

Assessment and recommendations

- *Recent macroeconomic developments and short-term prospects*
- *Monetary and financial policies*
- *The fiscal position is strong, but the government budget is small*
- *Raising government revenues*
- *Improving living standards by sustaining long-term inclusive growth*
- *Reducing poverty and inequality*
- *Ensuring the regulatory framework and civil service perform better*
- *Making the most of natural resources while preserving the environment*

Indonesia has enjoyed strong and stable growth in the decade and a half since the Asian Crisis (Table 1). This performance was in no small measure due to policy reforms put in place over this period, notably a robust macroeconomic framework. Much of the growth was domestically driven, with household consumption in particular providing a steady and solid base. Labour market conditions improved, and this, in combination with increasingly effective poverty-alleviation programmes, helped to bolster household incomes and confidence. The external sector also played an important role, especially through global demand for commodity exports. The pace of reform has eased, and this may in part account for the recent slowing in output growth.

Strong per capita gains and increasingly efficient and well-targeted government measures have been instrumental in reducing poverty. However, income inequality as measured by the Gini coefficient has risen over the past decade. Annual per capita income is around USD 9 300 in purchasing power parity terms, and a significant share of the workforce is still engaged in low-productivity agriculture. Indonesia is thus still well within the catch-up phase of economic development. Ensuring continued strong and inclusive growth will require sustained increases in spending on education, health, poverty alleviation and infrastructure. This, in turn, will require revenue increases, as well as reprioritising spending. The recent decision to cut fuel subsidies was a laudable step in this direction. Indonesia's abundant natural resources also need to be harnessed to support development, by raising investment and improving the regulatory environment. Environmental outcomes remain poor due to the central role played by fossil fuels, as well as weak enforcement of existing laws and regulations, especially in forestry.

The key messages of this *Economic Survey* are:

- Growth has been strong in the decade and a half since the Asian Crisis but has slowed in recent years, reflecting weaker international demand, the fall in commodity prices and low investment growth, due in large part to heightened regulatory uncertainty and infrastructure bottlenecks.
- The pace of reform needs to accelerate as the backlog of necessary structural reforms and public investments has accumulated. But some of the directions policymakers have headed are worrisome, with protectionist tendencies sometimes coming to the fore.
- Healthy per capita growth and expanding social security programmes have helped to reduce poverty significantly. However, income inequality has risen, and the social safety net needs to be further developed.
- Indonesia's abundant natural resources can be better harnessed by raising productivity in agriculture, increasing efficiency in coal-fired power plants, and progressively shifting to renewable energy, especially geothermal.

Recent macroeconomic developments and short-term prospects

Since 2012, the Indonesian economy has encountered a good deal of turbulence. In 2013, GDP growth fell below 6% for the first time since the financial crisis, and growth

Table 1. Selected indicators for Indonesia

	1995	2000	2005	2011	2012	2013	2014 ¹
Population							
Total, million	205.9	208.9	224.5	243.8	246.9	249.9	252.8
Age distribution							
0-14	33.6	30.7	30.0	29.6	29.3	28.9	28.5
15-65	62.2	64.7	65.1	65.3	65.6	65.9	66.2
65+	4.2	4.7	4.9	5.1	5.1	5.2	5.3
Absolute poverty rate (per cent) ²		19.1	16.0	12.4	11.7	11.5	11.0
Gini coefficient		0.30	0.36	0.41	0.41	0.41	
Net enrolment ratio (secondary education, per cent)				67.5	70.7		
Employment and inflation							
Employment (million)	80.1	89.8	95.4	107.4	112.5	112.8	114.6
Informal employment, per cent of employment			70.5	63.9	61.4	60.1	59.6
Unemployment rate (per cent)	7.2	6.1	10.5	7.5	6.1	6.2	5.9
Inflation (CPI, end of year, per cent)	9.0	9.3	17.1	3.8	4.3	7.7	8.4
Supply and demand							
GDP (in current trillion rupiah)	546.4	1 520.7	3 035.6	7 831.7	8 615.7	9 524.7	10 542.7
GDP (in current USD billion)	243.6	182.4	313.2	894.3	921.4	916.8	888.8
GDP growth rate (real, in per cent)	8.2	4.9	5.7	6.2	6.0	5.6	5.0
GDP growth rate (real, in per capita terms, per cent)	6.1	5.1	4.2	4.8	4.7	4.3	3.8
Demand (growth in per cent)							
Private consumption	12.6	1.6	4.0	5.1	5.5	5.4	5.3
Public consumption	1.3	6.5	6.6	5.5	4.5	6.9	2.0
Gross fixed investment	10.3	10.8	9.5	7.9	12.2	3.9	6.3
Exports	14.0	16.7	10.9	8.9	9.1	5.3	4.1
Imports	7.7	26.5	16.6	14.8	1.6	4.2	1.0
Supply (in per cent of nominal GDP)							
Agriculture		14.3	13.1	14.7	14.5	14.4	14.3
Mining		11.0	11.1	11.8	11.8	11.3	10.5
Manufacturing		25.4	27.4	24.3	24.0	23.7	23.7
Services ³		49.4	48.3	49.1	49.7	50.6	51.5
Public finances (central government, in per cent of GDP)							
Revenue	13.1	13.5	16.3	15.5	15.5	15.1	15.5
Expenditure	12.0	14.6	16.8	16.5	17.3	17.3	17.8
Nominal balance (central government)	1.1	-1.1	-0.5	-1.1	-1.8	-2.2	-2.3
Gross debt (general government)		81.1	43.3	23.1	23.0	24.9	24.4
Balance of payments (in per cent of GDP)							
Trade balance (goods)	2.7	13.7	5.6	3.8	0.9	0.6	0.8
Current account balance	-2.6	4.9	0.1	0.2	-2.8	-3.2	-3.0
In USD billion	-6.4	8.0	0.3	1.7	-24.4	-29.1	-26.2
International reserves (gross, USD billion)			34.7	110.1	112.8	99.4	111.9
Outstanding external debt		77.7	41.7	25.2	27.4	29.0	32.9

1. Estimates.

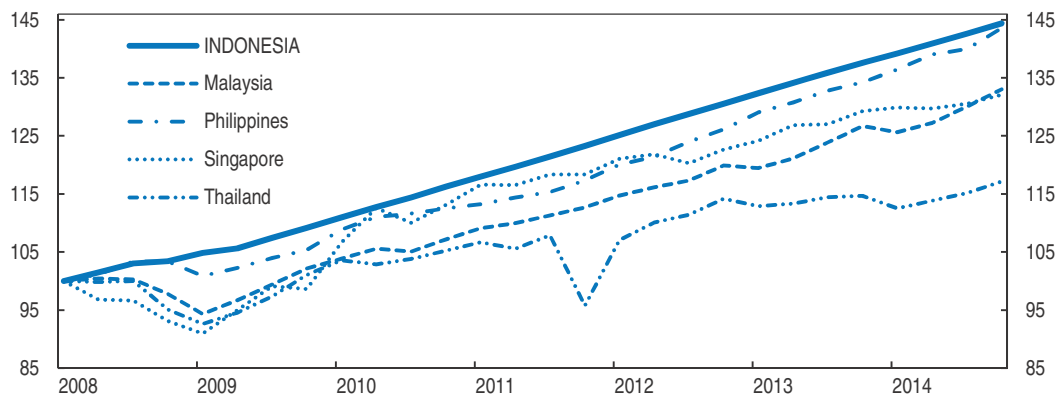
2. Per cent of people below the national poverty line, where the latter is the value of per capita expenditure per month needed for a person to enjoy decent living conditions.

3. Includes electricity, gas, water and construction.


Source: Statistics Indonesia, Government financial statement (audited), World Bank, and OECD calculations.

continued to soften through 2014. Despite the slowdown, Indonesia's economic growth has outperformed its ASEAN peers (Figure 1). This performance can be attributed to both a robust consumer base and to sound macroeconomic policies, such as inflation targeting and fiscal prudence. Until mid-2014, consumption had been supported by firming

Figure 1. **Level of real GDP in selected ASEAN countries**
2008 Q1 = 100

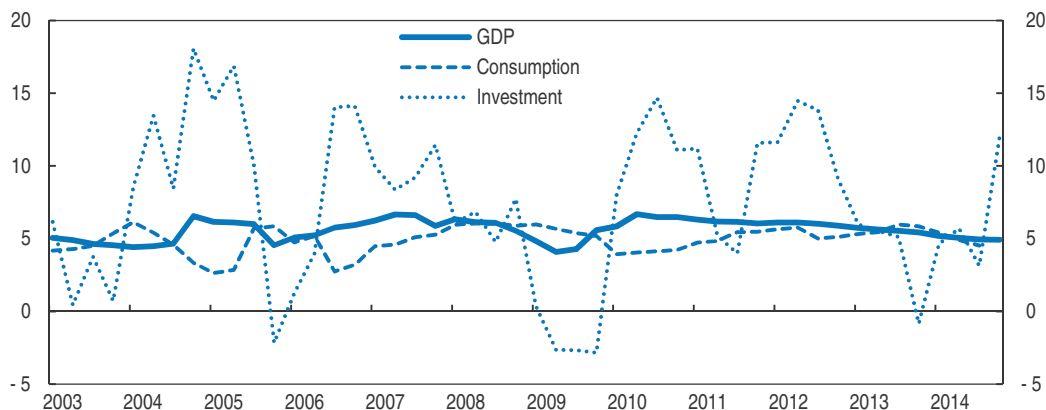


Source: National statistics offices.


StatLink  <http://dx.doi.org/10.1787/888933199951>

confidence, cash transfers to poor families, strong wage gains and improving labour market outcomes. Despite a surge in exports in late 2013, as exports of mineral ores were bought forward before the enforcement of the export ban, the contribution of external demand to growth has been disappointing, exacerbating current account worries starting in mid-2011 and again in the mid-2014. Investment also weakened in 2013-14, led by slowing investment in machinery and transportation equipment (Figure 2). This deceleration in investment should be a concern, not only because of its effect on productivity but also its growing share in GDP: one quarter in 2013, up from one fifth in 2000.

Figure 2. **Indonesian real GDP, consumption and investment growth**
Year-on-year percentage changes



Source: OECD Quarterly National Accounts Database.

StatLink  <http://dx.doi.org/10.1787/888933199961>

The economy grew at 5% in 2014 and is projected to accelerate somewhat in 2015 and 2016, as exports accelerate, thanks to the lower exchange rate, and a pickup in government investment (Table 2). A rapidly expanding middle class, combined with improving confidence, will help to sustain consumption and lift private investment. While the depreciated currency will help to curb imports, robust domestic demand will offset this to

Table 2. **OECD economic projections for Indonesia**

	2012	2013	2014	2015	2016
Real GDP growth	6.0	5.6	5.0	5.3	5.9
Inflation rate (CPI)	4.3	6.4	6.4	4.8	4.0
Short-term interest rate	5.9	6.3	8.8	7.0	6.6
Fiscal balance (% of GDP)	-1.9	-2.2	-2.4	-2.0	-1.8
Current account balance (% of GDP)	-2.8	-3.2	-3.0	-2.8	-2.5

Note: Real GDP growth and inflation are defined as percentage changes from the previous period.

Source: OECD staff estimates.

some extent, with the current account deficit persistently high. Even if core inflation remains low and the current account is stabilising, Bank Indonesia (BI) needs to remain cautious about official interest rates, especially in light of the continuing reliance on external sources of funding in the context of global financial uncertainty. The 2014 budget deficit remained elevated, in part due to lower revenues from the extraction sector, as commodity prices declined. The fiscal balance is expected to remain in moderate deficit, as is appropriate.

Risks to the outlook are tilted to the downside and mainly external. Trading partner demand, especially from China, may not recover as quickly as assumed, and commodity prices could weaken further. While financial markets have partly factored in imminent monetary policy normalisation in the United States, Indonesia is still vulnerable to an increase in international interest rates, as external funding requirements remain significant. Natural disasters are also an omnipresent risk to the resilience of growth. Indonesia is particularly prone to catastrophic natural disasters, such as earthquakes, tsunamis and volcanic eruptions. Between 2000 and 2014, close to 200 000 people died from natural disasters in Indonesia. This is a per capita death rate four times higher than both the Asian and world averages (CRED, 2015). Finally, the 2014 elections resulted in an unclear balance of political power, leaving the new President with the challenge of getting his ambitious reform agenda through a parliament in which his allies do not hold a majority. Related to this, the temptation remains strong to resort to misguided but politically popular protectionist actions whose long-run consequences are inimical to inclusive and sustainable development.

Monetary and financial policies

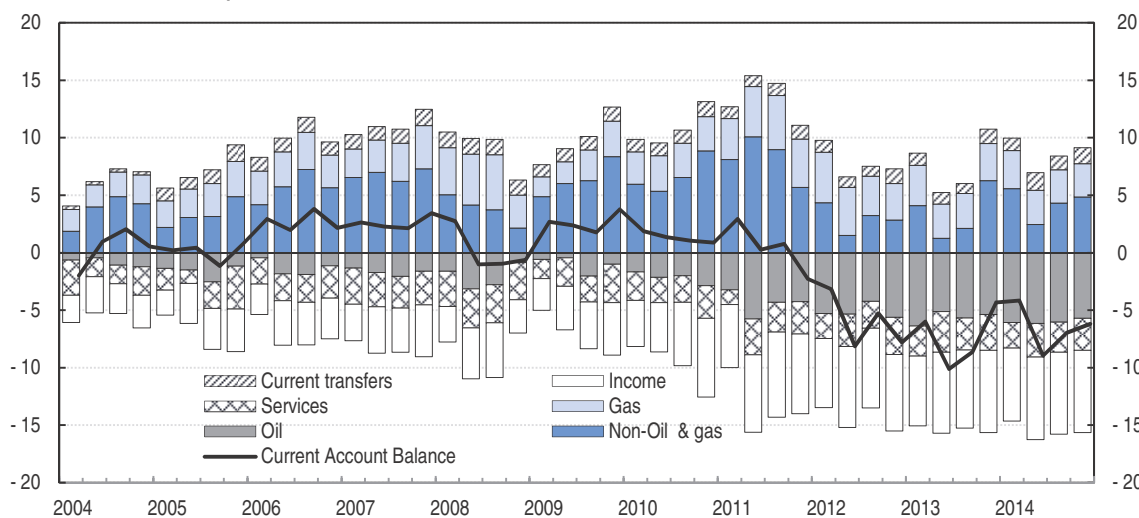
Monetary policy: Balancing internal and external constraints

The authorities' approach to managing external imbalances changed over the past three years. As the current account worsened starting in mid-2011 (Figure 3, Panel A), Bank Indonesia (BI) used its foreign currency reserves to intervene heavily in the foreign exchange market in order to cushion the fall in the rupiah (Panel B). In the second half of 2013, Indonesian shares, bonds and the domestic currency came under strong pressure after the Fed signalled that it would begin scaling back its bond-buying programme. This led to a change in policy as interest rates were raised, and BI started rebuilding its reserves. The current account deficit widened again in the second quarter of 2014 to 4.0% of GDP, and the rupiah has been adjusting downwards in an orderly manner, consistent with the IMF (2013) view that it was overvalued. This was assisted by strong portfolio capital inflows through 2014. The current deficit improved to below 3% of GDP at the end of 2014.

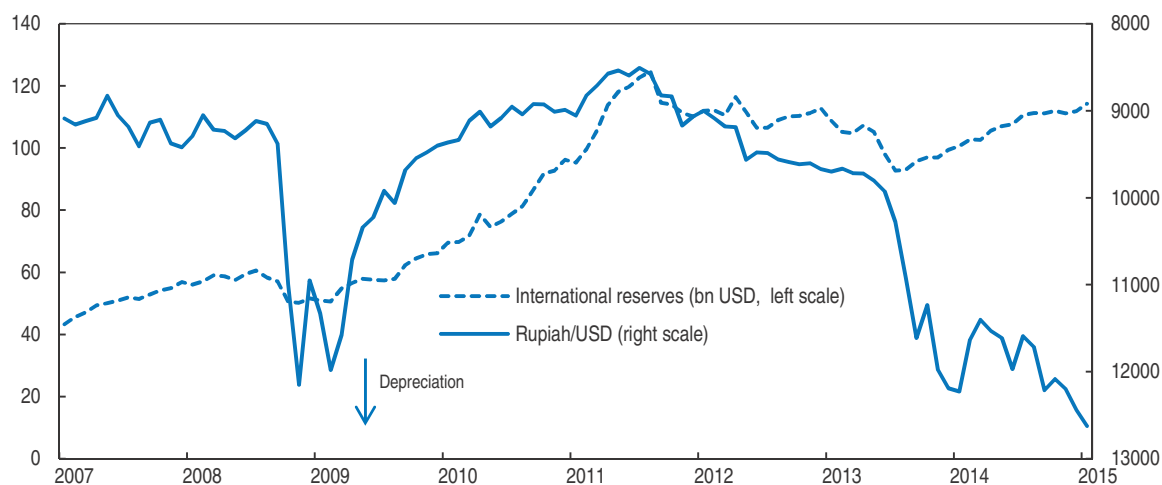
Current policy rates are appropriate, given residual tensions on financial markets, including the need to attract capital to fund the current account deficit, and moderating

Figure 3. **Current account and exchange rate developments**


A. Current account decomposition, bn USD



B. Exchange rate and BI reserves



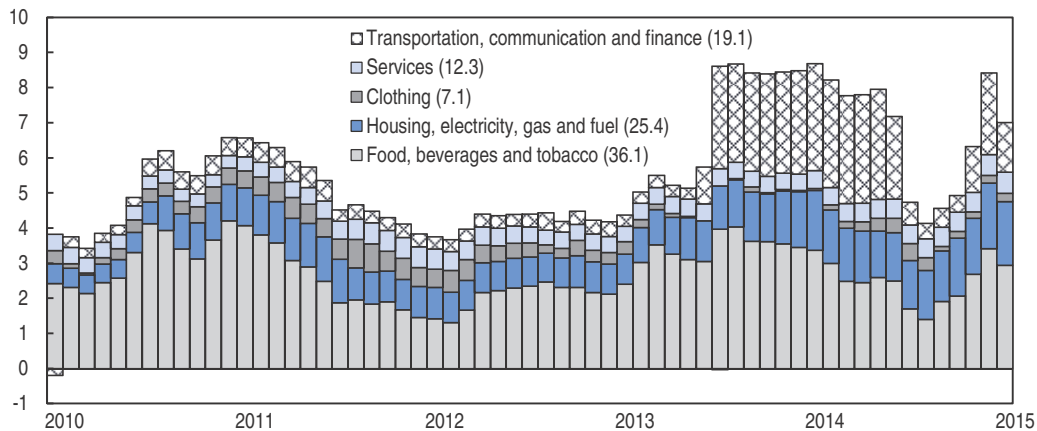
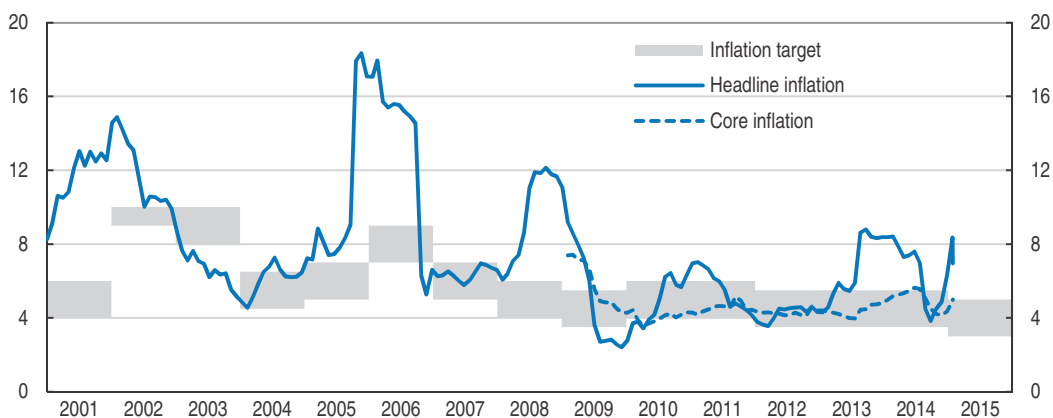
Source: Bloomberg and CEIC.

StatLink  <http://dx.doi.org/10.1787/888933199976>

underlying inflation (Figure 4, Panels A and B). The small quarter-point point increase in November 2014, which followed a cut in fuel subsidies, was consistent with the inflation-targeting framework and signalled the Bank's determination to anchor inflation expectations. And the quarter-point point decrease in February 2015 was in response to inflation declining more rapidly than expected, mainly because of falling global oil prices. Going forward, BI should remain cautious in changing its policy settings, taking into account both external and internal factors, especially in light of signs that any reacceleration in domestic growth will be more tepid than previously projected.

Broadening and deepening the financial system

The financial system is dominated by banks, which held 79% of financial-sector assets in 2013 (compared to 50% in Malaysia, for example), leaving little room for other financial

Figure 4. **CPI inflation, decomposition and target**A. **CPI decomposition¹, year-on-year growth**B. **CPI inflation, target, year-on-year growth**

1. CPI component weights in brackets.

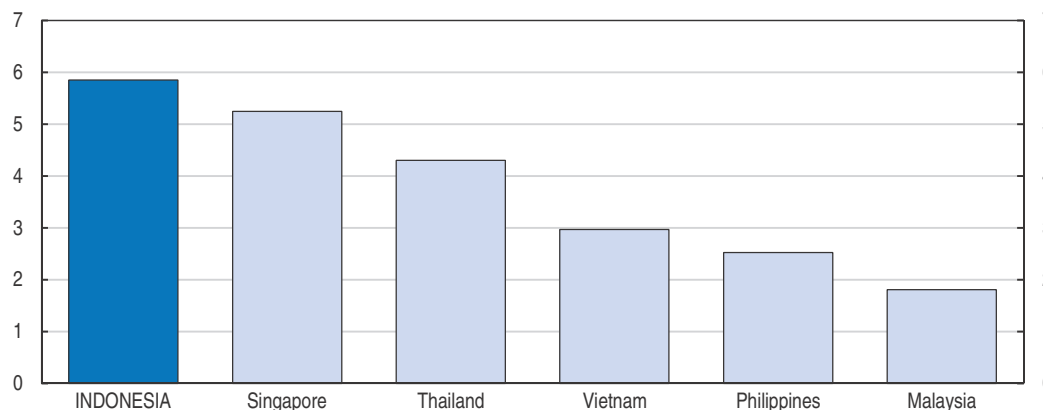
Source: CEIC and Bank Indonesia.

StatLink  <http://dx.doi.org/10.1787/888933199986>


institutions. Insurance companies on the other hand hold about 10% of financial-sector assets, and less than 3% are held by pension funds (IMF, 2013). Indonesia needs to accelerate the deepening and broadening of its financial system by encouraging formal domestic savings (which requires a low-inflation environment) and facilitating the mobilisation of funds from non-bank institutions to finance investment, especially in infrastructure. This would enhance financial stability and increase liquidity. Volatility in capital inflows has contributed to the periodic sharp swings in the rupiah, bond and stock prices. Despite being the largest economy in the Southeast-Asian region, Indonesia's forex transactions are less than 5% of neighboring Singapore. Authorities thus need to continue efforts to develop the foreign exchange market and decrease the risk premium on rupiah-denominated assets underlying the transactions, generalising hedging and options to reduce the dominance of spot transactions and progressively eliminating remaining restrictions on foreign-currency-denominated bank deposits.

Indonesian banks have higher margins between borrowing and lending interest rates than those from other ASEAN countries (Figure 5). This reflects their need to cover higher operating costs (between 2.5% and 4% of their assets, as against 2% in Malaysia and 1% in

Figure 5. **Banks' interest rate margins on lending to private customers**
Percentage points, 2012



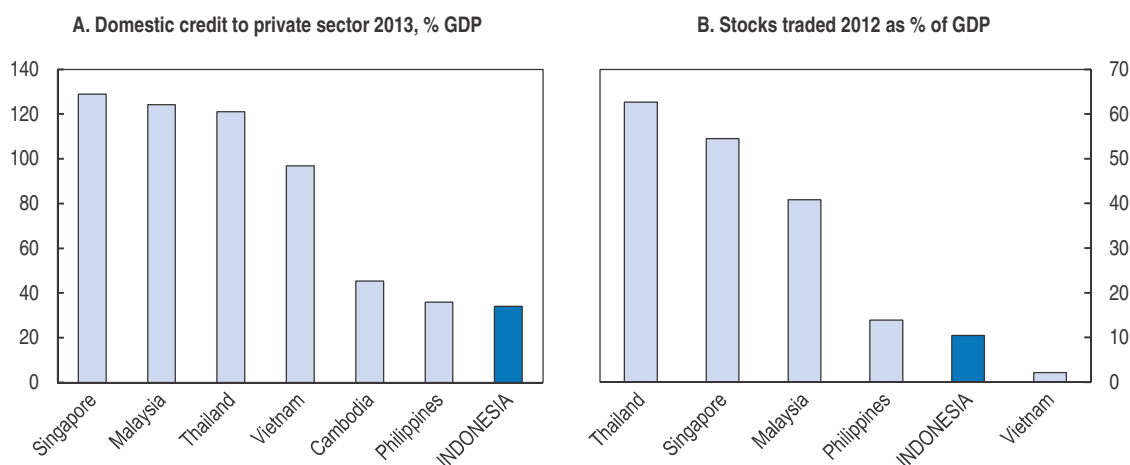
Source: World Bank, World Development Indicators.

StatLink  <http://dx.doi.org/10.1787/888933199997>


Singapore), due to Indonesia's unique geography and inefficiencies: they have some of the highest ratios of operating expenses to total assets among banks in the G20 (Bloomberg, 2013). However, Indonesian banks are also the most profitable among the G20 economies, with an average return on equity at 23%, ahead of China at 21% and more than double the United States at 9% (Bloomberg, 2013). The high returns in Indonesia are driven by net interest margins, which at an average of 7 percentage points, are the highest in the G20 (the average interest rate on loans is 12%, while the average rate paid to depositors is 5%). Recent steps taken by authorities towards encouraging more competition and transparency in order to bring down spreads were appropriate, but measures to cap foreign ownership in banking should be reconsidered.

Domestic credit as a percentage of GDP is significantly below that of neighbouring ASEAN peers, suggesting that there is much room for financial deepening (Figure 6). The financial system shrank in the aftermath of the 1997-98 crisis. Between 1997 and 2012, domestic credit to the private sector fell from 61% to 35% of GDP and the number of commercial banks from 239 to 122. But rapid economic growth since then, combined with a clearer and stronger supervisory regime, makes it appropriate to expand the banking sector once again and to further encourage a greater role by non-depository institutions in providing credit. Indonesian households are also lagging on a range of financial and credit-access indicators (Figure 7). Overall, 20% of adults have an account at a formal financial institution, compared to 35% in India, 56% in Brazil and 64% in China (Demirguc-Kunt and Klapper, 2013). Moreover, only 8% of the bottom two quintiles of Indonesian households hold an account at a formal financial institution. Governments in other emerging-market economies are moving forward with plans to improve this situation. For example, in August 2014, the Indian government introduced the Jan Dhan Yojana scheme, which aims at opening 75 million bank accounts by end-January 2015. Opening an account through the scheme will entitle a holder to an accidental insurance cover and, after six months of operations, to an overdraft facility. In Indonesia, a large proportion of poor households, micro-businesses and SMEs are excluded from formal banking and lending services, or use shadow banks, which charge much higher rates. The outstanding value of SME loans was worth just 0.7% of GDP in 2010, compared with 30.7% in Thailand and 17.4% in Malaysia. Finally, the high margins enjoyed by Indonesian banks may also be a sign that credit

Figure 6. Credit and stocks traded for selected ASEAN countries



Source: World Bank, World Development Indicators.

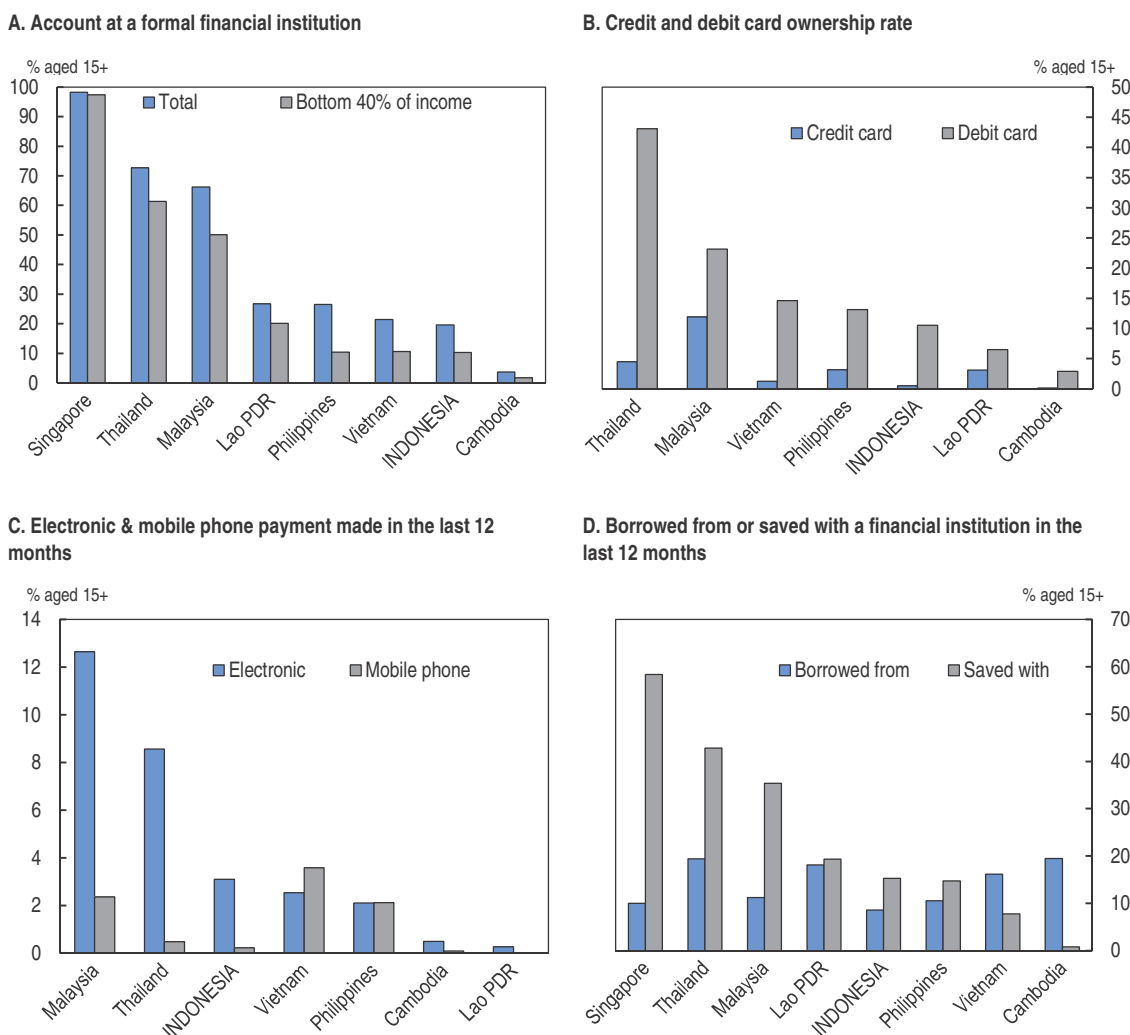
StatLink  <http://dx.doi.org/10.1787/888933200000>

growth is being constrained by the lack of deposits (Bloomberg, 2013). Improving financial inclusiveness may assist in this regard.


By eliminating the need for costly branch infrastructure, branchless banking could foster financial inclusion by making serving poor and isolated, unbanked households and businesses profitable (World Bank, 2014c). To enhance financial inclusion, more attention could be given to less costly methods of service provision such as mobile phone banking. This has been a success in countries like Kenya and the Philippines (World Bank, 2012b; and BBVA, 2015). Financial services could also be offered through local gas stations or shops, as in Mexico or Brazil. In Mexico, new regulations enabling the use of nonbank correspondents (also known as banking agents) make it possible for financial institutions to increase their reach at lower costs both for banks and potential customers. BI recently conducted a pilot in some provinces (Stapleton, 2013), and if it is judged successful, branchless banking should be extended. Branchless banking can also be used by the government for tax collection for unbanked segments of the population. Government ministries' early adoption of branchless banking would also accelerate social security payments in areas where the unbanked are concentrated.

Banking oversight was strengthened with the implementation of all three pillars of Basel II, and Basel III is to be implemented before 2018. In 2014, banking supervision was transferred from BI to the newly established Financial Services Authority (Otoritas Jasa Keuangan, OJK), which oversees capital market regulation, banks and non-bank financial institutions. The financial system has come a long way in improving its health and coherence, as evidenced by its ability to withstand the global financial crisis, in sharp contrast with the turmoil seen in 1997-98. However, non-bank corporations have again started to accumulate foreign currency denominated debt. To confront these risks, in October 2014 BI introduced rules for such borrowing that require a minimum hedging ratio in order to mitigate currency risk, a minimum foreign exchange liquidity ratio to allay liquidity risk and a minimum credit rating to lessen overleverage risk.

At 2% of GDP in 2014, the local currency bond market is very small, in contrast with Thailand at 19% and Malaysia at 42% (ADB, 2015). Indonesia's corporate bond landscape remains shallow, dominated by mining firms and state-owned utilities, which issued more

Figure 7. **Financial development indicators for selected ASEAN countries, 2011**

Source: World Bank, Global Findex (Global Financial Inclusion Database).

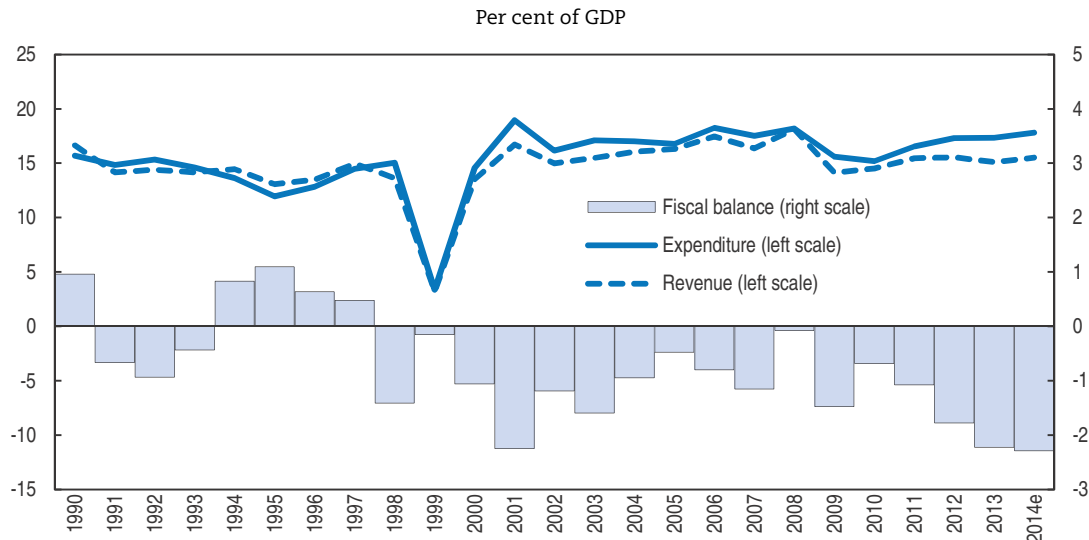
StatLink  <http://dx.doi.org/10.1787/888933200019>

than half of all such bonds in 2009-13, and the 20 largest issuers were responsible for around 90% of total bond issuance in 2013. Only 30% of corporate bonds issued in Indonesia in 2012-13 were denominated in local currency (RBA, 2012). Efforts to develop a local corporate bond market should therefore be stepped up.

The fiscal position is strong, but the government budget is small

Thanks to strong growth prospects and well-entrenched fiscal prudence, exemplified by a fiscal rule limiting the budget deficit to no more than 3% of GDP, the fiscal outlook is solid, with government debt stabilising at an enviable 26% of GDP. But revenue is low, and spending needs are increasing; the deficit has been rising for the past four years (Figure 8). Under current circumstances, this stimulus is broadly appropriate, but only to the extent it does not signal a significant structural deterioration in the budget.

Until end 2014, over 20% of spending had been on fuel and electricity subsidies, to keep energy affordable for the poor and to raise household purchasing power. But the

Figure 8. **Central government revenue, expenditure and balance**

Source: CEIC data; Bank Indonesia; DPJU; and OECD Economic Outlook 96.

StatLink  <http://dx.doi.org/10.1787/888933200021>

subsidies did not work as intended, as 40% of subsidy benefits went to the top income decile and less than 1% to the poorest (World Bank, 2014a). Subsidies also had unintended consequences in the form of increased demand, traffic congestion and environmental damage, whose deadweight loss had been estimated at USD 4-8 billion annually (Davis, 2014). Declining production from maturing oil fields (requiring more imports) added to the problem. Fuel subsidies were reduced in June 2013 and again in November 2014, bringing subsidised fuel prices closer to market prices. Then, at the beginning of 2015, the government dexterously grasped the opportunity offered by falling world oil prices and scrapped its existing petrol and diesel price-setting regime. Both domestic petrol and diesel prices are now linked directly to world prices, with only diesel getting a fixed subsidy of IDR 1 000 (USD 0.08) a litre. The small subsidy on diesel has been retained because of its use in public and freight transport. A programme is in place to phase out diesel use in favour of liquefied natural gas (LNG).

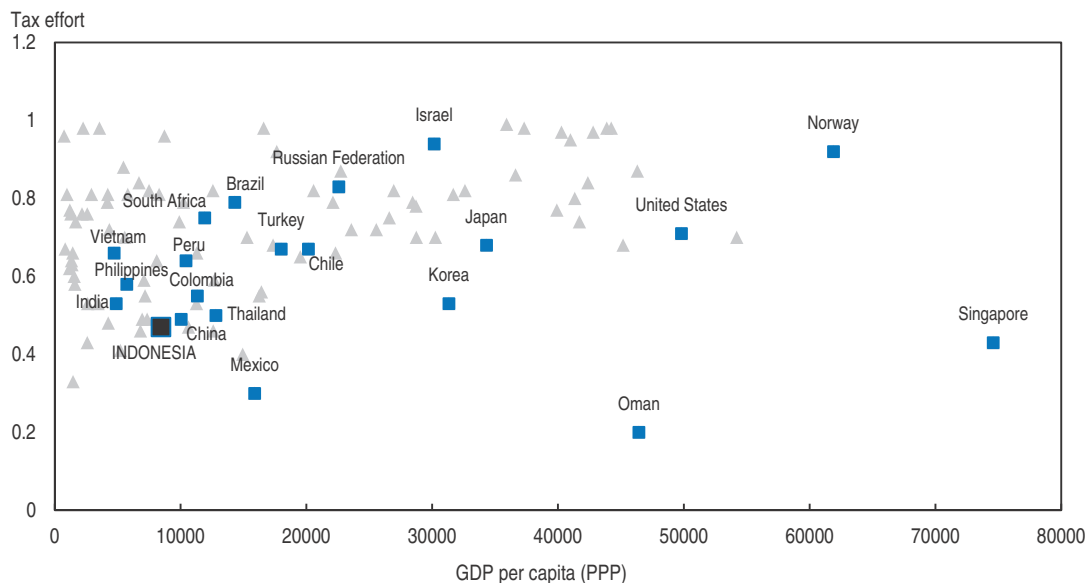
The 2015 budget originally contained fuel subsidies worth more than 13% of total government expenditure, but this has now been whittled down to only 1%. The government has allocated the savings from the fuel subsidy cut largely to infrastructure and the remainder to social spending, local-level projects and deficit reduction. Electricity subsidies remain an issue, and because most generation capacity takes the form of coal- and oil-fired power plants, this is indirectly a fossil fuel subsidy. Electricity subsidies amount to around 8% of total government expenditure. The ongoing reforms in this area should continue, including gradual price reforms until electricity pricing fully recovers the ongoing costs of maintaining and improving Indonesia's electricity system.

Raising government revenues

The government budget is small, even by the standards of peer countries. Central tax revenue (excluding non-tax resource revenue) is around 12% of GDP where it has remained for the past decade, despite increasing efforts to combat tax fraud (see below). The vast majority of revenue is raised at the central government level, rather than by provincial or

municipal governments. Its tax effort (the ratio of actual tax revenues to their potential), estimated at around 50%, is among the lowest for peer countries (Figure 9; Fenochietto and Pessino, 2013). Indonesia, as a resource rich country, relies heavily on corporate taxes on the large and profitable extraction sector. Correspondingly, personal taxes comprise a low share of total revenues; this may reflect the very large informal sector.

Figure 9. **Tax effort versus GDP per capita, 2011**



Note: Tax effort is the ratio of actual tax revenues to estimated potential tax revenues.

Source: Fenochietto, R. and C. Pessino (2013), "Understanding Countries' Tax Effort", *IMF Working Paper*, WP/13/244; World Bank, *World Development Indicators*.

StatLink  <http://dx.doi.org/10.1787/888933200030>

Realising the new government's economic agenda, which includes expanding social services, improving education and lifting infrastructure spending, requires more revenues. To that end, the President has pledged to lift the tax-to-GDP ratio to 16% by 2019 (BAPPENAS, 2015). The 2012 *Economic Survey* (OECD, 2012) included a chapter on the tax system. It recommended increasing tax compliance by bringing more self-employed into the tax net and by both boosting the efficiency of and increasing resources for tax collection. The performance of the tax office could be further improved by greater empowerment of tax officials (including through heightened legal protection), more frequent and targeted auditing, better access to third-party sources of information, and enhanced co-operation with local authorities. Indonesia should continue to be actively engaged in the OECD's Base Erosion and Profit Shifting (BEPS) Project.

Recommendations for fiscal, monetary and financial policy

Key recommendations

- Bank Indonesia should remain cautious with regards to monetary and macro-prudential policies, taking into account both external and internal factors.
- Raise government tax revenues in order to fund a needed longer-term increase in government spending. Revenue could be raised by bringing more self-employed into the tax net and by improving the effectiveness of tax collection.

Other recommendations:

- Deepen and broaden financial markets by making more room for non-banks and the stock market in financing the economy. Further develop the foreign exchange market by reducing the role of BI, generalising hedging and options, and enlarging the class of assets underlying the transactions.

Improving living standards by sustaining long-term inclusive growth

Indonesia's level of real per capita GDP (adjusted for purchasing power) has doubled from around 5% of US levels in 1960 to 10% in 2012, rising from 130th of 143 countries in 1960 to 90th (Penn World Tables, 2013). However, with per capita income of around USD 9 300, it is still in the catch-up phase. The growth dividend for multi-factor productivity (MFP) accruing from earlier policy reforms in sustaining convergence continues to be high but is slowly decreasing (Box 1). Moreover, sustained and robust growth is a vital ingredient in eliminating poverty, which is still widespread, even when compared to other countries at similar levels of per capita income.

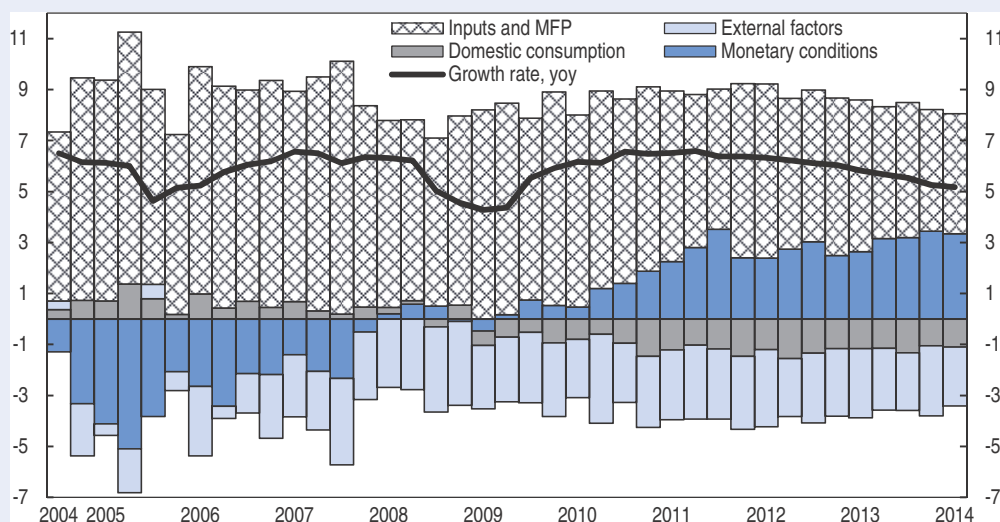
Indonesia's per capita GDP gap with high-income OECD countries reflects lower hourly labour productivity. The new government has set itself the target of raising labour productivity by 40% by 2019. Per capita hours worked are already close to high-income countries (Figure 11). As in Japan, Korea and Chinese Taipei in the past, the process of convergence in Indonesia will involve the continued transfer of labour resources from low-productivity sectors, like agriculture, to manufacturing and services. However, convergence is conditional on the right economic fundamentals, put in place by an appropriate mix of policies. Indonesia is benefiting from an ongoing demographic "bonus" (Figure 12), with the labour force participation rate expected to peak only around 2030. Youth unemployment is high at over 20%. Sufficient high-quality formal-sector jobs will need to be created in order to absorb the continuing large inflow of young people into the labour force. Chapter 1 of this Survey explores the types of policies Indonesia needs to promote sustainable and inclusive growth.

The large productivity gap is, at least in part, due to large segments of the labour force still engaged in agriculture. Indeed, Indonesia's comparative advantage has been in primary products, as is indicated by their rising share of exports. In that regard, the recent fall in the mining and energy share is for the most part due to the sharp decline in coal prices, Indonesia's top export (Figure 13). Indonesia also has the lowest export share of manufactures among ASEAN countries. Part of the MFP catch up will involve fostering robust manufacturing and services sectors. And manufacturing FDI has risen substantially since 2009 and accounted for nearly half of all FDI in 2012.


Box 1. A new decomposition of growth

Using a dynamic stochastic general equilibrium (DSGE) model of Indonesia, growth can be decomposed into four main components: changes in supply factors (capital, labour and multi-factor productivity), changes in external conditions (such as the risk premium on domestic bonds and world growth), changes in monetary conditions (in particular interest rates) and changes in consumption decisions by households (Figure 10). As expected, most of Indonesia's growth over the last decade has been driven by supply factors, especially rising multi-factor productivity (MFP) as Indonesia reaped the benefits of post-Asian-crisis structural reforms. The pace of multi-factor productivity growth has slowed since 2010, however, a decelerating trend reinforced by slower world growth and less dynamic domestic consumption. A series of interest rate cuts has successfully managed to offset those headwinds. Absent further structural reforms to revive productivity growth, the current supportive monetary environment will not be sufficient to sustain long-term growth and poses inflation risks.

Figure 10. Sources of growth

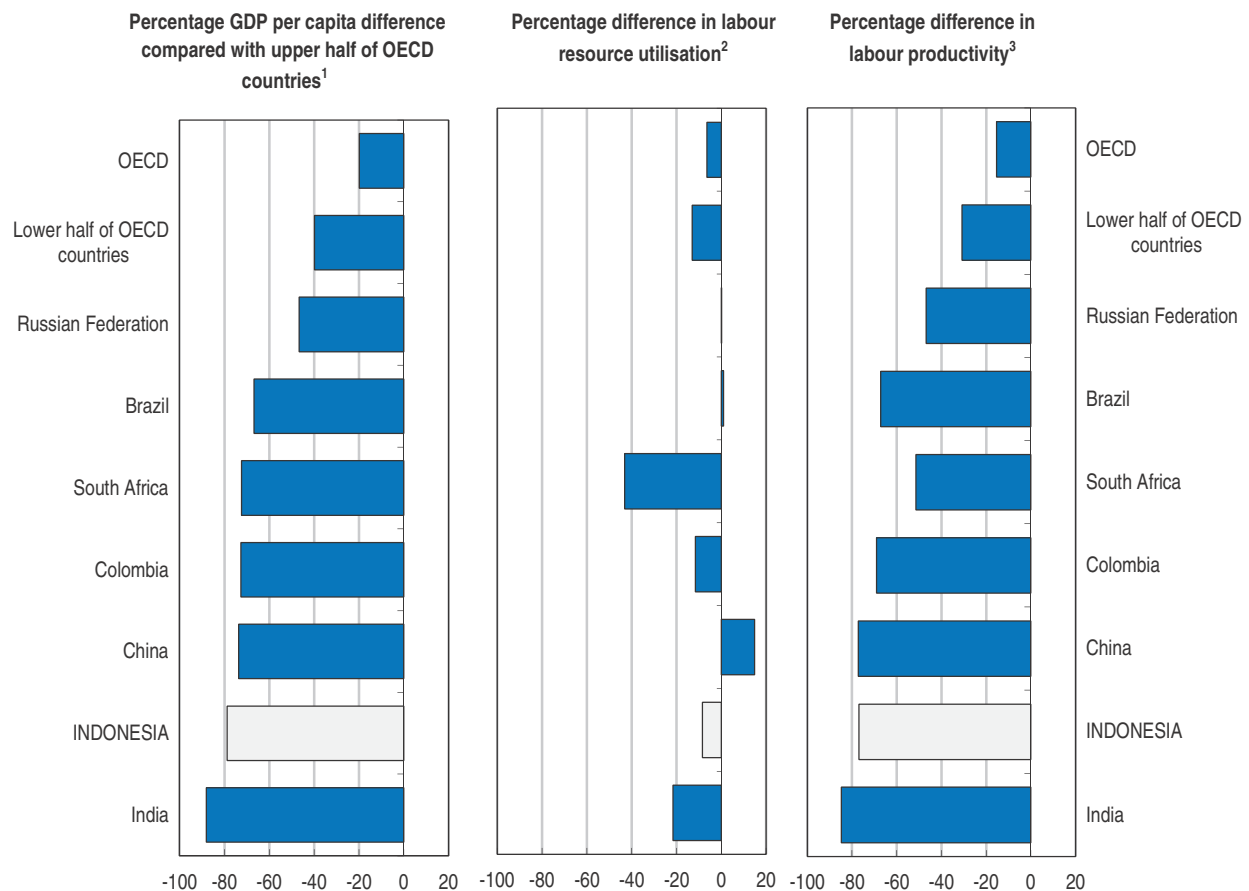


Source: Dutu, R. (2015), "Decomposing Shocks to the Indonesian Business Cycle Using an Estimated DSGE Model", *Technical Background Paper* (2015).

StatLink  <http://dx.doi.org/10.1787/888933200049>

Protectionist sentiment has long been evident in policy making in Indonesia. This sentiment comes from the arguments that recent policy measures introduced by the government are aimed at increasing value-added to some of its strategic commodities, reaching self-sufficiency, and climbing up its value chain to diversify economic activity and create jobs as mandated by its Constitution. Having said this, Indonesia has taken concrete steps to liberalise trade, both unilaterally and through regional free trade agreements (ASEAN, and ASEAN + Japan, China, Australia and New Zealand). These trade agreements account for a large proportion of Indonesia's traded goods and to some extent render unilateral protectionist policies ineffective. Moreover, self-sufficiency does not necessarily mean protectionism. In some contexts, self-sufficiency can be directed towards enhancing production efficiently, sustainably, and environmentally friendliness.

Figure 11. Differences in income per capita for selected emerging economies, 2013




1. Compared to the simple average of the 17 OECD countries with highest GDP per capita in 2012, based on 2012 purchasing power parities (PPPs). The sum of the percentage difference in labour resource utilisation and labour productivity do not add up exactly to the GDP per capita difference since the decomposition is multiplicative.

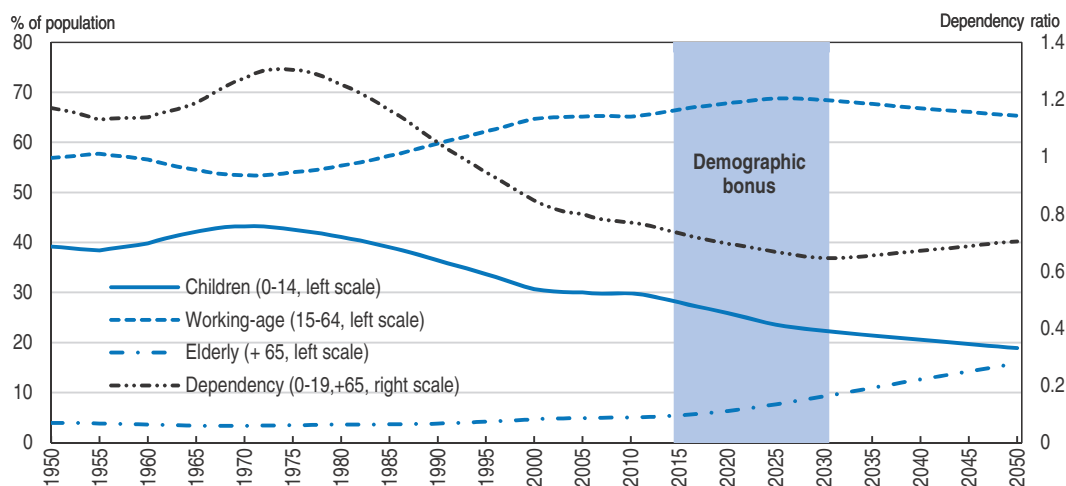
2. Labour resource utilisation is measured as employment as a share of population.

3. Labour productivity is measured as GDP per employee.

Source: OECD National Accounts, OECD Economic Outlook and OECD Employment Outlook Databases.

StatLink  <http://dx.doi.org/10.1787/888933200051>

However, the 2014 Trade Law establishes a new legal basis for the government to manage exports and imports of tradable goods by authorising the restriction of imports to protect and promote local industries; to impose tariffs where necessary; to limit or halt exports of strategic commodities to ensure adequate local supplies; to act in the general interest of the country's trade balance. Agriculture has long been the sector in which self-sufficiency and protectionist measures have been most evident. These policies often conflate and confuse different objectives, including protecting farmers' incomes, managing food price volatility and achieving national food self-sufficiency by minimising reliance on foreign imports. The New Food Law No. 18/2012 articulated the general principle of food security (*kemandirian pangan* or self-reliance) and established domestic production of staples as the priority. Production targets were set for 39 products, and for five (rice, corn, soybean, sugar and beef) the targeted levels aim to achieve self-sufficiency. The law imposed restrictions on the import of fruits and vegetables resulting in high domestic prices. Rice is a case in point, with estimates that in mid-2014, the domestic price of rice was 60% higher than world prices

Figure 12. **Demographic projections for Indonesia**

Source: United Nations, World Population Prospects: The 2012 Revision.


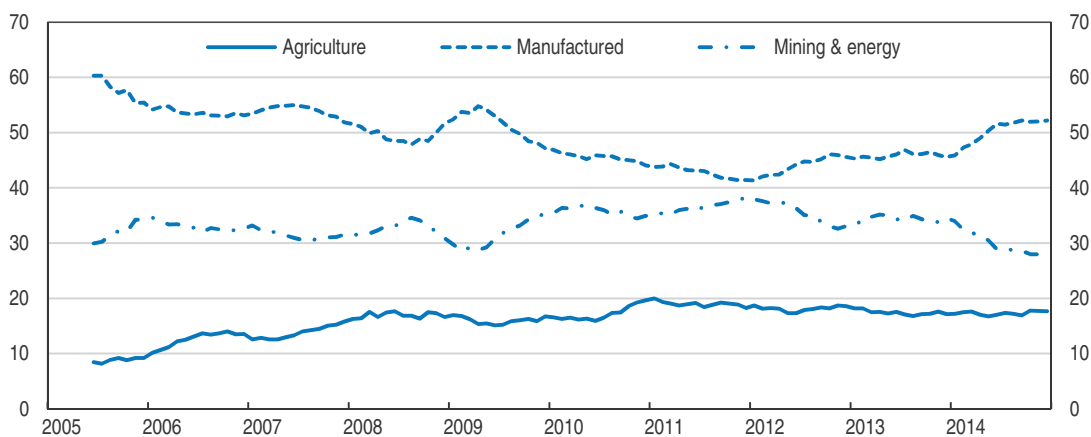
StatLink  <http://dx.doi.org/10.1787/888933200064>


Figure 13. **Composition of Indonesian goods exports¹**

Per cent of goods exports



1. Palm oil and processed rubber are included in Agriculture, and oil products are in Mining & Energy.

Source: Bank Indonesia.

StatLink  <http://dx.doi.org/10.1787/888933200074>

(Timmer, 2014). This imposes a significant burden on poor households, for whom expenditure on rice comprises a large proportion of their budget.

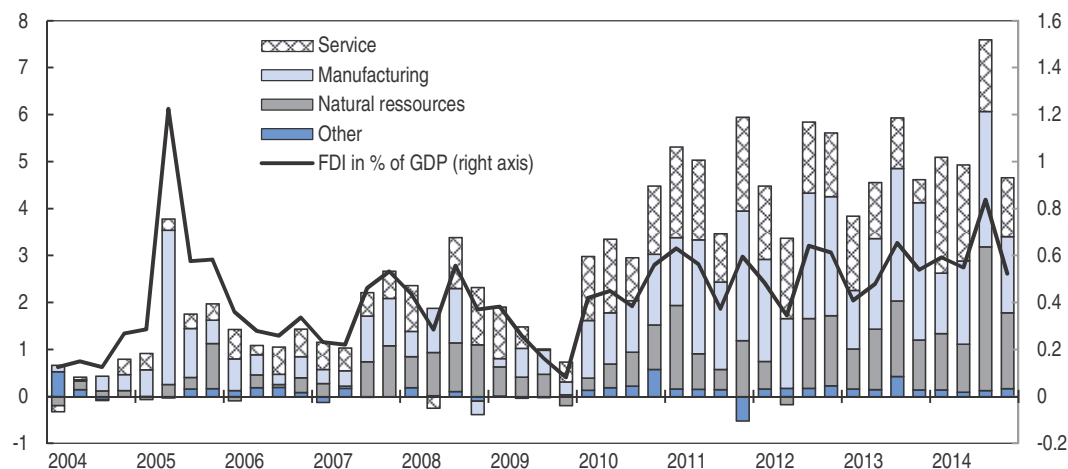
Many other sectors of the economy are also protected from foreign competition. For example, limits on the foreign ownership of mines have hampered investment in the sector (see Chapter 2). The inauguration of the ASEAN Economic Community (AEC) free trade area in 2015 has prompted some changes, including a revision of the Negative Investment List (NIL), which sets out sectors of the economy that are either wholly closed to foreign direct investment or in which foreign direct investment is limited to a certain share. In May 2014, changes to the NIL reflected both national development priorities and AEC obligations. Restrictions on foreign investment in some infrastructure sectors such as ports, electricity generation and waste treatment were relaxed, and special provisions were

made for ASEAN investors. However, the May 2014 revision of the NIL also included tightening of restrictions in other sectors, including in the oil industry and in logistics.

In 2013, Indonesia had the fourth most restrictive FDI regime among 58 countries, according to the OECD FDI regulatory restrictiveness index. As noted above, the December 2013 revision to the list of sectors requiring official approval for FDI (the Negative Investment List) is more restrictive than its predecessor in several key sectors, such as oil and gas. Nevertheless, FDI inflows have remained high, as strong growth prospects and favourable funding conditions triggered an FDI boom beginning in 2010 (Figure 14). Growth in FDI in the manufacturing sector has been particularly strong since 2010.

Figure 14. **Foreign direct investment**

USD billions and per cent of GDP



Source: Bank Indonesia.

StatLink  <http://dx.doi.org/10.1787/888933200088>

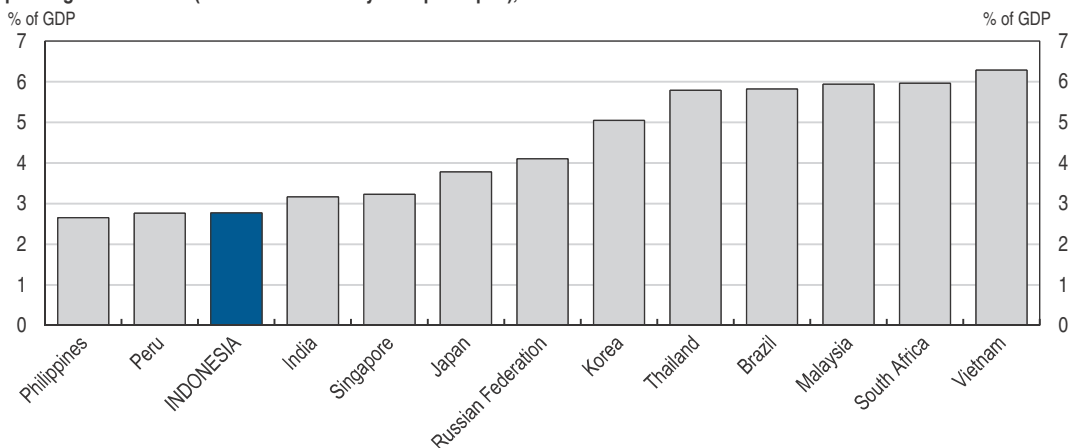
Boosting education outcomes and participation

The accumulation of human capital provides labour with the skills to move into more capital-intensive industry and services. Countries like Japan, Korea, Singapore and Chinese Taipei all put enormous resources (both public and private) into raising educational outcomes. In 2002, Indonesia put in place a spending floor on education of 20% of all public expenditure, but this has been only rarely met. In 2011, this share was around 15%, which compares with around 21% for both Malaysia and Vietnam, 24% for Thailand, but only 10% in India. In terms of GDP, Indonesia's education spending is particularly low compared to other countries – in 2011, it was 2.8% compared to 6.3% in Vietnam, 5.9% in Malaysia, 5.8% in Thailand and 3.2% in India (Figure 15, Panel A).

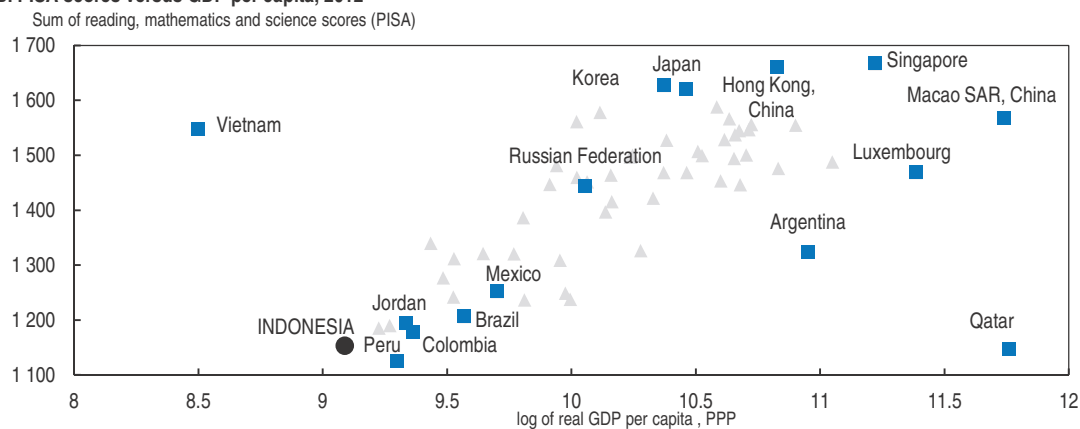
Indonesia has made many education reforms in the past two decades, with significant innovations in both organisational policy and practice, and pedagogic practices (OECD, 2014b), and these reforms have had positive returns. While its educational outcomes tend to lag those of other countries in the region and beyond, adjusting for its level of per capita GDP, Indonesia performs fairly well. For instance, while it ranks second-lowest among those countries that participated in PISA 2012, relative to its per capita income level, its performance is quite good: its PISA outcomes are on par with those of Peru and Brazil, both of which have higher per capita income (Figure 15, Panel B). Likewise, tertiary educational

Figure 15. **Education outcomes and enrolment versus GDP per capita, 2012**

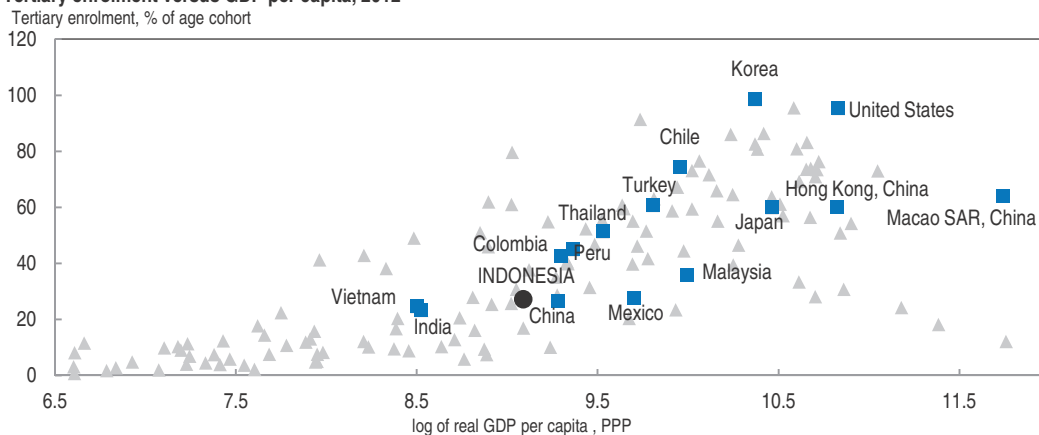
A. Spending on education (countries ordered by GDP per capita), 2012



B. PISA scores versus GDP per capita, 2012



C. Tertiary enrolment versus GDP per capita, 2012



Source: PISA Database 2012; World Bank, World Development Indicators.

StatLink  <http://dx.doi.org/10.1787/888933200091>

enrolment and attainment are quite low, but not relative to per capita income (Panel C). Moreover, most educational performance indicators have been improving steadily over the past few decades: tertiary enrolment was 3% in 1970, 9% in 1990 and 27% in 2011. Gender

outcomes have also been relatively equal. However, policymakers cannot be complacent. Indonesia's educational performance started from a low base, and the easiest gains, such as achieving universal primary school enrolment, have now been made. Serious policy challenges lie ahead, and if these are not tackled, the progress seen to date will stall, and improvements in economic outcomes, including inclusive growth, will slow. The OECD *Education Policy Review of Indonesia* (OECD, 2015) goes into these issues in more detail, including expanding vocational schemes aimed at promoting youth employment.

While participation at all levels of education has risen in recent decades and is consistent with Indonesia's level of economic development, there is significant variation in enrolment and outcomes across the country. Social programmes are currently in place to assist students from poor families and isolated communities in attending educational institutions. The BSM (*Beasiswa untuk Siswa Miskin*) programme is a mix of several independent initiatives designed to help children to stay in school. It includes bursaries and scholarships, providing transfers directly to students or the schools that they attend, contingent on enrolment, attendance and other criteria. Currently around 4.6 million students are covered. However, the individual initiatives within the BSM are independently administered and budgeted and poorly co-ordinated, even when run by the same institution (see Chapter 1).

The quality of educational resources, including school infrastructure and teaching, is also an issue. The efficiency of public spending on education needs to be re-examined, as it has increased substantially in the past decade but outcomes have remained largely static. Around one in ten children repeat their first year of primary school and 6% their second year (UNICEF, 2012). Class sizes tend to be large relative to OECD countries (OECD, 2012a). Around one-third of all elementary school teachers have not undertaken any professional teacher training beyond a high school diploma, and three-quarters lack an undergraduate degree (Baedhowi, 2009). Improving teaching quality will require regular teacher assessments. Limited teacher retraining and certification programmes are in place, but coverage should be expanded to all 2.8 million teachers, although this may be unachievable by the 2015 target mandated in the 2005 national teacher law (World Bank, 2013b). Continuous professional development programmes should become the norm, linked to salary increments and promotion opportunities. Local authorities should also be helped to develop the capacity to better monitor the quality of instruction.

Raising infrastructure investment

As discussed in detail in the 2010 *Survey* (OECD, 2010), a second priority is the provision of high-quality infrastructure through greater investment, and better maintenance – especially in light of Indonesia's difficult geography and slowing infrastructure spending since the Asian Crisis. Infrastructure increases productivity and attracts business activity by lowering transport and production costs and facilitating market access. It not only facilitates greater engagement in global value chains (GVCs), but also promotes personal mobility across the archipelago and hence makes growth more inclusive. In the three years immediately prior to the Asian Crisis infrastructure spending averaged around 9% of GDP, but since 1999 it has averaged only around 4% (World Bank, 2012a). Road and rail transport are underdeveloped and overburdened, both between and within cities. Given Indonesia's maritime character, with some 17 500 islands, 6 000 of them inhabited, the new administration's focus on sea-based infrastructure is welcome. A lack of electricity generating capacity is also inhibiting capital investment, and delays at the country's

outdated airports and ports are increasing the cost of international trade and hindering the formation of national value chains.

Given the opportunities offered by integration into GVCs, both in terms of generating well-paid jobs and boosting high value added exports, efficient communication and logistics are extremely important. Although progress has been made, including the introduction of a single window for port clearances, the World Bank's Logistics Performance Index (LPI) recently ranked Indonesia 53rd out of 160 countries in logistics, well behind other middle-income countries in the region in all aspects considered. Indeed, Indonesia ranks lowest in all sub-components of the LPI among such countries. Moreover, it scores poorly in openness to trade in the types of services that promote integration into GVCs. According to the OECD Services Trade Restrictiveness Index (STRI), Indonesia scores below the average of peer countries (Brazil, Chile, China, India, Mexico, Russian Federation, South Africa, Turkey) in 16 of the 18 service sectors included in the STRI. Indeed, it is in the logistics sectors like road freight transport and distribution services that Indonesia performs comparatively the worst.

In 2011, the government launched the Master Plan for Acceleration and Expansion of Indonesia Economic Development 2011-25 (MP3EI), which listed infrastructure as a national priority. The plan detailed the government's intention to build economic corridors, each supported by industry clusters, thereby optimising agglomeration advantages and strengthening national and international connectivity across those corridors. Its costs were estimated at USD 450 billion over 15 years; the government would directly finance 30%, and the private sector the rest. The government's aim should be to increase public spending on infrastructure to the levels that prevailed prior to the Asian Crisis, with a focus on transportation and logistics, and on poverty-alleviating infrastructure, such as natural disaster abatement, water treatment and sanitation.

The growing realisation that the government alone does not have the resources to meet all of the country's infrastructure needs means that the private sector is expected to play an important role. This is especially true given the 3% of GDP cap on government deficits. However, there remain major impediments to expanding the role of the private sector, both domestic and foreign. Greater efforts will need to be made to better channel available funds from public, private and Official Development Assistance (ODA) sources towards more productive infrastructure investments. Creating more transparent regulatory frameworks, improving accessibility to capital through more supportive financial markets and increasing the capacity to absorb capital inflows are all issues that need to be addressed. Allowing state-owned enterprises to borrow directly from ODA donors, under the supervision of Ministry of Finance, is a step in the right direction.

The government is strongly promoting the use of public-private partnerships (PPPs) to deliver infrastructure investment. A range of state-owned entities have been created to assist with PPP financing, including PT Penjamin Infrastruktur Indonesia (PT PII), which can provide project guarantees to improve the creditworthiness of the public-sector participants, thereby increasing private-sector participation and ring-fencing the government's contingent liability. Indonesia's sovereign wealth fund, *Pusat Investasi Pemerintah* (PIP), is capable of financing land acquisition for PPPs, and a Viability Gap Fund has also been established to provide additional capital to ensure projects' financial viability. Despite these initiatives, as of October 2013, of the 21 PPPs that have been tendered since 2009, only seven had reached the final stage of negotiations (BAPPENAS, 2013).

Moreover, although the central government's capacity to deliver PPPs has been strengthened, more needs to be done to boost the resources and capacities of sub-central governments, which are often the contracting authorities in PPP agreements. The recently established PPP centre within the Ministry of Finance is a timely step. This will focus on developing a pipeline of bankable government-supported infrastructure projects. Likewise, the recently instituted Infrastructure Prioritising Body (KP2IP) is welcome. It will assess and prioritise project proposals, and allocate them for implementation to line agencies, state-owned enterprises or the PPP centre in the Ministry of Finance. It will also provide guidance on how each project can be appropriately financed. Key challenges to improve the business environment and encourage good decision-making are to ensure that its deliberations and decisions are transparent and that it succeeds in enhancing co-ordination among infrastructure-related government bodies.

Given the complexities, including dealing with regional governments, a central co-ordinating entity is needed to help champion and shepherd PPP projects, including offering direct assistance to private firms tendering for them, but it remains unclear if the new PPP Centre or KP2IP will play this role. In any case the government's contingent liabilities need to be made public to avoid the temptation to hide them away from public scrutiny.

A major impediment to infrastructure investment and other fixed investment in Indonesia has been the long and arduous process of land acquisition. The 2011 Land Acquisition Act seeks to address this. It allows the government to acquire private land for public works projects and establishes a fair and transparent framework for compensating landowners, including spelling out a simplified and accelerated appeals procedure using prescribed time frames for each stage of the process. The Widodo government has announced plans for a land bank which would facilitate government purchases of land required for infrastructure development.

Improving inter-governmental co-ordination and regulations to promote infrastructure investment

Decentralisation, which started in 2001, devolved numerous expenditures, such as local roads and water treatment, to sub-national governments. Central government's share in infrastructure investment fell from around 80% to about 35% (World Bank, 2013a). While local governments are in a better position to assess regional infrastructure needs, this poses the challenge of effective integration of sub-national measures and regulations with national plans, such as MP3EI. Regulatory bottlenecks have been identified in at least nine national laws, six national government regulations, five presidential regulations, decrees and instructions, nine ministerial regulations and a number of sub-national regulations and permits (OECD, 2012b). The 2015-19 National Medium Term Development Plan (RPJMN 2015-19) (BAPPENAS, 2015) makes explicit the government's commitments for regulatory "debottlenecking" in order to overcome barriers that inhibit investment and business development in each sector and region. The government should not only accelerate the process of regulatory streamlining but make explicit efforts to ensure regulatory reforms are coherent across levels of government.

Recommendations for promoting inclusive and sustainable economic growth

Key recommendations

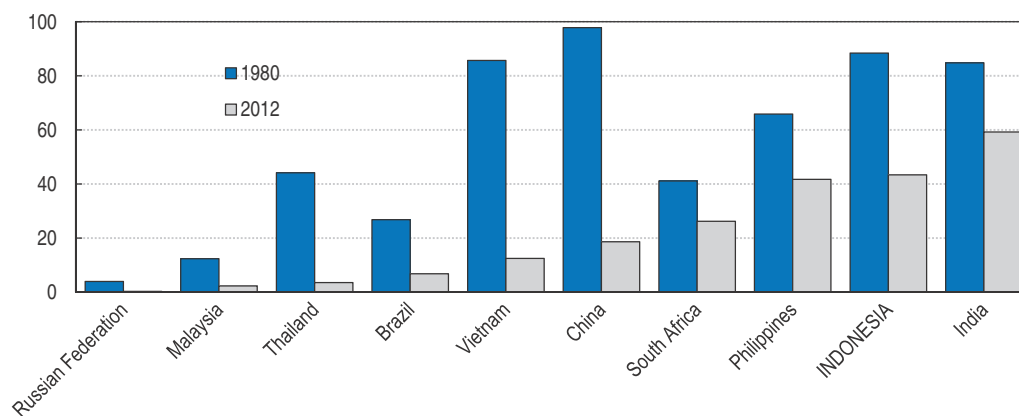
- Direct more public resources to improving education access and outcomes. Continue regular teacher assessments and professional development, and link teacher salaries more closely to qualifications and performance.
- Raise public spending on infrastructure. Focus on transportation and logistics to support industry, as well as natural disaster prevention and water treatment.
- Avoid protectionist measures that inhibit openness to trade and foreign investment with uncertain development payoff.

Reducing poverty and inequality

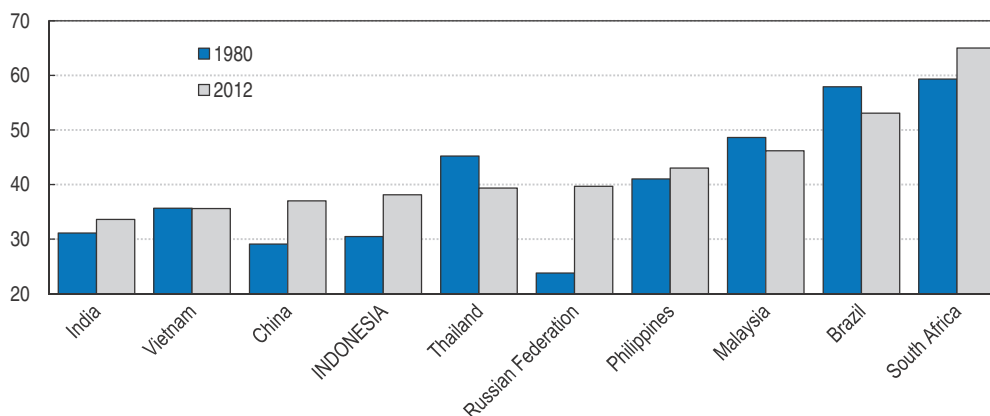
Indonesia has performed admirably in reducing absolute poverty. Over the past three decades per capita GDP growth has averaged around 3.5% annually, and this, in combination with government poverty-reduction programmes, has reduced the USD 2 per day poverty headcount from around 85% of the population to 43% since 1980 (Figure 16, Panel A). For

Figure 16. **Poverty and inequality**

A. Poverty headcount ratio at \$2 a day (PPP) (% of population)



B. Gini coefficient



Source: World Bank, World Development Indicators.

StatLink  <http://dx.doi.org/10.1787/888933200106>

Indonesia, poverty is mostly, but not exclusively, found in the rural and agricultural areas where about half the population lives. In 2012, 14.3% of the rural population were below the rural poverty line, compared to only 8.4% of the urban population.

However, income alone is not the sole measure of the well-being of the poor. For example, less than half of the rural poor have access to clean water, only three-quarters of all Indonesians have access to electricity, and only 55% of poor children complete junior high school. Moreover, the falling absolute poverty rate masks a high degree of vulnerability: much of the population is clustered just above the official poverty line, consuming approximately IDR 248 000 per month in March 2013 (about USD 22). Around 22% of Indonesians live below or within 20% of it, while 34% of the population lives below 1.5 times the poverty line and is almost equally vulnerable. The World Bank (2012) estimated that 40% of Indonesians are highly vulnerable to poverty.

Indonesia's record in reducing income disparity has been less impressive, particularly over the past decade when the Gini coefficient rose significantly (Figure 16, Panel B). However, in comparison with many other developing countries, income inequality remains low. Nevertheless, top income shares rose sharply in the late 1990s, coinciding with the economic crisis and remain generally higher than in other countries (Leigh and van der Eng, 2009).

Indonesia currently operates two large conditional cash transfer (CCT) schemes: BSM, focusing on education, and PKH (*Program Keluarga Harapan*), for health and education. These schemes are being facilitated by the recent rollout of smart cards and have a number of advantages. First, they typically focus on investment in the education, nutrition and health of children from households in extreme poverty. They therefore help reduce intergenerational poverty transmission and improve efficiency and productivity on a much broader scale. Second, they are typically well targeted, as they are by definition designed to provide resources to those most in need. Verification of need can therefore often be built into the scheme. However, the government should take measures to improve targeting of social assistance programmes, including CCT schemes, by continuing efforts to develop a single registry of vulnerable households (PPLS11), which will result in better cost-effectiveness.

Indonesia has made steady and significant progress on several key population health measures over the past few decades. However, poor nutrition and stunting remain serious issues among the poor, and universal access to good-quality health care across the entire archipelago is still inadequate. Total spending on health care as a share of GDP is low, as is the number of physicians per thousand inhabitants. While the new health insurance scheme and the rollout of *Healthy Indonesia* cards are welcome, these programmes need to be monitored closely to ensure that they properly protect households (including those that have children, elderly, non-salaried and informal workers) from catastrophic medical costs and ensure satisfactory accessibility to affordable health-care services.

There are several other priority areas where Indonesia could focus efforts to further tackle poverty and inequality. These include improving access to schooling, continuing to formalise land tenure and titles, improving infrastructure particularly in rural areas, and better using the tax and transfer system to improve assistance to the poor. Chapter 1 examines these policy options in depth.

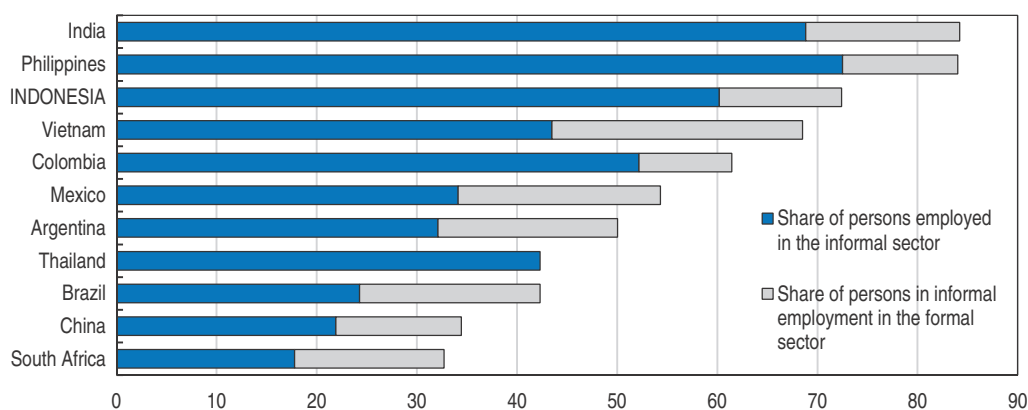
Labour informality exacerbates poverty and inequality

The International Labour Organisation (ILO) estimates that 60% of all non-agricultural jobs in Indonesia are informal. While this is less than in India (68%) and the Philippines (73%), it is much higher than in China (33%) and Vietnam (44%) (Figure 17, Panel A). Informality in Indonesia arises from several factors. The minimum wage, which according to ILO data was 63% of the average wage in 2010, is very high by international standards (Panel B). The high minimum-wage cascades through the economy, as it is used as a reference in broader wage negotiations; recent large increases have thereby propagated across the wage structure. In addition to hurting competitiveness more generally, this is likely to have retarded job creation in the formal sector and encouraged informal employment. Rigid labour- and product-market regulations, including stringent hiring and firing rules, also exacerbate labour-market informality and encourage unregistered micro-enterprises by raising the cost of taking on formal workers. At the same time, policies aimed at formalisation, such as stricter enforcement of laws and regulations, may actually

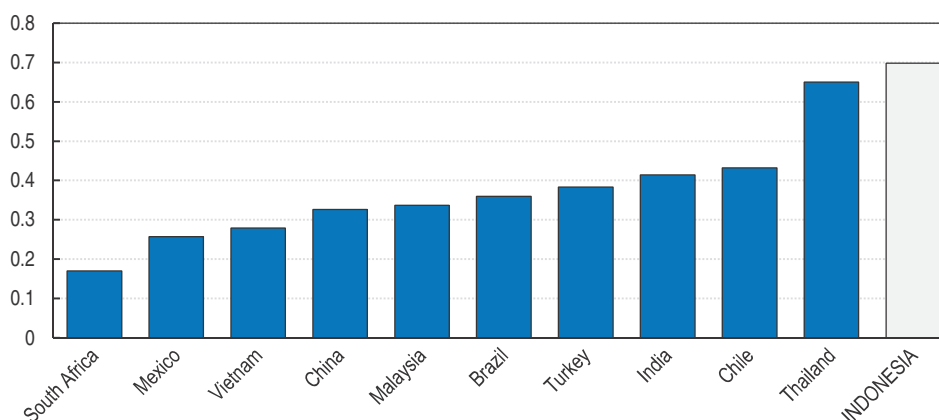
Figure 17. Labour market informality and minimum wages in selected EMEs

A. Labour market informality


Per cent of non-agricultural employment



B. Minimum wage relative to average wage



Source: ILO (2012), *Statistical Update on Employment in the Informal Economy*, June; and ILO, *Wages Database*.

StatLink  <http://dx.doi.org/10.1787/888933200117>

increase poverty and vulnerability by pushing already vulnerable people into even more difficult situations.

The tax and transfer system can affect the livelihood of the poor beyond the public provision of goods and services that both directly and indirectly target poverty. To the extent that workers are in the formal sector and therefore within the tax net, the progressivity of personal income tax and the social transfers can have a direct and immediate impact. However, with over 60% of the total labour force outside the formal sector, and a much greater percentage of poor workers, the reach of the tax and transfer system is likely to be limited. So a first step in boosting its effectiveness as a tool for poverty alleviation is to take measures to promote workforce formalisation.

Recommendations for reducing poverty and inequality

Key recommendations

- Increase, and further improve targeting of, spending on poverty alleviation and health measures. Direct more public resources to improving education access and outcomes.
- Increase financial inclusiveness by further developing branchless banking, drawing lessons from such countries as India, Mexico, the Philippines and Kenya.
- Tackle labour market informality by reducing rigidities in the formal sector, and by enhancing the effectiveness of the tax-transfer system for poverty alleviation and channelling other social benefits.

Other recommendations

- Continue building a single registry of vulnerable households to better target assistance.

Ensuring the regulatory framework and civil service perform better

Weaknesses in the legislative, legal and bureaucratic processes remain impediments to inclusive and sustainable growth and development. On several other measures of good governance, Indonesia lags many of its neighbours as well as other emerging economies (Table 3). The Rule of Law Index Report 2014 released by the World Justice Project indicates that corruption is still widespread in the judiciary and law enforcement (WJP, 2014). Moreover, while decentralisation of government to the regions in 1999 has been a political success, it has also exacerbated the problems of bureaucratic capacities and inefficiency and led to an increase in local-level corruption (Martini, 2012; Rinaldi et al., 2007; Rock, 2007). Indonesia Corruption Watch estimates that around one-third of the country's education budget is misappropriated, largely through the improper procurement of goods and services. The consultancy firm A.T. Kearney estimates that Indonesia loses USD 4 billion every year (0.5% of GDP) due to poor public procurement practices. Around 30% of the cases handled by the Corruption Eradication Commission (KPK) over the past decade were related to poor procurement practices (A.T. Kearny, 2010).

Administrative and governance reform had top priority in the 2010-14 National Medium Term Development Plan (RPJMN 2010-14) and continues to do so in RPJMN 2015-19. The RPJMN 2010-14 aimed to achieve this by ensuring the adequate capacity of government personnel. The Government Public Procurement Agency (LKPP) was established in 2010 to

Table 3. **Governance and corruption indicators, selected regional and emerging economies**

Ease of doing business rank ¹		Corruption perception index ²		Control of corruption index ³		Government effectiveness index ⁴		Global competitiveness report rank ⁵	
Malaysia	18	Malaysia	52	Brunei	0.6	Malaysia	1.0	Malaysia	20
Thailand	26	Brazil	43	Malaysia	0.3	Brunei	0.8	China	28
S. Africa	43	S. Africa	42	Brazil	-0.1	S. Africa	0.3	Thailand	31
Russia	62	India	38	S. Africa	-0.2	Thailand	0.2	Indonesia	34
Vietnam	78	Philippines	38	Thailand	-0.3	Philippines	0.1	Philippines	52
China	90	Thailand	38	China	-0.5	China	0.0	Russia	53
Philippines	95	China	36	Vietnam	-0.6	Brazil	-0.1	S. Africa	56
Brunei	101	Indonesia	34	India	-0.6	India	-0.2	Brazil	57
Indonesia	114	Vietnam	31	Philippines	-0.6	Vietnam	-0.3	Vietnam	68
Brazil	120	Russia	27	Indonesia	-0.7	Indonesia	-0.3	India	71
Cambodia	135	Laos	25	Russia	-1.0	Russia	-0.4	Laos	93
India	142	Cambodia	21	Laos	-1.0	Cambodia	-0.8	Cambodia	95
Laos	148	Myanmar	21	Cambodia	-1.0	Laos	-0.9	Myanmar	134

Sources: 1. World Bank "Ease of Doing Business" 2015. 2. Transparency International 2014. 3. World Bank *Worldwide Governance Indicators* 2012. 4. World Bank *Worldwide Governance Indicators* 2012. 5. World Economic Forum 2014-15.

monitor and evaluate procurement practices within the public sector. The new government has also articulated a particularly strong focus on these issues. Its goal is to ensure a professional and adaptive government bureaucracy that is neutral, clean and corruption-free. The RPJMN 2015-19 not only addresses financing issues but also necessary regulatory and institutional reforms to support the government's cross-cutting, sectoral and regional priorities.

There has been progress in improving the performance of the civil service (World Bank, 2012a). However, overstaffing, nepotism and difficulties laying off staff mean that progress in adjusting ministerial and agency staffing has been slow. Early retirement, offering severance packages to surplus staff, giving lower-level managers more responsibility for recruiting and terminating employees, and decentralising personnel budgets to individual ministries could provide the flexibility needed to enhance performance. The government has committed to review the functions and structures of all central government ministries and agencies by 2019. Central government, perhaps the Ministry of Administrative Reform and Bureaucratic Reform (PAN Kemeneg), should be tasked with providing guidance on severance procedures, as individual ministry-level programmes may face conflicts of interest.

A pilot bureaucracy reform programme was started in 2004 in the Ministry of Finance, and in 2008 the programme was rolled out to many other ministries and agencies before extension to the regional level in 2013. Its principle objectives are to: i) tackle corruption, collusion and nepotism; ii) improve service delivery; iii) improve civil servants' capacity and accountability; iv) upgrade human resource management policies and practices; and v) address overlapping, inconsistent and vague laws and regulations. The reform programme has been a success, and rolling it out to the regions should continue. The government has committed to publish a "Grand Design and Roadmap for Bureaucratic Reform" by 2019.

Box 2. **Corruption Eradication Commission (KPK)**

The KPK was established in 2002 as an ad hoc corruption fighting agency, independent from the executive, legislature and judiciary. It works alongside incumbent agencies such as the Attorney General's Office and national police and is authorised to conduct pre-investigation, investigations and prosecutions against corruption cases that: i) involve law enforcers, state officials and other individuals; ii) have generated significant public concern; and/or iii) have lost the state at least IDR 1 billion (USD 70 000). Moreover, based on Article 6 Law No. 30/2002, KPK has mandates to conduct investigation and prosecution of corruption cases, to prevent corrupt practices, to co-ordinate with government agencies, supervise corruption case handled by other law enforcement authorities (the national police force and Attorney General's Office) and also to monitor the implementation of good governance throughout the country.

The KPK is led by five commissioners and has a staff of around 1 200, including some 250 investigators and prosecutors. The commissioners operate as a panel and all investigations need to be vetted by it. The investigators and prosecutors of the KPK are typically experienced agents recruited mainly from the Indonesian National Police and the Attorney General's Office. Experts from other government agencies are also taken on, particularly financial experts. While not ideal from the point of view of independence and avoiding possible contagion of corruption from one agency to the next, thorough testing and vetting has been largely successful in avoiding this problem. Following their selection, investigators and prosecutors are engaged on fixed-term contracts and after three to five years they are expected to return to their home agencies. KPK funding has more than doubled since 2008. Its budget in 2014 was IDR 559 billion (USD 43 million).

The KPK's focus has been on high profile cases, and the public perception of its effectiveness is high. Since its inception in 2002, the KPK has prosecuted only around 320 cases but has achieved a conviction rate of 100%. The convictions it has obtained include government ministers, top management and officials from private companies, provincial governors, police, judges and prosecutors. As stipulated in the 1999 Governance Law, all state officials are obliged to submit a wealth report to the Commission within two months of starting or finishing their tenures. This includes the President and government ministers. President Joko Widodo was the first president to require all ministerial candidates to be vetted by the KPK, as well as by the Financial Transaction Reports and Analysis Centre (PPATK) which tracks international money transfers with a view to uncovering corruption, fraud and tax avoidance.

The authorities have made great strides in battling corruption (through both enforcement and preventative measures), which has long been an impediment to growth. Indonesia improved on the Corruption Perception Index from 1.9 in 2001 to 3.0 in 2011 (USCS, 2012). The KPK was established in 2002 as part of broader anti-corruption legislation and has had significant success in raising public awareness by pursuing high-profile cases (Box 2). Decisive action has been taken to stamp out corruption in customs and tax administration, including by the dismissal of senior public officials and a significant increase in compensation for civil servants working there. Nevertheless, perceptions of corruption remain, especially regarding the lower rungs of the civil service and in the regions.

Devolving some political and revenue-raising powers to the regions increased the potential for inconsistent and incompatible regulations across levels of government. The 2004 law on the Establishment of Laws and Regulation sought to address this issue, and

further measures have been taken since, including setting up mandatory *ex ante* central government reviews of sub-national regulations that impose new taxes and charges (OECD, 2012b). However, there is no national institution that has formal responsibility for co-ordinating and providing oversight of these reviews and for providing best-practice guidelines. Indeed, a major issue remains sub-central governments' lack of capacity (as can be seen in administering PPPs). This is another area in which the central government could provide direction and assistance to its sub-national counterparts.

The new President has identified improving the business climate as a major priority. Indonesia lies in the bottom half of the World Bank's "Ease of Doing Business" rankings (Table 3) although its position has improved. Indonesia performs poorly in the subcategories of "Starting a business", "Paying taxes" and "Enforcing contracts". The government plans to expand the number of one-stop shops for business to streamline the permit and licensing process by combining these functions into a single office. The government should consider adopting a "silence is consent" policy whereby a license is deemed to be granted if a response is not received from the agency after a certain pre-defined number of days.

Recommendations for better regulation and reducing corruption

Key recommendations

- Improve mechanisms to prevent corruption, while further increasing efforts to combat all forms of corruption.
- Expand support to sub-national governments for capacity building, including the provision of technical and administrative assistance by the central government.

Making the most of natural resources while preserving the environment

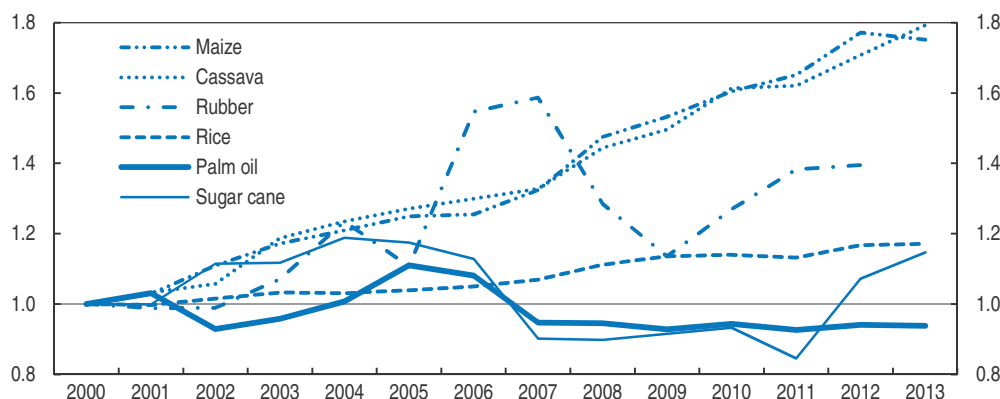
Indonesia abounds with natural resources, but they are spread over a vast country composed of thousands of islands. The unique nature of its geography coupled with the lack of transport infrastructure makes exploitation of natural resources challenging. The agricultural sector, despite progress, suffers from lagging productivity and misplaced support for staple crops. Unwieldy regulations make the exploitation of mineral deposits difficult. In the last Fraser Institute's (2013) survey, mining companies ranked Indonesia last out of 96 jurisdictions when evaluating the attractiveness of its mining policies.

Increasing productivity and encouraging diversification in agriculture

Indonesia has become a global player in many key farm and food markets (e.g. palm oil, rubber, fishery products). Improvement in agricultural yields has varied widely across crops, however. Rice yields have surpassed Malaysian levels but remain below Vietnamese and Chinese counterparts (OECD, 2012c). On the other hand, crude palm oil yields have declined (Figure 18). Boosting productivity growth will be crucial, as it will be increasingly difficult to expand agricultural land, given environmental concerns. Indonesia should encourage more partnership arrangements between large estates and smallholders under the so-called "nucleus plasma" scheme [smallholders occupy 87% of cultivated land and produce 90% of total rice and maize output (Jeon, 2013)]. This 30-year old programme has successfully provided large companies (nucleus), both private (such as Unilever) and state-owned, with subsidised capital and long-term leases for public lands for estate crop

Figure 18. **Selected crop output per hectare**

Index, 2000 = 1



Source: FAOSTAT.

StatLink  <http://dx.doi.org/10.1787/888933200126>

production, on condition that these companies provide technical and marketing services to neighbouring smallholders (plasma).

Productivity growth is also hampered by lack of scale economies due to the large number of small parcels (arable land per farmer is at 1 000 square meters, half the world average). While small farms provide a living to tens of millions of households, smallholders have only limited financial capacity to expand and upgrade production methods. Increasing farm size will require reform of the complex land-tenure system. Most rural households have unregistered land rights usually acquired through inheritance. The situation hinders consolidation of property and accessing credit, and hence fixed capital formation, as farmers must provide collateral to meet bank lending requirements. Creating an agency dedicated to accelerating land rights registration should be a priority.

Diversification away from traditional crops is another avenue for upgrading the agricultural sector. While government support is focused on staple crops (OECD, 2012c), Indonesia should allow farmers to diversify by providing them with better information on high-return specialised crops and corresponding market prices. Diversification would enhance their involvement in international farm trade, and would encourage risk taking and innovation. It could be encouraged by establishing an insurance scheme against adverse climatic or price developments. In addition, fertiliser subsidies (1.3% of total government expenditure on average over the last three years), which are applied disproportionately to staple food crops (rice, maize, soybeans), should be phased out and the savings used to finance a voucher system leaving farmers free to decide how to use those funds. Besides, state-owned fertiliser companies operate at high costs, use obsolete technologies and are often slow in their deliveries. Privatisation of the five fertiliser companies could raise efficiency and help fund the voucher reform as well.

Indonesia has made major improvements in achieving food self-sufficiency. Crop yields have risen, including in staples, and the prevalence of undernourishment is currently estimated at 9% of the population, half of what it was only a decade ago. Food security remains high on the policy agenda. This takes various forms such as rice reserves, priority to domestic production, price support, delivery of rice at subsidised prices to poor households (RASKIN), and foreign trade restrictions and licenses. These policies, however, tend to worsen the situation: the domestic rice price was 60% higher than the reference

international price in 2010-12, compared to 8% in 2000-02, and simulations show that such policies would increase the rate of undernourishment under various risk scenarios (OECD, 2014c). In addition, Indonesia imports only 13.1% the cereals it consumes. This percentage has not moved much since 1998, and is on par with Thailand (12%) and Vietnam (13.4%). It is, however, much lower than wealthier countries such as Malaysia and Japan, both at 80.7% (2011 data, three-year average) (FAOSTAT, 2015). By removing trade restrictions and phasing out price support, Indonesia could lower prices for both domestic and imported food, making costly self-sufficiency policies less necessary. Indeed, challenging logistics (e.g. low capacity for refrigerated shipping) play an important role in undermining food security.

As an alternative to RASKIN, which does not always reach its target population and bears high administrative costs, food vouchers or cash transfers would improve diversity and be more cost effective (Hidrobo et al., 2014). They would also further encourage crop diversification. In order to reduce food poverty through trade, trade restrictions should be eliminated over time, in co-ordination with other ASEAN members. Import restrictions, especially in areas where Indonesia has no comparative advantage, are especially burdensome.

Policy should better acknowledge differences in refining profitability among minerals

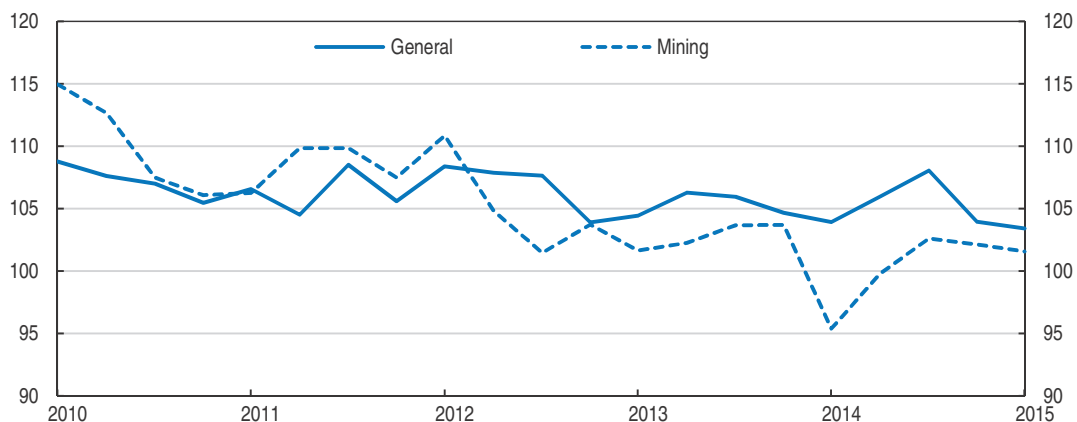
In January 2014, the government began enforcing the ban on the export of unprocessed mineral resources, first legislated in 2009. While mineral ore exports such as nickel and bauxite are now banned, exports of so-called mineral concentrates (copper, iron, manganese, lead and zinc) will be permitted for the next three years under a new regulation taxing semi-processed mineral exports at 20-25% of sales revenues, rising to 60% by 2016 unless firms guarantee they will build a smelter. To show their commitment Newmont has paid a bond of USD 25 million and Freeport USD 115 million, and both are currently discussing possible locations for the smelters. These measures aim to foster processing in Indonesia, rather than overseas.

Such import-substitution strategies have been used elsewhere, although with mixed effects. If successful, they can raise long-term growth by launching new growth engines. Examples of successful policies protecting infant industries can be found, although mainly in developed countries. Airbus successfully entered the world aircraft market thanks to strong support from European governments. In Indonesia the tax on crude palm oil (CPO) exports succeeded in keeping it as an affordable input into many domestic industries rather than being exported at high prices. In all instances the global context needs to be taken into account. In Airbus' case, it penetrated an uncompetitive market characterised by high monopoly rents, making the rationale for government support stronger. However, in the case of the Indonesia ore export ban, the benefits may depend on the details of the extraction and refining processes. For example, nickel and bauxite refining generates more value than that of copper for which most market value comes from concentration, which is already conducted in Indonesia (USAID, 2013). The industry also suffers from mismanagement and corruption. A KPK audit of Indonesia's mining industry earlier in 2014 uncovered more than USD 2.3 billion in tax fraud, leading to the revocation of more than 4 000 mining permits. The new government has asked the KPK to undertake a comprehensive study of the management of the entire oil and gas sector, including the state-owned energy company (Pertamina).


The ore export ban has direct costs. The mineral extraction sector, and the tax revenues it provides, are being hurt because of falling exports. Successful import

substitution will require large investments in refining capacity and supporting infrastructure. The announcement appears to have caused a sharp drop in business expectations (Figure 19), and such policies risk damaging Indonesia's international reputation as a good place to invest and do business. Mineral exploration investment is already quite low by comparison: it was only USD 80 million in 2011 (Energy and Mining Journal, 2012), in contrast with USD 2.9 billion in Australia (Australian Bureau of Statistics, 2014). To maximise the benefits and contain the risks, the government should reconsider its strategy based on the expected profitability of onshore processing for each metal.

Figure 19. **Business expectations**
Above 100 corresponds to improving business conditions



Source: CEIC.

StatLink  <http://dx.doi.org/10.1787/888933200137>

Protecting the environment and tapping the potential for renewables

Rapid economic and population growth and rising urbanisation are putting pressure on the environment. The 2010 ADB-ILO-IDB Environmental Performance Index positioned Indonesia 134th of 163 countries (OECD, 2012c). One major issue is the growing role of fossil fuels in Indonesia's energy mix, challenging its 2009 G20 commitment to reduce greenhouse gas (GHG) emissions by 26% by 2020 against a business-as-usual trajectory. Indeed, CO₂ emissions from fossil fuel combustion were already 12.3% greater in 2011 than in 2009 (IEA, 2013). Indonesia is the world's fifth largest fossil-fuel-based electricity producer, ahead of the United States. The trend is reinforced by an implicit negative carbon price for coal due to Indonesia's electricity subsidy system (OECD, 2014a). Phasing out all subsidies would raise the implicit price and reduce consumption. Coal-fired electricity generation efficiency, which lags both by world and Asian standards, is also a concern and could be improved by transitioning to cleaner and more efficient plants.

Deforestation is a major contributor to Indonesia's poor emissions record. Its forest cover as a share of land area shrank by more than 10 percentage points from 1990 to 2011. The government should increase the resources devoted to reforestation and combatting illegal logging, and punish illegal deliberate forest fires more severely. New agricultural activities should be authorised only on scrub land and abandoned agricultural land. The KPK recently announced that 89% of the nation's 128 million hectares of forest were under no regulation or permit, making them difficult to protect (Jakarta Post, 2013). The

government should ensure that all privately and publicly owned land has well defined property rights and is under clear regulation.

Mining is also contributing to environmental degradation, mostly through water pollution and damage to the ecosystem. Most coal mining operations are open-cast and carried out in remote, pristine areas, increasing the risk of environment damage. However, some major mining companies who belong to the Indonesian Coal Mining Association are pursuing ambitious rehabilitation programmes. Nevertheless, smaller, often illegal mines lack the incentives and the means to repair the damage done by their activities. More resources should be devoted to combating illegal mining.

Indonesia's geothermal energy reserves, which are estimated at 40% of the world total (IEA, 2008), should be developed more aggressively. Although expensive to develop, geothermal energy is clean and abundant. In August 2014, the House of Representatives approved a revised geothermal law allowing for the exploitation of geothermal sources in the country's conservation forests. It also returned the power to issue permits or conduct tenders related to geothermal energy exploitation to the central government. As the new regulatory environment becomes operational, the government should accelerate the exploration and tendering of new geothermal projects. In order to attract investors the ceiling price for electricity generated from geothermal power plants should be raised. Other underutilised renewable energies include hydropower and solar. Given agriculture's important role, the potential for biomass is also vast, as any unused agricultural by-product is potentially biomass. Several initiatives have already begun, such as the recent signing of an agreement between state-owned energy companies and General Electric for the development and deployment of biomass gasification systems.

Recommendations for making the most of natural resources while preserving the environment

Key recommendations

- Refocus the mineral ore export ban based on an evaluation of the costs and benefits of onshore processing for each mineral. Provide infrastructure and electricity to the new smelters.
- Increase agricultural productivity by providing technical assistance and training, including through agreements between smallholders and large estates. Increase farmers' access to credit by accelerating land titling. Lower food prices by decreasing trade restrictions.
- Devote more resources to enforcing laws against illegal forest clearing, logging and mining.
- Reduce greenhouse gas emissions by further developing clean power, especially geothermal.

Bibliography

- Australian Bureau of Statistics (2015), *ABS Database*, available at www.abs.gov.au/.
- ADB (2015), Asian Development Bank: Asia Bonds Online, <http://asianbondsonline.adb.org>, accessed 25 February.
- BAPPENAS (2013), *Public-Private Partnerships: Infrastructure Projects Plan in Indonesia 2013*, Badan Perencanaan Pembangunan Nasional (Bappenas), <http://pkps.bappenas.go.id/attachments/article/1154/PPP%20BOOK%202013.pdf>.

- BAPPENAS (2015), *Medium Term National Development Plan (RPJMN) 2015-2019*.
- BBVA (2015), *Mexico Banking Outlook, January 2015*, www.bbva.com/wp-content/uploads/2015/02/1501_MexicoBankingOutlook_Jan15.pdf.
- Bloomberg (2013), “World’s Most Profitable Banks in Indonesia Double U.S. Returns”, 5 February.
- CRED (2015), Centre for Research on the Epidemiology of Disasters EM-DAT: International Disaster Database. www.emdat.be/database, accessed 25 February.
- Davis, L. (2014), “The Economic Cost of Global Fuel Subsidies”, *American Economic Review: Papers & Proceedings*, Vol. 104, Iss. 5, pp. 581-585, May.
- Demirguc-Kunt, A. and L. Klapper (2013), “Measuring Financial Inclusion – Explaining Variation Across and Within Countries”, www.brookings.edu/~media/Projects/BPEA/Spring-2013/2013a_klapper.pdf?la=en.
- Dutu, R. (2015), “Decomposing Shocks to the Indonesian Business Cycle Using an Estimated DSGE Model”, *Technical Background Paper* (forthcoming).
- Energy and Mining Journal (2012), “Transforming the Nation’s Mining Industry. Indonesian Coal Giants Look to Take the Next Step”, pp. 52-59.
- FAOSTAT (2015), FAOSTAT Database, available at <http://faostat3.fao.org/faostat-gateway/go/to/home/E>.
- Fenochietto, R. and C. Pessino (2013), “Understanding Countries’ Tax Effort”, *IMF Working Paper*, WP/13/244.
- Fraser Institute (2013), *Survey of Mining Companies 2012/2013*, Vancouver.
- Hidrobo, M., J. Hoddinott, A. Peterman, A. Margolies and V. Moreira (2014), “Cash, Food, or Vouchers? Evidence from a Randomized Experiment in Northern Ecuador”, *Journal of Development Economics* Vol. 107, pp. 144-156.
- IEA (2008), *Energy Policy Review of Indonesia*, OECD/IEA Publishing.
- IEA (2013), *CO₂ Emissions From Fuel Combustion Highlights 2013*, OECD/IEA Publishing.
- IMF (2013), “Indonesia Staff Report for the 2013 Article IV Consultation”, *Country Report*, No. 13/362.
- Jakarta Post (2013), “REDD+ Agency to Begin Work Soon”, 20 December.
- Jeon, S. (2013), “Agricultural Transformation and the Escape from the Middle-Income Country Trap: Challenges Facing Small Farmers in Indonesia in a Time of Green Restructuring”, PhD thesis, The Graduate Institute, Geneva.
- Johansson, A., Y. Guillemette, F. Murtin, D. Turner, G. Nicoletti, C. de la Maisonnette, G. Bousquet and F. Spinelli (2013), “Long-Term Growth Scenarios”, *OECD Economics Department Working Papers*, No. 1000, OECD Publishing.
- Leigh, A. and P. van der Eng (2009), “Inequality in Indonesia: What Can We Learn from Top Incomes?”, *Journal of Public Economics*, Iss. 1-2, Vol. 93, pp. 209-12, February.
- Martini, M. (2012), “Causes of Corruption in Indonesia”, *Transparency International U4 Expert Answer*, 7 August, No. 338, www.u4.no/publications/causes-of-corruption-in-indonesia/downloadasset/2890.
- OECD (2012a), *Education at a Glance 2012: OECD Indicators*, OECD Publishing.
- OECD (2012b), “Indonesia: Government Capacity to Assure High Quality Regulation”, *OECD Reviews of Regulatory Reform*, September, OECD Publishing.
- OECD (2012c), *OECD Review of Agricultural Policy, Indonesia*, OECD Publishing.
- OECD (2012d), *OECD Economic Surveys: Indonesia*, OECD Publishing.
- OECD (2014a), *Toward Green Growth in Emerging and Developing Asia*, Chapter 2, OECD Publishing.
- OECD (2014b), *Measuring Innovation in Education: A New Perspective*, OECD Publishing.
- OECD (2014c), *Transitory Food Insecurity in Indonesia*, OECD Publishing.
- OECD (2015), *Education Policy Review of Indonesia 2015*, OECD Publishing.
- RBA (2013), “East Asian Corporate Bond Markets”, *Reserve Bank of Australia Bulletin – September Quarter*.
- Rinaldi, T., M. Purnomo and D. Damayanti (2007), *Fighting Corruption in Decentralised Indonesia*, The World Bank, Jakarta.
- Rock, M. (2007), “Corruption and Democracy”, *United Nations/Department of Economic and Social Affairs Working Paper*, No. 55, August.

- Stapleton, T. (2013), "Unlocking the Transformative Potential of Branchless Banking in Indonesia", *Bulletin of Indonesian Economic Studies*, Vol. 49, No. 3, pp. 55-80.
- Timmer, C. (2014), "Rice Price Stabilization in Indonesia: A Century-Long Perspective", presentation to World Bank conference "Food Price Volatility, Food Security and Trade Policy", 18-19 September.
- UNICEF (2012), *Indonesia: Annual Report 2012*, New York.
- USAID (2013), *Economic Effects of Indonesia's Mineral-Processing Requirements for Exports*, April, Washington, DC.
- USCS (2012), "Doing Business in Indonesia: 2012 Country Commercial Guide for U.S. Companies", US Commercial Service and US State Department, Washington, DC.
- WJP (2014), "WJP Rule of Law Index 2014", World Justice Project, Washington, DC.
- World Bank (2012a), *Indonesian Economic Quarterly*, October, Washington, DC.
- World Bank (2012b), *India Economic Update*, September, Washington, DC.
- World Bank (2013a), *Indonesia Economic Quarterly FY13*, May, Washington, DC.
- World Bank (2013b), *Spending More or Spending Better: Improving Education Financing in Indonesia*, March, Washington, DC.
- World Bank (2014a), "Why Is Reducing Energy Subsidies a Prudent, Fair, and Transformative Policy for Indonesia?", *Economic Premise*, No. 136, Washington, DC.
- World Bank (2014b), "Investment in Flux", *Indonesian Economic Quarterly*, March, Washington, DC.
- World Bank (2014c), "The Opportunities of Digitizing Payments: How Digitization of Payments, Transfers, and Remittances Contributes to the G20 Goals of Broad-Based Economic Growth, Financial Inclusion, and Women's Economic Empowerment", World Bank Development Research Group.
- World Bank (2014d), "Delivering Change", *Indonesian Economic Quarterly*, December, Washington, DC.



From:
OECD Economic Surveys: Indonesia 2015

Access the complete publication at:
https://doi.org/10.1787/eco_surveys-idn-2015-en

Please cite this chapter as:

OECD (2015), "Assessment and recommendations", in *OECD Economic Surveys: Indonesia 2015*, OECD Publishing, Paris.

DOI: https://doi.org/10.1787/eco_surveys-idn-2015-3-en

This work is published under the responsibility of the Secretary-General of the OECD. The opinions expressed and arguments employed herein do not necessarily reflect the official views of OECD member countries.

This document and any map included herein are without prejudice to the status of or sovereignty over any territory, to the delimitation of international frontiers and boundaries and to the name of any territory, city or area.

You can copy, download or print OECD content for your own use, and you can include excerpts from OECD publications, databases and multimedia products in your own documents, presentations, blogs, websites and teaching materials, provided that suitable acknowledgment of OECD as source and copyright owner is given. All requests for public or commercial use and translation rights should be submitted to rights@oecd.org. Requests for permission to photocopy portions of this material for public or commercial use shall be addressed directly to the Copyright Clearance Center (CCC) at info@copyright.com or the Centre français d'exploitation du droit de copie (CFC) at contact@cfcopies.com.