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Policies for inclusive  
and sustainable growth  
in Indonesia

**Petar Vujanovic**

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**POLICIES FOR INCLUSIVE AND SUSTAINABLE GROWTH IN INDONESIA**

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**By Petar Vujanovic**

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## ABSTRACT/RÉSUMÉ

### Policies for Inclusive and Sustainable Growth in Indonesia

Indonesia has a very good record of poverty reduction, having halved its incidence over the past two decades. Nevertheless, almost 30 million people still live below the national poverty line, mostly in rural areas and in certain provinces. In order to make further progress in lifting these people out of poverty and economic vulnerability, policy needs to focus on generating strong, inclusive and sustainable growth. Pro-poor growth can assist in the process of economic convergence by facilitating the migration of workers out of the low-productivity agricultural sector into the industry and services sectors. By putting in place the right fundamentals, such as a well-designed and inclusive education system, efficient infrastructure and a stable macroeconomic environment, Indonesia will have decades of strong growth ahead by virtue of economic convergence with frontier countries. This has the potential to lift millions more out of poverty without exacerbating income inequality. Moreover, it will set Indonesia up for the next phase of innovation-driven growth that will propel it into the ranks of high income countries. While existing poverty reduction programmes have become increasingly effective, more resources are required, and efficiency could be further enhanced, especially through better targeting. The distribution of income has become markedly more unequal over the past decade and needs to be kept in mind when formulating growth policies.

This Working Paper relates to the 2015 *OECD Economic Survey of Indonesia* ([www.oecd.org/eco/surveys/economic-survey-indonesia.htm](http://www.oecd.org/eco/surveys/economic-survey-indonesia.htm))

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*Keywords:* Indonesia, poverty, income distribution, inequality, social security, inclusive growth, sustainable growth, convergence, education, infrastructure, productivity, middle income trap

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### Des politiques en faveur d'une croissance inclusive et durable en Indonésie

L'Indonésie a obtenu de très bons résultats en matière de réduction de la pauvreté, dont l'incidence a été divisée par deux au cours des vingt dernières années. Néanmoins, presque 30 millions d'Indonésiens vivent toujours en dessous du seuil national de pauvreté, dont la majorité dans des zones rurales et dans certaines provinces. Pour qu'il soit possible de continuer à aider ces populations à sortir de la pauvreté et de la vulnérabilité économique, l'action publique doit viser en priorité à susciter une croissance forte, inclusive et durable. L'instauration d'une croissance favorable aux pauvres peut rendre plus aisé le processus de convergence économique en facilitant le redéploiement des travailleurs du secteur agricole, à faible productivité, vers l'industrie et les services. Pour autant qu'elle mette en place les fondamentaux adéquats, comme un système éducatif bien conçu et inclusif, des infrastructures efficaces et un environnement macroéconomique stable, l'Indonésie aura devant elle des décennies de forte croissance en vertu de la convergence économique avec les pays frontières. Une telle évolution a le potentiel d'aider des millions de personnes à sortir de la pauvreté sans accentuer les inégalités de revenus. De plus, l'Indonésie sera ainsi bien placée pour aborder la phase suivante, celle de la croissance tirée par l'innovation, lui permettant ainsi de se hisser aux rangs des pays à haut revenu. Par ailleurs, les programmes existants de réduction de la pauvreté sont devenus de plus en plus efficaces, mais des ressources supplémentaires sont nécessaires, et l'efficacité pourrait être encore améliorée, notamment grâce à un meilleur ciblage. La distribution des revenus est devenue sensiblement plus inégale au cours de la dernière décennie et il conviendra de ne pas perdre cet élément de vue lors de la formulation des politiques en faveur de la croissance.

Ce Document de travail se rapporte à l'Étude économique de l'OCDE de l'Indonésie, 2015 ([www.oecd.org/fr/eco/etudes/etude-economique-indonesie.htm](http://www.oecd.org/fr/eco/etudes/etude-economique-indonesie.htm))

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*Mots clefs :* Indonésie, pauvreté, distribution des revenus, inégalités, sécurité sociale, croissance inclusive, croissance soutenable, convergence, éducation, infrastructures, productivité, piège du revenu intermédiaire

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## POLICIES FOR INCLUSIVE AND SUSTAINABLE GROWTH IN INDONESIA

By Petar Vujanovic<sup>1</sup>

### Introduction

With per capita income of around USD 9 300, Indonesia has barely exited the ranks of the low middle-income cohort of countries. By continuing to put in place the right policies, it can enjoy many more years of rapid per capita growth by virtue of economic convergence. This catch-up process happens as economic factors (labour, in particular) move from low productivity largely informal sectors (like agriculture) to higher-productivity sectors, and as firms emulate their foreign counterparts by importing and adapting more advanced technologies and production processes. This transfer and diffusion of technology can be further facilitated by attracting foreign direct investment (FDI).

Part of Indonesia's challenge in sustaining convergence is to manage the "curse" of its generous endowment of natural resources (Working Paper No. 1236). While its comparative advantage in natural resources cannot be denied, it should not be allowed to distort the reallocation of resources into other productive sectors, and rent seeking should be minimised by ensuring that the dividends flowing from it are utilised for the long-term economic betterment of all Indonesians. However, this needs to be managed very carefully so as not to discourage further development in the commodities sector.

Another challenge for Indonesia is to make growth inclusive, that is, to ensure that its fruits are shared equitably and that social cohesion and poverty reduction remain high on the policy agenda. Indeed, over recent decades poverty in Indonesia has fallen significantly, thanks to strong and steady economic growth, declining joblessness, rising incomes and poverty-alleviation programmes that have become increasingly effective. However, despite this impressive performance, Indonesia has a long way to go in further lowering the incidence of poverty, which remains widespread. Indeed, compared to the group of countries clustered around Indonesia's per capita income level, its poverty rate is relatively high. While an efficient, responsive and well-targeted social safety net is extremely important, particularly for protecting economically vulnerable households, more fundamental reforms are also critical. The focus must be on the

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1. Petar Vujanovic is the Head of the Indonesia Desk at the Economics Department of the OECD in Paris, France. This paper is based on Chapter 1 of the 2015 OECD Economic Survey of Indonesia published in March 2015, under the authority of the Economic and Development Review Committee (EDRC). The author is grateful to Alvaro Pereira, Robert Ford, and Peter Jarrett for their guidance. The author is thankful to Richard Dutu, James Sheppard, Victor Duggan, Elizabeth Fordham, Yuki Murakami, Yuri Belfali, Clarisse Legendre, Richard Yelland, Shingo Kimura, Jesus Anton, Andrzej Kwiecinski, Trudy Witbreul, Franck Van Tongeren, Caroline Paunov, as well as Indonesian government officials and members of the EDRC for their valuable comments and suggestions. The author would also like to thank Anne Legendre for statistical research and Mee-Lan Frank, Dacil Kurzweg and Krystel Rakotoarisoa for technical preparation.

formulation and implementation of policies and strategies that enable the poor to participate in and benefit from economic growth.

### **Stable and sustainable growth**

With its abundant natural resources and large and youthful population located in the most dynamic part of the world, Indonesia has plenty of scope for economic catch-up over the coming decades. By continuing to put in place the right fundamental policies that best harness its generous resource endowment, both natural and human, Indonesia should enjoy decades of strong growth that could lift it into the ranks of the upper-middle-income group of countries. Growth is a vital ingredient in tackling poverty, and with poverty still widespread, even when compared to other countries at similar levels of per capita income, sustained and robust growth will be needed to make inroads into poverty across the archipelago.

The challenge will be to sustain long periods of strong and stable growth that is inclusive and pro-poor. In this phase of Indonesia's development, a critical element for reducing poverty is growth that is jobs-rich – particularly in the employment of unskilled labour. In the long run, the main requirement for both growth and poverty reduction is undoubtedly education. However, the temptation for quick fixes and moving too quickly needs to be avoided. Policies that ignore the country's comparative advantages and advocate a “great leap forward” in industrial development are misguided. Only by putting in place a fundamental basis for economic development and transformation will the economy progress. Industrial policies, in the absence of the prerequisite and complementary human capital and infrastructure, will not generate the desired results. Policy reforms need to be focused on equipping the economy for the next phase of development – by boosting the human capital of all Indonesians and increasing investment in infrastructure throughout the country. In this way growth will be both sustainable and inclusive.

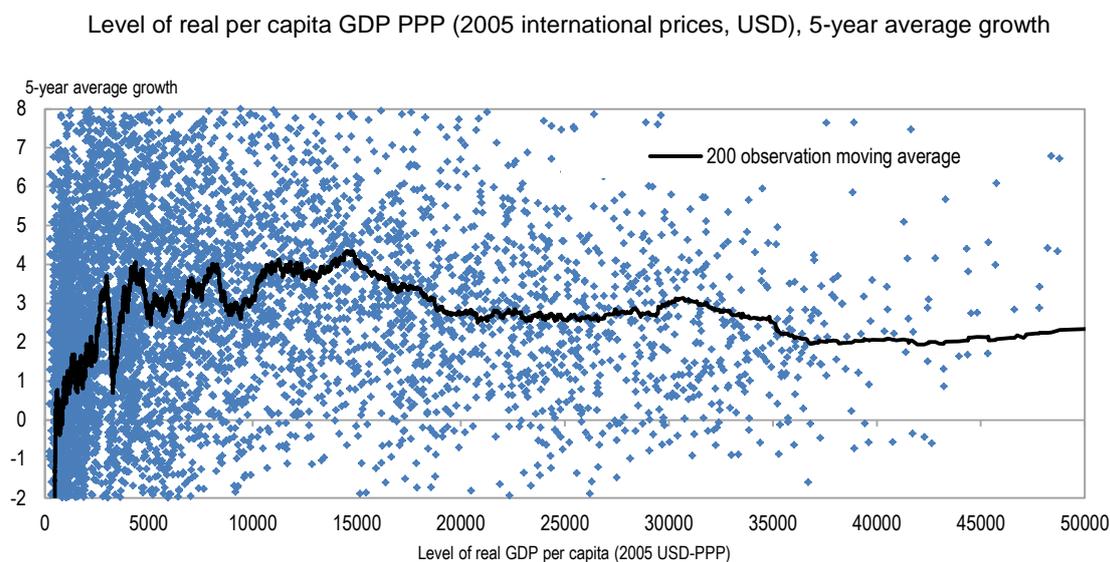
Macroeconomic stability is paramount for poverty reduction, given that output declines caused by economic crises are the biggest source of long-lasting welfare losses among developing countries. On average, it takes 6-12 years for per capita GDP to return to pre-crisis levels after an initial output drop (IMF, 2012). With a large share of Indonesians clustered around the poverty line, many are vulnerable to economic shocks that can tip them into poverty. It is critical that Indonesia continues to build policy frameworks that minimise the frequency and amplitude of economic cycles by avoiding home-made crises and by strengthening the economy's resilience in the face of external shocks. The large deterioration in the current account balance starting in mid-2011 was a case in point. That episode threatened to plunge Indonesia into crisis, and this uncertainty precipitated volatile capital outflows, a very large depreciation in the currency and a sense of vulnerability among policy makers that led to a number of unwise policy choices. In the end, in the most important domains the right choices were made: the currency was allowed to depreciate, helping to address international competitiveness issues; and interest rates were increased to tackle the imported inflation and to dampen import demand.

### ***Economic convergence and the “middle income trap”***

The idea that the country is confronting a so-called “middle-income trap” has gained currency among some Indonesian politicians and policymakers. On this view at a certain threshold level of per capita income countries encounter a barrier and growth stagnates, preventing progress to high-income status. In a recent study Shekhar et al. (2013) show that growth-slowdown episodes are disproportionately likely to occur in middle-income countries. Eichengreen et al. (2013) find two “traps”, one at the USD 10 000 to USD 11 000 per capita income range and another at USD 15 000 to USD 16 000, both far higher than Indonesia's current level. These thresholds are in PPP constant 2005 USD. By this measure, in 2011 Indonesia was at 4 300 USD per capita; a considerable distance from these thresholds.

Figure 1, which plots five-year average growth rates against levels of real per capita GDP for the 164 countries in the *Penn World Tables Database*, confirms the existence of an apparent threshold at just below USD 15 000 after which growth tends to slow down. However, there does not seem to be any evidence of a cluster or logjam of countries “trapped” below this threshold. Growth slows down, that is clear, but countries typically continue to progress, albeit more slowly, up the rungs of the income ladder.

Figure 1. Per capita GDP growth and levels



Source: Penn World Tables 8.0 and OECD calculations.

In a similar vein, Rodrik (2011) argues that economic convergence is not preordained and depends on sustaining rapid structural change in the direction of tradables such as manufacturing and modern services. He finds that low-productivity countries tend to enjoy faster productivity growth in the industrial sector while catching up with frontier countries. Importantly, he finds that this catch-up is not conditional on country characteristics – the industry sector in any country enjoys this catch-up regardless of the particular features of that country; that is to say, industrial-sector convergence is unconditional. Eichengreen et al. (2013) find that slowdowns are less likely in countries where the population has a relatively high level of secondary and tertiary education and where high-technology products account for a relatively large share of exports. Shekhar et al. (2013) try to identify the determinants of growth slowdowns for middle-income countries, showing that factors such as institutions, demography, infrastructure, macroeconomic environment and policies, economic and trade structure all have some influence on the probability of a slowdown.

In contrast, the World Bank’s (1993) report *The East Asian Miracle* analysed the East Asian Tigers’ catch-up growth (economic convergence), and some of its conclusions are relevant to the “middle-income trap”. Contrary to the emphasis some put on policies to foster high-tech manufacturing, the Bank stressed the need to “get the basics right”: macroeconomic stability, relatively low distortions to domestic competition, openness to external trade, broad-based and effective education, flexible labour markets and adequate investment in tangible infrastructure. The report argued that these fundamental “horizontal”, economy-wide policies are far more important than “vertical” industrial policies that promote favoured sectors and national champions. It accepted that convergence is conditional on country fundamentals, and putting these fundamentals in place allows growth convergence to higher income levels by allowing the maximum mobilisation of capital and labour inputs, and large productivity gains from efficient resource reallocation. For middle-income countries, additional reforms are advocated that go beyond liberalisation of product markets to encompass deregulation of factor markets, opening up of services sectors, upgrading

“soft infrastructure” (such as higher education and skills) and improving the quality of public administration, regulatory agencies and judicial systems. These lift the convergence frontier even further and pave the way for the subsequent mode of catch-up – namely productivity – and innovation-based growth.

Overlaying these arguments is the idea that countries should focus economic resources in sectors where they have a comparative advantage. In the case of a commodity rich country like Indonesia, this would be mining, forestry and agriculture. The argument here is that policies that direct resources away from sectors in which the country enjoys a comparative advantage can have a large opportunity cost and will lower national welfare. And, indeed, industry policies that promote certain favoured sectors, before the economic prerequisites, like skills and infrastructure, are in place are inefficient and wasteful. Instead, efforts should be focused on fundamental “horizontal”, economy-wide policies that improve the general efficiency of the economy, including the sector in which there is a comparative advantage.

However, this static policy proscription seems unfair in the opinion of many developing country policy makers. For example, Chang (2002) argues that the principle of comparative advantage may have helped developed countries maintain relatively advanced technology and industry compared to developing countries. The author argues that all major developed countries used interventionist and protectionist economic policies in order to get rich, and these countries now try to dissuade other countries from following the same pattern of development. This leaves developing countries lagging behind, and polarisation of wealth becomes entrenched. Chang asserts that premature free trade has been one of the fundamental obstacles to the alleviation of poverty in the developing world.

The fundamental question is whether comparative advantage is immutable, and, if not, to what extent is trying to manipulate comparative advantage distortionary and wasteful. Many economists, such as Chang (2002) and Rodrik (2011) believe that the only way to escape the “middle income trap” is with policies that actively promote sectors higher up the technology scale and in which the local value-added component is larger. However, while “getting the prices wrong” (interventionist) policies (Amsden, 1989; Wade, 1990; Rodrik, 1995) might be the way to go, without the accompanying fundamental reforms, these are likely to be very costly, both fiscally and in terms of opportunity cost. A successful, self-sustaining, export-focused manufacturing sector will not succeed without an efficient and well-functioning economic foundation upon which to build. This includes a well-educated workforce, well-functioning legal and economic institutions, minimum corruption, good transport and other infrastructure, and an efficient business service sector.

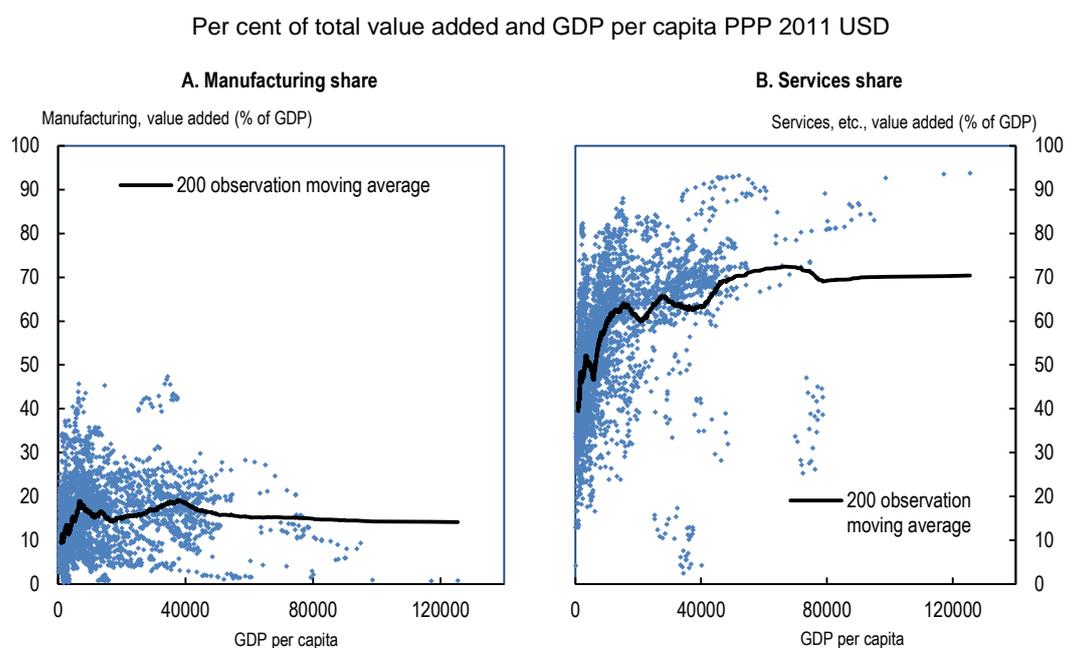
Global value chains (GVCs) build on the idea of comparative advantage. Close integration into GVCs allows countries to specialise in particular segments of global manufacturing chains and thereby reap a share of the value added embodied in these manufactured goods (OECD, 2013b). This very much works to the advantage of countries that in the past would have missed out on the benefits and their associated positive externalities, because developing domestic manufacturing would have involved co-locating many of the contiguous links in the chain locally. But many developing countries are unable to do this due to a lack of the prerequisite skills or infrastructure. Integration into GVCs gives countries a foothold in global manufacturing best practice, starting with those links in the chains for which they have a comparative advantage. But, once again, in order to integrate into GVCs it is critical to have the right fundamentals in place. These include minimal trade distortions, policies to promote innovation, skills and infrastructure, and a flexible service sector that facilitates co-ordination of GVC manufacturing links and processes. Indonesia’s integration into GVCs is discussed in more detail below.

### *Economic convergence and structural change*

It is clear that economic convergence involves structural change. The significance of the agricultural sector shrinks dramatically as productivity rises and resources shift to manufacturing and especially services. After about USD 10 000 per capita (PPP constant 2011 USD), very few countries have an agricultural sector larger than 15% of total value added. On average, the share of manufacturing plateaus at around 20% of total value added – poorer countries do indeed have smaller manufacturing sectors, but its share peaks at income levels of around USD 9 000 per capita (Figure 2, Panel A). Moreover, a large manufacturing sector is not associated with higher per capita growth. The feature of sectoral shares that is unequivocally associated with higher GDP per capita is the services sector (Panel B) – the share of services in total value added keeps increasing with respect to GDP per capita. Indeed, since 1960 no country (except Equatorial Guinea) has exceeded USD 30 000 per capita GDP without a services sector accounting for more than 55% of total value added. Indonesia’s services share of just 38% in 2012 lags most other countries in its per capita GDP cohort. In contrast, its manufacturing share of around 24% is just above the average for its per capita GDP cohort.

The current structure of the Indonesian economy reflects its comparative advantage in agriculture and natural resources. Agriculture’s share of output has declined from around 45% in 1970 to around 14% in 2012, still large by comparison with other comparable countries (Table 1), although in line with its level of GDP per capita (Figure 3, Panel A). Its share of total employment, at around 36%, is even larger, reflecting the sector’s low productivity. Similarly, non-manufacturing industry’s share of GDP is relatively large and has increased over the past 40 years, which, as in Chile, reflects the growth of the mining sector. Indonesia has also had a significant increase in the share of manufacturing, especially from the mid-1980s. However, since the turn of the century manufacturing’s share has started to decline as a result of the growing dominance of the mining sector. The services sector on the other hand has been stagnant in terms of its share of GDP over the past four decades (Panel B).

Figure 2. **Sectoral shares and real GDP per capita**<sup>1</sup>



1. Sample between 1960 and 2012, for all 214 countries in the World Bank WDI database except major oil exporters.

Source: World Bank, *World Development Indicators*.

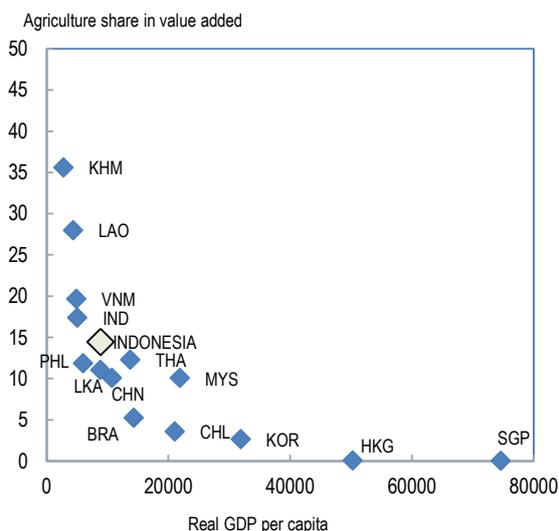
Table 1. Economic structure for selected countries  
1970 and 2012

		Agriculture	Industry (less manufacturing)	Manufacturing	Services
Indonesia	1970	44.9	8.4	10.3	36.4
	2012	14.4	23.0	23.9	38.6
Brazil	1970	12.3	9.0	29.3	49.4
	2012	5.2	13.0	13.3	68.5
Chile	1970	6.9	16.1	25.9	51.1
	2012	3.6	24.5	11.0	60.9
China	1970	35.2	6.7	33.7	24.3
	2012	10.1	14.3	32.5	43.2
India	1970	42.0	6.8	13.7	37.6
	2012	17.4	12.2	13.5	56.9
Korea, Rep.	1970	29.3	8.2	17.8	44.7
	2012	2.6	8.1	31.1	58.2
Malaysia	1970	29.4	15.0	12.4	43.2
	2012	10.1	16.6	24.2	49.1
Philippines	1970	29.5	7.0	24.9	38.6
	2012	11.8	10.5	20.5	57.1
Thailand	1970	25.9	9.4	15.9	48.8
	2012	12.3	9.6	34.0	44.2

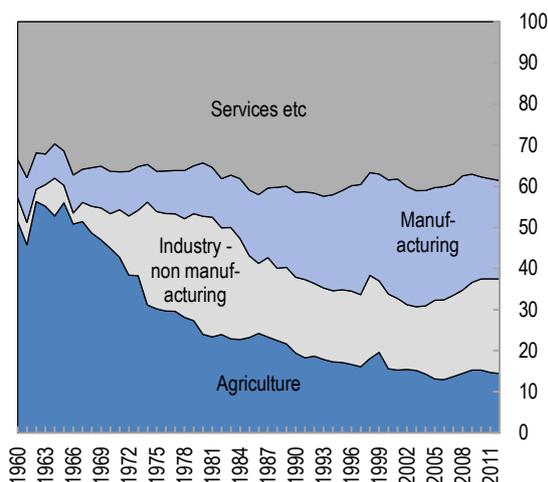
Source: World Bank, World Development Indicators.

Figure 3. Shares of total valued added

A. Agriculture's share of total value added and real per capita GDP (PPP 2011 USD)



B. Indonesian sectorial shares of total value added Per cent



Source: World Bank, World Development Indicators.

The services sector is also expected to expand as the middle class grows, boosting demand for social services, like health and education, and as the retail sector grows and the economy becomes more formalised. Continued urbanisation will also drive this process. Tourism is a service sector in which Indonesia has a strong comparative advantage and which has the potential to generate strong jobs growth

(Box 1). Putting in place policies that facilitate this transformation and avoiding those that hinder it needs to continue. The first half of this paper goes through a number of areas that deserve particular attention from Indonesian policymakers if the process of economic convergence is to continue to drive sustainable and inclusive growth.

#### Box 1. **Tourism in Indonesia**

In 2012, the tourism sector contributed 3.9% to the national economy. After about 10 years of stagnation, international tourism has been growing quickly and continuously since the mid-2000s. In 2013, the number of foreign tourist arrivals increased by 9.4% to 8.8 million but was accompanied by a slight decline in the average length of stay. Nevertheless, the contribution of foreign tourists to Indonesia's foreign exchange earnings has increased steadily to reach USD 9.1 billion in 2012. Indeed, tourism is the country's fifth largest foreign currency earner.

Domestic tourism is also increasing. In 2012, the number of domestic tourist trips was estimated at 245.3 million, with average expenditure of IDR 700 000 (USD 62) per trip. This growth is being driven by rising household incomes and the promotional campaign "Know and Love Your Country", as well as the growing number of national tourism attractions and events. The 2012 budget for the Ministry of Tourism and Creative Economy was IDR 2 730 billion (USD 242 million), a 62.5% increase on 2010

Despite having the potential to be a major tourist destination for the rapidly growing Asian middle class, there are obstacles to further growth, such as poor infrastructure, lack of tourist facilities and concerns about safety. In its 2013 travel and tourism competitiveness index, which ranks nations according to their ability to develop their tourism industries, the World Economic Forum ranked Indonesia 70th out of 140 countries (OECD, 2014c).

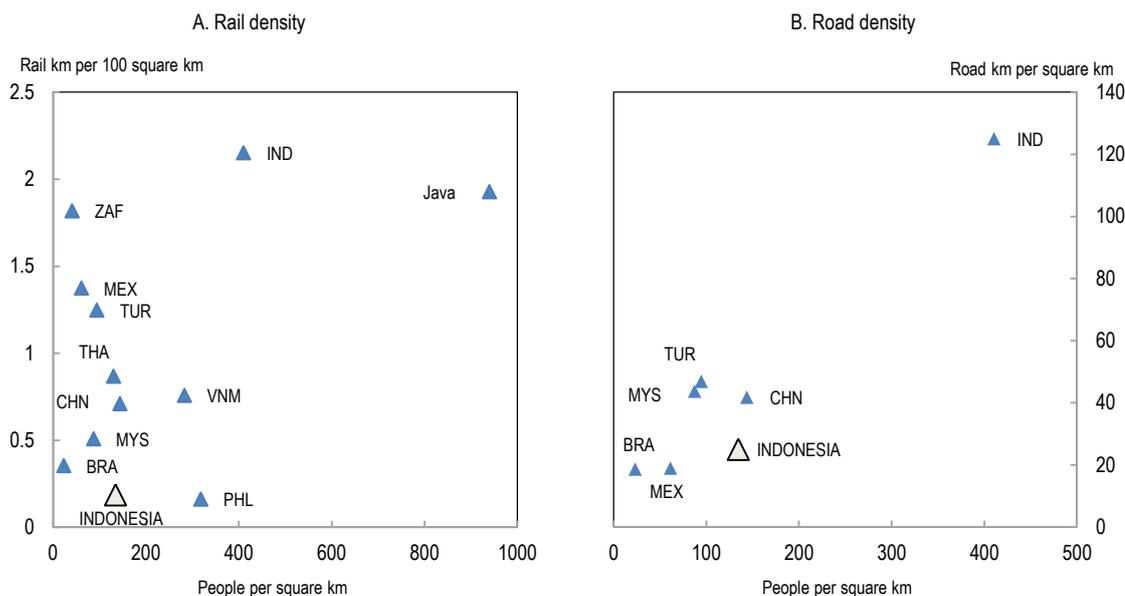
### ***Infrastructure***

Good-quality infrastructure is a key ingredient for inclusive and sustainable economic growth. The *2010 Survey* (OECD, 2010b) highlighted the urgent need to step up infrastructure investment. In the three years immediately prior to the Asian Crisis infrastructure spending averaged around 9% of GDP, but since 1999 the average has only been around 4% (World Bank, 2012c). The lack of infrastructure, and the poor quality thereof, has long been seen as the biggest hindrance to continued economic development. Intercity road transport is overburdened, and traffic jams in the major cities, particularly in Jakarta, are major impediments to doing business. Air pollution is also a serious health issue. Furthermore, both road and rail networks are considerably smaller than what Indonesia's population density would call for compared to other emerging economies (Figure 4). However, this comparison may not be fair given that Indonesia is a scattered archipelago, and population densities vary greatly across the islands. Indeed, around three-quarters of the country's total rail track length is located in the most densely populated island, Java. Only 10% of railway lines are electrified. Local governments play an important role with regards to roads, with around 80% of the network's total length presently under their responsibility. Furthermore, the provision of infrastructure is a major factor in improving health and tackling poverty and deprivation, including through the provision of drinking water and modern sanitation.

A lack of power generating capacity is also inhibiting capital investment, and delays at the country's outdated airports and ports are increasing the cost of international trade. Given the opportunities offered by integration into GVCs, both in terms of generating well-paid jobs and boosting high-valued added exports, efficient communication and logistics are extremely important. Indeed, the situation in ports is deteriorating, with average import container dwell time at Tanjung Priok Port in Jakarta, which handles two-thirds of Indonesia's international trade, increasing from 4.8 days in 2010 to 6.4 days in 2013 (World Bank, 2014a). Moreover, the two main container terminals in Tanjung Priok, which together account for 70% of all Indonesian container traffic, are both operated by the same joint venture. This means that there is virtually no intra-port competition (OECD, 2014b). This leads to high logistics costs for firms, which are

then passed onto consumers and businesses in higher prices. The World Bank (2013) estimates that logistics costs across Indonesia account for some 24% of GDP – an enormous tax on Indonesia’s economic growth – while LPEM (2005) estimates that logistics account for 14% of total production costs, significantly higher than Japan’s 5%. The World Bank’s 2014 Logistics Performance Indicator (LPI) report ranks Indonesia 53th out of 160 countries, well behind other middle-income countries in the region. Indeed Indonesia ranks lowest in all sub-components of the LPI, when compared to Malaysia, Singapore, Thailand, China, Chinese Taipei and Vietnam; and particularly poorly in international shipments.

Figure 4. Rail and road networks relative to population density



Source: World Bank, *World Development Indicators*; PT Kereta Api Indonesia (Indonesian Railway).

Numerous studies show the importance of infrastructure in spurring growth, and especially in the manufacturing sector. Moreover, as world-wide manufacturing moves to exploiting GVCs, connectedness is becoming increasingly important. Day and Ellis (2013) show that in Indonesia manufacturing firms benefit from localisation economies and that the “economic distance” between firms is extremely important for fostering growth in this sector. Interestingly, urbanisation itself does not seem to be a positive impetus to growth in this sector.

The recently established 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 improving co-ordination among infrastructure-related government agencies. As the government alone does not have the resources to meet all of the country’s infrastructure needs, the private sector, both domestic and foreign, is expected to play an important role. However, there remain major impediments to expanding the private sector’s role. For instance, Blundell-Wignall and Roulet (2015) show that in the sample of 56 countries Indonesia is the 2nd least open to portfolios flows (after only Argentina) and that this has a significant negative impact on both infrastructure and non-infrastructure business investment across countries. Greater efforts will need to be made to better channel available funds from both public and private 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 flows are all issues that need to be addressed.

The new government has chosen maritime connectivity as one of its major policy focuses. This includes enhancing inter-island links and upgrading port infrastructure. Many of the ports are in poor shape and impede the country's internal and external maritime commerce. The plan is to significantly expand maritime infrastructure to reduce logistics costs, boost economic growth and reduce inequality between Indonesia's more remote eastern islands and the demographic concentrations of the western part of the country. The plan includes the establishment of a minimum of 10 new deep-water ports to connect the far reaches of the archipelago to the rest of the country and the world. In addition to maritime connectivity the new government's other immediate focus will be on irrigation (including dam building), water supply and energy. Funding for these projects would be public, utilising the fiscal space created by the recent cut in fuel subsidies. Giving state-owned enterprises direct access to Official Development Assistance (ODA) funds, under the supervision of the Ministry of Finance, is also being considered.

One positive development in removing barriers to investment in infrastructure was the 2011 Land Procurement for Development in the Public Interest Act ("Land Acquisition Act"). Prior to its enactment, the long process of land acquisition inhibited investment in infrastructure and other business-related fixed investment. The new law allows the government to acquire private land for public works projects and sets out 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 government is strongly promoting the use of public-private partnerships (PPPs) to deliver infrastructure investment. A Presidential Regulation provides the legal framework for PPPs to deliver roads (including toll roads and bridges), irrigation systems, drinking water, waste management, telecommunications, power and oil and gas infrastructure. Indonesia's National Development Planning Agency (BAPPENAS) recently released its latest PPP Book which identified 27 projects worth USD 47.3 billion to be made available to investors from 2014. While progress has been made in establishing the legal framework for PPPs, to date no PPP financing has yet been closed.

As part of the Regulatory Reform Review of Indonesia (2012) the OECD assessed the framework for developing, procuring and managing PPPs. Indonesia thus participated in a peer review process in the OECD Network of Senior PPP Officials based on the Principles for Public Governance of PPPs (2012). 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. 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 these projects, but it remains unclear as to whether the new bodies will play this role. 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).

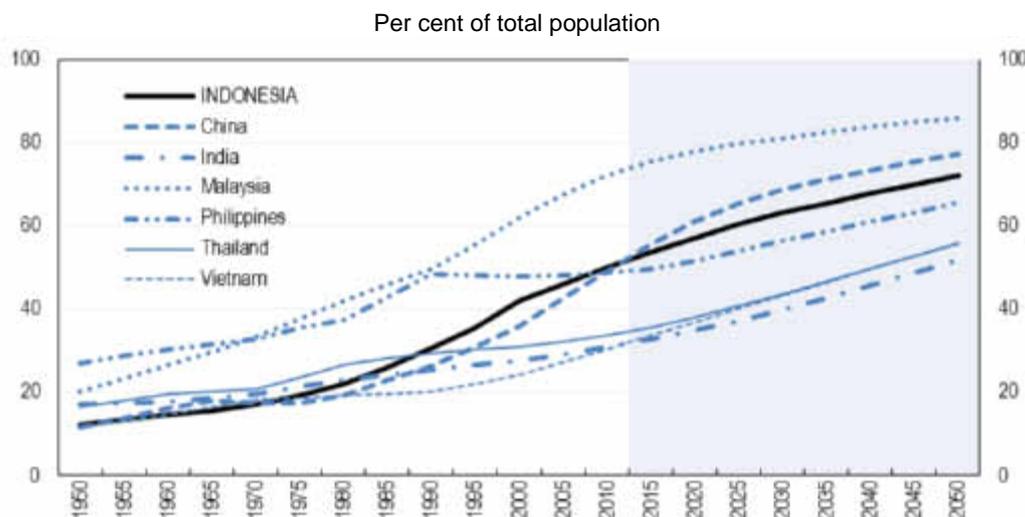
Infrastructure bonds are another avenue that could be pursued. Indonesia could learn from countries like China and Malaysia, which have successfully accelerated the development of infrastructure by issuing bonds, both those issued directly by the government or through state-owned enterprises. In Malaysia they accounted for about 35% of Malaysia's corporate bond issuance in 2006-10, amounting to an average of USD 6 billion per year over this period. Infrastructure bonds are typically long-dated and match the bond's maturity with the lifetime of the infrastructure project. The bonds can be conventional or Islamic, and their principal and coupons can be secured by the assets and cash flow of the infrastructure project. Typically,

infrastructure bonds are structured similarly to project finance loans. There are designated accounts to ring-fence the project's cash flow and assets so that they can be used to meet debt-servicing requirements. Although government guarantees are not involved, infrastructure projects are usually backed by concession agreements (for example, for toll roads) or power purchase agreements. The ratings and pricing of the infrastructure bond take into account factors including the concession/purchase agreement, the strength of the issuer and the integrity of the financing structure.

### Urbanisation

Urbanisation has been and will remain a powerful driver of growth and social change in Indonesia. While agglomeration economies can have positive effects, rapid urbanisation is challenging the capacity of governments and private-sector entities to provide infrastructure and job opportunities. Indonesia has urbanised more quickly than most of its neighbours, and with over 70% of the population expected to live in urban areas by 2050 – up from around 50% currently (Figure 5) – inefficiencies and bottlenecks in cities will become increasingly serious impediments to economic development. Indeed, urbanisation is associated closely with the process relocating out of agriculture into higher-productivity sectors, and urban concentration delivers the benefits of clusters and agglomeration. For example, in Jakarta wages are higher, economic growth is stronger and, while unemployment is not notably lower than other regions, the city continues to draw migrants from rural areas in search of work. Urbanisation is also associated with improving living standards and migration of underemployed farmers to urban areas; their remittances help to lift per capita income in rural areas, helping to limit the rural-urban income gap.

Figure 5. Urbanisation projections



Source: United Nations, Department of Economic and Social Affairs, Population Division (2012). *World Urbanization Prospects: The 2011 Revision*, CD-ROM Edition.

The two largest cities in Indonesia are Jakarta and Surabaya. Jakarta has grown from 2.7 million residents in 1960 to 9.8 million in 2011 (United Nations, 2012), with a density of more than 14 400 people per square kilometre. Surabaya's population was around 2.5 million in 2011, with around 12 500 people per square kilometre. The agglomerations are of course much larger and have been growing much more quickly. Indeed, in the case of Jakarta, the population of the core of the city has actually been shrinking over the past decade due to suburbanisation, while that of the entire Jakarta agglomeration, encompassing Bogor, Tangerang, Depok and Bekasi (abbreviated as Botadabek), has continued to increase rapidly – from

17 million in 1996 to 27 million in 2007. Part of the reason for suburbanisation is that moderate and high-income families have been moving out of the central city to the Botadebek, where amenities are of higher quality (World Bank, 2012a). In addition, poorer Jakartans are relocating to the fringe areas because commercial expansion in the central city has increased rents and reduced space dramatically.

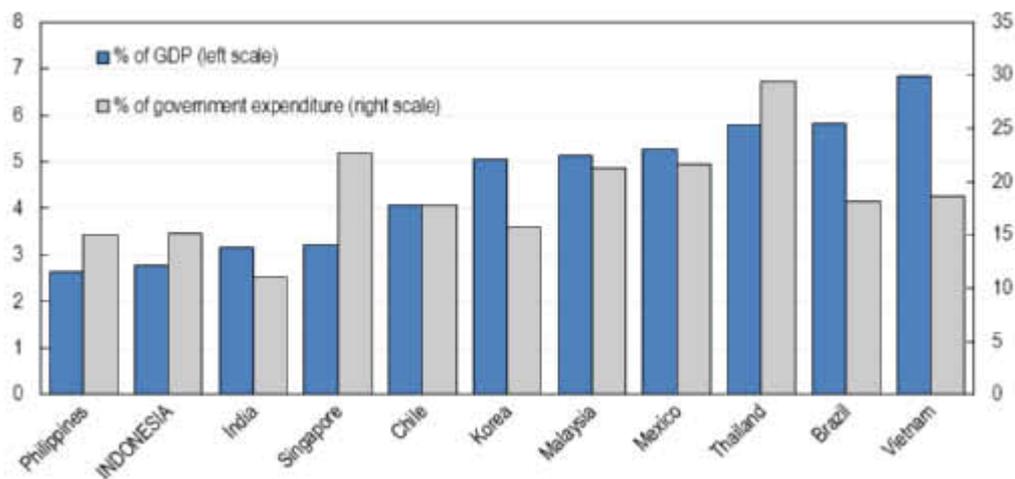
While urbanisation brings considerable benefits, it also has costs. In a number of big cities, and most particularly in Jakarta, traffic congestion is a major headache for citizens and businesses, and periodic flooding plagues the city, causing major disruptions. The new satellite towns have grown rapidly, but road infrastructure has not kept pace, causing massive traffic jams and long commutes for residents. Only now is there some progress in building new metro and elevated roads within Jakarta and adding toll roads that connect the city's suburbs. Large-scale investment in infrastructure is required to facilitate intra-urban links between core and periphery. The new Land Acquisition Act should remove one of the major impediments to building infrastructure. International connectivity also needs to be improved with better ports and airports. Consideration should be given to creating manufacturing estates so as to avoid industrial sprawl. Improvement is needed in the co-ordination across districts and with central government regarding planning and prioritising investments. For Jakarta, expanding the city limits, so as to bring under one political administration many of the urban areas adjoining the city, would help with integrated planning.

### ***Improving human capital formation***

In 2011, the Indonesian government spent around 15% of its total expenditures on education (excluding social assistance schemes). This is a decline over recent years and well below the official 20% floor set in 2002. Nevertheless, the current share of education spending is on a par with many OECD countries, but a little lower than many other emerging economies. As a share of GDP spending on education is only 2.8%. This is low even by developing-country standards (Figure 6) but has increased substantially from around 1% in 1990 and has plateaued over the last decade. Enrolment rates in Indonesia are high at the primary level but drop off at the secondary and particularly the tertiary levels (Figure 7). While these enrolment rates are roughly on a par with other countries at similar per capita income levels, the emphasis should remain on doing as much as possible to promote access to higher education for all young Indonesians. A particular problem is not the drop-out rates within the three levels of non-tertiary education, but rather at the interface between them, specifically at the ages of 12 and 15. Increasing the resources directed at building human capital should be a top priority for Indonesia, especially if it wants to best utilise its abundant supply of labour. Currently Indonesia is being out-performed by countries like Vietnam, China and Thailand in accumulating the human capital needed to facilitate the further emergence of industries that rely on a skilled labour force. 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.

According to the 2012 Programme for International Student Assessment (PISA), 15 year-old Indonesian students score poorly by international standards in mathematics, science and reading. While there has been some improvement over time, Indonesia is ranked second last among the 65 countries that participated, ahead only of Peru. That said, when adjusted for GDP per capita, Indonesia's performance is not out of line with other countries at similar levels of development. Moreover, when accounting for the share of students from disadvantaged backgrounds, Indonesia's performance does not look so bad by international comparison, even though a number of neighbouring countries such as Vietnam and Thailand significantly outperform it in this regard. Another positive feature of Indonesia's PISA 2012 performance is the gender equality in outcomes.

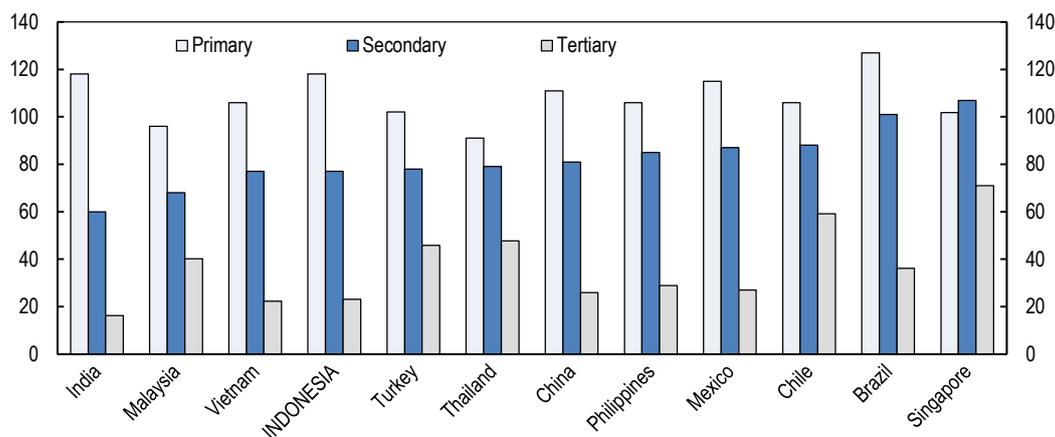
Figure 6. Spending on education in selected emerging economies, 2012



Source: World Bank, *World Development Indicators*.

Figure 7. Enrolment rates in selected emerging economies<sup>1</sup>

Per cent of respective school-age populations



1. Gross enrolment rates are calculated on the basis of standard school-age age cohorts. Enrolment rates over 100 per cent occur because students outside the standard age cohorts may be enrolled at that level of education.

Source: United Nations, *International Human Development Indicators 2013*.

PISA tests 15 year-olds in school, and Indonesia’s low enrolment rates at this age are likely to mean that the academic capacity of the whole age cohort might actually be well below that suggested by PISA. However, in this regard Indonesia performs on a par with peer countries. Enrolment rates at the primary levels are around 120% of the age cohort, and the secondary enrolment rate of around 80% is only a little lower than other countries at a similar level of economic development. Likewise, tertiary enrolment, while low by OECD standards, at around 20% of the age cohort, is also comparable to other emerging economies like India, China, Vietnam and the Philippines. One interesting feature of tertiary enrolment in Indonesia is the relatively low share of Type-B or vocational tertiary enrolment, which is considerably lower than most OECD countries and also much lower than all the other emerging economies for which data are available. Given the success of vocational training in providing a smooth school-to-work transition for non-academic

students in many OECD countries, consideration should be given to boosting the vocational share in tertiary education. These are also skills that are highly valued in the growing industrial and manufacturing sectors.

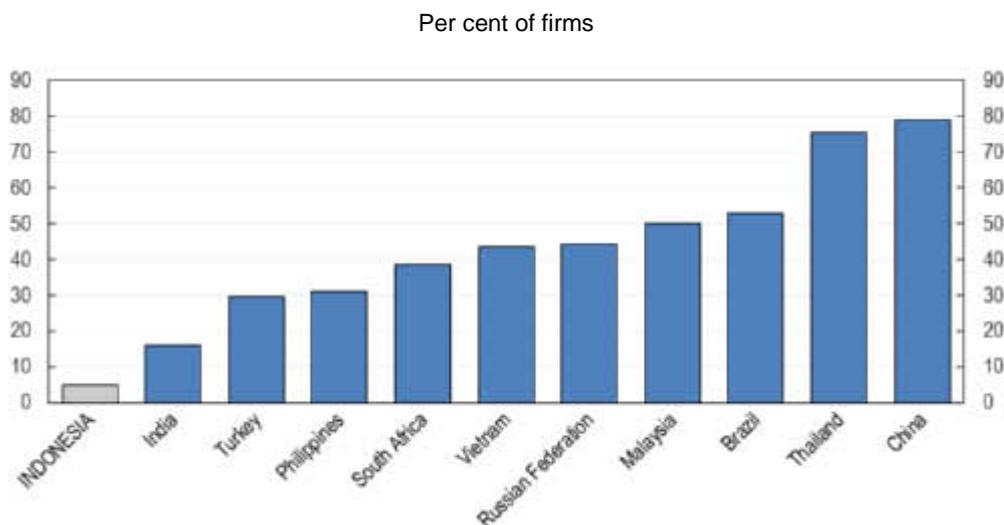
Quality of learning remains a concern in Indonesia, with around one in ten children having to repeat their first year of primary study to attain the required standards (UNICEF, 2012). While class sizes tend to be large compared to OECD countries (OECD, 2012b), increasing the quality of teaching is often a more efficient policy lever to improve student performance than reducing class size. Even though class size may affect how much time and attention a teacher can give to individual students, as well as the social dynamics among students, PISA results suggest that systems prioritising higher teacher quality over smaller classes tend to perform better. This confirms other research that shows that raising teacher quality is a more effective measure to improve student outcomes. For example, while in Japan and Korea, both of which perform strongly in PISA testing, school systems spend comparatively heavily on education, they tend to prioritise teachers' salaries over class size.

Improving the quality of teaching should go hand in hand with regular teacher assessments and increasing teacher salaries. Baedhowi (2009) estimates that around one-third of all elementary school teachers have not undertaken any professional teacher training beyond a high-school diploma, and 76% do not possess an undergraduate degree. Training and retraining is particularly important with the introduction of the *Curriculum 2013* reform, which shifts the emphasis to a “thematic and integrated” approach. The Teacher Law 2005 sets the target that teachers have at least a 4-year Bachelor degree and teaching certificates. Teachers with a Bachelor degree and teaching experience of at least 10 years may apply for teaching certificates by submitting a portfolio of documents to be assessed by a university panel. If the portfolio is assessed to meet the requirements, teachers are awarded a teaching certificate, and receive salary increases. Otherwise teachers are required to take 90 hours of training and then written and performance tests. If teachers pass these tests, they are then awarded teaching certificates; otherwise they are required to repeat the examination. These retraining and certification programmes should be expanded to all 2.8 million Indonesian teachers. Continuous professional development programmes should also be further developed and linked to salary increments and promotion opportunities. Local administrations should also be obliged to better monitor the quality of instruction.

While direct comparison with peer countries is difficult, teacher salaries in Indonesia are comparatively low in relation to average per capita incomes, even compared to low income OECD countries (OECD, 2012b). Moreover, teachers' educational attainment is not positively correlated to their earnings. Teachers with relatively low educational levels are comparatively overpaid, and those with relatively higher educational levels are underpaid compared to other occupations. This implies weak incentives for teachers to upgrade their academic qualifications. In addition, according to a World Bank (2008) study, compared to other occupations with an equivalent education level, teachers earn relatively low incomes. Perhaps related to low pay, teacher absenteeism remains a problem, and anecdotal evidence suggests that many teachers are forced to supplement their incomes by working in two or more schools or even at other part-time jobs. This undoubtedly affects teacher commitment and performance. Another problem is that because most teachers are paid by the central government, districts tend to over-recruit; this should be addressed, as recommended in the previous *Survey* (OECD, 2012a).

While professional development opportunities are important for teachers in Indonesia, this is equally true for workers in all other sectors. Opportunities for workers, including in the informal sector, to do on-the-job training is an important avenue through which overall productivity can be improved. However, Indonesia has a particularly poor record in this regard, with only around 5% of all firms offering training to their employees (Figure 8), considerably fewer than in many other comparable countries.

Figure 8. Firms offering formal training to their employees



Source: World Bank, *World Development Indicators*.

### ***Making taxes and expenditure more growth friendly***

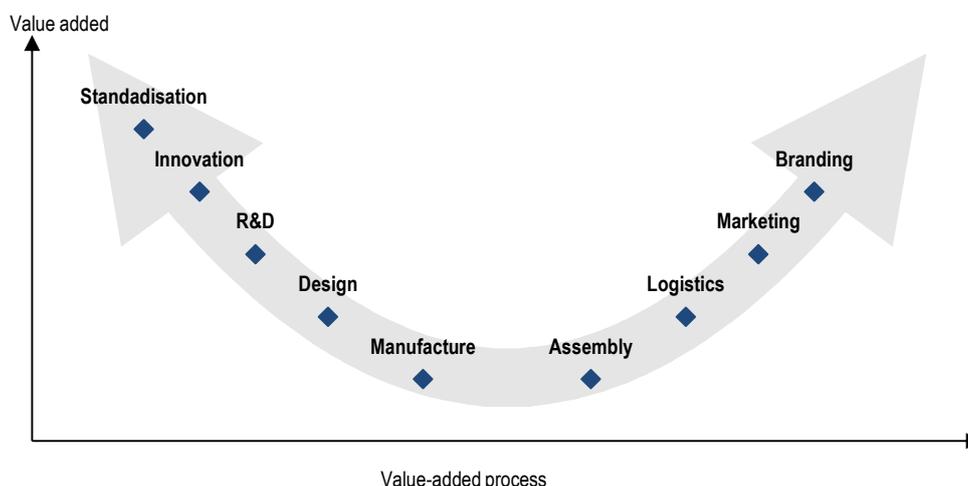
The *2012 Survey* made a number of recommendations to improve Indonesia's tax system. The principle motivation was to increase the amount of revenue raised and to improve efficiency, and in this way create the fiscal space to fund much needed increases in spending on education, infrastructure and social services. The recommendations included broadening the tax base by bringing the self-employed into the tax net and reducing exemptions to the value-added tax. Recommendations also focused on promoting longer-term growth, including the use of broad-based investment credits (in place of tax holidays), and introducing a simplified tax regime for small- to medium-size enterprises. It was also recommended that the taxation of the resources sector be rationalised so that rents are captured in a more comprehensive and less distortionary way. Working Paper No. 1236 looks at this issue more closely.

### ***Integrating into global value chains***

For low- and low-to-middle income countries like Indonesia, there are large pay-offs to successfully inserting themselves into GVCs. This offers them the opportunity to leverage their comparative advantage through deeper specialisation (Baldwin and Lopez-Gonzalez, 2013). Moreover, integration into GVCs facilitates the importing of technology, capital and know-how. Indonesia's current position in GVCs – that is, manufacturing and assembly – reflects its comparative advantage in basic commodities, other upstream inputs and labour. In the longer term, the challenge for countries like Indonesia is to move to higher value-added production and to capture the longest possible portion of the value chain (Figure 9). However, at its current stage of development Indonesia's focus should also be on competing with other similarly endowed countries for a greater share of the lower valued-added labour-intensive manufacturing and assembly links in the global production process, thereby drawing labour away from its low-productivity sectors and towards more productive and dynamic activities, which provide well-paid and secure jobs in the formal sector. While Indonesia currently does reasonably well in creating or capturing value added in GVCs, it may be falling behind relative to competitors. China's GVC income increased by a factor of five between 1995 and 2009, and in India it tripled, while Indonesia's only doubled to around USD 170 billion (OECD, 2013). Furthermore, the length of its value chains in the manufacturing sector is relatively short (Figure 10). According to the *World Investment Report* (UNCTAD, 2013), Indonesia, with a GVC participation rate of 44% (the share of a country's exports that is part of a multi-stage trade process), ranks

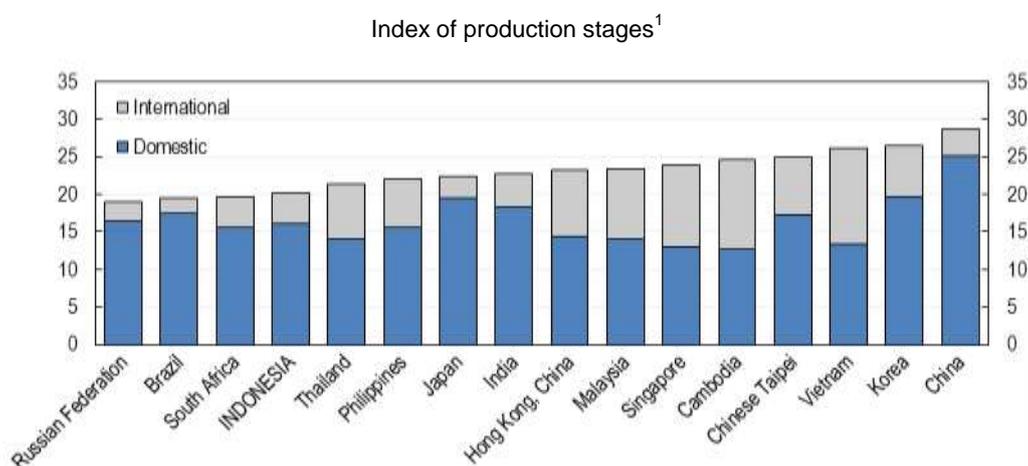
lower than its neighbours, including Singapore (82%), Malaysia (68%), the Philippines (56%), Thailand (52%) and Vietnam (48%).

Figure 9. **Valued added in the global value chain process**



Source: *Business Week International Extra Online*, 16 May 2005.

Figure 10. **Production stages in the manufacturing sector for selected emerging economies**



1. Index measuring the number of production stages required to realise a product or provide a service in a given final industry. In other words it measures the length of GVCs in each industry. The index takes the value of 1 if there is a single production stage in the final industry and its value increases when intermediate inputs from the same industry or other industries are used in the production of the final good or service. This indicator is decomposed to reflect domestic production stages and foreign production stages. Details on the index calculation can be found in the *OECD Trade Policy Paper*, No. 159.

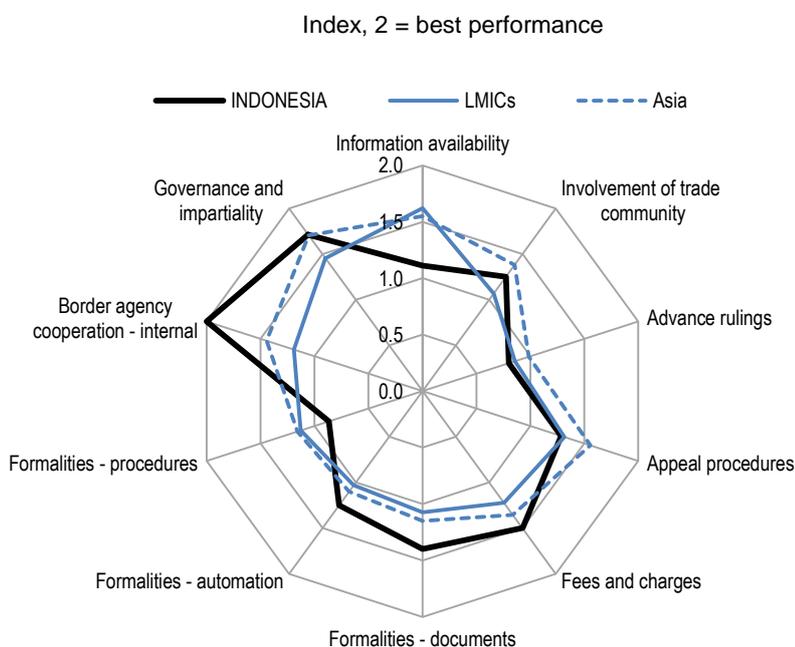
Source: OECD, *Global Value Chain Indicators*, May 2013.

One critical element in facilitating integration into GVCs is an efficient services sector that provides firms with access to competitive business services, such as finance, engineering, transport and logistics, and telecommunications. Moreover, the growth of the middle class will continue to increase demands for nearly all types of services, but particularly more sophisticated services in health, education and communications (Ghani, 2011). At around 38% of GDP Indonesia has a relatively small services sector, and services' share of foreign trade, at around 12%, is also small. While this share has increased steadily

for most countries, Indonesia’s services share has stagnated for the past 30 years. Its services sectors tend to be heavily regulated and market access for foreign services providers highly restricted. For example, in the business services sector, Indonesia ranks third from the bottom out of the 59 countries in the OECD FDI regulatory restrictiveness database, while in distribution it ranks the lowest.

Another critical element for closer integration into GVCs is openness to trade. Lower barriers to trade mean that intermediate goods from previous links in the chain can enter the country at a lower cost, ready for value to be added domestically before being re-exported to the next link. Import tariffs and export duties are examples of such impediments to trade, but there are other aspects that are equally important such as the efficiency of trade procedures. 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. Indeed, in the logistics sectors (road freight transport and distribution services) Indonesia’s settings are comparatively the most restrictive. In 2012, average most favoured nation (MFN) tariff rates in Indonesia were 7.8%, down from 9.5% in 2006 (WTO, 2013). This compares with 9.9 for China, 13.5 for Brazil, 13.7 for India, 6.5 for Malaysia and 6.2 for the Philippines. However, overall, Indonesia’s tariff rates show positive escalation, implying higher rates of effective protection. While the simple average applied tariff on goods at the first stage of processing is 5%, it is 6.2% for semi-processed goods and 9% for fully processed goods. Indonesia also imposes various export taxes, but these are principally on raw commodities, including palm oil, raw cocoa, and mineral ore exports (Working Paper No. 1236 for further details). According to the *OECD Trade Facilitation Indicators*, Indonesia performs better than the averages of Asian and lower-middle income countries in the areas of fees and charges, harmonisation and simplification of documents, automation and internal border agency co-operation (Figure 11). However, its performance in the areas of information availability and streamlining of procedures is below average.

Figure 11. Trade facilitation indicators for Indonesia



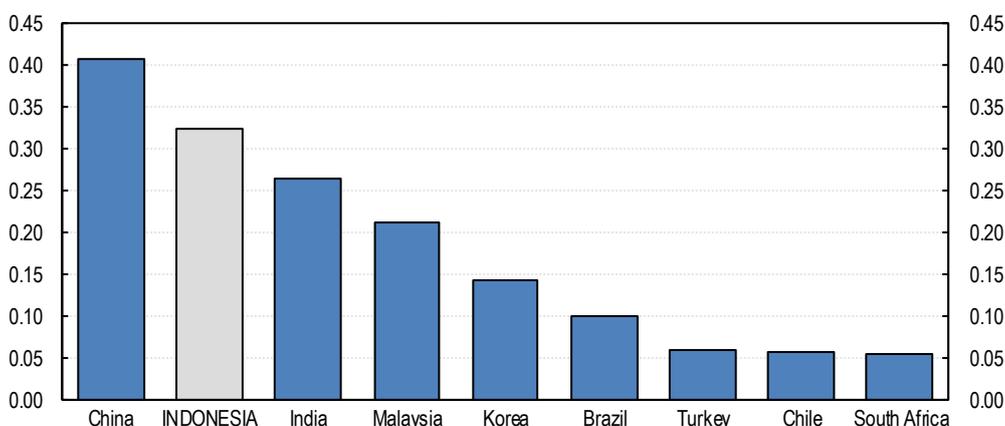
Note: LMICs: Lower middle income countries (World Bank classification). Analysis is based on latest available data as of January 2013 and the set of TFIs as constructed in “Trade Facilitation Indicators: The Potential Impact of Trade Facilitation on Developing Countries’ Trade” (OECD, *Trade Policy Paper*, No. 144) for 107 countries outside the OECD area.

Another important element in integrating into GVCs is openness to foreign investment. 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 in order to deepen the economy 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 efficiency, sustainability and environmentally friendliness. Many sectors of the economy are protected from foreign investment and competition. For example, limits on the foreign ownership of mines have hampered investment in the sector (see Working Paper No. 1236). 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.

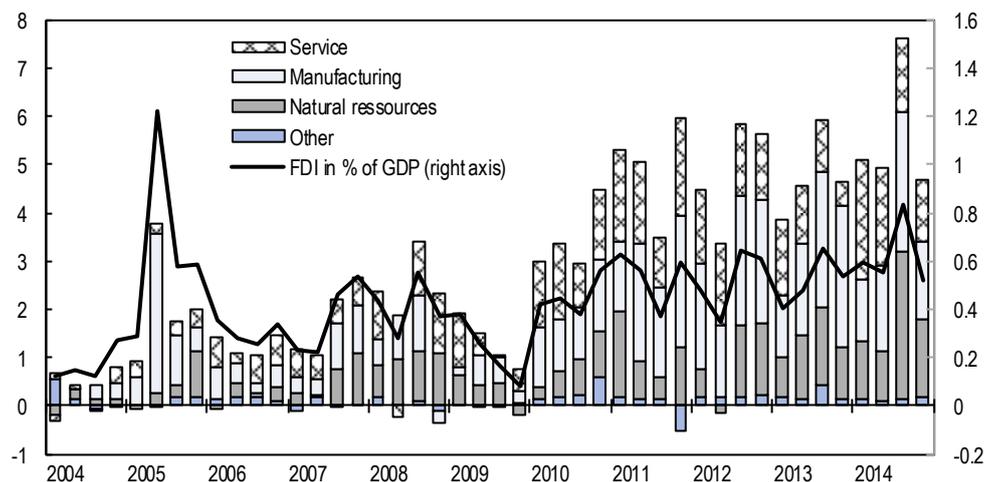
Indonesia is one of the most restrictive countries in terms of FDI as measured in the OECD FDI regulatory restrictiveness index (Figure 12, Panel A). While there have been big improvements over the past three decades, much remains to be done to open the economy to foreign investment. Even in important sectors like mining, Indonesia's rules relating to FDI are considerably more restrictive than many other commodity-based economies', like South Africa, Malaysia and Chile, which compete directly with Indonesia to attract mining FDI. That said, FDI flows into Indonesia have been strong in recent years, particularly in manufacturing, which between 2010 and 2014 attracted around 42% of all FDI inflows (32% in services and 23% in natural resources) (Panel B).

Figure 12. FDI restrictiveness and flows

A. FDI regulatory restrictiveness index, 2013 (closed =1 and open = 0)



B. Foreign direct investment (USD billions and percent of GDP)



Note: The FDI Regulatory Restrictiveness Index measures statutory restrictions on foreign direct investment.

Source: OECD; Bank Indonesia.

**Managing natural resources**

Managing Indonesia’s reliance on commodities is another major challenge. Working Paper No. 1236 discusses issues related to managing Indonesia’s rich natural resource endowment in a sustainable and efficient manner, to the benefit of all Indonesians. Its comparative advantage in commodities cannot be denied, but they should be utilised as a resource for broader national development. The benefits of the exploitation of these resources in the form of either employment or royalties are not equally distributed. Indeed, while the commodities super cycle has now ended, one troubling feature of Indonesia’s management of its natural resources is the lack of any substantial fiscal dividend through its duration. Many other resource exporters around the world, such as Norway, Chile and Botswana, benefited noticeably during the boom, recording fiscal surpluses, paying off debt, investing heavily and building up sovereign wealth funds. But Indonesia has failed to capture many resource rents, pointing to the need to

rethink that aspect of its fiscal framework. In this regard, Botswana and Chile provide excellent models from which Indonesia can draw lessons (Korinek, 2013 and 2014).

More fundamentally, a dependence on commodities may distort the process of economic convergence. McMillan and Rodrik (2011) argue that dependence on commodity exports and specialisation in a few highly profitable primary activities tend not to generate much productive employment, even when they spur growth. And, indeed, they may distort the process of convergence by inhibiting the transfer of factors towards high-productivity sectors. Moreover, they encourage rent seeking. This can be thought of as another variant of the natural resource curse. It is then the role of government to extract resource rents on behalf of citizens and to use these revenues to advance broader national development priorities, like education and infrastructure. But in doing this the government should be aware that with the end of the commodities super-cycle, international competitive pressures among suppliers are likely to mount in this sector, so strategies for extracting rent on behalf of the citizenry should be considered carefully so as not to inhibit future exploration and investment, particularly from foreign companies. Further consideration should then be given to measures such as a resource rent tax (also discussed in Working Paper No. 1236 and in the *OECD Economic Survey of Indonesia 2012*), which would be less distortionary than export taxes and ore export bans. There is an extensive literature on how to implement such a tax in the face of a number of specific sector characteristics, including significant uncertainty, high sunk costs, long payback periods and high output price volatility (Daniel et al., 2009).

#### **Recommendations for promoting sustainable and inclusive long-term growth**

- Create fiscal space so that more public resources can be directed at improving education access and outcomes, and improving infrastructure. Revenues could be boosted by better enforcing the taxation of small firms and the self-employed, improving enforcement of personal income tax and removing VAT exemptions.
- Raise public spending on infrastructure. Focus on transportation and logistics to support industry, as well as natural disaster prevention and water treatment.
- Continue promoting PPP investments. However, the framework is too complicated. The effectiveness of the new co-ordinating entities should be monitored.
- .Re-examine the option of issuing infrastructure bonds.
- Move forward with plans that will allow state-owned enterprises to borrow directly from Overseas Development Assistance sources, under the supervision of the Ministry of Finance.
- Accommodate the process of urbanisation through better planning and co-ordination between city, local and national authorities. In the same vein, expand the Jakarta administrative area to encompass the surrounding agglomerations.
- Direct more public resources to improving education access and outcomes. Accelerate the existing programme of regular teacher assessments and professional development. Link teacher salaries more closely to qualifications and performance.
- Develop programmes that focus on reducing drop-out rates between primary and middle school (at age 12), and middle and high school (at age 15).
- Facilitate trade so as to foster more integration into global value chains. This includes removing logistics bottlenecks in ports.
- Avoid protectionist measures that inhibit openness to trade and foreign investment with uncertain development payoff. Further relax foreign direct investment rules. This includes further paring down the “negative investment list”.

**Recommendations for promoting sustainable and inclusive long-term growth** *(cont.)*

- Remove barriers to the development of a vibrant services sector including overregulation of the sector.
- Relax employment protection legislation so as to encourage more employment in the formal sector.
- Re-examine ways to efficiently tax resources, including through a resource rent tax.

### **Poverty, inequality and inclusiveness**

On 11 October 2012, Indonesia's former President, Susilo Bambang Yudhoyono, declared that the reduction of poverty would be the government's top priority. He went on to state that poverty could be reduced through sustainable economic growth, recognising its importance in creating jobs and fulfilling the basic needs of the nation's people. Indonesia's National Long-Term Development Plan 2005-25 sets out the country's key aims in terms of poverty reduction and development:

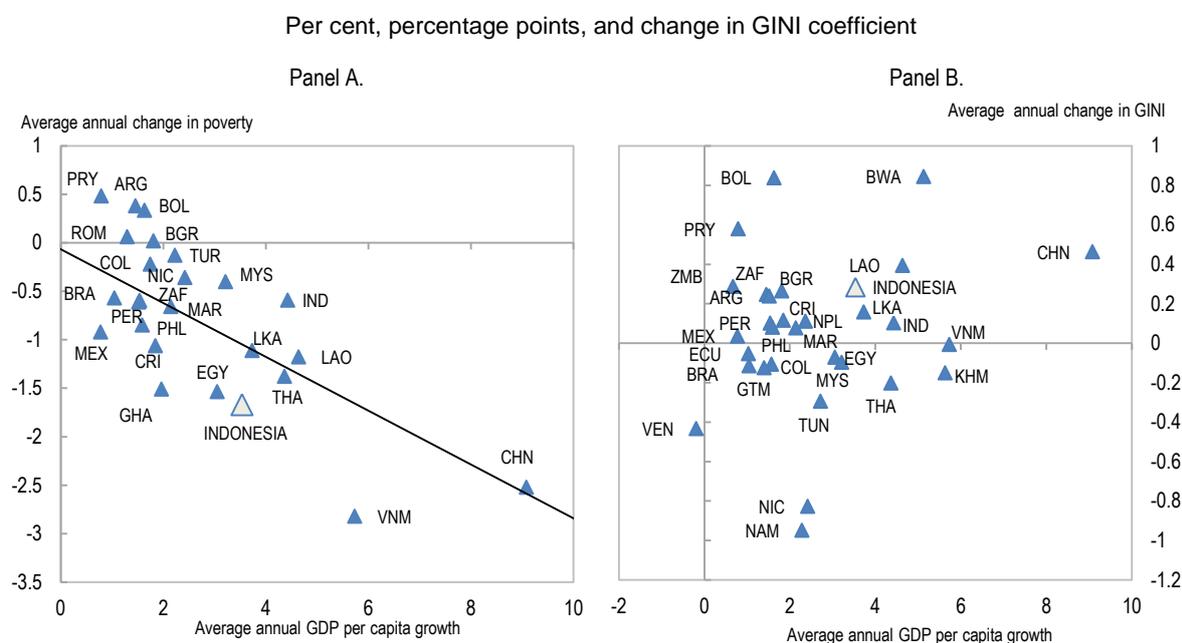
- Achieving equitable development that gives greater attention to those who are disadvantaged, including poor communities in remote or disaster-prone areas.
- Increasing national food security and self-reliance based on local diversified food resources.
- Developing rural areas through the promotion of agricultural production and the agro-food industry, by building capacity, developing infrastructure and enhancing access to information, markets and financial services.

The previous government also articulated a National Medium-Term Development Plan (RPJMN) for 2010-14, which included poverty reduction as one of its 11 national priorities and set a target of lowering poverty (national measure) to 8-10%. The new Widodo government released its five-year National Medium-Term Development Plan in January 2015, which includes a target absolute poverty rate of 7-8% by 2019. The absolute poverty rate was 11% in September 2014, before the reductions in fuel subsidies. Currently, Indonesia spends around 1.2% of GDP on social assistance, of which around a third is on poverty-related social assistance and the remainder on social insurance – principally on civil servants' pensions and health insurance. Of this only 0.5% of GDP is spent on targeted social assistance, compared to a regional average of 1%, and 1.5% for all developing countries.

Growth should be at the heart of policies aimed at alleviating poverty. As long as the proceeds of growth are to some extent shared across the income distribution and the purchasing power of the increase in income is not eroded by faster increases in the cost of living, then poverty will diminish (Kaary, 2004). However, while absolute poverty responds to sustained periods of growth, the impact on relative poverty is ambiguous. Cross-country evidence suggests that there is no systematic relationship between sustained periods of per capita income growth and the concentration of income (Figure 13, Panel B); De Silva and Sumarto (2014) find the same result looking just at time-series data for Indonesia. It is also evident that the relationship between growth and poverty reduction is not a simple one: the growth elasticity of poverty is not the same across countries. In Vietnam, Indonesia, Mexico, Brazil and several other countries the reductions in poverty for any given rate of income growth have been larger than for China, India, Malaysia and Turkey (Panel A). Clearly there are other factors at play in addition to just growth. Indeed, some countries have recorded sustained per capita GDP growth but have seen very small declines or indeed even increases in poverty. The literature suggests that growth appears to be a necessary but not a sufficient

condition for reducing poverty. In addition to the unique features of each country, including demographic and economic structure, poverty reduction policies and programmes are also likely to play a crucial role.

Figure 13. **GDP growth, poverty reduction and the change in the GINI co-efficient**

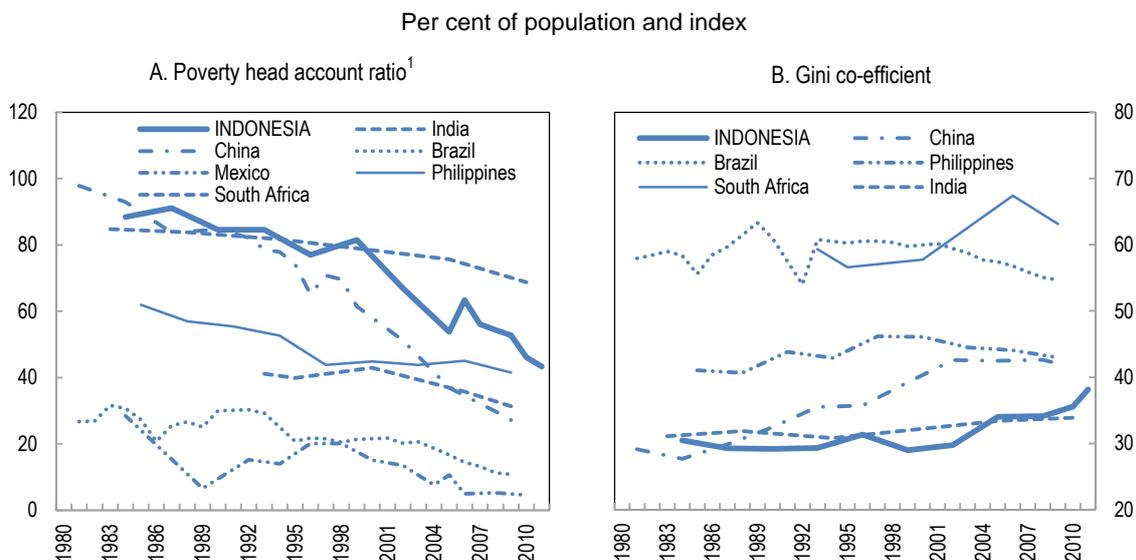


Note: GDP is GDP per capita, PPP (constant 2005 international dollars) and poverty is the poverty headcount ratio at USD 2 a day (PPP) (% of population). Varying periods starting from 1981 to 1993 and ending from 2006 to 2011.

Source: World Bank, *World Development Indicators*.

Like China and Vietnam, 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 poverty-reduction programmes, has been sufficient to make very impressive inroads into poverty. The USD 2 per day poverty headcount halved from around 85% of the population to 43% (Figure 14, Panel A). However, income alone is not the sole measure of the well-being of the poor; there are other figures that cannot be overlooked: for example, less than half of the rural poor have access to clean water, only three-quarters of all Indonesians have access to electricity (IEA, 2013), and only 55% of poor Indonesian children complete junior high school.

The government has two official poverty lines for each province, reflecting the different cost of living in rural and urban areas in each province. As of September 2014, the average rural poverty line was IDR 297 000 per capita per month (around USD 24) and the urban poverty line was IDR 327 000 (around USD 26). These poverty lines are determined by a complex function taking into account what the poor spend on food to reach 2 100 calories per day, as well as costs associated with dozens of non-food items, including housing, clothing, education and health care. According to these definitions, in September 2014 there were 10.4 million urban poor and 17.3 million rural poor, comprising 8.2% of the urban population and 13.8% of the rural population, down sharply from 13.6% and 20.2% a decade ago.

Figure 14. **Poverty headcount ratio and GINI coefficient**

1. At USD 2 a day (PPP).

Source: World Bank, *World Development Indicators*.

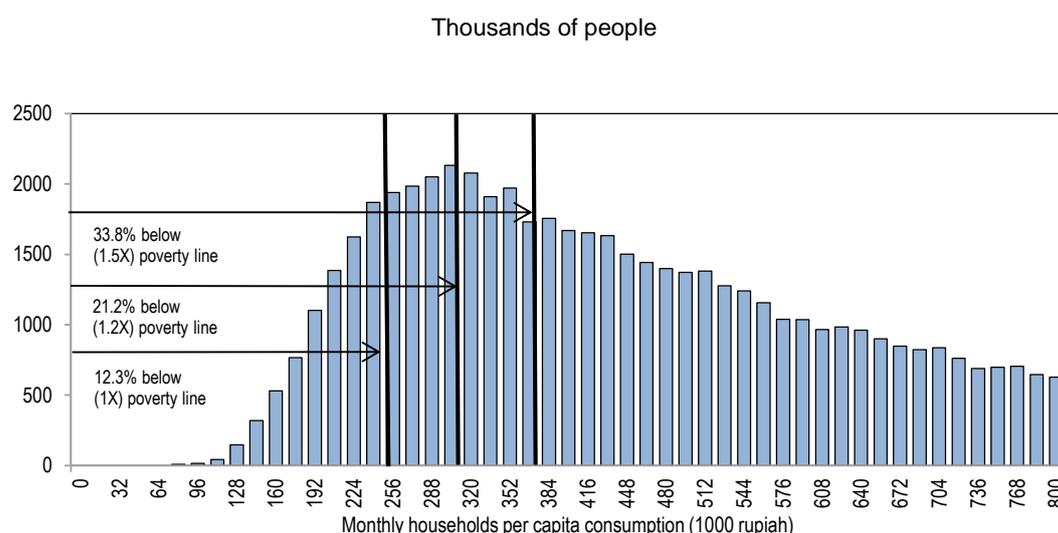
Indonesia's record concerning income distribution has been less impressive, particularly over the past decade, which saw a notable increase in the Gini coefficient (Figure 14, Panel B). Since the 1997-98 Asian financial crisis, the gap between rich and poor has widened. However, despite this increase, in comparison to many other developing countries, income inequality in Indonesia remains low. Of the 154 countries for which World Bank data are available, Indonesia ranks 74th in terms of income inequality: lower than China, the Philippines, Malaysia, Singapore and Thailand but above India. There was a sharp rise in top income shares in Indonesia during the late 1990s, coinciding with the 1997-98 economic crisis (Leigh and van der Eng, 2009), and they remain generally higher than elsewhere. The 0.1% top income earners in Indonesia tend to be wealthier than those in other countries, although the income share of the top 10% seems to be on par with other countries in the region. A number of reasons have been put forward to explain the recent deterioration in consumption equality in Indonesia. First, the rents from the booming mining and other commodity industries are likely to be concentrated at the top income levels (Yusef et al., 2013). Also the real price of rice increased substantially in the mid-2000s, eroding the purchasing power of poorer household in which rice makes up a large part of the consumption bundle, and this may account for the spike in inequality seen over that period (Yusef, 2014). Labour market developments, including increases in severance payments, rising minimum wages, slower growth in manufacturing employment and greater informality, are all likely have resulted in less low-wage jobs growth. Finally, the regressivity of fuel subsidies may also have played a role in increasing inequality (Agustina et al., 2013).

### **Vulnerability**

The falling absolute poverty rate, however, partially masks a high degree of vulnerability: much of Indonesia's population is clustered just above the poverty line. Around 21% of Indonesians live below or close to the official poverty line (with consumption of less than 1.2 times the poverty line), while 34% of the population live below 1.5 times the poverty line and is almost equally vulnerable (Figure 15). The World Bank (2012) estimates that 40% of Indonesians are highly vulnerable to poverty. Turnover among the poor is considerable: Sumarto (2014) estimates that of the 30 million poor in 2010, 55% were not classified as poor the previous year, even though the absolute level of poverty did not increase over those

two years. Even relatively small shocks to these vulnerable households can be enough to push them into poverty. Indeed, the poor are particularly affected by food prices, with up to three quarters of expenditure going on food. In addition to lifting families out of poverty, social assistance programmes need to be responsive enough so as to provide an effective social safety net so households close to the poverty threshold do not slip back into poverty in the event spikes in food prices or natural disasters, such as earthquakes, to which the country is prone.

Figure 15. **Distribution of per capita consumption, 2012**



Source: World Bank, SUSENAS and OECD calculations.

Astuti et al. (2012) estimate that the following factors are the strongest indicators of vulnerability to falling into poverty in Indonesia: young households; female-headed (rural areas only); low education; working in agriculture; high dependency ratio; larger households; and living in Nusa Tenggara (urban) and Papua (rural). More work needs to be done on identifying risk factors for households falling into poverty, and programmes should be fine-tuned to earmark them for early assistance.

### **Rural poverty**

For Indonesia, poverty is mostly, but not exclusively a rural and agricultural phenomenon. Approximately half of the population lives in such areas, and, as mentioned previously, in 2012 around 14.3% of the rural population were below the rural poverty line, compared to around 8.4% of the urban population. Poverty is most severe in the remote eastern islands of Indonesia, where up to 95% of people in rural communities can be poor. These provinces are home to many indigenous peoples, who are often on the margins of development processes and programmes. Most of their inhabitants are small close-to-subsistence farmers, farm workers and fishers who are unable to take advantage of the opportunities offered by economic growth. They are often geographically isolated and lack access to social services, including health and education, as well as markets and financial services.

In addition to gender, age, family size, and landholding condition of the household head, the level of education of the head of the household is a critical determinant of poverty in Indonesia (Hondai, 2005). Families whose household head has at least finished junior high school have a far smaller-than-average incidence of poverty. This suggests that providing more education is an essential element in reducing poverty. Estimates of the rate of increase in household expenditure associated with an additional year of education by area and by industry show that increases are almost zero in the agricultural and

manufacturing sectors in rural areas. Even if a rural household head completes more education than junior high school, the household may not be able to raise its expenditure as long as s/he stays in one of these two sectors. To enjoy greater benefits from higher educational attainment, s/he has to find work in other sectors. This implies that education alone will not solve the poverty problem in rural areas. Effective poverty alleviation there requires other measures. Such measures would include: *i*) improving rural employment opportunities; *ii*) expanding rural non-farm activity, and *iii*) encouraging migration out of rural areas.

Pro-poor growth should focus on rural areas, improved incomes and productivity in agriculture and must make intensive use of available labour. Indonesia's geographical diversity, including its many islands and mountainous topography, makes the provision of social services to the rural poor particularly challenging and costly, and development and assistance programmes need to be adapted to this (Box 2). Certain innovation policies can help play a role in promoting inclusiveness. For instance, the National Community Empowerment Program (PNPM) provides communities with block grants for spending on projects (related to infrastructure, education, etc.) developed through a participatory, bottom-up planning process, which is facilitated by social and technical specialists who provide advice to communities.

#### Box 2. Existing social assistance programmes

Social assistance programmes first emerged in Indonesia during the 1997-98 Asian financial crisis, with the government introducing a number of temporary measures aimed at assisting the most affected households. These programmes were supplemented in 2005 with measures designed to help low-income households to cope with price increases associated with a reduction of fuel subsidies. More recently conditional cash transfer (CCT) schemes have been rolled out, focusing on promoting school attendance and the use of health services.

The Bantuan Langsung Tunai (BLT) programme is one of the largest targeted cash transfer programmes in the developing world. It was established in 2005 – initially called the Fuel Subsidy Reduction Compensation Fund (PKPS-BBM) – as a timely and fungible one-off assistance programme to compensate the poor for reductions in fuel subsidies. It was used again in 2008 and 2013 for the same reason. It provides transfers of about USD 10 per month to about 19 million households below and near the poverty line.

On 1 January 2014, Indonesia introduced a new national health scheme, the National Health Insurance Program (JKN). It is being phased in to replace Jamkesmas (Jaminan Kesehatan Masyarakat or Health Insurance for the Poor). The plan is to roll out medical coverage under the new scheme for all of the country's 247 million people by 2019. For the first phase of the rollout, the participants are principally civil servants and military personnel and their families. The government pays the premiums of the poor, but others have a choice of three levels of cover. The existing programme, Jamkesmas, which covers around one-third of the population, was designed to mitigate health shocks and, like BLT, started as a scheme to help cushion the impact of reducing fuel subsidies in 2005. It is a free health-care programme, aimed at making basic health services available to beneficiary households. These households are given health cards entitling them to free health care at local clinics and in-patient treatment, as well as obstetric services, mobile health services, immunisations and medicines. It is financed by the central government without any insurance contributions or cost-sharing on the part of beneficiaries or local governments and accounts for about a quarter of the central government's annual health budget.

The RASKIN (Rice for Poor Families) programme was implemented during the 1997-98 crisis to alleviate poverty through the distribution of a regular ration of subsidised rice to vulnerable households. About one-third of the population benefitted from the programme at the time of the crisis. Under its current version, the National Logistics Agency (Bulog) purchases rice from wholesalers using a subsidy from the government. This rice is distributed to villages, where eligible households can buy up to a set quantity of rice at considerably less than market price. RASKIN currently distributes rice to around 17.5 million families across the country. It was also used as an additional compensatory mechanism for offsetting the impact of fuel price hikes on the poor in 2002-03 and 2005. However, administrative costs of this programme have been estimated to be as high as 30% (McCulloch, 2005).

### Existing social assistance programmes (cont.)

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. The amount of the transfers provided rises with the level of education, from IDR 360 000 annually for primary school to approximately IDR 1.2 million at the tertiary level, and includes vocational education. The individual initiatives within the BSM are independently administered and budgeted, with little co-ordination between them, even those run from within the same institution.

The Community Cash Transfer (PNPM Generasi) and Conditional Cash Transfer (PKH, Program Keluarga Harapan) programmes were launched as pilots in 2007. PNPM is a block grant to communities, giving them autonomy in designing and managing their own activities in pursuit of programme objectives of providing better community health and education services. PKH is a quarterly cash transfer targeting poor households, conditional on participation in health and education services, ranging from IDR 600 000 to IDR 2.2 million per year (depending on the number of qualifying dependents in the household). The direct household payments are contingent on verified pre- and post-natal check-ups, a professionally attended birth, new-born and infant weighing and health checks, and good school attendance records. In 2010, PKH reached 816 000 very poor households, with plans to expand to 3 million households nationally by 2014.

There are also a number of smaller programmes that provide cash and services aimed at assisting particular disadvantaged groups including vulnerable children (PKSA), the severely disabled (JSPACA) and vulnerable elderly (JSLU).

### Conditional cash transfer schemes

Indonesia currently operates two large conditional cash transfer (CCT) schemes: BSM focusing on education and PKH on both health and education (Box 2). CCT schemes have a number of advantages. First, they typically focus on expanding investment in the human capital (education, nutrition and health) of children from households in extreme poverty. They therefore help reduce the intergenerational transmission of poverty and improve efficiency and productivity on a much larger 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.

Brazil has successfully used CCT schemes to combat poverty. In 2003, the *Bolsa Família* programme was established as a single national cash transfer, consolidating four existing CCTs. The reform aimed to make efficient use of public resources, improve targeting, jointly promote education and health incentives, strengthen monitoring and evaluation and systematise complementarities between national and sub-national social safety net programmes. A consolidated single registry database, which enables beneficiaries to access additional programmes and services, is credited as being the single most important management tool available to *Bolsa Família*. It serves as a targeting and monitoring instrument to reduce both duplicate registrations and administrative costs, monitor eligibility requirements, improve efficiency and ensure horizontal co-ordination between social policies. The scheme costs only 0.4% of GDP, and covers more beneficiaries than other Brazilian social assistance programmes.

The newly-elected government expects existing poverty-alleviation programmes, as well as the accelerated rollout of the Indonesia Health Card (KIS), the Indonesia Smart Card (KIP) and the Prosperous Family Card (KKS), to lower the absolute poverty rate to 7-8% by 2019. The KKS card was used to facilitate monthly cash transfers to low-income household of 400 000 rupiah (approximately USD 31) in compensation for the November 2014 cut in fuel subsidies. As of December 2014, only 1 million households have been issued with the KKS card, but the aim is to distribute 15.5 million cards by end of

2015. The government has announced plans to combine these three social welfare cards into one by the end of 2016.

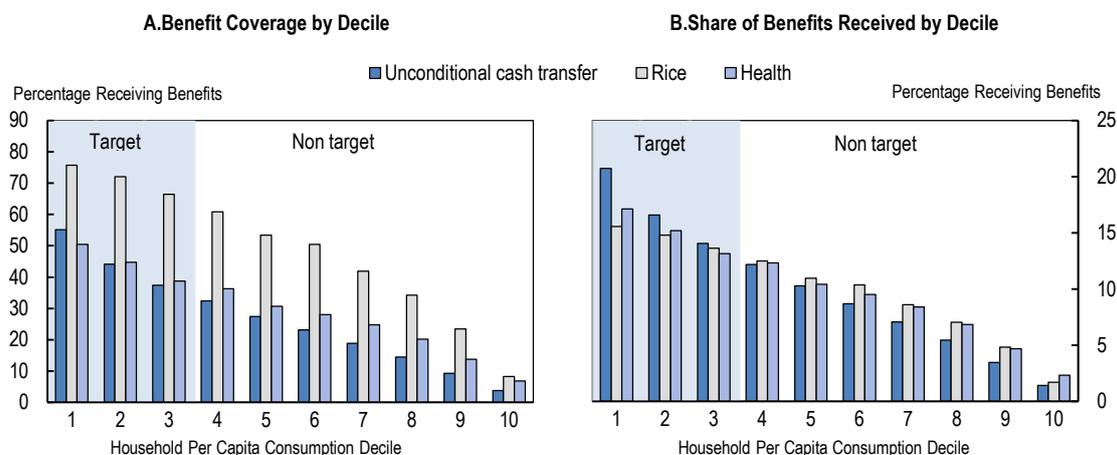
### *Improving targeting of social assistance programmes*

Most OECD countries rely heavily on the tax system for targeting, verification of eligibility and, in many cases, delivery of social assistance. In Indonesia, as in most other developing countries, this is difficult due to widespread labour-market informality (see below) and low tax compliance, particularly among very low income earners in isolated rural areas. Non-universal social assistance programmes, which try to target poor and near-poor households, will always need to identify which households qualify for assistance. Assessment of the entire population is expensive, so other data collection methods must be utilised to keep down costs and to reduce delays – especially when assistance might be urgently required. The lack of reliable information about individual household incomes and the costs in both time and money in gathering it means that there is a trade-off from greater efforts to reduce mis-targeting. This challenge is particularly acute in Indonesia, with its very large and dispersed population, preponderance of informality, decentralisation of much budgetary and operational governance, and frequent household turnover into and out of poverty. In addition to identifying target households, conditional programmes, such as school and health care attendance, add complexity.

A number of strategies can be employed to improve targeting. Geographic targeting or poverty mapping can help to identify areas for attention. Pre-nomination by local community members including community leaders and self-nomination can be used to build lists for further assessment and verification. However, relying on community leaders risks elite capture and nepotism, and they may use different criteria than the programme intends in identifying the needy. In poor communities the direct observation of income or consumption levels can be impossible, in which case methods such as proxy-means testing (PMT) can be employed. PMT indirectly measures household income using statistical techniques based on a set of easily observable and difficult to manipulate household characteristics. These include: housing, assets, household composition, head of household education and occupation, and village characteristics. This has the advantage of being relatively accurate, repeatable, verifiable, and difficult to manipulate if properly designed. On the other hand, it is better for identifying long-term poor rather than newly poor, does not allow for flexibility in assessing households and requires relatively high administrative capacity.

The BLT programme uses community-based nomination to identify candidate households before verification by PMT. If a poor household is not nominated, they are not assessed, and so they miss out on the programme. BLT is aimed at the poorest 30% of Indonesian households, but just 46% of these households actually received transfers (World Bank, 2012b). At the same time, many better-off households are included and account for half of all benefits distributed. However, pure PMT identification outperforms alternative targeting strategies such as community and hybrid identification schemes (Alatas et al., 2012). The Rice for Poor Families (RASKIN) programme, which delivers subsidised rice to around half of all Indonesian households, also suffers from a degree of mis-targeting but in this case related to its implementation. According to National Socioeconomic Survey (SUSENAS) data, targeting of RASKIN is relatively poor with a significant share of the benefits goes to the higher income deciles (Figure 16). Over half of RASKIN rice goes to families above the target three poorest deciles. Distribution of subsidised rice is handled by village and community leaders, but often, for cultural and political reasons, leaders often choose to distribute the rice equally to the entire community, rather than just those in particular need. RASKIN also suffers from high administrative costs and its exclusive focus on rice distorts the market, including because of corrupt practices. The option of converting RASKIN into a food voucher programme (or cash transfer) that includes other foodstuffs beyond just rice should be considered. This would diversify the diets of the poor and reduce operational costs.

Figure 16. Coverage of social security programmes



Source: Sumarto (2014).

Compiling and maintaining a comprehensive unified census-based database of all households and their incomes would be expensive. Instead, a national targeting system (NTS) that includes a single registry of vulnerable households would result in reasonably accurate and cost-effective targeting and greater programme effectiveness. In 2011, a further step in this direction was taken when the National Team for Accelerating Poverty Reduction (TNP2K) in the Vice President's office and Statistics Indonesia (BPS) spent considerable resources updating the existing list of Indonesia's poor. This project, called PPLS11, had the objective of including in the database 40% of the poorest Indonesians. This update, which increased the number of households surveyed from around 19 million in 2008 to 25 million, covering up to 40% of the country, could serve as the basis for a unified registry. In addition to increasing the number of households surveyed, a broader range of demographic data are being collected as well, which can be used as targeting criteria for different programmes, and the additional indicators being collected could serve to improve targeting by PMT scoring. Moreover, moving towards a NTS, if sufficiently comprehensive, would help in the implementation of the whole array of social assistance measures envisioned by the government, including health-care coverage and unemployment insurance.

Another impediment to the efficient delivery of social assistance in Indonesia is the very low rates of financial inclusion, even relative to other countries with similar income per capita levels. For example, only around 20% of Indonesians above the age of 15 hold an account in a formal financial institution, and for households in the bottom two income quintiles the rate is less than half that. (Demirguc-Kunt and Klapper, 2013). These are among the lowest financial inclusion rates for countries in the region. 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). Improving the financial inclusion of the poor would help with moves towards digitising social assistance payments which in turn would help to lower delivery costs and barriers (World Bank, 2014a). In addition, branchless banking can be used by the government for tax collection for unbanked segments of the population. Governments in a number of 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. 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, 2012d, 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.

### *Schooling for poor families*

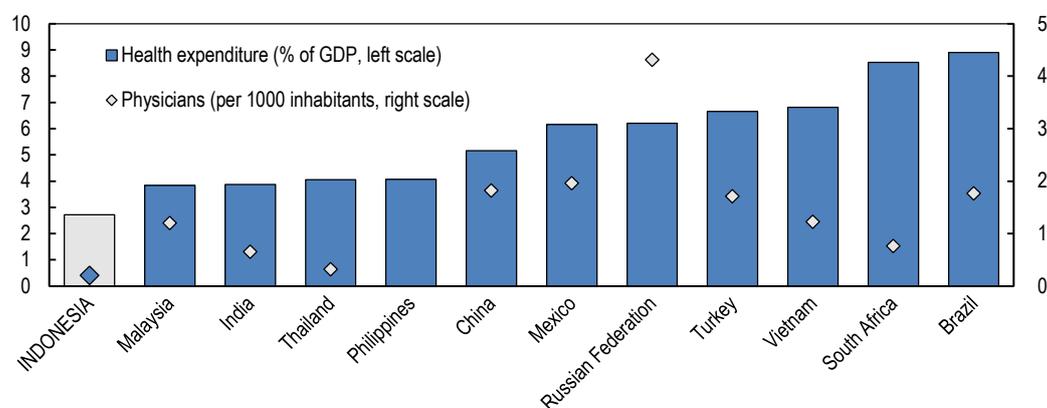
As in most developing countries, Indonesian children from poor families tend to get less schooling. The inability of poor families to finance their children's education has long been recognised as a key factor perpetuating poverty across generations. Families often cannot afford to keep their children in school for long and thus miss out on the higher returns to education that could accrue in the next generation with each year of schooling. Lower education levels reduce the earnings potential and mobility of labour. Education also affects health, child mortality and household size. De Silva and Sumarto (2014) find that education is the single largest determinant of inequality in Indonesia. Policies that can promote the extended schooling of children from poor families are important for improving both equity and efficiency, and allow poor people to escape from a self-perpetuating poverty trap. Moreover, there is solid evidence that social policies targeted at reducing poverty and promoting human development can have a powerful impact. For example, CCT programmes in Brazil and Mexico were responsible for about 20% of the decline in inequality over a ten-year period (IMF, 2012). As already mentioned (Box 1), the two large Indonesian CCT schemes that focus on education (BSM and PKH) function well, although coverage and targeting are issues for both. The expansion of the PPLS11 database should improve their effectiveness. The section above on sustainable growth and human capital makes several recommendations aimed at improving the performance of the education system more generally.

### *Health services for the poor*

Indonesia has made steady and significant progress on several key population health outcomes over the past 50 years. Life expectancy has increased steadily from about 45 years in 1960 to almost 70 years in 2011. The under-five mortality rate has declined from 216 per 1 000 live births in 1960 to 31 in 2012 (UN IGME Childinfo, 2014). However, infant and child mortality remain higher than for comparable countries, and for the lowest wealth quintile in Indonesia it is over three times that of the highest quintile (OECD, 2014a). Moreover, 36% of all children were stunted in 2010 because of a lack of proper nutrition (UNICEF, 2013), and 9% of the population suffered from undernourishment (FAO, 2013). Total spending on health care as a share of GDP is low, as is the physicians share of the population (Figure 17). Indeed, by the time China had reached Indonesia's current GDP per capita (in 2005), it was spending almost double the share of GDP on health care. Moreover, the Philippines, India and Vietnam, all of which are currently at a lower level of GDP per capita, all spend a greater share. Indonesia needs to spend significantly more on the health care of its population through some combination of expanded private insurance schemes and direct government expenditures.

While health insurance coverage has increased significantly over the past decade, almost 60% of the population remains uncovered, and out-of-pocket expenses remain high, even for those with coverage. The prevalence of the informal sector makes expanding coverage especially challenging. At the beginning of 2014, Indonesia implemented a new universal social security system that will put Indonesian employees and residents under a single health-care regime by 2019 (Box 3). While some formal employees may see automatic deductions from their salaries for the health-insurance plan, non-salaried or informal workers will be given three options with different monthly fees – IDR 25 500 for third-class wards, IDR 42 500 for second-class and IDR 59 500 for first-class. However, there remains a serious question mark as to whether the level of these premiums will be sufficient to provide an adequate quality of medical services without drawing too heavily on governments resources.

Figure 17. **Total health expenditure and the number of physicians in emerging economies**  
% of GDP and per 1 000 inhabitants, 2011 or nearest year



Source: OECD Health data 2013 and World Bank, World Development Indicators.

### Box 3. India's health insurance scheme for the poor

In 2008, India created a health insurance scheme, the Rashtriya Swasthya Bima Yojana (RSBY), which provides hospitalisation coverage for the poor and informal sector workers. As of February 2014, the RSBY operated in 512 districts across 28 states and union territories (out of 35) and covered 37 million families, out of the 69 million below-the-poverty-line families in India (RSBY, 2014), totalling 120 million people.

Currently, the scheme reimburses spending up to Rs. 30 000 (USD 485) for a family per year. A small annual premium of Rs. 30 (USD 0.7) is paid by each family and the remainder is financed for by the government. The central government funds 75% of premiums under the RSBY, and states contribute the balance. The programme itself is operated by private insurance companies which tender for operating within regions. With the premium paid for each household enrolled, insurers have an incentive to enrol as many households as possible from the beneficiary list.

It gives users a choice across private and public hospitals, creates incentives for public providers to increase volumes of care and for private insurers to extend coverage rapidly.

In order to best suit the poor in India, the scheme was designed to be a cashless and paperless way of claiming benefits (lowering the risk of abuse and corruption) and to cater for migration across regions. The principle way these objectives have been achieved is through the introduction of a biometric-enabled smart card. The RSBY smart card, which is linked to a central database but also provides offline capabilities for use in remote unconnected locations. The card is increasingly being used as a platform for the distribution of other social benefits, with pilot schemes for some subsidies launched in some areas to minimise leakages; for example, the National Social Assistance Programme in Jharkhand, and the food and kerosene subsidy in Chhattisgarh where in some cases it has largely eliminated fraud, which was involved in up to 70% of disbursements.

The RSBY operates accredited hospitals, public or private, across the country – 6 823 private hospitals and 4 064 public as of February 2014. The RSBY thus introduces some level of competition among providers. With hospitals paid on a per case basis, the RSBY also creates incentives to increase the volume of activity.

Targeting remains an issue with RSBY. The initial beneficiaries were identified from a scored-based census that is conducted once every 10 years, with some inter-period updating. While RSBY enrolment includes some verification, this only disqualifies non-poor families and does not add new poor to the list. With plans to broaden eligibility, targeting should become less of a problem.

Out of pocket expenses are very high, even for those with insurance. About 45% of total health expenditure in 2012 came from out-of-pocket spending, up from 43% in 2009, with the majority for hospital care; for example 77% of all expenditure on out-patient care comes from household out-of-pocket spending (Soewondo et al., 2011). While the new health-insurance scheme is welcome, it needs to be monitored closely to ensure that it properly protects households (including those that have children, elderly, non-salaried and informal workers) from catastrophic payments for illnesses and ensures good accessibility to health-care services at a low cost.

### ***Land tenure and titles***

The poor often do not have access to credit markets and lack land title or other collateral; hence, potential investments lie dormant. Access to credit is critical to managing household consumption, particularly insofar as the poor are concerned, because it affords them the means to smooth their incomes in the event of unfavourable shocks, such as a failed harvest or natural disaster. Moreover, without adequate insurance and credit markets, poor households face higher risks of investment and so underinvest compared with households with more diversified income sources or access to funds to tide them over following shocks. Since 2007, agrarian reform has been a priority for the government, and part of this has involved clearing up the legal title of land. This follows the ideas of Peruvian economist Hernando de Soto (1986) that the solution to rural poverty lies in providing secure property rights to the poor, and integrating their land assets into the market system. The policy tool to achieve this is a massive government land registration and titling effort.

The land tenure legal system in Indonesia is administered under the Basic Agrarian Law No. 5 Year 1960. Land tenures and titles are the jurisdiction of The National Land Agency (“Badan Pertanahan Nasional” or “BPN”), a government body that manages all grants, extensions, renewals of certified titles as well as running the land registration system. Land ownership titles in Indonesia are divided into two broad categories: customary traditional land title (“adat” land rights), and certified titles. Traditional land is usually owned by inheritance and is not registered in the BPN, although land plots containing such “adat” title can be converted into certified titles and registered in the BPN. Buying land with traditional title is always riskier than with certified title. Certified land titles are registered at the local BPN office and can take a number of forms that confer on the holder of the title the right to utilise the land in various ways. These include freehold, the right to use, the right to build and the right to exploit resources located on the land.

BPN has dramatically increased the rate at which it registers land title since 2007, although the original agrarian reform goal of redistributing land to the poor seems to have been forgotten. The argument in favour of land titling is that “legalising” individual titles makes land easier for small land holders to sell or to mortgage their property – especially if they lack capital or other resources to efficiently use the land, and thereby makes the land more valuable to those who do have access to these resources. However, without accompanying agrarian reforms that help small farmers become more productive, titling results in farmers selling their land more quickly so that the distribution of land becomes more unequal.

### ***Infrastructure***

Infrastructure is important for pro-poor growth. Without infrastructure and human capital, poor regions cannot attract investments from outside, and people living in those regions face even greater obstacles to seeking opportunities elsewhere. A number of studies have concluded that infrastructure spending is one of the most powerful instruments that can be used to promote economic growth and poverty reduction (OECD, 2006). Infrastructure supports pro-poor growth by: *i*) enhancing economic activity by reducing production and transaction costs, increasing private investment and raising productivity; *ii*) removing bottlenecks in the economy, which hurt poor people by impeding asset

accumulation, lowering asset values and imposing high transactions costs; *iii*) generating distributional effects on growth and poverty reduction through poor people's increased participation in the growth process by increasing their access to factor and product markets, and reducing risk and vulnerability. The section above on sustainable growth and infrastructure looks at impediments to infrastructure investment in Indonesia and makes several recommendations as to how it can be boosted.

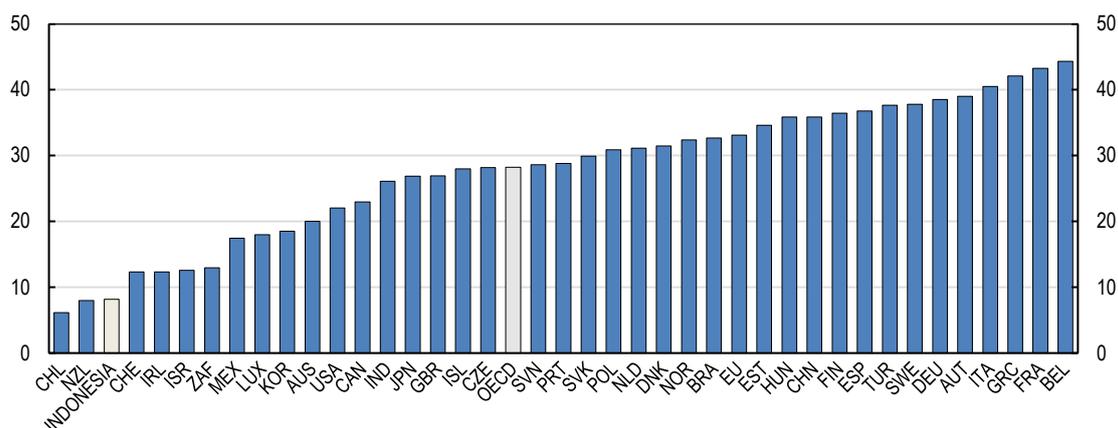
### *The tax and transfer system*

The previous *Survey* (OECD, 2012a) examined Indonesia's tax system and found that while improvements have been made in raising revenues and improving efficiency, the tax take was still low, especially in light of Indonesia's public infrastructure, social protection, health and education needs. Indonesia's tax-to-GDP ratio of around 12% in 2012 is low even by the standards of other countries at similar GDP per capita levels. The Ministry of Finance estimates that 70% of all income tax revenues come from just the top 5% of income earners, principally because of poor enforcement. Moreover, the tax wedge on labour income is very low, even by standards of other emerging-market economies (Figure 18). One consistent recommendation across all three *Surveys* to date has been the need to increase fiscal space to make room for increased public expenditures on infrastructure, social protection, health and education. As we have seen in terms of tackling poverty, all these issues are important. The new Medium Term National Plan aims to lift the tax-to-GDP ratio to 16% by 2019 (BAPPENAS, 2015).

In addition to the public provision of goods and services that both directly and indirectly target poverty, the tax and transfer system can also directly impact on the livelihoods of the poor. To the extent that workers are in the formal sector and therefore within the tax system, the progressivity of personal income tax and the deductions and transfers integrated within the tax system can have a direct and immediate impact. However, with over 60% of the labour force outside the formal sector (see below), and a much greater share of the poor, the reach of the tax and transfer system is likely to be limited in so far as addressing poverty is concerned. So a first step in addressing the effectiveness of the tax and transfer system as a tool for poverty alleviation is to take measures to promote formalisation of the workforce.

Figure 18. Average tax wedge on labour

At 100% of average worker earnings, couple with two children<sup>1</sup>



1. Couple with two children, at 100% of average worker earnings for the first earner. Average of three situations regarding the wage of the second earner (0%, 33% and 67% of average worker earnings).

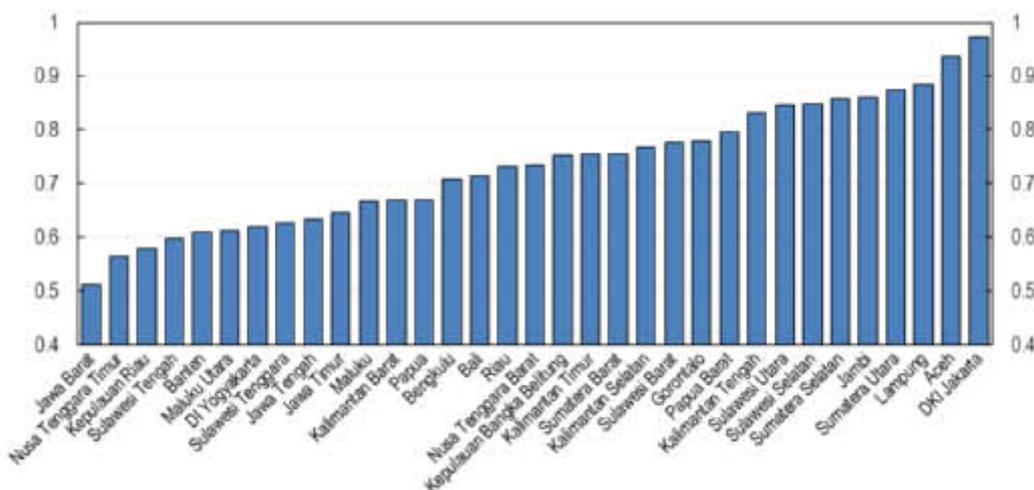
Source: OECD (2013), Taxing Wages Database; For BIIICS countries, data represent the latest figures based on the methodology described in: L. Gandullia et al. (2012), "Modelling the tax burden on labour income in Brazil, China, India, Indonesia and South Africa", *OECD Taxation Working Papers*, No. 14.

**The minimum wage**

Imposing a minimum wage can be one way to alleviate poverty. Minimum wages are stipulated under Articles 88, 89 and 90 of Act 13 of Indonesia’s Labour Law (2003), which allows for district and provincial governments to set minimum wage levels. There is no nationwide minimum wage. The governor of each province, or mayor of each district/city, decides the minimum wage rates in their jurisdiction based on recommendations and advice from district- and provincial-level wage councils. The wage councils typically include representatives of governmental officials, entrepreneurs and various labour unions. The law allows for employers to apply to be exempted from the minimum wage if they can prove that increases would hurt them financially. To obtain this exemption, the company must provide the Ministry of Industry and Trade access to its accounts covering the previous two fiscal years to prove that its profits would be seriously affected. In addition, the business needs to obtain written consent from its employees. According to the Ministry of Manpower, 941 firms have applied for this exemption to date, but only 47 applications have been approved.

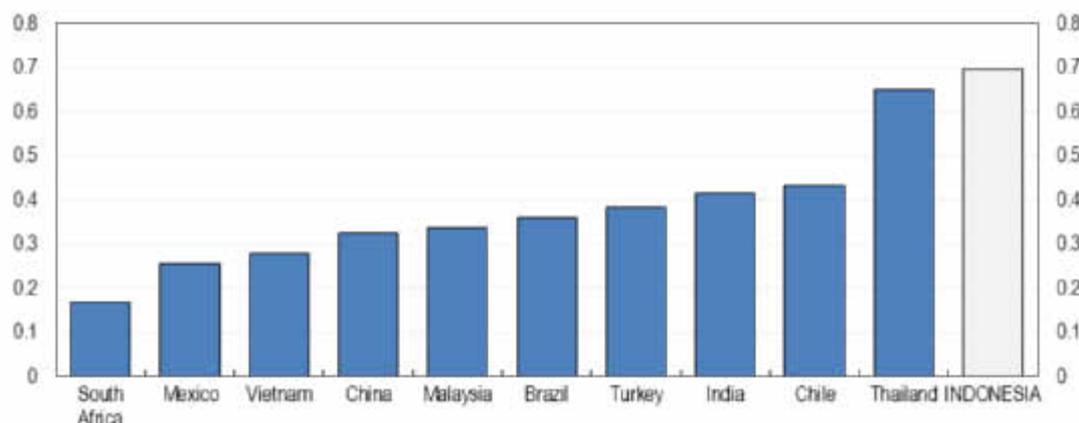
Minimum wages have risen considerably in recent years; indeed, between 2011 and 2013, while the national economy was slowing and unemployment flat, the average increase across all provinces was around 25%, but ranging from 8% to over 60% (Figure 19). These increases seem to be uncorrelated with any features of provincial economies or labour markets more specifically. (see the previous *Survey*). In 2013 the minimum wage itself ranged from IDR 1.2 million to 2.1 million per month. In terms of the ratio to the average wage, Jakarta was highest at 0.97, a very high level by any standard. According to ILO data, the national average ratio of the minimum to average wage was 0.63 in 2010, which is also very high by international standards (Figure 20).

Figure 19. Provincial minimum wage as a ratio of provincial average wage, 2013



Source: Statistics Indonesia (BPS).

Figure 20. Ratio of minimum to average wage for selected countries, 2011



Source: ILO, *Global Wage Database* 2012.

High minimum wages can help to alleviate poverty, but only for insiders, that is, those with jobs, and, in Indonesia's case, only those with jobs in the formal sector where the minimum wage is enforced. To the extent that it reduces employment (Neumark et al., 2013; Sabia, 2013), especially of low-skilled and young workers (at least in the formal sector), a higher minimum wage may in fact not be as effective as might be expected in reducing poverty across the population. For Indonesia, a low-cost manufacturing exporter that is competing directly with other such countries like Vietnam and China, increases in the minimum wage that exceed productivity growth in these sectors may bite more deeply.

The minimum wage is used as a reference in wage negotiations, meaning that the large increases in the minimum wage have propagated across the wage structure. This has resulted in a rapid increase in unit labour costs, which is likely to have hurt international competitiveness, especially relative to countries in the region like Vietnam where, in the manufacturing sector, wage growth has been slower, productivity growth has been higher, and the absolute level of the average wage in US dollars has been around 25% lower than in Indonesia in recent years.

The authorities should carefully consider the consequences of raising minimum wages. More fundamentally, the degree to which minimum wages spill over to the wage structure would be reduced if firm-level collective bargaining were strengthened so that wage increases better reflect firm-level productivity, and not a provincial minimum wage. The government is currently preparing a wages policy in a draft government regulation (RPP), and this should include reforms that delink wages higher up the pay structure from the minimum wage.

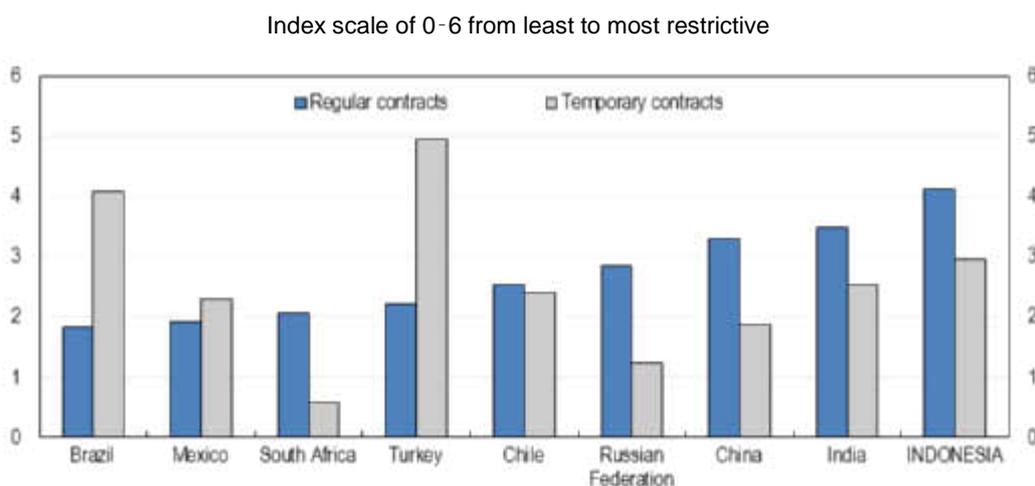
### ***Labour market informality***

Indonesia needs to generate more good jobs to fully share the benefits of sustained economic growth with all workers. Labour is one of the few assets that the poor possess, and if they are to earn their way out of poverty, they need good jobs. In particular, policies that foster job growth in the formal, non-agricultural sector are a priority, both in terms of poverty reduction as well as sustaining development and growth. The Indonesian labour market is characterised by a rigid formal sector and a very large unregulated informal sector. These jobs are outside the formal structures that govern taxes, wages, workplace regulations and social protection schemes, and consequently workers in the informal sector are often exploited. This can perpetuate poverty. The International Labour Organisation (ILO) estimates that around 60% of all non-agricultural jobs in Indonesia are in the informal sector and over 90% in the construction and trade

sectors (ILO, 2012). While this aggregate figure is lower than in India (68%) and the Philippines (73%), it is higher than in China (33%) and Vietnam (44%).

There are several causes of informality in Indonesia. The *first* is the long-standing prevalence of unregistered micro-enterprises that are not tied into the formal structures of the labour market and tax and social security systems. *Second*, it might be that formal regulations have mostly been designed for larger enterprises and are therefore often inappropriate for the needs and conditions of micro-firms. Related to this is the rigidity of hiring and firing rules that apply in the formal sector. These increase the cost to employers of engaging workers in the formal sector. Employment protection legislation is particularly strident in Indonesia (Figure 21). *Third*, employers may try to make formal workers informal as part of a strategy to lower labour costs and deal with competition. Given the relatively high minimum wage, as discussed above, this is likely to be an important factor in the case of Indonesia. This can hurt particularly young and low-skilled workers, given that high minimum wages truncate the distribution of wages in the low-skilled low earners segment of the labour market (Kantor et al., 2006). *Fourth*, the strong growth in the minimum wage may have contributed to informality – or at least slower than otherwise formalisation of employment. Comola and de Mello (2011) show that high minimum wages have curtailed the creation of formal relative to informal jobs in Indonesia.

Figure 21. **Employment protection legislation, 2013**



Source: OECD (2014), *Going for Growth Interim Report*.

While it is preferable to move workers out of the informal sector and into formal employment, not least as a means of addressing poverty, policies aimed at achieving this may in fact be at the cost of these jobs themselves and thereby exacerbate poverty. Rather than reducing poverty, policies aimed at formalisation, such as stricter enforcement of laws and regulations, may contribute to increasing poverty and vulnerability by pushing already vulnerable groups of people into even more difficult situations. With this in mind, a three-pronged approach should be pursued:

- Working informally is often the only way for the poor to participate in the labour market. Policies should consequently try to free these people from their low-productivity activities, enable them to be more productive and provide them with economic opportunities on fair terms. Specific recommendations include expanding active labour market policies, such as vocational training and skill-development programmes, aimed specifically at workers in informal jobs; and improving credit,

business development services, technology and market access and knowledge for those who operate informal enterprises.

- To the extent that informal employment is a deliberate choice to avoid taxes or administrative burdens, the government should create structures that encourage workers and micro-enterprises to join the formal sector, including flexible and simple business registration and tax regimes, and credible enforcement mechanisms.
- To the extent that informal employment is a consequence of insufficient job creation in the formal economy, pro-poor growth that generates employment in the formal sector should be pursued. This means policies that facilitate migration of labour away from low-productivity informal sectors to higher-productivity jobs in the formal sector.

#### **Recommendations for tackling poverty**

- Increase, and further improve targeting of, spending on poverty alleviation, health and education.
- Make poverty alleviation programmes more responsive to the needs of households vulnerable to slipping into poverty due to misfortune and economic shocks. Part of this work should be to further develop measures that help to earmark vulnerable households for rapid assistance.
- Continue progress towards a single registry of vulnerable households which would result in accurate and cost-effective targeting outcomes and greater effectiveness of poverty-alleviation programmes.
- Expand the use of conditional cash transfers (CCTs) so as to motivate families to keep children in school and encourage the regular use of health-care services – particularly maternity clinics.
- Consider converting RASKIN into a food voucher programme that includes other foodstuffs beyond just rice.
- Maintain the focus on increasing access to education, especially for students from remote regions and disadvantaged backgrounds. Focus on keeping children at school beyond the primary level. The current CCT programmes that are conditional on school attendance could be refined to focus more on facilitating access and improving targeting.
- Increase spending on health care significantly. Carefully monitor and assess the adequacy of the new health insurance scheme.
- Maintain the programme of land titling, but combine it with agrarian reforms that ensure that titling land does not lead to its more unequal distribution.
- Improve the minimum-wage-setting mechanism, so that the process is more transparent and predictable and better reflects firm-level productivity.
- Improve the effectiveness of the tax and transfer system as a tool for poverty alleviation by promoting formalisation of the workforce.
- Tackle informality in the labour market by:
  - Improving opportunities for informal workers to join the formal sector through schemes to improve their productivity, including active labour market programmes and vocational training;
  - Creating structures that encourage workers and micro-enterprises to join the formal sector, including flexible and simple business registration and tax regimes.

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