COUNTRY SECTOR AND THEMATIC STRATEGIES AND PLANS

A. Agriculture and Rural Development Sector

1. Overview

1. Indonesia has a competitive advantage in the production of rice, corn, soybean, rubber, palm oil, tea, and other tropical crops. This advantage has not been exploited, and the sector stagnated in the 1990s. In 2000, however, about 58% of the poor still derived their income primarily from agriculture, and the sector employed 42% of the labor force. Agricultural growth and rural development are thus key to reducing poverty.

2. Sectoral Needs and Challenges

2. Until recently, the unfavorable regulatory environment was a major constraint on agricultural growth. A number of policy reforms have recently been initiated. The Government abolished many monopolies and monopsonies, removed marketing quotas and production restrictions, withdrew input subsidies, and removed regional taxes and levies on agricultural trade. However, reforms have been isolated, often ad hoc, and at times faltering. The implications of reforms have yet to be rigorously analyzed and policy options examined. Required reforms will need to be properly enforced and complementary measures initiated to enhance benefits.

3. Infrastructure bottlenecks are another major impediment to agricultural growth. The problem has recently become increasingly serious as financial constraints have slowed implementation of ongoing projects and prevented maintenance of existing infrastructure and facilities. Major infrastructure constraints include inadequate irrigation facilities, farm-to-market roads, and postharvest processing facilities. The development of irrigation infrastructure and its operation and maintenance (O&M) have claimed a large share of public resources invested in agriculture during the last three decades. Despite high subsidies, O&M were not efficient or sustainable as most of the funds were used to pay staff salaries and benefits, and farmers' participation in O&M was insignificant. In April 1999, a presidential decree was issued on irrigation management policy reform (IMPR), with participatory irrigation development as the core of the reform agenda. The implementation of IMPR will require institutional strengthening at the local government and farm levels, complemented by an investment program to catalyze technical, institutional, and management improvements in existing irrigation systems and selected development of new systems. Encouraging the involvement of nongovernment organizations (NGOs) will help ensure transparency and accountability in operations.

4. About 20% of farm produce is lost in transport, storage, and processing. Inadequately developed and poorly maintained roads and other facilities have prevented realization of the full benefits from previous investments in smallholder tree crops. This has often been the result of top-down planning and implementation that mirrored the centralized administrative structure. Decentralization offers the chance to devolve planning to local governments and thereby improve the targeting of public investments. Innovative approaches to community participation will be required to reduce the burden on local governments in construction and maintenance of farm-to-market roads and other rural infrastructure. Community-based and private sector-supported initiatives will also be required for sustainable development of agroprocessing facilities.

5. Although a wide range of rural finance and microfinance institutions provide financial services to different segments of rural people, the vast majority of the rural poor are deprived of institutional credit because of the following:

(i) The financial sector strategy does not include financial services to the poor as a key element and does not promote operational linkages between formal and semiformal sector institutions.
(ii) Financial institutions providing sustained microfinance services are weak.
(iii) Most ongoing microcredit programs do not try to help borrowers efficiently manage the funds disbursed.

Bank Indonesia (BI) has been playing a major role in capacity building of microfinance institutions (MFIs) and channeling of microcredit funds. The Central Bank Law 23/1999 prevents BI from undertaking these operations beyond 2002, and an alternate institutional structure to continue operations is urgently needed.

6. Growth has also been hindered by inadequate technological innovation. The research agenda for agriculture lacks attention to specific local issues, and farming systems have not been appropriately developed to realize diverse comparative advantage. During decentralization, the linkages between the national and regional research institutions need to be reviewed and redefined.

3. Government Policy

7. The State Policy Guidelines adopted by the People's Consultative Assembly in 1999 highlight the importance of agricultural and rural development and a number of measures to improve the agricultural policy environment. These include (i) decentralization of agricultural support services, with greater autonomy to local governments; (ii) deregulation of domestic agricultural trade; (iii) dismantling of monopolies, monopsonies, and market quotas; (iv) reforming operations of the food logistics agency; and (v) removal of fertilizer subsidies.

8. The Government's 5-year National Development Plan (PROPENAS) 2000—2004 outlines a set of objectives and development priorities. For the agricultural and rural sector, it prioritizes (i) diversification of agriculture and development of nonrice food crops in areas with comparative technical and marketing advantage; (ii) beneficiary empowerment and participation in development; (iii) improvement of infrastructure, logistics, and support services; and (iv) implementation of programs to help disadvantaged, poor communities.

4. ADB Sector Experience

9. The Asian Development Bank (ADB) has provided the most funding to the agriculture and rural sector, with loans of $3,418.8 million for 49 projects, mostly for irrigation and rural development ($1,919.0 million), followed by agricultural support services ($861.1 million), tree crops and agro-industry ($541.3 million), and livestock ($97.2 million). Of 29 postevaluated completed projects, 11 were rated as generally successful, 14 partly successful, and 4 unsuccessful. Of the four unsuccessful projects, two were in livestock and one each in irrigation, and rural development and agriculture support services.

5. Activities of Other Funding Agencies

10. Other providers of external assistance to the agriculture sector include the Australian Agency for International Development (AUSAID), Japan International Cooperation Agency (JICA), Japan Bank for International Cooperation (JBIC), German Agency for Technical Cooperation (GTZ), United States Agency for International Development (USAID), Food and Agriculture Organization, and World Bank. Small grant projects from the Department for International Development (DFID) and GTZ have helped make development methods more participatory. GTZ has established a successful model of village-level finance units. DFID has helped decentralize extension services and established a model of direct payment by farmers for extension services. JICA has a long history of working with NGOs to promote agricultural development. The World Bank's recent projects have emphasized participatory processes.

6. ADB's Sector Strategy

11. The sector is home to the largest segment of the population and the poor, and will play an important role in achieving ADB's overall country objectives of poverty reduction. To achieve the objective, the strategic thrust of sector operation in the short and medium term will be on agricultural productivity increases and rural growth. The strategy will include the following:

(i) rationalization of sector policies, based on an in-depth review of sector issues and constraints, to improve the regulatory environment and provide incentives for increased efficiencies in production, transportation, storage, processing, and marketing of agricultural produce; and enhanced involvement of the private sector;

(ii) empowerment of rural communities by strengthening their capacity to plan and manage local development activities; and investment support to develop rural infrastructure, establish off-farm business enterprises, and foster rural-urban linkages;

(iii) provision of IMPR, emphasizing a participatory approach to rehabilitation, upgrading, and maintenance of existing irrigation systems, and development of new systems;

(iv) promotion of linkages between national and regional research institutions and encouragement of technical innovations responding to location-specific technical issues and constraints;

(v) institutional and investment support to develop tree crops, focusing on productivity improvement in smallholder plantations and optimization of benefits from previous investments;

(vi) improvement of policy and institutional frameworks for regulation, supervision, and monitoring of MFIs, and assistance for them in developing programs to provide financial services to disadvantaged rural communities and strengthen their capacity for efficient management of funds; and

(vii) adoption of environment-friendly inputs and technology in agriculture and agroprocessing.

7. Implementation Issues

12. Experience in recent years identified areas that require attention to improve implementation performance of sector projects. The lack of adequate qualified staff for supervision and monitoring often reduces implementation efficiency. Standard Management Information Systems (MIS) should be developed for all projects. Better use should be made of qualified staff of local agencies, including community organizations and universities, in addition to district government staff. The lack of qualified staff also sometimes affects efficient procurement. Contractor performance has been unsatisfactory and beneficiary complaints are often not addressed. Contractor accountability to beneficiaries, with more responsibility for procurement accorded to them, can solve the problem, particularly for rural development projects. Projects increasingly need to be designed with realistic estimation of counterpart funds available, particularly with fiscal decentralization to the districts. Project design should also ensure that districts are aware of what to expect from the center and what they will be required to provide from their own resources. Finally, beneficiary participation at all stages of the project—from design to implementation, monitoring, and evaluation—have been shown to increase project quality, overcome counterpart staff constraints, increase procurement effectiveness, and alleviate funding constraints.

8. Performance Monitoring

13. Benchmarks that will be used to monitor performance are poverty indicators, by rural occupational category and the rural sector as a whole. Other indicators are growth rates for agricultural and rural nonagricultural output and productivity.

Agriculture and Rural Sector Road Map

	INDICATORS	
	Current (%)	10 Years (%)
1. Sector Outcomes		
Proportion of those employed in agriculture who are poor	40	25
Proportion of rural population that is poor	26	15
Rural child malnutrition	34	15
Agricultural GDP growth	3.3	4.0
Agricultural Productivity Growth	Stagnant	Robust
Agricultural Exports as percent of agricultural production	17.4	30
Rural non-agricultural GDP growth	tbd	tbd
2. Sector Outputs		
Beneficiary participation in local development	Low	High
Rural finance availability	Low	High
Agricultural Input availability	Restricted	Adequate
Rural infrastructure development	Inadequate	Improved
Agricultural support services	Poor	Efficient
Appropriate technology availability	Inadequate for marginal areas	Improved

3. Sector Issues/Constraints	(i) Inadequate technological innovation; (ii) deficient physical and social infrastructure; (iii) weak institutions; (iv) improper incentives; (v) lack of access by the poor to land, finance, extension, education, and inputs; appropriate technologies; and decision-making processes; (vi) inadequate policy support for broad-based rural development; (vii) unsupportive legal and regulatory framework for rural nonfarm agricultural enterprises; and (viii) insufficient human capital to support broad-based rural development.

	By Agency			
4. Actions/Milestones/Investments	Schedules	ADB	Other Funding Agencies	Govern-ment
A. Policies				
Preparation of an agriculture and rural development strategy (identification of the most pressing constraints from item 3 for different types of agriculture, and development of a medium-term strategy outlining the role of the Government in addressing the constraints)	2002	ARSDP	FAO, JICA	X
Agriculture Sector Development Program (support for a time slice of the above strategy) - Policy support for broad-based rural development - Support for decentralized technological innovation - Rural investment planning including institutional development - Center-local distribution of responsibilities - Domestic trade barriers - Land reform - Private sector agricultural marketing development - Legal and regulatory reform - Small and medium-sized agroprocessing development - District revenue generation	2004-2006	ARSDP		X

	By Agency		
	ADB	Other Funding Agencies	Govern-ment
B. Capacity and Institutional Development			
Improvement of quality of district agricultural services, including human resource development for technical support, and streamlining agricultural support services	ARSDP	WB, DFID	X
Strengthening of microfinance institutions, including the development of capacity for funds management	RMP	GTZ, JICA	
Development of farmer organizations, with a concentration on postharvest management	PFMP		
C. Investments			
Market information development			
Rural infrastructure	ARSDP	WB, JICA	X
Rural microfinance	CERDP		
Agroforestry	RMP	USAID, GTZ	
Farmer-led production and marketing innovation			
Information and communication technology for rural development	PF		
Agricultural technology development	X	WB	X

ARSDP= Agriculture and Rural Sector Development Project; RMP= Rural Micro Finance; CERD= Community Empowerment for Rural Development; PF= Poor Farmers' Income Improvement.

B. Environment and Natural Resource Management Sector

1. Overview

14. Indonesia's rich and unique natural resources are significant assets. The forests and marine and coastal resources are of global importance because of their rich biological diversity. However, all resources—water, marine and coastal resources, forests, and land—are under severe stress. Inadequate management and overexploitation have caused resource depletion and environmental degradation. While these resources are still substantial and the economy will remain dependent on natural resources in the short term, unsustainable management of these resources will aggravate environmental degradation and adversely affect the livelihood of many people, particularly the poor. The ongoing administrative and fiscal decentralization provides opportunities for increased local participation in development activities and increased transparency in resource allocation and management. However, if the related policy and institutional issues are not addressed and capacities of the local governments and sectoral agencies for implementing a sustainable development program not enhanced, resource management may continue to deteriorate. This section discusses water, marine and fishery, and forest resources. Subsector needs and strategies for urban air and water pollution are discussed more fully in the section on the urban sector.

2. Sectoral Needs and Challenges

15. **Water Resources**. The increasing competition for water for agricultural, urban, and industrial uses; degradation of watersheds; recurring severe floods in Java and Sumatra; and deterioration of water quality are the major problems. In recent years, the Government has substantially rationalized policies and institutional framework for the sector. The Government prepared and approved the National Water Resources Policy (NWRP) in December 2001. It provides for a framework to coordinate water resource development and management at national and regional levels and recommends integrated water resource management within a river basin to meet multisectoral demands and needs. The successful implementation of NWRP will require strengthening the national and regional sectoral institutions and the legal judicial system. The draft of a new water law is under review in Parliament.

16. **Marine and Fishery Resources**. The marine and fishery resources of the world's largest archipelago remain undeveloped. Indonesia trails far behind Thailand and the Philippines in the production, processing, and exporting of marine and aquatic products, partly due to inadequate attention to the sector in the past and largely to the lack of technology, management, and financial support; weak law enforcement; and overfishing and environmental degradation in coastal zones. Environmental degradation has extensively affected coral reefs, which have been further damaged by global warming and associated coral bleaching. Since coral reefs are habitats of some 90% of the fish caught in the coastal areas, their degradation has considerably affected the livelihood of artisan fishers.

17. **Forest Resources**. Major problems are the high rate of deforestation, forest fires, unsustainable forest management by concessions, excess capacity of the wood-processing industry over sustainable forest yields, lack of local government and community involvement in the management of forestlands, and conflicts in forest areas between government control and customary rights. Overexploitative logging and forest and land fires have resulted in about 20 million hectares (ha) of degraded land, most of which previously provided subsistence to forest dwellers. Some 9.7 million ha of forest and peat were burned by uncontrolled fires in 1997-1998

alone. Over 700 million tons of carbon dioxide were released into atmosphere—one of the world's largest emissions.

18. **Regionally Specific Needs.** Environmental problems and priorities are correlated with the geographical pattern of development. Improving water resource management to meet multisectoral demands, restoring degraded coastal resources, improving sanitation and solid waste management, and controlling vehicle emissions and industrial and urban pollution are the priorities on the densely populated and industrialized inner islands. On the outer islands, the main environmental issues concern the sustainable use of forests, marine, and other resources; and conservation of biodiversity. These regional challenges underscore the need to integrate regional, social, and environmental considerations into economic decision making, and to evolve appropriate regional environmental management strategies, including appropriate pricing of resources, improvement of livelihood of families dependent on depleted resources, effective regulation, and local capacity building.

3. Government Policy

19. The State Policy Guidelines dictate that natural resources should be managed to ensure that their carrying capacity is preserved for the welfare of present and future generations, and to protect the national wealth of biodiversity. The guidelines require enacting legislation to gradually delegate authority for managing natural resources to the local level. The guidelines give special attention to the empowerment of local communities and traditional and nongovernmental institutions for natural resource management. PROPENAS builds on the Guidelines, requiring transparency in the allocation and management of natural resources, and increased community participation in decision making.

4. ADB Sector Experience

20. ADB has greatly supported environment and natural resource management, having provided 28 loans amounting to $890.3 million. The marine and fishery resource subsector has been the largest recipient ($440.0 million), followed by flood control and water resource management ($244.0 million), forestry and biodiversity conservation ($125.9 million), and land resource evaluation and planning (LREP) ($80.4 million). Eight completed projects were postevaluated—one for LREP and seven for fishery development. The LREP project was rated partly successful. One fishery development project was rated generally successful, four partly successful, and two unsuccessful. All the postevaluated fishery projects were prepared in the 1970s and early 1980s, and were production oriented (marine capture fisheries, fishing ports, and aquaculture). The lessons learned in these projects led to a major shift in emphasis from production to resource conservation and management in subsequent ADB-assisted projects in the sector.

5. External Assistance

21. External assistance for the development and management of the environment and natural resources has come from a large number of institutions. ADB has been the lead funding agency for marine and coastal resources, including fisheries. It has provided limited assistance for replanting degraded forestland, rehabilitation and management of mangrove forests, biodiversity conservation, and management of forest fires and haze. The major providers of external assistance to forestry have been the World Bank, European Community, and various bilateral agencies and governments.

6. ADB's Sector Strategy

22. ADB's environmental strategy for Indonesia is anchored on the core objective of mainstreaming sound environmental management in all development activities across sectors. Strategic thrusts will thus be to (i) integrate environmental concerns in development policies, regulatory measures, and institutional reforms; (ii) establish environmental performance criteria; (iii) establish market-based instruments and incentives for resource conservation and environmental protection; and (iv) enforce laws. Operational priorities specific to individual natural resource subsectors are outlined below.

23. **Water Resources.** ADB will continue to help establish policy and regulatory frameworks to manage water resources, strengthen sectoral institutions at national and regional levels, and foster integrated water resource management and interlinked investments within river basins for multisectoral uses and flood management. Assistance will be provided for water conservation and improvement of efficiency in irrigation systems through interventions that promote a participatory approach to development and management of the systems, reduce government subsidy in system maintenance, and improve sustainability. The strategy will support Government initiatives to improve and expand water delivery services, establish autonomous and accountable service providers, and promote private sector participation.

24. **Marine and Fisheries Resources**. Improving the policy and regulatory framework for sustainable management of marine and fishery resources, and building capacity for decentralized management of resources, will continue to be short- to medium-term priorities for ADB assistance. It will support an integrated approach to coastal resource management, including rehabilitating damaged ecosystems and conserving biodiversity, reducing fishing activities to regenerate fish stock in priority areas, and developing social services and alternative livelihood for participating coastal communities, including developing technology and financial services for sustainable aquaculture.

25. **Forest Resources**. ADB will continue to support joint initiatives of multilateral and bilateral agencies to help the Government formulate a national forest program containing an overall strategy and policy reform agenda for sustainable management of natural forests. It will be selective in providing investment support to the subsector, and priority areas for interventions will include rehabilitation and management of degraded forestlands and conservation of biodiversity, and development and implementation of the program for prevention of forest fires and for drought management recommended in ADB-assisted studies.

7. Implementation Issues

26. Implementation issues in recent years reflect economic difficulties and the evolving administrative and fiscal decentralization, and are common to various sectors. Problems include lack of clarity in the interim arrangements for sharing institutional and fiscal responsibilities by national, provincial, and district governments; delays in the procurement of goods and services; and delays in approving project budgets and releasing funds. While the participatory approach to development has been accepted in principle by most of the agencies in the natural resource sector, change within them has been slow, and institutional capacity is lacking at local levels, within government and nongovernment institutions, to mobilize local communities to participate in development activities. A near-total lack of good governance in forestry has inhibited enforcement of policies and greatly complicates any plan to support sectoral interventions.

8. Performance Monitoring

27. Medium-term sector performance will be monitored in the following areas: (i) participation of local communities in natural resource management; (ii) annual expenditures on environment-related activities; (iii) water quality of major rivers and coastal zones; (iv) marine parks or sanctuaries; and (iv) restored forest and coastal lands. Mainstreaming of environmental concerns in ADB projects will be monitored on the basis of project data.

Environment and Natural Resource Road Map

	INDICATORS	
	Current	10-Yrs
1. Sector Outcomes/Impacts		
(i) Carbon dioxide emission (mt/capita)	1.3	0.75
(ii) Freshwater available for multisectoral use (m^3/person)	n.a.	tbd
(iii) Economic loss due to floods	n.a.	tbd
(iv) Water quality in rivers, lakes and aquatics	n.a.	tbd
(v) Live corals in good to excellent condition (%)	< 30	50
(vi) Marine and coastal resources' contribution to GDP	20	30
(vii) Poverty incidence among upland and fishing communities	25	15
2. Sector Outputs		
(i) Irrigation systems turned over to water users associations (ha)	1.0	3.0
(ii) integrated water resource management institutionalized in districts	-	8
(iii) community-based coastal resource management scheme established	7	50
(iv) integrated coastal zone planning and management concept institutionalized in districts	-	45
(v) marine area protected to maintain biological diversity (million ha)	4.4	10.0
(vi) degraded lands restored (thousand ha)	-	100
(vii) cleaner fuel use in energy generation increased	35	45

3. Sector Issues/Constraints	(i) inadequate policy and regulatory framework for environment and natural resource management (ii) weak institutional capacity at regional level (iii) inadequate community participation in resource management (iv) inadequate O&M of irrigation infrastructure (v) degradation of watershed, natural drainage and retention basins (vi) overfishing and destructive fishing in coastal zones (vii) pollution of water bodies including coastal zones (viii) high incidence of poverty among fishers and forest dwellers (ix) forest fire and haze (x) air pollution by vehicles and power stations

	By Agency			
4. Actions/Milestones/Investments	Schedules	ADB	Other Funding Agencies	Govt
A. Policies				
(i) National Water Resources Policy (NWRP) approved and implemented	2002-2010	PSIP WRMP	WB, Neth, JBIC	X
(ii) Government Regulation 77 of 2001 on Irrigation Implemented	2002-2010	PSPI WRMP	WB, Neth, JBIC	X
(iii) Formulation, enactment and implementation of Coastal Resource Management Act	2002-2010	MCRMP	CIDA, USAID	X
(iv) Preparation and Implementation of National Forestry Plan	2002-2010		EU, WB	X
B. Capacity and Institutional Development				
(i) Strengthening capacity of district governments and water users associations for implementation of Government Regulation 77 of 2001	2002-2010	PSIP WRMP	JBIC, Neth, WB, etc.	X
(ii) Strengthening of sectoral agencies at national, provincial and district levels for implementation of NWRP	2002-2010	WRMP PSIP	JBIC, Neth, WB. etc	X
(iii) Strengthening, planning, and management of coastal resources by district governments and local communities	2002-2010	MCRMP ICRMP	AusAID, CIDA, USAID	X
(iv) Developing community-based coastal monitoring, control and surveillance system	2002-2010	COFISH COREMAP ICRMP	AusAID, WB	X
(v) Strengthening local governments and community for management of degraded lands	2003-2010	CBLRMP		X
C. Investments				
(i) Water resource management	2002-2010	PISP WRMP	JBIC, Neth, WB	X
(ii) Flood management	2004-2010	IMSRB	Neth, WB	X
(iii) Coastal resource management	2002-2010	ICRMP	AusAID, WB, USAID	X
(iv) Alternative livelihood for fishers	2004-2010	SAD		X
(v) Land rehabilitation and management	2003-2009	LPMP		X
(vi) Clean energy generation	2003-2010	X		x
(vii) Forestry Management				

PISP= Participatory Irrigation Project; WRMP= Water Resource Management Project; MCRMP= Marine and Coastal Resource Management Project; COFISH= Community Development and Fisheries Resource Management; COREMAP II= Coral Reef Rehabilitation & Management; ICRMP=Integrated Coastal Resource Management; SAD= Sustainable Agriculture Development for Poverty Reduction;

C. Education Sector and Training Sector

1. Overview

28. Indonesia has one of the largest education systems in the world. About 46 million students attend nearly 220,000 schools and other education institutions, and another 2 million children are in over 40,000 preschools and kindergartens. The impressive quantitative growth of education at all levels, however, masks wide differences between regions and groups, with a strong negative correlation between poverty and net enrollment rate. In addition to equity, quality of education has been a major problem throughout the system. In a recent survey of education quality in 12 Asian countries, Indonesia's education system was rated second to the bottom.[4] Improved quality in education is vital for the workforce in an increasingly competitive world.

2. Sectoral Needs and Challenges

29. Decentralization is the context of the education sector. A clear vision is needed for human resource development and for a strategy to transform a bureaucratic education system into a dynamic and responsive one. Developing a regional education policy linked to the region's economic development, a school-based education management, and a teacher-upgrading program will be among the development challenges. Minimum service standards to be prepared by the Ministry of National Education (MONE) are urgently needed. However, it is not clear what districts should minimally provide, and no guidelines help the regions develop human resources appropriate to the regions' aspirations.

30. Current university reforms will only benefit the regions that have the few elite universities. Other regions wish to have better universities and more and better vocational skills training. Since 1998, teachers have organized unions, which have become a strong force for lobbying for better service conditions in districts.

31. Overall, the quantity and quality of education development have been seriously constrained by a lack of resources. Government expenditure for education as a proportion of gross domestic product (GDP) (2%) and total government expenditures (15%) is one of the lowest in the region. Increased budget for education will be needed to achieve the desired objectives.

3. Government Policy

32. PROPENAS attaches priority to education development and reaffirms the Government's commitment to (i) reduce inequity, (ii) improve quality and relevance, and (iii) improve management capacity. In basic education, the Government aims to (i) achieve universal 9-year basic education by 2010; (ii) enhance transparency and accountability of the system by fostering school-based management and community participation; and (iii) establish school boards in each district, and school committees in each primary and junior secondary school. The Government has already successfully piloted a national program on school-based management in 1999-2000 school years in selected public junior secondary schools.

33. Under decentralization, district governments have authority over education and are responsible for all aspects of basic education (planning, financing, managing, and delivering

[4] Political and Economic Risk Consultancy, Hong Kong, September 2001.

primary and junior secondary education), and for operating and managing secondary schools, as well as vocational training. Some 1.5 million teachers and administrative staff were transferred last year from the central Government to the district governments. MONE maintains authority over (i) national planning and development policy, (ii) guidelines for minimum service standards, (iii) accreditation of educational institutions and professionals, and (iv) guidance and supervision of regional autonomy.

34. Higher education is exempted from decentralization. However, under the Government's "new paradigm for higher education," higher education is being deregulated and funding will be competitive and performance based. The new paradigm incorporates three core programs: (i) good governance and management, (ii) improvement of relevance and quality, and (iii) attainment of geographical and social equity. The top state universities have become autonomous, and other state universities are in various stages of deregulation and given more responsibility for the education they provide.

4. ADB Sector Experience

35. ADB has been supporting the education sector for two-and-a-half decades, and has financed 31 education and training projects totaling about $2.2 billion, and technical assistance (TA) grants of about $17.0 million. ADB extended support to all subsectors of education, including basic and secondary, vocational, and higher education. Project assistance was provided to public and private institutions, as well as Islamic *madrasahs* that offered modern secular subjects. Postevaluation studies indicate the overall success of ADB-funded projects that contributed significantly to the country's human resource development. Most education projects have been rated successful.

36. A lesson learned during the crisis is the utility of the block-grant mechanisms managed by the beneficiary institutions. Project and technical assistance was provided based on block grants to school committees and district boards, targeting poorer and underserved districts with low education achievement. In upgrading science and engineering education at the tertiary level, ADB provided a sector project to support the Government's policy of competitive funding through block grants accessible by public and private institutions, underpinned by regional equity. These innovative fund-channeling mechanisms should be used in future projects.

5. Activities of Other Funding Agencies

37. A number of funding agencies assisted the education sector, including AUSAID Canadian International Development Agency (CIDA), GTZ, JBIC, JICA, the Netherlands, United Nations (UN) agencies, United Nations Educational, Scientific and Cultural Organization (UNESCO) and United Nations Children's Fund (UNICEF), and the World Bank. Although in the past they covered all or selected subsectors of education, most recently these agencies focus on basic education. At the 2001 annual meeting of the Consultative Group Meeting for Indonesia (CGI), basic education was included in the agenda. ADB is coordinating the CGI working group on education, which comprises representatives from the Government and international community.

6. ADB Sector Strategy

38. ADB will continue to support selected interventions in education, focusing on improving the quality of and access to education under regional and district governments and targeting poor communities. Support for decentralized education will involve strengthening school-based

management capacity and securing the participation of civil society and NGOs in school planning and management.

39. A focus on district-based basic and secondary education is closely linked to poverty reduction, but some resources will be needed to address the mid- and higher-level institutional requirements. Investment in information technology (IT) holds the promise of upgrading education quality and relevance, including nonformal and distance education. Investment in higher education and IT development should, however, (i) maximize private sector participation, (ii) reorient the role of the Government to policy development and regulation, (iii) enhance productivity and effectiveness, and (iv) ensure equitable access to these services by women and the poor.

7. Implementation Issues

40. Efforts could be made in a number of areas to improve project implementation. Some efforts may be generic but are applicable to education projects:

- (i) transparent fund-channeling mechanisms, especially for block grants to education institutions and districts and provinces, with an appropriate monitoring system in place;
- (ii) adequate counterpart budgets and timely release of funds at national and decentralized entities;
- (iii) wherever possible, centralized procurement of textbooks and equipment under an umbrella arrangement that will allow economy, efficiency, and competition; and reduce opportunities for corruption;
- (iv) provision for independent audit and monitoring, and random checking of financial management to ensure compliance;
- (v) capacity building at national and decentralized structures; and
- (vi) increased Economic Thematic and Sector Works (ETSW) linked to education projects

8. Performance Monitoring

41. Progress will be measured annually at all levels using a comprehensive set of benchmarks, including (i) gross enrollment, (ii) progression rates, (iii) dropout rates, (iv) teacher-student ratios, (v) class size, (vi) teacher qualifications and skill mix, (vii) availability of textbooks per student, (viii) use of technology, (ix) community and/or civil-society participation in school management, (x) external efficiency (employment record etc.), and (xi) funding for education at different levels and sources of funding.

Education Sector Road Map

	INDICATORS	
	Current[1] (%)	10-Yrs[2] (%)
1. Sector Outcomes		
Gross Enrollment Rate at SD and MI	112.57	120.0
Net Enrollment Rate at SD and MI	92.74	100.0
Gross Enrollment Rate at SLTP–MT	72.24	100.0
Net Enrollment Rate at SLTP–MT	56.42	90.0
Gross Enrollment Rate at SMU, SMK, and MA	39.87	70.0
Net Enrollment Rate at SMU, SMK, and MA	32.20	50.0
Gross Enrollment Rate for Higher Education	12.40	20.0
Net Enrollment Rate for Higher Education	10.0	15.0
Ratio of Girls to boys in Tertiary Education	80.0	100.0
Adult Literacy Rate	84.8	99.0
Women's Literacy Rate	80.0	90.0
Primary Level Graduate Rate (SD/MI)	94.9	100.0
Junior Secondary Level Graduate Rate (SLTP, MTs)	92.2	100.0
Senior Secondary Level Graduate Rate (SMU, MA, SMK)	93.6	99.0
Higher Education Graduate Rate	N.A.	--

2. Sector Issues/Constraints

(i) Inequity in access
(ii) Unequal distribution of educational institutions
(iii) Weak education management
(iv) Human resources: untrained/underqualified teachers, inadequate number, uneven distribution and skills mismatch
(v) Low and ineffective public-private sector linkages
(vi) Very limited use of new technology (IT)
(vii) Low financing to sustain education development

3. Actions/Milestones/Investments	By Agency		
	ADB	Other Funding Agencies	Gov't
A. Policies			
(i) Decentralization of education	L.1863-INO	WB, Neth.	X
(ii) Equalization of MONE and MORA schools	L.1442-INO		X
(iii) Empowering local authorities, institutions and the civil society	L.1519-INO		
(iv) Transforming bureaucratic education system to a dynamic and democratic system	TA3798-INO	WB, Neth.	X
(v) Establishing minimum service standards			
(vi) Regional education policy to reflect the aspirations and goals of the region	TA3701-INO	WB	X
(vii) Increasing budgetary allocation for education financing			
(viii) Encouraging meaningful public-private sector partnership at all levels of education			
(ix) Reforms in curriculum to reflect the national and local needs in the new socioeconomic context	TA3701-INO	WB	X
(x) Establishing transparent and equitable accreditation system for public and private institutions		WB	
	TA3701-INO	WB	
(xi) Providing autonomy to higher education institutions and introduce good governance			

[1] Source: SUSENAS, 2000 and BAPPENAS
Note: SD – Primary School
MI – Primary Level Madrasah

[2] The targets are still tentative
SLTP – Jr. Secondary School
MT – Jr. Secondary Madrasah School

[3] Source: DGPSE, MONE 2001
SMU – Senior Secondary School
MA – Sr. Secondary Madrasah School
SMK – Sr. Secondary Vocational School

	By Agency		
	ADB	Other Funding Agencies	Govt
B. Capacity and Institutional Development			
(i) Education policy development at national and regional levels			
(ii) Decentralized education management			X
(iii) Capacity building at central, regional, and district levels	TA3701-INO	WB	X
(iv) Quality assurance and accreditation systems			X
(v) Development of science and technology capacity	L.1432-INO	WB	X
(vi) ICT capacity development	L.1792-INO	WB, JICA	
(vii) Institutional capacity to sustain educational assets			
C. Investments			
(i) Basic Education (SD/MI – SLTP/MT)			
	L.1442-INO	WB,	X
	L.1863-INO	UNICEF,	
		UNESCO,	
(ii) Secondary (SMU – MA)		Neth.	
	L.1519-INO		X
(iii) Vocational (SMK)	L.1573/74-INO		X
(iv) Higher Education		IDB	X
(v) Nonformal Education	1792-INO	WB, JICA	X
		UNESCO,	
(vi) ICT		NGOs	
	L.1432-INO	JICA	X
	L.1792-INO		

D. Health, Nutrition, and Population Sector

1. Overview

42. The health of the population has gradually improved. The infant mortality rate declined from 145 infant deaths per 1,000 live births in 1970, to 45 in 1999, and life expectancy at birth increased from 63 (1990) to 66 years in 1999. But the maternal mortality rate—estimated at 390 deaths per 100,000 live births—remains among the highest in the region. The human development index is disappointing in comparison with neighboring countries: Indonesia was ranked 109th out of 174 in 2000. Gains were uneven and significant differences remain among regions, between urban and rural areas, and especially among rich and poor. Although cardiovascular and chronic diseases became the main causes of mortality in 1992, infectious and parasitic diseases dominate morbidity and are still a major cause of death, especially among the poor. Tuberculosis, malaria, respiratory infections, and diarrhea are major public health problems.

43. The family-planning program has been successfully developed by National Family Planning Coordinating Board (BKKBN). With its slogan, "Small Happy Family," BKKBN advocates birth spacing and small families, and ensures availability of modern methods of contraception all over the country, resulting in a significant contraceptive prevalence rate (57.4% in 1997). The average number of births per woman (total fertility rate) declined from 4.1 in 1985 to 2.8 in 1997, and the annual population growth rate steadily decreased from 2.2% in 1985 to 1.7% in 1993. However decentralization could slow down further progress unless local governments get timely support.

44. In the 1980s and early 1990s, the Government developed a nationwide network of health facilities. It achieved its physical targets, but the use of public health services, the main source of health services, remains low. While the health system relies heavily on the public sector, the private sector plays an increasing role in the delivery of health services in many places. Doctors in the public system provide private services after office hours, and full-time private practitioners are found in urban communities. Unfortunately, public and private sectors have been developing with little coordination and cooperation.

45. Total expenditure for health is low, increasing slightly from 1.0% of GDP in 1995 to 1.2% in 1998. As a percentage of total government expenditure, health expenditures have accounted for roughly 3% of the total. During the crisis, government health expenditure declined in real terms by 16.5% between 1995 and 1998.

46. When the crisis started in 1997-1998, ADB helped develop a safety-net program to maintain access to essential health and family-planning services for the poor.[2] The program helped prevent disruption of health service delivery, introduced some reforms, and facilitated decentralization. However, not all the poor were protected, and some nonpoor benefited unduly from the program. Immunization coverage seems to have declined. With the crisis, malnutrition has become a concern for children, pregnant women, and lactating mothers in several areas.

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[2] Loans 1622-1623 INO: Social Protection Sector Development Program, approved in July 1998; and Loans 1675-1676: Health and Nutrition Sector Development Program approved in March 1999.

2. Sectoral Needs and Challenges

47. The following are the major constraints in improving health services and the people's health:

(i) inequities in access and use of health services;
(ii) inadequate health service financing, insufficient and declining budget allocation for health services, and need to mobilize new resources;
(iii) unsatisfactory quality of health services, especially in poor and remote areas;
(iv) ineffective public-private partnership;
(v) inappropriate human resources, inadequate number, qualification, skill mix, and management;
(vi) insufficient attention to nutrition and early childhood development;
(vii) high maternal mortality ratio;
(viii) high risks for the future of the national family-planning program because of decentralization;
(ix) improving programs targeting major public health diseases (tuberculosis, malaria, HIV/AIDS, vaccines for preventable diseases); and
(x) emerging challenges posed by new patterns of diseases.

Infectious diseases remain a serious problem, and chronic diseases such as diabetes, chronic respiratory, and heart diseases are becoming major public health issues.

3. Government Policy

48. The vision, strategy, and policy of the Ministry of Health (MOH) is described in *Healthy Indonesia 2010*, developed in 1999. MOH's long-term objective is to ensure that the people are healthy and live in a healthy environment, and able to reach effective, efficient, and evenly distributed services. People must be actively involved in maintaining and promoting health, and protecting themselves from disease. Efforts will focus on four areas: (i) cross-sector cooperation, (ii) health staff and public empowerment, (ii) quality and accessibility of health services, and (iv) prioritization and funding of health activities. Professional management of health services with community participation will determine the success of the policy, which should prioritize health promotion and maintenance, and disease prevention. Funding for health activities should increase. This will require the development of an efficient, equitable, and participatory health prepayment system, and better collaboration with the private sector. MOH has defined four priority strategies: national development with health concerns, better professional qualification, strengthening of health maintenance insurance, and decentralization.

49. During the Country Programming Mission, MOH emphasized two short-term priorities that require more resources: effective decentralization of health services and the specific health needs of the poor. With decentralization, health services may be disrupted because the health sector may be given lower priority by local parliaments, and because local health staff lack experience. Worrying preliminary data show that fund allocation for the health sector may be decreasing. Continuous and intensive advocacy to the local governments is needed to maintain budget allocations for health. Local capacity for new roles and functions under decentralization still requires strengthening. The central level also needs support to adapt to new roles and functions and requires capacity building as well. MOH would like to develop a "rapid intervention unit" to provide technical support to the local level when needed. One issue, which requires resources, is occupational and environmental health, which particularly affects poor workers.

50. The safety-net program that guaranteed access to essential health services for the poor needs to be adapted to the new environment, and sustainable mechanisms must be developed and put in place. MOH is considering the establishment of a poverty reduction health fund, which would be a source of matching grant funds for public health programs and medical services for the poor.

4. ADB Sector Experience

51. ADB support for the health sector has focused on building local capacity, strengthening district capacity, encouraging community empowerment, and developing efficient relations between the various levels of the community and the Government. Recent projects target diseases affecting the poor, or finance activities that benefit poor families in poor districts, to empower them and help the poor become responsible for their health, with the support of the local health professionals. This type of project requires intensive advocacy and technical support, but increases local ownership and the chances of long-term impact. ADB health projects in Indonesia have been usually successfully implemented when long-term technical support was provided at the central and local (provincial and district) levels. With decentralization, this intensive support is even more critical. Project implementation usually improved when local beneficiaries became more involved not only in implementation but also in decision making. Finally, ADB projects have promoted collaboration between BKKBN and MOH in reproductive health services, and this effort needs to be pursued to combine both agencies' experience and skills.

5. Activities of Other Funding Agencies

52. The World Bank also supports decentralization in the health sector in provinces not covered by ADB. The next World Bank health project will support human resource development. German official assistance supports decentralized health services in East and West Nusa Tenggara. Social insurance, particularly health insurance and managed care, are being developed with the assistance of GTZ, European Union, and USAID. The Islamic Development Bank is financing district hospitals in East Java. AusAID is involved in the Healthy Mother and Healthy Babies Project in Sulawesi and supports some activities of the HIV/AIDS program. Dutch cooperation supports a tuberculosis control program. JBIC helps strengthen safe blood supply. Several bilateral partners (Spain, Netherlands, and Japan) support hospital services.

6. ADB Sector Strategy

53. In the medium term, ADB will help the Government improve the quality of health services and develop and implement mechanisms that will guarantee universal access to essential health and family-planning services, including supporting decentralization of health and the family-planning program and improving access to and quality of health services that focus on the needs of the poor. ADB support will focus on (i) local capacity building for health services; (ii) health care financing and development of a sustainable system that ensures universal access to quality services; (iii) public-private partnership in services delivery; (iii) human resource policy in the health sector; (iv) improving nutrition, particularly of children and women; (v) controlling infectious diseases; (vi) prevention of chronic and noncommunicable diseases; and (vii) strengthening the national family-planning program.

7. Implementation Issues

54. Most projects address policy and health sector reforms, which require intensive and long-term policy dialogue. With decentralization, policy dialogue is not only required at the central but also at the local level. Project implementation has been sometimes delayed due to the lack of knowledge of ADB procedures for procurement of goods and services. Under decentralization, the risk of misunderstanding ADB procedures increases significantly, compounded by weak local capacity. The national policy on flow of funds from the center to the regions is still not clearly defined and is thus a major obstacle to smooth processing of new projects. Project supervision during regular field visits, essential under decentralization, is very demanding of time and staff.

8. Social Protection

55. During the crisis, ADB helped develop a multisector safety-net program to maintain access of the poor to essential services in health and education (para. 2). The program helped the Government during considerable fiscal difficulty. Although the economy has recovered, decentralization puts at risk the effort to ensure provision of basic services to the poor. Political and ethnic conflict has created a large population (around 1.3 million) of internally displaced persons sorely in need of assistance.

56. Although Indonesian society has strong informal family and community safety nets, which played a significant part during the economic crisis, they are not sufficient to meet the needs created by decentralization and conflict. The Government is, therefore, considering developing social protection mechanisms to protect the most vulnerable in an efficient and sustainable way, and ADB is willing to fully support these efforts.

57. While poverty reduction strategies have traditionally focused on ways to improve the basic conditions of poor households, social protection measures aim to reduce poor households' vulnerability to sudden reductions in welfare. Policies that help households manage risk by reducing the impact of shocks, for example, fall under the purview of social protection. It must be extended beyond such policies and address the issue of risk management through various instruments that act as safety nets. The vast majority of the poor are in the informal sector. The level of institutional development limits the scope of social protection to formal mechanisms. Improving institutional capacity is a lengthy process, and social protection strategies have to look beyond formal mechanisms and incorporate programs that involve informal community-based institutions.

58. In response to the Government's request, ADB will help develop social protection mechanisms for the vulnerable, including the internally displaced. Various crosscutting strategies will be considered: social funds, child protection, social security, and pension and provident funds. Social funds are earmarked grants to increase sustained access of the poor to small-scale infrastructure and services. Social funds can be geographically targeted and offer efficient means of providing social protection during economic crisis and transition. Labor market policies favoring the poor need to be developed. Poverty hits children hardest, with a disabling impact of their minds, bodies, and future potential. Child protection strategies need to be reinforced in health, education, social assistance, and community-based projects. Early childhood development is one strategy to improve children's health, nutrition, and quality of life, through a comprehensive life-cycle approach including better maternal health and early childhood nutrition. Social security contributions are moderate and the system only provides floor protection. Social security programs are appropriate for membership in the formal urban

sector. Given that 70% of workers are in the informal sectors, a social security program for them is needed. The elderly also require social protection. Retirement support includes state-managed, mandatory pension fund schemes for the civil service, and the armed forces, and that managed by PT JAMSOSTEK which handles social security funds for formal sector labors. Privately managed voluntary schemes include employer pension funds, and pension funds operated by banks or life insurance companies. Although private companies have retirement benefits, defined contribution social protection plans are growing in importance. ADB will help the Government assess and develop various social protection mechanisms.

9. Performance Monitoring

59. The Millennium Development Goals will be used to monitor health and nutrition status. The objectives are to reduce (i) infant mortality and child mortality by two thirds in 2015, (ii) the maternal mortality ratio by three quarters in 2015, and (iii) the under-5 malnutrition rate from 30% in 1998 to 20% in 2015. Other service indicators will also be used: immunization coverage, contraceptive prevalence rate, unmet contraception needs, and populations without easy access to health facilities. For social protection, education and health indicators will be used, focusing on the value of the indicators for the poor and the extent of safety-net service provision (see Road Map).

Health, Nutrition and Population Sector Road Map

	INDICATORS				
1. Sector Outcomes	Before	Current	5 Years	10 Years	15 Years
Lower infant mortality rate	56 (1990)	44	35	30	<20
Lower child (1-5 years) mortality rate	84 (1992)	Male = 50 (2001) Female = 40 (2001)	Male = 40 Female = 30	Male = 30 Female = 20	<25
Lower maternal mortality rate	450 (1998)	334	250	150	<100
Undernourished children under 5	35.4 (1994)	26.1 (2001)	20	15	<10
Higher Life Expectancy	63.2 (1990)	Male = 63.4 Female = 67.4	Male = 66 Female = 69	Male = 68 Female = 70	Male = 70 Female = 72
2. Sector Outputs					
Higher immunization rate (%)	93.7 (2000)	87.31 (2001)	95	> 95	> 95
Contraceptive prevalence rate (%)	57.4 (1997)	60.8	67.4	72	>75
Contraception unmet needs (%)	9.2 (1997)	8	6.5	5	4

3. Sector Issues/Constraints

(i) Inequities in access and use of health services
(ii) Unsatisfactory quality of health service in poor and remote areas
(iii) Insufficient and declining budget allocation for health services
(iv) Participation of families and communities for better health
(v) Ineffective public-private partnership in services delivery
(vi) Inadequate number, qualification, skill mix, and management of human resources
(vii) Malnutrition and early childhood development issues
(viii) High maternal mortality
(ix) Decentralization of the national family-planning program
(x) Efficacy of major disease control programs (tuberculosis, malaria, HIV/AIDS, vaccine-preventable diseases)
(xi) Emerging new pattern of diseases

4. Actions/Milestones/Investments	By Issue	Schedule	By Agency: ADB Projects	By Agency: Others/ External	By Agency: Govt.
Access to health services					
	Communicable Diseases Control				
Policy:		1997-on	L. 1523	WHO	Policy
	Safety program		L.1622-1675	WB, USAid, GTZ	counterpart funds
Institutional:	Social Protection	1998	L in 2003		
Investments:	Decentralization	2002			counterpart funds
		started in	1810	GTZ, WB,GTZ, EU	counterpart funds
	Decentralization	1994			counterpart funds
Institutional:		2000 on	1810		
	Epidemiological surveillance				policy change
Investments:	CDC programs	1997 on	1523		
	Health Financing for the Poor	1997 on	1523	GTZ-JICA-WB	
	Physical infrastructure	ongoing	1623-1675-1810	GTZ-JICA-WB	counterpart funds
	Safety net program	ongoing	1299-1471-1810		counterpart funds
		1998-2002	L 1623-1675		
Quality of health services	Public-private partnership use of ICT		1810		policy change
Policy:		2003-on			
	Health sector reforms				
Institutional:	Health management information			WHO, WB	counterpart funds
	system	ongoing	1523-1622-	WHO	
Investments:	Physical infrastructure		1675-1810	GTA,JICA, WB	counterpart funds
	Health sector reforms: capacity		1299-1471-1810	GTZ, WB	
Funding of health services	building	since 1996	all loans		
Policy:		2000-		GTZ	policy change
	Health insurance schemes		1471-1622-1675	GTZ-WB	policy change
Institutional:	decentralization	since 1994	1810	WHO, WB	
Investments:	Health management information			GTZ	
	system		1299-1675-1810		counterpart funds
Participation for health	Capacity building for health care	since 1998			
Policy:	Financing	since 1996		WB-GTZ	
			1810	WB-GTZ	
	Decentralization		1471-1810	WB	
Institutional	Health committees	since 1996	L1810	WB-GTZ	
Investment	Involvement of local universities		1471	WB-GTZ	
			L 1471-1810		
	Capacity building				

5. Actions/Milestones/Investments	By Issue	Schedule	By Agency		
			ADB Projects	Others/ External	Govt.
Human resources					
Policy:	Decentralization	2000	1810	WB	policy change
Institutional	HR management			WB	
Investments	Capacity Building	since 1994	all loans	WB	counterpart funds
Malnutrition and Early Childhood					
Policy:	Food availability and use of local food	1998-	1622-1675	WFP	policy change
Institutional			policy dialogue		
Investment	Better nutrition	1998-	1471-1676	AusAID	counterpart funds
Reproductive health and Maternal Mortality					
Policy:	Decentralization of BKKBN	since 1994	1810		policy change
Institutional	Capacity building				
Investment	Referral system	1994-	L1299-1810	WHO	counterpart funds
	Family planning	1994-	1299-1471-1676	UNFPA	counterpart funds
	Reproductive health	1994-		AusAID	counterpart funds
Communicable Diseases Control					
Policy:	HIV/AIDs			WHO-WB	
Institutional	Decentralization CDC programs		1523-1810		
Investment	Immunization program	since 1997	1523	Dutch-CIDA	counterpart funds
	HIV/AIDS			UNICEF-WHO	counterpart funds
	Emerging diseases	since 1996		WB-USAID-AusAID WHO	counterpart funds

E. Urban Development Water Supply and Shelter Sector

1. Overview

60. Indonesia is rapidly urbanizing. The urban population is now approximately 85 million or 42% of the total population, and is expected to rise to 166 million and 60% by 2025. The social, economic, and environmental future of Indonesia depends overwhelmingly on how well urbanization is managed by local governments. Almost half of all urban households may be vulnerable to falling below the poverty line.[3]

2. Sectoral Needs and Challenges

61. Local governments are underresourced for the challenges. Except for a few relatively wealthy cities, local revenue sources are not sufficient to support investment needs. The municipal credit market has failed, the central Government has almost entirely ceased making special grants to local urban governments, and private sector participation is limited. Consequently, investment in municipal infrastructure has stalled and municipal services are declining, especially affecting urban water supply. Housing finance is also inadequate. Only the National Savings Bank is likely to survive the crisis, and community-based housing finance schemes have not been significantly successful. Compounding the lack of resources, local urban management and governance have improved little over 15 years of integrated urban infrastructure development programs (IUIDPs).

3. Government Policy

62. PROPENAS identifies urban development priorities for 2000-2004 as (i) building capacities for urban management and handling social problems, (ii) encouraging private sector participation, and (iii) enhancing urban functions. PROPENAS overlooks a key lesson from past efforts: the need to distinguish between capacity building and good management or governance. Local government resource constraints are addressed only in the context of calling for enhancing private sector participation. The Government does not yet have a national vision and program for urban sector support in the decentralized era. A financial burden-sharing policy and an effective fund flow mechanism are needed.

4. ADB Sector Experience

63. ADB has financed 27 loan projects (totaling $2.1 billion in loan commitments) in the urban[4] sector since 1972. ADB has also financed 42 urban sector TA projects amounting to $19.7 million. Most support has been for IUIDPs and stand-alone water supply and sanitation (WSS) projects. More recently, support for WSS has been through IUIDPs, and the only stand-alone WSS projects have been for rural beneficiaries. Physical implementation of projects has generally been satisfactory, but financial and technical sustainability has been variable, particularly for WSS projects. Three of six postevaluated WSS projects were rated "partly successful," whereas all three postevaluated IUIDPs were rated "successful." During the "New Order," WSS and urban projects were centrally planned and supervised but implemented and maintained by local governments, resulting in limited local project ownership and accountability. This approach is now fundamentally changed under decentralization. The WSS subsector has suffered inadequate delivery of services partly due to insufficient cost recovery, with adverse

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3 According to the Social Monitoring and Early Response Unit based in Jakarta. Households are “vulnerable” if they may face one episode of poverty in three years.

4 Urban sector includes water supply and sanitation and shelter.

consequences for the financial health of utilities. Deterioration of urban infrastructure owing to poor-quality works has been a recurrent issue in the urban development sector. Improved management and monitoring, particularly for dispersed projects, is essential.

5. Activities of Other Funding Agencies

64. The World Bank cofinanced Indonesia's first IUIDP with ADB in 1987. After this, the two agencies funded 15 years of geographically separate IUIDPs. The last IUIDPs will finish in 2002 and 2003, and program development has had a hiatus since the crisis and during the uncertainty of decentralization. The World Bank's recent urban sector support has been either in direct response to the financial crisis or specifically targeted, for example for water supply enterprises (PDAMs).

65. Bilateral support typically focuses on supporting decentralization, including the USAID-assisted regional management and urban development activities. The Netherlands Government finances community-based initiatives of United Nation Development Programme (UNDP) and the United Nations Call for Human Settlement Services (UNCHS), which also target the urban poor.

6. ADB Sector Strategy

66. In compliance with ADB's Long Term Strategic Framework (LTSF) and Medium-Term Strategy (2001-2005), ADB and the Government agreed on a broad sector approach with medium-term flows of support favored over stand-alone projects. A sector plan and program will be founded on helping local urban governments deliver good urban services and reduce poverty. Support will aim to reduce the following key development constraints: (i) inadequate municipal credit and other sources of local development finance; (ii) poor local governance and management, including in local public enterprises; and (iii) inappropriate pricing policies for local services and underdeveloped regulatory structures. ADB support will strictly target these three development constraints, and will be delivered in three defined "corridors" of influence: (i) integrated urban development and poverty reduction (including municipal credit); (ii) water supply, sanitation, and hygiene; and (iii) shelter and housing finance.

67. **Integrated Urban Development and Poverty Reduction.** Activities will center on a project cluster to help (i) provide a flow of urban development finance through an efficient municipal credit market and matching grants program, and (ii) provide a flow of specialist services to help local urban governments achieve good management and governance. Private sector participation will also be supported to increase capital flows to the sector and achieve operational efficiencies. These two core flows—finance and specialist services—will help autonomous urban local governments meet the development and poverty reduction challenges of their cities. Local development finance (loans and matching grants) will finance mostly municipal urban infrastructure, including (i) urban roads and bridges, (ii) drainage and flood control, (iii) neighborhood upgrading, (iv) solid waste management, and (v) other income-generating activities such as market and public transport terminals. Specialist services will help local governments undertake good strategic urban planning and investment programming. Strategic planning and programming will be biased toward (i) participatory processes, (ii) information-based analysis, and (iii) infrastructure investments to promote local economic development.

68. ADB will help the Government establish a screening and incentives system to select and improve local government investment proposals to be financed, and to encourage good local

urban governance and pro-poor investments. Policy dialogue will guide the Government with respect to municipal credit, matching grants, and screening systems. Financial burden sharing between central and local governments will be key.

69. **Water Supply, Sanitation, and Hygiene.** Support will help turn around the crisis faced by PDAMs by providing a flow of sector reform support, operational support, and development capital. An efficient municipal credit market is crucial. Sector reform support will focus on tariff structures, operational autonomy for PDAMs, and regulatory institutions—all essential preconditions to attract private sector inputs. The corridor also includes rural and urban fringe communities not covered by PDAMs.

70. **Shelter and Housing Finance.** ADB support will build on recent policy work and community-based pilot schemes for low-cost housing and credit. Projects will (i) help local governments establish and strengthen local housing offices, (ii) finance housing development projects, (iii) provide home loans for low-income households, and (iv) provide shelter sector policy advice. Local housing offices will implement programs, including for sector planning, housing projects, and home loans.

7. Implementation Issues

71. ADB's urban, water supply, and shelter support strategy and program require clarity and/or closure on the following issues:

(i) developing a burden-sharing formula and manner of allocation of special grants from central to local governments for urban infrastructure investments, planning and investment programming, and institutional strengthening;
(ii) establishing an efficient municipal credit market, including flow of funds from external sources;
(iii) rescheduling debts of delinquent local governments and local public enterprises;
(iv) establishing regulatory frameworks for urban water supply markets and other income-generating local public services; and
(v) finalizing and committing on the WSS Sector National Strategic Framework.

8. Performance Monitoring

72. Benchmarks to monitor long-term goals and medium-term objectives will include a variety of indicators to measure performance in the critical areas of (i) living conditions of the urban poor and vulnerable; (ii) management and development systems of local governments; (iii) access to credit by local governments; (iv) access and quality of water supply, shelter, and hygiene; and (v) success of developing housing finance (see Road Map).

Urban Development, Water Supply and Shelter Sector Road Map

1. Sector Outcomes	INDICATORS (to be developed by sector committee)				
	5 years ago[a]	Current	5-yrs[b]	10-Yrs[b]	15-Yrs[b]
Population or urban poor (% of total urban)	16	20	16	10-12	8-10
Population of urban vulnerable (%)	40	45	40	30-35	25-30
Urban population with access to piped water (%)	38	40	45	60-65	70-80
Urban population with access to sanitation (%)	70	75	80	80-85	85-90
Floor area per person (m^2)	20	20	22	24-26	25-27
Households per dwelling unit					
2. Sector Outputs					
Urban unemployment/underemployment rate					
No. of urban H/H without secure tenure (%)	17		15	12-14	10-12
Annual value of dev't loans to urban LGs (Rp)					
Annual value of mun. infra. private sector invest.					
Urban WW receiving secondary treatment (%)					
H/H solid waste regularly collected (%)	45	50	55	60-70	70-80
Solid waste properly disposed (%)					
Urban areas with proper drainage (%)	63	65	67	68-70	70-75
Number of plots tenured (%)					
Annual production of low cost/very low cost houses					
Proportion of total informal res. areas not yet upgraded					
Annual disbursement of mortgage loans <Rp.20m					

a: Immediately prior to 1997 financial crisis.
b Staff estimates

3. Sector Issues/Constraints

(i) Inadequate municipal credit and adverse PSP conditions, including for utility enterprises
(ii) Poor local urban management and urban governance
(iii) Regressive urban water supply sector conditions and poor PDAM corporate management
(iv) Low level of local government participation in pro-poor shelter facilitation; and
(v) In adequate shelter finance for low- and middle-income households.

4. Actions/Milestones/ Investment (to address above)	By Issue	Schedule	By Agency: ADB	Others/ External	Govt.
Ensuring functioning municipal credit market and PSP					
Policies:	Policy dialogue & matrix for integrated urban Development & poverty reduction (IUD&PR) cluster	2002 2003-10	TA: IUD&PR Ln: IUD&PR Cluster	WB, USAID, GTZ	Part of decentralization program
	Policy support on financial mechanisms for local gov'ts	2002-03 2002-03	TA: FMLGD TA: Fiscal Decentralization		
	Policy support on regulatory framework for PSP	2003-04	TA: PSPDFUI Ln: PSPDFUI		
Institutional:	Financial institutions participating in municipal credit	2003-10 2002-03	Ln: IUD&PR Cluster TA: FMLGD Ln: PSPDFUI		
	Private sector proponents and commercial financiers participating in municipal development	2003-04	TA: PSPDFUI TA: Reg PSP		
Investments:	Flow of municipal credit and private investment capital	2003-10 2002-04 2005-10	Ln: IUD&PR Cluster Ln: PSPDFUI Possible municipal finance loan		

Actions/Milestones/ Investment (to address above)	By Issue	Schedule	By Agency		
			ADB	**Other/External**	**Govt.**
Improving urban management and governance					
Policy:	Policy dialogue & matrix for IUD&PR cluster	2002 2003-10	TA: IUD&PR Ln: IUD&PR cluster	WB, USAID, GTZ, UNCHS/ UNDP	Part of decentralization program
Institutional:	Local urban government and provincial governments	2002 2003-10	TA: IUD&PR Ln: IUD&PR Cluster		
	MSRI, MoF, and MOHA	2002 2003-10	TA: IUD&PR Ln: IUD&PR Cluster		
Investments	Support to local governments	2003-10	Ln:IUD&PR Cluster TA: WMEPUPC		
Water sector reform and PDAM performance					
Policy:	Policy support for PDAMs	2002-03	TA: RWE	WB	National WSS Strategic Framework
	Policy dialogue and matrix for water supply sector reform	2002 2002	Ln: WSSS TA: Reg WSS		
	Sector conditions and analysis	2003	Water Sector Profile		
	Policy dialogue for rural and urban fringe WSS	2003-04	TA: CWSH		
	PSP in WSS	2003-04	TA : Reg PSP TA: Reg WSS		
Institutional:	PDAMs and controlling LGs	2002-03	TA: RWE		
	PERPAMSI	2002	LN: WSSS		
	MSRI and MoF	2003			
	Rural and urban fringe LGs	2003-04	TA: CWSH		
	Small-scale and community-based WS operat.				
Investments:	PDAMs support	2003-10	Ln: WSSS & cluster		
	Water regulatory support	2005-08	Possible water regulatory loan		
	Rural and urban fringe WSS	2004-10	CWSH loan & cluster		
Local government support for shelter					
Policy:	Policy dialogue and matrix for shelter sector Project	2002-03 2003-08	TA: Shelter Sector	WB, UNCHS/ UNDP, Dutch Govt.	Part of decentralization program
	Policy lessons from pilot project on neighborhood level economic development	2003-04	JFPR		
	Policy support on revitalization of ROWs	2004-05	ADTA or staff consultancy		
Institutional:	Local governments	2002-03 2003-08	TA: Shelter Sector JFPR		
	Community shelter credit organizations	2004-05 2004-05	TA: Shelter Sector Project		
Investments:	Local government support	2003-08	Shelter Sector Project		
Ensuring functioning shelter finance markets for low and middle income H/Hs					
Policy:	Policy dialogue and matrix for shelter sector project	2002-03	TA: Shelter Sector	UNCHS/UNDP, Dutch Gov.	Part of decentralization program
	Policy support on housing finance for low and middle income H/H	2003-08 2004-05	ADTA or staff consultancy		
Institutional:	Financial institutions MoF	2002-03 2003-08 2004-05	TA: Shelter Sector ADTA or staff consultancy		
Investments:	Financial institutions	2002-08	Shelter Sector Project		

CWSH= Community Water Supply and Health; FMLGD= Financing Mechanism for Local Government Development; IUD&PR= Integrated Urban Development and Poverty Reduction; JFPR= Japan Fund for Poverty Reduction; PSPDFUI= Private Sector Participation Development Facility for Urban Infrastructure; Reg PSP= Institutional and Regulatory Framework for Private Sector Participation; Reg WSS= Regulatory Framework for Private and Public Water Supply and Waste Water Enterprise; RWE= Reform of Water Enterprises; WMEUPUPC= Waste Management and Environmental Protection for Urban Poor Communities; WSSS= Water Supply and Sanitation Sector

F. Energy Sector

1. Sectoral Needs and Development Challenge

73. Indonesia has a variety of energy resources that contribute to economic growth through exports and by assuring supply of adequate primary energy to meet domestic demand. A large export-oriented manufacturing sector has taken root, providing employment and value added.

74. The Government recently enacted a new oil and gas law that removes National Oil Mining Company (PERTAMINA's) monopoly and encourages additional private sector resources for exploration and production. The biggest challenge for the Government is to set up an appropriate pricing structure for petroleum products to encourage their economic use in the domestic market. Investments in gas transportation will also be required to create larger domestic markets for natural gas to meet primary energy requirements (instead of using other more easily traded fuels). Use of natural gas is also considerably less polluting.

75. Historically, investments in power have mostly been in Java-Bali, which is the country's economic center. The region has a fully integrated power grid and a reasonably balanced generation mix. The cost of power is comparable if not lower than in most countries in the region. However, regions outside Java-Bali urgently need more power generation capacity and power grids to keep pace with the growing economic activities. While State Electricity Corporation (PLN) is responsible for developing and managing the power sector, consumers have installed captive power plants with about 12,000 megawatts (MW). (PLN's 21,000 MW are spread across hundreds of isolated power grids.) A market that promotes efficient use of the captive power plants' capacity is needed.

2. Government Policy

76. The new oil and gas law will provide the appropriate legal environment for the sector, and the Government will use competitive bidding to develop resources. Parliament is scrutinizing the new electricity law, and its enactment will enable establishment of a competitive electricity market in Java-Bali by December 2006. Outside Java-Bali, PLN is being reorganized into regional units that can later be spun off as separate power companies with investment support from the regional governments.

77. The Government proposes to remove all subsidies on fuels and electricity by 2005. However, a mechanism will be put in place for targeted support for the poor.

78. Other than on the larger islands in Indonesia, power grids are small and economies of scale not available. In regions with low population density and low average consumption per capita, costs of service are even higher. In such situations, the use of renewable energy sources, such as mini hydropower, becomes an attractive alternative and opens opportunities to benefit from clean development mechanisms being established under the Kyoto Protocol.

79. Of a total 60,519 villages, 48,674 (80%) have been electrified. The Government plans to electrify another 8,845 villages in 2001-2010 to raise the proportion of electrified villages to 95%. The Government estimates that it will need to invest about $33 billion in power generation, transmission, and distribution to achieve the target. Private sector participation is no longer a choice but an imperative.

3. ADB Sector Experience

80. ADB has provided assistance for about 30 years to implement a variety of power projects in different parts of the country, and to formulate policy. ADB is deeply engaged in the ongoing power sector restructuring, and is perceived as the lead funding agency in this regard.

81. Loans and TAs have also been extended for the natural-gas sector. While private sector investment is clearly more efficient for exploration, production, and distribution, public sector investments may be necessary to help create markets and encourage private sector development.

4. Activity of Other Funding Agencies

82. In addition to ADB, the other major lenders in the power sector are JBIC, KfW, and the World Bank, although none has processed a project loan since the crisis. The lack of support has stymied investments and serious supply shortages loom in the coming years in Java-Bali and many of the other industrialized regions. JBIC is expected to commit significant funds to ensure power sector sustainability, and promote the reform agenda. KfW made considerable earlier investments in scattered, diesel-based power generation in the outer islands, but has given lower priority to new investment. The World Bank has supported large investments in power generation, transmission, and development of renewable energy and is considering a medium-sized project loan for approval by mid-2003.

5. ADB Strategy

83. ADB's strategy to support the development and growth of the energy sector will be based on the following:

(i) establishment of policies and practices that reduce monopolies, promote commercialization, and increase private sector participation with balanced risk-sharing mechanisms;
(ii) support for restructuring of the power sector to ensure that it grows rapidly; provides efficient, high-quality power supply for the benefit of the consumers; and is financially independent; including horizontal unbundling (separating Java-Bali, where commercial operations are viable, from the other regions that will need public sector investments until economies of scale become possible), and vertical (separating generation, transmission, distribution, and supply);
(iii) regional capacity building outside Java-Bali to establish well-managed and financially sound regional power companies;
(iv) investments in market facilities and capacity building needed to establish a competitive electricity market in Java-Bali;
(v) development of central government capacity to formulate progressive policies; plan long-term, sustainable development of the energy sector; and establish and support independent and capable regulatory bodies;
(vi) support for a pricing regime that will gradually eliminate distortions in economically efficient use of fuels and electricity, including the removal of subsidies, except transparent mechanisms to support the use of modern energy sources by the poor;

(vii) encouragement of use of domestic reserves of cleaner fuels (natural gas) and renewable energy resources (geothermal, wind and solar energy, small and mini hydropower);
(viii) assistance for mitigating environmental impacts of fuel use in manufacturing and transport industries;
(ix) assistance for natural-gas transport infrastructure to encourage private sector investment;
(x) support for public sector investments outside Java-Bali to increase efficiency of power supply and expand the electricity supply, particularly for access by the poor;
(xi) support for public sector investments in Java-Bali to complement power plants developed by the private sector and to maintain reasonable quality and reliability of power grid supply that is essential for economic growth; and
(xii) close coordination with other major institutional lenders to maximize the developmental impact of the assistance.

6. Implementation Issues

84. ADB's future assistance in the energy sector must address identified implementation issues in ongoing projects. Inadequate cost recovery has been one such issue. Insufficient tariffs had, for example, hampered PLN's financial recovery in the past. Similarly in the oil sector, continuance of administered prices had affected the sector's development. The Government now plans to remove the subsidy from fuels and electricity by 2005, which would help generate resources to expand the energy sector, making it less dependent on budget allocations and more attractive to private investors. Future projects must address issues relating to sharing of resources between regions and the central Government, which will require constant dialogue and confidence building. Security concerns in some areas are also a risk factor for future projects. Since 1999, the Government has adopted a more open and consultative process in policy formulation and legislation. Parliament is subjecting the draft bill to close scrutiny, which, although time-consuming, will improve ownership and help implement the legal provisions that require a structural change in the energy sector. One energy sector project in the pipeline is to mitigate urban pollution by promoting the use of natural gas for transportation. While suitable infrastructure has to be built on the supply side, vehicle owners, manufacturers, and service providers will be required to invest in using the new fuel. This project will also require enactment of appropriate legislation.

7. Performance Monitoring

85. ADB will monitor the financial health and corporate governance—which are closely related to the level of electricity tariff and subsidy in petroleum products—of the public sector entities in the sector. The success of the ongoing reforms will, to a great extent, depend on demonstrable price levels and the consequent revenue expectation from the investments made by the private sector in meeting future energy demand. The other important parameter in the power sector is the quality of supply. Since Indonesia is broken up into a very large number of grids, generalization becomes difficult. Several key indicators (see Road Map) will be monitored to ascertain that development is on track.

Energy Sector Road Map

Sector Indicators
(only for the power and natural gas subsectors)

Item	Current	2006
Installed power generation capacity of PLN (state-owned electricity company) (MW);		
Indonesia	20,760	24,500
Java-Bali	18,600	23,100
(low average growth scenario: sales=7%, GDP=5%)		
Installed power generation capacity, captive (MW)	11,850	na
Installed power generation capacity, private sector (MW)	3,605	4,900
Annual energy sales by PLN (TWh),	86.7	120
Residential (%)	39	38
Industrial (%)	43	42
Commercial (%)	13	14
Others (%)	5	6
Average selling price ($/kWh)	0.039	0.07
Residential (Rp/kWh) [a]	207	590 [b]
Industrial (Rp/kWh)	302	725
Commercial (Rp/kWh)	380	700
Energy losses (%)	11.65	12
Number of household consumers (million)	27.8	34.2
Electrification ratio [c] (%)	54	60
Total length of natural gas transmission pipe line network managed by PGN (stated-owned natural gas transmission and distribution company) (km)	3,020	5,170
Natural gas transmission by PGN (million cubic meter)	39,200	tbd
Natural gas sales (million cubic meter)	19,570	under
For use by industry (%)	58	TA
For use by transport (%)	–	3671-
For use by households (%)	–	INO
For non-energy use (%)	42	

(source: PLN Statistics, 2000; PLN Annual Report 2000; PGN Annual Report 2000; and World Energy Council Internet website; the 2006 projection are based on PLN planning estimates of December 2001)
tbd-to be developed

[a] The average selling price by category is based on revenue in December 2000, when the average selling price was Rp280/kWh.

[b] The projected levels of revenue are estimates with limited cross-subsidy, i.e., the variation of tariff by category to be less than 10% of the required average selling price. The Government proposes to subsidize electricity consumed by poor consumers from budget resources. In which case, the tariff for industrial and commercial consumers will be lower.

[c] Ratio of residential consumers to number of households.

Major Issues

(i) Resources required for capital investment to meet future demand of electricity and natural gas; (ii) high level of general subsidy for fuel and electricity; (iii) enactment of the new electricity law to enable competition in Java-Bali; (iv) development of facilities for the bulk electricity market; (v) establishment and capacity building of regulatory body; (vi) reorganization of PLN; (vii) creation of a suitable legal and regulatory framework to attract private sector investment in oil and natural-gas exploration and production, and power generation; (viii) expansion of the domestic natural gas market; (ix) promotion of cleaner energy use, particularly for the transport and industrial sectors; and (x) exploitation of potentials available by energy conservation and energy efficiency improvement.

Sector Outputs

	Schedule	Financing Source		
I. Policies		Gov.	ADB	Others
A. Reform of power subsector [1]				
a. power sector restructuring	1999-2006	X	X	World Bank
b. establishing competition	2002-2010	X	X	
c. adjusting tariffs	2000-2005	X		
d. increase private sector participation	1999-2002	X		
e. strengthening regulation	2002-2004	X	X	
B. Preparation of gas subsector development plan [2]	2002		X	
C. Divesting part ownership of the Grissik-Duri and Grissik-Singapore (under implementation) to a strategic investor [3]	2002	X	X	
II. Institutional Development				
A. PLN				
a. Reorganization and Financial Rehabilitation Study	2001-2002			World Bank
b. Java-Bali power development plan study	2001-2002			JICA
c. Establishing strategic business units (SBUs)	2003-2006	X		
d. Privatization of SBUs	2007-2010	X		
e. Strengthening regulatory body	2003-2005	X	X	
f. Strengthening system and market operator	2006-2007		X	
III. Investments				
A. Power Subsector				
a. Power generation (conventional)	2002-2007	X		JBIC, bilateral private sector
b. Renewable energy resources	2002		X	
c. Power evacuation	2003			World Bank
d. Subtransmission	2002		X	
e. Distribution	2002-2007	X		
f. Market facilities	2002		X	
g. Energy conservation and energy efficiency improvement	2002-2007	X	X	World Bank, bilaterals
B. Natural Gas				
a. Exploration and production	2002-2007	X		private sector
b. Cleaner use of energy	2003		X	
c. Development of trunkline	2005		X	JBIC
d. Development of distribution network	2003-2005	X	X	World Bank

[1] Under loan 1673-INO and 1674-INO; and as included in the 2002 loan proposal for INO.
[2] Under TA 3671-INO.
[3] Under Loan 1357-INO.

G. Transport Sector

1. Sectoral Needs and Development Challenges

a. Overview

86. The transport system is multimodal, comprising a road network of about 314,790 kilometers (km), including 500 km of privately operated toll roads; a 6,810 km railway system on Java and Sumatra; inland waterway systems on Kalimantan, Sumatra, and Papua; extensive interisland and coastal shipping services; and domestic and international air transport networks.[5]

87. Road transport is the dominant mode, with an estimated share of about 92% of the total freight transport in tons and about 84% of passenger movements. Interisland and coastal shipping is the second major transport mode, with about 7% of freight and passenger movements, followed by rail with 1% of freight transport and 7% of passenger movements. Inland waterways and air carry the remaining traffic.[6] The Government continues to subsidize many nonprofitable airports to support regional integration, especially in eastern Indonesia.

88. ADB's involvement in the transport sector so far has been predominantly, although not exclusively, in the road subsector. ADB plans to become more heavily involved in other transport sectors such as ports and airports, but only after a detailed examination of needs and responses to be conducted in 2002. Although discussions with the Government have indicated needs in the transport sectors besides roads, interventions in the non-road sector have been programmed only tentatively in later years and will be included only after such a study.The discussions in this sector are thus focused mainly on development of road infrastructure and road transport.

b. Vehicle Fleet and Transport Industry

89. The country's vehicle fleet has grown at an average annual rate of about 11% per annum during 1993-1997, but slowed with the crisis. The number of motor vehicles was 17.6 million in 1998, with passenger cars accounting for 15.5%, buses 3.5%, trucks 8.9%, and motorcycles 72.1%. The average traffic levels on national roads are currently 3,000–13,000 vehicles per day (vpd), considerably higher on sections linking the major urban centers. On provincial roads, traffic volume is generally less than 3,000 vpd.

90. The road transport industry (trucking and bus services) is largely dominated by the private sector; only about 25% of trucking operations and 5% of bus services are provided by government-owned corporations. The industry is highly competitive and generally considered efficient, although it has safety and service concerns. Entry into the industry is essentially unrestricted, and tariffs are determined by market forces, except for economy-class bus services, for which fares are set by the Government.

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[5] Re: RRP for Road Rehabilitation Sector Project, November 2000.

[6] Re: ADB-financed (Loan 1089-INO) Transport Sector Strategy Study for Indonesia, June 2000. Government statistics include the freight carried by ferries in the road figures.

c. Development Challenges

91. Public investment in transport is essential to preserve assets and meet growing demand for services. Critical needs include (i) rehabilitation of deteriorated road networks, (ii) investments in rural roads, (iii) improvement of national transport and interisland links to forge new trade relationships and to support urban growth, and (iv) policy issues including appropriate budget provision and user charges for O&M of infrastructure.

92. The crisis reduced funding for transport projects. The unexpected increase in inflation rendered some contracts unworkable. Financing and implementation of land acquisition and resettlement have also presented major problems. The national transport planning framework lacks cohesiveness, and regional transport strategies lack focus.

93. The core of the transport strategy in the short term is that the role of transport agencies needs changing; aggressive private sector participation is needed; and program and project preparation procedures must be made consistent, comprehensive, and transparent between national and regional levels. Western Indonesia (Java, Sumatra, and Bali) has few short-term requirements for major new infrastructure, although container facilities need expanding. In eastern Indonesia the road and inland waterway networks are fragmented and lack connectivity, there are no railways, and some ports and airport facilities need modernizing and upgrading. In many regions, demand is not sufficient to justify new investment on purely market terms, but national objectives need to be considered. In some cases, for example, the provision of services such as the ferry transport system and air transport services need to be maintained and improved.

d. Sector Issues

94. The main issues facing the sector relate to capacity development, attention to maintenance, higher budgetary allocations for the sector, and improved financial health of transport utilities. Greater private sector participation is also a major issue. Capacity requirements include improved regulations for public and private sector operations and institutional arrangements and capacity building. The implementation of the Transport Sector Policy Action Plan is a major sector objective. Improving road maintenance is a major concern, including routine, periodic rehabilitation, and betterment works. Insufficient funds and inadequate quality standards of maintenance works have led to rapid deterioration of infrastructure, particularly road infrastructure, requiring frequent renewal. The lack of sufficient budgetary funds, particularly during the first few years of the crisis has been an issue, and inadequate funding continues to plague the sector. With decentralization, maintenance and expansion of road infrastructure under regional governments has been affected by a lack of regional resources.

2. Government Policy

95. Following the crisis, the Government reduced spending for the transport sector, limiting commitments mainly to rehabilitation. This approach seems likely to continue over the medium term while policies to improve the institutional framework for designing and managing transport sector projects through decentralized administration are put in place.

96. PROPENAS 2001-2005 outlines the Government's medium-term strategic development priorities for infrastructure. The priority plan for public investment will focus on rehabilitation and betterment of existing infrastructure, and work will be prioritized based on economic and urgent

social considerations. Improving infrastructure services that support production, exports, and expansion of employment and business opportunities will be the key priorities of medium-term investment. Greater competition and enhanced participation of the private sector in infrastructure provision based on transparent competition is envisioned.

3. ADB Sector Experience

97. Since 1976, ADB has provided assistance to the road sector amounting to about $1.3 billion for 14 projects. This assistance has yielded positive results. Project completion reports have been prepared for the first 12 ADB-financed road projects. Project performance audit reports have been prepared for seven projects, which have all been rated generally successful. Lessons include the following: (i) future projects should focus on periodic maintenance and rehabilitation; (ii) conventional project planning methods should be used and/or a rapid field confirmation of the results carried out; (iii) economic evaluation should be more thorough, especially traffic counts and forecasts; (iv) the practice of omitting drainage of roadways should be avoided; and (v) international consultants proved useful in overseeing the design and construction activities.

4. Activity by Other Funding Agencies

98. Indonesia has received about $7.6 billion of foreign assistance for road development since FY1984.[7] The World Bank and JBIC have been the major sources of assistance, with a share of total assistance of about 33% each, followed by ADB with about 17%. Other bilateral sources such as Australia, Austria, Germany, Kuwait, Saudi Arabia, and United States provided the remaining 17%. The share of foreign funding in the Government's total road expenditures had declined to about 20% in the years immediately before the crisis, but increased to more than 35% during.

99. The major external funding agencies closely coordinated with regard to their projects' geographic coverage and scope to avoid duplication of effort and maximize the impact of external assistance. Before the crisis, JBIC, World Bank, and ADB agreed on a broad division of work based mainly on geographic criteria. Thus, the World Bank and JBIC focused on West Java, while ADB gave priority to off-Java regions, particularly eastern Indonesia. The World Bank gave priority to primary roads, and ADB to secondary roads. After the crisis, the Government reestablished coordination with JBIC to finance rehabilitation of district roads in Sumatra and Java, build a new road in South Sumatra, and procure equipment for road maintenance; ADB concentrated on road rehabilitation in Java, Sumatra, Kalimantan, and Sulawesi. ADB and World Bank also closely coordinate their sector policy dialogue with the Government.

5. ADB Sector Strategy

a. Transport Strategy

100. The strategy concentrates on maintenance, rehabilitation, and selective development of strategic transport systems. The ADB[8] approach recognizes the need for balanced distribution in transport service provision between resource-rich and resource-poor provinces in relation to needs and priorities and the level of funding available. Decentralizing the administration to local

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[7] Re: RRP for Road Rehabilitation Sector Project, November 2000.
[8] Re: Transport Sector Strategy Study (ADB Loan 1089-INO), June 2000.

governments and financing transport infrastructure using innovative private and public partnerships will have significant impact. Trade corridors are a key transport strategy concept. They will link the production areas built around land and water routes for intra- and interregional communication and transportation. ADB lending will thus focus on (i) improving the quality of the road network through road improvement and betterment, bridge construction, and periodic road maintenance works; and (ii) strengthening the capacity of central and local Government agencies through advisory services and training. ADB assistance for road development in the eastern islands has been consistent with the Government's development priorities.

b. Short- to Medium-Term Strategy

(i) Maintain and rehabilitate transport infrastructure, including routine and periodic maintenance programs, facilities, and services throughout Indonesia, to support economic growth.
(ii) Conduct a sector study to determine priorities for nonroad subsectors and validate the road sector strategy. Focus on upgrading or completing deficiencies in each system (land, sea, and air) in line with a defined strategic level of service and other requirements, specific to each region.
(iii) Implement the Government's Action Plan on the Road Traffic and Transport Sector Policies after formulation; and follow up with the concerned agencies to complete its formulation.

c. Medium- to Long-Term Strategy

(i) Rehabilitate the road system, which serves the great majority of inter-urban passengers, and general freight transport.
(ii) Upgrade the railway, and ferry and inland waterway systems, within regions and corridors where passenger volume and/or bulk freight demands justify it.
(iii) Rehabilitate the sea transport system, especially for interisland passengers; international and domestic containers; and high-volume, low-value cargo.
(iv) Upgrade the air transport system, particularly for interisland and international passenger travel and high-value freight.
(v) Implement regulatory reforms, which are essential to improve economic efficiency and attract private sector funds to the sector. Increased tariffs and independent economic and technical regulation are key features.
(vi) Focus on the institutional adjustments that are also needed to strengthen coordination between agencies involved in multimodal transport planning and implementation at the national, provincial, and districts (*kabupaten)* level.
(vii) Finalize implementation of the Government's Action Plan on the Road Traffic and Transport Sector Policies, including regulation reform and law enforcement, transport sector planning and policy, road development, road safety, technology, energy and environment, institutional strengthening, private sector, local government investment, and improvement of transport services

6. Implementation Issues

101. Implementation issues include lack of ownership, slow progress in policy and institutional reforms, poor quality of works, lack of maintenance, and need to better address environmental concerns. These factors are being addressed in all new project designs. Lack of capacity in financial and human resources will pose a major implementation issue in the context of decentralization.

102. Land acquisition and resettlement of the right of way is essential to timely implementation of infrastructure projects. Delays cause poor quality of works and overbudget project costs. Issues of jurisdiction, in cases of resettlement, for example, may pose problems for future projects.

103. Overloading is also becoming a cause of premature failure of pavement and road accidents must be solved jointly by the central and local agencies.

104. The adequate allocation of funds for the regular maintenance of infrastructure (road and bridges) is important for its service life and for preventing undue capital costs. Improving allocation of general revenue at the national, provincial, municipality (*kotamadya)*, and kabupaten levels, and application of road taxes can raise the necessary maintenance funds.

105. The implementation of the Government's Action Plan on the Road Traffic and Transport Sector Policies as soon as possible is of paramount importance to the sustainability and long-term development of the road and transport sector.

7. Performance Monitoring

106. Performance monitoring in the Road Sector will use indexes relating to road conditions; proportion of paved roads to total; progress in reduction of traffic accidents; growth of transport services and extent of private sector participation in road construction work. Policy and institutional development will also be monitored.

Transport Sector Road Map

A. ROADS

I. & 2. Sector Outcome/Output	Total KM	Current Condition %		2010 Good %	2010 Fair%
1. Average condition of National Road Network	27,294	Good/Fair	45	60	30
Average condition of Provincial Road Network	37,596	Good/Fair	40	50	30
Average condition of Kotamadya/Kabupaten Road Network	249,000	Poor	65	40	25
2. Paved Road Network – National	23,015	80%		90%	
Paved Road Network – Provincial	27,913	70%		80%	
Paved Road Network – Kabupaten	79,680	32%		40%	
3. Funding for Maintenance – National Roads only (Current estimated annual need is Rp5.5 trillion)		Rp3.3 trillion		Rp 8.0 trillion	
4. Improve Road Roughness Index per Km					
National Road		7		4.0	
Provincial Road		7		4.5	
Kabupaten Road		18		17.5	
5. Traffic Accident /10,000 vehicles- Road Safety		60		20	
6. Transport Services Growth – Intra-sector (Vehicle/day)					
Java		458,100		728,700	
Sumatra		197,100		304,100	
Kalimantan		3,000		4,600	
Sulawesi		2,200		3,600	
7. Increase private sector participation in road maintenance activities round the year.		NA		10% of contractors in each province	

3. Major Issues/Constraints

1 An integral national transport sector blueprint, with input from the provinces in all subsectors, land, air and sea is necessary.
2 The policy enforcing completion of land acquisition and resettlement prior to starting project implementation can save time and cost for the borrower and ADB
3 The legal framework to facilitate private sector participation in infrastructure is essential to meeting the infrastructure demand in the short to medium term.

4. Actions/Milestones	Schedule	Financing Source: Govt.	Financing Source: ADB	Financing Source: Other
Policy.				
Road sector policies Action Plan drafted	2004	Policy change	Loan 1798-INO	
• Preparation of National Road Law underway				
• Road maintenance fund through user charges				
• Overloading control and upgrading load bearing capacity to reduce wastage of investments	2007(Approx)	Through Program loan	RRSP II (under preparation)	
• Reduction of fuel subsidies and application of taxes directly linked to road fund				
Institutional	2004			
• Improving allocation of general revenue in each National, Provincial, Kotamadya and Kabupaten levels			Loan 1798-INO	
Investment	2004			
• Road Rehabilitation and upgrading -- national and provincial			Loan 1798-INO	
• Training Program				
• Road Sector Training and Education as a policy instrument – roads planning, design maintenance, environmental aspects, and quality control.				

5. Investments	
2003	
Loans	**Technical Assistance**
1. Road Rehabilitation (Sector) II	1. Local Roads Development Sector (PPTA) 2. Subregional Transport Cooperation (ADTA) 3. Interisland Transportation (PPTA) 4. Review and Finalization of Medan Airport (PPTA) 5. Strategic Development Plan for Ports (ADTA
2004	
1. Interisland Transport 2. Local Roads Development Sector	1. Interisland Transport (PPTA) 2. Master Plan and Feasibility Study of Ports (Makassar, Teluk Bayur) (PPTA)
2005	
1. Sumatra Transport Development	1. Urban Railway Transportation (PPTA) 2. Local Roads Development Sector II (PPTA)

B. OTHER TRANSPORT

I. Sector Outcome/Output	Growth **%age/yr**	**Traffic** In year 2000	**Traffic In year 2009**
RAIL:			
Inter-Provincial passenger growth	2.8	31.4 million	40.4 million
Share of coverage among other principal transport modes		4.0%	6.0%
AIR TRANSPORT:			
Domestic passenger growth	5.1	7.7 million	10.6 million
International passenger Growth	6.8	4.4 million	7.5 million
International Freight Growth	8.6	312,690 Tonnes	585,650 Tonnes
SEA TRANSPORT:			
Domestic passenger Trips per year	6.0	7.7 million	14.1 million
International passenger Trips per year	6.5	2.7 million	4.9 million
International Freight Growth- Imports	8.2	12.4 Tonnes	31.3 Tonnes
International Freight Growth- Exports	4.8	24.4 Tonnes	39.1 Tonnes
Domestic Freight Growth	4.0	22.1 Tonnes	32.3 Tonnes
INLAND WATERWAYS AND FERRY TRANSPORT:			
Ferry Passengers Trips	5.1	21.8 million	35.0 million
4 Wheel Vehicles	4.5	3.2 million	5.2 million
	1. The projected demand for the investment in the transport infrastructure in all subsectors is huge and cannot be met without active contribution by the private sector. 2. The necessity of an integral national transport sector blueprint, with input from the provinces in all subsectors, land, air and sea. 3. The legal framework to facilitate private sector participation in infrastructure is essential to meeting the infrastructure demand in the short to medium term.		

H. Finance Sector and Corporate Governance

1. Background

107. The crisis highlighted risks associated with vulnerable financial structures in a financially integrated world. Vulnerabilities in Indonesia stemmed from strategic weaknesses, including (i) excessive dependence on imprudent noncommercial lending; (ii) a small and underdeveloped nonbank financial sector; (iii) inadequate corporate and financial regulation and supervision; and (iv) weak governance, including poor compliance with accounting and auditing standards and lack of adequate disclosure. The crisis also highlighted the need to establish adequate social protection systems and retirement income through better designed and managed financial plans to ensure social stability. The $1.4 billion Financial Governance Reforms: Sector Development Program in 1998 was part of the Government's efforts to address critical issues. That program and ADB's subsequent reform efforts have focused on improving the governance of financial and public sector allocation of resources through (i) adopting best financial governance practices, (ii) increasing disclosure and transparency of financial information, and (iii) strengthening the legal and regulatory framework of the financial sector.

2. Government Policy

108. PROPENAS' financial objectives include promoting the social security system; creating economic and monetary institutions, and promoting and strengthening capital market institutions; providing economic development facilities and infrastructure; and promoting more equitable development throughout the regions.

3. Sector Issues

a. Weak Regulatory and Supervisory Framework

109. A lack of supervisory independence and insulation from political interference are core issues in the banking and financial crises and continue to be critical areas for reform. Banks, the securities market, insurance firms, private pension funds, finance companies, and the venture capital industry are regulated and supervised by multiple agencies that have lacked effective governance because of low accountability and their absence of political and financial independence. The multiple-agency structure provides segmented and fragmented regulatory and supervisory oversight and is not conducive to the supervision of financial conglomerates. Mandatory pension and insurance programs are considered ineffectively supervised in the regulatory sense, and there is no unified policy, supervisory regulatory, or legal framework for the state pension sector. Poorly managed financial institutions have taken risky asset-liability and currency positions that resulted in mismatches and liquidity problems. The Central Bank is independent, but the capital market supervisory agency lacks the autonomy, resources, and capacity to enforce laws and regulations or inspect and investigate brokerage and securities firms.

b. Inadequate Corporate Governance

110. Inadequate corporate governance and prudential regulations and their weak enforcement in financial markets remain key concerns. Prospects for a return to financial stability depend on reducing investment risks to manageable levels by strengthening the legal and regulatory regimes, enhancing accountability and transparency, ensuring impartial enforcement of commercial laws and regulations, and streamlining company incorporation and

registration processes. Although Indonesia has a comprehensive legal and regulatory framework for corporate governance, enforcement has been insufficient. Similarly, accounting and auditing standards, while by and large in line with international standards, are not strictly applied and enforced. Comprehensive disclosure in corporate reporting, independent directors or commissioners safeguarding the rights of minority shareholders, and transparency in financial dealings with related parties are lacking.

c. Corruption and Public Governance

111. Corruption hinders progress in the sector. Clear public sector mandates, accountability, and public planning and implementation capacity will all be needed. Decentralization has introduced new concerns. Successful fiscal and political decentralization will require solid foundations and management, otherwise rapid decentralization could accentuate macroeconomic instability, worsen inequalities, and increase corruption.

d. Specific Subsectoral Needs

112. **Insurance Sector Solvency.** Some companies may be in danger of technical insolvency. New risk-based capital requirements are being phased in until 2004 to encourage the industry to rehabilitate itself through rationalization and consolidation. Transparency and disclosure must be increased along with reliable published data. To ensure adequate consumer protection and an orderly market transition, plans for rehabilitation, restructuring, and consolidation should be undertaken on an industry-wide basis.

113. **Inadequate Social Security System.** The JAMSOSTEK mandatory pension (a defined contribution savings scheme) does not provide adequate retirement income due to low contribution rates, low wage replacement rate, early withdrawals, lump-sum payments, lack of indexed annuity requirement, poor investment performance, high administrative and operating costs, and Government-directed investments at returns below the market rate. The program is further damaged by weak internal governance, lack of disclosure and transparency, lack of public confidence, and lack of enforcement. Comprehensive reforms are needed for this agency as well as others in the field.

114. **Municipal Financing System.** The establishment of an appropriate municipal financing mechanism is critical under decentralization. Multilateral lending to local governments is channeled through either the regional development account or subsidiary loan agreements. However, the performance of the account has largely been unsatisfactory, with at least 50% of loans in arrears as of end-1999.

115. **Lack of an Anti-Money-Laundering Regime.** In June 2001, the Financial Action Task Force on Money Laundering added the country to the list of Noncooperative Countries and Territories following the assessment of its anti-money-laundering regime. Parliament adopted a new anti-money-laundering law in March 2002, but critical issues and challenges remain to be addressed to achieve a working system to combat the practice. Strengthening existing institutions capabilities, developing newly established institutions, establishing systems to monitor suspicious transactions, and training officials will be key.

4. ADB's Sector Strategy

116. ADB financial sector strategy focuses on core reforms, including improving governance through (i) increased disclosure, transparency, and enforcement of regulations; (ii) audit of state

banks and enterprises; (iii) development of a legal framework for anticorruption and anti-money-laundering efforts; and (iv) capacity building in existing institutions and creation of new institutions and systems for effective supervision. Legislative reform of capital markets, pensions, and insurance laws to strengthen prudential supervision and regulation and to bring standards and practices in line with international best practices are also essential elements of sector strategy. A stable and sound financial system requires expeditious restructuring of financially weak insurance companies and reform of the pension and provident funds and capital markets. A framework for harmonized financial sector supervision and regulation has been supported, including preparation of a draft law to establish a consolidated supervisory and regulatory body and implementation plans. This new body is envisioned to facilitate better compliance and effect needed reforms and restructuring. Under decentralization, a municipal financing system will be introduced, developed, and supported to ensure that adequate and balanced development will continue.

117. Improvement of the supervision and management of funds collected under various existing schemes is critical to protect consumers and preserve capital. ADB will continue its support for assessments and audits of mandatory pension and provident fund schemes. Valuations of unfunded pension liabilities and an assessment of requirements to develop a unified social security system will be conducted to identify reforms to broaden coverage, protect members' funds, and improve retirement income. To ensure effective administration, accounting, payment of benefits and transferability of pensions, ADB will support the development of a unified identification system.

118. The performance of the financial sector is closely related to corporate performance and governance. ADB's corporate governance strategy includes reform of the company registration system; adoption by private companies of a code for good corporate governance; and, for public sector companies, improved management and audit to support commercialization of public service obligations and gradual privatization.

5. Implementation Issues

119. The timely passage of the law establishing the Financial Services Authority (FSA), effective integration of the relevant agencies and offices into FSA, and sufficient capacity building will be important for effective supervision, reform, and restructuring.

120. The ability to conduct independent and complete financial audits, and financial and management reviews of mandatory pension and provident fund programs and financially weak insurance companies will be critical to determine financial position, required assistance, restructuring plans, and necessary reforms.

121. A good and strong interface and cooperation with the regional and municipal authorities will be required for timely adoption of an appropriate municipal financing system under decentralization.

122. Political will to combat money laundering, and a continuing commitment by the Government to financial sector reforms and social security unification following national elections in 2004 will be essential.

6. Performance Monitoring

123. Several indicators will be used to monitor the health of the financial sector (see Road Map) and its overall performance. Indicators will also track institutional and policy changes and improvements in governance.

Financial Sector Road Map

1. Selected Sector Indicators (Outcomes/ Outputs)	Current	2010
Banking • NPLs including loans transferred to AMCs as % of total loans	53	15
Capital markets • Market capitalization (% of GDP)	20	150
Insurance • Percentage of companies in compliance with risk-based capital requirements (%)	TBD	100
Pensions and provident funds • Coverage (% of labor force) in mandatory programs • % of assets in mandatory programs managed by independent asset managers • Public disclosure of list of portfolio assets in mandatory programs and current valuation • Percent of pension fund managers of non-listed funds that are licensed	20 0 No 0	30 25% Yes 100%
Institutional change		
• Establishment of integrated financial services regulatory and supervisory authority • Demutualization of Jakarta Stock Exchange • Establishment of Institute of Directors • Indonesia membership in the International Association of Insurance Supervisors (IAIS)	No No No No	Yes Yes Yes Yes

2. Sector Issues/Constraints

i. Domination of sector by banks, with lack of diversification of financial markets and instruments
ii. Continued vulnerability of banking sector despite recapitalization
iii. Weak regulatory and supervisory framework for the financial sector and lack of supervisory independence
iv. Danger of significant insolvencies of firms in the insurance sector
v. Low level of confidence by international investors in the capital markets and private investments
vi. Political opposition to privatization
vii. Inadequate legal framework for development of local government financing
viii. Inadequate social security system and a lack of transparency, disclosure and enforcement

3. Actions/ Milestones

	Schedule	Financing source		
		Gov.	ADB	Others
Policies • Strengthening regulation and supervision in the financial sector • Strengthening non-bank financial institutions • Development of stock market • Strengthening of social security system • SOE reform & privatization • Corporate governance reform (SOE) • Development of anti-money laundering regime • Municipal Financing Mechanism	2002-2005 2002-2005 2002-2005 2002-2007 2002-2007 2002-2007 2002-2005 2002-2006	X X X X X X X X	Cluster : 1st Loan 2002; 2nd Loan 2003 & piggyback TA; TA3620 “ “ “ Loan 1866; PPTA & Loan (pipeline 2003, 2004) TA 3849 PPTA, Loan (2003 pipeline SSES/SEGF)	World Bank, AusAID, IMF, JICA, USAID CIDA USAID, JICA Netherlands USAID World Bank, CIDA, GTZ, AusAID, ASIC, USAID, AusAID; USAID; World Bank; DFID
Institutional Development • Consolidated Financial Services Supervisory & Regulatory Body (OJK) • Financial Intelligence Unit (PPATK)	2002-2004 2002-2003	X X	TA 3620;TA3850 TA 3849	AusAID

I. Small-and Medium-Sized Enterprises (SME) Sector[9]

1. Overview

124. The industrial structure in Indonesia is dominated by large enterprises in terms of value added and, hence, productivity. A similar pattern is found in trade and other services. In manufacturing, large enterprises contributed 85% of value added while SMEs provided only 11% and microenterprises 4%. However, small firms provide the bulk of employment: of 10.2 million people employed, 60% were with microenterprises and SMEs. Despite the potential productivity gains for the economy from the employment growth of small firms, few small firms in Indonesia tend to grow into medium-sized firms. The absence of productive medium-sized firms or "the missing middle" is only a symptom of a larger problem. Relative to other regional economies, Indonesia has a small SME sector and a large corporate sector. The productivity gap between small and large firms is a serious problem.

2. Sectoral Constraints

125. SMEs face constraints that hinder their productivity and, hence, their long-term capacity to reduce poverty in a sustainable manner:

(i) **external constraints** in the business environment, which are reflected in government interventions biased toward large businesses, including State Owned Enterprises (SOEs), such as overregulation, corruption, and inadequate infrastructure;
(ii) **internal constraints** within SMEs, which are reflected in weak entrepreneurial skills, production management, accounting, and business planning, and have translated into low-quality products; and
(iii) **lack of access to productive financial and export markets** needed for a level playing field in finance and trade.

126. The traditional approach to lifting these constraints shifted dramatically after the crisis. The country's past paradigm for government-directed growth of large industrial enterprises is giving way to a focus on SMEs under a market-oriented approach.

3. Government Policy

127. PROPENAS acknowledges that the development of SMEs lags behind that of large corporations. The constraints on SME growth are (i) limited access to productive resources (information, technology, capital, and markets); (ii) limited institutional support for SMEs; and (iii) the low quality of human resources. Another problem is that high transaction costs for SMEs have resulted from a highly regulated business environment that encourages inefficient allocation of resources.

128. PROPENAS acknowledges SMEs as the backbone of a decentralized economic system. Their empowerment has become of utmost importance in accelerating equitable development.

129. In April 2002, the Government announced the Medium-Term Action Plan for 2002-2004. It includes three basic areas of focus for government policy, including developing an enabling

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[9] Related areas are discussed in the private sector development section.

business climate, ensuring the provision of financing and business services, and encouraging entrepreneurship for potentially competitive SMEs.

4. ADB Sector Experience

130. ADB's support for SME development focused initially on rationalizing and streamlining industrial policy, regulation, and institutional frameworks to improve the incentives for trade and industry. Since 1998, ADB has led in SME policy development. In formulating the Industrial Competitiveness and Small-and Medium Enterprises Development Program (ICSMEDP) policy framework, ADB has launched substantial ESW and coordinated an SME policy agenda. In line with ADB strategy, substantial work was undertaken in 1999-2000 to develop an understanding of issues and constraints facing the sector. An ADB study on SMEs in EAGA identified a series of problems that hinder SME growth and development. Under ADB's program lending,[10] necessary structural reforms in three key sectors (finance, industry and trade, and privatization of SOEs) have been supported.

5. Activities of Other Funding Agencies

131. JICA focuses on SME development through 2002 projects focusing on regional training centers as well as studies of clusters across Indonesia. German official assistance provided $79.2 million in 1999-2000 for SME business promotion and vocational training, and an investment credit line through provincial banks. Other agencies, including CIDA, SwissContact, and the Asia Foundation, work on SME policy reform and nonfinancial services, often in close cooperation with multilateral funding agencies such as the World Bank and ADB.

6. ADB Sector Strategy

132. ADB's sector strategy will do the following:

(i) Focus on capacity building in local governments to improve local business environments. Lift external constraints, particularly the myriad business and banking regulations that carry large fixed costs but have little impact on SMEs,

(ii) Remove internal constraints. The Government and Funding Agencies have frequently provided Business Development Services (BDS) through public institutions. Commonly, these programs have suffered from low-quality, supply-driven services with limited outreach. The new approach will focus on facilitating sustainable BDS through private providers to allow access to quality services.

(iii) Improve access to financial and export markets. The traditional approach dictated subsidized credit through government institutions, and supply-driven information and regulation from them. The new approach supports access to financial resources based on public-private partnerships as well as on SME export promotion in clusters in the provinces. Public-private partnerships will increase the availability of credit and direct investments and produce better credit information and techniques for SME lending through adequate TA. Export opportunities based on local competitiveness and international and regional demand will emerge by accelerating regional cooperation.

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[10] Supported by program loans such as INO-1618: Financial Sector Reform; INO-1738: Industrial Competitiveness and SME Development; and INO-1866: Privatization of SOEs.

7. Implementation Issues

133. Major issues to improve implementation relate to progress in reforms and to on-lending operations for industry and trade promotion. The following are other areas where efforts could be made to improve project implementation, some of which may be generic but applicable to industry and trade projects:

(i) Transparent fund-channeling mechanism with appropriate monitoring system in place;
(ii) Adequate counterpart budgets and timely release of funds;
(iii) Independent audit and monitoring, and random checking of financial management;
(iv) Capacity building; and
(v) Increased ESW linked to industry and trade projects.

8. Performance Monitoring

134. Overall performance in the long and medium term will be gauged by the pace of reforms as well as actual development of SMEs, such as their contribution to GDP, total nonagricultural employment, and exports. Other areas of performance to be tracked are spread of SMEs to less developed areas and SMEs' success in securing credit.

Industry and SME Road Maps

	Indicators (to be developed by sector committee)					
	5-Yrs ago	Current	5-Yrs	10-Yrs	15-Yrs	25-Yrs
1. Sector Outcomes						
Productivity Gap between Large and Small Enterprises	5 times	4 times	3 times	2 times	2 times	2 times
Competitiveness Index	Low	Low	Medium	High	High	High
Use of Business Development Services	20%	20%	25%	30%	35%	50%
Non-performing bank loans by SMEs	Low	2%	2%	1%	1%	1%
Share of Exports by SMEs	<15%	15%	20%	25%	30%	50%
2. Sector Outputs						
Number of Microeconomic and SMEs (% total enterprise)	99	99	99	99	99	99
Employment by Micro and SMEs (% total employment)	<90	89	90	90	90	90
GDP by Micro and SMEs (% of total GDP)	<40	40	45	50	55	60
Participation of SMEs in Regulatory Process	Nil	Low	High	High	High	High
Number of non-Java Micro and SMEs (% of total)	<34	34	35	36	37	38
Employment by non-Java Micro and SMEs (% of total)	<26	26	28	29	30	30
GDP by non-Java Micro and SMEs (% of total)	<30	30	36	40	45	50
Foreign Direct Investment (FDI) in SMEs	Low	Low	Medium	Medium	High	High
3. Sector Issues/Constraints	(i) Poor business climate, especially in the regions (ii) Highly fragmented SME promotion (iii) Low access and low quality of business services offered to SMEs, especially in the regions (iv) Low access to adequate financing (v) Low access to export markets					
	By Issue		Schedule	By Agency		
4. Actions/Milestones/Investments *(to address above)*	Improve Business Climate			ADB	Others/Ext.	Govt
	Policy:		2000-2	TA 3416 & Loan 1738	USAID, WB, GTZ	Policy Change
	Institutional:					Count. Staff
			2000-2	TA 3417	-	Count. Staff
			2000-2	TA 3829	USAID	Count. Staff
	Investment		2002-4	TA 3829	USAID	Count. Staff
			2003-5	Loan (2003-5 Pipeline)	-	& Funds
	Improve Business Dev. Svcs.					
	Policy:		2000-2	Loan 1738	-	Policy Change
	Institutional:		2002-4	TA 3829	USAID	Count. Staff
	Investment		2002-4	TA 3829	GTZ, CIDA Swisscontact	Count. Staff & Funds
	Increase Access to Finance and Export Markets					
	Policy:		2000-2	Loan 1738	WB	Policy Change
	Institutional		2003-5	TA (2002 pipeline)	JICA	Count. Staff
	Investment		2000-3	TA 3417 & TA 3829	IFC	Count. Staff
			2003-5	Loan (2002 pipeline)	KfW	Count. Staff
			2004-5	Loan (2003-5 pipeline)		Count. Staff

J. Gender and Development

1. Overview

135. Gender inequalities are deeply rooted in Indonesia. It ranks 90th out of 165 countries in the gender development index of the UNDP, behind its regional neighbors. Traditional assumptions about gender roles and responsibilities affect basic health and education, and are reflected in high maternal mortality rates, malnutrition, high rates of abortion, and increased prevalence of HIV/AIDS. Illiteracy is still higher for women although the gap has closed significantly as school enrollment rates become more balanced. Enrollment rates in secondary schools for girls and boys are closely related to poverty and location. At the end of the 1990s, girls' enrollment decreased significantly in junior secondary school in poor areas of Jakarta, but increased more than that of boys in several rural areas. Female nonagricultural employment rates have increased significantly, but because many urban girls have dropped out of school and urban housewives have joined the labor force for the first time. These women are concentrated in low-skill, low-paying jobs. Rural women are most affected by unemployment. Women have also not fared well in participating at higher levels of economic and political decision making, especially at the local level where community decisions are generally the right and responsibility of men.

2. Needs and Challenges

136. Decentralization will affect the achievement of gender equity. The formulation and revision of regulations by regional governments represent a juncture where the perspective of gender equity can be discussed and integrated into laws and regulations. The local-level perspective provides opportunities for including participation of key stakeholders to ensure that the development of new rules and regulations reflect local attitudes and needs. The transfer of policy formulation for regional development to local government means that regional legislative parliaments now play a decisive role in addressing and reflecting gender equity concerns in policies and programs at the local level.

137. Enhancing the participation of women in politics and policymaking is key to achieving gender equity. Affirmative action requires additional institutional, administrative, and social changes. National and local government and legislative agencies and political parties must enhance the capacity of women to join political parties and participate in politics.

3. Government Policies

138. The Government's objective, through the State Ministry for Women's Empowerment (SMWE), is to attain gender equity and equality, and protect children. Gender policies will (i) improve the quality of life of women, (ii) intensify information dissemination of gender equity and equality, (iii) eliminate violence against women, (iv) improve the welfare and protection of children, and (v) strengthen the independence of institutions and organizations working for women's empowerment and children's welfare.

139. The objectives will be achieved by implementing the following strategies: (i) mainstream gender concerns in all development processes and stages to ensure that planning, implementation, monitoring, and evaluation of all development policies, programs, projects, and activities at the national and local levels incorporate gender dimensions; (ii) conduct activities targeted at women through direct interventions of women's groups; and (iii) improve the capacity and capability of institutions and organizations, including women's organizations.

140. At the end of 2000, the Government issued Presidential Instruction 9 to define procedures to ensure gender mainstreaming in government policies and program:

(i) mainstreaming gender by all central and regional government institutions in all policies and program planning, implementation, monitoring, and evaluation;
(ii) establishing institutions and other mechanisms to support gender mainstreaming;
(iii) conducting a gender analysis of all policies, programs, projects, laws, and budget allocations;
(iv) collecting and making available gender-disaggregated data for each sector; and
(v) evaluating and reporting annually on progress made in achieving gender equality and equity.

4. ADB Experience

141. In 1993, ADB supported the strengthening of the gender mainstreaming capacity of MWE through TA to monitor and evaluate the Government's plan to mainstream women's concern into all sectoral policies, plans, and programs. Another TA was provided in 1996 to review and compile a knowledge base on the sociolegal status of women. Finally, TA was approved in 2002 to (i) continue the earlier work on developing sustainable community-based approaches to strengthen mainstreaming of gender equity concerns, (ii) assess and strengthen the institutional capacity for gender equity at the district level, and (iii) identify and implement strategic pilot projects on community-based approaches to mainstreaming gender equity concerns.

5. Gender and Development Strategy

142. The three-pronged strategy for gender and development (GAD) in the context of regional autonomy includes (i) strengthening mainstreaming of gender equity and poverty reduction into policies and programs, (ii) supporting institutional strengthening and capacity building of regional governments, and (iii) strengthening civil-society organizations to increase community participation in gender issues.

143. ADB's strategy for supporting mainstreaming of gender equity will be based on the following:

(i) Focus on mainstreaming gender equity in ADB policies, programs, and projects where gender issues are particularly relevant. This includes involving women in planning and implementing project and programs at the decision-making level and setting targets for women's participation and/or access to project/program benefits.
(ii) Coordinate with MWE to ensure development of a database on the integration of gender into sectoral policies and programs, and to promote gender best-practice case studies among projects implemented by funding agencies, including ADB.
(iii) Include MWE in the steering committees of projects and programs that have potential GAD impact.
(iv) Include indicators measuring women's involvement in project planning and implementation, and indicators measuring the impact of projects on women.
(v) Build the capacity of local government institutions in gender-sensitive policy and program formulation and implementation.

(vi) Facilitate a process for gender-sensitive formulation, investigation, and testing of proposed regulations by sectoral offices and legislators for gender-sensitive assessment of proposed regulations.
(vii) Promote participatory and community-based approaches to strengthen local institutions through pilot projects.
(viii) Support research and studies by universities and other research centers on gender issues, emphasizing local characteristics.
(ix) Enhance the ability of NGOs and Civil Society Organizations (CSOs) to provide inputs regarding specific gender issues to legislative bodies.
(x) Encourage and test community-based approaches to strengthening GAD in government policy formulation
(xi) Implement pilot projects testing new and diverse GAD initiatives.

6. Performance Monitoring

144. To monitor achievement of long-term goals, progress will be measured against benchmarks of gender-specific human development indicators in 2002 and those projected for 2010; and similarly for maternal mortality and school enrollment indicators and participation rates of women in national and regional public institutions, particularly at decision-making levels. Medium-term objectives will be monitored in the following areas:

(i) Reporting in Country Strategy and Program Updates (CSPU) on the mainstreaming of ADB projects on the basis of project-level data, where indicators will include but not be limited to the (a) level of participation of women in project activities; (b) women's access to project benefits, and structural and practical gender needs addressed by the project; and (c) impact of the project on women;
(ii) Establishment of a database on best practices in terms of mainstreaming gender equity in policy and programs;
(iii) Number of revised laws and regulations affecting gender equity;
(iv) Number of local policies and projects addressing gender equity concerns;
(v) Number and type of gender-focused NGOs directly or indirectly established as a result of the concerted effort to establish institutions that address gender equity concerns through the project; and
(vi) Achievements in strengthening civil-society groups working on gender and women's issues, to be gauged by their performance, which they will be asked to report.

Gender and Development Road Map

Focus and Justification	Activity Areas Outputs	ADB Inputs	Other Donor Agencies
1. Strengthening mainstreaming of gender equity and poverty reduction into policies and programs			
i. Increased transparency, formalization and streamlining of governmental procedures ii. Improving coordination with the MWE through steering committee of projects that have a potential GAD impact iii. Enhancing sectoral participation of women in DINAS through specific allocations in program implementation and sectoral training programs	Improving processes for regulation formulation, and testing Strengthening mechanisms for civil-society monitoring and advocacy and private sector participation Research and studies on gender issues in sectoral economic development	Loan: 2002-Capacity Building for Decentralization Staff Study: 2003-Institutional Analysis for the Effective Integration of Gender Equity in Regional Development (Case Studies) TA: 2002-Support for Civil Society Monitoring of ADB projects TA: 2002-Gender Equity in Policy and Program Planning	Netherlands/UNDP project on Gender Mainstreaming. UNIFEM UNFPA AUSAID The Asia Foundation USAID JICA
2. Support institutional strengthening and capacity building of regional governments in mainstreaming gender issues in policies and programs i. Capacity building for executing agencies and legislators ii. Conduct of local-specific gender and poverty research iii. Development of a stakeholder consultation mechanism	Formalizing and streamlining of sectoral procedures Provision to women with specific allocations for their participation in program implementation and sectoral training programs Enhanced sectoral professionalism and expertise of women	Various ADB loans and TAs (see GAD Action Plan) but in particular: TA: 2002-Agriculture and Rural Development Strategy Loan: 2002/3-Rural Micro Finance I and II Loan: 2002/3-Community Empowerment for Rural Development II	Netherlands/UNDP project on Gender Mainstreaming. World Bank GTZ

Focus and Justification	Activity Areas Outputs	ADB Inputs	Other Donor Agencies
		Loan: 2004-Rural Poverty Reduction Loan 2004-Poor Fishermen Income Improvement Project JFPR: Sustainable Income Generation Activities for Landless Poor Fisher Folk	
3. Strengthen civil-society organizations involved in gender issues to increase community participation in policy and program planning and implementation	Involvement of women study centers and civil-society groups in the design and implementation of development projects/ programs to strengthen gender equity and gender-sensitive community-based projects/programs.	TA: 2004-GAD Initiatives TA: 2005-Community Based Approaches to Strengthening Gender Equity	Netherlands/UNDP project on Gender Mainstreaming. UNIFEM UNFPA AUSAID The Asia Foundation USAID
i. Involving women study centers and civil-society groups, including NGOS, CSO, and CBOs in gender planning and implementation ii. Promoting participatory and community based consultation approaches	Based on a documentation of good practices, strengthening of consultation processes that highlight public participation in the implementation of government projects and programs for gender		

K. Governance and Decentralization

1. Overview

145. Indonesia is going through a complex and wide-ranging transition to democracy and a more stable economic environment. The continuing transition affects the political system, business community, civil society, and, in particular, governance. Governance institutions formerly operated where the state managed essential parts of the corporate sector, good governance was neglected, the rule of law was absent, and corruption ruled over common interests. These institutions should now operate to secure democracy, support the market economy, and provide good governance.

146. Decentralization dominates institutional development while poor governance and widespread corruption remain the main barriers to progress. Budgetary capacity to develop and support a well-performing administration is obviously limited in the short and medium term, which requires firm yet selective government action.

147. The primary challenges to enhancing good governance are (i) high levels of corruption affecting private sector development and government performance, (ii) lack of accountability and transparency in the public sector, (iii) weak links between policy planning and resource allocation, (iv) problems in revenue generation and collection, (v) incomplete and/or contradictory legal bases, (vi) deficiencies in law enforcement and policy implementation, (vii) poorly managed decentralization of service delivery and financing with limited mechanisms for local accountability, and (viii) inadequate civil-society participation.

2. Governance Needs and Challenges

148. The decentralization of functions and resources under Law 22/1999 on Regional Government and Law 25/1999 on Fiscal Balance is intended to make governments responsive and regional executives accountable, and thus deliver high-quality services efficiently. Although Indonesia should be praised for its rapid decentralization, reform takes place in a context of poor governance, lack of capacity, and pervasive corruption, raising concern for the outcome of decentralization.

149. Almost all government implementation responsibilities have been decentralized to the regions, especially the district (regency and city) level. At the beginning of 2001, some 2.3 million civil servants were successfully transferred from the central Government to the regions, together with associated sectoral assets, to provide regions the capacity to carry out their new functions.

150. While implementation and, thus, expenditure responsibilities have been given to regional governments, the central Government still collects revenue, of which a minimum 25% is transferred back to the regions through a block grant—the general allocation grant, which is not primarily designed to equalize regional wealth disparities. Public services in poor regions are put at risk. While regional governments have shares of revenues from the commercial exploitation of natural resources and can be provided earmarked grants through a grant for specific purposes, the Special Allocation Funds (DAK) have not reduced regional inequalities.

151. Much attention is focused on combating fraud and corruption. The Government has declared its determination to eradicate corruption, collusion, and nepotism. Corruption hampers economic recovery, obstructs the rule of law, and hinders development projects. A shift to

democracy and a market economy will require eradication of corrupt practices and prevailing attitudes to them.

152. The dual budget system, with routine and development budgets, does not provide for efficient public expenditure management. Public institutions are dependent on off-budget funds. Accounting standards are not enforced and financial reporting is inadequate. The public audit function needs restructuring and the external audit function needs strengthening. The public procurement regime needs reform.

153. Capacity building is a concern. In spite of large transfers of staff, it is uncertain whether local governments have the capacity to absorb the new expenditure responsibilities and deliver the full range of services efficiently and effectively. Building capacity in key crosscutting functions such as accounting and financial management, control and audit, procurement and contract management, data processing and archiving, as well as in personnel management are urgent needs.

3. Government Policy

154. The Government has taken a number of legal steps to combat corruption. The Clean Government Law (28/1999) requires public officials to declare their assets before assuming their posts and to agree to have their assets officially audited during and after their terms. The Law on Eradication of Criminal Acts of Corruption (31/1999) defines corrupt practices of a criminal nature, and provides the basis for establishing charges and for prosecution. The law also provides for an independent anticorruption commission. A draft law aiming to establish this commission is being reviewed by Parliament. An anti-money-laundering law was passed in March 2002.

155. New laws on public finance are being drafted, covering budgeting, accounting, and public audit. These new laws will be crucial for much-needed improved public expenditure management and strengthened audit. The Government, with external assistance, is drafting a new law on procurement.

4. ADB Governance Experience

156. ADB has strongly supported governance reforms, especially during and after the crisis. An interim strategy, adopted to guide ADB's operations during 1998-2000 in response to the deepening crisis, had good governance as a key theme. The interim strategy emphasized policy and institutional reforms in key economic sectors, support for implementation of the decentralization agenda, and strengthened measures for poverty reduction and social protection. ADB's 2001 Country Operational Strategy (COS) recognizes good governance as the main anchor for ADB assistance, focusing on decentralization, anticorruption, and corporate governance. ADB has provided TA for fiscal decentralization, focusing on budgetary reform and training and on anticorruption, especially for the Attorney General's Office and the Anticorruption Commission. Capacity building for decentralization is still an important ADB contribution.

5. Activities of Other Funding Agencies

157. Decentralization and anticorruption activities are among the focus areas of the Partnership for Governance Reform in Indonesia.[11] The partnership has defined its priorities and is building coalitions with relevant government and civil-society partners. Many bilateral and all multilateral funding agencies are involved in decentralizing implementation responsibilities and the fiscal framework. Decentralization has thus long been a focus of activity for most international funding agencies, particularly AusAID, GTZ, UNDP, USAID, and World Bank. Most international development partners have also focused on anticorruption, particularly the Netherlands, UNDP, USAID, and the World Bank. Because of good coordination, funding agencies complement rather than overlap with each other although active in the same reform areas.

6. ADB Governance Strategy

158. Within the CSP framework, ADB will continue to selectively support good governance initiatives for decentralization and anticorruption, especially fiscal decentralization, improved public expenditure management, strengthened audit, and reformed public procurement. Regional capacity building to meet new needs related to crosscutting management functions will continue to be a major area for ADB support.

159. ADB will continue to support the fight against corruption through (i) improved public expenditure management, particularly improved budgeting, accounting, and auditing; (ii) support to key anticorruption institutions, particularly the Attorney General's Office and Anticorruption Commission; and (iii) legal and judicial reform, particularly improved law making and issuing of regulations and procedures for administrative decision making. ADB will support initiatives for legal empowerment of the poor and initiatives to give civil society a role in monitoring government performance and fighting corruption.

7. Implementation Issues

160. The following are areas where efforts could be made to improve the impact of ADB's projects:

(i) Activities should not be limited to legislation. A focus on law enforcement, institution building, funding, and performance management is needed to achieve sustainable results.
(ii) Corruption cannot be fought through general anticorruption projects only. Improved administrative state functions, particularly those related to public finance, law making, and civil service management, are needed.
(iii) The media and NGOs should be recognized for their important contribution to fighting corruption by monitoring government performance and reporting on corrupt practices.

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[11] The Partnership for Governance Reform in Indonesia was formed with ADB, UNDP and the World Bank as founding members to coordinate the international community's support for improving governance across a wide range of sectors.

8. Performance Monitoring

161. Performance will be monitored on the basis of key actions that are critical in the medium terms such as actions necessary for efficient functioning of the Anti-corruption Commission and passage of important legislation such as the Administrative Procedures Act. ADB project performance will be closely monitored to prevent corruption. Progress in decentralization can be gauged by monitoring local capacity to mobilize resources and provision of basic services through budgetary data, and local public expenditure reviews, development efforts, and poverty reduction efforts through regional-level data.

Governance Reform Road Map

Focus and Justification	Targets/ Activity Areas	ADB Input	Other Funding Agencies
1. The Partnership for Governance Reform has the potential to become an institution with trust and credibility from all stakeholders.	The Partnership established on regional level	TA: 2001-02 Support to the Partnership TA: 2004 Support to the Partnership	UNDP, EU, WB, NL, UK, others
2. Decentralization. Capacity of most regional governments is weak and transferring responsibilities and funds to them may be risky in some cases.	Improved capacity	PPTA: 2002 Capacity Building for Decentralization Loan: 2002 As above	WB, UNDP, U.S, other bilateral Funding Agencies
The DAU is not yet in a shape that funds received correspond to needs based on expenditure obligations. Mechanism for channeling of donor funds to regions is not yet established.	Improved policies Improved budgeting and financial management/ Equalizing transfer mechanisms	TA: 2004 Policy Issues in Decentralization TA: 2002 Implementation of Fiscal Decentralization	WB, AUS, U.S.
Most regional governments have low revenues. Capacity to generate non-distorting revenues is underdeveloped.	Established on-lending mechanism Improved local revenue generation	PPTA: 2003 Local Government Financing Loan: 2003 As above	
Accounting responsibilities are scattered. The Institute for Accountants needs strengthening to become an accreditation institution in line with international standards.	Improved accounting in MoF Improved monitoring in MoF Improved public accounting	Loan: 2005 Local Development Finance Facility TA: 2002 Support for Country Financial Accountability TA: 2003 Improving Project Monitoring Capacity in MoF ESW/SS: 2005 Policy Dialogue for Improved Accounting	
Audit responsibilities are overlapping and external audit does not comply with international standards.	Improved public audit complying with decentralized government and international standards. Reformed inspector general function in MSRI	Loan: 2003 Support for Public Audit Reforms TA: 2002 Strengthened Capacity in MSRI to Combat Fraud and Corruption	
Public procurement is one major source of corruption. Decentralization moves procurement responsibilities to regional governments. The legal framework is not	Reformed public procurement regime, improved practices, and the National Office established	TA: 2001-02 Development of Procurement Policies, Institutional and Legal Frameworks	

Focus and Justification	Targets/ Activity Areas	ADB Input	Other Funding Agencies
sufficient and procedures are not efficient and coherent. A central capacity for coordination and monitoring is lacking.			
	New procurement regime disseminated and inculcated	SSTA: 2001-02 Public Relations to Support Government's A/C Efforts in PUPS	
Regional governments have implementation responsibility in most sectors and for most services.	Defined indicators for good governance	ESW/SS: 2002 Good Local Governance	
	Improved performance	TA: 2004 Indicators for Local Government Performance	
	Strengthened regional development	PPTA: 2004 Regional Development Authority	
	Improved efficiency in service delivery	Loan: 2005 Commercialization of Public Sector Obligations	
Decentralization carries a risk of distortion of national policies aiming to change traditional and archaic values.	Safeguarded gender equity	TA: 2004 Gender Issues in Public policy and Administration	
Many poor are excluded from public services in bigger cities to a larger extent than elsewhere.	Improved urban management	PPTA: 2004 Management and Development of Metropolitan cities to Benefit the Urban Poor	
3. Anticorruption Anticorruption activities need to target institutions and functions key to the fight against corruption.	Improved performance of the Public Prosecution Service (AGO)	TA: 2002 Support to the AGO	
	Effective Anticorruption Commission	TA: 2003 Capacity Building for the Anti-Corruption Commission	UNDP, GER, AUS, UK, other bilateral Funding Agencies
Anticorruption progress requires activities that aim for improvements in the administrative processes of the country.	Improved policies	TA: 2004 Support for Anti-Corruption Activities	
Overregulation and low quality regulations nurture corruption, burden citizens, distort the market and creates a high-cost society. Non-transparent administrative decision making prevents the rule of law and weakens access to public services for the poor.	Improved regulatory management and strengthened rule of law	TA: 2005 Law-drafting; Impact Assessment and General Adm. Procedures	
	Empowered poor	TA: 2005 Legal Empowerment of the Poor	WB
4. Corporate Governance SOE revenues subsidize operations of certain public institutions outside the state budget. This is one reason for the slow privatization and it encourages corruption.	Restructured and efficient enterprises Privatization goals met	PPTA 2003 SOE Governance and Privatization Program II Loan: 2004 As above	

L. Private Sector Strategy

1. Overview

162. The rapid growth of Indonesia in the decades before the crisis led to fundamental changes in the standard of living and economic structure. Deregulation, reform, and a shift to market-based resource allocation, especially in the 1980s, were important elements of this success. Structural reforms and privatization of SOEs enhanced the private sector's role. However, the pace of reforms slackened even as growth continued. Critically needed reforms in the financial sector, legal and judicial system, and corporate governance were not made. These weaknesses were highlighted during the crisis, which reinforced the conclusion that without reforms to strengthen the private sector, growth would be insignificant and vulnerability to shocks would remain.

163. The crisis burdened the corporate and financial sectors with unsustainable foreign currency debts, resulting in major parts of the corporate and banking sectors becoming insolvent. The Government has been extensively involved in bank restructuring and recapitalization programs; most of the banking sector has been nationalized with government ownership and control. The corporate sector also struggles under debt burdens from the crisis. Structural problems, including overly concentrated industries and lack of bankruptcy mechanisms, impede restructuring and change. Corporate ownership is highly concentrated, with the top 10 families holding more than 60% of corporate assets. While formal bankruptcy institutions exist, they do not function properly, providing little incentive to restructure indebted family firms.

2. Sectoral Needs and Challenges

164. Greater political stability now provides a basis for the Government to progressively address the wide-ranging constraints and structural impediments to private sector development. The challenges are substantial. The Government owns much of the banking system following extensive bank recapitalization, and through SOEs has extensive ownership and control in the industrial and services sectors. Private sector ownership has also been highly concentrated, particularly in the corporate sector, which still faces an extensive unresolved debt problem. This reduces competition, discourages investment, and encourages corruption. With access to subsidized financing from the Government, SOEs continue as a source of inefficiency in the economy and a drain on public finances.

165. The planned privatization of these assets will allow the private sector to significantly broaden its economic role. While the Government supports the progressive sale of these assets, implementation will be challenging in the face of divided political and public support for privatization, and the continuing uncertain investment climate.

166. The banking system has been extensively recapitalized at substantial cost to the Government. However, banks are only cautiously returning to lending operations and providing credit to support private sector growth. This reflects the limited balance sheet capacity of recapitalized banks to rapidly switch their holding of recapitalization bonds into loan assets, the limited experience of many banks in lending to SMEs following a previous focus on corporate lending, and the limited range of creditworthy lending opportunities when a large portion of nonperforming corporate loans remain unresolved. Foreign banks will help the bank privatization program by bringing in new capital and skills and supporting improved credit appraisal techniques and use of credit bureau information. A long-term, critical requirement for

renewed bank lending—and business activity generally—remains the establishment of the court system as a means of addressing and resolving commercial disputes in accordance with the rule of law.

167. Despite the return to political stability, the business environment remains unattractive to private sector investment, particularly by foreign investors. The Government plans to introduce an investment law in 2002 that provides greater assurance to investors. However, it may not directly offset regional investment uncertainties arising from decentralization, and concerns in competition policy, weak corporate governance, and weak administration of justice. Overcoming these concerns will require consistent improvements across a range of areas to establish a business environment that is attractive to investment.

3. Government Policy

168. Wide-ranging policies address many constraints on private sector development to enable Indonesia to become a modern market economy. However, often lacking are consistent and effective implementation of policies and reforms that must address major problems and reverse longstanding practices inimical to effective economic growth.

169. The Government has an SOE and bank privatization program that offers the potential for the state to withdraw from its overextended ownership role and allows the private sector to become a greater driving force for growth. Accelerating resolution of the corporate debt overhang remains a key challenge despite extensive efforts through Indonesia Bank Restructuring Agency (IBRA) and other initiatives. The Government has also taken measures to fight corruption in public administration, develop the rule of law through the court system, encourage transparent transactions through more competition and better corporate governance, and create a business environment based on rules rather than crony capitalism. Obstacles to SME development are being removed, including through the recent adoption of the SME medium-term action plan. An investment policy statement was released in 2001, and an investment law is planned in 2002. As part of the effort to develop a more effective and resilient financial sector, the Government plans an integrated financial sector regulator, with relevant legislation to be submitted to House of Representatives (DPR) in 2002. The direction of policies and reforms is broadly appropriate. However, the magnitude of the problems being addressed is substantial, and consistent implementation of policies and related strengthening of institutional capacities are needed.

4. ADB Sector Experience

170. ADB has provided extensive assistance to reform the policy environment for private sector development. Over the past 5 years, this has included support for financial and corporate governance reform, industrial and SME policy, and SOE reform and privatization. Before the crisis, ADB provided direct support to private enterprises through the ADB private sector window, as well as credit lines through the Government.

5. Activities of Other Funding Agencies

171. Most other lenders and agencies support policy reforms and capacity building in at least some areas that impact on developing an enabling environment for private sector development. In recent years, only JBIC and KfW have provided significant loans to the Government for relending to private sector enterprises. Direct loans and investments to private sector

enterprises without government guarantee have been largely limited to IFC and German Investment and Development Company (DEG).

6. ADB Strategy

172. ADB's strategy for supporting private sector development addresses, first, the creation of enabling business conditions, focusing on support for SOE reform and privatization, further strengthening of financial governance, development of a more diversified and resilient financial sector, and improvements in competition policy. Second, the strategy recognizes that while many essential policy reforms have been initiated, their implementation will be protracted and the expected outcomes in many cases will take time to be realized. Accordingly, recovery of private investment in the near term will be modest, particularly in major infrastructure development that is necessary for sustained growth. ADB's public sector lending operations in these areas will, therefore, seek to develop public-private partnerships and generate business opportunities for private sector participation. Finally, through ADB's private sector window, selective support will catalyze private investments in projects with a strong demonstration effect.

7. Performance Monitoring

173. Performance will be gauged through legislative and administrative policy actions. Passage of the investment law is targeted in 2002. Privatization of SOEs and sale of majority stakes in state-owned and recapitalized and/or nationalized banks will be monitored against targets. Other benchmarks include growth of investment approvals for domestic and foreign investors; demutualization of the Jakarta Stock Exchange (targeted for 2003); recovery in foreign investor investment in the Jakarta Stock Exchange from 20% of total investments in January 2002; and growth in net funds raised by the stock market.

Private Sector Development

Constraints on private sector development are (i) crowding out of the private sector given the dominant ownership role of the Government in the banking and corporate sectors and the challenges of privatization; (ii) the need for improved competition and reduction of monopoly and cartel powers; (iii) the need for improved investment climate with greater confidence in the rule of law, particularly given the uncertainties of decentralization; (iv) poor standards of corporate governance; and (v) limited capacity of the financial sector to meet the increasing needs for diversified financial services to support private sector growth.

Sector Outputs	Cost ($million)	Schedule	Financing Source		
			Gov't	ADB	Other
Policy Reform and Capacity Building Programs and Projects					
• Implementation of State-Owned Enterprise and Privatization Program	400	2002-04		Loan	
• Implementation of Privatization and Restructuring of State-Owned Enterprises	2.47	2002-04		TA	
• Implementation of Commercialization of Public Sector Obligations	1.0	2002-04		TA	
• Implementation of Financial Services Authority	1.5	2002-2004		TA	
• Financial Governance and Social Security Reform Program	150	2002		TA	
• Financial Governance and Social Security Reform 2 Program	150	2003		Loan	
• Provincial SME Development	80	2004		Loan	
• SOE Governance and Privatization Program 2	100	2004		Loan	
• Industrial Competitiveness	0.8	2005		PPTA	
• Commercialization of public sector obligations		2005		Loan	
Projects supporting Public-Private Partnerships (PSP)					
• PSP in Urban Infrastructure	10	2003		TA Loan	
• Gas Trunkline Development	1.0	2003		ADTA	
• Road Rehabilitation Sector	150	2003		Loan	
• Local Grids development	100	2004		Loan	
• Interisland Transport	150	2004		Loan	
• Power Sector Development	150	2005		Loan	