided to BPKP to conduct international audits of selected state enterprises, to review existing anti-corruption legislation, and to prepare a national anti-corruption strategy. Funding was provided to support *Lembaga Administrasi Nasional* (LAN) in preparing a research study on reforms in public administration.

34. In September 1998 the Government requested Bank support specifically to combat KKN. In response, the ADB adopted (in May 1999) an anti-corruption action plan for Indonesia based on its Anti-corruption Policy. The action plan calls for implementation of various measures to fight corruption (both by the Government and the ADB) and will provide technical assistance to support, among others, workshops/seminars, activities encouraging and developing greater involvement of civil society in anticorruption efforts, assistance to implement the anticorruption strategy for the Government, a study on improving efficiency of public financial management, and capacity building for improving public sector procurement.

35. On 22 July 1999, the Action Plan was presented at a joint Government-ADB high level workshop on anti-corruption. At the workshop, the Government's progress on introducing, developing, and implementing anti-corruption measures was also presented. Both the Government and the Bank agreed to support each other's efforts. In particular, the Government expressed support for the Action Plan and indicated it would work with the Bank on its implementation. The Bank in turn expressed its desire to closely coordinate with the Government on its implementation. A summary of the workshop discussions was presented to the donor community and civil society groups on the same day.

36. In the area of decentralization, the ADB has provided assistance to encourage more intensive involvement of NGOs and LCOs in monitoring program and project implementation, particularly in the provision of safety nets. Decentralization, it is hoped, will make public administration more responsive to people and their needs and to bring about greater efficiency and effectiveness in public service delivery. The ADB's future assistance in various sectors will aim to support the Government's decentralization efforts.

37. Like the ADB, the World Bank's (WB) involvement in governance related activities predates the Asian financial crisis and the change of government, although the level and extent of its involvement has increased markedly since then. In 1995, the WB provided a technical assistance grant to BAPPENAS and the Ministry of Justice to undertake a diagnostic review of the legal and judicial system. The resulting report was completed in 1997 and was widely circulated. In 1996, the WB introduced the use of a client survey to help address expressed concerns of fraud and corruption in the implementation of a land administration project. The results of the survey, which included objective information on bureaucratic corruption, were made available to the Government.

38. Together with the IMF, the ADB, and several other donors, the WB has assisted Government in addressing financial restructuring and corporate governance issues through its Policy Reform Support Loan (PRSL) operations. A major thrust of current WB efforts is in the area of diagnostic studies. In February 1999, it launched an initial assessment of the state of the Indonesian civil service that identified fundamental problems in the incentive structures that have governed and continue to govern the civil service. The effort was supported by the ADB with ADB staff directly participating in the assessment. Most recently, the WB initiated a public expenditure review that focussed on the broad parameters that influence the budget process. Some attempt at coordinating this work with the civil service assessment and a planned ADB study on public expenditure management is expected in the near future.

39. The WB has been active on the anti-corruption front. Two high level missions specifically focussed on combating corruption have been launched since mid 1998 which have resulted in an initial diagnostic report on corruption and an aggressive effort to help draft new procurement regulations for the Government. To extend this work and integrate it with broader governance concerns, the WB has committed to the preparation of a "National Institutional Review" (NIR) which will summarize all the diagnostic work done so far, define a strategic framework for its governance work in Indonesia, and provide guidance on prioritizing WB actions or interventions.

40. The WB is also currently developing a consultation strategy with civil society groups to help encourage more civil society participation in public decision making. At the local level, it is implementing a pilot project that will complement the effort to encourage participation. The project, funded by ASEM, will experiment with ways of increasing transparency in the operations of local government.

41. Many other donors are active or plan to become active in the good governance/anti-corruption fields. Recognition of the importance of these interventions is fast increasing, and resource commitments seem to reflect this awareness. The GTZ for instance has long been involved in decentralization support, directed at the Ministry of Home Affairs and other relevant agencies. It is now expanding the scope of its support to include a good governance initiative to be housed in the agency concerned with state reform (currently *Menkowasbangpan*). UNDP has supported the development of the legal framework for the elections, and is now examining the possibility of a major capacity building effort to provide a basic orientation or training to the new legislative members at provincial and district/city level.

42. CIDA is currently seeking to redirect project activities to better support good governance reform and capacity building initiatives, and has a project specifically geared to this field as well (Good Governance Support Project) that will soon be active in fields that have received insufficient attention, such as civil service reform. The USAID Clean projects, supporting both BAPPENAS and MOHA will soon shift back to decentralization and capacity building, after being largely preoccupied with the social safety net effort in the last two years. Various other donors

are also intensifying efforts. It also has a significant civil society supporting project in the pipeline.

43. There are a number of local Indonesian nongovernment agencies/foundations active in good governance and advocacy work. For instance, *Aka Tiga*, a Bandung-based NGO, seeks to determine the high cost imposed on the business sector, particularly small businesses, from illegal levies imposed by the public sector. Other organizations, like the Indonesian Corruption Watch, act more as oversight or watchdog groups.

44. Complementing local efforts are a number of regional or international foundations that have been stepping up efforts in good governance. Among them are the Asia Foundation, Ford Foundation and the *Stiftung* attached to German political parties. Their efforts in Indonesia have focused on the development of civil society and in promoting sustainable economic growth. Their initiatives have supported efforts to implement free and fair elections and they are encouraging the development of civil society; promoting pluralism and religious and ethnic tolerance; fostering human rights through civic education, monitoring and advocacy; promoting women's full participation in civil society; developing and implementing effective counter-corruption reforms; and creating an efficient and transparent business environment conducive to the growth of small and medium businesses.

IV. Continuing Efforts

45. Indonesia has moved significantly on the governance front in the last year. A number of large family based monopolies and cartels have been or are being broken up. The first nation wide elections in more than 30 years proceeded smoothly and has paved the way for electoral accountability to play some role in restraining arbitrary government behavior. Major laws on regional autonomy, antimonopoly, bankruptcy, and anticorruption/nepotism/collusion have been passed with discussions on implementation procedures now ongoing. NGOs and the media have been granted more freedom to scrutinize and criticize government policies, programs, and actions. All these are promising efforts towards the improvement of governance and the consequent reduction in corruption.

46. But much more needs to be done. Serious questions and problems surround the issue of fiscal decentralization which need to be addressed adequately if the benefits of regional autonomy are to be fully realized. UU PKPD was enacted by Parliament but with much acrimony, debate, and dissatisfaction. On one extreme, some favored the specification of formulas for the allocation of transfers; on the other side, others, mostly the MOF, preferred not to have such specifications included in the law and instead favored a clause indicating that the precise nature of the transfers would be determined by implementation regulations. The final result has been a rather unhappy compromise, which suggests that renewed efforts, may be needed to revisit these matters.

47. The uncertainty that surrounds fiscal decentralization is exacerbated by the weak capacity of local governments and the present lack of structure and direction in the use of fiscal transfers, e.g. for social expenditures, which falls within the realm of Law 22 (UU PD). The latter shortcoming, if not attended to in follow up regulations, will likely cloud the link between spending and accountability and may create significant problems in service delivery.

48. UU PD on administrative decentralization suffers from several shortcomings, and is vague on key aspects. It is improbable that the elaboration of the law would be completed by

the target date of July 1999. Moreover, within the required two-year time frame will also be difficult. More specifically, the shortcomings appear to be as follows.

- (i) The assignment of functions promises much more to the districts/cities than may be in keeping with current varying capacities. The financial relations, further elaborated in UU PKPD, appear to be out of tune with fiscal realities, and have been fixed ahead of functional assignments (which is still to be concluded). The match between functions and funding is jeopardized in this approach.
- (ii) The law leaves a lot open for subsequent government regulations, and the possible conflict between levels of Government could pose enormous challenges in determining allocation of funds to various levels.
- (iii) Some sections have drafting lacunae, making it very difficult to effectively and consistently elaborate the law without breaching some part of the law itself.
- (iv) The law allows for functions (not listed) to be passed by the districts/cities to the provinces, except for some obligatory functions (not specifically listed, just given as a sectoral list). The undetermined status of these functions, and whether the province must accept them (given that they would have to pay for them) creates much uncertainty over ownership, roles and funding.
- (v) The rapid and drastic degree of decentralization anticipated on the functional assignment should be more clearly reflected in the drafting of complementary instruments regarding the requisite shift of public servants, funding and organizational restructuring at the regional level. It may well happen that significant leeway is given in one area, for example in setting organizational structures, while tight control is kept in a very related area, such as setting the regional/agency establishments.

Given these potential difficulties, much work will be needed in preparing and/or revising the implementing procedures.

49. In this context, it would be significantly helpful to the Government if donor assistance could be provided quickly for the formation of a secretariat within *Menkowsabangpan* that will coordinate the efforts of all the agencies involved in crafting the implementing regulations for the two decentralization laws (as well as broader good governance reforms). A recent Presidential decree has designated *Menkowsabangpan* as the coordinating body for these efforts. *Menkowsabangpan* cannot carry out this mandate without a properly functioning secretariat. The significance of developing workable implementing regulations cannot be understated. The formation of the Secretariat will facilitate and help guide this process.

50. In other areas of reform, the Government also has considerable tasks to accomplish. The civil service is in need of serious overhaul where compensation, personnel management practices, and financial/budget management practices combine to create distorted incentives that lead to lower productivity and/or corruption. Serious efforts at improving governance generally involves reforming key aspects of the public administrative machinery. In Indonesia, particular attention will have to be given to the dichotomy and lack of coordination between the development budget and the recurrent budget. There is some indication that a good portion of the development budget is used to top off civil servant salaries, the rationale being that official salaries and allowances are grossly inadequate to compensate civil servants. While useful in increasing compensation to levels closer to those in the private sector, this arrangement tends

to redirect efforts of civil servants towards “project creation or project seeking” with the consequent effect of reducing productivity and encouraging corruption. Reduced productivity tends to lead to the hiring more civil servants – since the work needs to get done -- which in turn further depresses future increases in salaries and/or allowances. This cycle will have to be broken if significant headway is to be made towards curbing bureaucratic corruption. In short, much more effort will have to be devoted to both budget and civil service reform.

51. The World Bank and the ADB have begun to undertake diagnostic studies that will offer guidance on budget and civil service reform and in particular on possible strategies for (a) creating tighter coordination between the development and the recurrent budget and (b) increasing civil service compensation within affordable limits. A logical next step upon completion of these studies is a dialogue among donors and between the donor community and the Government that charts a medium term plan for budget and civil service reform and elicits commitments from all parties to support specific components of and steps included in the plan.

52. Improving tax administration will help in the effort to raise the compensation and improve the welfare of public officials. Experience in other countries suggests that any significant improvements will require institutional changes that alter the incentives of tax collectors. The Government is firmly committed to improving tax collection but it will need technical assistance to develop an appropriate plan and corresponding implementation strategy.

53. On the expenditure side, the Government has initiated efforts to improve public procurement processes. It has assigned more than 4,000 staff to serve as procurement managers each to be assisted by a tender committee comprised of at least five other public employees. It has sought donor assistance to establish a “National Procurement Institute” to provide training and assistance on public procurement and to serve as a body certifying the skill adequacy of individuals in the area of procurement.

54. In connection with the procurement effort, the Government is building a role for NGOs to help in various stages of the procurement process. And in a related drive, it is taking steps to boost the freedom of the press in order to widen the availability of information and enhance transparency. More donor support for activities of this sort is badly needed. Mechanisms to involve greater citizen participation in the thrust towards better governance have to be developed and encouraged. The NGO community, while vibrant, lacks adequate skills and resources to help build up citizen understanding and concern for the public good and thus imbed public accountability of government officials as a principal feature of society. While donors have been actively assisting NGOs, more is needed. The sustainability of reforms depend crucially on the involvement of civil society. NGOs are a crucial link in resolving collective action problems that inhibit such involvement.

55. The Government has taken a significant step towards establishing a well functioning judiciary. Recommending the separation of the judiciary from the executive is a necessary step in the right direction. Functional independence however does not guarantee that the judiciary will be able to perform its duties adequately. Just like the civil service, the judiciary will have to be governed by appropriate personnel and financial management systems and judges and prosecutors will likely have to be retrained. For instance, poor compensation of judges is likely to translate the freshly won independence into new avenues for corruption. Hence a serious, immediate study of the institutional aspects and intensive retraining activities are both warranted.

56. The Government has been most aggressive in promoting market competition. However its efforts have to be continued and deepened. On SOEs, there are still a large number of banks and enterprises that may be better off privatized or liquidated. Appropriate and predictable regulatory regimes need to be established particularly in the infrastructure sectors, e.g. energy. There are also questions that plague the anti-monopoly law, specifically the role of the Independent Supervisory Commission.

V. Conclusion

57. Economic recovery cannot be sustained without sufficient and sustained progress on governance reforms. The need for such reforms has become even more compelling today with the evolving trend towards globalization of economic activity. Hence, while Indonesia has been remarkably successful in promoting and sustaining economic development in the past, it will now have to confront the tougher challenges of promoting good governance and reducing corruption if it hopes to sustain its nascent recovery and ensure long term economic progress.

58. The economic crisis has shown that the general public has borne enormous costs of poor governance. Recent events indicate that the public has responded strongly and is keenly observing the performance of the Government. There is thus a golden opportunity to galvanize public support for nation building activities. But this will require serious effort on the part of the Government to combat corruption: its credibility and thus its success will depend on how effective it is in reducing corruption.

59. Regaining the confidence of the business community, and in particular foreign investors, is critical to the future economic development of Indonesia. In the past, regaining macroeconomic stability was generally sufficient to restore economic growth. But today, more is required. Concrete progress on governance is seen as a key to renewed investment flows into Indonesia at levels comparable to the past.

60. The donor community is also expecting to see progress on governance reforms. As such, it is prepared to provide enormous resources to support the country's efforts at improving governance and reducing corruption. But it will also be more vigilant at ensuring that such support is not frittered away through corruption.